

# Development Effectiveness and Results-Based Budgeting

Papers presented during meetings of the Regional Policy Dialogue's Public Policy Management and Transparency Network.



Development effectiveness and results-based budgeting: Papers presented during meetings of the Regional Policy Dialogue's Public Policy Management and Transparency Network (5<sup>th</sup>: 2009: Brasilia, Brazil)

p. cm.

Includes bibliographical references.

1. Budget process—Latin America—Congresses. 2. Finance, Public—Latin America—Congresses.  
I. Inter-American Development Bank. II. Title.

HJ2056.7.R48 2010

This publication was prepared for the PRODEV initiative of the Institutional Capacity and Finance Sector, Office of the Vice President for Sectors and Knowledge (VPS) of the Inter-American Development Bank (IDB). The results, interpretations and conclusions included in this publication are the exclusive responsibility of the authors and cannot be attributed in any way to the IDB, to its affiliated organizations, members of its executive board or the countries that they represent. The Inter-American Development Bank does not guarantee the accuracy of the information contained within this publication and is not therefore responsible for any aspect of the possible consequences arising from its use.

May 2010

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# List of Abbreviations

|                 |                                                                                                                                  |                 |                                                                                                              |
|-----------------|----------------------------------------------------------------------------------------------------------------------------------|-----------------|--------------------------------------------------------------------------------------------------------------|
| <b>ABB</b>      | Activity Based in the Budget                                                                                                     | <b>CNR</b>      | National Irrigation Commission (Chile)<br>(abbreviation in Spanish)                                          |
| <b>ACCI</b>     | Colombian Agency of International<br>Cooperation (abbreviation in Spanish)                                                       | <b>COCHILCO</b> | Chilean Copper Commission<br>(abbreviation in Spanish)                                                       |
| <b>ACE</b>      | Annual Cost Equivalent                                                                                                           | <b>CoDelCo</b>  | Copper Corporation (Chile)<br>(abbreviation in Spanish)                                                      |
| <b>ADEFAS</b>   | Debts from Previous Fiscal Years<br>(Mexico) (abbreviation in Spanish)                                                           | <b>Coneval</b>  | National Commission for the Evaluation<br>of Social Development Policy (Mexico)<br>(abbreviation in Spanish) |
| <b>AGPP</b>     | System of Expenditure Analysis<br>(abbreviation in Spanish)                                                                      | <b>CONFIS</b>   | Superior Council of Fiscal Policy<br>(Colombia) (abbreviation in Spanish)                                    |
| <b>ASIP</b>     | Public Budget International Association<br>(abbreviation in Spanish)                                                             | <b>CONPES</b>   | National Council of Economic and Social<br>Policy (Colombia)<br>(abbreviation in Spanish)                    |
| <b>BANOBRAS</b> | National Bank of Public Works and<br>Services (Mexico)<br>(abbreviation in Spanish)                                              | <b>CORFO</b>    | Corporation for the Promotion<br>of Production (Mexico)<br>(abbreviation in Spanish)                         |
| <b>BCB</b>      | Central Bank of Brazil<br>(abbreviation in Portuguese)                                                                           | <b>DGAeYS</b>   | General Directorate of Economic<br>and Social Affairs (Peru)<br>(abbreviation in Spanish)                    |
| <b>BCCh</b>     | Central Bank of Chile<br>(abbreviation in Spanish)                                                                               | <b>DGP</b>      | General Budget Directorate (El Salvador,<br>Paraguay) (abbreviation in Spanish)                              |
| <b>BCE</b>      | Central Bank of Ecuador<br>(abbreviation in Spanish)                                                                             | <b>DGPN</b>     | General Directorate of the National<br>Budget (Costa Rica)<br>(abbreviation in Spanish)                      |
| <b>BfR</b>      | Budget for Results                                                                                                               | <b>DIPRENA</b>  | Directorate of the National Budget<br>(Panama) (abbreviation in Spanish)                                     |
| <b>BIP</b>      | Integrated Bank of Projects (Chile)<br>(abbreviation in Spanish)                                                                 | <b>DIPRes</b>   | Budget Directorate (Chile)<br>(abbreviation in Spanish)                                                      |
| <b>BPIN</b>     | National Investment Project Bank<br>(Colombia) (abbreviation in Spanish)                                                         | <b>DNP</b>      | National Planning Department<br>(Colombia) (abbreviation in Spanish)                                         |
| <b>BT</b>       | Traditional Balance (Mexico)<br>(abbreviation in Spanish)                                                                        | <b>DNPP</b>     | National Directorate of the Public Budget<br>(Peru)(abbreviation in Spanish)                                 |
| <b>CEPEP</b>    | Center of Investigation for the<br>Preparation and Socioeconomic<br>Evaluation of Projects (Mexico)<br>(abbreviation in Spanish) | <b>DTCD</b>     | Department of Technical Cooperation<br>for Development (abbreviation in Spanish)                             |
| <b>CEREPS</b>   | Special Account for Productive and Social<br>Reactivation (abbreviation in Spanish)                                              | <b>DTP</b>      | Technical Budget Directorate (Guatemala)<br>(abbreviation in Spanish)                                        |
| <b>CIAPEP</b>   | Inter-American Course in the Preparation<br>and Evaluation of Projects<br>(abbreviation in Spanish)                              | <b>ECLAC</b>    | Economic Commission for Latin America<br>and the Caribbean                                                   |
| <b>CLAD</b>     | Latin America Center for Development<br>Administration (abbreviation in Spanish)                                                 |                 |                                                                                                              |
| <b>CNE</b>      | National Energy Commission (Chile)<br>(abbreviation in Spanish)                                                                  |                 |                                                                                                              |

|               |                                                                                                                       |              |                                                                                                  |
|---------------|-----------------------------------------------------------------------------------------------------------------------|--------------|--------------------------------------------------------------------------------------------------|
| <b>EECE</b>   | Criteria of Analysis of Economy, Efficiency and Efficacy (abbreviation in Spanish)                                    | <b>GNC</b>   | National Central Government (Colombia) (abbreviation in Spanish)                                 |
| <b>ENAMI</b>  | National Mining Enterprise (Chile) (abbreviation in Spanish)                                                          | <b>GpR</b>   | Government for Results (abbreviation in Spanish)                                                 |
| <b>ENAP</b>   | National Petroleum Enterprise (Chile) (abbreviation in Spanish)                                                       | <b>GpRD</b>  | Government for Development Results (abbreviation in Spanish)                                     |
| <b>FAC</b>    | Saving and Contingency Fund (Ecuador) (abbreviation in Spanish)                                                       | <b>HDI</b>   | Human Development Index                                                                          |
| <b>FARAC</b>  | Trust Fund for the Bailout of Highway Concessions (Mexico) (abbreviation in Spanish)                                  | <b>ICBF</b>  | Colombian Institution of Family Welfare (Colombia) (abbreviation in Spanish)                     |
| <b>FARP</b>   | Support Fund for the Restructuring of Pensions (Mexico) (abbreviation in Spanish)                                     | <b>IDB</b>   | Inter-American Development Bank                                                                  |
| <b>FEIEF</b>  | Stabilization Fund for the Revenues of Federal Entities (Mexico) (abbreviation in Spanish)                            | <b>IDEA</b>  | Institute for Democracy and Electoral Assistance                                                 |
| <b>FEIIP</b>  | Stabilization Fund for Investment in Infrastructure of Mexican Petroleum Companies (Mexico) (abbreviation in Spanish) | <b>IEPS</b>  | Special Tax on Production and Services (Mexico) (abbreviation in Spanish)                        |
| <b>FEIP</b>   | Stabilization Fund for Petroleum Revenues (Mexico) (abbreviation in Spanish)                                          | <b>IESS</b>  | Ecuador Social Security Institute (Ecuador) (abbreviation in Spanish)                            |
| <b>FEP</b>    | Petroleum Stabilization Fund (Peru) (abbreviation in Spanish)                                                         | <b>IFP</b>   | Public Finance Report (Chile) (abbreviation in Spanish)                                          |
| <b>FI</b>     | Infrastructure Fund (Chile) (abbreviation in Spanish)                                                                 | <b>ILPES</b> | Latin American and Caribbean Institute of Economic and Social Planning (abbreviation in Spanish) |
| <b>FINFRA</b> | Infrastructure Investment Fund (Mexico) (abbreviation in Spanish)                                                     | <b>IMF</b>   | International Monetary Fund                                                                      |
| <b>FM</b>     | Finance Ministry                                                                                                      | <b>INDEC</b> | National Institute of Statistics and Census (Argentina) (abbreviation in Spanish)                |
| <b>FNDR</b>   | National Regional Development Fund (Chile) (abbreviation in Spanish)                                                  | <b>INEI</b>  | National Institute of Statistics and Information Technology (Peru) (abbreviation in Spanish)     |
| <b>FONDEN</b> | National Disaster Fund (Mexico) (abbreviation in Spanish)                                                             | <b>IO</b>    | International Organization                                                                       |
| <b>FonPeT</b> | Territorial Pension Fund (Colombia) (abbreviation in Spanish)                                                         | <b>IPPR</b>  | Indicators of Inputs, Process, Outputs and Results (abbreviation in Spanish)                     |
| <b>FUNDEF</b> | Fund for the Development of Primary Teaching (Brazil) (abbreviation in Portuguese)                                    | <b>IRR</b>   | Internal Rate of Return (abbreviation in Spanish)                                                |
| <b>GDP</b>    | Gross Domestic Product                                                                                                | <b>ISS</b>   | Social Insurance Institute (Colombia) (abbreviation in Spanish)                                  |
| <b>GFAA</b>   | Financial management, auditing and procurement (abbreviation in Spanish)                                              | <b>LAC</b>   | Latin America and the Caribbean                                                                  |
|               |                                                                                                                       | <b>LDO</b>   | Budget Guidelines Law (abbreviation in Portuguese)                                               |
|               |                                                                                                                       | <b>LEG</b>   | Strategic Management Guidelines (Uruguay) (abbreviation in Spanish)                              |
|               |                                                                                                                       | <b>LFPRH</b> | Federal Law of Budget and Financial Responsibility (Mexico) (abbreviation in Spanish)            |

|                 |                                                                            |                  |                                                                                                  |
|-----------------|----------------------------------------------------------------------------|------------------|--------------------------------------------------------------------------------------------------|
| <b>LIF</b>      | Annual Revenues of the Federation Law (Mexico) (abbreviation in Spanish)   | <b>OPLAP</b>     | Office of Planning and Budget (Chile) (abbreviation in Spanish)                                  |
| <b>LRC</b>      | Reserved Law of Copper (Chile) (abbreviation in Spanish)                   | <b>OPP</b>       | Office of Planning and Budget (Uruguay) (abbreviation in Spanish)                                |
| <b>LRF</b>      | Fiscal Responsibility Law (abbreviation in Spanish)                        | <b>PE</b>        | PetroEcuador (Ecuador)                                                                           |
| <b>M&amp;E</b>  | Oversight and Evaluation (abbreviation in Spanish)                         | <b>PEF</b>       | Budget of Expenditures of the Federation (Mexico) (abbreviation in Spanish)                      |
| <b>MEF</b>      | Ministry of Economy and Finance (abbreviation in Spanish)                  | <b>PEG</b>       | Strategic Management Plan (Uruguay) (abbreviation in Spanish)                                    |
| <b>MEFP</b>     | Manual of Statistics and Public Finance (abbreviation in Spanish)          | <b>PEMEX</b>     | Mexican Petroleum (abbreviation in Spanish)                                                      |
| <b>MHCP</b>     | Ministry of Finance and Public Credit (Colombia) (abbreviation in Spanish) | <b>PEMP</b>      | Medium Term Strategic Plan (Guatemala) (abbreviation in Spanish)                                 |
| <b>MiDePlan</b> | Ministry of Planning (Chile) (abbreviation in Spanish)                     | <b>PGE</b>       | General National Budget (Ecuador) (abbreviation in Spanish)                                      |
| <b>MOP</b>      | Ministry of Public Works (Chile)                                           | <b>PGN</b>       | General National Budget (Colombia) (abbreviation in Spanish)                                     |
| <b>MTEF</b>     | Medium Term Expenditure Framework                                          | <b>Pidiregas</b> | Projects with Differed Impact in the Registry of Expenditures (Mexico) (abbreviation in Spanish) |
| <b>MTF</b>      | Medium Term Framework                                                      | <b>PM</b>        | Multi-Annual Budget (Guatemala) (abbreviation in Spanish)                                        |
| <b>MTFF</b>     | Medium Term Fiscal Framework                                               | <b>PND</b>       | National Development Plan (abbreviation in Spanish)                                              |
| <b>MTMAF</b>    | Medium Term Multi-Annual Framework                                         | <b>PNIP</b>      | National Public Investment Plan (Argentina) (abbreviation in Spanish)                            |
| <b>MTMF</b>     | Medium Term Macroeconomic Framework                                        | <b>POA</b>       | Annual Operating Plan (Guatemala) (abbreviation in Spanish)                                      |
| <b>NGO</b>      | Non-Governmental Organization                                              | <b>POAI</b>      | Annual Operating Investment Plan (Colombia) (abbreviation in Spanish)                            |
| <b>NPM</b>      | New Public Management                                                      | <b>PoR</b>       | Budget for Results (abbreviation in Spanish)                                                     |
| <b>OAS</b>      | Organization of American States                                            | <b>PPA</b>       | Multi-Annual Budget (abbreviation in Spanish)                                                    |
| <b>ODEPA</b>    | Office of Agrarian Studies and Policies (Chile) (abbreviation in Spanish)  | <b>PPA</b>       | Multi-Annual Plan (Brazil) (abbreviation in Portuguese)                                          |
| <b>ODI</b>      | Office of Investment (Peru) (abbreviation in Spanish)                      | <b>PPBS</b>      | Planning, Programming and Budgeting System                                                       |
| <b>OECD</b>     | Organization for Economic Cooperation and Development                      | <b>PPI</b>       | Investment Programs and Projects (Mexico) (abbreviation in Spanish)                              |
| <b>OEI</b>      | Organization of Iberian American States (abbreviation in Spanish)          | <b>PPI</b>       | Multi-Annual Institutional Plan                                                                  |
| <b>ONAPRE</b>   | National Budget Office (Venezuela) (abbreviation in Spanish)               | <b>PPP</b>       | Public-Private Companies (Abbreviation in Portuguese)                                            |
| <b>ONP</b>      | National Budget Office (Argentina) (abbreviation in Spanish)               |                  |                                                                                                  |
| <b>OP</b>       | Planning Office                                                            |                  |                                                                                                  |
| <b>OPA</b>      | Annual Budget Objectives (abbreviation in Spanish)                         |                  |                                                                                                  |
| <b>OPI</b>      | Office of Programming and Investment (Peru) (abbreviation in Spanish)      |                  |                                                                                                  |

|                  |                                                                                                       |                |                                                                                                      |
|------------------|-------------------------------------------------------------------------------------------------------|----------------|------------------------------------------------------------------------------------------------------|
| <b>PPPs</b>      | Public-Private Partnerships                                                                           | <b>SHCP</b>    | Secretary of Finance and Public Credit (Mexico) (abbreviation in Spanish)                            |
| <b>PPS</b>       | Service Provision Projects (Mexico) (abbreviation in Spanish)                                         | <b>SHRFSP</b>  | Historic Balance of Financial Requirements of the Public Sector (Mexico) (abbreviation in Spanish)   |
| <b>PRODEV</b>    | Program to Implement the External Pillar of the Medium Term Action Plan for Development Effectiveness | <b>SIAF</b>    | Integrated System of Financial Administration (Guatemala, Paraguay, Peru) (abbreviation in Spanish)  |
| <b>ProNaFiDe</b> | National Program of Development Financing (Mexico) (abbreviation in Spanish)                          | <b>SIAFF</b>   | Integrated System of Federal Financial Administration (Mexico) (abbreviation in Spanish)             |
| <b>RFSP</b>      | Financial Requisites of the Public Sector (Mexico) (abbreviation in Spanish)                          | <b>SIAFI</b>   | Integrated System of Financial Administration (Brazil) (abbreviation in Spanish)                     |
| <b>ROSC</b>      | Reports on the Observance of Standards and Codes                                                      | <b>SIAFPA</b>  | Financial Information System (Panama) (abbreviation in Spanish)                                      |
| <b>RPI</b>       | Inter-temporal Budget Restriction (abbreviation in Spanish)                                           | <b>SICGP</b>   | Integrated System of Control of Budget Management (Mexico) (abbreviation in Spanish)                 |
| <b>RPS</b>       | Social Price Reason (Colombia) (abbreviation in Spanish)                                              | <b>SIDIF</b>   | Integrated System of Financial Administration (Argentina) (abbreviation in Spanish)                  |
| <b>SAFI</b>      | Financial Administration System (Ecuador) (abbreviation in Spanish)                                   | <b>SIDOR</b>   | Integrated System of Budget Data (abbreviation in Portuguese)                                        |
| <b>SAFI</b>      | Integrated Financial Administration System (El Salvador) (abbreviation in Spanish)                    | <b>SIGAF</b>   | Integrated System of Financial Administration (Costa Rica) (abbreviation in Spanish)                 |
| <b>SDG</b>       | System for the Distribution of Expenditures (Uruguay) (abbreviation in Spanish)                       | <b>SIGECOF</b> | Integrated System of Management and Control of Public Finances (Venezuela) (abbreviation in Spanish) |
| <b>SDR</b>       | Social Discount Rate                                                                                  | <b>SIGEF</b>   | Integrated System of Financial Management (Ecuador) (abbreviation in Spanish)                        |
| <b>SEBI</b>      | Basic Statistics and Investment System (Chile) (abbreviation in Spanish)                              | <b>SIGFE</b>   | Information System for State Financial Management (Chile) (abbreviation in Spanish)                  |
| <b>SECTRA</b>    | Executive Subsecretariat of the Urban Transportation Commission (Chile) (abbreviation in Spanish)     | <b>SIGMA</b>   | Integrated System of Management and Administrative Modernization (Bolivia) (abbreviation in Spanish) |
| <b>SENA</b>      | National Learning Service (Colombia) (abbreviation in Spanish)                                        | <b>SiGob</b>   | Governmental Information System (Colombia, Guatemala, Mexico) (abbreviation in Spanish)              |
| <b>SEP</b>       | PRODEV Evaluation System (abbreviation in Spanish)                                                    |                |                                                                                                      |
| <b>Seremis</b>   | Regional Ministerial Secretaries (abbreviation in Spanish)                                            |                |                                                                                                      |
| <b>SEV</b>       | Performance Evaluation System (Uruguay) (abbreviation in Spanish)                                     |                |                                                                                                      |
| <b>SEV-PEG</b>   | Management Evaluation System and Strategic Management Plans (Uruguay) (abbreviation in Spanish)       |                |                                                                                                      |
| <b>SGP</b>       | General System of Revenue Sharing (Colombia) (abbreviation in Spanish)                                |                |                                                                                                      |

|                 |                                                                                                      |                |                                                                                           |
|-----------------|------------------------------------------------------------------------------------------------------|----------------|-------------------------------------------------------------------------------------------|
| <b>SigPlan</b>  | Management and Planning Information System (Brazil)<br>(abbreviation in Portuguese)                  | <b>SOF</b>     | Secretary of the Federal Budget (Brazil)<br>(abbreviation in Portuguese)                  |
| <b>SII</b>      | Internal Tax Service (Chile)<br>(abbreviation in Spanish)                                            | <b>SP</b>      | Budget Subsecretary (Ecuador)<br>(abbreviation in Spanish)                                |
| <b>SIIF</b>     | Integrated System of Financial Information (Bolivia, Colombia, Uruguay)<br>(abbreviation in Spanish) | <b>SPI</b>     | Oversight of Investment Projects (Colombia)<br>(abbreviation in Spanish)                  |
| <b>Sinergia</b> | National System of Evaluation and Management for Results (Colombia)<br>(abbreviation in Spanish)     | <b>SUBDERE</b> | Secretary of Regional Development and Administration (Chile)<br>(abbreviation in Spanish) |
| <b>SIP</b>      | Public Investment System<br>(abbreviation in Spanish)                                                | <b>USAID</b>   | US Agency for International Development                                                   |
| <b>SIP</b>      | Budget Information System (Uruguay)<br>(abbreviation in Spanish)                                     | <b>USE</b>     | Undersecretary of Expenditures (Mexico)                                                   |
| <b>SISI</b>     | System of Information and Oversight of Investment (Uruguay)                                          | <b>VAB</b>     | Gross Value Added<br>(abbreviation in Spanish)                                            |
| <b>SISIN</b>    | Investment Information System (Bolivia)<br>(abbreviation in Spanish)                                 | <b>VAC</b>     | Current Cost Value<br>(abbreviation in Spanish)                                           |
| <b>SM&amp;E</b> | Monitoring and Evaluation System<br>(abbreviation in Spanish)                                        | <b>VAIN</b>    | Current Value of Net Revenues<br>(abbreviation in Spanish)                                |
| <b>SNIG</b>     | Investment Oversight System (Uruguay)<br>(abbreviation in Spanish)                                   | <b>VAN</b>     | Net Current Value<br>(abbreviation in Spanish)                                            |
| <b>SNIP</b>     | National Public Investment System (Guatemala) (abbreviation in Spanish)                              | <b>VAT</b>     | Value Added Tax                                                                           |
|                 |                                                                                                      | <b>VMPC</b>    | Vice-Ministry of Budget and Accountancy (Bolivia)<br>(abbreviation in Spanish)            |
|                 |                                                                                                      | <b>WB</b>      | World Bank                                                                                |



# Prologue

This publication represents the principle themes analyzed within the framework of the Public Policy Management and Transparency Network: Development Effectiveness and Results-Based Budget Management, of the Regional Policy Dialogue and the PRODEV initiative, which is part of the Institutional Capacity and Finance Sector of the Office of the Vice President for Sectors and Knowledge at the Inter American Development Bank (IDB). This network's main aim is to create an analytical forum and to share best practices that promote improved budget quality and enhance results-based management.

From 2005 until the present, four regional meetings and two sub-regional meetings have been held: one focused on the countries of Central America and another on the Caribbean countries. In each meeting, the thematic agenda is set by budget controllers or other high-ranking civil servants in charge of the budget process within their respective countries.

In these meetings, reports are presented by experts in each of the selected thematic areas, along with progress reports by Network members on countries within the region. Alongside the Network's full members, the Organization for Economic Cooperation and Development (OECD), the World Bank, the Economic Commission for Latin America and the Caribbean (ECLAC), the *Asociación Internacional de Presupuesto Público* (ASIP) (Public Budget International Organization) and the International Monetary Fund (IMF) also take part as observers.

This publication was presented in 2009 to coincide with the 5th Annual Meeting, in order to disseminate and share the expertise arising from these encounters with a wider audience.

This publication brings together the principle themes addressed at the meetings, with the aim of contributing to analysis and discussion among civil servants, academics, legislators, experts and those members of civil society interested in the subject of results-based budget management and development effectiveness.

Mario Marcel Cullell

*Manager*

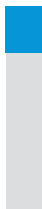
*Institutional Capacity and Finance Sector  
Vice Presidency for Sectors and Knowledge*





# I Integration of the Plan and the Budget





# Strategic Planning Systems and Innovations in Budgeting

19

Martus Tavares\*

Nora Berretta\*\*

## Introduction

The central dilemma of economics resides in the decision about how to allocate scarce resources among multiple objectives. This is, in fact, a particular expression of the more general and permanent conflict between what human beings desire and what is obtainable. The relationship between strategic planning and budgets is another way in which this dilemma is expressed. What is “desired” is laid out in the strategic plans of governments and what is “possible,” in the available budget resources. The dilemma is further complicated because, generally speaking, responsibility for achieving these two opposing objectives lies with different government agencies.

This study seeks to analyze the possibility of progress in linking strategic governmental planning with decisions about the allocation and application of public sector budget resources. Special attention is paid to the recent experiences of five Latin American countries that have undertaken important efforts and achieved significant results in this direction, such as Brazil, Colombia, Guatemala, Mexico and Uruguay. Various institutional factors that can help or hinder the possibility of progress in this area are a particular focus of the analysis. In order to carry out this task, civil servants from the governments of all of these countries were asked to take part, and all very kindly shared information as well as their experiences and opinions. None of them, however, is responsible for any errors that might be encountered in the text. The authors are very grateful for the extensive assistance provided by these individuals.

The chapter is divided into three sections. The first sets forth the conceptual framework and reviews the evolution of ideas in relation to budget and planning in recent years and provides an analysis of the current characteristics of the budget process. In the second section, the selected group of countries is briefly analyzed, and their principle characteristics and achievements are identified. The third section presents some ideas and notable experiences in order to advance understanding of the subject.

## Budget and Strategic Planning: A Conceptual Framework<sup>1</sup>

### *A Short History of Planning and Budgeting*

Planning, Programming and Budgeting Systems (PPBS) emerged in the 1960s with the objective of promoting development in the countries of Latin America. It was a concept that was closely linked to the idea of the welfare state, in which the state was given a central role in economic growth and development, and to ideas put forward by the Economic Commission for Latin America and the Caribbean (ECLAC). These ideas were also influenced by the example of the centrally planned economy of the Union of Soviet Socialist Republics (USSR) after World War II.<sup>2</sup>

These ideas found technical expression in the establishment of programmed budgets, aimed at integrating policy planning into the budget process. This technique became widely established in many of the countries that reformed their constitution in the 1960s.

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1. For more information, see Schick (2003) and Echebarría, et al (2005).

2. The PPBS was developed in the United States during World War II, based on the experiences of the Agriculture and Defense Departments. Since the end of the 1960s, it has been applied to the whole public administration.

From the second half of the 1970s until the end of the 1990s, perspectives linked to the idea of the welfare state lost favor, while viewpoints that considered the private sector to be the dynamic factor behind economic growth gained influence. In this perspective the state was considered to be responsible for stabilizing the economy and ensuring a sustainable and balanced macroeconomic framework. Public welfare was expected as a natural outcome of economic growth, which would in turn generate genuine employment for broad sectors of the population and permit the possibility of developing targeted social policies for indigent groups. In the 1990s, the Washington Consensus inspired the adoption of policies aimed at reducing the size and cost of the public sector and creating a smaller state through the sale of public enterprises to the private sector. At the same time, modernized public management systems were put forward which were based on the New Public Management (NPM) approach. Although state reform has often been associated with conservative or neo-liberal governments thought to be generally disposed to downsizing the state, in fact such reforms were undertaken in countries with governments led by parties of both Left and Right political orientations. Even though there have been differences in approach, in method and in consequences (Echebarría, 2000), in general all such modernization efforts have shared the goal of making profound changes in the role and functioning of the state by concentrating its activities on satisfying the specific needs of citizens (OECD, 1995; 1999; 2001).

At the beginning of the 2000s it became more broadly accepted that economic growth alone is not sufficient to guarantee the expansion of the welfare of the whole population. This was evident in the fact that in some countries vast sectors of the population had become impoverished in countries where the middle classes once predominated. The importance of the public sector role in the design and implementation of public policies aimed at spreading the benefits of economic growth to disadvantaged social sectors gained new appreciation, without, however, calling into

question the central role of the private sector as the dynamic factor behind that growth.

The state's new role implies, once more, a reevaluation of the planning tool, but with different characteristics from the 1960s model. The new model maintains a preoccupation with budget matters at the macroeconomic level through the NPM instruments (product-based management or results-based management) and insists on focusing on the provision of services to citizens.

### ***The Characteristics of the Political Process Related to Budget Decision Making***

The formulation of the budget is a process ripe with conflict, due to the differing interests that exist between opposing actors attempting to influence decision making. Given that budget decisions depend on the interaction of a combination of actors, each with their own preferences and objectives, they can never be optimum. The main governmental actors are the agencies responsible for overall economic management: on one side, the so-called “Guardians of the Treasury” and on the other side, the other agencies responsible for sector programs and projects in diverse areas of the state—the “Advocates of Government Programs.”

The Guardians of the Treasury are the agencies responsible for ensuring macroeconomic equilibrium and achieving a balanced budget. The chief budget institution is the *Ministerio de las Finanzas Públicas o de Hacienda* (MF) (Ministry of Public Finance or Treasury Department). The *Oficina de Planificación de la Presidencia* (OP) (Presidential Planning Office) guides the budget formulation process, providing advice and taking responsibility for drafting the public investment budget. The Guardians of the Treasury have a global vision that is often at odds with the sectoral vision of the ministries and their managers, the program directors. In the majority of countries, the MF comes closest to taking on the role of “owner” and, in the majority of cases, the relationship between this “owner” and the public sector is unsustainable, given the MF's persistent sensation that the public sector is a “black hole”

that consumes money without producing results commensurate with those resources.

Allen Shick (2005) points out that in some countries it seems that the budget takes precedence over the plan while in others the reverse happens. This shapes the different influence wielded by MFs over medium-term decision making. In Brazil's case, for example, the planning requirements defined at the federal level by the Ministry of Planning take precedence, and the role of the MF is subservient to the whole. In other countries, such as Uruguay and Chile, the budget takes precedence over the plan and the MFs have a greater role in medium term decision making.

The Advocates of Government Programs are the directors of agencies, including ministers and their technical advisors. When there is a coalition government, directors belonging to those parties with which the government had to reach a governing accord are the ones which offer the greatest resistance to central government guidelines. In turn, public managers are subjected to sectoral and group demands: from civil servants, businessmen and, sometimes, service users. Along with parliament, they represent, generally speaking, the shop window through which rent seekers can gain access to budget resources. This openness of the budget process to sectoral and interest group pressures is reinforced when the central government's strategic orientations, regarding spending limits and political priorities, are not sufficiently clear and firm.

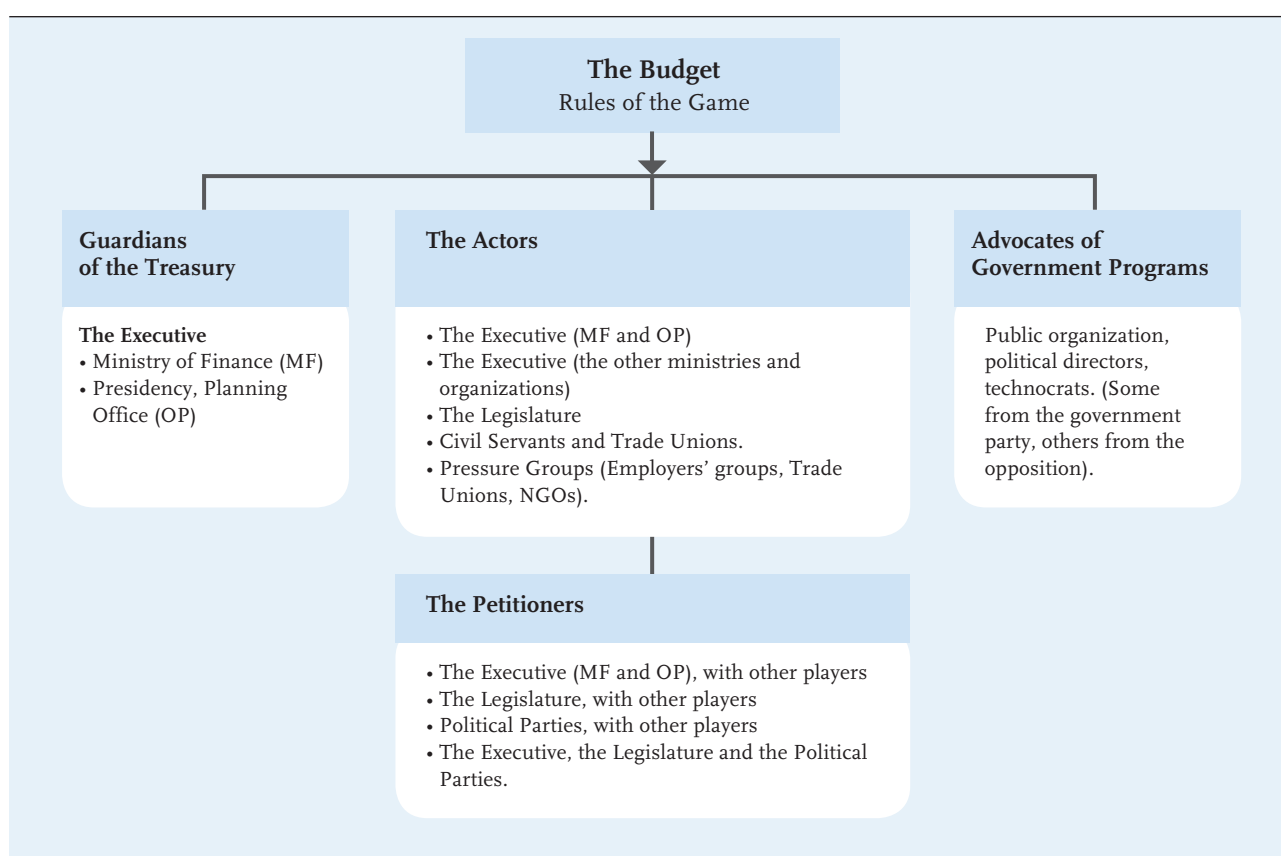
In addition to these actors, civil servants also influence budget formulation, either directly, by demands made to immediate superiors or to upper level management, or indirectly, through their respective trade unions. The legislature begins to intervene at the stage when constitutional stipulations bring the budget into its orbit. However, it is common for trade unions, civil

servants, and private sector organizations to take their demands to this decision-making body prior to that date. In the past decades parliaments across the world have tended to increase their power in respect to the budget, a trend which has coincided with the tendency to extend the budget timeframe in order to tighten control over aggregate fiscal outcomes. Figure 1 shows the relationships that exist between the various actors taking part in the arena of conflict surrounding the budget, and what their respective interests are.

There is little doubt that the organization of the budget process and the behavior of these actors affect fiscal outcomes. Some studies have shown that countries with more hierarchical and transparent budget processes, exhibit greater fiscal discipline. Hierarchical procedures are those that give greater power to the head of the Treasury, the Minister of Finance, than to the other ministries involved in governmental negotiations, and that limit the role of the legislature in its capacity to introduce amendments to the executive's budget proposal. In order for the budget formulation process to reach a successful conclusion, it is necessary for the different stakeholders to encounter adequate space for negotiation at each of the four principle stages of the budget process (proposal, discussion, approval and evaluation) and for a resolution of differences to occur through a process following a set of rules and procedures known as "budget institutions."

In general, the strategic plan is the factor that can lower tension levels during the budget process. In other words, the greater the strategic clarity evinced by the government —implying a specification of priorities in each corresponding policy area and the entities to be favored by resource allocation— the less conflictual will be the budget process.

Figure 1. Relationships between the different actors taking part in the budget process



Source: Authors' elaboration.

### ***Innovations in the Budget Process***

The innovations that have been introduced into budget systems in recent years can be classified into three types:

- i) budget reform at the macroeconomic level;
- ii) distributive budgeting and
- iii) budget reform at the microeconomic level.

When budgeting is applied to large budget aggregates, it aims to improve fiscal discipline. Distributive budgeting reforms address the allocation of costs. Finally, microeconomic innovations are linked to service provision and public programs and projects.

### ***BUDGET REFORM AT THE MACROECONOMIC LEVEL***

Budgets in the majority of countries have tended to increase spending and, often, also the deficit. In developed countries, the increase in life expectancy has led to increased social security costs; in underdeveloped countries, the costs of social programs directed toward young persons have risen, primarily in education. In order to tackle this tendency, various instruments designed to control spending have been applied, establishing commitments that provide signals to actors of medium term stability. The experiences of New Zealand, the European Union and the United States have been used as examples. In federal and decentralized countries such as Brazil, the European experience with the Maastricht agreements has been of great importance (Tavares and Martus, 2004).

*THE MEDIUM-TERM MACROECONOMIC FRAMEWORK*

At present, the majority of countries incorporate the Medium-Term Expenditure Framework (MTEF), either as a part of the budget law or as an annex to this law. This instrument was first employed in Australia, where spending restrictions for coming years were explicitly defined (usually for three years) as a framework for constraining annual budget decisions.

*THE RULES OF MACROECONOMIC RESPONSIBILITY*

These rules are explicit government commitments to adhere to certain limits, expressed quantitatively, on certain variables they wish to control: borrowing, fiscal deficit, or —sometimes— public spending. The majority of countries have either introduced these rules into their budget laws, or within special laws.

It has been pointed out that numerical rules present some advantages and some disadvantages (Fernández Arias, 2005). Among the advantages, when such rules are respected, is the resolution of problems, such as the strategic incurrence of debt associated with the electoral spending cycle. There are, however, some disadvantages: the regulations provide incentives for “creative accounting” that limit the capacity to stabilize the tax structure, and they tend to be too inflexible, unless they are contingent and can adapt to economic cycles. Given these disadvantages, the rules are often not respected unless there is an effective enforcement mechanism in place.

In some countries, there are other kinds of rules that tend to guarantee procedural transparency. The government commits itself in principle to pursue responsible fiscal management and to clearly explain to the citizens why it has strayed from “normal” values whenever this occurs. In New Zealand, for example, the Fiscal Responsibility Act (1994) does not include numerical rules.

In general, fiscal regulations are incorporated into fiscal responsibility legislation, such as the *Ley Complementaria 101* (2000) (Complementary Act 101) in the case of Brazil. However, their existence does not guarantee that they are respected (as was the case in Argentina). By contrast, some countries exercise fiscal control without the need for legislation (Chile).

*COUNTERCYCLICAL ACTION ON PUBLIC SPENDING*

A common problem of public expenditure is that it increases when there is an upturn in economic activity, while there are no provisions allowing spending to be increased when there is a downturn in the economy. In order to counter this tendency, some countries, like Sweden, have established two stages in the budget formulation process, separated by several months, so that decisions are made on the basis of current indicators. During the first phase, the government updates its macroeconomic forecasts and submits these forecasts and budget perspectives to parliament for approval, thus establishing a medium-term expenditure framework approved by the legislature. At this stage, the aspirations of service-providing agencies are not considered. Several months later, the government takes into consideration sectoral demands, which must respect the expenditure ceiling already approved by the legislature.

*THE COMPREHENSIVE BUDGET*

With the aim of providing protection against “creative accounting,” the English-speaking countries have steadily broadened the definition of government in their budgets, including the majority of extra-budget operations, and they have applied to all government operations extremely rigorous accounting standards. New Zealand was the first country to apply this global concept of government that comprises the central government, autonomous agencies, and public enterprises (including the Central Bank), although local governments are excluded. Other activities that had been excluded have been progressively included within the budget, such as tax expenditures and contingent liabilities. These countries have also begun to incorporate the criteria of share-holders equity accounting, to better identify the relative costs of inputs used.

The result of applying these diverse systems is that while countries have brought fiscal deficits under control, there has been no observable deceleration in expenditure. On the contrary, in studies carried out by the Organization of Economic Cooperation and Development (OECD), it has been noted that practically all countries report a level of expenditures that is larger

as a share of Gross Domestic Product (GDP) than was the case 10 or 20 years ago. The era of prolonged and vigorous economic growth might be over, but public budgeting keeps on operating in a similar way because of inertia (Schick, 2003).

***Distributive Budgeting:  
Priority-Based Resource Allocation***

Once a spending limit, or “ceiling,” to preserve fiscal outcomes has been decided upon, the redistributive aspects acquire greater importance and the budget process in general thereby becomes more conflictive. It is no longer possible to resolve conflicts by increasing expenditures (incremental budgeting); it is now necessary to reallocate funds from one sector or organization to another. The best way to lower the level of conflict at this stage of the budget process is for the government to clearly establish its strategic objectives, thereby determining what ministries or sectors take priority and thereby facilitating resource distribution. Intersectoral reallocations should be decided at the highest level of government. At the level of the national government, priorities are defined (strategic guidelines) and care is taken that the targets and objectives defined by organizations are compatible with these guidelines.

Strategic planning is a methodology that permits the identification of both an organization’s priority objectives and the goals that it commits itself to achieving within a given timeframe. Activities are redefined based on the strategic plan, and, consequently, so are the budget priorities of the organization. Resources are allocated on the basis of results. Unlike program budgeting, which seeks to integrate policy planning into the budget process, strategic planning is assumed to be a process that is separate from the budget process. It has no time restrictions, nor is it subject to financing pressures.

***RESULTS-BASED MANAGEMENT AND BUDGETS***

Over the last three decades, public management has tended to link the budget with results-based management (RBM). A results-based budget (RBB) is one that

entails the drafting of contracts between the government and specific government entities (ministries or government agencies) and links any increase in an agency’s resource allocation to a commensurate increase in productivity, or in the results obtained (Schick, 2001). This can be a very formal agreement, as in the case of countries such as the United Kingdom, New Zealand, Australia and Chile, or it can be implicit: the objectives and targets are defined and budget resources are allocated which are deemed adequate to achieve them. This is the predominant system in the majority of countries. In order to commit to achieving particular results, the organizations must first carry out a strategic planning process.

RBM can thus be defined as the model that proposes the administration of public resources centered around the fulfillment of the strategic actions defined in the government plan for a set period of time (Makon, 2000).

What objectives does an RBB seek to achieve? First, strategic clarity: to identify precisely the government’s priority objectives over the medium-term, and to concentrate the necessary resources to achieve them. Second, transparency; to keep citizens informed about these objectives and to commit to accomplishing them.

***BUDGET FLEXIBILITY***

Governments’ room for maneuver or, in other words, the possibility of prioritizing particular areas of public spending, depends on the degree of flexibility in the budget in relation to spending and revenue. The possibility that governments might set out to accomplish new goals is followed immediately by analysis of how to finance them, either with the existing level of spending or a higher level. In general, public expenditures are not very flexible: they are principally directed towards paying the salaries of civil servants, who cannot be removed in the majority of countries, or to paying operating costs that are also not easy to reduce (because these are comprised largely of social expenditures, such as on foodstuffs and medicines). Investment expenditures are therefore more flexible and more feasibly reallocated towards new projects. Unfortunately,

it is this spending that suffers whenever public spending needs to be reduced and when, as in many cases, investment expenditures are earmarked for projects of a permanent nature (routine maintenance), such that the portion of total public expenditures that can be assigned to new projects is limited.

#### RIGIDITIES

Budgets include particular legal and contractual commitments that the government must address. In some recent studies, commitments limiting government capacity for short-term discretionary action regarding amendments to expenditure or resources have been described as rigidities. The expenditure items that are the most clearly inflexible are the payment of debts and personnel costs, meaning the payment of liabilities, salaries and all the other necessary disbursements that sustain the state bureaucracy.

There are, however, other types of budget items that are fixed by laws or decrees. Three types of rigidities can be distinguished (Echeverri et al., 2006):

- i) expenditure rigidities, which entail the obligation to maintain expenditures in a given area;
- ii) revenue rigidities, which tie a given line of revenue to a specific use and
- iii) a group comprised of other rigidities, in particular tax exemptions and parafiscal levies.

Budget rigidities have effects at the macroeconomic level because they impede the adjustment of fiscal aggregates to the economic context, and therefore, undermine the possible stabilizing influence of fiscal policy. In general, they reinforce the incremental tendency of public spending and lead to constant pressures to increase the public debt.

Although it is true that certain rigidities guarantee that a part of public expenditures can be assigned in a stable manner to certain essential services and functions, beyond the vagaries of politics, it is not always possible to ensure they are limited to priority services.

It is true that rigidities are quite often comprised of resource assignments to important functions, such as health or education, because the legislature has sought to guarantee resource provision to these areas. But, a large number of rigidities arise from specific interest groups' capacity to exert pressure (so-called rent seeking).

Moreover, revenue allocation, transfers and special funds all contribute to making the budget highly complex and impede the clear definition of public policies, as well as the evaluation of the amount of resources allocated to different functions or to different regions of the country.

#### MANAGEMENT EVALUATION

In the traditional budget, a certain sum of money is given to a specific organization to spend on particular inputs or resources.

**Inputs** → **public organization**

The traditional budget determines, for example, which inputs are to be used and how much public organizations may spend on these inputs. Traditional budget control ensures that these actions are legally valid and that expenditures are kept within the authorized limits.

In RBB, organizations receive resources to spend on inputs as they see fit, with the aim of generating a certain foreseen volume of outputs. These outputs, in turn, generate other results for society.

**Inputs** → **Outputs** → **Results**

RBB offers additional information about, for example, what is being produced by public agencies, who is producing public goods, how many goods are being produced, what results are expected to be achieved with them, and how much it is costing to achieve such

3. Parafiscal levies are resources that some private or mixed-ownership entities receive for a specific purpose: special funds, private companies with public capital, among others. Tax exemptions are a de facto subsidy granted to individuals resulting from not collecting certain taxes from them.

results. Because the relationship between outputs and expected results is described in a quantified manner, it is possible to measure success and assess performance.

To this end, management indicators are used. These offer information through quantitative measurement of outcomes or the services (goods or services) provided by a given institution, both in terms of their quantitative and qualitative aspects.

The indicators can be of various types:

- i) Effectiveness: these indicators measure the degree of attainment of institutional objectives and they can also indicate effectiveness in achieving desired goals. The quantity of goods and services that an institution produces, measured in terms of the number of benefits delivered, the number of people benefiting from the service or the program's coverage can be quantified with relative ease. It is more complex, however, to assess performance on the basis of indicators regarding results over which the organization controls only indirectly, like tax collection, the poverty level, or the growth of exports.
- ii) Economy: these measure the institutional capacity to obtain and mobilize resources in pursuit of objectives. In some institutions it is linked to the capacity for self-financing, or to the ability to recover the costs of loans.
- iii) Effectiveness: these describe the relation between two dimensions; the result or the delivered product, and the input or resources used in its production. In general, measurements of physical productivity can be obtained in relation to the level of activity.
- iv) Service quality: this refers to an institution's capacity to respond quickly and directly to the needs of its clients.
- v) Impact: this is the effect that the achievement of the goal has on society. In general, it involves making comparisons with a control group and requires more sophisticated instruments and a more complex interpretation.

Providing parliament or citizens with an evaluation of results forms the basis of public management accountability, by enhancing transparency in government management and increasing the degree of

communication between the state and the citizen. There is a generalized tendency for citizens to exert more social control over government; not only do they wish to know how much is being spent, but also what is being done with the resources being spent.

Evaluation can be used to assess government planning and agency's strategic plans and budget allocations. Performance evaluation should give rise to an incentive system that guides internal management through the assignment of individual and collective rewards and punishments. Evaluation allows public managers to be held accountable for the results obtained during their tenure. But while apportioning responsibilities in this way is suitable for autonomous agencies run on corporate management lines, it does not seem appropriate for public organizations with traditional bureaucratic structures (Echebarría, 2005).

In general terms, it can be stated that efforts made in the previous decade to introduce RBM into public administration have made some progress in terms of the provision of performance information, the definition of objectives and their measurement, the introduction of integrated accounting systems and the expansion of information available through the internet. However, management capacity and results-based evaluation continues to be insufficient due to the weakness of information systems, the limited use of control mechanisms, the insufficient use of evaluation reports and the minimal consequences for public agencies from the evaluation of their performance (Schick, 2001).

The control culture that holds sway within institutions responsible for public finances stands in the way of progress in the implementation of RBM. Traditionally, centralized control is based on suspicion and this generates a negative orientation when decisions made by public managers are evaluated. At the same time, in response a defensive attitude is often found among sectoral organizations, which repeatedly argue that a lack of central government funding accounts for their meager achievements. The need for more staff and greater resources is at the basis of almost all explanations of departmental performance.

An additional difficulty found in establishing this kind of system lies in the fact that it supposes that governments have accounting systems at their disposal that are capable of differentiating between the fixed and the variable costs of services, or that can calculate the total production cost of a given volume of goods or services. Little progress has been made in this field, and this is not due so much to technical as to bureaucratic reasons. As Schick points out, public organizations are not comfortable when obliged to break their activity down into production units, or when forced to calculate budgets on the basis of predicted production levels. It is obvious, however, that the time for results-based budgeting will come. Advances in output measurement and quantification, and growing demands for efficiency and quality in service provision, will oblige governments to allocate expenditures on this basis.

#### *MANAGERIAL AUTONOMY AND DECENTRALIZATION AS PERFORMANCE INCENTIVES*

The reform experiences carried out in various OECD countries have shown that an increase in management autonomy at the operational level, combined with firm, but predictable spending-reduction frameworks, constitute key incentives for improving performance. When ministries are given more individual responsibility for resource allocation, incentives to redistribute expenditure within a limited budget are created, and RBM is enhanced. In the same way, processes tending to increase decision-making autonomy at the regional level have led to more careful financial management regarding expenditures, and more effectiveness in the achievement of results.

It is also true that for some developing countries, the combination of very little autonomy and too many budget restrictions has led to increasingly poor results, especially in respect to strategic performance, and the efficiency and effectiveness of program and services. Separating policy, planning and budgeting has had negative consequences and weakened government capacity to define new strategic priorities and to reallocate expenditures (World Bank, 1998).

#### *PROGRAM BUDGETING AND RBB*

The new concept of RBB, associated with strategic planning, should not be confused with the old concept of program budgeting that was a characteristic of the centralized planning of the 1960s.

- In RBB, the budget is assigned to organizations that define strategic plans, which reflect the policy goals and objectives agreed with the government. Although this was an experience that various countries began at the beginning of the 1990s, the clearest example is the Government Performance and Results Act in the United States (1993). The activities undertaken allow budget requirements for the achievement of a particular goal to be identified. It is a managerial proposal that seeks to find the most efficient method for obtaining a given objective and enhancing government agency effectiveness. It also seeks to give greater autonomy in the management of public services in exchange for achieving specified results, which must be measured in respect to their effectiveness, efficiency, and quality.
- On the other hand, programs budgeting defines budget allocations for different policies that compete amongst themselves. The objectives vary and the system is not designed to be management-based, but rather to allocate resources. It requires a means of measuring efficiency, outputs, and results and of identifying the unit costs of production as a way of estimating each individual policy's resource requirements. This system was exported to many developing countries during the 1960s and met with little success in its implementation. Program budgeting faced various criticisms, ranging from its inflexibility when faced with policy change to the need to reform public management capacity before changes could be incorporated. In general, it is a long, drawn out process that gives rise to much information that is not subsequently useful, except during the approval phase or for public accountability. Moreover, the budget assigned to the budget programs did not strictly reflect sectoral plans, which prevented knowledge of the future

impact on these sectors of current allocations. There was no increase in either efficiency or effectiveness in comparison with the traditional budget process, and compliance criteria ended up being as formal as in the traditional budget. In addition, outcomes were not important: programs having either favorable or unfavorable results could not be identified, which meant they could not be eliminated or modified (Diener, 2005). Therefore, programs tended to remain as they were, except when they required new resources, which meant that the system only functioned with an incremental budget.

How can the old technique of program budgeting be transformed into RBB?

The key to articulating both methods is to ensure that an organization and, in particular, the manager of that organization, is accountable for achieving the objectives set out by a given program. If managers are to be held responsible, they must be given the freedom to make decisions with a certain degree of autonomy (for example, by allocating expenditures). In that case managers can commit themselves to the achievement of particular outcomes because such results depend on their decisions.

#### *THE DIFFICULTIES OF MEASURING IMPACT*

The causal relationship between government's strategic priorities, the allocation of budget resources, and the results obtained is, generally speaking, extremely weak. This is due, in part, to the fact that various programs can affect a particular set of outcomes or because complex programs do not only depend on government actions, but also on the actions of other institutions, and on the social and cultural characteristics of the people to whom the programs are directed.

This weak causality has resulted in strategic objectives, or government objectives, being considered as orienting signals or strategic guidelines, without establishing a close link with resource allocation decisions. In spite of this weakness, however, it is useful to attempt to identify causal nodes, and to estimate the cost of programs developed. For example, although the indicator's tendency cannot be imputed completely, the government should know if the rate of infant mortality is increasing or decreasing, and it should also be aware of how much it is spending on programs that might be exerting an influence on that tendency, in order to take appropriate action based on the available data.

Problem definition forms the basis of RBB. A problem is understood to be the difference between the existing situation and the optimum situation desired by an organization. This discrepancy might consist, for example, of the perception that there are insufficient means available to fulfill the institutional mission or that the mission is inadequately conceptualized such that it no longer reflects the real activity that should be undertaken to satisfy the current social demands placed on that organization. The desired situation, the orienting direction of institutional efforts, puts in place the optimal set of conditions for the functioning of the organization. Its role during the planning phase is that of guide or point of reference of the "grand vision" for the design of the activities that the institution seeks to undertake at the operational level. It is also possible to turn the argument around and state that if the government does not know what its priorities are, then those priorities can never be fully reflected in the budget.

### Budget Reform at the Microeconomic Level

#### THE OPERATING BUDGET

The operating budget constitutes the budget's microeconomic level. The operating budget determines the quantity, quality, and the real cost of the goods and services that the public sector places at the general public's disposal. The citizens get to know their government precisely through the services that they receive from it. Even though it might appear to play only a modest role, the operating budget is important because it directly affects the relationship between citizens and government.

In the microeconomic dimension, the budget is an economic and social planning mechanism that in the short term, puts into practice medium and long-term policies. Moreover, it is a governing instrument, because its activities, products, and annual objectives lend themselves to formulation in a budget. It is also an administrative tool, which allows each agency or implementation level to understand not only its own resources and objectives, but also the nature and scope of the goods and services to which it contributes by its participation.

#### THE BUDGET WITHIN A MULTIANNUAL FRAMEWORK

In the majority of countries, the budget is formulated annually (among the study group countries, only Uruguay has a multiannual budget, corresponding to a full period of government). An annual budget has the advantage of being flexible and malleable and therefore able to adapt to changing circumstances, but it has the disadvantage of generating debate each year that might alter the country's strategic direction. The multi-annual budget has the advantage of being consistent with the medium-term plan, but it could have the disadvantage of creating rigidities.

#### SUMMARY

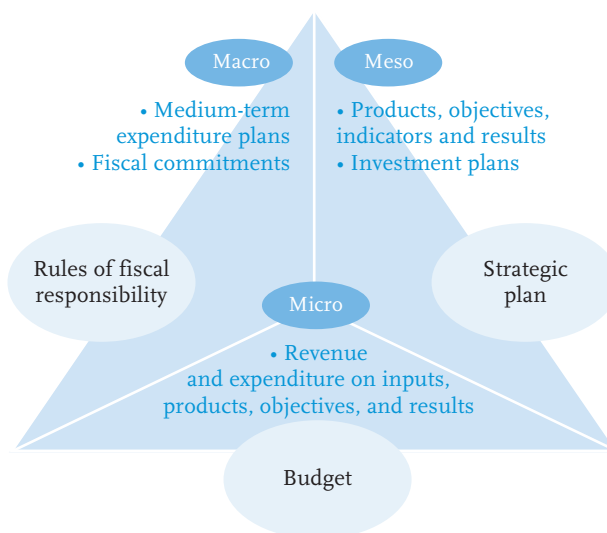
The budget process can become a tool for simultaneously solving the problems of fiscal solvency and discipline and of allocating resources in the medium

term to meet the government's strategic priorities and promote public service efficiency and effectiveness. In order for that to happen, a balance must be maintained and progress made on three levels—macro, meso, and micro—as shown in Figure 2. Each level is also associated with a product:

- Fiscal responsibility;
- Strategic plan;
- Budget and expected results;
- Fiscal balance;
- Priority-based strategic budget allocation; and
- Effectiveness and efficiency in the use of resources.

Each level offers information that should be monitored and evaluated in order to identify whether management is being effective and efficient and it is adequately attending to citizen expectations.

Figure 2: RBB: Macro, meso and micro levels



Source: Authors' elaboration.

Until recently, budget reforms have centered around budget discipline at the aggregate level and on efficiency in operational management, that is, at the macro and micro levels. However, the design of budget reform has not paid sufficient attention to the need for improving the capacity for strategic management

and to the adaptation of public policies. Distinguished reports of the Swedish Finance Ministry show clearly that the *efficiency gains* made from greater productivity are much less than the gains brought about by changes in public policies (so-called *system gains*), although they recognize that these are harder to achieve because they require forceful and innovative leadership. The studies undertaken show that the number of indicators used in public management has increased, but they mainly address factors related to *outputs* rather than *outcomes*.

Furthermore, public policy implementation increasingly requires state interaction with many different organizations. This requires that coordination is achieved without counting on traditional, hierarchical authority structures. In an approach based on accountability for results, additional problems appear (known as *wicked problems* in the United Kingdom): problems of a transversal nature that affect all organizations.

## Experiences of Strategic and Budget Planning in Latin America

This section analyzes various aspects of the institutional designs and applied experiences in five countries: Brazil, Colombia, Guatemala, Mexico, and Uruguay. Comparison of experiences across countries is not straightforward since, while they are similar, each has its own characteristics and it is not always possible to draw generally applicable lessons from them. In recent years, these countries have undergone transformations in both their budget processes and in public accountability, with an increasing tendency to employ strategic planning as an instrument for improving public management and for bringing government closer to citizens.

## Innovations at the Macro Level

### THE POLITICAL SYSTEM

All of the countries analyzed have a presidential political system and, with the exception of Uruguay, in all cases the budget is annual. With the exception of Mexico, where the government's term lasts for six years, and Uruguay, where the term is five years, in the rest of the countries the term of office is four years.

The existence of a presidential system causes greater tensions during the the budget debate. In general, in the parliamentary political system found in most English-speaking countries, decisions are made by the cabinet ministers under "collective responsibility and the budget proposal is submitted to parliament, which can make amendments. These amendments must be approved by vote; generally, the vote is won by the government party which supports the budget proposal submitted by the executive. If the opposition wins the vote, however, and the approved amended budget is not acceptable to the executive, this is understood to be a vote of no-confidence and fresh elections must be called" (Craig and Manoel, 2002).

### FISCAL RESPONSIBILITY LAWS

All the countries analyzed have established legal rules with commitments of a fiscal nature. In Table 1, the scope of some of these rules is presented. In two countries, Uruguay and Guatemala, fiscal responsibility laws have not been established. In the case of Uruguay, rules of this kind have been increasingly included within the annual budget laws. In Mexico, fiscal responsibility rules were established in 2006 in Section II of the *Ley Federal de Presupuesto y Responsabilidad Hacendaria* (Federal Budget and Fiscal Accountability Law).

Brazil's fiscal responsibility law has the greatest reach due to its wide-ranging field of application.<sup>4</sup> It is applicable to the three spheres of government (national government, provincial government, the federal district

4. See *Ley de Responsabilidad Fiscal*, (Fiscal Responsibility Act) available at: <http://federativo.bndes.gov.br>.

and more than 5,500 municipalities) and to the three branches of government; the executive, the legislature, and the judiciary. Its coverage is extensive, including also foundations, autonomous organizations and state-owned enterprises. It is a code of good behavior in public finance, made up of indicators to be observed, limits on indebtedness and spending on human resources, rules of conduct and financial and criminal penalties for those who do not comply. Although they are not mandatory, along with the medium-term macroeconomic framework, the federal government provides estimates of spending for subnational governments.

#### THE MEDIUM-TERM MACROECONOMIC FRAMEWORK

In all countries, the Treasury establishes a medium-term macroeconomic framework. The aim of the medium-term macroeconomic framework is to provide a stable and predictable context for budget decision-making, which is not an easy task given the external instabilities to which these countries have been subjected. In general, the framework points out the necessity of establishing aggregate budget limits for several years, in order to moderate budget demands made by organizations in the current year.

#### FISCAL RULES

The large majority of the countries studied have opted to define fiscal rules that, in general, establish a specific target for the ratio between the primary fiscal deficit and GDP. Others have gone even further, committing to limits on levels of indebtedness.

In Brazil, fiscal rules are set by the *Ley de Directrices Presupuestarias* (Budget Guidelines Act), taking into consideration the current year and the two following years. This law was defined by the *Cámara de Política Económica*, (Chamber of Economic Policy) comprised by the *Ministerio de Planeamiento* (Ministry of Planning), the *Ministerio de Hacienda* (Treasury), and the Central Bank. The rules are centered on the primary deficit, and there are debt reduction targets set by the Senate for several years into the future. In Colombia, goals in respect to the primary surplus are presented, as well as an

analysis of debt sustainability. In Guatemala, targets are established on spending and debt. In Mexico, targets are set concerning the size of the primary deficit in relation to GDP. In the *Programa Nacional de Financiamiento del Desarrollo* (ProNaFiDe) (National Program of Development Finance), long-term goals are established, including in respect to the level of public indebtedness. Finally, in Uruguay, fiscal objectives are established by the *Ministerio de Economía y Finanzas* (Ministry of Economy and Finance) in coordination with the *Oficina de Planeamiento y Presupuesto* (Office of Planning and Budget) and the Central Bank. The present budget contains a spending-related commitment that includes a primary spending limit related to the principle macroeconomic indicators (before there were only thresholds placed on public sector borrowing).

#### BUDGET CEILINGS

In general, all the countries studied have experienced difficulties in establishing whether to start by defining expenditure limits at the sector level or to first set out the objectives for sectoral policy-making. Which decisions should be made first?

If the decision is made to first establish spending thresholds, the most probable outcome is that all that can be achieved is to accept the historic structure of spending. In this case the priorities of the previous government tend to be repeated. If, on the other hand, sectoral ministries are called upon to define their programs without having been provided any guidelines about the quantity of available resources, unreasonable demands will probably be made. This can generate significant conflict within the executive when the demands for spending have to be limited. Thus a key question is how priorities can be defined before the strategic plan is drafted.

In fact, this dilemma begs the question as to whether the budget restrictions are going to determine the plan's limits or, on the contrary, whether the needs expressed in the plan's objectives are going to define the spending levels foreseen in the budget. In some cases, such as in Uruguay and Colombia, weak signals about resource

Table 1. Fiscal responsibility and scope of expenditure accounting

|                                                                                                 | Brazil                                                                                                                                                                                           | Colombia                                                                                                                                                                                                                                        | Guatemala                                                 | Mexico                                                                                                                                                                                 | Uruguay                                                                                                                                                                                                                                                          |
|-------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Do fiscal responsibility rules exist?</b>                                                    | Yes.<br><i>Ley de Responsabilidad Fiscal</i> (Fiscal Responsibility Law).<br><i>Ley anual de Directrices presupuestarias</i> (Annual Budget Guidelines Law).                                     | Yes.<br><i>Ley de Responsabilidad y Transparencia Fiscal</i> . (Fiscal Responsibility and Transparency Law).                                                                                                                                    | No.                                                       | Yes.<br>Chapter II of the <i>Ley Federal de Presupuesto y Responsabilidad Hacendaria</i> (Federal Budget and Fiscal Accountability Law) 2006.                                          | Yes.<br>In the budget.                                                                                                                                                                                                                                           |
| <b>Public organizations outside of the national budget</b>                                      | At the federal level, public enterprises not dependent on the national treasury.<br><br>Autonomous organizations in relation to the subnational levels of government: states and municipalities. | State-owned industries and enterprises (financial and non-financial).<br><br>Banco de la República (Central Bank) and other autonomous entities at the territorial level.<br><br>Parafiscal levies administered by entities outside of the PGN. | Autonomous and decentralized entities and municipalities. | At the federal level, only the Bank of Mexico and some public enterprises.<br><br>Autonomous organizations in relation to subnational levels of government: states and municipalities. | State-owned industries and enterprises (financial and non-financial).<br><br>Public Banks and entities at the territorial level (Departmental governments and autonomous organizations).<br><br>Third-party funds administered by national budget organizations. |
| <b>Is there a common classification system for all organizations in the budget?</b>             | Yes.                                                                                                                                                                                             | Yes.                                                                                                                                                                                                                                            | Yes.                                                      | Yes. At the federal level.                                                                                                                                                             | Yes.                                                                                                                                                                                                                                                             |
| <b>Is there a common classifier for all public organizations?</b>                               | Yes.                                                                                                                                                                                             | No.                                                                                                                                                                                                                                             | Yes.                                                      | Yes. At the federal level, except for the Bank of Mexico.                                                                                                                              | No.                                                                                                                                                                                                                                                              |
| <b>Is there an integrated system capable of providing information on total public spending?</b> | Yes.                                                                                                                                                                                             | No.                                                                                                                                                                                                                                             | No. (At present in implementation phase.)                 | Yes. Integral Information System on Revenue and Public Expenditure.                                                                                                                    | No.                                                                                                                                                                                                                                                              |

Source: Authors, based on interviews of civil servants in each country.

availability were given at the wrong time and the demands made by the organizations exceeded the budget provisions. A considerable effort was then necessary to return to values more in accordance with existing resource levels. In general, the solution to this conflict is reached at the highest level of government: the president and the cabinet define priorities and agree on the budget ceilings for each organization.

#### THE COMPREHENSIVENESS OF THE BUDGET

Those countries with a federalist structure seem to be the ones that have achieved greater comprehensiveness in the public entities included in the budget. Both in Brazil and in Mexico, progress has been made towards developing a common classification scheme for all organizations included in the budget at the federal level. In both cases some public enterprises are included. In the case of Brazil, the classification was completely unified at the national level, and it is to this success that the possibility of complete integration between the plan and the budget can be attributed.

In other countries, explicit proposals have been made to develop information systems that link the state-owned enterprises and subnational governments with the national budget, in order to register revenue and spending in real time at the global level. The capability to integrate this information has only been made possible by the efforts undertaken to implement integrated information systems, in which information is incorporated in a decentralized manner:

- In Brazil; the *Sistema Integrado de Administración Financiera* (SIAFI) (Integrated System for Financial Administration) and the *Sistema Integrado de Datos Orçamentários* (SIDOR) (Integrated System of Budget Information);
- In Colombia; the *Sistema Integrado de Información Financiera* (SIIF) (Integrated System for Financial Information) and the *Sistema de Información Gubernamental* (SIGob) (Governmental Information System);
- In Guatemala; the *Sistema Integrado de Administración Financiera* (SIAF) (Integrated System for Financial Administration), the *Sistema de Información Gubernamental* (SIGob) (System for Governmental Information) and the *Sistema Nacional de Inversión Pública* (SNIP) (National System for Public Investment);
- In Mexico, the *Sistema Integral de Control de la Gestión Presupuestaria* (SICGP) (Integrated System for Budget Management Control), the *Sistema de Información Gubernamental* (SIGob) (System for Governmental Information) and the *Sistema de Metas Presidenciales* (Presidential Objectives System);
- In Uruguay, the *Sistema Integrado de Información Financiera* (SIIF) (Integrated System for Financial Information), the *Sistema de Información Presupuestaria* (SIP) (Budget Information System), the *Sistema de Evaluación del Desempeño* (SEV) (Performance Evaluation System) and the *Sistema de Información y Seguimiento de la Inversión* (SISI) (Investment and Information Monitoring System).

The *Proyectos de Infraestructura Productiva de Largo Plazo* (*Pidiregas*) (Long-Term Productive Infrastructure Projects) in Mexico were set up in 1995 as a long-term financial instrument of the government independent of the banks or the financial institutions. It has been demonstrated that the *Pidiregas* have permitted the federal government to carry out financial operations outside of the budget. Public investment arising from contracts made with the private sector is known as public sector-driven investment.

In Brazil, the *Parcerías Público-Privadas* (PPP) (Public/Private) is a state-guided system of private investment established by law in 2004. These are aimed at increasing the quantity and quality of services offered and improving the performance of investment projects to the extent that these are dependent upon yielding a return for the private investment partner. The PPPs are mainly oriented towards financing large-scale infrastructure projects such as ports, roads or railway lines.

### ***Innovations at the Meso Level: Results-Based Resource Allocation***

#### ***STRATEGIC PLANS***

In all the countries analyzed, strategic planning processes have been developed that have tended to identify medium-term objectives (in general, coinciding with a government's term of office) that provide strategic orientation for governmental management. In Table 2, the principle characteristics of these processes in each country are shown.

Except in the case of Brazil, where there is a ministry responsible for planning, in the other countries planning is carried out by organizations linked to the presidency (Directorate, Secretariat or Advisory Council, as the case may be) and is thereby divorced from the budget process carried out by the ministry of finance (MF).

The process of defining the government's primary strategic objectives has been a consideration that in general is closely linked to the identification of the president's own goals. In the case of Colombia, Guatemala, and Uruguay, the priority programs have been selected on the basis of government-defined programs. In the case of Brazil and Mexico, more wide-ranging actions have been undertaken, with greater participation from different social actors.

What form does the integration of plan and budget take? The plan and the budget can either be integrated during the formulation phase, as prior estimates of expenditures and outputs to be achieved, or during the implementation phase, when it is possible to verify the effective allocation of resources and the results obtained. In general, all countries have achieved greater integration between the plan and budget during the formulation phase than during the executive phase.

- In Brazil, plans to be developed in each region are defined and the investment projects identified, calculating their costs and their cost effectiveness. At this stage, the priorities established in the *Plan Plurianual* (PPA) (Multi-annual Plan) for a four-year period, the budget directives contained within the *Ley de Directrices Presupuestarias* (Budget Directives Act) and the restrictions on resource allocation

stipulated by the Ministry of Planning for each ministry and organization are taken into account. The latter draft their proposals and send them to the Ministry of Planning, which analyzes and verifies the conformity of their strategic orientation with the priorities defined in the PPA and with the directives and the quantitative restrictions regarding targets and fiscal resources. The Ministry of Planning then consolidates the budget proposal to be sent to the congress. The most significant characteristic of the Brazilian planning process is that, although it is structured upon the basis of government programs, the plan, as Schick (2005) points out, is really designed to change society. The plan is a comprehensive one, covering all of the projects that involve public expenditures and effectively constitutes a multi-year budget aimed at guiding national development, rather than merely financing the programs already underway.

- In Colombia, integration of the *Plan Nacional de Desarrollo* (PND) (National Development Plan) is carried out via the *Plan Nacional de Inversiones* (PNI) (National Investment Plan), which specifies total investment spending in real terms by the central government, the departments and municipalities and public entities in the non-financial sector for a period of four years. Investment is considered to be the basic tool for putting the PND into action and the current or operating budget is therefore separated from the investment budget. The first comes under the aegis of the Treasury and the latter, the *Dirección Nacional de Planeación* (DNP) (National Planning Directorate). With regard to the annual budget, the *Plan Operativo Anual de Inversiones* (POAI) (Annual Investment Plan) specifies the annual sums allocated to each investment project included in the budget, which must be consistent with the figures expressed in the PNI. The substantial negotiations on budget distribution, therefore, take place around investment expenditure, and this is where the DNP plays its most important role. The DNP, along with the *Consejo Nacional de Planeación de la Política Económica y Social* (National Council for the Planning

Table 2. Characteristics of the strategic plans

|                                                                                           | Brazil                                                                                                                                               | Colombia                                                                                 | Guatemala                                                                                                                                                                                                                                                        | Mexico                                                                                                                                                              | Uruguay                                                                                                                                                                                 |
|-------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Planning system</b>                                                                    | <i>Sistema de Planificación y Presupuesto</i> (Planning and Budgeting System).<br><br>PPA                                                            | <i>Sistema de Metas de Gobierno</i> (Governmental Objectives System) (SIGOB).<br><br>PND | <i>Sistema de Metas Presidenciales</i> (Presidential Objectives System) (SIGOB).                                                                                                                                                                                 | PND and <i>Programa Nacional de Financiamiento del Desarrollo</i> (National Finance for Development Program) (ProNaFiDe).<br><br>System of Presidential objectives. | <i>Sistema de Evaluación de la Gestión</i> (Management Evaluation System) and <i>Planes Estratégicos de Gestión</i> (Strategic Management Plans) (SEV-PEG).                             |
| <b>Administering organization</b>                                                         | <i>Ministerio de Planificación, Presupuesto y Gestión</i> (Ministry of Planning, Budgeting and Management).                                          | <i>Dirección Nacional de Planeamiento</i> (National Planning Directorate).               | <i>Sistema Nacional de Evaluación y Gestión por Resultados</i> (National System of Results-Based Management and Evaluation) (Sinergia).<br><br><i>Secretaría de Planificación y Programación Presupuestaria</i> . (Budget Planning and Programming Secretariat). | <i>Oficina de la Presidencia para la Innovación Gubernamental</i> (Presidential Office for Governmental Innovation).                                                | <i>Oficina de Planeamiento y Presupuesto de la Presidencia</i> (Presidential Office of Planning and Budgeting).                                                                         |
| <b>How are government priority projects and programs selected?</b>                        | Under the Cardoso Government, based on a specific regional study. Currently it is done based on existing project portfolios.                         | Reflects the Government's program and the PND.                                           | Based on the Government's program.                                                                                                                                                                                                                               | Presidential objectives are established, alongside the <i>Agenda de Buen Gobierno de la Presidencia</i> . (Presidential Agenda of Good Governance).                 | The priority investment projects are selected based on strategic objectives.                                                                                                            |
| <b>Are the Government's principle strategic objectives clearly and precisely defined?</b> | Yes, the strategic fiscal objectives are set out in the <i>Ley de Directrices Presupuestarias</i> (Budget Directives Act) and the others in the PPA. | Yes, included in the PND.                                                                | Each entity defines its own strategic and operational objectives and targets are set for each expenditure program.                                                                                                                                               | General interest areas are established within the PND.                                                                                                              | Yes, strategic objectives are defined based on the Government's <i>Lineamientos Estratégicos de Gestión</i> (LEG) (Strategic Management Guidelines); these are quantifiable objectives. |

Table 2. Characteristics of the strategic plans

|                                                   | Brazil                                                                                                                                                                                                                                                                             | Colombia                                                                                                                                                                                                                    | Guatemala                                                                                                                                                                                                | Mexico                                                                                                                                                                                                                                                                         | Uruguay                                                                                                                                                                                                                                                                 |
|---------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Are management objective costs calculated?</b> | No, only when they depend on an investment project.                                                                                                                                                                                                                                | Yes, the cost foreseen in the PND is calculated.                                                                                                                                                                            | From 2006 onwards, there will be a multi-annual budget linking the plan and the budget.                                                                                                                  | Resource allocation happens at the institutional activity level, not at the level of objectives, targets and the indicators associated with this activity level.                                                                                                               | The cost of 100 objectives was estimated for the budget. This will have to be compared with the real costs of execution.                                                                                                                                                |
| <b>Strategic plan contents.</b>                   | <p>The executive's strategic guidelines.</p> <p>Objectives of important organizations (ministries).</p> <p>Quantified objectives.</p> <p>Effectiveness indicators.</p> <p>Estimated unit costs of public outputs (some organizations have this information at their disposal).</p> | <p>The executive's strategic guidelines.</p> <p>Objectives of important organizations (ministries).</p> <p>Strategies.</p> <p>Quantified objectives.</p> <p>Effectiveness indicators.</p> <p>Outcome indicators (some).</p> | <p>The executive's strategic guidelines.</p> <p>Objectives of important organizations (ministries).</p> <p>Quantified objectives.</p> <p>Effectiveness indicators.</p> <p>Outcome indicators (some).</p> | <p>The executive's strategic guidelines.</p> <p>Objectives of important organizations (ministries).</p> <p>Quantified objectives.</p> <p>Efficiency indicators.</p> <p>Effectiveness indicators.</p> <p>Outcome indicators.</p> <p>Estimated unit costs of public outputs.</p> | <p>The executive's strategic guidelines.</p> <p>Objectives of important organizations (ministries).</p> <p>Quantified objectives.</p> <p>Efficiency indicators.</p> <p>Effectiveness indicators.</p> <p>Quality indicators (some).</p> <p>Impact indicators (some).</p> |
| <b>Where is the plan published?</b>               | www.planejamento.gov.br.<br>www.sigplan.gov.br                                                                                                                                                                                                                                     | www.dnp.gov.co                                                                                                                                                                                                              | www.segeplan.gob.gt                                                                                                                                                                                      | www.pnd.presidencia.gob.mx/<br>www.innova.gob.mx                                                                                                                                                                                                                               | www.cepre.opp.gub.uy                                                                                                                                                                                                                                                    |
| <b>Results evaluation and assessment</b>          | Yes, PPA evaluation system by project, organization and sector.                                                                                                                                                                                                                    | No.                                                                                                                                                                                                                         | Yes.                                                                                                                                                                                                     | Partial. Only with regard to innovation and quality.                                                                                                                                                                                                                           | Partial. Only within the executing unit.                                                                                                                                                                                                                                |
| <b>Consequences of management outcomes</b>        | Information on organizations that have obtained successful outcomes is highlighted and published.                                                                                                                                                                                  | No explicit consequences. The president communicates directly with those responsible for results.                                                                                                                           | Yes, whenever this has been included in performance agreements.                                                                                                                                          | Prizes and recognition for innovation and quality in public administration.                                                                                                                                                                                                    | Individual prizes based on achievement of results in the executing units of the <i>Dirección General Impositiva</i> . (General Directorate for Taxation).                                                                                                               |

Source: Authors, based on interviews with civil servants in each country.

of Economic and Social Policy) exercises its function as the leader of national planning efforts and the central coordinator of the *Sistema Nacional de Planeación* (National Planning System). The ministers and the administrative department heads set out targets for the current year and for the four years of the plan's duration, based on the established sector policy objectives. Thereafter, during the execution phase, progress toward the achievement of goals is monitored every six months, so that each entity is subject to a periodic evaluation of management performance, and also so that resources can be reallocated and feedback can be provided for the planning process.

- In Guatemala, the link between the strategic plan and the budget is achieved via a multi-year budget, corresponding to a three-year period and based as much on resource availability—defined after fixed or rigid costs have been deducted—as on the estimation of the costs of the government's policy priorities. The multi-year budget demands that each entity draws up a *Plan Estratégico de Mediano Plazo* (PEMP) (Medium-Term Strategic Plan) so that the *Planes Operativos Anuales* (POA) (Annual Operational Plans) become the annual expression of the PEMP. The strategic plan is drafted at the program level of each executing unit. Then, a combination of priority programs and projects are identified, based on the government's own program. Strategic and operational objectives are set out and targets are defined for each expenditure program. Investment projects are sometimes, but not always, assigned to objectives. For example, an important part of the investment corresponding to various organizations, such as those in education, is assigned to the *Ministerio de Obras Públicas* (Ministry of Public Works). The projects are budgeted annually and have to be contained within the *Plan de Inversiones de Mediano Plazo* (SNIP) (Medium-Term Investment Plan).
- In Mexico, the PND contains guiding objectives lasting for six years, or the normal government term of office. In general, in spite of the fact that each government could alter them, few changes have in

fact been made since 1982. The guiding objectives are taken each year to serve as the basis for the budget, given that the budget objectives and targets correspond to them. However, the indicators for the Federal expenditure budget are more or less contained within the PND, due to the fact that there are program indicators and targets for which various different units are responsible. In these cases, it is very difficult to analyze which part of the resources employed in a program has been provided by each executing unit. In the case of investment projects, however, it is easier to clearly identify which unit is responsible, and also easier to analyze the cost of achieving the targets. There are various planning systems in place, and there is no scheme of objectives that would clarify the relations between them, or between the agencies that propose them. For example, the objectives of the president's office do not necessarily come from the PND. In fact, the existence of various systems reflects the need for different areas to have access to specific information in relation to specific topics and opportunities. It is understood, however, that it is necessary to carry out a cross-departmental analysis and for this reason the systems would need to be somehow integrated.

- In Uruguay's case, the budget is multiannual, but a clear and enduring integration with the plan has not been achieved. The *Ministerio de Economía y Finanzas* (Ministry of Economy and Finance) sets total expenditure ceilings according to macroeconomic forecasts and the executive defines the allocations for each organization. Then, the organizations define their own strategic plans by taking into account the resources available, which are then assigned by programs. There is no analysis of the precise costs of obtaining the targets, unless targets correspond to investment projects. The 2000-2004 budget was developed according to the *activity-based budget* (ABB) methodology, which allowed the plan and the budget to be formulated simultaneously, allocating resources to objectives, targets and activity centers. Finally, however, the budget was approved along traditional lines: resources for inputs and organizations.

In conclusion, in all the countries analyzed, efforts have been made to identify the real cost of programs and objectives, with varying degrees of success. Brazil seems to be the country that has achieved the greatest degree of integration between plan and budget. Plans are presented to parliament for approval, and then published on a webpage to provide the media and citizens at large full access to the information.

The integration between the plan and the budget appears to be the weakest during the execution phase. In general, it is not always possible to identify the genuine costs of strategic goals and objectives, except in the case that they have been assigned to an investment project. This makes it more difficult to employ useful information for correcting budget allocations for the following year, or to correct the strategic orientation.

In the majority of countries, the achievement of results does not lead to a performance assessment of the organizations involved and does not have explicit consequences for those organizations, their managers or their staff, except in the case of Mexico, where the presidency awards prizes to those organizations that have achieved certain standards in public management quality and innovation. In Brazil, Guatemala and Colombia, in general, successful outcomes are publicized. In Uruguay, a compensation system has recently been established in the *Dirección General Impositiva* (General Directorate of Taxation) for civil servants whose executing units achieve their objectives.

#### THE BUDGET AND PLANNING IN INVESTMENT

Efforts to measure progress in terms of outputs and to analyze whether results match up to expectations are most visible within systems that track public sector investment projects. Investment projects form the backbone of the PPAs in Brazil and the PNDs in Colombia, Guatemala, and Mexico. In all of these countries, special efforts have been made to identify regional expenditure allocations and the results achieved in different regions, down to the municipal level. In Brazil, an investment project cannot be implemented unless it is included within the multi-annual program.

A system offering detailed project information according to the geographical zone in which the project is located is a very useful analytical tool for analyzing the achievement of strategic goals within a territorially-based planning system. The combination of projects defined as being of high priority (approximately 50) due to their impact on regional development represents the backbone of the PND, and subsequent detailed monitoring permits the identification of government progress regarding public, sectoral and regional entities. Investment programs also allow the responsible entities and sectors to identify where spending should be channeled.

In the case of Brazil and Mexico, investment project information systems are very important for strategic planning. Important advances can also be observed in Guatemala and Colombia due to the use of systems integrated with the *Dirección de Presupuesto* (Budget Office). In Uruguay, a new *Sistema de Seguimiento de la Inversión* (SNIG) (Investment Monitoring System) is being formulated.

#### **Innovations at the Micro Level: Budget Execution and Accountability**

##### INFORMATION SYSTEMS ON BUDGET EXECUTION

The effort in establishing systems capable of recording revenues and expenditures in real time has been crucial for providing integrated information. These systems are generally associated with a budget information system that registers the expected revenues and expenditures during budget formulation and subsequently the revenues and expenditures effectively executed, with specific subsystems for investment projects. System information input is undertaken by participating organizations acting autonomously and the information is subsequently compiled and revised at the central level by the *Direcciones de Contabilidad y de Presupuesto* (Budget and Accountancy Directorates).

In Guatemala, the SIAF registers the general government's budget of revenue and expenditures by employing the same budget classification scheme that is applied in all public sector organizations. The budget is formulated by executing units, programs, subprograms and

Table 3. Investment projects and results

|                                                       | Brazil                                                                                                                 | Colombia                                                                            | Guatemala                                                                                    | Mexico                                                                                                                                                         | Uruguay                                                                                                            |
|-------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------|
| <b>Information system used for investment project</b> | <i>Sistema de Informaciones Gerenciales y de Planeamiento</i> (SIG Plan) (Management and Planning Information System). | <i>Seguimiento de Proyectos de Inversión</i> (SPI) (Investment Project Monitoring). | <i>Sistema Nacional de Inversión Pública</i> (SNIP) (National System for Public Investment). | <i>Cartera de Programas y Proyectos de Inversión</i> (PPI) (Long-Term Productive Infrastructure Projects).                                                     | <i>Sistema de información y seguimiento de la inversión</i> (SISI) (Investment and Information Monitoring System). |
| <b>Organization administering the system</b>          | Ministry of Planning, Budgeting and Management.                                                                        | National Planning Directorate.                                                      | <i>Sinergia</i><br><br>Presidential Budget Planning and Programming Secretariat.             | <i>Unidad de Inversiones de la Secretaría de Hacienda y Crédito Público</i> (Investment Unit of the Secretariat of the Treasury and Public Credit Department). | Presidential Office of Planning and Budgeting.                                                                     |
| <b>Information</b>                                    | Organizations, sectors, regions.                                                                                       | Organizations, sectors, regions.                                                    | Organizations, sectors, regions.                                                             | Organizations, sectors, regions.                                                                                                                               | Organizations, sectors, regions.                                                                                   |
| <b>Evaluation</b>                                     | Yes, physical balance sheet.                                                                                           | Efficiency and effectiveness in products and results.                               | Effectiveness.                                                                               | Ex post cost/profit relation. Effectiveness.                                                                                                                   | Physical balance sheet.                                                                                            |
| <b>Evaluation results</b>                             | Successes highlighted.                                                                                                 | Successes highlighted.                                                              | Strategic plan redefined and guidance given for annual budget.                               | Successes highlighted. Strategic plan redefined and guidance given for annual budget.                                                                          | No.                                                                                                                |

Source: Authors, based on interviews with civil servants in each country.

projects. The SIAF then registers the physical results, which it has been possible to monitor since the system was set up in 2002. A process of extending the system to all decentralized institutions, autonomous organizations and social funds is underway with the aim of decentralizing the SIAF until it reaches the executing units (the so-called third level). The SIAF will thereby have a total accounting of the budget at its disposal, as well as a verified account of the entire public sector in real time and with physical results.

In Uruguay's case, outstanding possibilities are offered by the *Sistema de Distribución del Gasto* (SDG)

(Expenditure Distribution System) that permits the execution of expenditures to be monitored for each center of activity (the organizational units that make up an executing unit) on a monthly basis, with an organization based on centers of spending. This precise information on spending, found in the lower-level organizational units within the state structure, was instrumental in permitting the launching of the *Sistema de Análisis del Gasto por Producto*, (AGPP) (Analysis System for Unit Output Expenditures), which has unfortunately, fallen into disuse.

To the extent that management goals for centers of activity have been established, the system is very

Table 4. The operating budget

|                                                                                             | Brazil                                                                                                                       | Colombia                    | Guatemala                                                                                                                       | Mexico                                                                                                                                          | Uruguay                                                                                                                                                                          |
|---------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------|-----------------------------|---------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Organizations that guide the budget formulation and execution phases</b>                 | Ministry of Planning, Budgeting and Management, via the Secretaría de Presupuesto Federal (Secretary of the Federal Budget). | Ministry of Public Finance. | The Treasury and Public Credit Department (management and debt servicing) and National Planning Directorate (DNP) (investment). | <i>Secretaría de Hacienda y Crédito Público</i> (SHCP) (Secretary of the Treasury and Public Credit) via the expenditure sub-secretariat (SSE). | <i>Ministerio de Economía y Finanzas</i> (MEF) (Ministry of Economy and Finance) and the <i>Oficina de Planeamiento y Presupuesto</i> (OPP) (Office for Planning and Budgeting). |
| <b>Is yearly information contrasted with previous years presented? With how many years?</b> | Yes. The previous five years considered.                                                                                     | Yes. Two years.             | Yes. Two years.                                                                                                                 | Yes. Two years. The recently approved <i>Ley Federal de Presupuesto</i> (Federal Budget Law) stipulates the last five years.                    | Yes. One year.                                                                                                                                                                   |
| <b>Are there regular reports on budget execution during the course of the year?</b>         | Yes. Congressmen also have access to this information.                                                                       | Yes.                        | Yes.                                                                                                                            | Yes.                                                                                                                                            | No.                                                                                                                                                                              |
| <b>Cases of combined analysis of information on public management and expenditure</b>       | Do not formally exist.                                                                                                       | Do not formally exist.      | There is internal evaluation by the central government, coordinated by the president.                                           | Do not formally exist.                                                                                                                          | Do not formally exist.                                                                                                                                                           |
| <b>Cases where information on management results is used to amend the budget</b>            | Results feed into annual budget, but not formally.                                                                           | Do not formally exist.      | Do not formally exist.                                                                                                          | Do not formally exist.                                                                                                                          | Do not formally exist.                                                                                                                                                           |

Source: Authors, based on interviews with civil servants in each country.

efficient at the micro level in identifying where expenditures are made, who is responsible for them and what the outcomes are. However, it is obvious that the causal relations explaining government impact on results at the macro level cannot easily be established by using this operational level of the organizational structure as a departure point.

### ***Suggestions for Ways Forward Based on the Innovations Analyzed***

The preoccupation with achieving specific results in public policy, especially in social policy, by attempting to identify results that do not seem to be produced in an automatic way, has driven the desire to move from public output identification towards identifying the results and

impact of public policies. This preoccupation has led to a wide range of practices being introduced in the different countries considered in this study. As they are all conscious of the fact that they find themselves in “the process” of developing new systems, there is great eagerness to share experiences and to become acquainted with new innovative proposals. But why is it turning out to be so difficult to make progress in this branch of public management reform, after so many years of effort? How can measurement and evaluation systems be improved and new RBB practices introduced? (Zapico, 2004).

Public management suffers from the effects of diverse specific factors that get in the way of the control and evaluation of results: the plurality of diverse and conflicting interests, uncertainty regarding targets and objectives, interdependency between the multiple organizations and decision-making levels involved in connected programs, social instability and unforeseen economic changes.

The academic literature raises questions about the possibility of consolidating the reform model through the simple solution of doubling the level of effort, without first proposing qualitative changes in the design and strategy of budget system reform.

In all countries analyzed, efforts to improve and modernize budget and planning systems have been led from three different administrative areas. These are: the *Dirección de Presupuesto del Ministerio de Finanzas* (Ministry of Finance’s Budget Directorate), the *Dirección de Inversiones* (Directorate of Investment) and the *Dirección de Planificación* (Directorate of Planning) (which in almost all of the cases is part of the office of the presidency).

#### ***Information Provided by Accounting Systems: Monitoring of Operations at the Micro Level***

The evaluation of budget execution is based on two information systems. Information on financial implementation comes directly from the accounts registers, and information on physical execution should be provided by the relevant executing units.

Some countries have made progress in improving their accounting systems to provide detailed information on expenditure at the institutional level, based on organizational units or expenditure centers inside executing units, geographical location and physical production units. This information, when juxtaposed with information about budget execution, gives a full account of a public institution’s routine activities and permits constant measurement of the productive process. The relationships drawn between fiscal and physical variables are the basis for indicators that permit the effectiveness and efficiency of public organization management to be measured.

Systems can thereby provide new answers to questions such as; who is producing, what are they producing, and how much does what they produce cost? Progress in large-scale programs must be based upon simple and specific information: for example, the cost per day of a bed in a public hospital; the cost per student in the school system and the cost of producing a high school graduate; the cost of keeping a prisoner in custody for a year and the cost of his rehabilitation; and the cost of a day of maritime patrol by the Armed Forces. This information could become an important instrument for estimating the costs of projects to be included in the budget.

Detailed and constant provision of information at the operational level permits the direct monitoring of production levels and public organization efficiency by providing information that is, without a doubt, extremely useful for the decision-making process within those organizations. The management-related indicators are not only useful at the political and managerial levels for evaluating the quality of management and adopting timely corrective measures, but also for providing information to the legislature and to the general public about the current state of the management process.

The great challenge facing public accounting systems is to make the transition from budget accounting to real accounting (Likierman, 1998). In the latter, the unit costs of goods and services should be registered, at cost center level, for all services provided, the patrimonial value of public assets, with depreciation costs

included, should be registered, and all subsidies and transfers made between different services should also be reflected. Progress has been made in both Guatemala and in Uruguay to provide better information about production related to budget execution, in a manner that is integrated with the systems that record the execution of expenditures. This approach stresses the importance of cost-efficiency analysis.

### ***The Strategic Budget through Investment Projects***

Except in the case of Brazil, where there is a Ministry of Planning that unifies various functions, in the other four countries considered, planning activities are the responsibility of the Directorate of Planning, linked to the Office of the Presidency. The Directorate is given responsibility for formulating budget proposals while the Treasury controls the execution phase. Both responsibilities in theory should be perfectly integrated but, as often happens in the case of shared responsibilities across institutions, integration is complicated in nearly all cases.

One of the most important obstacles impeding progress in respect to innovation resides in the prevailing culture within the public sector, which disposes agencies to want to maintain the budget in its traditional format in the budget offices of the Treasury, where more emphasis is placed on the importance of obtaining good quantitative information.

These organizations sincerely believe that information about planning is subject to a high degree of variation and haphazardness, and that it is not wise to invest in information systems which will contain information whose quality they will not subsequently be able to control due to variations in the contents that come from the Ministry of Planning. Two opposing viewpoints are counterposed: on the one hand, the “technical and objective” and, on the other, the “uncertain and changeable.”

For its part, the Directorate of Planning is the organization that is most concerned with the results of public policy and has the most interest in making them known. It seems to place greater importance on demonstrating the levels of program coverage and the impact of policies than on service costs or program efficiency.

The Directorate of Investment functions in some countries in conjunction with the Directorate of Planning, sometimes under the auspices of the Office of the Presidency (Guatemala, Colombia, and Uruguay). Due to this institutional dependence, and the kind of information at their disposal, these institutions are more inclined to incorporate results-based budgeting. Investment projects take up the discretionary part of public expenditure, allowing them to be associated with the government's strategic objectives. It is precisely this part of the budget that can best be integrated with strategic planning.

The Directorate of Investments is mainly concerned with generating information about financial and real execution in the medium term, and is accustomed to working with information of a temporary nature, given that projects are fixed term. If projects are well designed, they should relate to the principle strategic objectives.

Making progress in strategic planning through the use of investment projects—which, in general, are perfectly integrated in the budget through the scheme for classifying expenditures—might be a relatively simple way of integrating the budget and the plan more effectively. The experiences of Brazil, Mexico, and Colombia provide some insights in this direction.

### ***Regional Monitoring of Government Programs: Decentralized Management***

Incorporating information about the territorial distribution of public expenditures is of vital importance in large federal countries, where negotiations between central and regional governments on the transfer of resources to the regions are usually complex. The process is particularly important with regard to social programs. Decentralization improves the efficiency of public resource management and permits greater involvement by those who know better about the nature of the problems being confronted.

When information favors comparison between the cost of an x-ray or a vaccine in different regions, questions are bound to be asked about efficiency, and demands made for better resource allocation. Similarly, when comparisons are made between the educational results

achieved in schools in different regions, questions are also raised about the effectiveness and equity of expenditures. Identifying the destination of public spending in the light of regional development plans can therefore improve the basis for decision making and contribute to making the decentralization of public administration effective.

***The Relationship between Program and Organization: Autonomous and Results-Based Management***

By incorporating integrated financial information systems, the countries considered in this chapter have become more efficient in handling routine financial operations. It is an open question, however, if such systems have really changed the way in which governments administer public resources. Integrated systems can inspire the decentralization of financial management and give division managers greater discretion when it comes to implementing their budgets. However, is this really what has happened or, on the contrary, have the systems tended to increase centralization by monitoring and controlling operational decisions much more closely?

Effective planning implies a change in the culture of bureaucracies and in citizens alike in order to move from a “procedures-based” approach to a “results-based” approach. It is obvious that nearly all governments have taken on board the objectives of greater transparency and strategic orientation. In many cases, however, greater efforts seem to have been made in establishing the system than in achieving the final objectives of RBB, which should consist in giving greater managerial autonomy to public sector managers, assessing the results they produce, providing feedback in the formulation of the budget and, at the end of the day, deciding which programs should remain and which should be eliminated.

If reform is centered on the instrument and not the objective, success can be achieved by the mere publication of a report detailing policy goals and objectives. If the objectives are transparency, the achievement of strategic objectives and efficiency, then the publication of documents might even cause some discontent.

If there is no commitment to achieving such results, it is better not to spend time and money on establishing expensive information systems when the tangible results they provide will be minimal.

At the beginning of this chapter, it was suggested that the existence of greater autonomy for making management decisions on the basis of results is what distinguishes RBB from program-based budgeting, and this is precisely what justifies investment in costly strategic planning systems. One of the reasons why results are not used is often because civil servants and public managers do not administer with the purpose of achieving results (Schick, 2003).

***Institutional Structure and RBB***

To what extent are current institutions responsible for the lack of integration between the budget and the plan? In the countries analyzed, there is one organization responsible for the plan and a different one in charge of the budget, except in the case of Brazil, where the Ministry of Planning takes on both responsibilities. Brazil is also the only country that has managed to integrate the entire state into the plan. Schick (2005) points out that in the Brazilian model both planning and budgeting have been made easier by the organizational fusion of planning, budget and management within a single ministry, with a separate secretary for each of the functions. Schick adds; “Consequently, the plans seem more realistic than if they were entrusted to a ministry whose only option was the production of a medium-term plan every four or five years” (2005).

However, this result should not lead us to think that, in the other countries, the guiding role of the Ministry of Finance leads to the predominance of a traditional and accounting vision of the budget process. Even in the countries where the Ministry of Finance does play the leading role, significant innovations have been adopted which have tended to associate budget management with the strategic plan. This is the case with both Guatemala’s SIAF and Uruguay’s SDG. In these countries, there has been a tendency towards a budget approach similar to that which Schick (2005)

calls service-oriented budgets that buck the current trends by being “typically product and results-based, a budget oriented towards public service that would allocate resources based on the activities and functions carried out by government entities. The idea is strengthened by the notion that the best way to link resources with services is by specifying in the budget what activities are to be undertaken (by the organizations) if they are allocated the money. Activities consist of what public agencies do, and what they spend their money on (...) they are the connecting nodes between citizens and government.”

He adds that “in this sense, governments could develop a basic service that would show the types and volumes of services foreseen under the current budget allocations, and the changes that would occur if the allocations were either augmented or diminished”.

In the same work, Schick (2005) asks: “Is there not some kind of arrangement that might lead to a stronger and more consistent integration between the plan and the budget?” It is not possible to say that institutional change is decisive, but it also seems difficult to see how change in budgets could result unless there is a change in the role of institutions.

### ***The Use of Results: Cultural Change and Incentives***

Achieving a genuine link between planning, programming, and budgeting does not depend upon a law to make it obligatory. Rather, a cultural change is called for at all levels of government.

Reforms that have a real, lasting effect are those that change people’s behavior. The actors participating in the budget, the “Guardians of the Treasury” and the “Advocates of Program Spending,” the public officials who prepare the options and the legislators, etc, all have to change their behavior. The existence of incentive schemes that generate good and bad consequences, according to the results achieved by organizations can bring about genuine and not virtual systems that produce enduring change within the culture of the public administration. If an organization’s results have no effect on the level of funding that it receives, then public sector culture

cannot be drastically altered. In order for change to happen, therefore, the legislature must take results into consideration.

Paying attention to institutions and incentives means that budget reforms require interventions that ensure certain rules are observed once evaluation has been carried out.

A cultural change towards a results-based approach in public management is needed. In other words, it is not merely a matter of changing information systems, but rather of changing the mentality of decision-makers, so that they discharge their responsibilities on the basis of the new information available, and in such a way that their daily actions are directed towards achieving results. For that to happen, a system of positive and negative incentives should be designed (“carrots and sticks”) (Waissbluth, 2002).

### ***International Organizations and Their Effect on Budgeting***

In recent years, international organizations (IOs) have contributed to the adoption of the fiscal rules behind some of the most successful international experiences (United Kingdom, New Zealand).

They have also played a crucial role in supporting state reform programs, tending to introduce changes within the framework of so-called New Public Management (NPM), such as improvements in public management, RBM, management contracts, greater managerial autonomy and decentralization, citizen-based service provision, transparency and accountability. Similarly, the privatization of state-owned enterprises was encouraged, along with the deregulation and the reduction of the size of the state and its burden on public spending.

Within this framework of actions, IOs have supported the development of detailed budget information systems. These comprehensive and decentralized systems account for spending on an accrual basis, with the principle aim of contributing to increased transparency and control of public spending. Other kinds of systems proposed have been those that incorporate strategic goals and objectives and tend to evaluate results and

outcomes, with the aim of achieving greater management efficiency and enhanced transparency.

Both lines of progress have been very beneficial but these systems have generally ended up working in parallel, depending on different governmental agencies (usually the Ministry of Finance and the Ministry of Planning). Opportunities for developing synergies in the use of information have been missed, either by mixing results with budget execution or, worse still, by causing the executing units unnecessary work by asking them for duplicate information. Progress made in Guatemala and Colombia, in the form of combined actions for information generation, seems to show the way forward.

Nevertheless, it is likely that results-based management systems that are internally immature and proposed in countries lacking human resources of the necessary quality and quantity, have contributed to the creation of purely ritualistic management systems, with little real impact on processes and the culture of the persons involved. It is also true that the mere fact of knowing that decisions are made public through information systems does yield managerial improvements. This is very evident in the implementation of procurement systems, for example.

Schick (2003) asserts that “One of the misconceptions of the performance movement is the notion that

organizations are transformed by having information on how well they are doing. This optimism is rarely justified, for organizations—both public and private—have enormous capacity to assimilate or deflect data on results without changing their policies or operations. It requires sustained political and managerial will to re-orient an organization in response to information on what it is doing or hopes to accomplish. In fact, genuine organizational change may be a precondition for effective use of performance information.”

In general, countries have encountered various bottlenecks when attempting to reconcile the New Public Management with the existing institutional framework. These obstacles are directly connected with the implications of public management in the old frameworks of political and administrative accountability still in force (Echebarría, 2003). Countries sometimes need to satisfy some preconditions before being able to implement a new management system. In particular, they need to develop and formalize a market economy, establish reliable external controls (including financial controls), train the civil service, and establish real budgets (Schick, 2005). It is particularly necessary to develop incentives systems that promote rapid changes in behavior. To this end, the establishment of prizes for good behavior consisting in something more than an honorary mention might be contemplated.

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## Appendix | Interviews

### Mexico (22 to 24 February 2009)

- MAX DIENER  
*Director General Jurídico,*  
*Subsecretaria de Egresos,*  
*Secretaría de Hacienda y Crédito Público*  
(Legal General Director,  
Undersecretariat of Expenditure,  
Ministry of Finance)
- ALEJANDRO BALLESTEROS VILLALOBOS  
Undersecretariat of Expenditure  
of the Ministry of Finance
- LUIS ALBERTO IBARRA  
Undersecretariat of Expenditure  
of the Ministry of Finance
- JORGE CASTAÑÓN LARA  
Investment Unit,  
Undersecretariat of Expenditure  
of the Ministry of Finance

### Brazil (12 March 2009)

- MARTUS TAVARES  
Ex-Secretary for *Planeamiento Estado de Sao Paulo* (Planning, the State of Sao Paolo)  
Ex-Minister for *Planeamiento Gobierno Nacional* (Planning, National Government)

### Colombia (27 to 28 February 2009)

- FERNANDO JIMÉNEZ  
Ministry of Finance
- DIEGO LUIS JARAMILLO  
Ministry of Finance
- CECILIA CORREA  
Advisor to *Alto Consejero Presidencial*  
(High Presidential Councilor)
- CARLOS CIRO  
Technician at *Alta Consejería Presidencial*  
(High Presidential Council)
- LINA ZULUAGA  
Advisor
- ANA MARÍA FERNÁNDEZ  
*Departamento Nacional de Planeación*  
(National Planning Department)
- CAROLINA SOTO  
Central Budget Director - National Planning  
Department

### Uruguay

- DANIEL MESA  
Sub-director at the *Oficina de Planeamiento y Presupuesto - Ministerio de Economía y Finanzas* (Ministry of Economy and Finance, Planning and Budgeting Office)

**Guatemala (26 to 28 February 2009)**

- ERIC COYOY ECHEVERRÍA  
Advisor to *Despacho Ministerial*  
(Ministerial Office)
- INGENIERO EDGARDO RESQUIN  
Consultant responsible for setting up  
the SIAF
- MARÍA CASTRO  
Director of *Políticas Públicas*  
(Public Policies) for SEGEPLAN
- EDGARDO ARTURO PESQUERA OCHOA  
Principle expert on budgeting (SIAF-SAG)
- RUBEN LEMUS DE LEÓN  
Director of the *Dirección Técnica  
del Presupuesto* (Budget Technical  
Directorate)
- EDWIN OSVALDO MARTÍNEZ CAMEROS  
Sub-director of the Technical Directorate  
for the Budget

# Medium-Term Frameworks and the Budget Process in Latin America<sup>1</sup>

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Gabriel Filc\*

Carlos Scartascini\*\*

*“When the plan ambitiously portrays a bountiful future with enhanced public services, but the budget fails to make a down-payment on that future—it does not allocate spending increases to social programs—then the government probably is using the plan to escape from its dire predicament.”*

*Schick, A. (1998, p. 38)*

## Introduction

The budget process of a country is where decisions about how much to spend and on what are made. In a democratic context, the decisions are not made by a social planner, but they are the result of negotiations among a set of actors, each with its own preferences and incentives. Thus, the president and his/her ministers, legislators, civil servants, and civil society actors interact in the different stages of the process to set their priorities, attempt to influence the amounts and the form in which the resources are implemented, and try to ensure that promises are fulfilled. The role of each of these actors varies from country to country, according to both what type of institutions oversee the operation of the process in its different stages and the capacity of each actor to make use of its prerogatives in the process (Filc and Scartascini, 2006, 2007).

The budget process is not an isolated discussion. On the contrary, it is one of, if not the main bill to be discussed each year in a country. Because almost every policy has a budget component (affecting spending, income, and financing decisions, among others), each one has to be discussed during the budget process.

Despite the fact that the budget process has usually been considered as a technocratic process, this is rarely the case. Budget decisions are significant not only in terms of their implications for the efficiency and effectiveness in reaching a policy goal but also in terms of their political implications. Through the budget process not only are public policies financed, but they can also be used to compensate those affected by certain reforms, and the foundations can be laid for forming coalitions that may help to implement the government's agenda (Filc, Scartascini, and Stein, 2005; Hallerberg, Scartascini and Stein, 2009b). In some countries, it may become the mechanism to hold agreements together and sustain coalitions. Consequently, the budget process is at the core of the more general policy-making process.

Budgets, therefore, are a key tool for the implementation of public policies and in some cases for ensuring the durability of the government. However, the annual horizon of traditional budgets entails certain limitations that reduce their potential for ensuring a correct execution of governmental policy. In terms of the efficiency of expenditures and their accounting, public policies and public works have implications that transcend the budget year. First, administrative processes, such as bids, can extend beyond the calendar year. Second, infrastructure projects can take many years to be completed. Third, capital investments may entail future operating expenses. When these aspects are not taken into account, public finances and the success of policies can be negatively affected.

All these factors imply that the annual budget process is not adequately integrated with the planning of

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1. The authors thank the authorities and staff members of the governments who provided the information and data included in this document and these officials and other participants at the meeting of Senior Budget Officials sponsored by the IDB for their comments. They also are grateful for the suggestions provided by Mark Hallerberg and Mario Sangines. The opinions expressed in this chapter are those of the authors and do not necessarily reflect those of the Inter-American Development Bank.

public policies. One of the main problems then is that the availability of adequate budget resources is not necessarily taken into account when designing public programs. On the contrary, programs are started but their long term financing needs may not be secured.

From a political perspective, yearly budgets may not be the best mechanism for cementing long-term agreements. With a yearly budget, some policies have to be negotiated every year, making them less likely to survive. In response, many countries have introduced earmarks, which make the annual budgets more rigid. In the long run, earmarks are making it harder for governments to adapt the budget to the needs of the moment.<sup>2</sup>

In the Latin American context, the weaknesses of annual budget processes —reflected in problems related to the sustainability and efficiency of public policies— have been persistent. In contrast to this, medium-term frameworks (MTF) can provide a better foundation for the discussion of public policies and reduce some of the deficiencies of annual budgets.

This document explores this hypothesis. Since the experience in the region with the implementation of the MTF is very recent, an evaluation of its impact is not possible at this time. Instead, this document discusses the normative merits of using the MTF and describes the situation in LAC. Then, it compares the implementation of these frameworks with the evidence of other countries that have set up these frameworks (particularly, countries in Africa and in the Organisation for Economic Cooperation and Development, OECD). Finally, the cases of Argentina, Colombia and Peru are studied and presented in detail. Although it is not possible to establish an unambiguous diagnosis, this document lays the groundwork that should help to advance towards the consolidation of the MTFs in the region.

### ***The Medium-Term Frameworks***

Medium-term frameworks are institutional tools aimed at extending the planning horizon of public policies beyond the annual budget schedule. The cornerstone

of the MTFs are the macroeconomic projections, which increase the transparency of fiscal policy and the predictability of financial flows. This information helps to establish expenditure levels compatible with the level of indebtedness and the resources in the economy over the medium term.

Although the application of MTFs in developing countries is relatively recent, they are rooted in the Public Investment Programs (developed mainly for infrastructure investments financed by international agencies) and, even, in the more famous “development plans.” The level of depth with which the MTF is promoted and the types of projections included determine the type of framework that is used (Oxford Policy Management, 2000).

A framework with a smaller number of projections is called a medium-term fiscal framework (MTFF). It is usually limited to establishing fiscal policy objectives and presenting a set of projections and comprehensive goals in respect to macroeconomic and fiscal outcomes. Usually, the central variable of the analysis is the evolution of the public debt with respect to gross domestic product (GDP). In turn, other variables are considered in relation to the construction of this variable, such as the evolution of expenditures and government receipts, inflation, debt, and GDP.

Second in terms of the number of projections is the medium-term budget framework (MTBF or basic MTEF). This framework includes the projections in the MTF and adds medium-term expenditure estimates for individual administrative units. The objective is to provide some predictability to expenditures for the different units consistent with overall fiscal discipline. The projections that typify this approach are those that classify expenditures by purpose-function, sector, or ministry.

Finally, the medium-term expenditure framework (or expanded MTEF) is a broader instrument which adds elements of program- and results-based budgeting. This instrument is supposed to increase the efficiency of public spending. The MTEF can adopt different

2. The chapters in Hallerberg, Scartascini, and Stein (2009a) describe the situation in each country in South America.

**Table 5. Fiscal, budget and expenditure MTF**

|      |      |      |                                            |
|------|------|------|--------------------------------------------|
| MTEF | MTBF | MTFF | GDP Projections                            |
|      |      |      | Inflation Projections                      |
|      |      |      | Aggregate Expenditure Projections          |
|      |      |      | Aggregate Income Projections               |
|      |      |      | Expend. Projections by Administrative Unit |
|      |      |      | Expend. Projections by Function            |
|      |      |      | Disaggregated Income Projections           |
|      |      |      | Expend. Projections by Program             |
|      |      |      | Results Projections                        |

degrees of detail in its expenditure projections, up to the point that all of the classifications of the annual budget are replicated.

Table 5 shows what information is included in each of these modalities.

Another reason why the MTFs can affect fiscal results beyond those listed above (such as better planning) is because of their impact on budget institutions. Budget institutions are the set of standards, practices, and procedures according to which the budgets are prepared, approved, and implemented. Budget institutions influence the rules of the game within which the agents interact, either by imposing restrictions on the entire budget process, or by distributing power, responsibilities, and information among the different actors, therefore affecting the fiscal results (Von Hagen, 1992).

The literature has demonstrated that among the budget institutions that affect fiscal outcomes are numerical rules, such as limits on the deficit, the degree of hierarchy of decision-making authority—which measures if any agency has more power in the negotiations or if the relationship among agencies is more collegiate—and the degree of transparency (including what information must be made public and the form in which this is done) (Alesina *et al*, 1998; Filc and Scartascini, 2006). The MTFs influence these dimensions. First, they can strengthen or weaken compliance

with the numerical rules. Second, the mechanism used for defining goals may affect the degree of decision-making hierarchy (both within the national executive branch and among the different branches or levels of government). Finally, they affect the degree of transparency of the budget process. How much and how they affect each of these dimensions depends on the type of MTF.

### ***Typologies of the MTFs***

The MTFs may be classified according to a set of characteristics: degree of coverage, flexibility, recurrence or periodicity, and detail (European Commission, 2007).

- Degree of coverage. These instruments may cover all or part of the general or central government. In principle, the broader their coverage, the better the results will be (IMF, 2001). Lower levels of coverage can work against both planning capacity and sustainability. Its effects on the degree of hierarchy of decisions are relatively direct in the vertical dimension: lower levels of coverage will imply less capacity of the national government to influence the decision-making of sub-national governments.
- Flexibility. Flexible MTFs allow revisions of the objectives each year. By contrast, in fixed MTFs the most important budget objectives are set only once

and are formulated around a projection of total expenditures that cannot be changed except in the case of significant shocks (for example, a serious recession or a change of government). By construction, the fixed MTFs link the annual budget with the multiannual budget. To the extent that this is the case, the degree of hierarchy of decision-making increases as the framework gets closer to being a pure fixed model.

- Recurrence or periodicity. Periodic frameworks cover a finite time period and are not reviewed, except in emergencies, until the period is completed. Usually, they are linked to the government period and emphasize planning over the search for sustainability (similar to the old development plans). Conversely, recurrent frameworks are reviewed annually. In each review estimates for a new year are added.
- Level of detail of medium-term expenditure and income projections. The degree of detail of the estimates (by program, function, etc.) is what allows the medium-term frameworks to be classified in their three general types: fiscal, budget, and expenditure.

### ***Objectives of the MTFs***

The three major objectives sought by medium-term frameworks are macro-fiscal discipline and stability, strategic allocation of resources (allocation efficiency), and technical efficiency (reduce the waste of resources). Macro-fiscal stability can be classified as a macro level objective, while the other two can be classified as micro level objectives (UNDP, 2007).

The MTFFs may have their greatest impact on macro-fiscal stability, granting greater credibility to budget decisions and increasing the transparency of the future outlook of public finances for all economic agents. In the absence of a MTF it is not possible to take into account the long-term results of current political and expenditure decisions. In addition, they may affect technical and allocation efficiency by granting greater predictability to the annual budget cycles.

Since they entail a broader range of projections, MTBFs and MTEFs are aimed at improving both

technical efficiency and the strategic allocation of expenditures. Through better linkage between policies and expenditures, these frameworks facilitate a better allocation of inter- and intra-sectoral resources, provide greater budget predictability to the spending ministries, and encourage strategic planning within the institutions.

The implementation of MTEFs especially improves technical efficiency because these frameworks facilitate oversight and control of programs and projects that take several years to be completed. In turn, these frameworks facilitate greater rationality in budget decisions since the changes that are proposed must be explained with respect to the known current budget estimates and the commitments made.

### ***Stages in the development of the MTFs***

In order for medium-term frameworks to gain the support and compliance of those who make policies, their development should include opportunities for interaction between the leading unit of the expenditure framework and the executing units to promote coordination between planning and budgeting. Thus, their design has to be based in stages that combine the determination of the ceilings “from the top down” and the establishment of priorities “from the bottom up”. According to Le Houerou and Talercio (2002), the stages can be characterized as follows:

- Stage 1. Development of a macroeconomic/fiscal framework: designed based on a model that makes medium-term income and expenditures projections.
- Stage 2. Development of sectoral programs: agreements are reached concerning sector objectives, products, and activities. Existing programs are reviewed and new ones are developed. The cost of the programs is estimated.
- Stage 3. Development of sectoral expenditure frameworks: inter and intra-sectoral *trade-offs*. Development of consensus concerning the strategic allocation of resources.
- Stage 4. Definition of sectoral allocation of resources: determination of medium-term sectoral budget ceilings (approved by the cabinet).

- Stage 5. Preparation of sectoral budgets: medium-term sectoral programs based on the budget ceilings.
- Stage 6. Final political approval: presentation of budget estimations to the cabinet and parliament for approval.

### *Desirable features in MTFs*

Although the objectives and the stages that should be included are obvious, the set of desirable features that the frameworks should have varies across countries, depending on their capacities and budget needs as well as the political context in which they are applied. Despite this, experience suggests that a minimum set of features is desirable.

First, the frameworks should cover the entire general government in order to take into account the medium-term impact of political decisions on the budget. In some cases, sub-national government and public enterprise expenditures represent a considerable share of total public spending. Thus, the possibility of forecasting the public sector's impact on the economy over the medium term diminishes if they are not included.

Second, ideally they should coordinate the actions of the national government and sub-national governments. MTF's potential as a planning tool is reduced if the different government levels that are involved in a particular public policy sector are not included.

Third, medium-term fiscal goals should have a high level of political commitment to have credibility. Without the support of decision-makers to comply with the provisions, the frameworks will not be able to increase predictability or solve collective action problems. For example, while in the OECD countries the role of the legislative branch is essential given its responsibilities in the approval of the MTFs, in Latin America it does not play such an important role. In turn, a key factor for the credibility of the goals lies in the transparency of the projections (Oxford Policy Management, 2000).

Fourth, the projections should be conservative since an overestimation of GDP and of available resources to finance the expenditures of the government may create ex ante pressure to increase multi-year expenditure

plans. This risk may be strengthened by the fact that spending ministers may consider the projections as a vested right, thus making it very difficult to negotiate reductions in expenditures later on. A possible alternative for avoiding revenue overestimations is the implementation of "a safety margin," either through an automatic downward adjustment of the macro assumptions, or through the incorporation of contingent reserves in the budget that can be activated only in the event of unexpected expenditures resulting from shocks (European Commission, 2007). The use of prudent factors is being applied in countries such as Canada and the Netherlands. In the case of Canada, the projections are based on an exercise with the private sector consisting of subtracting an amount allocated to a contingency fund and an amount stipulated by a factor of economic prudence to the average projections of the private sector. The annual budget process must be strongly related to the medium-term frameworks in such a way that the multi-year goals set in these frameworks become the basis from which the budget is prepared.

Moreover, although expenditure projections should not be regarded as vested rights by the different agencies (Holmes and Evans, 2003), the MTF must have a clear link with the annual process. That is, while the annual budget should not be automatically prepared based on the multiannual budget, the latter should really be taken into account when preparing the former. The objective of the projections in the frameworks is to establish a series of possibilities given the existing and potential policies and the estimated macroeconomic context. Under adequate conditions, these can become the baseline for a new programming period (Allen and Tommasi, 2001). Unlike what is observed in the case of a multiyear budget such as the 5-year budget of Uruguay, MTFs preserve the annual budget system. By not establishing legal obligations for the future, the projections have enough flexibility to be adapted in response to a changing economic environment (Moreno, 2005).

Finally, there should be virtuous feedback between the MTFs and the political process of formulating the budget. On the one hand, for its proper operation it is key that the finance ministries regard it as a fundamental tool

and promote its use and management in the spending ministries, particularly by their political directors. This, in turn, requires that the spending ministers see some benefit in using the framework. Budget reforms are sustainable only if the key actors that participate in the process can observe their benefits fairly quickly. In this case, one of the most obvious benefits for the spending ministers is the increase in the predictability of the flow of funds (Oxford Policy Management, 2000).

After identifying the desirable characteristics of the frameworks, it is useful to compare them with other similar instruments, such as “development plans.” These plans, used by many developing countries during the 1960s and 1970s, consisted of from four-to six-year plans aimed at defining and implementing medium-term economic and social objectives. However, the fact that they had fixed time horizons and were prepared in each government period often made them not very realistic and not sufficiently flexible to incorporate changes in the economic framework. Thus the assumed perspective was static, valid for just a specific period, and usually defined outside the budget process, without much commitment in terms of fiscal discipline (Schiavo-Campo *et al.*, 1999). On the other hand, the MTFs involve a continuous, encompassing, and disciplined process that promotes the review of the prioritization of expenditures in the context of a dynamic of evaluation, adjustment, and constant updating of information.

### ***The MTFs and the Budget Process***

As mentioned in the introduction, the budget process plays a key role in the development and feasibility of public policies. On the one hand, it is the space where decisions are made regarding how much and to what ends public resources are allocated. On the other hand, since most public policies have a budget component, it is an opportunity to negotiate and agree upon public policies. Thus, the MTFs have an impact on the way in which the different actors interact in the annual budget process. Since it affects the rules of the latter, it can have an impact on both the balance of power and the nature of feasible exchanges.

Experience has shown that the best outcomes are achieved when the financing stage is controlled by the Ministry of Finance and the planning stage by the spending ministries. These processes have to be permeable to receiving information and guidelines but in an institutionalized arena in which consensus can be reached. It is essential, therefore, that the medium-term framework is not turned into a tool to limit the political discussion concerning the distribution of resources (it is more likely for this to occur in the case of the MTFFs). It should establish the channels to achieve better results. In this regard, it may also be valuable to use the MTEF or the MTBF to open the public policy decision-making process to community stakeholders. Uganda and Tanzania, for example, have used these instruments for this purpose.

Another political institutional factor that may affect the operation of the MTF is the division of responsibilities within the executive branch. Based on the experience in African countries, it is necessary to design adequate institutional arrangements to develop a correct interrelationship between the planning and budget agencies.

The countries that have promoted the decentralization of public expenditures present a greater challenge to the MTEF. This challenge has two dimensions. On the one hand, the impact can be of a budgetary nature, since decentralization potentially takes away the effectiveness of the MTEF. On the other hand, the implementation of this instrument may be used by the central government as a means to limit the powers of sub-national governments.

Finally, the medium-term frameworks can influence the budget process since they help to address the problem (or tragedy) of common resources. The problem of common resources occurs when public goods, or transfers, that have particular beneficiaries are financed from the general revenues of the government. The fact that those that benefit from the expenditures only pay a fraction of their cost leads to greater expenditures than those that would be agreed to based on a decentralized mechanism in which each group has to pay for the provision of its public goods. By explicitly indicating the future consequences (for example, payment of debt services) on the cash flow

available to the different sectors, the MTF helps to change the focus of the discussion from the total amount of government expenditure to the possibilities for real-locating expenditures in a given period.

### ***The MTFs and the features of the budget***

Given that they can affect the way actors interact, medium-term frameworks have various effects on certain central features of the budget process. The possibility that the “tragedy of the commons” may be mitigated could improve sustainability. Coordination of financing and planning activities could lead to an advance in efficiency. Finally, this division of responsibilities can potentially have a positive effect on representativeness. We will now briefly examine some of these features.

- **Sustainability.** The MTFs contribute to a better inter-temporal management of fiscal policy. This occurs for two reasons. In the first place, the existence of a developed MTF makes it more difficult for the governments to conceal or underestimate the multi-year effect of new measures. Second, a well-defined MTF forces the fiscal authorities to commit themselves to a predefined evolution of the principal aggregate public finance variables (Filc and Scartascini 2005).
- **Efficiency.** The frameworks can improve efficiency in two ways. In the first place, greater predictability favors more efficient expenditure programming. Secondly, the MTEFs and MTFFs that are aimed at establishing a linkage between planning and budgeting allow periodic evaluation of the allocation of resources toward the achievement of goals. The possibility of improving efficiency through this channel increases if the frameworks are integrated with a results-based budgeting system. However, according to the case studies of developing countries, improvements in the cost of programs and policies are more difficult to achieve. Achieving them, requires information resulting from the active participation not only of the spending ministries but also a developed technical capability.
- **Representativeness.** Its results are not evident. It depends both on whether it is a MTFF or a MTEF

and on its particular design, especially the role given to the congress, the spending ministries, and the community stakeholders in the multiannual process. Since the objective of the MTFFs is to improve fiscal results, they usually tend to concentrate decision-making power in the finance ministry, which *a priori* diminishes representativeness. The presence in the case of the MTBF and MTEF of collegiate entities in which sectoral ceilings are discussed has the potential to increase budget representativeness. This possibility is strengthened if planning is participatory and open to civil society stakeholders.

## **International Experience**

### ***The experience of the developed countries***

Multiannual budgeting mechanisms in the developed countries are long-standing. The implementation of programming processes and medium-term expenditure projections started in OECD member countries between the 1960s and 1970s. Some illustrative cases are those of Germany, the United Kingdom, and Australia. In Germany, in 1969, the Budget Principles Law mandated that the federal government carry out a multiannual framework. In the United Kingdom, since 1980 there has been a multiannual framework called the Medium-Term Financing Strategy. In Australia, after a failed attempt in the 1970s, one of the most successful MTEF was implemented in 1982.

Although at first these tools were aimed at identifying policy alternatives and their financing, this situation changed in the mid-1980s. In a scenario in which the medium-term projections reflected a list of needs based on different sectoral interests, changes in the economic context forced a rethinking of the use of the MTF. From this moment on, it began to be used to gain control of future expenditures (Allen *et al.*, 2001).

The adoption of fiscal goals within the framework of the Treaty of Maastricht gave a new impetus to this tool in the countries belonging to the European Union since it was believed that an adequate MTEF could facilitate

compliance with the budget goals required for compliance with the treaty. In this context, it is not surprising that, as shown in Table 6, there are few countries within the European Union that do not have a medium-term expenditure framework.

The frameworks adopted by the countries belonging to the European Union have many points in common in their design. Most of them place an emphasis on transparency, their time horizon is similar (except Latvia, which is five years, all frameworks cover a period of three or four years), and finally, except in the case of Holland, all frameworks are recurrent (Table 7). The differences are more notable in the degree of coverage. In 14 countries, the framework totally covers the general government. In the Netherlands and Sweden, the MTEF covers the central government and social security. In Ireland, it covers the central government and local governments, while in the remaining three it covers only the central government (Table 6).

### *The experience in developing countries*

One of the main incentives for the implementation of MTFs in developing countries has been to find an instrument that improves the relationship between planning and budgeting but without the characteristic deficiencies of medium-term development plans (Shack, 2008). An intermediate instrument between the two are the revolving public investment plans known as PIPs (Public Investment Programs) that were implemented in countries with high dependence on international assistance. The World Bank, one of the principal advocates of such an instrument, was the actor that supported the implementation of the MTFF in Africa to resolve poor budget outcomes that resulted from the inadequate connection between policies, planning, and budgeting (World Bank, 1998).

In that context, the second half of the 1990s witnessed the emergence of different MTEF experiences in developing countries. According to a World Bank report (2001), at the beginning of the century there were 25 countries in Africa, Asia, Latin America, and Eastern Europe in different stages of implementing or adopting

a MTEF while ten more were considering adopting one. The introduction of the frameworks occurred in a short period of time. Of the existing cases in 2001, 90% had been implemented in the four previous years.

### *What have we learned so far?*

#### *CAPACITY AND DEPTH*

The experience of developing countries shows that, at least at first, the use of a limited MTEF (MTBF) is advisable. Implementing the broader MTEF requires the management of technical and human resources that often are outside the scope of developing countries. This effort can be counterproductive, because it diverts these resources from more productive uses. For those countries with greater capacities, the MTEF has potential advantages because it provides a perspective of results-based budgeting.

#### *COVERAGE*

The study of these experiences highlights other aspects of the implementation of fiscal frameworks. First, it is important that the fiscal framework, in any of its three versions, be as broad as possible. That is, it should not leave out expenditures of other levels of government, or extra-budget funds or quasi-fiscal activities. Second, it is advisable for only one administrative unit to coordinate all aspects of the budget. It is also suggested that this unit publish a document centered on the MTEF in which both the fiscal goals and the priorities and sectoral policies are discussed. To do this, the work of the spending sectors in the development of strategic approaches that also include community stakeholders is important (Holmes and Evans, 2003).

#### *RESULTS*

The experience in European countries and in the rest of the OECD suggests that the MTEFs improve budget processes and outcomes through various channels. In the first place, they delimit policy objectives. Secondly, they achieve greater predictability in budget allocations. Finally, they facilitate greater transparency in the use of resources.

**Table 6: Characteristics of the MTEFs in the European Union, part 1**

|                | When are medium-term budget objectives established and reviewed? |                   |       |            | Framework Coverage    |               |              |                 |
|----------------|------------------------------------------------------------------|-------------------|-------|------------|-----------------------|---------------|--------------|-----------------|
|                | Annually                                                         | With Gov't Change | Other | Don't have | All the general Gov't | Central Gov't | Local Gov'ts | Social security |
| Germany        | X                                                                |                   |       |            |                       | X             |              |                 |
| Austria        | X                                                                |                   |       |            | X                     |               |              |                 |
| Belgium        |                                                                  |                   |       |            | X                     |               |              |                 |
| Bulgaria       | X                                                                |                   |       |            | X                     |               |              |                 |
| Cyprus         |                                                                  |                   |       | X          |                       |               |              |                 |
| Denmark        | X                                                                |                   |       |            | X                     |               |              |                 |
| Slovakia       |                                                                  | X                 |       |            | X                     |               |              |                 |
| Slovenia       | X                                                                |                   |       |            | X                     |               |              |                 |
| Spain          | X                                                                |                   |       |            | X                     |               |              |                 |
| Estonia        | X                                                                |                   |       |            | X                     |               |              |                 |
| Finland        |                                                                  | X                 |       |            |                       | X             |              |                 |
| France         | X                                                                |                   |       |            | X                     |               |              |                 |
| Greece         |                                                                  |                   |       | X          |                       |               |              |                 |
| Netherlands    |                                                                  | X                 |       |            |                       | X             |              | X               |
| Hungary        |                                                                  |                   |       | X          |                       |               |              |                 |
| Ireland        | X                                                                |                   |       |            |                       | X             | X            |                 |
| Italy          | X                                                                |                   |       |            | X                     |               |              |                 |
| Latvia         | X                                                                |                   |       |            |                       | X             |              |                 |
| Lithuania      | X                                                                |                   |       |            | X                     |               |              |                 |
| Luxemburg      |                                                                  |                   |       | X          |                       |               |              |                 |
| Malta          | X                                                                |                   |       |            | X                     |               |              |                 |
| Poland         | X                                                                |                   |       |            | X                     |               |              |                 |
| Portugal       |                                                                  |                   |       | X          |                       |               |              |                 |
| United Kingdom |                                                                  |                   | X     |            | X                     |               |              |                 |
| Czech Republic |                                                                  |                   | X     |            | X                     |               |              |                 |
| Romania        |                                                                  |                   |       | X          |                       |               |              |                 |
| Sweden         |                                                                  |                   | X     |            | X                     |               |              |                 |
|                | 14                                                               | 3                 | 3     | 6          | 16                    | 5             | 1            | 1               |

Source: Authors' compilation based on data from the European Commission (2007).

**Table 7: Characteristics of the MTEFs in the European Union, part 2**

|                | Period covered by the MTEF | How are multiannual goals incorporated in the formulation of the budget? |                 |       |
|----------------|----------------------------|--------------------------------------------------------------------------|-----------------|-------|
|                |                            | Fully complied with                                                      | Serves as basis | Other |
| Germany        | 4                          |                                                                          | X               |       |
| Austria        | 4                          |                                                                          | X               |       |
| Belgium        | 4                          |                                                                          |                 |       |
| Bulgaria       | 3                          |                                                                          | X               |       |
| Cyprus         | No MTEF                    |                                                                          |                 |       |
| Denmark        | 4                          |                                                                          |                 | X     |
| Slovakia       | 3                          | X                                                                        |                 |       |
| Slovenia       | 3                          |                                                                          | X               |       |
| Spain          | 3                          | X                                                                        |                 |       |
| Estonia        | 4                          | X                                                                        |                 |       |
| Finland        | 4                          |                                                                          | X               |       |
| France         | 3                          |                                                                          | X               |       |
| Greece         | No MTEF                    |                                                                          |                 |       |
| Netherlands    | 4                          |                                                                          | X               |       |
| Hungary        | No MTEF                    |                                                                          |                 |       |
| Ireland        | 5                          |                                                                          | X               |       |
| Italy          | 3                          | X                                                                        |                 |       |
| Latvia         | 5                          |                                                                          | X               |       |
| Lithuania      | 2                          |                                                                          | X               |       |
| Luxemburg      | No MTEF                    |                                                                          |                 |       |
| Malta          | 3                          | X                                                                        |                 |       |
| Poland         | 3                          |                                                                          | X               |       |
| Portugal       | No MTEF                    |                                                                          |                 |       |
| United Kingdom | Other                      |                                                                          | X               |       |
| Czech Republic | 3                          | X                                                                        |                 |       |
| Romania        | No MTEF                    |                                                                          |                 |       |
| Sweden         | 3                          |                                                                          | X               |       |
|                |                            | 6                                                                        | 13              | 1     |

Source: Authors' elaboration based on data from the European Commission (2007).

**AMBITION**

The expected goals are not always met. In two-thirds of the cases, improvement of the government's fiscal balance was less pronounced than projected in the goals, particularly in those cases where growth was lower than estimated. The evidence suggests that MTFs do not provide magical solutions with regard to fiscal sustainability since there is a statistically significant relationship between the degree of ambition of the MTF in terms of the extent of reduction it aims for, GDP and their degree of compliance (European Commission, 2007).

**IMPLEMENTATION**

Another lesson from the experience of developed countries is that a certain degree of fiscal balance needs to have been obtained before large benefits are sought from the MTF (IMF, 1999). Otherwise, fiscal imbalances can affect the predictability of financing flows. However, it may also happen that in those countries with sustainability problems, the MTEF can help improve the budget process if the projections are made with honesty and realism (Holmes and Evans, 2003).

**STRATEGIC USE**

The strategic use of the projections, a mechanism usually used to increase the discretion of the executive branch over the budget, is a clear example of practices that undermine the positive effects of the MTFs because it takes credibility away from the projections (Hallerberg, Scartascini and Stein, 2009a; Jonung and Larch, 2006). Furthermore, if discretionary use of projections is done to reduce the space of other actors it will always be difficult for efforts linking planning with budgeting to succeed.

**POLITICAL CONTEXT**

Another relationship that emerges from the analysis of the cases of the European Union, is the one between the

results of the MTF and political institutions. Theoretical arguments of various authors that a medium-term approach to the budget process is particularly advisable in countries with ideologically diverse coalitions are verified in practice. What this relationship implies is that in these countries, where each party of the coalition must deliver to its electoral base, the problem of common resources can be exacerbated and generate larger deficits (European Commission, 2007).

***The Situation in Latin America***

The experience in Latin America is more recent. Various countries implemented a MTFF at the beginning of this decade, in many cases accompanied by fiscal responsibility laws (Filc and Scartascini, 2007). In this region, unlike what is observed in Africa, the panorama is not only heterogeneous with respect to the degree of depth of the medium-term fiscal frameworks, but also displays differences in the focus of the multiannual approach adopted. That is, there are not only cases in which MTFF or MTEF have been adopted, but differences are observed concerning their relationship to the annual budget, as in the Uruguayan case, or in regard to dynamic by which it is updated, as in the cases of Brazil, Venezuela, and Uruguay. It should be noted that the Uruguayan case is not only unique in this regard, but is also one of the first developing countries to have adopted the MTF.

The differences in the degree of depth (the first dimension of classification) can be observed in Table 8.

Below, the characteristics of the frameworks are explored in greater detail, country by country. The order used is the degree of depth of implementation, depending on whether they have a MTFF, MTBF, or MTEF.<sup>3</sup>

A first group are those countries that have implemented the MTFF in its most basic form. That is, they

3. For the preparation of this section the following sources were used, among others: Surveys of Open Budget Initiative (2006); Organic Law of Budget System of Venezuela; Organic Law of the Financial Management of the Public Sector; United Nations Development Program (UNDP), (2007); Resolution N.º 616 of the Ministry of Finance of Paraguay; Organic Law of Fiscal Responsibility, Stabilization, and Transparency of Ecuador; Public Finance Report: Draft legislation of Public Sector Budgets 2008 of Chile; Shack (2008); Law of Fiscal Responsibility of Brazil; Pares (2007); Federal System of Fiscal Responsibility of Argentina; Law of Fiscal Solvency of Argentina; Multi-Year Macroeconomic Frameworks of Peru; Medium-term Expenditure Frameworks of Colombia; Medium-term Fiscal Frameworks of Colombia; Law of Fiscal Responsibility of Colombia; General Criteria for Economic Policy (2008) of Mexico; Multiannual Plan of Brazil; Medium-term Budget Framework of Nicaragua; Multiannual Budget of Honduras; Multiannual Budget of Guatemala.

Table 8. Degree of depth of the MTF in Latin America

| Countries              | MTF                          |                       |                                 |                                 |                                                |                                     |                                   |                                    |                     |
|------------------------|------------------------------|-----------------------|---------------------------------|---------------------------------|------------------------------------------------|-------------------------------------|-----------------------------------|------------------------------------|---------------------|
|                        | MTFF                         |                       |                                 |                                 | MTBF                                           |                                     |                                   |                                    |                     |
|                        | GDP Projections <sup>5</sup> | Inflation Projections | Aggregated Spending Projections | Aggregated Revenues Projections | Expenditure by Administrative Unit Projections | Expenditure by Function Projections | Dissaggregated Income Projections | Expenditure by Program Projections | Results Projections |
| Argentina <sup>1</sup> | x                            | x                     | x                               | x                               | x                                              | x                                   | x                                 | x                                  | x                   |
| Bolivia                |                              |                       |                                 |                                 |                                                |                                     |                                   |                                    |                     |
| Brazil                 | x                            | x                     | x                               | x                               | x                                              | x                                   | x                                 | x                                  | x                   |
| Colombia               | x                            | x                     | x                               | x                               | x                                              | x                                   |                                   |                                    |                     |
| Costa Rica             |                              |                       |                                 |                                 |                                                |                                     |                                   |                                    |                     |
| Chile <sup>2</sup>     | x                            | x                     | x                               | x                               |                                                |                                     | x                                 |                                    |                     |
| Dominican Rep.         |                              |                       |                                 |                                 |                                                |                                     |                                   |                                    |                     |
| Ecuador                |                              |                       |                                 |                                 |                                                |                                     |                                   |                                    | x                   |
| El Salvador            |                              |                       |                                 |                                 |                                                |                                     |                                   |                                    |                     |
| Guatemala              | x                            | x                     | x                               | x                               | x                                              |                                     | x                                 |                                    |                     |
| Nicaragua              | x                            | x                     | x                               | x                               | x                                              | x                                   | x                                 | x                                  | x                   |
| Mexico <sup>3</sup>    | x                            | x                     | x                               | x                               |                                                |                                     | x                                 |                                    |                     |
| Honduras               | x                            | x                     | x                               | x                               | x                                              | x                                   | x                                 | x                                  |                     |
| Panama                 |                              |                       |                                 |                                 |                                                |                                     |                                   |                                    |                     |
| Paraguay               | x                            | x                     | x                               | x                               | x                                              | x                                   |                                   |                                    |                     |
| Peru <sup>4</sup>      | x                            | x                     | x                               | x                               |                                                |                                     |                                   |                                    |                     |
| Uruguay                | x                            | x                     | x                               | x                               | x                                              | x                                   | x                                 |                                    |                     |
| Venezuela              | x                            | x                     | x                               | x                               |                                                |                                     |                                   |                                    |                     |

Source: Own preparation.

1. The projections of expenditure by program and result are pilot experiences.

2. Expenditure projections are made by economic classification.

3. With regard to programs, projection is based on a static perspective and only for those sectors related to production.

4. Peru has multi-year sectoral frameworks, some of which carry out financial projections of the expenditure for four years but not as part of an encompassing medium-term expenditure framework.

5. If they are made outside a multiannual budget framework they are not taken into account.

have multiannual information in respect to macroeconomic variables.

In Chile, based on the reform of the Financial Management Law, the Ministry of Finance was mandated to develop a medium-term fiscal framework. Currently, a financial projection of the public sector

for a period of four years is presented in the draft legislation of Public Sector Budgets prepared by the Finance Ministry, which has been made public since 2000. It includes macroeconomic<sup>4</sup> assumptions, income classified as budgetary and extra-budgetary, and lastly, expenditures, also classified as budgetary and extra-budgetary.

4. GDP (real variation rate and GDP growth trend); real variation rate of internal demand; inflation; exchange rate; copper price; molybdenum price.

Finally, it presents the projection of the budget balance of the consolidated central government, which incorporates the provision for the fulfillment of the goal of obtaining a structural fiscal surplus of 0.5% of GDP. The coverage of this framework encompasses the consolidated central government. Its objective is basically related with anticipating allowances or restrictions with current legislation and commitments in order to adopt preventive measures that allows expenditure levels compatible with fiscal policy rules to be maintained. It is prepared in a revolving annual time horizon.

In Peru, the multiannual macroeconomic framework is framed within the scheme established in the Fiscal Responsibility and Transparency Law. The goal is to increase transparency as well as to frame the budget within the economic policy of the government. Budget and non-budget expenditures and income projections are included. At the same time, the framework presents projections for macroeconomic variables as well as for fiscal results. Both the limited scheme and its relation to the Fiscal Responsibility Law establish a scenario in which the framework is oriented toward facilitating compliance with the fiscal rule.

The case of Ecuador is unique and difficult to classify. The institutions submit an Institutional Multiannual Plan (IMP) in which the multiannual budget for different activities must be included. However, as in the Peruvian case, they are not part of a comprehensive and consolidated medium-term budgeting system. These plans include the description of the vision and mission of the institution as well as its functions and principal operations. The multiannual plans for the different institutions must be framed within the multiannual plan of the national government.

This multiannual plan, which is considered static it is not recalculated with the same time horizon each year, since the plan coincides with the beginning of

the presidential term, establishes the objectives and the medium-term strategic goals. This document, which is submitted to the congress, does not specify a financing dimension establishing the needs for medium-term expenditure even though its purpose is to guide expenditure and public investment decisions (Organic Law of Fiscal Responsibility, Stabilization, and Transparency No. 2002-72). It should be noted that the monitoring of the multiannual plan of the government and of the budget is carried out by different entities.

In Mexico, the multiannual framework is presented in the rationale for the Draft Budget Law as the projected evolution of the economy and of public finances in the medium term or a time period of six years. It includes projections of macroeconomic variables,<sup>5</sup> of budget revenues classified according to those that are oil and not oil-related, of expenditures broken down into the categories salaries and wages, pensions, subsidies and transfers, capital expenditure. Finally, it also includes projections of the economic balance and the net debt. It should be pointed out that unlike other cases the expenditures are not presented as current values but as a share of GDP.

Forecasts of economic and GDP growth, as well as the financial requirements of the public sector are developed in the General Criteria for Economic Policy (also as a percentage of GDP). Only for certain expenditure categories and investment expenditure were multi-year forecasts provided as established in the law following approval of the Finance Reform.

According to its regulatory framework, the MTF in Venezuela combines characteristics related to fiscal stability and to planning. The Multiannual Budget Framework (MBF) has a fixed time horizon of three years which does not coincide with the presidential period.<sup>6</sup> This document is prepared through the joint effort of the Ministry of Finance, the Ministry of Planning and

5. Real variation of GDP, inflation, interest rates, the current account, aggregate supply (GDP and imports), aggregate demand (consumption, gross capital formation and exports).

6. The national executive branch, through the Minister of Finance, will present to the National Assembly the draft legislation of the multiannual budget framework, before July 15<sup>th</sup> of the first and the fourth year of the constitutional period of the Presidency of the Republic, and this will be approved before August 15 of the same year of its presentation.

Development, and the Central Bank. The MBF includes the economic policy objectives, the medium-term macroeconomic assumptions,<sup>7</sup> the limits of expenditure and indebtedness for the annual budgets of the period, the objectives of long-term fiscal policy, and the general guidelines for the formulation of the budget. According to the regulatory framework (Constitution and Organic Law of the Budget Financial Management), the macro-fiscal rules are directly related to the medium-term fiscal framework, while they are defined with respect to the period of effectiveness of the multiannual budget framework.<sup>8</sup>

A second group of countries promoted medium-term budget frameworks (MTBF). This limited version of the medium-term expenditure framework (MTEF), also presents projections for expenditure by function or economic classification.

In Guatemala, a multiannual budget has been included in the budget documents submitted to congress since 2003. In 2006, a strategic vision that takes into account the medium-term goals drafted by the ministries in their multi-year plans was incorporated. The Multiannual Budget (MB) is included in compliance with the Organic Law of the Budget. The MB contains estimations of the revenue and expenditure fiscal aggregates for the following three years. The document prepared by the Ministry of Finance of Guatemala includes projections of institutional and sectoral expenditures (a classification which differs from the classical functional classification), GDP, inflation, exports and imports, as well as revenues classified by type of tax.

According to the current regulatory framework, the preparation process is divided into two stages. During the first stage, the medium-term macroeconomic framework that serves as the basis for the revenue estimation and expenditure ceilings for the period is defined. In the second stage, the administrative entities formulate their respective provisional drafts of the multiannual budget based on their allocated expenditure limits.

Since 2006, Colombia also has had a MTBF with a revolving time horizon of four years. Along with the medium-term expenditure framework presented with the Draft Budget Legislation, projections of fiscal balances, expenditure ceilings by administrative unit, and an explanation of the differences relative to the previous medium-term expenditure framework are published.

The last group of countries opted for the broader MTEF scheme in which expenditure projections by program are also included.

In Nicaragua, starting in 2006, a medium-term budget framework has been prepared that covers various macroeconomic aggregates and the consolidated operations of the public sector and of the principal government agencies in a revolving time horizon of three years. Pursuant with what is stipulated in the Law of Financial Management and Budget Regime, the formulation, approval, and execution of the budget must be linked to the National Development Plan (NDP), the medium-term budget framework, and the Public Investments Program, among other policy instruments. Included in the MTBF are macroeconomic aggregates and consolidated operations of the public sector and of the principal government agencies.

The medium-term expenditure framework of Brazil is probably the most developed and stands out also for the predominant role that planning plays. The budget of the federal government that is effective for one year is formally linked with the planning system which comprises four years, known as *Plano Brasil*. This plan is approved by law at the beginning of each presidential period. The instrument that bridges the plan and the annual budget is called Budget Directives, which is a law that is passed for each new fiscal year.

In the Brazilian budget context there are, thus, three planning horizons. The first one is a long-term indicative stage (eight years). Next is a programming stage that entails the preparation of the four-year multiannual budget (MB) in which the allocation of budget resources is

7. The projections included are: PDVSA exports, the price of oil for export, GDP variation, inflation, tax revenues, primary expenditures, current expenditures, capital expenditures, and debt evolution.

8. The multiannual framework of the last period (2008-2010) presented to the National Assembly is not available on the Internet, which could threaten its transparency if not resolved.

defined by programs and activities in accordance with the goals of the government. Revenue projections, macroeconomic variables, and fiscal results are also established in this framework (estimations for sub-national governments are also included), in addition to the annual budget.

Some characteristics of the MB differ from the traditional MTF which reveal an attempt to link planning to budgeting. The classification of financing is clearly focused on the programs and their goals. The global amount is consistent with the revenue projections and the fiscal goals for the period (for example, in MB 2004-2007 the goal was to maintain a primary surplus of 4.25% of GDP each year). The aim to address planning is clear in that programs are classified under macro-objectives and these, in turn, are categorized into mega-objectives within a hierarchical framework.

However, the ambitious approach integrating plans and budgets under the orbit of the Ministry of Planning, has yet to yield all of the expected results. With respect to fiscal prudence in particular, the results of the Brazilian experience have not been as successful as expected (Gómez and Martínez-Vázquez, 2008).

In Paraguay, Decree No. 8,215 of 2006 granted the ministry of finance the task of formulating the Referential Multiannual Budget. This multiannual budget has a revolving time horizon of three years and encompasses the general government. The document includes revenue and expenditure projections as a percentage of GDP within the scheme of savings-investment-financing, macroeconomic variables (GDP, inflation, and exchange rate), and expenditure by function, institution, and broad social goals.

In Honduras, as in Nicaragua, the influence of the Poverty Reduction Strategy and international assistance associated with it laid the foundation for the implementation of a MTEF. As a result, since 2003 the budget proposal sent by the executive branch to the congress includes an annex with a multi-year budget with information on the projected evolution of fiscal aggregates for the following three years. Although it includes not only macro projections but also projections of expenditures by programs, to date, this budget has consisted basically in a projection of the data of the base year for

the fiscal year and three more years, assuming certain assumptions on the trends of specific expenditure categories (Acevedo, 2007).

Argentina has a three-year multiannual framework with a revolving time horizon that covers the general administration, decentralized entities and trust funds but does not mandate actions and is intended mainly as an information tool. It should be pointed out that most social spending is executed by the provinces, particularly education and health, and is consequently left out. The multi-year budget includes projections of macroeconomic variables, revenues, expenditures by objective and function, expenditures by administrative unit, and expenditures by program.

Although the regular budget in Uruguay has a multiannual nature, clarification is necessary. Its five-year budget coincides with the presidential term and does not have a specifically annual counterpart, thus differing from the large majority of MTEF experiences. In the first place, this particular scheme implies that it must be approved by the congress. Secondly, unlike other cases observed in Latin America, compliance is compulsory and its purpose is not mainly the provision of information. However, it can be modified. After one year, the record of budget execution is reported and a series of modifications are presented to the congress, which are subject to its approval. Since the MTEF is not considered to be a multiannual budgeting system that establishes legally binding expenditure allocations stretching out for several years, the multiannual budget in Uruguay would not be considered a MTEF.

The government of Costa Rica presented a MTEF for the first time for the 2008-2010 period containing projections for a three-year revolving time horizon of the principal revenue and expenditure categories of the budget. The multiannual budget is proposed as a guide for the medium-term fiscal policy of the state and is a frame of reference for the annual budget and the public investment plan.

Among the remaining countries, the Dominican Republic and Panama have already developed the legal framework that will guide the implementation of medium-term fiscal frameworks.

In the case of the Dominican Republic, in accordance with the Organic Law for the Public Sector Budget promulgated in 2006, during 2008 work was carried out to prepare a four-year multiannual budget for the non-financial public sector. The strategic guidelines of the Multiannual National Plan of the Public Sector must be consistent with the financial framework prepared by the Ministry of Finance for the same period. Although this medium-term framework will only be of an informative nature, the decree approved in 2007 that governs the Planning and Public Investment Law established as functions of the Governing Council to be knowledgeable about, debate, and make decisions in relation to this multiannual budget.

Panama is on the verge of approving a MTFF. In April 2008, the Finance, Planning, and Economic Policy Commission presented to the Plenary of the National Assembly the Draft Legislation of Fiscal Social Responsibility. This law has the characteristics of a fiscal responsibility law in which a MTFF is included. The draft legislation defines the compulsory nature of presenting a Government Strategic Plan at the beginning of each administration, which must include the Economic and Social Strategy, the five-year Financial Program, and the Public Investments Indicative Plan. The law covers all the entities of the public sector. Since this task is carried out at the beginning of each administration, the MTFF coincides with the government period and, as a result, has a fixed time horizon. The amendments to the Strategic Plan must be approved by the Cabinet Council. The macroeconomic assumptions will include, at least, the following variables: the rate of growth of GDP and annual inflation, measured by the Consumer Price Index; revenue and expenditure projections of the non-financial public sector; amount of public investment, and expected changes in the public debt level. The special feature of the Panamanian draft legislation is that the medium-term fiscal framework must contain, at the very least, a comparison of the programmed fiscal goals against the results achieved and, in the case of noncompliance with the expected goals, a detailed explanation of the reason or reasons for the non-compliance and the magnitude of the necessary fiscal adjustment to resume compliance with the fiscal goals.

## Case Studies

Understanding how the MTFs are working in LAC requires an in-depth understanding of the conditions of implementation, their characteristics, and evaluating as adequately as possible whether they are fulfilling their objectives. This section describes the MTFs in three countries and analyzes their effects on the budget process. The cases have been selected so that each of the different MTF types is covered.

### *The MTF in Colombia*

#### *DESCRIPTION*

The MTEF was introduced in Colombia at the time it passed its Fiscal Responsibility Law. After the fiscal crisis of the 1990s, Colombia reached an agreement with the International Monetary Fund (IMF) to implement various economic adjustments in expenditures, pensions, and fiscal rules. Among the last rules adopted within the framework of the fiscal responsibility law were the fiscal and medium-term expenditure frameworks.

The Medium-Term Fiscal Framework has a time horizon of ten years and a fundamental objective to reduce, and increase the sustainability of, the public debt. To this end, it sets primary surplus goals in line with goals for the debt and establishes GDP and revenue collection projections that determine expenditure ceilings. The goal that guides the MTFF is to reach a net debt level of 25% of GDP by 2018. In order to achieve this, a surplus of 2.5% is considered necessary, with GDP growth of 4.5%.

During the drafting of this document the macro discussion takes place, estimating the adjustments needed that are consistent with meeting the goal, taking into account inflation, unemployment, growth (productivity), and investment projections. The framework is prepared jointly by the Ministry of Finance and the National Planning Directorate which represents the sectors.

Preparation of the MTEF began in 2006. It has a time horizon of three years, is recurrent and sets expenditure goals for the different sectors. In its preparation

the primary surplus goals of the MTFF, as well as the data produced within each entity, are taken into account. This document provides the context for the budget discussion in respect to the spending under execution and compulsory transfers (for example, those stipulated in the Constitution) and debt service, which is a significant, rigid portion of the budget. It should be noted that the Fiscal Responsibility Law establishes firm restrictions on increasing current expenditures (with the exception of certain sectors, such as the Armed Forces, the Office of the Comptroller, and Audit). The rest of the discussion deals with the investment expenditure framework.

However, these are not the only medium-term planning instruments. There is a Government Plan that establishes sectoral goals for the presidential term. The sectors and the National Planning Directorate participate in establishing these goals, but the Ministry of Finance does not participate. The Government Plan has a financing section that encompasses all expenses that are not operational in nature (taking into account the MTFF) and a programming section. It includes sectoral plans prepared by each ministry. These sectoral plans must be adapted to the conditions imposed by three different processes: the Government Plan, the MTEF, and the long-term Sectoral Plans that have a ten-year time horizon. The latter establish general goals without including a financing facet. A noteworthy characteristic is that its preparation is the result of a collective process in which different sectoral actors participate (for example, those in education: unions, universities, NGOs, political parties, etcetera).

The existence of various parallel medium-term frameworks is not the only element of originality exhibited by the Colombian case. The budget is articulated on the basis of a classification that does not coincide with the notion of capital and current expenditure. On the one hand, the Ministry of Finance manages three quarters of the budget. This portion includes part of the current and operational expenditures such as acquisition of equipment, maintenance, and personnel, as well as debt service. On the other hand, the National

Planning Directorate manages investment spending, including that related to education programs, as well as health subsidies, military expenditure, fixed capital, and transfers to sub-national entities.

First, a medium-term budget programming circular is sent to the ministries with sectoral ceilings approved by the cabinet. Based on this circular, the sectors review their medium-term programs. Subsequently, the sectors submit a financing request that must be accompanied by an adjustment in the goals (although formally there is no direct linkage) if it surpasses the ceiling. At this time, the first filter for adapting the requests from the sectors to the MTEF is set in motion. Technical groups from the Ministry of Finance, the National Planning Directorate, and the different sectors meet to reconcile the financing requests.

The second filter consists of bilateral discussions between the Ministers of Finance and Planning, on the one hand, and the ministers of each sector, on the other. In this stage, an attempt is made to structure policy and program priorities. Finally, this is discussed again in the cabinet. At this point, the sectors typically gain strength. Usually the president supports the expenditure ministers particularly in certain strategic areas that he/she prioritizes, such as education. To this end, the ministers put into play the achievement of the goals of the development plan.

It should be pointed out that throughout this process the congress does not have the power to interfere. In fact, the MTEF and the MTFF are sent to the legislators for information purposes only, given that the congress does not have the power to modify or veto them.

What are the prevailing perceptions of the quality and timeliness of the social, physical and financial statistical information? The feeling one is left with is that the accounting system at the sub-national level is quite inefficient as well as the physical (actual) statistics. Also, according to the sources interviewed, the information “below the line” (for example, in the calculation of the pension debt) is deficient in various respects. Despite this, there is a general perception that the information systems have improved.

*PROJECTIONS*

As can be observed in Table 9, the macroeconomic projections of both GDP and inflation have been fairly accurate. The expenditure projections by sector were incorporated in 2007, which means that it is too early to evaluate them.

*THE BUDGET PROCESS*

The implementation of the medium-term fiscal and expenditure frameworks has generated changes in the budget process. It should be noted that the MTEF has not been in operation long enough to consider the effects observed as institutional changes that have become consolidated.

A first achievement was for the process of adjusting expenditure to budget constraints to be done with greater involvement of the sectors. This does not imply that the ceilings are necessarily agreed upon. Before the adoption of the framework, the pressure to comply with expenditure limits fell on the Ministry of Finance which led, in some cases, to arbitrary cuts. This change in the budget dynamic is also expressed in the fact that, previously, the sectors tended to develop “inflated” provisional budget proposals in order to prevent cuts from the Ministry of Finance. This trend was reduced with the multiannual perspective.

The improvement in the predictability of the allocation of funds also had positive effects. The resources that were previously assigned but not delivered have been reduced. This is due to the fact that previously the entities preferred to ensure the receipt of funds although they did not have plans about how to spend them. According to the interviewees, without the MTEF the budget became institutional plunder, since no entity had guaranteed financing in the future, which led each of them to seek to obtain as much as possible each year. The MTEF made it possible to view a time horizon beyond one year and to begin to prioritize and program for the medium term. However, there are factors outside of this process that can alter both planning and budgeting. Among them are laws passed by congress that require investments

to be made and judicial rulings. It should be pointed out that these two branches are excluded from the MTEF.

In turn, certain characteristics of the budget process and of the policy-making process prevent the MTEF from functioning to its full potential, particularly the conflict between the national government and the sub-national governments. The principal reason is the decision of the central government to assume traditional functions of the sub-national governments, such as water supply systems and roads. This competition between the different levels generates negative incentives that are aggravated because the periods of government and the plans do not coincide at the national and sub-national levels.

Another issue that remains uncertain is what will happen when an administration has to determine the MTEF of a subsequent government. Up to now this has not occurred, since the government was reelected. Although at the level of the MTFF it does not seem that it is going to generate too many problems, the case of the MTEF is different. In this case, it is possible that the framework establishing the Government Plan grants the necessary flexibility to the budget process.

*CONCLUSIONS ABOUT THE COLOMBIAN CASE*

In addition to the previously mentioned effects on the budget decision-making process, the actors’ perceptions are that the MTFs have demonstrated various positive effects. The MTFF has served as a reference for generating fiscal discipline; it has made the different actors aware of fiscal restrictions, and has made budget discussions more transparent. This is observed in the fact that even though there is no formal relationship between the Government Plan and the MTFF, during preparation of the former the restrictions imposed by the second are taken into account.

The problems of expenditure efficiency related to results-based budgeting are an issue that the MTEF has not addressed. This is due mainly to the fact that a scheme has been chosen that is limited to the operating environment. However, this process has influenced

**Table 9: Projections of the MTFF, Colombia**

| Medium Term Macroeconomic Framework | Projected Year | Inflation |        | GDP Growth |        |
|-------------------------------------|----------------|-----------|--------|------------|--------|
|                                     |                | Projected | Actual | Projected  | Actual |
| 2004                                | 2004           | 0.055     | 0.055  | 0.04       | 0.046  |
|                                     | 2005           | 0.044     | 0.0485 | 0.04       | 0.057  |
|                                     | 2006           | 0.035     | 0.0448 | 0.04       | 0.069  |
| 2005                                | 2005           | 0.05      | 0.0485 | 0.04       | 0.057  |
|                                     | 2006           | 0.045     | 0.0448 | 0.04       | 0.069  |
|                                     | 2007           | 0.04      | 0.0569 | 0.04       |        |

Source: Authors' compilation based on the medium-term fiscal frameworks, Ministry of Finance and Public Credit and National Administrative Statistics Department, Colombia.

the efficiency of expenditures. First, based on what is perceived by the sectors, the MTEF increased predictability and facilitated the flow of certain processes that implied a longer than annual time horizon. This perception is shared by the political leadership.

In this regard, it also improved the availability of statistical information. The task of establishing goals purified the baselines although the monitoring challenges indicate problems related to delays in the production of the information.

Furthermore, there are certain pending aspects. For example, the effect of the MTEF on the reduction of the inertial nature of the budget is relative. This is explained to a great extent by the rigidity resulting from earmarking and the expenditures by function and the debt. In regard to investment spending, according to the sources consulted, the MTEF has helped make expenditures flexible and, as a result, reduces their inertial nature.

In the Colombian case, although the main objective of introducing the frameworks was to gradually reduce the public debt, elements that were incorporated aimed at favoring planning based on the participation of the spending ministers in the process. Despite this, weaknesses persist in relation to planning capacity. One of the main flaws is that in practice it is difficult to reach the municipal level, although the latter plays a relevant role in the execution of public policies.

### ***The MTF in Peru***

#### ***DESCRIPTION***

As in Colombia, the MTFF was instituted in Peru as a part of a series of reforms of the budget process contained in the Fiscal Responsibility Law. This framework, known as the Medium-Term Macroeconomic Framework (MTMF) was adopted in 2000; it has a revolving time horizon of three years, and is prepared for the general government. Its main objective is to adapt the expenditures and the evolution of the debt to the fiscal rules.

The document is prepared by the General Directorate of Economic and Social Affairs (DGAyS, in Spanish) under the Ministry of Economy and Finance. This unit is responsible for guiding and coordinating the formulation, execution, monitoring, and evaluation of the short, medium, and long term economic and social policies, as well as the Economic Program. It should be pointed out that this entity is not in charge of the annual budget. The Public Budget National Directorate is responsible for the National Budget System and prepares the provisional draft of the Annual Budget Law.

To develop the MTMF, the DGAyS uses historical budgeting of total expenditures plus a given additional percentage. This procedure implies two things: First, that the methodology has incremental characteristics. Secondly, that the planning done by the line ministries is not taken into account in the calculation of the ceiling established in the MTMF. Thus, the MTMF ends up

being almost exclusively a restriction on expenditures and not a programming tool.

Indeed, the different administrative units do not participate as sectors in the preparation of the macro framework. What does take place is that the historical expenditures are used as an input to calculate the ceiling for total expenditures. However, the sectors provide information to the Ministry of Economy and Finance. The administrative units provide information concerning indebtedness and debt service payments to adapt to the fiscal rules.

Furthermore, there is an information flow in the opposite direction. The MTMF gives the sectors reference ceilings both for planning the subsequent years and for the annual period. It allows them to relate the variable projections such as GDP, total income and total expenditures to the historical allocation of the sector to predict certain tentative expenditure levels.

The resulting document is reviewed by the central bank. After responding to the comments that may have been made, it is submitted to the cabinet (Council of Ministers) for its approval. The final document is sent to congress one month before the annual budget goes to committee since the macroeconomic framework serves as the basis for the budget debate. Given that the Medium-Term Macroeconomic Framework is only submitted for information purposes, Congress usually does not discuss it. However, there have been occasions in which certain specific aspects of the projections, such as those related to the exchange rate, have been subject to debate.

Although there is no medium-term expenditure framework, the different sectors carry out a planning exercise, which is incorporated into the Medium-Term Sectoral Plans. These documents are, basically, a medium-term management tool. Although they have a financing section, they do not necessarily bear a direct relation to the macroeconomic framework, although they use it as an input. These four-year sectoral plans coincide with the government term of office and are annually evaluated.

In turn, for some sectors such as education and health, these sectoral plans are framed as a part of national plans that establish long-term goals for the year

2020. Unlike the sectoral plans, the latter do not have a financial component. This is not the only difference between long-term and medium-term plans. Long-term plans are prepared through a more inclusive process, with sectoral stakeholders invited to participate during their development.

In addition to these initiatives within the sectors, the Ministry of Economy and Finance has undertaken some steps to strengthen the MTFF. The first of its initiatives—to establish multiannual budgets for investment projects—was carried out through the reform of the National Public Investment System Law No. 27,293. Since multi-year investment budgets are extended at the administrative unit level, the know-how and the necessary information for taking this step are available.

Another initiative is the preparation of a social macroeconomic framework. This recently launched instrument is aimed at defining sectoral goals. Although it has a financial component, not all of those responsible for sectoral budget management participate in its preparation. The objective of this initiative, which is led by the cabinet, is to reorient social programs toward reducing poverty levels. It should be pointed out that congress is not involved in this initiative.

The social macroeconomic framework is, in turn, accompanied by the introduction of other budgeting techniques. In 2006, a pilot was begun of results-based programs in five sectors (among the programs included in this initiative are those focused on nutrition, maternal-neonatal health care, and student achievement). These programs, which are considered strategic, are evaluated on a quarterly basis in terms of their achievement of physical goals and results. Five strategic programs in results-based programming were initiated this year.

In order for undertakings such as multiannual frameworks or programs with results-based budgeting to work, adequate statistical information needs to be available. The different sectors have a negative perception of the statistical data available. Serious problems are evident with respect to the quality of the data and there are numerous gaps. Due to the lack of coordination with the National Statistics and Informatics Institute (INEI) a solution in the short term is not expected.

*PROJECTIONS*

As can be observed in Table 10, the projections for GDP growth are moderate. This difference is associated with greater expenditures and surpluses than projected.

*THE BUDGET PROCESS*

The Medium-Term Macroeconomic Framework is not an area of public policy discussion. In practice, the sequence that determines the ceilings is as follows: projection of GDP into the future, calculation of income and, finally, the projection of expenditure levels consistent with the compliance with fiscal rules. As mentioned earlier, within an analysis based on the sustainability-planning dichotomy, the MTF in Peru is oriented toward sustainability.

Within this scheme, it is consistent for the DGAEyS to attempt to prepare a moderate macro framework. Since one of the functions pursued is to restrict expenditure requests from the sectors, it tries to be conservative in its projections. Such practices have not generated complaints among the ministers. Thus, the ceilings established by the DGAEyS are usually approved without modification by the cabinet.

This does not imply that the sectors lack a space in which to discuss the financing of public policies. The annual budget process is where this discussion takes place. According to the opinions of those interviewed, the allocation of budget limits stipulated by the Ministry of Economy and Finance, usually does not meet the budget needs of the sectors. As a result, additional demands are added to the ceiling amounts. The probability of getting those additional funds depends to a great extent on the political weight of the head of the administrative unit during the discussion of the budget in the Council of Ministers.

During the annual budget process the lack of coordination between the sectoral plans and the budget comes to light. At times, this situation leads to conflicts between the spending ministries and the Ministry of Economy and Finance, which is perceived as an obstacle

to its own ability to implement policies. Since the goals are established in the medium- and long-term sectoral plans while the allocation of resources is determined, ultimately by the Ministry of Economy and Finance, such inconsistency results in noncompliance with the established goals. All these conflicts could be resolved through the strengthening of the fiscal framework in a MTEF.

However, as previously seen, it is not necessarily sufficient to establish a MTEF to obtain coordination between planning and budgeting. In the case of Peru, there are other features of the political dynamic that should be controlled. For example, sectoral plans tend to be reviewed with each management change. Since rotation of ministers is important, planning loses most of its *raison d'être*.

The other factor of the political process that generates problems in planning and that should be taken into account at the time of designing a MTEF is the relationship between different levels of government. Currently there are coordination problems between the sectors at the national level and the regions. Although sectoral goals are established by the national ministries, the regional authorities in charge of executing the expenditures enjoy a high level of discretion in reassigning the expenditure among functions. As a result, a MTEF should include the participation of sub-national actors to allow management agreements to be reached that imply a commitment to carry out the actions aimed at reaching the goals.

*CONCLUSIONS FOR PERU*

As currently developed, the MTFF in Peru prioritizes those instruments related to the pursuit of macroeconomic stability over those that would strengthen the planning aspect of the MTF. This results from the fact that the MTF does not include programming or functional categories.<sup>9</sup> This functional design for compliance with the fiscal rules also has effects on the distribution of the power of the actors. By not establishing

9. This situation is not intrinsic to the Peruvian case, but is associated with the function given to the framework. Evaluation of the MTFF in Mozambique reveals the same situation. From this case it is apparent that without an effective connection between budgeting and strategic planning, the framework becomes simply a tool to achieve fiscal discipline (Batley et al. 2006).

**Table 10: Projections of the MTF, Peru**

| Medium Term Framework | Projected Year | Non Financial Expenditure<br>(millions of new soles) |        | Primary Result<br>(millions of new soles) |        | GDP<br>(millions of new soles) |        | Consumer Price Index |        |
|-----------------------|----------------|------------------------------------------------------|--------|-------------------------------------------|--------|--------------------------------|--------|----------------------|--------|
|                       |                | Projected                                            | Actual | Projected                                 | Actual | Projected                      | Actual | Projected            | Actual |
|                       | 2004           | 43.162                                               | 39.730 | 1.218                                     | 2.080  | 225.70                         | 234.30 | 2.50                 | 3.50   |
| 2004                  | 2005           | 45.170                                               | 44.488 | 2.759                                     | 3.662  | 242.40                         | 258.40 | 2.50                 | 1.50   |
|                       | 2006           | 47.693                                               | 49.318 | 4.357                                     | 11.098 | 261.70                         | 305.80 | 2.50                 | 1.14   |
|                       | 2005           | 41.750                                               | 44.488 | 2.960                                     | 3.662  | 248.30                         | 258.40 | 2.50                 | 1.50   |
| 2005                  | 2006           | 43.844                                               | 49.318 | 3.615                                     | 11.098 | 266.00                         | 305.80 | 2.50                 | 1.14   |
|                       | 2007           | 45.985                                               | 58.715 | 4.509                                     | 6.099  | 285.10                         | 330.40 | 2.50                 | 2.00   |
|                       | 2006           | 46.704                                               | 49.318 | 3.000                                     | 11.098 | 270.50                         | 305.80 | 2.50                 | 1.14   |
| 2006                  | 2007           | 48.878                                               | 58.715 | 3.659                                     | 6.099  | 288.40                         | 330.40 | 2.50                 | 2.00   |
|                       | 2008           | 51.722                                               |        | 5.093                                     |        | 311.20                         |        | 2.50                 |        |
|                       | 2007           | 51.293                                               | 58.715 | 3.427                                     | 6.099  | 307.60                         | 330.40 | 2.50                 | 2.00   |
| 2007                  | 2008           | 53.606                                               |        | 5.220                                     |        | 329.30                         |        | 2.50                 |        |
|                       | 2009           | 56.333                                               |        | 8.212                                     |        | 354.00                         |        | 2.50                 |        |

Source: Authors' compilation based on the medium-term macroeconomic frameworks (2004-2008), Ministry of Economy and Finance, Peru.

consensus-based mechanisms in the preparation of the ceilings, this framework tends to concentrate budget decision-making power in the MEF.

In addition to affecting the powers of the actors, the MTFF affects the results of budget policy. Although the effects on sustainability are positive, they are probably negligible or strengthen the preexisting dynamics in respect to efficiency and representativeness. With respect to efficiency, the greatest input the frameworks can provide is to increase predictability and reduce incrementalist practices. According to the opinions of those interviewed, this has occurred in Peru to a limited extent. The perception in the spending ministries is that a MTEF that provides certainty with respect to the flow of funds for a period greater than one year could be useful in avoiding under-disbursement as a result of rigid administrative procedures.

### *The MTF in Argentina*

#### *DESCRIPTION*

The MTF was introduced in Argentina in 1999. Previously, there were some budget tools with a multiannual time horizon such as the Public Investment Law that stipulated a three-year plan for investment spending.

Although it does not replicate the annual budget, the MTF entails a level of detail that makes it the closest to doing so among the cases reviewed. This framework not only includes the functional classification and administrative unit, but also incorporates information by program (even if it does not take into account the lower levels of this classification, such as subprogram, activity, project, and works) with the expected trends for the physical goals and their sources of financing. As a result, it meets the characteristics of a MTEF.<sup>10</sup>

10. It includes projections of resources by categories; expenditure projections by purpose, function, and of an economic nature; investments program for the period; programming of credit operations from multilateral agencies; description of the budget policies that support the projections and the expected economic and financial results.

As observed in Colombia and Peru, the Argentine experience originated in a broader fiscal reform promoted by an agreement with the IMF. The adoption of a Fiscal Responsibility Law by the national government (Law 25,152) implied, among other obligations, the commitment of the national executive branch to prepare a multiannual budget of at least three years. Given the prevailing economic situation and the latent fiscal crisis, the objective was mainly to achieve a time period of predictability in the reduction of the deficit.

Thus, since 1999, all the agencies that compose the national administration annually prepare a document known as a Multiannual Budget in a process which is integrated with the process for formulating the National Budget Law Proposal. This integration implies not only sharing the financial information system, but also a single timetable to be followed by the administrative units.

The first step in the preparation of the framework consists in the preparation of ceilings for each year of the three-year period for each national agency by the National Budget Office. For this budget, the NBO relies on different offices that perform the projections from the information used. The spending ministries can provide preliminary budgets that serve as an input in defining the ceilings. Combining the inputs produced by the sectoral officers of the National Budget Office (NBO) with the restrictions on consolidated expenditures imposed by the fiscal goals, the ceilings for each administrative unit are established. Through this exercise, the annual ceilings are also established. Based on those ceilings, the agencies prepare their provisional drafts of annual and multiannual budgets. Since budget ceilings are usually lower than initially required (either in the preliminary budgets or from the needs stated to the NBO), administrative units tend to submit “over-the-ceiling” budgets. They do not have to necessarily maintain the same programming for the second and third years, since possible termination of existing programs or the implementation of new policies are taken into account.

After a period of political decisions in which the demands from the different units are rejected or approved by the Chief of the Cabinet,<sup>11</sup> the proposed annual budget is submitted to the legislative branch. It should be noted that the multiannual budget presented to congress is for information purposes and does not need the approval of this body.

#### PROJECTIONS

Table 11 shows that during the first years following the devaluation, the projections diverged significantly from the actual values. That situation improved over time, particularly with regard to inflation projections. However, with regard to GDP, the continuous and apparent differences suggest the strategic use of the projections. This is probably the result of the use of this practice in the preparation of the annual budget. Since the differences between projected and observed primary results are low, it can be inferred that a portion of the resources are allocated in a discretionary manner by the executive.

#### THE BUDGET PROCESS

Although the MTF functions correctly, according to evaluations made by former staff members of the NBO (Vega, 2004), in practice the MTF exhibits various deficiencies that minimize its positive effect on the budget process. One of the reasons for this is that, despite the advice of the International Monetary Fund (IMF, 1999), the framework was not promoted in an environment in which the fiscal balance was ensured, but during the development of one of the most profound fiscal crises in Argentina. In fact, in the period 2002-2004, the MTF was not prepared due to the volatile characteristics of the existing crisis.

This situation has threatened the accuracy of the macro-fiscal projections developed. This problem, in addition to the strategic use of projections (Abuelafia *et al*, 2009), has eroded the credibility in multiannual budgeting. Low credibility in turn was furthered by

11. Although technical recommendations are made by the NBO to accept them or not, the final decision is made by the Chief of Cabinet. The role played by the Ministry of the Treasury varies in accordance with the idiosyncrasy of the person who heads the institution.

**Table 11. Macroeconomic projections of the multiannual budget and real values, Argentina**

| Multiyear Budget | Projected Year | Inflation |        | GDP<br>(Current Millions of Pesos) |             | Primary Result<br>(% GDP) |        |
|------------------|----------------|-----------|--------|------------------------------------|-------------|---------------------------|--------|
|                  |                | Projected | Actual | Projected                          | Actual      | Projected                 | Actual |
|                  | 2003           |           |        | 533,726                            | 375,909,361 | 2.18%                     | 2.40%  |
| 2003             | 2004           |           |        | 621,087                            | 447,643,426 | 2.72%                     | 3.90%  |
|                  | 2005           |           |        | 700,095                            | 531,938,722 | 3.24%                     | 3.50%  |
|                  | 2004           | 10.50%    | 4.40%  | 416,865                            | 447,643,426 |                           | 3.90%  |
| 2004             | 2005           | 8.00%     | 9.60%  | 469,965                            | 531,938,722 |                           | 3.50%  |
|                  | 2006           | 6.50%     | 10.90% | 501,451                            | 654,438,985 |                           | 3.54%  |
|                  | 2005           | 7.90%     | 9.60%  | 476,360                            | 531,938,722 | 3.20%                     | 3.50%  |
| 2005             | 2006           | 6.00%     | 10.90% | 526,043                            | 654,438,985 | 3.23%                     | 3.54%  |
|                  | 2007           | 5.70%     | 8.40%  | 565,624                            | 812,072,369 | 3.28%                     | 3.30%  |
|                  | 2006           | 8.60%     | 10.90% | 593,974                            | 654,438,985 | 3.26%                     | 3.54%  |
| 2006             | 2007           | 8.00%     | 8.40%  | 658,426                            | 812,072,369 | 3.35%                     | 3.30%  |
|                  | 2008           | 7.20%     |        | 729,180                            |             | 3.40%                     |        |
|                  | 2007           | 9.60%     | 8.40%  | 694,195                            | 812,072,369 | 3.14%                     | 3.30%  |
| 2007             | 2008           | 7.00%     |        | 754,401                            |             | 3.17%                     |        |
|                  | 2009           | 5.50%     |        | 809,069                            |             | 3.33%                     |        |

Source: Authors' compilation based on multiannual budgets, Ministry of Finance, Secretariat of Economic Policy and the National Statistics and Census Institute (INDEC).

the limited dissemination of this instrument among relevant political, technical and academic actors. One indicator of this is that concerns or comments have not been made on the multiannual budgets prepared (Vega, 2004), something that also has not occurred in Colombia nor Peru where congress does not discuss the MTF in depth. However, another symptom revealing little interest on the part of policymakers in the multiannual process is the fact that demands for more funds above the ceilings established by the NBO are made in respect to the annual budget, which is the one with legal force. The ceilings for the subsequent years are not discussed until they coincide with the current year.

Probably, one of the most decisive factors that explain the limited involvement of politicians and the technical sectors is the absence of a planning entity to support the allocation of funds from the multiannual budgets. The lack of a plan to serve as a foundation for the budgeting process is compounded by the fact of

having to adhere to a very tight timetable for the preparation of the budget, making it difficult to embark on planning tasks. The result has been that, in practice, the multiannual budget consists of a formal exercise in which the budget of the first year of the multiannual budget is extended into the future (Vega, 2004).

Paradoxically, despite having a very complex tool, since it is not based on comprehensive planning, the logic that ends up prevailing is similar to that in Peru: to strengthen the fiscal restrictions without achieving very much in terms of the strategic allocation of resources and technical efficiency.

Another deficiency of the multiannual budget is that, despite the new norm of the Federal System of Fiscal Responsibility, most of social spending is the responsibility of the provinces and is not part of a multiannual budget. In the future this situation should change based on the approval of Law 25,917 in 2004. This law created the Federal System of Fiscal Responsibility, which, among other things, establishes the preparation of

multiannual budgets by the national government, the provincial governments, and the government of the Autonomous City of Buenos Aires. Despite the law being in effect, provincial multiannual budgets are not operational in the whole country.<sup>12</sup>

#### CONCLUSIONS FOR ARGENTINA

Despite the various deficiencies mentioned, the perception that prevails in the National Budget Office is that the MTF has been beneficial for the budget process. It is emphasized in particular that the exercise of forecasting results in a probable scenario provides them inputs to improve the budgets for subsequent fiscal years.

Beyond that, the need for a greater role for those responsible for managing the preparation of the budgets of the agencies is recognized. This point brings to light the underlying issue that lies beneath the limitations of the MTF in Argentina: medium-term budgeting appears detached from the planning of medium-term sectoral policies.

The lack of a space in which to integrate the different planning initiatives limits multiannual budgeting. The result is the impossibility of implementing a comprehensive process. As a result, the MTF ends up being nothing more than a reinforcement of the fiscal restriction.

#### CONCLUSIONS OF THE CASE STUDIES

The three cases analyzed differ in respect to the depth of the coverage and objectives of the medium-term framework that was implemented. Peru has a MTFF, Colombia a MTBF, and Argentina a MTEF. Despite this difference, all the frameworks were part of fiscal reform processes promoted by the IMF. As a result, all the experiences initially reflected a bias toward the prioritization of objectives linked to the achievement of fiscal sustainability.

This situation probably hinders ownership of the MTF on the part of local policymakers as a tool to facilitate budget management. In Peru, the choice was a scheme that is totally divorced from planning processes.

As a consequence, the MTF preparation process is not very participatory.

The Colombian experience reveals an interesting case in which implementation occurred gradually. In the first place, the adopted MTFF limited planning or the participation of the spending ministers in the establishment of the budget ceilings. When the medium-term scheme was strengthened, according to the perception of the actors, the medium-term budget constraints had already been internalized. Although its implementation is too recent to make an adequate evaluation, based on an agreement between the central actors in the process (Ministry of Finance and NPD) and the spending ministries, an area was established in which it is possible to discuss the financing of medium-term sectoral policies.

Although a scheme that theoretically favors the integration of budgeting and planning was chosen in the Argentine case, in practice this objective has not been achieved. Still, in a country with a long experience in working with a modern financial management system, the lack of institutionalized planning entities has led to a multiannual budget that, in practice, is only a formal exercise. In turn, the fact that the implementation of this tool coincided with one of the most profound economic crises in Argentine history and, subsequently, with a change in the role assumed by the state in the delivery of economic services, has hindered its correct performance.

The lesson learned from these three experiences is the need for greater institutional learning. In Colombia this process has been perhaps more fluid because of the gradual implementation of the MTFF and the MTEF in a scenario in which medium-term sectoral planning was already consolidated in a government plan (Boex *et al*, 1998). Initiatives such as the social framework in Peru and the Strategic Territorial Development Plan in Argentina may signal the beginning of an evolution toward the integration of the political, planning, and budgeting processes.

12. The jurisdictions that have promoted it are: Buenos Aires, Chubut, Córdoba, Entre Ríos, Formosa, Mendoza, Río Negro, San Juan, Santa Cruz, Santa Fe, Tucumán, and the Autonomous City of Buenos Aires (CABA). All include projections of the resources by category and economic classification. With regard to expenditures, most of them classify by economic function while only CABA, Córdoba, Entre Ríos, Mendoza, Río Negro, and Santa Fe do it by objective and function (Federal Council on Fiscal Responsibility, 2007).

Some difficulties common to the three countries conspire against the odds of integrating these processes. First, the representativeness of the budgets is limited. The two countries that allow the participation of civil society in the preparation of sectoral goals do so in an institutional setting that is not directly linked to the MTF. The participation of civil society actors with a stake in sectoral policies could provide greater legitimacy to these frameworks that may, on occasion, encompass periods from different governments.

Civil society is not the only actor that seems to be excluded from the formulation of the frameworks. The role of legislative branches in Latin America in the medium-term frameworks is minimal. Although at times it can be attractive for the executive branch to not subject the frameworks to debate, if they are not discussed in the legislatures, their political sustainability cannot be guaranteed.

Finally, the lack of coordination between government levels is also a weakness common to the cases discussed. This problem is particularly limiting in federal countries such as Argentina where the degree of decentralization of public policies is substantial. In order to resolve this, it is not only necessary to establish consistent MTFs for the different levels of government, but also to establish mechanisms that facilitate information flow and allow joint planning and coordination of policy execution at the different levels of government.

#### *FINAL THOUGHTS*

The experience of implementing MTFs in Latin America (except for the particular case of Uruguay) is relatively recent if compared with that of developed countries or even Africa, since the first attempts took place at the end of the 1990s. However, their use is quite extensive. In the coming years, when some countries that are already developing the use of this tool are added, most of the region will have medium-term frameworks.

The moment in which they were adopted and the actors who promoted them have influenced the logic that guided their implementation. Those countries that

adopted this tool as a part of agreements with the IMF—leading to Fiscal Responsibility Laws—were aimed more at obtaining fiscal sustainability (even Colombia, which today has a MTEF, began with a MTFF). In turn, those countries where poverty reduction plans favored a greater role for other international organizations in the budget problems (such as Honduras and Nicaragua) opted for the MTEF. This is similar with what is observed in Africa, where the World Bank played a key role in the implementation of MTFs.

Although their recent application makes it premature to identify what problems are related to a lack of experience in the use of the instruments and which are due to more serious causes, among the apparent weaknesses of the frameworks are problems related to the participation of key actors, coordination between different levels of government, the estimation of projections, and the quality of financial statistics.

Low participation in the preparation of the MTF by actors who play an important role in the execution of the annual budget (spending ministries, congress, civil society) make it difficult to strike a balance between the objectives of facilitating and improving planning and ensuring fiscal sustainability. In order to achieve a better balance between the medium-term sectoral goals and the fiscal or medium-term expenditure frameworks, the participation of stakeholders in the preparation processes of these frameworks should be sought. This should also take place within the ministries, where at times coordination between the management and budgeting units is not as fluid as it should be.

The lack of coordination with sub-national governments affects both the objective of improving fiscal sustainability and increasing efficiency. In some cases, like that of Argentina, sub-national governments are not included in the MTF. In others, the delay in the arrival of financial information on sub-national governments and the form in which it is presented prevents an evaluation of their effect on sustainability. With respect to the efficiency of expenditures, coordination deficiencies between the different levels of government, and problems in information flows result in an overlapping of

programs and the impossibility of establishing a results-based budget. All these problems work against attempts at using this tool to establish medium-term guidelines.

The quality of statistics and the estimation of projections is another issue that threatens the positive development of the frameworks. Only with quality information can the frameworks serve the purpose of guiding future investments. With respect to the estimations, many of the MTFs seem to reproduce the deficiencies observed in the annual budgets. For example, they strategically use the macroeconomic projections (over or underestimation of economic growth) to boost the discretion of the executive branch in managing the budget.

Beyond these specific problems, the use of this tool warrants its detailed analysis and expansion in many countries. These processes are gradual and generate feedback dynamics with the budget processes and the political-institutional frameworks; thus their impact is not immediate. Given their relatively recent implementation vis-à-vis other experiences, the lack of development of the systems is understandable. In those cases where technical capabilities allow it, MTFs should be integrated more deeply with the planning processes and with other fiscal management tools such as stabilization funds and results-based budgeting.

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# The Current and Future Situation of National Investment Systems in Latin America

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## Background

What is a National Public Investment System (NPIS)? This question appears to have multiple answers considering the differences in the structure, coverage, and characteristics of NPIS across the region. It is also not

easy to give a theoretical answer as that would require clearly defining what is considered “public investment” and what a “national system” is. A response to what the definition of public investment is can be found in the documentation related to NPIS. Box 1 contains some examples from countries in the region.

## Box 1. Definitions of public investment

### ARGENTINA

**National Public Investment:** *The application of resources in all types of goods and activities that increase the assets of the entities that make up the national public-sector with the goal of initiating, expanding, improving, modernizing, replacing, or rebuilding the production capacity of goods or service providers.*

Source: Law N.° 24.354, Article 2.

### BOLIVIA

**Public Investment:** *It is understood as all public expenditures aimed at increasing, improving or replacing existing physical capital in the public domain and/or human capital, with the objective of expanding the capacity of the country to provide services or produce goods.*

*The concept of public investment includes all the pre-investment and investment activities realized by entities in the public-sector.*

Source: Supreme resolution 216768, Article 8.

### COLOMBIA

**Net Investment:** *Investment expenditures are defined as those outlays capable of generating returns or being otherwise economically productive, or that are composed largely of durable goods, also called capital expenditures, as opposed to operating ones, which are usually meant to disappear after use. Moreover, those expenditures intended to create social infrastructure.*

*The fundamental characteristic of this expenditure must be that its allocation increases productive capacity and productivity in the areas of physical, economic and social structure.*

Source: Manual de Programación de la Inversión Pública, DNP, March 2000.

\* Expert, Latin American and Caribbean Institute for Economic and Social Planning (ILPES) and Economic Commission for Latin America and the Caribbean (ECLAC).

Public investment is generally understood to include all public spending intended to maintain or increase the capacity for the production of goods or services.

But, there is not the same agreement on the definition of what characterizes the national system for the administration of public investment. In some cases, the NPIS covers only the central government, while in others it also includes sub-national governments. Likewise, some NPIS only register initiatives financed with resources from the general budget, while others incorporate projects financed with external assistance.

Despite wide differences between the NPIS in different countries, they are similar in respect to their objectives, their structures, and the methodologies used. This document studies the similarities and differences among current NPIS in different countries of the region, highlighting tendencies observed in their development with the purpose of drawing conclusions that will contribute to their better understanding. Likewise, the weaknesses of existing NPIS and their possible future development will be discussed.

### ***Historic Development in the Region***

The first experience in the development of a Project Bank (from which the idea for NPIS evolved) was in 1982 when the government of Chile —through the National Planning Office (ODEPLAN), and with the technical cooperation of the United Nations, the United Nations Development Program and the Department for Technical Cooperation for Development (DTCD)— began implementing a system to standardize information for public investment projects. For this purpose, the inventory of public investment projects that had been carried out as pilot programs in four regions was taken as a baseline (United Nations, 1985). Using the project as a framework, the system was expanded to all regions of the country and to all ministries.

However, the large volume of information that needed to be recorded and managed made clear the need for an information system. This gave rise to the creation of the Integrated Bank of Public Sector Projects (known as BIP). Given that at the beginning of the 1980s the

technology that would permit the implementation of a distributed database did not exist, computerization forced the centralization of information into a single database which was accessed by the different entities through terminals.

In the 1980s, other countries in the region, such as Guatemala, the Dominican Republic, and Venezuela, initiated similar efforts. Nevertheless, for different reasons these experiences did not produce the desired results and the systems were not consolidated.

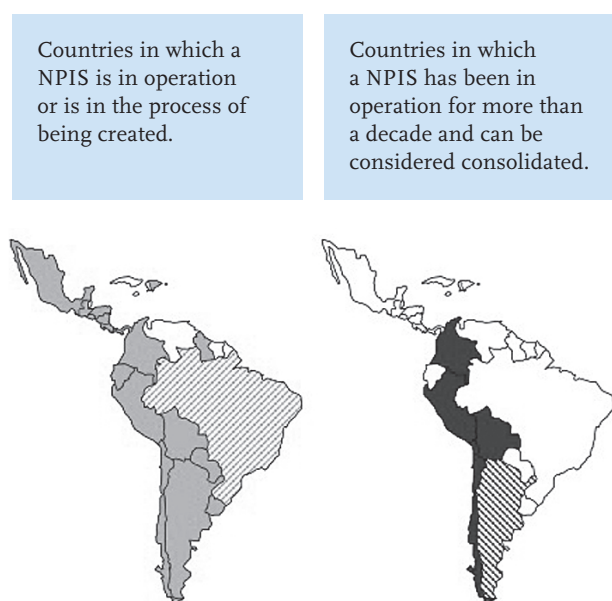
Thus, the next successful experience was the creation of the National Investment Projects Bank (BPIN) in Colombia. It began in 1986 when the National Planning Department, with the support of the Organization of American States (OAS), initiated a project bolstering activities of pre-investment and investment at the territorial level. But the true impetus for this initiative came with the enactment of Law 38 (April 21, 1989) of the Organic Statute of the General National Budget. Article 32 of this law created the BPIN and assigned responsibility to the DNP for its design, initiation, and operation. Subsequently, the DNP, with financing from the Inter-American Development Bank (IDB), signed an agreement with the Latin American and Caribbean Institute for Economic Social Planning (ILPES by its acronym in Spanish) for the development and implementation of the BPIN (ILPES, 1993).

In the 1990s, several other countries in the region developed or started developing National Public Investment Systems based on the concept of Project Banks. Particularly notable are the experiences in Bolivia and Peru, which gave a strong push to the creation of their NPIS. These more recent initiatives have taken advantage of the experience accumulated in other countries, both in relation to factors contributing to successful outcomes as well as factors to keep in mind in order to avoid failure. This is reflected in a clearer and more solid legal structure and in information systems that fully take advantage of the capabilities of the Internet.

Figure 3 shows the countries that have tried to implement a NPIS in the last three decades and those in which they can be considered to be consolidated. A system is considered to be consolidated when it has been

in operation for at least a decade (it has survived at least two changes in administration) and registers a majority percentage of total public investment. In the case of Argentina, the system has been in place for more than a decade but only in recent years has it started to be adopted at the provincial and municipal level, which has significantly increased its coverage.

**Figure 3. Countries in the region that have implemented a NPIS**



### General structure

Before analyzing the patterns that have appeared during NPIS development, it would be useful to describe their general structure. Although project banks were initially conceived only as information systems for proposed projects and those in development, in practice it became convenient to implement national investment systems based on the concept of project banks. The implementation of this type of system requires the simultaneous development of four aspects: methodologies, information systems, legal and institutional reforms, and training (Aldunate, 1994). In particular, the four fundamental components of any BPIN implementation project are:

- the institutional and legal component, which comprises the preparation and passage of laws, decrees, and regulations that define, regulate and support the operation of a NPIS, such as the institutional reforms necessary to respond to demands generated by the administration and operation of the system;
- the methodological component, which requires the preparation of methodological manuals for project identification, preparation, and evaluation, as well as manuals for the evaluation and control of projects;
- the components of information systems made of the equipment (*hardware*) and programs (*software*) that allow for agile management of the large amount of data that a NPIS generates, registers, and utilizes, as well as operation manuals for information systems; and
- the training component to adjust the management culture for public investment in order to be able to rely on qualified human resources indispensable to the operation of NPIS. This may include courses, seminars, agreements with training entities, preparing training materials, and technical assistance activities.

The next section analyzes the trends in how these components have been put into practice in different NPIS of the region.

### Current situation and trends

#### NPIS objectives

First, it is important to analyze what objectives countries were seeking in the implementation of NPIS. The following boxes provide information in this respect for some countries.

**Box 2. NPIS implementation in Argentina****General objective**

According to Article 1 of Law 24,354: “This creates the National Public Investment System whose objectives are the establishment and constant updating of the inventory of national public investment projects and the annual formulation and management of the National Public Investment Plan”.

According to the document on the budget system in Argentina: “The general objectives (of the National Investment System, NIS) consist in endowing the process of allocating investment resources with efficacy, efficiency, and effectiveness, through the creation of the Investment Projects Bank (BAPIN, by its acronym in Spanish).”

**Specific objectives**

The established system proposes to:

1. Increase the productivity of public investment in the country by standardizing the processes of formulation, evaluation, and selection of projects using technical criteria of excellence.
2. Identify, promote, and evaluate investment projects, registering them in a Project Investment Bank created for this end.
3. Select and propose projects to be included in the Public Investment Plan approved by the National Parliament.

Source: [www.mecon.gov.ar/folle/tex1.htm](http://www.mecon.gov.ar/folle/tex1.htm)

**Box 3. NPIS implementation in Bolivia****Specific objectives**

According to Article 2 of supreme Resolution N.º 216768:

1. Achieve an efficient allocation and administration of public investment expenditures so as to maximize their socio-economic benefits.
2. Establish methodologies, parameters, and criteria for the formulation, evaluation, and execution of projects that public-sector entities must apply in their management of public investment projects.
3. Establish procedures so that public investment projects have access to internal and external sources of financing and may be incorporated into the national budget.
4. Establish procedures for the co-financing of investment projects among public entities and the central government.
5. Ensure the availability of updated, timely, and reliable information about public investment.
6. Ensure constant coordination among NPIS, the National Planning System, and the other systems established in Law 1178.

**Box 4. NPIS implementation in Chile****General objective**

*“... improve the quality of national public investment by allocating resources to initiatives with higher social and economic yields according to the guidelines of government policy.”*

Source: <http://www.mideplan.cl/sni.htm>

**Box 5. NPIS implementation in Colombia****Specific objectives**

1. Support management and decision-making for Colombian public investment.
2. Contribute to the incorporation of efficiency and efficacy criteria in the allocation and use of state investment resources.
3. Facilitate the achievement of policy goals through the definition of programs and projects as coherent sets of specific, realizable, and fundable actions that are spatially and temporally identified.
4. Provide accurate and reliable information on results of public investment.
5. Be responsible for the consolidation of information on national, departmental, district, and municipal public investment independent of the funding source, executing agency, or location of the program, project, or activities.
6. Support the processes of appraisal, monitoring, results evaluation, and ex-post evaluation for public investment decisions.

Source: El BPIN para principiantes, DNP, 12/2002

**Box 6. NPIS implementation in Peru****General objective**

According to Article 1 of Law N.° 27293 of the National Public Investment System: “the present Law creates the National Public Investment System with the goal of optimizing the use of public resources for investment, through the establishment of principles, processes, methodologies, and technical norms associated with various phases of investment projects.

**Specific objectives**

According to Article 5 of Law N.° 27293:

1. Promote the application of the Public Investment Project Cycle: profile – prefeasibility – feasibility – technical file (design) – execution – ex-post evaluation.
2. Strengthen capacity for public-sector planning.
3. Create conditions for the development of Public Investment Plans for multi-year periods of no less than three years.

The preceding boxes show that NPIS have in common the objectives of contributing to the improvement of the quality (efficiency, efficacy) of public investment, as could be expected. Likewise, various NPIS also share the goal of serving as a support tool for planning and providing timely information on proposed investment initiatives or those in progress.

### **Legal framework**

The legal framework of the NPIS is derived from two main sources. In some countries NPIS have been created by laws, and regulations have been decreed to support these statutes. For example, this is the case in Argentina and Peru.

#### **Box 7. Legal framework based on laws, in Argentina and Peru**

##### **Argentina**

*The National Public Investment System (NPIS) is created by Law N.º 24.354 that was passed on August 22, 1994. It is complemented by the Executive Branch Regulatory Decree N.º 720/95 from May 22, 1995 that assigns the Public Investment and Project Financing National Directorate of the Secretary of Economic Programming of the Ministry of Economy and Public Works and Services as the agency responsible for the NPIS and creates the Public Investment Projects Bank.*

##### **Peru**

*The Law for the National Public Investment System (Law N.º 27293), which was enacted on July 9, 2000, created the legal framework. Its operation is regulated by Supreme Decree N.º 086-2000-EF dated August 14, 2000, which was later updated through Supreme Decree N.º 102-2007-EF on July 19, 2007.*

In other countries, the NPIS legal framework is incorporated into legislation on the budget process, with more or less specificity. In some cases, specific articles exist pertaining to the NPIS, while in others the

operation of the system is based on a collection of citations in different laws and regulations. This is the type of legal foundation for the NPIS in place, for example, in Chile and Colombia.

#### **Box 8 Legal framework included in the budget framework, in Chile and Colombia**

##### **Chile**

- Decree-Law N.º 1,263, Article 19 bis of 1975 and Law N.º 18.768 of 1988, Article 68, item c, financial administration for the state and complementary standards of financial administration.
- Law N.º 18,482 of 1985 from complementary standards of financial administration and budget incidence.
- Law N.º 18,989 of 1990 and Decree N.º 268 of 2003; create the Ministry for Planning and Cooperation and determine the internal structure for the Ministry for Planning and Cooperation.
- Law N.º 19,107 of 1991: modifies Article 2 of Law N.º 18,989 and creates the Ministry for Planning and Cooperation.
- Regulations to Article 19 of Decree-Law N.º 1,263 of 1975 on budget identification of previous studies of investment, programs, or investment projects.
- Annual Public-Sector Budgets Law.
- Decree-Law N.º 1,349 of 1976: creates the Chilean Copper Commission.

- Decree-Law N.º 2,224 of 1978: creates the National Energy Commission.
- Decree-Law N.º 18,196 of 1982: added to Law N.º 1,350 of 1976 creating CODELCO.
- Decree-Law N.º 18,267 of 1983: National Mining Enterprise
- Law N.º 18,605 of 1987: Constitutional Organic Law (*Ley Orgánica Constitucional*) of the Regional Development Councils.
- Law N.º 18,695 DFL-1 19,704 of 2002. Undersecretary for Regional and Administrative Development (SUBDERE, by its acronym in Spanish). Organic Law of Municipalities.
- Law N.º 19,300 of 1994: General Framework for the Environment.
- Memorandum (Oficio Circular) N.º 71 of December 29, 2003 of the Ministry of Finance, DIPRES: Specific instructions, items 6 and 10.
- Memorandum (Oficio) N.º 02 of the Presidential Cabinet of January 25, 2001: order to keep up-to-date information on the execution of public investment projects in the BIP.

Source: SIN website, Marco Legal que Regula el Sistema Nacional de Inversiones.

### **Colombia**

- Law 38 of April 21, 1989 “Estatuto Orgánico del Presupuesto General de la Nación”: creates the BPIN in article 32 and assigns its design, organization and operation to the DNP.
- Decree 2410 of October 20, 1989: creates the Methodology and Operations and Systems Divisions in the DNP and assigns them functions.
- Decree 841 of April 20, 1990: regulates BPIN operations.
- Resolution 3127 of November 20, 1992: devolves the viability rating of projects and their registration in the BPIN to ministries and national government administrative departments.
- Law 179 of December 30, 1994: states that no project or program included in the budget may be executed unless it has previously been evaluated by the appropriate agency and registered in the BPIN. Changes its name to National Projects and Programs Bank.

In practice, the form adopted by the legal framework does not greatly influence the system’s operation. A specific law governing the NPIS may exist but not be fully complied with, while on the other hand, a collection of decrees and regulations might be followed rigorously. That is to say, although a NPIS requires a

legal framework for it to function, its degrees of rigor does not significantly influence the process of strengthening the system. On the other hand, the designation of the entity responsible for its operations, or its coordination with the budget entity does have an important effect.

**Table 12. Managing entities in countries of the region**

| Country          | Entity governing NPIS                                                                                                                                           |
|------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Argentina</b> | Secretary of Economic Policy of the Ministry of Economics and Production through the National Public Investment Directorate.                                    |
| <b>Bolivia</b>   | Vice Ministry of Public Investment and External Financing (VIPFE) of the Ministry of Development Planning through the General Directorate of Public Investment. |
| <b>Chile</b>     | Ministry of Planning through the Division of Planning, Studies, and Investment.                                                                                 |
| <b>Colombia</b>  | National Planning Department through the Directorate of Investment and Public Finances.                                                                         |
| <b>Mexico</b>    | Undersecretary of Expenditures for the Secretary of Finance and Public Credit (SHCP) through the Investments Unit.                                              |
| <b>Peru</b>      | Vice Ministry of Economics of the Ministry of Economics and Finance through the General Directorate for Multiannual Programming for the Public Sector.          |

**Administration**

Practically all public sector entities participate in the operation of a NPIS but the responsibility for managing its operation usually falls on only one unit. Depending on the country, NPIS are administered by planning ministries (Chile, Colombia, Bolivia), economic ministries (Argentina, Peru) or finance ministries (Mexico).

Despite this diversity with respect to the governing entities of the NPIS, what is important for the success of a system is that the recommendations given about various investment initiatives are taken into account during the process of resource allocation. Without a doubt, it makes a difference if the NPIS is part of the entity that allocates the investment budget (for example, the SHCP in Mexico or the DNP in Colombia). A NPIS also operates well if there is a good relationship of cooperation between the body that manages it and the budget directorate (as is the case in Chile). On the other hand, if the NPIS is not administered by the budget entity or is not adequately coordinated with it, it is probable that financing may be assigned to many projects not registered with the NPIS or that are not recommended by it.

**Coverage**

NPIS came about in a context of processes of decentralization when the central government was searching for a way to maintain some level of control or vigilance on the utilization of resources that were being transferred to sub-national levels. This is the case in three of the NPIS precursors –Bolivia, Colombia, and Chile– which paradoxically developed as centralized systems but that decentralized in later phases. As a consequence, these NPIS have had as much coverage at the sub-national level as at the national level practically since their creation.

By contrast, more recent systems, frequently created through specific laws, started with limited coverage at the central level, and then were later extended to the sub-national level. For example, this is the case in Colombia.

A different situation is found in countries with federal systems such as Argentina and Mexico. In these countries, the central government cannot impose the NPIS on the states or provinces, given their federal structure. Thus, the system's coverage is limited to investments financed by the federal budget or other

**Box 9. Harmonization among levels of government in Argentina**

*Beginning at the end of 2002, the Secretary of Economic Policy decided to promote the implementation of the system called BAPIN II which provides integrated information on investment projects, covering the entire lifecycle of projects.*

*Based on this decision, regional meetings were convened in El Calafate, Jujuy, Mendoza, Iguazú and Rafaela, where it was decided to recreate the NPIS and provinces were invited to adhere to it through the signing of an agreement.*

**Achievements:**

- 6,000 projects incorporated into Provincial Banks
- 720 projects in the National Bank from 17 provinces
- Adherence by municipalities (Agreement Model)
- 230 communities and municipalities have adhered in their respective provinces, more precisely:
  - i) Córdoba: 180 communities and/or municipalities
  - ii) Corrientes: 12 municipalities
  - iii) Entre Ríos: 24 municipalities
  - iv) Santa Fe: 12 municipalities
  - v) Catamarca: 1 municipality
  - vi) Formosa: 1 municipality

Source: [http://www.mecon.gov.ar/peconomica/basehome/inversionpub\\_prov.htm](http://www.mecon.gov.ar/peconomica/basehome/inversionpub_prov.htm)

sources of funding to which the national government has access. States (or provinces) are free to choose whether they want to create their own systems, adopt the national system, or simply refrain from creating an investment system. In this context, the progress achieved in Argentina by the central government in

coordinating the use of BAPIN with the provinces, and the provinces, in turn, with the municipalities, is notable.

Table 13 presents NPIS coverage in different countries according to the levels of government and funding sources incorporated into the system.

Table 13. NPIS coverage

| Country   | NPIS coverage                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                  |                                                                                                                                                                                                                                                                                                                                   |
|-----------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|           | Territorial                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                    | Funding sources                                                                                                                                                                                                                                                                                                                   |
| Argentina | <p><b>National level</b>, NPIS rules are applied.</p> <p><b>Provincial level</b>, subject to consultation on investments in their territory.</p> <p><b>Source:</b> Law N.° 24,354 and National Executive Power Regulatory Decree N.° 720/95.</p>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                               | <p>Transfers, subsidies, contributions, guarantees, credits, and/or any type of benefits that directly or indirectly affect the public treasury with present or future, certain or contingent budget repercussions.</p> <p><b>Source:</b> Law N.° 24,354, Article 3.</p>                                                          |
| Bolivia   | <p>The NPIS comprises the following institutional levels, according to the Integrated System of Financial Information's Public Sector Classifier:</p> <p><b>National:</b> includes all the ministries, national secretaries, decentralized entities, publicly-owned enterprises, and investment and development funds that channel resources for sectoral public investment.</p> <p><b>Departmental:</b> comprises all departmental prefectures and their dependent entities that channel resources for regional public investment.</p> <p><b>Municipal:</b> comprises all municipal governments and their dependent entities that channel resources for local public investment.</p> <p>Supreme resolution N.° 216768, Article 4.</p>                                                                                                                                                                                                         | <p>According to funding modalities, public investment projects are classified as:</p> <ul style="list-style-type: none"> <li>- Resources of the national treasury</li> <li>- Resources specific to public entities</li> <li>- External resources</li> </ul> <p><b>Source:</b> Supreme resolution N.° 216768, 1996, Article 9.</p> |
| Chile     | <p>The institutions that comprise the public-sector, i.e. the services and institutions defined in article 2 of the Organic Law of the Financial Administration of the State that have a budget with income and expenditures detailed each year in the Public Sector Budgets Law are the only ones authorized to present investment initiatives directly to the National Investment System for the budget process in 2009.</p> <p><b>Source:</b> Institutions that can present initiatives, NIS web site.</p> <p>The territorial levels are:</p> <ul style="list-style-type: none"> <li>- <b>National:</b> Managing agencies and ministries.</li> <li>- <b>Regional:</b> Governors, regional ministerial secretaries (Seremis), regional governments.</li> <li>- <b>Communal:</b> Mayor and municipal council.</li> </ul> <p><b>Source:</b> National Public Investment System and Integrated Project Bank, Ministry of Planning, May 1996.</p> | <p>The National System of Investments is applied to all public sector institutions independent of the source of financing.</p> <p><b>Source:</b> Law N.° 2890, 12/20/2007, Provides instructions for the 2009 process.</p>                                                                                                        |

| Country       | NPIS coverage                                                                                                                                                                                                                                                                                                                                                                                                                                                                             |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                     |
|---------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|               | Territorial                                                                                                                                                                                                                                                                                                                                                                                                                                                                               | Funding sources                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                     |
| <b>Mexico</b> | <p>Agencies and entities of the federal public administration.</p> <p><b>Source:</b> Guidelines for registration in the Investment Programs and Projects Portfolio, as well as the integration of investment programs and projects with the Federal Expenditures Budget.</p>                                                                                                                                                                                                              | <p>The following must apply for registration with the portfolio:</p> <ul style="list-style-type: none"> <li>- Investment Programs and Projects (IPP) executed by Agencies and Entities of the Federal Public Administration.</li> <li>- Long-term Productive Infrastructure Projects (Pidiregas).</li> <li>- Service Delivery Projects.</li> <li>- Investment Programs and Projects supported by public trusts.</li> <li>- Other investment expenses as determined by SHCP.</li> </ul> <p><b>Source:</b> Presentation on the Public Investment System, 04-2008.</p> |
| <b>Peru</b>   | <p>“Nonfinancial Public-Sector Entities and Enterprises of the three levels of government* that execute Investment Projects with Public Resources are subject to the present Law.”</p> <p><b>Source:</b> Law creating the National Public Investment System. Law N.° 27,293, Article 2 (modified by the only article of Law N.° 28,802, published in the official newspaper “El Peruano” on July 21, 2006.)</p> <p>*The three levels of government are national, regional, and local.</p> | <p>In terms of the National Public Investment System, public resources are understood to be all financial and nonfinancial resources that are the property of the state or that are administered by public-sector entities. Financial resources include all funding sources.</p> <p><b>Source:</b> National Public Investment System Regulations. Supreme Decree N.° 102-2007-EF, Article 2.</p>                                                                                                                                                                    |

### Methodologies

Project evaluation methodologies are a fundamental element for the proper operation of a NPIS. Currently, all NPIS employ their own methodologies for project formulation and evaluation.

In general, all these methodologies have a similar structure. Table 14 illustrates some examples.

Table 14. Current NPIS methodologies in Latin America

| Bolivia                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                      | Chile                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                  | Colombia                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                               | Mexico                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                | Peru                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                           |
|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <p>There are the following:</p> <p><b>Minimum Profiles:</b></p> <ul style="list-style-type: none"> <li>- General</li> <li>- Water</li> <li>- Roads</li> <li>- Education</li> <li>- Electrification</li> <li>- Market</li> <li>- Irrigation</li> <li>- Health</li> <li>- Railway system</li> </ul> <p><b>Project preparation and evaluation methodologies:</b></p> <ul style="list-style-type: none"> <li>- Agriculture and livestock</li> <li>- Education</li> <li>- Rural electrification</li> <li>- Environment</li> <li>- Health</li> <li>- Basic services</li> <li>- Transportation</li> </ul> <p><b>Source:</b> VIPFE web site, methodologies list.</p> | <p>Methodologies exist for the following sectors:</p> <ul style="list-style-type: none"> <li>- General methodology</li> <li>- Airports</li> <li>- Potable water</li> <li>- Rainwater</li> <li>- Primary health care</li> <li>- Commercial fishing sites</li> <li>- Rural roads</li> <li>- Flood prevention</li> <li>- Sports</li> <li>- Public works</li> <li>- Education</li> <li>- Rural electrification</li> <li>- Infrastructure and equipment</li> <li>- Chilean police force</li> <li>- Youth establishments</li> <li>- Prisons</li> <li>- Neighborhood improvement</li> <li>- Urban road maintenance</li> <li>- Regional airports</li> <li>- Equipment replacement</li> <li>- Waste management</li> <li>- Irrigation</li> <li>- Information and communications technology</li> <li>- Rural internet and technology centers</li> <li>- Rural telephone systems</li> <li>- Intermediate roadways</li> <li>- Interurban roads</li> <li>- Urban roads</li> <li>- Law enforcement</li> </ul> <p><b>Source:</b><br/><a href="http://sni.mideplan.cl/">http://sni.mideplan.cl/</a></p> | <p>A general guide exists, <b>General Adjusted Methodology</b> with the following <b>sectoral guides</b> in the annex:</p> <ul style="list-style-type: none"> <li>- Guide N.º 1 for environmental projects</li> <li>- Guide N.º 2 for science and technology projects</li> <li>- Guide N.º 3 for regional commercialization projects</li> <li>- Guide N.º 4 for small irrigation projects</li> <li>- Guide N.º 5 for construction, improvement, and rehabilitation of rail infrastructure</li> <li>- Guide N.º 6 for mining projects</li> <li>- Guide N.º 7 HDM Model for road construction and improvement projects</li> <li>- Guide N.º 8 for solid waste integrated management projects</li> <li>- Guide N.º 9 for correctional, tribunal, and judicial office projects</li> <li>- Guide N.º 10 for education projects</li> <li>- Guide N.º 11 for energy projects</li> <li>- Guide N.º 12 for health care projects</li> <li>- Guide N.º 13 for gender equality</li> </ul> <p><b>Source:</b> <a href="http://www.dnp.gov.co">www.dnp.gov.co</a></p> | <p>The following manuals exist:</p> <ul style="list-style-type: none"> <li>- General guide for the preparation and presentation of public investment projects</li> <li>- Guide for road projects</li> <li>- Guide for health projects</li> <li>- Guide for equipment replacement projects</li> <li>- Analysis for equipment replacement</li> <li>- Guide for public works projects</li> <li>- Guide for rural potable water delivery services projects</li> <li>- Guide for potable urban water projects</li> <li>- Guide for sewer projects</li> <li>- Guide for municipal sewage treatment plants construction projects</li> </ul> <p><b>Source:</b><br/><a href="http://www.cepep.gob.mx">www.cepep.gob.mx</a></p> | <p>A general guide exists, the <b>General Guide for the Identification, Formulation, and Social Evaluation of Public Investment Projects Profiles</b>, and the following <b>guides by type of project:</b></p> <ul style="list-style-type: none"> <li>- Rural electrification</li> <li>- Universities</li> <li>- Secondary roads</li> <li>- Education</li> <li>- Health</li> <li>- Rural basic sewer systems</li> <li>- Basic sewer systems in small cities</li> <li>- Minor irrigation</li> <li>- Medium and major irrigation</li> <li>- Flood protection and/or control in agricultural or urban areas</li> <li>- Guidelines for Public Investment Projects (PIP) for territorial planning capacity development</li> <li>- Guide for the <i>ex post</i> evaluation of medium and major irrigation.</li> </ul> <p>There are also 8 practical cases to be used as examples and other documents for methodological support.</p> <p><b>Source:</b><br/><a href="http://www.mef.gob.pe/DGPM/instrumentos.php">http://www.mef.gob.pe/DGPM/instrumentos.php</a></p> |

As can be gleaned from this table, in all these cases the methodology used depends on the formulation and evaluation of projects. Formulation encompasses diagnosing the current situation, studying alternatives,

and analyzing supply and demand. Evaluation employs methodologies for the determination of costs and benefits, socioeconomic evaluation, and, in some cases, private evaluation.

Table 15. Selected methodologies from different NPIS

| Methodologies for the transportation sector                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                      |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                              |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                  |                                                                                                                                                                                                                                                                                                                                                                                       |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                               |
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| Bolivia                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                          | Chile                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                        | Colombia                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                         | Mexico                                                                                                                                                                                                                                                                                                                                                                                | Peru                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                          |
| Project preparation and evaluation methodologies in the construction, improvement, and maintenance components of paved interurban roads.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                         | Preparation and evaluation methodologies for interurban transportation projects.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                             | Adjusted general methodology.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                    | Guide for the preparation and presentation of social evaluation studies for roadway projects.                                                                                                                                                                                                                                                                                         | General guide for the identification, formulation, and social evaluation of Public Investment Projects at the profile level.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                  |
| Contents                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                         |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                              |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                  |                                                                                                                                                                                                                                                                                                                                                                                       |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                               |
| Bolivia                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                          | Chile                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                        | Colombia                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                         | Mexico                                                                                                                                                                                                                                                                                                                                                                                | Peru                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                          |
| <b>1. Project preparation</b> <ul style="list-style-type: none"> <li>- Diagnosis of the current situation</li> <li>- Area of influence for the project</li> <li>- Supply and demand projections</li> <li>- Socioeconomic diagnosis</li> <li>- Study of supply and demand</li> <li>- Definition of the situation without the project</li> <li>- Technical alternatives to the project</li> <li>- Size and location of project</li> <li>- Quantification of the environmental technical analysis of the project</li> </ul> <b>2. Project evaluation</b> <ul style="list-style-type: none"> <li>- Socioeconomic evaluation</li> <li>- Private financial evaluation</li> <li>- Environmental impact study</li> <li>- Sensitivity analysis</li> </ul> | <b>Introduction</b><br><b>1 Theory on which methodology is based</b> <ul style="list-style-type: none"> <li>1.1 Benefits of a road project</li> <li>1.2 Costs of a road project</li> <li>1.3 Analysis of the road network</li> <li>1.4 Evaluation horizon</li> <li>1.5 Economic indicators</li> <li>1.6 Economic evaluation</li> </ul><br><b>2 Project preparation</b> <ul style="list-style-type: none"> <li>2.1 Project description</li> <li>2.2 Background analysis</li> <li>2.3 Diagnosis</li> <li>2.4 Optimization of the current situation</li> <li>2.5 Project alternatives</li> <li>2.6 Preliminary selection of alternatives</li> <li>2.7 Analysis and estimation of future vehicular demand</li> </ul><br><b>3 Project evaluation</b> <ul style="list-style-type: none"> <li>3.1 Description of costs and benefits</li> <li>3.2 Estimation of benefits</li> <li>3.3 Estimation of costs</li> <li>3.4 Evaluation and economic indicators</li> </ul> | <ul style="list-style-type: none"> <li>I. Introduction</li> <li>II. User's manual</li> <li>II. Presentation</li> <li>IV. Legal framework</li> <li>V. Conceptual framework</li> <li>VI. Project formulation</li> </ul><br>A. Module 1: Identification<br>B. Module 2: Preparation<br>C. Module 3: <i>Ex ante</i> evaluation <ul style="list-style-type: none"> <li>1. Financial evaluation</li> <li>2. Economic and social evaluation</li> </ul><br>D. Module 4: Programming <ul style="list-style-type: none"> <li>1. Physical-financial programming</li> <li>2. Programming of funding sources</li> </ul><br>E. Module 5: Basic statistical investment form<br><br>Bibliography | <ul style="list-style-type: none"> <li>1. Project origin and objective of the study</li> <li>2. Diagnosis of the current situation</li> <li>3. Situation without the project</li> <li>4. Situation with the project</li> <li>5. Socioeconomic evaluation of project</li> <li>6. Conclusions, recommendations, and limitations of the study</li> <li>7. Informative annexes</li> </ul> | <b>Introduction</b><br><b>Module 1:</b> General aspects <ul style="list-style-type: none"> <li>1.1 Project name</li> <li>1.2 Unit which will formulate and execute the project</li> <li>1.3 Participation by involved entities and beneficiaries</li> <li>1.4 Frame of reference</li> </ul><br><b>Module 2:</b> Identification <ul style="list-style-type: none"> <li>2.1 Diagnosis of current situation</li> <li>2.2 Definition of problem and its causes</li> <li>2.3 Project objectives</li> <li>2.4 Solution alternatives</li> </ul><br><b>Module 3:</b> Formulation <ul style="list-style-type: none"> <li>3.1 Project cycle and its evaluation horizon</li> <li>3.2 Demand analysis</li> <li>3.3 Supply analysis</li> <li>3.4 Supply-demand balance</li> <li>3.5 Sequence of phases and activities for each alternative project and its duration</li> <li>3.6 Costs at market prices</li> <li>3.7 Cost flow at market prices</li> </ul> |

| Contents |                                                                                                                                                                                      |          |        |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                           |
|----------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------|--------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Bolivia  | Chile                                                                                                                                                                                | Colombia | Mexico | Peru                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                      |
|          | <b>4. Project presentation</b><br>4.1 Summary and conclusions<br>4.2 Project preparation<br>4.3 Project evaluation<br>4.4 Conclusions and recommendations<br><br><b>5. Financing</b> |          |        | <b>Module 4: Evaluation</b><br>4.1: Economic evaluation at market prices<br>4.2 Estimation of social costs<br>4.3-a Social evaluation, applying the cost effectiveness methodology<br>4.3-b Social evaluation, applying the cost-benefit methodology<br>4.4 Sensitivity analysis<br>4.5 Select the best alternative project<br>4.6 Sustainability and analysis of selected project<br>4.7 Environmental impact analysis of the selected project<br>4.8 Logical framework for the selected project<br><br><b>Module 5: Conclusions</b><br><br><b>Module 6: Annexes</b><br><br>Bibliography |

Despite the large number of existing manuals in various NPIS, methodologies have evolved very little. Since their creation in the 1970s, socioeconomic evaluation methodologies have been utilized that aim to determine the social net present value (NPV) and the social internal rate of return (IRR) of projects. In those types of projects where this is not possible, or determining benefits is too costly, methodologies aim to determine cost-efficiency parameters like the present value of costs (PVC), the annual equivalent cost (AEC), or the gross value added (PVC-GVA).

In recent decades, all NPIS have worked on the development of methodologies specific to different sectors. Methodological progress has been greatest in the

sectors of physical infrastructure (potable water, electrification, roads, urban roadways, etc.) and agriculture (irrigation), and to a lesser degree, in the social sectors with an emphasis on health and education.

The only major methodological change that transpired in various NPIS has occurred in the last decade and consisted in the adoption of the logical framework methodology as a complementary tool in the formulation of projects and programs and in the evaluation of results.

However, current methodologies have not advanced with respect to the treatment of an important factor: risk. The NPV, the IRR or AEC, and the PVC/GVA are treated as if they were deterministic values. In the best

case scenario, uncertainty is recognized and a sensitivity analysis is done, usually a fairly rudimentary one. For example, some methodologies recommend recalculating parameters for variations of  $\pm 10\%$  or  $20\%$  of costs and for similar fluctuations of demand. In other cases, cost or demand values are ascertained that cause the NPV to be zero or the IRR to equal the current social discount rate (SDR). Scenario analyses are not performed or, when they are, they are basic and without any justification for their choice.

Profitability indicators are actually estimates based largely on assumptions, and there is a possibility of error for each. In actuality, these are probabilistic values and not deterministic ones, and should be reported as such. That is to say, it should not be reported that the NPV is XXXX, but rather that the value of the NPV is between XXXX+YY and XXXX-YY with a probability of ZZ. Or, it could be reported that the probability of the IRR being greater than 12% (for example) is ZZ%.

These determinations are entirely feasible and do not require much additional work for those determining the NPV of a project. It is sufficient to establish a possible range of variation and assign it a probability distribution at the time that the more important parameters that enter into the calculation of profitability indicators are estimated. Later, applying Monte Carlo simulation, it is then possible to determine which probability distribution for profitability indicators to report.

The document “Pautas para la incorporación del análisis de riesgo en PIP” (“Guidelines for incorporating risk analysis in PIP”) prepared for the General Directorate of Multiannual Planning of the Ministry of Economics and Finances for Peru, with the support of the Sustainable Rural Development Program of the Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ, German Technical Cooperation), is evidence of progress for the inclusion of risk analysis in project evaluation. In this document, recommendations are given for analyzing risks projects might face and how to incorporate methods of prevention or mitigation and include them in evaluation. However, socioeconomic profitability indicators continue to be calculated as certain, not probable, values.

Another aspect that has not been developed sufficiently in methodologies is distributional analysis. A project’s NPV or IRR is reported but specifically who pays the costs and who receives the benefits is not analyzed. This information would help give more transparency to decision-making since it would be apparent which groups would be beneficiaries and to what extent, as well as which groups would incur additional costs in the realization of a project (ECLAC, 2001a, 2001b, 2001c).

### *The use of accounting prices*

The methodologies employed by the NPIS for socioeconomic evaluation require the use of accounting prices or shadow prices since they are attempting to determine the true costs and benefits for society. This requires eliminating price distortions.

This aspect does not appear to receive the attention it deserves in the different NPIS currently in operation, and few take care to regularly update accounting price values. This is because the studies required for determining these prices are not simple and contracting universities or research centers to handle this task is costly. In addition, since economic policies that lead to large distortions in market prices have mostly been abandoned in the region, the difference between the social price and private price of inputs has diminished. In many cases, just eliminating taxes or subsidies (when appropriate) provides a good approximation of the social costs of inputs or of the social value of production.

Table 16 presents values for some accounting prices in different NPIS that have been recently updated (the year of the update is indicated).

**Table 16. Selected methodologies for various NPIS**

| Accounting prices                                                 | NPIS | Bolivia                                                                                       | Chile                                                                                                           | Mexico                                                                                                               | Peru                                                                                                                                                                            |
|-------------------------------------------------------------------|------|-----------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|                                                                   |      | Ministerial Resolution N.° 159, La Paz, September 22, 2006.                                   | Social prices for project evaluation.                                                                           | Guidelines for the preparation and presentation of cost-benefit analyses for investment projects. SHCP – March 2008. | General directive of the National Public Investment System Directorial Resolution N.° 009-2007-EF/68,01 NPIS Annex 09 v 1.0.                                                    |
| <b>Social discount rate</b>                                       |      | 12.67 %                                                                                       | 8 %<br>2008 based on a 2003 study                                                                               | 12 %                                                                                                                 | 11 %                                                                                                                                                                            |
| <b>Social value of labor</b>                                      |      | Skilled 1.00<br>Semi-skilled 0.43<br>Urban unskilled 0.23<br>Rural unskilled 0.47<br><br>2006 | Skilled 1<br>Semi-skilled 0.94<br>Unskilled 0.89<br><br>2008 based on a 2002 study<br><br>*from 2009 on         | Unspecified                                                                                                          | Metropolitan Lima 0.86<br>Rest of urban/rural coast 0.68/0.57<br>Urban/rural mountain region 0.60/0.41<br>Urban/rural forest region 0.63/0.49<br>Date of study is not indicated |
| <b>Adjustment factor for the social value of foreign exchange</b> |      | 1.24<br><br>2006                                                                              | 1.01<br><br>2008 based on a 1987 study                                                                          | Unspecified                                                                                                          | 1.08<br><br>Date of study is not indicated                                                                                                                                      |
| <b>Social value of time</b>                                       |      | Unspecified                                                                                   | Time of urban commute of all vehicles: 823 Pesos (US\$ 1.69)/hour/person 2008<br>Date of study is not indicated | Unspecified                                                                                                          | Work purpose, urban areas:<br>4.96 Soles/hour (US\$ 1.80)<br>Date of study is not indicated                                                                                     |

As seen in the preceding table, the only social price published by all NPIS is the social discount rate. This is not surprising as it is a fundamental parameter for calculating the social NPV. However, the studies that support the establishment of this parameter are not performed with the frequency necessary to ensure that it represents the true opportunity cost of public resources. On occasion, the SDR is set at 12% for the sake of convenience (because this rate coincides with that suggested by international financial entities), but without a study that demonstrates its validity for the country.

The remaining social prices are updated with less frequency and are not always publicized. Upon observing

the values —of, for example, the adjustment factor for foreign exchange or the adjustment factors for labor— it can be seen that not utilizing these prices can lead to significant errors in determining the social NPV, and therefore, bad investment decisions.

### Training

Training is a fundamental component of a NPIS. Without personnel trained in the use of socioeconomic evaluation methodologies and in the operation of the system, it is not possible for them to yield useful results. For this reason, the main experiences in the region have included training programs for the professional staff

working with the systems. Agencies administering the NPIS, international organizations, consulting firms, and universities have all participated in these programs.

Table 17 presents the history and current situation of training programs in some of the countries analyzed.

**Table 17. History of NPIS training programs in the region**

|                                                    | Chile                                    | Colombia                     | Peru                                                    | Mexico                                                                                                                                                                 |
|----------------------------------------------------|------------------------------------------|------------------------------|---------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Entities that have participated in the past</b> | Mideplan<br>Catholic University<br>ILPES | DNP<br>Universities<br>ILPES | Ministry of Economics and Finance (MEF)<br>Universities | SHCP<br>National Bank of Public Works and Services (Banobras)<br>Research Center for the Preparation and Socio-economic Evaluation of Projects (CEPEP)<br>Universities |
| <b>Currently participating entities</b>            | Mideplan<br>Universities                 | DNP<br>Universities          | MEF<br>Universities<br>ILPES                            | Universities                                                                                                                                                           |

Training can have three levels of specialization or depth:

- i) a basic level for administrators;
- ii) an intermediate level specific to focal points; and
- iii) a specialized level (diploma or masters') that provides for the training of the NPIS leadership staff and those that will work towards its modernization and development.

Training at the advanced level has been in the hands of universities that offer diplomas or masters' degrees in the socioeconomic evaluation of projects. The content of these training programs has been largely very

similar, with a strong emphasis on macroeconomic and social evaluation topics. Only recently have some of these programs of study incorporated subjects such as the logical framework methodology or the management of project execution.

Training at the intermediate and basic levels has mostly been in the hands of the agencies administering the NPIS, directly or through the hiring of advisory services like ILPES/ECLAC. This type of training is generally through week-long or month-long courses and a strong emphasis on practical matters.

**Box 10. Web sites of some NPIS in the region with training information**

*The following are NPIS web sites that provide details about their training programs.*

Colombia: <http://www.dnp.gov.co/PortalWeb/PolíticasdeEstado/BancodeProgramasyProyectosdeInversiónNal/ComponentedeCapacitaciónyAsistenciaTécnica/tabid/171/Default.aspx>

Chile: <http://sni.mideplan.cl/herramientas.asp?token=@pln=herra>

Peru: <http://www.mef.gob.pe/DGPM/capacitacion.php>

### ***Commentary on the current situation and future development of NPIS***

Existing NPIS aim to determine the socioeconomic profitability of investments, reporting parameters like NPV, IRR, AEC, etc. but not providing information on the distribution of costs and benefits among population groups. They also tend to not include a good analysis of risk; parameters are reported as fixed values when they are actually estimates that should be reported as the probability that the value of the parameter will fall in a given range, or else as the probability that the value of the parameter will be above a certain level.

At the same time, current NPIS do not perform appropriate monitoring of investment initiatives throughout their lifecycle. Only in specific cases (like some projects in Mexico) is it possible to find systematic use of estimated costs versus real costs for projects, as well as an estimated NPV versus an actual NPV. When this information is not made public, accountability for *ex ante* estimations is not encouraged.

NPIS are frequently criticized, especially by political leaders who characterize them as bureaucratic systems that impede and delay the investment process. On occasion, these criticisms are based on the interest of advancing projects that do not promise positive socioeconomic returns. In other cases, they are based on the desire to complete projects within a short time span by skipping all initial studies. Both situations are deplorable. In the first case, advancing the project would result in the inefficient use of resources and instead of progressing as a result of the project, the country would suffer economically (although some group would in fact gain, since otherwise there would be no support for the project). In the second situation, it is not known if the project is good for the country or not. But even if it were, initiating projects without major studies results in higher costs than if the studies were performed. In addition, completing the project will take much more time without the benefits of the studies, even taking into account the time necessary to carry these out.

It is likely that criticisms will remain, but what is troubling are NPIS' weaknesses in confronting them.

The public knows little or nothing about these systems and their use by institutions like the legislature or other elected public officials. Therefore, a challenge lies ahead to validate NPIS in the eyes of the public and among popularly elected leaders. This requires a major change in focus in how NPIS are managed.

Currently, the objectives of NPIS are to promote greater efficiency and efficacy in public investment, as previously stated. To that end, these systems work as a kind of filter that lets through projects (giving a positive recommendation) that demonstrate their advantage to the country in terms of social NPV or AEC. Thus, they tend to be rather normative systems where the ultimate aspiration of many professionals is to get only the projects they recommend financed. In addition, in many cases they look to the creation of inter-sectoral prioritization methodologies in an attempt to give more "scientific" support to decision-making in public investment. This focus is deeply erroneous. NPIS should not and can not replace decision-making in the allocation of resources by elected politicians. These are the people who the citizenry, and their vote, has delegated with the responsibility to decide what to invest in or not. Nobody has voted for a NPIS.

The correct focus must be to think of the NPIS as a system of managerial information within the public sector whose objective is to supply public officials with reliable, complete, and current information to improve the decision-making process. At the same time, the NPIS should provide the public with comprehensive information on proposed, approved, and completed investments, as well as those currently being executed, thereby contributing to transparency in the process of public sector investment. NPIS should be called National Systems for Public Investment Decision-Making in order to capture the essence of their role. A NPIS does not exist to make decisions about investment, since that corresponds to political, not technical, processes. The role of the system should be to provide decision-makers with the best information possible regarding the consequences of decisions for the country or area involved, as well as for participating institutions and the community at large.

These objectives must not be confined to paper, but rather should translate into concrete actions in the development of NPIS, actions that will permit them to overcome their stigma of being an obstacle to investment and to evolve using all the modern tools technology has put at their disposal.

Thus, in respect to their role as a managerial information system for elected officials (mayors, governors, representatives, senators, presidents), NPIS should be able to provide detailed information on the status of any investment initiatives, including prospective information like the possible date of initiation, the total sum needed for investment, benefits that would be generated from the operation, etc. In addition, all this information must be easy for public officials to access, including when they are in the field. For this, NPIS could consider, in addition to remote access by Internet, an interface by personal digital assistant (PDA). This would allow elected officials to utilize the system at any moment to respond to inquiries from citizens or to discuss projects in execution with other public officials.

NPIS must also find a way to get closer to the citizenry and encourage greater use of its potential. As an example, it would not be at all costly to open up debate web pages about each proposed project or those

in development, which would give an early idea about who supports or who opposes a given project. At the same time, this could permit the timely collection of opinions from those benefiting from or affected by the project with regards to aspects that could be improved, or risks that could affect its implementation. Additionally, information need not be presented to the public only as a table with numbers and data. NPIS could include architectural plans and plans for the location of the project which would illustrate how the completed project would look. Information from a distributional analysis study that indicates who would benefit from the project and to what degree, as well as those negatively affected, could also be provided.

With regard to this last point, some might argue that this is not advisable since it could generate opposition to the project. Although this could occur, that same opposition could also object later in the process, causing important delays and cost overruns during the execution of the project. If the opposition to the project is known and recognized sufficiently early in the process, however, compensatory or mitigation measures could be incorporated that would allow for the development of the project without costly interruptions.

### Annex. Comparison of some NPISs

The following tables present a comparison of some basic aspects of the NPIS of five South American countries.

This information has been obtained mostly from the Internet. Therefore, the information is more complete and up-to-date for countries making extensive use of the Internet than for countries that do not yet fully utilize it.

### NPIS websites

**Argentina:** <http://www.mecon.gov.ar/peconomica/basehome/inversionpub.html>

**Bolivia:** <http://www.vipfe.gov.bo/dgip/index.html>

**Chile:** <http://sni.mideplan.cl/>

**Colombia:** <http://www.dnp.gov.co/PortalWeb/Pol%C3%ADticasdeEstado/BancodeProgramasyProyectosdeInversi%C3%B3nNal/tabid/95/Default.aspx>

**Peru:** <http://www.mef.gob.pe/DGPM/index.php>

Table 18. Definitions of public investment in different Latin American countries

| Argentina                                                                                                                                                                                                                                                                                                                                                                          | Bolivia                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                      | Chile                                                                                                                                                                                                                                                                              | Colombia                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                       | Peru                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                       |
|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <p><b>National Public Investment:</b> The application of resources in all types of goods and activities that increase the assets of the entities that comprise the national public sector with the goal of initiating, expanding, improving, modernizing, replacing, or rebuilding the capacity to provide goods or services.</p> <p><b>Source:</b> Law N.º 24.354, Article 2.</p> | <p><b>Public Investment:</b> It is understood as all expenditures of resources of public origin aimed at increasing, improving, or replacing existing physical capital in the public domain and/or human capital, with the objective of expanding the capacity of the country to provide services or produce goods. The concept of public investment includes all the activities of pre-investment and investment realized by public sector entities.</p> <p><b>Source:</b> <u>Supreme resolution 216768</u>, Article 8.</p> | <p><b>Investment</b> is an increase in the capital stock that allows for an expansion in the production possibilities, and in the end, societal income.</p> <p><b>Source:</b> <u>Sistema Nacional de Inversión Pública y Banco Integrado de Proyectos, MIDEPLAN</u>, May 1996.</p> | <p><b>Net Investment:</b> Investment expenditures are defined as those outlays capable of generating returns or being otherwise economically productive, or that are embodied in durable goods, also called capital expenditures as opposed to operating ones, which are usually meant to disappear after use. Also, those expenditures intended to create social infrastructure.</p> <p>The fundamental characteristic of this expenditure must be that it increases productive capacity and productivity in the areas of physical, economic and social structure.</p> <p><b>Source:</b> <u>DNP site</u>.</p> | <p><b>Public Investment Project:</b> Any time-constrained intervention involving the use of public resources with the purpose of expanding, improving, and modernizing the capacity to produce goods or deliver services, whose benefits are independent from those of other projects.</p> <p><b>Source:</b> <u>Supreme Decree N.º 086-2000-EF, Article 1</u>. <a href="http://www.minag.gob.pe/ogpa/inversion_sectorial/Data/reglamento.pdf">http://www.minag.gob.pe/ogpa/inversion_sectorial/Data/reglamento.pdf</a></p> |
| It can be seen that, in general, public investment is understood to be any outlay from a public source meant to maintain or increase the capacity to produce goods or services.                                                                                                                                                                                                    |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                              |                                                                                                                                                                                                                                                                                    |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                            |

Note: In all tables, underlined text represents hyperlinks to the documents quoted, or the institutions mentioned.

Table 19. Legal framework

| Argentina                                                                                                                                                                                                                                                                                                                                                                                                                                                                                       | Bolivia                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                              | Chile                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                | Colombia                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                           | Peru                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                        |
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| <p>The National Public Investment System (NPIS) was created by Law N.° 24,354 which became law on August 22, 1994. Executive Regulatory Decree N.° 720/95 enacted on May 22, 1995 designates the National Directorate for Public Investment and Financing for Projects of the Secretary of Economic Programming of the Ministry of Economics and Public Works and Services as the entity responsible for the NPIS and creates the Public Investment Project Bank (BAPIN).</p>                   | <p>Law 1178 (July 20, 1990) in article 21 signals that the governing entity of the National Public Investment System will be the Ministry of Planning and Coordination. Law N.° 1,493 (September 17, 1993) bestowed the Ministry of Finance with the role as governing entity of the National Public Investment System. This was repealed by Law 1,788 (September 16, 1997) which reaffirmed the entity responsible for this role.</p> <p>Supreme resolution N.° 216,768 of June 18, 1996 establishes the Basic Norms for the National Public Investment System.</p> <p>Ministerial resolution N.° 528 (June 12, 1997) establishes basic regulations for NPIS operations.</p> <p>Ministerial resolution N.° 612 (June 27, 1997) establishes basic regulations for operations of the investment information system (SISIN).</p> <p>Ministerial resolution N.° 613 contains basic regulations for pre-investment.</p> <p>Ministerial resolution N.° 1,484 (December 14, 1998) establishes accounting price ratios.</p> | <p>Law 18,768 (December 29, 1980), the Organic Law for the Financial Administration of the State, adds to Decree Law N.° 1,263 (1973) Article 19 is establishing that previous studies on investment and projects must have an opinion by the (national or regional) planning organism based on a technical-economic evaluation, will be identified budget terms by decree or resolution, and will have an unalterable code and name.</p> <p>Law N.° 19,989 (7/19/1990) creates MIDEPLAN, assigning the Division of Planning, Studies, and Investment responsibility for the maintenance of public sector projects and their evaluation, as well as establishing criteria for the economic and social evaluation of projects financed directly or indirectly by the state.</p> <p>In addition, rules for the identification of projects are established annually in the Public Sector Budget Law and instructions for the identification of investment studies and projects are outlined in a DIPRES memorandum.</p> | <p>Law 38 (4/21/1989) "Organic Statute of the Nation's General Budget" creates (Art. 32) the National Investment Project Bank (BPIN) and confers authority to the National Planning Department (DNP) for its design, establishment, and operation.</p> <p>Decree 2410 (10/20/1989) creates and assigns functions to the methodologies, operations and systems divisions of DNP.</p> <p>Decree 841 (4/20/1990) regulates the operation of the BPIN.</p> <p>Resolution 3127 (11/27/1992) delegates the rating of the viability of projects and their registration in the BPIN to Ministries and Administrative Departments at the national level.</p> <p>Law 179 (12/30/1994) orders that no project or program that forms part of the National General Budget may be implemented if it has not been previously evaluated by the corresponding entity and registered with the BPIN.</p> <p>The name was changed to National Projects and Programs Bank.</p> <p><b>Source:</b> DNP, BPIN web site Legal, institutional, and procedural component.</p> | <p>The National Public Investment System Law (Law No.27293) Its operation is regulated in Supreme Decree N.° 086-2000-EF of 8/14/2000 and is later updated in Supreme Decree N.° 102-2007-EF of 7/19/2007.</p> <p>This decree orders that social prices, parameters and other required norms are approved through Directives from the Investment Office of the Ministry of Economics and Finances, particularly the National Public Investment System General Directive and NPIS General Directive Complementary Norms.</p> |
| <p>All countries have legislation that regulates the operation of their NPIS. The more recently established the system, the more clear and precise the legal provisions that support it; thus, the oldest (Chile) does not possess a specific legal framework, but rather is fundamentally supported through the public sector budget law. More recently initiated systems (Argentina, Peru) rely on a specific law that creates the NPIS and regulatory decrees that govern its operation.</p> |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                      |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                      |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                    |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                             |

Table 20. Objectives defined for the NPIS in different countries

| Argentina                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                   | Bolivia                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                       | Chile                                                                                                                                                                                                                                                                                                                                      | Colombia                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                 | Peru                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                |
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| <p><b>General:</b><br/>According to Article 1 of Law N.° 24.354: "This law creates the National Public Investment System, whose objectives are the inception and constant updating of an inventory of national public investment projects and the annual formulation and management of the National Public Investment Plan." According to the document on the budget system in Argentina: "Its general objectives (of the NIS) consist in providing efficacy, efficiency, and effectiveness to the process of allocating resources for investment, with the support of the creation of the Project Investment Bank (BAPIN)".</p> <p><b>Specifics:</b><br/>1. Increase the productivity of public investment in the entire country, standardizing the processes of project formulation, evaluation, and selection with technical criteria of excellence.</p> | <p><b>General:</b><br/>Undefined</p> <p><b>Specifics:</b><br/>According to Article 2 of Supreme resolution N.° 216.760:<br/>1. Achieve the efficient allocation and administration of public resources used for investment, maximizing their socioeconomic benefits.<br/>2. Establish methodologies, parameters, and criteria for project formulation, evaluation, and execution that public-sector entities will apply in the implementation of their Public Investment Projects.<br/>3. Established procedures by which Public Investment Projects can access internal and external funding sources and be incorporated into the General National Budget.<br/>4. Established procedures for the co-financing of investment projects between public entities and the central government.</p> | <p><b>General:</b><br/>"... improve the quality of national public investment, allocating resources to initiatives with higher social and economic return according to the guidelines of government policy."</p> <p><b>Source:</b> <a href="http://sni.mideplan.cl">http://sni.mideplan.cl</a></p> <p><b>Specifics:</b><br/>Undefined.</p> | <p>The objectives indicated below correspond to the BPIN since the National Public Investment System and the National Management System for Public Investment Projects and Programs mentioned in some documents does not have formal status.</p> <p><b>General:</b><br/>Undefined</p> <p><b>Specifics:</b><br/>1. Support management decision-making for Colombian public investment.<br/>2. Contribute to the incorporation of efficiency and efficacy criteria in the allocation and use of state investment resources.<br/>3. Facilitate the achievement of policy objectives through the definition of programs and projects as coherent sets of feasible actions that can be financed with specific time and space allotments.<br/>4. Provide true, reliable information about the results of public investment</p> | <p><b>General:</b><br/>According to Article 1 of the National Public Investment System Law (Law N.° 27.293): "... optimize the use of public resources allotted for investment..."</p> <p><b>Specifics:</b><br/>According to Article 5 of Law N.° 27.293:<br/>1. Promote the use of the Public Investment Projects Cycle: profile-prefeasibility-feasibility-technical file-execution-ex post evaluation.<br/>2. Strengthen the capacity for planning in the public sector.<br/>3. Create the conditions for the generation of Public Investment Plans for multiannual periods of no less than 3 (three) years.</p> |

Table 20. Objectives defined for the NPIS in different countries (continued)

| Argentina                                                                                                                                                                                                                                                                                                                                                                                            | Bolivia                                                                                                                                                                                                                                                                     | Chile | Colombia                                                                                                                                                                                                                                                                                                                                                                                                                                                                            | Peru |
|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------|
| <p>2. Identify, promote, and evaluate investment projects, registering them in an Investment Projects Bank (BAPIN) created for this purpose.</p> <p>3. Select and propose projects to be integrated into the Public Investment Plan that the legislature approves.</p> <p><b>Source:</b> <a href="http://infoleg.mec.gov.ar/txtnorma/18973.htm">http://infoleg.mec.gov.ar/txtnorma/18973.htm</a></p> | <p>5. Ensure the availability of up-to-date, timely, and reliable information on public investment.</p> <p>6. Ensure constant coordination and a complementary relationship between the NPIS, the National Planning System, and other systems established in Law 1,178.</p> |       | <p>5. Serve as unit for consolidation of information on national, departmental, district, and municipal public investment independent of the source of financing, executing agency, or location of the program, projects, or activities.</p> <p>6. Support the processes of <i>ex ante</i> evaluation, monitoring, results evaluation, and <i>ex post</i> evaluation of public investment decisions.</p> <p><b>Source:</b> <a href="#">El BPIN para principiantes, 12/2002.</a></p> |      |
| In all NPIS studied, a common and central objective is obtaining greater efficiency and efficacy in the allocation of investment resources and in the administration of projects. Other common objectives are guaranteeing the availability of timely information on public investment and establishing homogeneous criteria for project formulation and evaluation.                                 |                                                                                                                                                                                                                                                                             |       |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                     |      |

Table 21. Governing entity in different countries

| Argentina                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                       | Bolivia                                                                                                                                                                | Chile                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                              | Colombia                                                                                                                                                                           | Peru                                                                                                                                                                  |
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| <p><b>General:</b><br/>“The Secretary of Economic Programming of the Ministry of Economics and Production shall be the Enforcing Authority of Law N.º 24-354 and will thus dictate the complementary and/or clarifying norms for implementation and will carry out all actions required for the full implementation of the National Public Investment System (NPIS).”</p> <p><b>Source:</b> Executive Regulatory Decree N.º 720/95 Article 1 (Currently the National Directorate for Public Investment is part of the <u>Secretary of Economic Policy</u>.)</p> | <p>The General Directorate for Public Investment in the <u>Vice Ministry Of Public Investment and External Financing of the Ministry for Development Planning</u>.</p> | <p>The Ministry of Planning and Cooperation, MIDEPLAN, in its capacity as collaborator with the President of the Republic, and the Directorate for Budgets of the Ministry of Housing (DIPRES), in its capacity as Administrator of the National Budget, have the authority to regulate and administer the SNI, applying it to all those services, institutions, and enterprises of the public sector that are involved in investment activities.</p> <p><b>Source:</b> National Public Investment System and the Integrated Project Bank, MIDEPLAN, May 1996.</p> | <p>The National Planning Department (DNP) is the entity in charge of regulating the operation of the BPIN.</p> <p><b>Source:</b> Law 38, Article 32 and Decree 841, Article 3.</p> | <p>Vice Ministry for Economics in the Ministry of Economics and Financing through the General Directorate for <u>Multianual Programming in the Public Sector</u>.</p> |
| <p>Given that Project Banks, from which was derived the idea for NPIS, came about as an instrument of support for investment planning, older systems are associated with planning ministries or offices. As these were restructured or eliminated, more recently created systems are linked to finance or economic ministries. The only case in which there are two managing entities is in Chile, where the Ministries of Finance and Planning coordinate with each other.</p>                                                                                 |                                                                                                                                                                        |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                    |                                                                                                                                                                                    |                                                                                                                                                                       |

Table 22. Other entities involved in NPIS administration

| Argentina                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                          | Bolivia                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                      | Chile                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                   | Colombia                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                   | Peru                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                        |
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| <p>Provincial governments. They are responsible for providing opinions on the programs and projects located in their territories that are included into the draft National Public Investments plan.</p> <p>The environmental regulatory body. It must be consulted for projects and programs covered by Annex 1 of Law N.º 24,354 and communicate its opinion and recommendation as to whether environmental aspects of these programs and projects are being adequately addressed.</p> <p>The executive branch authorizes the Secretary of Economic Programming to set the maximum amount for the investment program or project that will be approved directly by the initiating agency or entity for its inclusion in the national plan for public investment.</p> <p><b>Source:</b> Law N.º 24,354 of the NPIS, articles 11 and 12, and Executive Decree N.º 720/95, articles 7, 9, and 10.</p> | <p>The National Development Council represents the level of coordination of the National Public Investment System and has the following functions according to Supreme Decree 23,873 of October 13, 1994:</p> <ul style="list-style-type: none"> <li>- Achieve consistency among the National Planning and Public Investment Systems.</li> <li>- Harmonize the priorities of public investment and technical cooperation which are later negotiated and incorporated in the Public Investment Program and in the National Budget.</li> </ul> | <p>The Ministry of the Interior, through the <u>Undersecretary for Regional and Administrative Development</u>, does work similar to <u>DIPRES</u> with respect to the allocation and physical-financial monitoring of regional resources (<u>National Fund for Regional Development, FNDR</u>).</p> <p>The Ministry of Agriculture, through the <u>Office of Agrarian Studies and Policies</u> and the Ministry of Economics through the <u>Undersecretary of Fishing</u>, serve in an advisory capacity to <u>MIDEPLAN</u> in matters of technical regulation in their respective sectors.</p> <p>Other institutions that participate at the National level are:</p> <ul style="list-style-type: none"> <li><u>National Irrigation Commission</u>,</li> <li><u>National Energy Commission</u>,</li> <li><u>Chilean Commission on Copper (COCHILCO)</u>, and the <u>Executive Undersecretary of the Urban Transportation Commission</u>.</li> </ul> <p>The Regional Council and the Regional Ministerial Secretary for Planning and Coordination participate at the regional level.</p> <p><b>Source:</b> National Planning Investment System and the Integrated Project Bank, MIDEPLAN, May 1996.</p> | <p>The National Council on Economic Policy (CONPES) is the ultimate national authority in planning and serves as an advisory body to the government in all aspects related to the economic and social development of the country. To achieve this, it coordinates and guides agencies in charge of economic and social management in the government. The SOCIAL CONPES functions in the same way, but varies in composition.</p> <p>The DNP performs the functions of the <u>Technical Secretary for CONPES and SOCIAL CONPES</u> and therefore, is in charge of coordinating and presenting all documents to be discussed in session.</p> | <p>The Ministers (or highest level executive authority) that have authority in each sector and that, in accordance with budget norms, authorize the development of technical files, the implementation of Public Investment Projects and enforce compliance with the NPIS Law, its regulation, and norms issued within their framework.</p> <p>In the same way, the decision-making agency in each sector can delegate its authority to the entities and enterprises belonging to the sector.</p> <p>The Offices for Investment Programming, or those having a similar role in each sector, which maintain a technical-functional relation with the ODI of the Ministry of Economics and Finance also are involved in the administration of the NPIS.</p> <p><b>Source:</b> Law N.º 27,293, Article 10.</p> |
| <p>Within all the NPIS there are other entities that participate in the operation of the system, not as users, but rather as watchdogs for the compliance of plans and policies, providing technical advice to the governing entity. This contributes to the allocation of resources being efficient and effective in terms of national objectives. Although only in the case of Argentina is the environmental agency specifically mentioned, a similar agency also plays an important role in Chile.</p>                                                                                                                                                                                                                                                                                                                                                                                         |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                              |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                         |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                            |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                             |

Table 23. Entities incorporated into the NPIS

| Argentina                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                | Bolivia                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                       | Chile                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                         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                                                                                                                                                                                                                            | Peru                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                       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| <p>All organisms making up the national* public-sector, as well as private or public organizations that require transfers, subsidies, contributions, guarantees, credits, and/or any type of benefits for their investment projects that directly or indirectly affect the national treasury with present or future, certain or contingent budget repercussions.</p> <p>* This is defined as all jurisdictions of the national administration composed of the central administration and decentralized entities, whether autonomous or not, including social security institutions, the Central Bank of the Republic of Argentina, the national public banks, and autonomous financial entities of the national government; state enterprises and corporations, corporations with majority state ownership, mixed economy corporations, and all other business organizations where the government has a majority stake in capital or in the formation of societal decisions, and the bi-national entities that make up the national government.</p> <p><b>Source:</b> Law N.º 24.354</p> | <p>All entities of the public-sector mentioned in articles 3 and 4 of Law 1,78*, that participate in public investment activities under the responsibility of the highest level executive authority.</p> <p>* This Law states in article 3 that these are "...all public-sector entities without exception, including as such the Presidency and Vice Presidency of the Republic, the ministries, the administrative units of the Comptroller General of the Republic and the Electoral Courts; the Central Bank of Bolivia, the Superintendents of Banks and Insurance, the Development Corporations, and the state financial intermediation entities; the Armed Forces and National Police; the departmental governments, universities, and municipalities; the institutions, entities, and enterprises of the national, departmental, and local governments, and all other entities in which the state has a majority stake."</p> <p>Article 4 adds the administrative units of the legislative and judicial branches.</p> | <p>All those public sector services, institutions, and enterprises that are involved in investment activities.</p> <p>The Offices of Planning and Budget (OPLAP) for each ministry are responsible for coordinating, analyzing, and reviewing projects sent by the dependent national services or ministerial secretaries and presenting them to the branch minister for their approval.</p> <p>Public enterprises, through their planning offices and their boards, send their projects to MIDEPLAN for analysis and recommendation. In regard to public investment at the regional level, the governors rely on the advice of the regional councils (political) and the Regional Ministerial Secretariat for Planning Coordination (technical). Even when municipalities do not form part of the public sector, they participate in the NIS since the bulk of their investments come from funds administered by entities that do make up part of the public sector. The Secretaries for Communal Planning advise the Mayor and Council to identify, formulate, prepare, and evaluate projects of communal interest.</p> | <p>BPIN regulations apply to all entities that implement investment projects financed or co-financed by resources from the National General Budget. This includes: the Comptroller's office, the Attorney General's office, the Civil Registry, the judicial branch, the ministries, the national administrative departments, the special administrative units, the National Police, the public establishments of the national level, the Superintendents, the Co-financing Funds; the National Congress, the Ombudsman's office, the Public Prosecutor's office, the Superior Judicial Council, the autonomous university entities, public enterprises; national entities attached or linked to ministries and national administrative departments, departments and municipalities having access to the National Co-financing System; entities attached (public establishments and special administrative units) or linked (state-owned industrial and commercial enterprises, mixed enterprises, public enterprises, and autonomous university entities) and other functional areas of ministries or administrative departments.</p> | <p>All the public sector nonfinancial entities and enterprises that implement public investment projects, including:</p> <ul style="list-style-type: none"> <li>- All the public sector nonfinancial entities and enterprises that implement public investment projects, including:</li> <li>- Ministries and their decentralized agencies</li> <li>- Decentralized public institutions</li> <li>- Constitutionally autonomous institutions.</li> <li>- Regional governments.</li> <li>- Public or private law state enterprises and mixed enterprises in which the control of decisions by management organs is in the hands of the state, as long as they are owned by the central or regional government and do not perform financial activities.</li> <li>- In general, institutions and agencies of the state that implement public investment projects, as long as they do not perform financial activities and are not related to local governments or their enterprises.</li> </ul> <p><b>Source:</b> Supreme Decree N.º 086-2000-EF, Article 3.</p> |
| <p>In all NPIS there are other entities that participate in the operation of the system, not as users, but as guarantors of compliance with plans and policies, or providing technical advice to the governing entity. This contributes to resource allocation for projects and programs being efficient and effective with respect to national objectives. Even though the environmental authority is mentioned only in the case of Argentina, it also plays an important role in the case of Chile.</p>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                               |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                           |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                        |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                              |

Table 24. Territorial levels

| Argentina                                                                                                                                                                                                                                  | Bolivia                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                   | Chile                                                                                                                                                                                                                                                                                                                                                                                                                                                                                    | Colombia                                                                                                                                                                                                                                                                                            | Peru                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                          |
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| <p><b>National level</b>, to which NPIS rules are applied.</p> <p><b>Provincial level</b>, subject to consultation on investments in their territory.</p> <p><b>Source:</b> Law N.º 24.354 and Executive Regulatory Decree N.º 720/95.</p> | <p><b>National:</b> includes all the ministries, national secretariés, decentralized entities, publicly-owned enterprises, and investment and development funds that channel resources toward sectoral public investment.</p> <p><b>Departmental:</b> comprises all departmental prefectures and their dependent entities that channel resources toward regional public investment.</p> <p><b>Municipal:</b> comprises all municipal governments and their dependent entities that channel resources toward local public investment.</p> <p>Supreme resolution N.º 216768, Article 4.</p> | <p>Decentralization involves three management levels in the decision-making process:</p> <ul style="list-style-type: none"> <li>- <b>National:</b> Governing organisms and ministries.</li> <li>- <b>Regional:</b> Governors, regional ministerial secretariés (Seremis), regional governments.</li> <li>- <b>Communal:</b> Mayor and municipal council.</li> </ul> <p><b>Source:</b> National Public Investment System and Integrated Project Bank, Ministry of Planning, May 1996.</p> | <p>In the National System for Project and Program Management, which is a part of the National Investment System and that is in a process of consolidation, the national, departmental, and municipal levels are differentiated.</p> <p><b>Source:</b> El BPIN para principiantes, DNP, 12/2002.</p> | <p>“Nonfinancial Public Sector Entities and Enterprises of the three levels of government”<sup>*</sup> that execute investment projects with public resources are subject to present law.”</p> <p><b>Source:</b> Law creating the National Public Investment System. Law N.º 27,293, Article 2 (modified by the only article of Law N.º 28,802, published in the official newspaper “El Peruano” on July 21, 2006.)</p> <p><sup>*</sup> The three levels of government are national, regional, and local.</p> |
| All NPIS cover national-level institutions. As they have been consolidating, they have also incorporated regional- and municipal- level entities.                                                                                          |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                           |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                          |                                                                                                                                                                                                                                                                                                     |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                               |

Table 25. Funding sources incorporated into the NPIS

| Argentina                                                                                                                                                                                                                                                                                                                                                                                                      | Bolivia                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                               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| <p>All national public sector investment projects, as well as those of private or public organizations, that require for their implementation transfers, subsidies, contributions, guarantees, credits, and/or any type of benefits that directly or indirectly affect the national treasury with present or future, certain or contingent budget repercussions.</p> <p><b>Source:</b><br/>Law N.º 24,354.</p> | <p>The Resources of the Nation's General Treasury are those administered by the central government that are transferred to central administration entities and to the Royalties Compensatory Fund created by Law 1,551 of April 20, 1994 to finance the Public Investment Budget, in accordance with norms established annually by the Governing Entity for their inclusion in the NGB.</p> <p>Resources specific to public entities are those that are collected and administered directly by public entities and are used to finance their Public Investment Budgets according to current legal provisions and should be incorporated into the NGB.</p> <p>External resources are those which the Governing Entity for the NPIS negotiates with multilateral financial organizations, international aid organizations, and governments, through credit or donation agreements, and which are transferred to public-sector entities in order to finance the Public Investment Program, in accordance with procedures established in these basic norms, their regulations, and the provisions of their respective funding agreements.</p> <p><b>Source:</b> Supreme resolution N.º 216,768, Article 9.</p> | <p>The Basic Investment Statistics System (SEBI) is applied to "all public institutions that apply for financing of basic studies, investment programs and projects using resources from the National Budget." This includes:</p> <ul style="list-style-type: none"> <li>- Sectoral funds: made up of their own resources, direct fiscal contributions, and resources from foreign borrowing.</li> <li>- Funds from state enterprises: correspond to resources through the concept of yearly depreciation and resources provided by internal and external loans.</li> <li>- The National Fund for Regional Development: composed of direct fiscal contributions and external debt that is designated for financing investments that encourage regional development.</li> <li>- "Presidente de la Republica" Social Fund. Composed of direct fiscal contributions, it finances social projects aimed at eradicating poverty.</li> <li>- Municipal Funds: correspond to resources of municipalities and resources from the <u>Municipal Common Fund</u>.</li> </ul> <p><b>Source:</b> Procedimientos y formularios para el SEBI 2002 y Sistema Nacional de Inversión Pública y Banco Integrado de Proyectos. MIDEPLAN, May 1996.</p> | <p>The following financing categories are established in the BPIN:</p> <ul style="list-style-type: none"> <li>- National government contributions</li> <li>- Resources administered by entities at the national level</li> <li>- Other resources, such as donations and contributions from the community.</li> </ul> <p><b>Source:</b> Sistema Nacional de Inversión. Manual del Usuario.</p> <p>The following sources are identified for territorial entities:</p> <ul style="list-style-type: none"> <li>- National sources.</li> <li>- Shared fiscal revenues (Situado fiscal).</li> <li>- Funds: Financial Agency for Territorial Development (Findeter), National Fund for Development Projects (Fonade), Institute for Industrial Promotion (IFI), National Energy Financing Agency (FEN), Foundation for Education and Social Development (FES), Environmental Compensation Fund, Tourism Promotion Fund, "Capacitar" Fund, National Fund for Neighborhood Roads, National Environmental Fund (FONAM), Investment Fund for Peace, Social Solidarity Network, Ministry for Economic Development.</li> <li>- Royalties, National Royalties Fund.</li> <li>- Institutes and Programs: Colombian Institute for Science and Technology Development (Colciencias), Colombian Sports Institute (Coldeportes), Ecopetrol, Colombian Institute for Family Wellbeing (ICBF), National Institute for Land Adequation (INAT), National Institute for Fishery and Aquaculture (INPA), Colombian Agricultural/Livestock Institute (ICA), National Institute for Social Interest Housing and Urban Reform (Inurbe), National Training Service (SENA), National Institute for Roads (Invias), National Plan for Microenterprise Development, Colombian Institute for Overseas Credit and Technical Studies (ICETEX), Institutional Strengthening for Urban Environmental Management, Forest Reforestation Incentive Certificate, Forest Conservation Incentive Certificate, Credits for Natural Resources, Colombian Corporation for Agricultural and Livestock Research (Corpoica), National Agricultural/Livestock Technology Transfer Program (Pronatta), Municipal Unit for Agricultural/Livestock Technical Assistance (Umatat).</li> </ul> | <p>The following funding sources were considered in the Directive for the Programming and Formulation of Institutional Budgets for the Public Sector for Fiscal Year 2007:</p> <ul style="list-style-type: none"> <li>- Ordinary resources</li> <li>- User fees and supplementary user fees.</li> <li>- Shares in customs duty collections.</li> <li>- Contributions to funds.</li> <li>- Resources collected directly.</li> <li>- Resources from official internal debt operations.</li> <li>- Resources from official external debt operations.</li> <li>- Donations and transfers.</li> </ul> <p>Also, in Regulation (Directiva) N.º 012-2007-EF/76.01 Instructions for the Evaluation of the 2007 Fiscal Year Institutional Budget of the Enterprise-like Entities, the following project financing sources are considered:</p> <ul style="list-style-type: none"> <li>- Own funds (includes own resources, capital resources, and surplus from previous years).</li> <li>- Internal debt.</li> <li>- External debt.</li> <li>- Donations and transfers.</li> </ul> |

Table 25. Funding sources incorporated into the NPIS (continued)

| Argentina                                                                                                                                                                                                                                                                                    | Bolivia | Chile | Colombia                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                             | Peru |
|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------|-------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------|
|                                                                                                                                                                                                                                                                                              |         |       | <ul style="list-style-type: none"> <li>- Internal Credit Resources: Fund for Agricultural Sector Financing (Finagro), Agrarian Bank.</li> <li>- Private sector: Development and Consulting Services Corporation (Sedecom), Ecofondo, National Association of Foundations and Corporations for Microenterprise Development.</li> <li>- Departmental sources.</li> <li>- Tax and nontax revenue and capital resources.</li> <li>- Institutions: Financial Institute for the Development of the Cauca Valley (Infivalle), "Ideas" Colombian University Corporation, Financial Institute for the Development of Risaralda (Infider).</li> <li>- Municipal sources.</li> <li>- Own resources: Tax and nontax revenue and capital resources.</li> <li>- International sources:</li> <li>- External credit resources, Colombian Agency for International Cooperation (ACCI), Organization of Iberoamerican States (OEI)</li> </ul> <p><b>Source:</b> Fuentes de Financiación y sus Condiciones para Entes Territoriales, DNP, May 2000.</p> |      |
| The kind of financing sources incorporated into the NPIS varies widely, but it can be said that, in general, the intent is to incorporate all investment resources available to entities belonging to the NPIS. It should be noted that most NPIS also include resources of external origin. |         |       |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                      |      |

Table 26. Current preparation and evaluation methodologies

| Argentina                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                 | Bolivia                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                              | Chile                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                              | Colombia                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                    | Peru                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                   |
|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| N/A                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                       | <p>Minimum profiles:</p> <ul style="list-style-type: none"> <li>- General</li> <li>- Water</li> <li>- Roads</li> <li>- Electrification</li> <li>- Market</li> <li>- Irrigation</li> <li>- Health</li> <li>- Railway system</li> </ul> <p>Project preparation and evaluation methodologies:</p> <ul style="list-style-type: none"> <li>- Agriculture and livestock</li> <li>- Rural electrification</li> <li>- Environment</li> <li>- Health</li> <li>- Basic services</li> <li>- Transportation</li> </ul> <p><b>Source:</b> <a href="#">VIPFE web site</a>, methodologies list.</p> | <p>Methodologies exist for the following sectors:</p> <ul style="list-style-type: none"> <li>- General methodology</li> <li>- Airports</li> <li>- Potable water</li> <li>- Rainwater</li> <li>- Primary health care</li> <li>- Commercial fishing sites</li> <li>- Rural roads</li> <li>- Flood prevention</li> <li>- Sports</li> <li>- Public works</li> <li>- Education</li> <li>- Rural electrification</li> <li>- Infrastructure and equipment</li> <li>- Chilean police force</li> <li>- Youth establishments</li> <li>- Prisons</li> <li>- Neighborhood improvement</li> <li>- Urban road maintenance</li> <li>- Regional airports</li> <li>- Equipment replacement</li> <li>- Waste management</li> <li>- Irrigation</li> <li>- Information and communication technology</li> <li>- Rural long-distance telephone centers</li> <li>- Rural telephone systems</li> <li>- Intermediate roadways</li> <li>- Interurban roads</li> <li>- Urban roads</li> <li>- Law enforcement.</li> </ul> <p><b>Source:</b> <a href="http://sni.mideplan.cl/">http://sni.mideplan.cl/</a></p> | <p>A general guide exists, General Adjusted Methodology with the following sectoral guides in the annex:</p> <ul style="list-style-type: none"> <li>- Guide N° 1 for environmental projects</li> <li>- Guide N° 2 for science and technology projects</li> <li>- Guide N° 3 for regional commercialization projects</li> <li>- Guide N° 4 for small irrigation projects</li> <li>- Guide N° 5 for construction, improvement, and rehabilitation of rail infrastructure</li> <li>- Guide N° 6 for mining projects</li> <li>- Guide N° 7 HDM Model for road construction and improvement projects</li> <li>- Guide N° 8 for solid waste integrated management projects</li> <li>- Guide N° 9 for correctional, tribunal, and judicial office projects</li> <li>- Guide N° 10 for education projects</li> <li>- Guide N° 11 for energy projects</li> <li>- Guide N° 12 for health care projects</li> <li>- Guide N° 13 for gender equality.</li> </ul> <p><b>Source:</b> <a href="http://www.dnp.gov.co/PortalWeb/PoliticadeEstado/Banco-deProgramasyProyectosdeInversion-Nal/ComponenteMetodologico/tabid/170/Default.aspx">http://www.dnp.gov.co/PortalWeb/PoliticadeEstado/Banco-deProgramasyProyectosdeInversion-Nal/ComponenteMetodologico/tabid/170/Default.aspx</a></p> | <p>There are the following methodological manuals:</p> <p>General:</p> <ul style="list-style-type: none"> <li>- General Guide for the Identification, Formulation, and Social Evaluation of Large and Medium Public Investment Projects.</li> <li>- General Guide for the Identification, Formulation, and Social Evaluation of Minor Public Investment Projects.</li> </ul> <p>By sector:</p> <ul style="list-style-type: none"> <li>- Manuals for Identification, Formulation and Evaluation of Projects: environment; institutional development; education; income generation; promotion of women, childhood, adolescence, and human development; promotion of indigenous peoples; natural resources; major and medium irrigation; minor irrigation; health; agricultural public services; inter-urban roads; urban roads.</li> </ul> <p>Also the following practical cases, intended as examples:</p> <ul style="list-style-type: none"> <li>- Rural electrification and renewable energies</li> <li>- Income generation</li> <li>- Environment</li> <li>- Indigenous peoples</li> <li>- Large and medium irrigation</li> <li>- Minor irrigation</li> <li>- Health</li> <li>- Agricultural public services.</li> </ul> <p><b>Source:</b> <a href="http://www.mef.gob.pe/DGPM/instrumentos.php">http://www.mef.gob.pe/DGPM/instrumentos.php</a></p> |
| As could be expected, systems that have been operating for a longer time have more methodologies for project preparation and evaluation (Chile, Colombia). However, the case of the NPIS in Peru stands out since barely a year after its creation, it already had a full toolbox of sector methodologies and practical cases to guide other types of projects. The convenient internet access to the methodological manuals provided by the systems of Bolivia, Colombia, and Peru should also be noted. |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                      |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                    |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                             |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                        |

Table 27. Structure of methodologies

| Argentina | Bolivia                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                         | Chile                                                                                                                                                                                                                                                                                                                                                                                                                                                           | Colombia                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                         | Peru                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                       |
|-----------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| N/A       | <p>Methodologies are contained in documents that describe, in detail, the steps to follow in preparing and evaluating a project. For example, the Methodology for the Preparation and Evaluation of Potable Water Projects has the following structure:</p> <ul style="list-style-type: none"> <li>1.1 Preparation</li> <li>1.2 Project title</li> <li>1.3 Diagnosis of the current situation</li> <li>1.4 Project objective</li> <li>1.5 Affected and target population</li> <li>1.6 Quantification of the deficit in water supply</li> <li>1.7 Optimization of the current situation</li> <li>1.8 Relation of the project with plans and programs</li> <li>1.9 Project description</li> <li>1.9.1 Presentation of alternatives and pre-selection</li> <li>1.9.2 Description of alternative(s)</li> <li>1.9.3 Project engineering</li> <li>1.9.4 Technical aspects of alternatives</li> <li>1.9.5 Operational aspects of alternatives</li> <li>1.9.6 Environmental aspects of alternatives</li> <li>1.9.7 Product, components, and activities of alternatives</li> <li>2 Evaluation</li> <li>2.1 Socioeconomic evaluation</li> <li>2.1.1 Benefits derived from project</li> <li>2.1.2 Costs</li> <li>2.1.3 Criteria for decision-making</li> <li>2.2 Private evaluation</li> <li>2.2.1 Benefits</li> <li>2.2.2 Costs</li> <li>2.2.3 Criteria for decision-making</li> <li>2.3 Sensitivity analysis.</li> </ul> | <p>Methodologies consist of a document that serves as a guide for those preparing project profiles. Most methodologies have the following general structure:</p> <ul style="list-style-type: none"> <li>- Introduction</li> <li>- Theory on which methodology is based</li> <li>- Project preparation</li> <li>- Project evaluation (in some)</li> <li>- Financing (in some)</li> <li>- Document presentation</li> <li>- Annexes (various, in some).</li> </ul> | <p>Methodologies consist of a series of templates that must be completed according to the instructions contained within each methodological manual. The principal aspects of the methodologies are (for each one, more than one format may apply):</p> <ul style="list-style-type: none"> <li>- Introduction</li> <li>- Module 1: Project identification. <ul style="list-style-type: none"> <li>1.1 Problem description</li> <li>1.2 Population and zone affected. Target population and zone.</li> <li>1.3 Description of current situation and its evolution</li> <li>1.4 Description of current situation and quantification of need</li> <li>1.5 Study of alternatives.</li> </ul> </li> <li>- Module 2: Project preparation and evaluation. <ul style="list-style-type: none"> <li>2.1 Description of benefits derived from project</li> <li>2.2 Valuation of costs of alternatives</li> <li>2.3 Investment and reinvestment costs for alternatives</li> <li>2.4 Investment cash flow</li> <li>2.5 Cash flow for operation and maintenance</li> <li>2.6 Summary of costs for alternative</li> <li>2.7 Environmental impact</li> <li>2.8 Selection of least-cost alternative</li> <li>2.9 Selection of project name.</li> </ul> </li> </ul> | <p>Methodologies consist of a complete and detailed document on tasks to be performed, annexes focusing on aspects such as gender, environmental evaluation, and the logical framework matrix, and a series of forms for registering the compiled information. The general methodological document contains the following::</p> <ul style="list-style-type: none"> <li>- Introduction</li> <li>- Module 1: Identification of large and medium-sized public investment projects <ul style="list-style-type: none"> <li>Task 1: Identify the central problem</li> <li>T.2 Generate the cause and effects tree</li> <li>T.3 Generate the means and ends tree</li> <li>T.4 Search for solutions and propose alternative possible projects</li> <li>T.5 Construct the Logical Framework Matrix for each possible project.</li> </ul> </li> <li>- Formulation of large and medium-sized public investment projects <ul style="list-style-type: none"> <li>T.1 Define objective for public investment project</li> <li>T.2 Establish the beneficiary area and population</li> <li>T.3 Propose a strategy for achieving the objective</li> <li>T.4 Established a time horizon for initial evaluation</li> <li>T.5 Generate an action timeline for each alternative</li> <li>T.6 Estimate project investment costs and contributions from interested parties</li> <li>T.7 Estimate total incremental costs for alternatives.</li> </ul> </li> </ul> |

Table 27. Structure of methodologies (continued)

| Argentina                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                      | Bolivia                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                              | Chile | Colombia                                                                                          | Peru                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                |
|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------|---------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                | <p>In addition, there are Excel spreadsheets with parameters that provide a flexible and efficient tool in the process of Investment Project formulation and evaluation.</p> <p>Minimum profiles consist of a series of forms to be completed. They are comprised of four sections:</p> <ul style="list-style-type: none"> <li>- Part 1: General aspects of the project.</li> <li>- Part 2: Identification of problem to be solved or potential to be developed.</li> <li>- Part 3: Solution proposed by the project.</li> <li>- Part 4: Conclusions and recommendations.</li> </ul> |       | <ul style="list-style-type: none"> <li>- Module 3: Project funding and sustainability.</li> </ul> | <ul style="list-style-type: none"> <li>- Module III: Evaluation of large and medium-sized public investment projects.</li> <li>T.1 Analysis of current situation without project</li> <li>T.2 Analysis and projection of the optimized situation</li> <li>T.3 Determine the price of the final product or service</li> <li>T.4 Estimate net incremental income received by agents involved in the project</li> <li>T.5 Estimate present value of net income and internal rate of return (IRR)</li> <li>T.6 Evaluate and define the economic life of the project</li> <li>T.7 Preliminary sensitivity analysis</li> <li>T.8 Sustainability analysis for investment alternatives</li> <li>T.9 Compare investment alternatives and select the best option</li> <li>T.10 Generate the logical framework for the selected alternative.</li> <li>- Module IV: Impact analysis for the selected alternative.</li> <li>T.1 Evaluate distributional impact of project</li> <li>T.2 Analyze project's environmental impact.</li> <li>- Glossary of terms.</li> <li>- Annexes (17).</li> </ul> |
| <p>The structure of methodologies is similar in all NPIS in that they incorporate chapters on project identification, diagnosis of the current situation, analysis of alternatives, and evaluation. The depth with which each topic is discussed and the way the information is requested to be presented may vary. In general, there is a tendency to develop methodologies that are progressively more detailed and self-explanatory (a trend that was pioneered by ILPES) and to present the results of the analysis performed in spreadsheets or standardized templates (Colombia, Bolivia, and Peru).</p> |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                      |       |                                                                                                   |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                     |

Table 28. Use of social prices

| Argentina                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                              | Bolivia                                                                                                                                                                                                                                                                                                                   | Chile                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                           | Colombia                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                         | Peru                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                  |
|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <p>In 1996, the following were established:</p> <ul style="list-style-type: none"> <li>- Interest rate or social discount rate to be used set at 12%.</li> <li>- Unskilled labor rates</li> </ul> <p>Greater Buenos Aires 0.886</p> <p>Pampas region 0.878</p> <p>Nuevo Cuyo region 0.875</p> <p>Northwest region 0.819</p> <p>Northeast region 0.891</p> <p>Patagonia region 0.891</p> <p><b>Source:</b> Resolution N.º 110/96 of the Secretary for Economic Programming. Article 2, which set social prices, was repealed by Resolution N.º 100/97 (they may have since changed, but more updated information is not available on the Internet).</p> | <ul style="list-style-type: none"> <li>- Social discount rate 12.67%</li> <li>- Foreign exchange: 1.24</li> <li>- Labor</li> </ul> <p>Unskilled urban 0.23</p> <p>Unskilled rural 0.47</p> <p>Semi-skilled 0.43</p> <p>Skilled 1.00</p> <p><b>Source:</b> Ministerial Resolution N.º 159, La Paz, September 22, 2006.</p> | <ul style="list-style-type: none"> <li>- Social discount rate: 8%</li> <li>- Foreign exchange 1.01</li> <li>- Social prices of labor:</li> </ul> <p>Skilled 0.98</p> <p>Semi-skilled 0.68</p> <p>Unskilled 0.62</p> <ul style="list-style-type: none"> <li>- Social value of time</li> </ul> <p>Urban commutes: 823 (pesos/hour/passenger)</p> <p>Interurban commutes: (pesos/hour/vehicle)</p> <p>Cars 5316</p> <p>Vans, pickups 7240</p> <p>Trucks – 2 axles 3601</p> <p>Trucks – 2 + axles 3601</p> <p>Buses 29814</p> <p>In addition, the following are calculated:</p> <ul style="list-style-type: none"> <li>- The social prices for fuel, tires, lubricants, maintenance time, and new vehicles.</li> <li>- The social costs of maintaining roads.</li> </ul> <p><b>Source:</b> Social prices for the social evaluation of projects.</p> | <ul style="list-style-type: none"> <li>- The social discount rate is 12%.</li> </ul> <p><b>Source:</b> DNP web site FAQ.</p> <p>The following Social Price Ratios (RPS) are utilized in the <u>General Methodological Manual</u>:</p> <ul style="list-style-type: none"> <li>- Physical structures, materials, and inputs 0.80</li> <li>- Machinery and equipment 0.77</li> <li>- Skilled labor 1.00</li> <li>- Unskilled labor 0.60</li> <li>- Other costs 0.80</li> </ul> <p>(These values correspond to the 1993 version of the manual, so they may have since changed.).</p> | <ul style="list-style-type: none"> <li>- Social discount rate: 14%</li> <li>- Foreign exchange: 1.08</li> </ul> <p><b>Source:</b> General Directorate for the National Public Investment System (N.º 009-2007-EF/6801).</p> <ul style="list-style-type: none"> <li>- Social value of time (soles/hour)</li> </ul> <p>Project users</p> <p>Urban area 4.96</p> <p>Rural area 3.32</p> <p>Transportation users</p> <p>Domestic air flights 4.25</p> <p>Interurban auto 3.21</p> <p>Interurban public transportation 1.67</p> <p>Urban auto 2.80</p> <p>Urban public transportation 1.08</p> <p><b>Source:</b> General Directorate for the National Public Investment System (N.º 009-2007-EF/6801).</p> |
| <p>The use of the social discount rate is standard in all countries. The use of social prices for labor, foreign exchange, and the social value of time is also common but not yet standard. Argentina appears to be the only country that applies regional values to the social prices of labor.</p>                                                                                                                                                                                                                                                                                                                                                  |                                                                                                                                                                                                                                                                                                                           |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                 |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                  |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                       |

Table 29. Connected systems

| Argentina                                                                                                                                                                                                                   | Bolivia                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                  | Chile | Colombia                                                                                                                                                                                                                                                                                                            | Peru |
|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------|
| <p>Financial Administration System for the National Public Sector.</p> <p>Systems for Managerial Control in the National Public Sector.</p> <p><b>Source:</b> <u>El Sistema Presupuestario Público en la Argentina.</u></p> | <p>National Planning System: Development plans and medium-term programming resulting from this should provide the frame of reference for public entities' investment projects.</p> <p>Operations Programming System: the Public Investment Program must be part of the integral programming of the operations of public entities, following the basic rules of this system.</p> <p>Budget System: investment projects included in the public investment program must be incorporated into public entities' budgets and into the National General Budget, following the basic rules of this system.</p> <p>System for the Administration of Goods and Services: all entities must follow its rules when performing contracting and acquisition operations for investment projects, within the framework of this system's rules.</p> <p>Treasury and Public Credit System: all applications for and contracting of credit for financing investment projects must be carried out within the limits and conditions established by this system.</p> <p>Integrated Accounting System: will take into account budget, financial, and patrimonial transactions in the results regarding project fulfillment.</p> <p><b>Source:</b> Supreme resolution N.º 216768, Article 6.</p> | N/A   | <p>National Planning System: defined as the group of actors (authorities and agencies), norms, procedures, and mechanisms that allow for the consolidation of economic and social development based on participatory planning processes.</p> <p><b>Source:</b> <u>El BPIN para Principiantes</u>, DNP, 12/2002.</p> | N/A  |

In general, NPIS are associated with all those systems involved in the management of public resources in a given country. Thus they tend to be linked to budget systems in respect to the allocation of resources and the oversight of their use, and to planning systems, to which they provide basic information in the preparation of multi-annual investment plans.

Table 30. Subsystems

| Argentina | Bolivia                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                        | Chile                                                                                                                                                                                                                                                                                                                                                                                                                                                 | Colombia                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                           | Peru                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                    |
|-----------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| N/A       | <p>The Investments Information System (SISIN) is structured based on the integrated operation of the following subsystems:</p> <ul style="list-style-type: none"> <li>- Project registration subsystem</li> <li>- Opinion registration subsystem</li> <li>- Financing requirements programming subsystem</li> <li>- Physical and financial execution programming and monitoring subsystem</li> <li>- Budget programming subsystem</li> <li>- Public investment project results evaluation subsystem.</li> </ul> <p><b>Source:</b> <u>Resolución Ministerial N.º 612</u>, articles 9 to 15.</p> | <ul style="list-style-type: none"> <li>- Technical-Economic Analysis Subsystem, also known as Basic Investment Statistics System (SEBI), operated by MIDEPLAN</li> <li>• Budget Formulation Subsystem, operated by DIPRES of the Finance Ministry.</li> <li>• Ex post Evaluation Subsystem, under development at MIDEPLAN.</li> </ul> <p><b>Source:</b> Sistema Nacional de Inversión Pública y Banco Integrado de Proyectos. MIDEPLAN, May 1996.</p> | <p>The National Public Investment System (NPIS) includes:</p> <ul style="list-style-type: none"> <li>- Integrated System of Financial Information (SIIF)</li> <li>- National Public Credit System</li> <li>- National Tax and Fiscal System</li> <li>- National Technical Cooperation System</li> <li>- National Co-financing System</li> <li>- National Program and Project Management System (the latter, currently under development, would be based on the National Program and Project Bank Network comprised of the BPIN, District Program and Project Banks, Departmental Program and Project Banks, Municipal Program and Project Banks).</li> </ul> <p><b>Source:</b> El BPIN para Principiantes, DNP, December 2002.</p> | <p>The National Public Investment System includes the following subsystems:</p> <ul style="list-style-type: none"> <li>- The Projects Bank composed of all public investment projects in the pre-investment phase that have been approved or rated as viable.</li> <li>- The Operating Monitoring and Evaluation System, defined as the set of procedures allowing the physical and financial supervision of public investment projects in support of decision-making in the investment phase.</li> </ul> <p><b>Source:</b> Decreto Supremo N.º 086-2000-EF, articles 8th and 14th.</p> |

Table 31. Information system (project banks)

| Argentina                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                          | Bolivia                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                    | Chile                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                   | Colombia                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                              | Peru                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                      |
|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <p>Investment project bank (BAPIN); this bank has been conceived as a system interconnected with and complementary to the financial management and the management control systems of the national public sector. BAPIN allows for the identification, formulation, oversight, and evaluation of programs, sub-programs, and projects, whether physical investment or social expenditure, carried out with resources from the national treasury or international financing, promoted by any public sector institution and executed by them or by provincial or municipal governments.</p> <p><b>Source:</b> <a href="http://www.mecon.gov.ar/peconomica/basehome/inversionpub_bapin.htm">http://www.mecon.gov.ar/peconomica/basehome/inversionpub_bapin.htm</a></p> | <p>SISIN is an instrument of the NPIS which recognizes the Public Investment Project as the system's unit and has the role of compiling, storing, processing, and disseminating the financial and non-financial information related to the life cycle of each project and its financing. SISIN's uniform form is the information compilation instrument that all public sector entities must use, to file the information related to their investment projects. The structure of SISIN is based on the integrated operation of the following subsystems:</p> <ul style="list-style-type: none"> <li>- Project registration subsystem</li> <li>- Report registration subsystem</li> <li>- Financing requirements programming subsystem</li> <li>- Physical and financial execution programming and monitoring subsystem</li> <li>- Budget programming subsystem</li> <li>- Public investment project results evaluation subsystem.</li> </ul> <p>It operates in a decentralized fashion, utilizing institutional modules or independent units to compile, store, process, and disseminate the information on the projects from all public sector entities carrying out pre-investment or investment activities.</p> <p><b>Source:</b> Resolución Ministerial N.º 612, articles 9 to 17.</p> | <p>The Integrated Project Bank (BIP) is a project information system with the main objective of supporting public investment decision-making. BIP allows for project monitoring over their entire life cycle, thus allowing their integration with the budget cycle and also integration with the public investment process in the country. It is the database for the National Investment System. BIP is based on a state-of-the-art computer (Sun), with a relational database administrator (Oracle). It utilizes an open platform operating system (Unix) with an interface for users in a Windows environment. Its operation covers the entire country, through a 64 Kbs digital network, which, in addition to data transmission, can be used for voice transmission.</p> <p><b>Source:</b> BIP page at the MIDEPLAN website.</p> | <p>The information subsystem is composed of several applications. BPIN application</p> <p>Technical characteristics: developed with the database handler FoxPro 2.0 for DOS.</p> <p>General system functions: project registry, budget programming, budget execution, physical execution. Has an information transfer subsystem allowing information transfers on magnetic media.</p> <p>SPI application (Investment Project Monitoring System).</p> <p>General system functions: constant monitoring of physical and financial progress of 100% of investment projects, with regional, sectoral, and transversal perspectives (Piloto Red Juntos); linking monitoring with the formulation (BPIN) and evaluation (Governmental Goals Management and Monitoring System - SIGOB) systems; establishing systems for information use and audit; structuring reports for decision-making (has data storage).</p> <p>There is also a Successful Projects Database.</p> <p><b>Source:</b> BPIN page at the DNP website.</p> | <p>NPIS has two applications for information management: the Project Bank (pre-investment phase) and the Operational Monitoring System (investment phase). Those applications can be accessed via the Internet, using Internet Explorer 5.0 or higher. A user name and password assigned by the Investments Office (ODI) are required for access. The Projects Bank includes the inventory of all projects at the pre-investment phase. It allows the storage, updating and publication of the "registration records," making possible the sharing of computerized information between the formulating units (UF), the Investments Programming Office (OPI) of the sector and ODI. The Operational Monitoring System records and stores the public investment projects' "monitoring records" during their execution phase.</p> <p>See. Preguntas frecuentes. NPISnet.</p> |
| <p>Considering the massive amount of information generated in a NPIS, Project Banks are an essential component. Their development and implementation is usually highly costly, and for this reason they tend to have a slow evolution. More recent NPIS take advantage of new technological developments (Intranet, Extranet, and Internet), while older ones have delayed implementation of such systems due to the high cost involved in developing new applications, migrating data bases, and retraining all users.</p>                                                                                                                                                                                                                                        |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                            |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                         |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                       |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                           |

Table 32. Training

| Argentina                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                         | Bolivia                                                                                                   | Chile                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                        | Colombia                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                 | Peru                                                                                                                                                                                                                                                                                                                                     |
|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| N/A                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                               | There are specific courses on project preparation and evaluation, in coordination with sectoral agencies. | <p>Since 1974 an intensive training program has been carried out, with the collaboration of the Catholic University of Chile for many years, through the Inter-American Course on Project Preparation and Evaluation (CIAPEP). Also, ILPES had a four year agreement with MIDEPLAN to offer courses in all the country's regions.</p> <p>Currently the Investments Directorate has three kinds of basic courses: Course on Program Formulation, Course on Project Preparation and Evaluation, and Course on the Integrated Project Bank.</p> | <p>Since BPIN started being implemented, DNP carried out an ambitious training program.</p> <p>Currently, the training and technical assistance component is composed of the policies, strategies, teaching instruments, learning aids and undergraduate or graduate education, specialization or training carried out by DNP and by other public or private entities, oriented to expanding the availability of human resources highly trained in project or program identification, preparation, formulation, evaluation or management, as well as other subjects typical of project theory. Training programs exist at the national and sub-national levels.</p> <p><b>Source:</b> Page on the training component on the DNP site.</p> <p>In May 2001, there were 55 different specialization programs offered by almost 40 different universities, foundations, and graduate schools.</p> <p><b>See:</b> El BPIN para principiantes, Anexo 2, Programas de Posgrado sobre Proyectos en Colombia.</p> | <p>There is an Integrated Training Program, sponsored by MEF. Among the latest courses offered are:</p> <ul style="list-style-type: none"> <li>- International Course on Preparation and Evaluation of Public Investment Programs. ILPES/CEPAL/MEF</li> <li>- Course on Building a Culture of Projects. PRODES-MEF agreement.</li> </ul> |
| <p>Training is a fundamental factor for the success of a NPIS. For this reason, most countries have developed training programs based on a structure of basic, intermediate and advanced courses, the latter usually through agreements with local universities. ILPES has played a significant, pioneering role in this respect, with an active participation in the development of the training program in Colombia, course management in the Chilean training program, several courses in other countries, and the design of new courses and training modalities. To date, the total number of professionals and technicians trained in project formulation, evaluation, and management through courses in which ILPES has participated is more than 5000.</p> |                                                                                                           |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                              |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                          |                                                                                                                                                                                                                                                                                                                                          |

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# Integrating the Plan and the Budget: Some Experiences in Latin America

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Nelson Schack\*

## Introduction

This study, which was undertaken in the context of putting into operation The Program to Implement the External Pillar of the Medium Term Action Plan for Development Effectiveness (PRODEV), aims to build upon the analysis and agreements reached in respect to the relationship between the plan and the budget during the May 2006 Meeting of the Public Policy Management and Transparency Network: Development Effectiveness and Results-Based Budget Management (*Reunion de la Red de Gestión y Transparencia de la Política Pública: Efectividad en el Desarrollo y Gestión Presupuestaria por Resultados*) under the auspices of the Regional Policy Dialogue (*Diálogo Regional de Política*) coordinated by PRODEV.

With this aim in mind, this paper analyzes the integration of the budget and planning in Latin America and includes a brief examination of each country's institutional characteristics and of the different systems for linking these two tasks and their relationship with the medium- and long-term financial framework. This analysis has been carried out on the basis of the study of planning and budgeting processes in 15 countries in the region—Argentina, Bolivia, Brazil, Colombia, Chile, Costa Rica, Ecuador, El Salvador, Guatemala, Mexico, Panama, Paraguay, Peru, Uruguay and Venezuela—based on information available on the Internet primarily during the first quarter of the 2007 fiscal year.

Previous studies carried out by Tavares and Beretta (2006) and Schack (2007) have been consulted extensively, and the conclusions of the comparative study have been tested *in situ* in three countries (Chile, Ecuador and Peru) through interviews with governmental actors relevant to the planning and budgeting processes.

Thanks are due to Herless Porras for his help as a research assistant, and Gabriel Filc, who read the first

draft of this document and made some valuable comments. Similarly, those persons who granted their time and shared their experiences and knowledge in the interviews are deeply appreciated. These interviews afforded a deeper understanding of the integration process between the plan and the budget, and helped improve the paper. Thanks are also extended to Heidi Berner, Ricardo Brodsky, Roberto Bustos, Andrea Carrión, Juan Carlos García, Laura Gómez, Marco Márquez, Waldo Mendoza, Patricia Rousseau and Roger Salhuana for their time and willingness to help. Any error or omission is the author's sole responsibility.

## Linking the Plan and the Budget

The debate about how best to integrate the plan and the budget has been going on for a long time in Latin America and at some points in time has been high on the public agenda. It has often been influenced by the different ideological perspectives on the role of the state and the market in the development process.

The subject has once again become a topic of discussion in regional political and academic forums given, on the one hand, the extremely favorable performance of countries in macroeconomic terms and, on the other, the low effectiveness of public policies implemented in recent years, particularly in respect to poverty reduction.

In fact, the need to strengthen the budget system along the lines of results-based budgeting is merely the physical reflection of civil society's demands for greater effectiveness in solving the problems of day-to-day life (in particular, for those groups that normally suffer from marginalization), for greater balance between the state's performance of its functions related to economic stabilization and allocation and distribution, and for harmony between the short- and long-term decisions included in the plan and the budget.

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As Tavares and Beretta (2006) correctly point out, if the central dilemma of economics resides in the allocation of scarce resources to multiple objectives—and this is only one expression of the general conflict between what is desired and what is obtainable—it would seem that the eternal question of how to harmoniously link planning and budgeting together is only another way of expressing this dilemma, in which our desires for the society in which we wish to live run up against the difficulties of satisfying them with the limited resources available.

In theoretical terms, both budget planners and controllers agree that the budget is the financial reflection of the plan. In practice, however, although we all have a clear idea of what the budget is, it is generally more difficult to know what plan it corresponds to, given the lack of integration between the plan and the budget.

The problem of the tension between the plan and the budget may be easily defined, but it is far more complicated to resolve due to the multiplicity of aspects (actors, roles, stages, operational dynamics and vested interests) that must be taken into consideration during the process of linking the two elements.

In all countries, there is “something” that strategically guides the activities of the state, and the incumbent government’s actions in particular. This “something” has varying degrees of formality, coverage and composition. Some countries have a national development plan; others have a national agreement; and others merely have an electoral program, a few presidential messages, or a strategy for fighting poverty in conjunction with international aid agencies. If, however, what is financed by the national budget is closely examined, it rarely seems to end up financing what had been previously defined as a priority.

It is quite common that, in spite of the existence of planning instruments establishing concrete projects and specific activities that should be financed with the aim of contributing to the development process, the necessary budget credits are frequently not allocated to the proposals that are formally declared as public policy priorities.

In order to simplify matters, budget controllers acknowledge the existence of certain priorities within development plans, but do not necessarily take them into consideration when drafting budgets. Planners recognize that budgets are formulated by following other criteria, not necessarily those of the plan, whereas managers seek to combine both aspects during the execution phase considering a budget scenario in which the rest of the administration substantially reduces the efficiency of its activities. High level politicians always approve both management instruments (the plan and the budget) at a general level and encourage the bureaucracy to continue perfecting them, but they do not generally take concrete measures to make the integration of the plan and budget viable in reality. In the meantime, civil society raises its voice now and then to protest about such inconsistency, although generally it concentrates its attention on other more urgent and pressing matters, such as the satisfaction of immediate basic material needs, while not understanding that the basis of governmental action (which probably has a decisive impact on the satisfaction of those needs) is linked to an adequate level of integration between the processes of planning, programming, budgeting and evaluation.

What is surprising is that this situation—which, unfortunately, has been, and continues to be frequent in the different countries of the region—persists year after year, sometimes with some marginal improvements, in spite of the concerns raised by various actors.

In order to modify the current state of integration between the plan and the budget, the following conditions must be met:

- A basic conviction is required among all actors that it would be better for all if there were an adequate harmonization between plans and budgets, rather than the current lack of integration, even though this might mean altering the distribution of the actor’s present negotiating powers.
- Sustained political leadership, of a high level and technical capacity, is required to guide the process of change from the current situation to the desired one.

With these ideas in mind, and based on a brief examination of the experiences in this area in 15 Latin American countries (Argentina, Bolivia, Brazil, Colombia, Chile, Costa Rica, Ecuador, El Salvador, Guatemala, Mexico, Panama, Paraguay, Peru, Uruguay and Venezuela), this paper seeks answers to the essential question: what really happens during efforts to integrate the plan and the budget?

This question will be tackled on the basis of the following premise: integrating the plan and the budget is the result of a technical and, above all, political process of continuous iteration and interaction which, in order to be effective, requires the following elements:

- Appropriate constitutional arrangements that go beyond the mere establishment of certain formal rules and roles for the actors and organizational structures, and that take into account the informal relations and the work processes through which the bureaucracy operates on a daily basis (in the best sense).
- A minimum level of technical capacities, not only in terms of the distribution of qualified personnel in planning, budgeting and management and the acquisition of administrative systems characterized by methodological rigor and flexibility, but also the establishment of information systems that, with effective use by the actors involved, support a sound decision-making process.

Therefore, if the integration between the plan and the budget is the result of a technical and political process—in which there are actors and rules, levels, spaces and moments of interaction—and the two previously mentioned fundamental requirements are taken into consideration, the process can be summarized according to several dimensions;

- i) effective integration seeks to maximize the synergy between both the fulfillment of the functions of both the plan (as a result of the planning process) and the budget (as a result of the budgeting process);
- ii) integration does not take place in a vacuum, but rather in a given historical, cultural and institutional context, and according to a dynamic that differs depending on the governmental or organizational level in which it is implemented (meaning, that

integrating the general governmental budget with the national development plan is one thing, while integration between an agency's budget and its institutional operational plan is another);

- iii) integration depends upon the existence of a minimum number of budget instruments that are used across a large number of governmental agencies. For example, the prior development of a medium-term fiscal framework and an adequate budget formulation process, as well as the use of an appropriate pragmatic functional budget classification are indispensable for such integration;
- iv) integration will encounter a more favorable environment the more it has at its disposal activity cost breakdowns, performance indicators, mechanisms for monitoring and evaluating management and a general orientation towards the achievement of development results in which the main focus is not on the execution of the means but rather the achievement of results;
- v) integration is more likely to be possible if institutional characteristics foster high standards of quality and stability in the bureaucracy, especially at the level of middle-management. But, in the end, integration can only be achieved as a result of the work of staff operating within a flexible and meritocratic civil service. Bureaucratic rigidity can be greater and more harmful than budget rigidity.

Let us examine each one of these aspects in more detail.

### ***The Planning and Budgeting Functions***

According to Martin (2005), it could be said that the essential functions of planning are prospective analysis, coordination and evaluation, in order for the budget to preserve the public sector's medium-term financial solvency, promote the efficient delivery of goods and services and allocate public resources according to government priorities (Schick, 2002; WB, 1998).

Under a more operational approach, the budget is;

- i) the financial reflection of the plan,
- ii) the prioritized allocation of revenues and

iii) the reflection of public sector processes and organizational culture. Within this framework, it should contribute to the state's complete fulfillment of its allocation, distribution and stabilization functions (Schack, 2006).

In recent decades Latin American countries' success in macroeconomic stabilization unfortunately has not been accompanied by progress in finding solutions to the principal social problems facing citizens. In these circumstances, it is easy to understand why demands for increasing the effectiveness of public spending have grown, and why demands for economic efficiency, social equality, political democracy and environmental sustainability are now on the public agenda of nearly all countries in the region.

In Latin America in recent years, a reevaluation of planning as a development tool has unexpectedly occurred within the context of the increasing availability of fiscal resources. As Martin (2005) states, however, this has not been guided by the idea of traditional and hierarchical planning in the style of the "Five Year Plans" of the centrally-planned economies, but rather a modern and flexible approach, characterized by the following three functions:

- Prospective analysis which entails articulating a vision for society as a whole, beyond the possibilities offered by the market and each actor in particular. It also anticipates the consequences of government decisions in different areas. A distinction can be drawn between prospective analysis of an exploratory nature (that sets out from the present reality to examine a spectrum of possible futures) and another of a normative nature (that articulates a vision of a desired future and designs a roadmap of necessary actions in order to achieve it.)
- Coordination entails the external interaction of the government with different social, economic and political forces—that permits agreements to be reached on various matters—and the interaction within the government for reaching the objectives of the state's plan. Although coordination involves a significant technical component, it is essentially a political function because it implies strategic

coordination in order to promote certain results from overall public activity. The programming and formulation stages of the budget cycle therefore provide the natural institutional space for coordination to take place, so that budget allocation corresponds to a technical process of programming and a political process of organization;

- Evaluation is one of the pillars of the new public management model and is one of the processes that links strategic planning to results-based budgeting, in which emphasis is placed on the attainment of goals through activities generating public value for citizens.

The form in which planning fulfills these functions differs in each country and at each moment. However, as the World Bank (WB), the Economic Commission for Latin America and the Caribbean (ECLAC), and the International Institute for Democracy and Electoral Assistance (IDEA) (2004) point out, one of the most important lessons from the various successful development experiences is that a national vision, which is combined with a serious commitment on behalf of all actors (government, private sector and civil society) to the implementation of the reforms necessary to put the plan into practice, is important for promoting and guiding the development process in these countries.

It is not so important that this vision and its strategic objectives are explicitly set out in a National Development Plan (*Plan Nacional de Desarrollo*, PND) as in Costa Rica, a Strategy to Overcome Poverty (*Estrategia de Superación de la Pobreza*) as in El Salvador, in a National Agreement (*Acuerdo Nacional*) as in the case of Peru, or even a plan that is implicit, as in Chile. What really matters is not the "document," but rather the vision and the strategic objectives. These should:

- i) Be shared by the majority of the political, social and economic actors, which means that objectives must be clearly-defined, simple and reasonable in number;
- ii) Originate from a confidence-building process designed to guarantee that collaboration is the mainstay of the interactions between relevant actors, within the framework of an inclusive dialogue;
- iii) Be functional for the development of priorities and technically and physically viable strategies, which can

be sequentially and logically implemented, with a limited number of easily-understood essential objectives that are objectively verifiable through indicators.

- iv) Represent a central tool for regulating the process of day-to-day interaction between politicians, bureaucrats and voters, and the continuous tension between the short-term (generally associated with the budget) and the long-term (normally linked to the plan).

### ***Planning Systems in Latin America***

From an operational point of view, efforts to integrate the plan and the budget can be made, with greater or lesser efficiency, during the formulation phase, as prior estimates of costs and products are obtained, or during the execution phase, when the effective allocation of resources and the real results obtained are verified.

In general, the Latin American countries analyzed here have achieved greater integration in the formulation phase than in the execution phase. Most of them have formal national development plans and have obtained different degrees of success in their efforts to identify the costs of programs and objectives within the plans, which are then usually published on a webpage, thereby making them available to citizens and the media.

It seems obvious that effective and efficient administration of public resources must necessarily entail a harmonious relationship between the processes of planning and budgeting. However, this relationship in fact involves the integration of four fundamental processes, which constitute the essence of public resource administration: strategic planning, tactical programming, budgeting for operating expenses and evaluative feedback (Schack, 2007d).

### ***Planning, Programming, Budgeting and Evaluation***

In order to effectively fulfill its functions, the budget should primarily concern itself with achieving what is essential (this underlines the importance of the strategic planning process). Systematic alignment with the center (to the finance ministry, for example), therefore, should only take place in respect to what might be called

the Annual Budget Objectives (*Objetivos Presupuestarios Anuales, OPA*), which are linked in the medium- and long-term with the PND (strategic orientation, national agreement, strategy to overcome poverty, for example) and the incumbent government's public policy priorities. This would enable the construction of a reasonably large set of performance indicators (30, for example), which are fundamentally related to outputs and results, in which the relationships between financial and non-financial indicators are clear. The alignment between the plan and the budget would take place at more tactical levels of public management for the rest of state activities.

An encompassing system could result in thousands of indicators (e.g. three indicators per institution multiplied by the number of existing entities in a typical country) which would be impossible to monitor and assess at the central level. Thus, while the law-making and regulatory functions would be centralized, operational aspects would need to be decentralized. In other words, this would entail the control and monitoring of management, rather than strategic, indicators, which are part of information systems and support decision-making in each department. This would not necessarily be an integral part of what might be conceptualized as a Performance Evaluation System tied to the finance ministry or to the office of the presidency.

In effect, if the state is considered as a whole, then four macro processes can be identified in governmental financial administrations:

- i) strategic planning,
- ii) tactical programming,
- iii) operational budgeting and
- iv) feedback through evaluation (Schack, 2007d).

First, strategic planning must be carried out at a macro or governmental scale and in terms of a long-term time horizon. The country's vision of development, the PND and other similar plans are the natural results of this process. For the process to be operational from the point of view of state management (not just from the perspective of budget management) and not just be part of the policy discussion, it must incorporate indicators that permit accurate measurement of the achievement of the established development objectives.

Table 33. National development plans

| Countries   | Is there an official PND or similar planning document?                                                                                                                               | Plan duration period | Administering agency                                                                                                                                                                                               | Are government's principle objectives clearly and precisely defined? | Are the costs of managerial objectives objectively calculated? | Strategic plan contents                                                                                                      | Where is the plan published?                                                                                         |
|-------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------|----------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------|
| Argentina   | No, but there is a Policy and Strategy for Development and Territorial Ordering ( <i>Política y Estrategia de Desarrollo y Ordenamiento Territorial</i> ) and a Multi-annual Budget. | 10 Years / 3 Years   | Ministry of Federal Planning, Public Investment and Services. Ministry of Economy and Production ( <i>Ministerio de Planificación Federal, Inversión Pública y Servicios</i> Ministerio de Economía y Producción). | Yes.                                                                 | No.                                                            | Territorial development policy, strategic vision, political instruments such as financial planning guidelines, among others. | <a href="http://www.minplan.gov.ar">www.minplan.gov.ar</a><br><a href="http://www.mecon.gov.ar">www.mecon.gov.ar</a> |
| Bolivia     | General Plan for Economic and Social Development ( <i>Plan General de Desarrollo Económico y Social</i> ).                                                                           | 5 Years              | Ministry of Planning for Development. ( <i>Ministerio de Planificación del Desarrollo</i> ).                                                                                                                       | Yes.                                                                 | No.                                                            | Policies, general strategies, programs, social indicators, macroeconomic, political and institutional sustainability.        | <a href="http://www.planificacion.gov.bo">www.planificacion.gov.bo</a>                                               |
| Brazil      | Multi-annual Plan (PPA).                                                                                                                                                             | 4 Years              | Ministry of Planning, Budget and Management ( <i>Ministerio de Planificação, Presupuesto y Gestión</i> ).                                                                                                          | Yes.                                                                 | Partial.                                                       | Objectives, targets, effectiveness indicators, unit costs estimates for public products.                                     | <a href="http://www.planejamento.gov.br">www.planejamento.gov.br</a>                                                 |
| Chile       | No, but the electoral program becomes the Government Plan.                                                                                                                           | 1 Year               | General Secretary of the Presidency. ( <i>Secretaría General de la Presidencia</i> ).                                                                                                                              | Yes.                                                                 | Yes.                                                           | No.                                                                                                                          | No.                                                                                                                  |
| Colombia    | PND                                                                                                                                                                                  | 4 Years              | National Planning Directorate. ( <i>Dirección Nacional de Planeamiento</i> ).                                                                                                                                      | Yes.                                                                 | Partial.                                                       | Policies, objectives, guidelines, strategies, calculated targets, indicators.                                                | <a href="http://www.dnp.gov.co">www.dnp.gov.co</a>                                                                   |
| Costa Rica  | PND                                                                                                                                                                                  | 5 Years              | Ministry of National Planning and Political Economy. ( <i>Ministerio de Planificación Nacional y Política Económica</i> ).                                                                                         | Yes.                                                                 | Yes.                                                           | Strategic actions, public production platforms, sectoral targets, costs.                                                     | <a href="http://www.mideplan.go.cr">www.mideplan.go.cr</a>                                                           |
| Ecuador     | PND: PPA                                                                                                                                                                             | 4 Years              | National Secretariat for Planning and Development ( <i>Secretaría Nacional de Planificación y Desarrollo</i> ).                                                                                                    | Yes.                                                                 | No.                                                            | Programmatic bases, development strategies, human development objectives.                                                    | <a href="http://www.senplades.gov.ec">www.senplades.gov.ec</a>                                                       |
| El Salvador | Government plan: National Strategic Plan ( <i>Plan Estratégico Nacional</i> ).                                                                                                       | 5 Years              | Technical Secretariat of the Presidency. ( <i>Secretaría Técnica de la Presidencia</i> ).                                                                                                                          | Yes.                                                                 | No.                                                            | Overall view of country, areas of activity, programs, among others.                                                          | <a href="http://www.mh.gob.sv">www.mh.gob.sv</a>                                                                     |

| Countries | Is there an official PND or similar planning document?                                                                                                        | Plan duration period | Administering agency                                                                                                                    | Are government's principle objectives clearly and precisely defined? | Are the costs of managerial objectives objectively calculated? | Strategic plan contents                                                                                            | Where is the plan published?                                                                                               |
|-----------|---------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------|-----------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------|----------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------|
| Guatemala | Government Plan for Hope: System of Presidential Objectives ( <i>Plan de Gobierno de la Esperanza: Sistema de Metas Presidenciales</i> ) Multi-annual-budget. | 4 Years              | Secretariat for Budget Planning and Programming ( <i>Secretaría de Planificación y Programación Presupuestaria</i> ).                   | Yes.                                                                 | Partial.                                                       | Objectives, strategic programs, calculated targets, indicators, costs.                                             | <a href="http://www.segeplan.gob.gt">www.segeplan.gob.gt</a>                                                               |
| Mexico    | PND and (National Program for Developmental Finance) ( <i>Programa Nacional de Financiamiento del Desarrollo</i> ).                                           | 6 Years              | Presidential Office for Governmental Innovation. ( <i>Oficina de la Presidencia para la Innovación Gubernamental</i> ).                 | Yes.                                                                 | Yes.                                                           | Objectives, strategies, priorities, indicators, costs, among others.                                               | <a href="http://pnd.presidencia.gob.mx">pnd.presidencia.gob.mx</a>                                                         |
| Panama    | National Coalition Agreement on Development ( <i>Acuerdos de la Concertación Nacional para el Desarrollo</i> ).                                               | 6 Years              | General Secretary of the Social Cabinet. ( <i>Secretaría General del Gabinete Social</i> ).                                             | Yes.                                                                 | No.                                                            | Objectives, development strategies, indicators, targets, among others.                                             | <a href="http://www.mef.gob.pa">www.mef.gob.pa</a><br><a href="http://www.concertacion.org.pa">www.concertacion.org.pa</a> |
| Paraguay  | Economic and Social Strategic Plan ( <i>Plan Estratégico Económico y Social</i> ) Multi-annual Budget.                                                        | 4 Years              | Technical Planning Secretariat ( <i>Secretaría Técnica de Planificación</i> ).                                                          | Yes.                                                                 | No.                                                            | Mission, objectives, policies, strategic platforms, activity platforms, among others.                              | <a href="http://www.stp.gov.py">www.stp.gov.py</a><br><a href="http://www.presidencia-gov.py">www.presidencia-gov.py</a>   |
| Peru      | National Accord and Multi-year Strategic Sectoral Plan ( <i>Acuerdo Nacional y Plan Estratégico Sectorial Multianual</i> ).                                   | 5 Years              | Ministry of Economy and Finance ( <i>Ministerio de Economía y Finanzas</i> ).                                                           | Yes.                                                                 | Yes.                                                           | Political guidelines, strategies, objectives, measurement indicators.                                              | <a href="http://www.mef.gob.pe">www.mef.gob.pe</a>                                                                         |
| Uruguay   | Strategic Management Plans <i>Planes Estratégicos de Gestión</i> (PEG).                                                                                       | 5 Years              | Presidential Office for Planning and Budgeting ( <i>Oficina de Planeamiento y Presupuesto de la Presidencia</i> ).                      | Yes.                                                                 | Yes.                                                           | Agency and Ministerial objectives, calculated targets, indicators of efficiency, quality (some) and impact (some). | <a href="http://www.cephre.opp.gub.uy">www.cephre.opp.gub.uy</a>                                                           |
| Venezuela | Plan for National Economic and Social Development <i>Plan de Desarrollo Económico y Social de la Nación</i> Multi-annual Budget Framework.                    | 6 Years              | Ministry of People's Power for Planning and Development. ( <i>Ministerio del Poder Popular para la Planificación y el Desarrollo</i> ). | Yes.                                                                 | No.                                                            | Economic, social, political, territorial and international guidelines.                                             | <a href="http://www.mpd.gob.ve">www.mpd.gob.ve</a>                                                                         |

Source: Current regulations and related documentation published on various websites. Information updated in the first quarter of 2007.

For that to happen, the indicators must contain objective targets, meaning indicator values that are expected to be reached in a given period of time and at a specified estimated cost, which must also be compatible with the broad economic restrictions facing the country.

A second process related to the achievement of development objectives, which is not as general as state strategic planning, nor as specific as programmatic and institutional budgeting, can be referred to as tactical programming. Tactical programming takes place within a medium-term fiscal framework. The fundamental programs to be carried out by the public sector in pursuit of development objectives are established and the costs are estimated, indicating the annual targets to be achieved (at the meso or sectoral scale) for each indicator, in the context of a multi-annual, and therefore revolving, fiscal scenario.

In practice, this kind of programming defines what the desired achievements are for the following and subsequent fiscal years, and the amount of public resources that in general terms will be assigned to each of the proposals. The central result of this process is therefore the drafting of a Medium-Term Fiscal Framework (*Marco Fiscal de Mediano Plazo*) (MTFF) and the definition of the OPA upon which the budget will be structured.

The process of operational budgeting, carried out yearly, entails specifying in detail (i.e. at the micro or institutional scale, at the entity or departmental level) how the activities tactically foreseen in the previous planning process will be implemented during the course of the following fiscal year: who will execute them, how, when and with what kind of resources, from what sources of financing and through which expenditure program, etc. Above all, how the attainment of program objectives will be verified throughout the process of generating value from public activity needs to be specified. This must be possible not only in terms of impact, for which the compiling of information on performance levels related to inputs, processes, outputs and results (based on the use of comprehensive performance and evaluation indicators) is essential, but also for the application of instruments such as methodologies for diagnosing problems, baseline definitions, and logical

frameworks and for the systematic implementation of cost-estimating methods related to accrual-based accounting, among others.

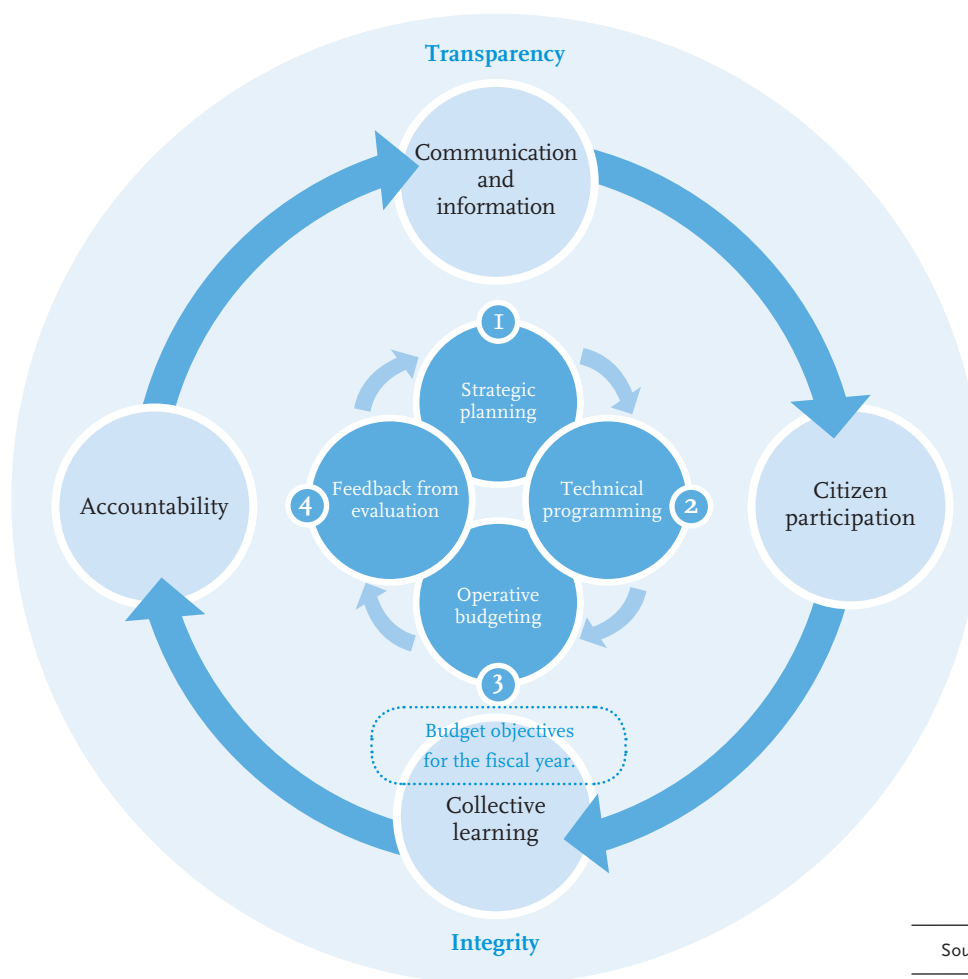
Finally, in order to promote analysis and improve performance in respect to the three macro-processes, a process of evaluation and feedback needs to be implemented, with its own specifications and levels (macro, meso and micro) that permits the fulfilment of the OPA to be monitored and verified and, in addition, contributes to the verification of the achievement of the government's strategic, tactical, and even operational, objectives.

Governing a system characterized by political democracy, social fairness, economic efficiency, cultural development, territorial integrity and environmental sustainability requires that these four macro processes, which influence the effectiveness of governmental financial administration and its impact on citizens' well-being, are carried out within a general framework characterized by ongoing processes of communication and information, citizen participation, collective learning and accountability. It is only within a context of integrity and transparency that sustainable human development is possible (Schack, 2007d).

However, the adequate development of the three macro processes ultimately depends upon how information is put into a systematic form, processed, analyzed, interpreted, used and disseminated, among other factors, according to each institutional arrangement during the course of decision-making. However, another question therefore crops up: how will information on objectives, goals and indicators be linked together in the budget registry? Or, in other words, what is the nature and structure of the budget classifications?

Although it might appear otherwise, the variables that will be registered and will yield information for monitoring and evaluation during the budget process depend on the classifications. Thus, it is very important to have an appropriate programmatic budget classification system in place that meets international standards, such as the International Monetary Fund's (IMF) Government Financial Statistics Manual (2001).

Figure 4. Macro-processes in government financial administration



Source: Schack (2007d).

### ***Budget classifications and information systems***

The operational concerns about how to integrate the plan and the budget have been reflected in the different budget techniques that have been established in the majority of Latin American countries since the 1960s, based upon the planning, programming and budgeting systems developed in the United States after the Second World War.

However, an adequate and effective integration of policy planning in the budget process generally has not been achieved for various reasons, including: the

inadequate or partial implementation of the postulates of the budget techniques; the limitations of the approach in respect to its flexibility to cope with changes of emphasis in policies and changes in expenditure priorities; the lack of detailed information about genuine program costs; or the lack of leadership in the execution of these changes, which has meant they have taken the form of mere administrative modifications rather than changes in the way that the budget is organized and managed. This means that the budget practices of all the Latin American countries analyzed (with the exception of Brazil and Chile) continue to be highly incremental.

**Table 34. Some budget techniques**

| Technique               | Aim                                                                                                             | Characteristics                                                                                  |                                                                  | Limitations                                                                                                           |
|-------------------------|-----------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------|------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------|
| Incrementalism          | Improve coordination of budget decisions, with the participation of multiple actors within a limited timeframe. | Approved allocations, thematic division.                                                         | Strict budget controls.                                          | Inefficiency in resource allocation, rigidity.                                                                        |
| Program-based budgeting | Improve efficiency of expenditure allocation and the relation with planning.                                    | Horizontal comprehensiveness, comparison of alternate expenditure packages with activity levels. | Strict budget controls, policy analysis, activity indicators.    | Rigidity in expenditure, increased costs for correcting errors, measurement of activity levels.                       |
| Zero-based budget       | Improve efficiency in the use of resources to achieve programmatic objectives.                                  | Comprehensiveness, conceptual rationality, operational design, levels of financing.              | Prioritization of policy objectives, clearly-defined objectives. | Ahistoric analysis, increases conflicts, when there is a lack of time for analysis, reverts to traditional budgeting. |

Source: Guzmán (2005).

In effect, the zero-based budget, the performance-based budget,<sup>1</sup> the program-based budget and the incremental budget (based on a budget by line items and objects of expenditure<sup>2</sup>), are all techniques that have been employed at different moments in the recent history of Latin American countries. Their application, however, has not substantially altered operational practices, nor has it aligned incentives for the various actors so that they focus on achieving ends, rather than on the execution of means.

Similarly, the interactions between the various actors, including the so-called “Guardians of the Treasury” and the “Advocates of Program Spending” in the budget process (which can be depicted as a form of a repetitive game (Tavares and Beretta, 2006) have not changed substantially. This process of allocating resources to each program or sector is annually determined through a complex negotiating process that is characterized by

a high level of engagement and conflict among numerous stakeholders.

Despite this reality, it should be pointed out that in all the countries analyzed, progress has been made in developing common expenditure and revenue classifications for all agencies in the budget, covering all current as well as capital expenditures. The implementation of such budget classifications has provided a readily-available tool that provides for uniformity and order and the interrelation of information about public institutions (regarding their ends and functions), as well as about anticipated revenues and expenditures in the public budget. The classification thereby guarantees homogeneity in financial transactions and fiscal policy analysis, as well as in budget execution, modification, control and evaluation.

The majority of Latin American countries analyzed in this chapter have implemented an Integrated Financial

1. This permits the definition of budget allocations based on anticipated volumes of work and average unit costs of the principal products which are generally intermediate in nature. Its main weakness is that it focuses on tasks and does not pay attention to the objectives and the selection of alternative solutions to problems; therefore, the intertemporal policy results tend to be ignored (WB, 1998).

2. As the WB points out (1998), “line item” budget management is in itself a reform dating back to the end of the nineteenth century, as a response to concerns that the lack of adequate expenditure controls contributed to creating an environment that was contributing to a growing danger of corruption.

Information System (*Sistema Integrado de Información Financiera*) (SIAF), which is made up of interrelated, interactive and interdependent elements that, when correctly aligned and coordinated, provide for greater transparency and efficiency in the administration of public funds. The most important of these elements are: planning, project banks, the budget, governmental accounting, the Treasury, public debt and personnel administration. All are governed by the principles and technical regulation guiding and orienting public institutions.

Generally, these financial administration systems are structured as a unique, integrated and uniform system. The system's governing agency is given sole responsibility for authorizing, in exceptional cases, the application of various technical criteria to the established principles and regulations. These instruments, therefore, promote efficiency, effectiveness, and transparency in the attainment and utilization of state resources; develop systems that generate timely and reliable information about public sector operations; foster the use of modern techniques in financial research and management; and promote employment of qualified staff in financial administration and facilitate their specialization and ongoing training (Castillo, 2003).

The entry of information is always done by the agencies themselves in a decentralized manner and the information is controlled at the central level by the technical budget authority. In general, these systems are associated with a budget system that registers planned expenditures and revenues during budget formulation, and thereafter during execution, developing specific systems for investment projects and government accounting modules considering the existing relationship between budget classifications and the plan of governmental accounts.

The basic characteristic of the SIAF and other similar systems is that they are centrally regulated but operationally decentralized. Centralized regulation is the task of the finance ministry or a similar institution; whereas operational decentralization implies that responsibility for financial operations rests with the executing units. In general, this system seeks to establish:

- Mechanisms for the coordination of financial administration among public agencies to establish criteria of prudence, effectiveness and efficiency in the attainment and application of public resources;
- Procedures to generate, register and provide useful, adequate, timely and reliable financial information for decision-making, and for the evaluation of the performance of managers who are responsible for each of the administrative areas;
- Direct responsibility of the upper management of each public sector entity for the establishment, maintenance, modernization and supervision of the functioning elements of the integrated financial administration system;
- Requirements for the active and coordinated participation of public officials and executing units in the diverse administrative processes arising from SIAF execution.

In general, evidence shows that public financial administration is, in a broad sense, comprised of budget, public credit, Treasury, accounting, tributary and patrimonial systems. These systems are interrelated and each one of them acts under the coordination of the ruling body. Overall governmental financial administrative efficiency depends on the level of integration and information exchange between such systems.

### ***Integration at the institutional and national level***

The budget is a management instrument that serves both the operational and the strategic functions of government, because it is not only a fundamental tool of social and economic planning, but also an administrative and governmental tool. In this sense, the idea of perfectly aligning each budget category with each objective, as some countries have attempted to do through a set of programmatic performance matrices, is an enormous and not necessarily useful task. Moreover, the budget's instrumental reality implies that integration with the plan takes place at each hierarchical level of organization through different mechanisms.

Table 35. Financial information systems

| Country            | Governing body of budgetary system                                                                                                                                                         | Budget and/or financial information system                                                                                                                                                                                                      | Legal foundation                                                                                |
|--------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------|
| <b>Argentina</b>   | National Budget Office (ONP) Budget Sub-secretariat, Secretary of the Treasury ( <i>Oficina Nacional de Presupuesto, Subsecretaría de Presupuesto, Secretaría de Hacienda</i> ).           | Integrated Financial Administration System (SIDIF). <i>Sistema Integrado de Administración Financiera</i> .                                                                                                                                     | - Act N.° 24,156 (1993)<br>- Act N.° 11,672 (1969)                                              |
| <b>Bolivia</b>     | Vice-Ministry for The Budget and Public Accounts (VMPC). Finance Ministry. <i>Viceministerio de Presupuesto y Contaduría. Ministerio de Hacienda</i> .                                     | Integrated Financial Information System and Integrated Administrative Management and Modernization SIIF-SIGMA, ( <i>Sistema Integrado de Información Financiera and Sistema Integrado de Gestión y Modernización Administrativa</i> ).          | - Act N.° 1,178 (1990)<br>- <i>Decreto Supremo</i> (Decree) N.° 26,455 (2001)                   |
| <b>Brazil</b>      | Federal Budget Secretariat. Ministry of Planning, Budget and Management SOF. ( <i>Secretaria de Presupuesto Federal Ministerio de Planificación, Presupuesto y Gestión</i> ).              | Integrated Financial Administration System and Integrated Budget Data System (SIAFI-SIDOR). ( <i>Sistema Integrado de Administración Financiera y Sistema Integrado de Datos Presupuestarios</i> ).                                             | - Act N.° 4,320 (1964)<br>- Act N.° 8 (1990)<br>- Act N.° 101 (2000)<br>- Act N.° 10,180 (2001) |
| <b>Chile</b>       | Budget Directorate, Treasury Department ( <i>Dirección de Presupuestos, DIPRES, Ministerio de Hacienda</i> ).                                                                              | State Financial Management Information System (SIGFE), ( <i>Sistema de Información para la Gestión Financiera del Estado</i> ).                                                                                                                 | - Decree N.° 1.263 (1975)<br>- Act N.° 18,591 (1986)                                            |
| <b>Colombia</b>    | Ministry of the Treasury and Public Credit (MHCP), National Planning Department (Investment). ( <i>Ministerio de Hacienda y Crédito Público and Departamento Nacional de Planeación</i> ). | Integrated Financial Information System (SIIF). ( <i>Sistema Integrado de Información Financiera</i> ).                                                                                                                                         | - Act N.° 819 (2003)<br>- Decree N.° 111 (1996)                                                 |
| <b>Costa Rica</b>  | Directorate General for National Budget (DGNP), Finance Ministry. ( <i>Dirección General de Presupuesto Nacional, Ministerio de Hacienda</i> ).                                            | Integrated Financial Administration System (SIGAF). ( <i>Sistema Integrado de Administración Financiera</i> ).                                                                                                                                  | - Act N.° 8,131 (2001)                                                                          |
| <b>Ecuador</b>     | Budget Sub-Secretariat, Ministry of Economy and Finance. ( <i>Subsecretaría de Presupuestos (Budget Sub-secretariat)</i> ).                                                                | Integrated Financial Management System and Financial Administration System (SIGEF-SAFI). ( <i>Sistema Integrado de Gestión Financiera y Sistema de Administración Financiera</i> ).                                                             | - Decree N.° 1,429 (1977)<br>- Act 18 (1992)<br>- Act TROLE I (2000)<br>- Act RO 337 (2000)     |
| <b>El Salvador</b> | Technical Budget Directorate, Ministry of Public Finance. ( <i>Dirección General de Presupuesto, Ministerio de Hacienda</i> ).                                                             | Integrated Financial Administration System (SAFI). ( <i>Sistema de Administración Financiero Integrado</i> ).                                                                                                                                   | - Act AFI N.° 516 (1995)                                                                        |
| <b>Guatemala</b>   | Technical Budget Directorate, Ministry of Public Finance. ( <i>Dirección Técnica de Presupuesto, Ministerio de Finanzas Públicas</i> ).                                                    | Integrated Financial Administration System (SIAF). ( <i>Sistema Integrado de Administración Financiera</i> ).                                                                                                                                   | - Decree N.° 101 (1997)                                                                         |
| <b>Mexico</b>      | SSE, <i>Subsecretaría de Egresos</i> (Expenditure Sub-secretariat) ( <i>Secretaría de Hacienda y Crédito Público</i> ) (Treasury and Public Credit Secretariat).                           | Integrated Federal Financial Administration Information System and Budget Management Control System (SIAFF-SICGP). ( <i>Sistema Integral de Administración Financiera Federal y Sistema Integral de Control de la Gestión Presupuestaria</i> ). | - LPCGF (1976)                                                                                  |

| Country          | Governing body of budgetary system                                                                                                                                                                        | Budget and/or financial information system                                                                                                                                        | Legal foundation                                   |
|------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------|
| <b>Panama</b>    | National Budget Directorate, Ministry of Economy and Finance (DIPRENA). ( <i>Dirección de Presupuesto de la Nación, Ministerio de Economía y Finanzas</i> ).                                              | Financial Information System (SIAFPA). ( <i>Sistema de Información Financiera</i> ).                                                                                              | - Act N.° 20 (2002)<br>- Act N.° 61 (2002)         |
| <b>Paraguay</b>  | Directorate General for the National Budget, Treasury Department. (DGP). ( <i>Dirección General de Presupuesto, Ministerio de Hacienda</i> ).                                                             | Integrated Financial Administration System (SIAF). ( <i>Sistema Integrado de Administración Financiera</i> ).                                                                     | - Act N.° 1,535 (1999)                             |
| <b>Peru</b>      | National Public Budget Directorate, Ministry of Economy and Finance. (DNPP). ( <i>Dirección Nacional del Presupuesto Público, Ministry of Economy and Finance</i> ).                                      | Integrated Financial Administration System (SIAF). ( <i>Sistema Integrado de Administración Financiera</i> ).                                                                     | - Act N.° 27,209 (1999)<br>- Act N.° 28,112 (2004) |
| <b>Uruguay</b>   | OPP ( <i>Oficina de Planeamiento y Presupuesto</i> ) Office for Planning and Budgeting, Ministry of Economy and Finance and ( <i>Contaduría General de la Nación</i> ) Accountancy General of the Nation. | Integrated Financial Information System and Budget Information System (SIIF-SIP). ( <i>Sistema Integrado de Información Financiera y Sistema de Información Presupuestaria</i> ). | - Act N.° 17,213<br>- Act N.° 194 (1997)           |
| <b>Venezuela</b> | National Budget Office, Ministry of People's Power for Planning and Development (ONAPRE). ( <i>Oficina Nacional de Presupuesto, Ministerio del Poder Popular para Economía y Finanzas</i> ).              | Integrated Public Finance Management and Control System (SIGECOF). ( <i>Sistema Integrado de Gestión y Control de las Finanzas Públicas</i> ).                                    | - LOAFSP G.O. 38,198 (2005)<br>- Act N.° 37,029    |

Source: Various websites. Information for the first quarter of 2007.

In effect, it is interesting to observe that the degree of integration between plan and budget increases as the levels of abstraction and aggregation decrease. In fact, the high degree of integration between an entity's annual operating plan and its budget is an everyday result observed in many public organizations. In truth, this can be seen more clearly in those public organizations described as "islands of excellence" by authors such as Cortázar (2007) (really clusters of archipelagos), which are present to a greater or a lesser degree in all countries in the region.

Linking what one desires (planning) and the means available to satisfy that desire (budgeting) are really two sides of the same coin. They are inseparable technical processes: if the plan is well drafted, it must consider

how and with what means it will turn its proposals into reality, and if a budget is well designed, it must consider the ends it wishes to attain with the resources at its disposal.

However, at higher levels of aggregation and abstraction (at the nationwide level, for example), the interactive and iterative relations become more complex and the differences between plan and budget become more evident.

- The budget process is always explicit, hierarchical, scheduled over time, and legal, while the planning process is not. In Latin America, very often it is not even a formal administrative system within the bureaucracy (as in the case of Peru);
- The budget is a short-term, generally annual, instrument, whereas the plan is usually long-term, because

it deals with a longer time horizon than just a calendar year;

- The budget clearly allocates resources and assigns clear responsibilities among managers, because it usually has a substantial institutional component in its formulation. In the articles of the Budget Act countless directives are often found, not only dealing with budget matters but also with public management in general. The plan, on the other hand, usually has a much more programmatic perspective. Given its level of aggregation, the achievement of the plan's objectives require high levels of intersectoral coordination, with transactional costs that are always very high due to existing institutional arrangements and the actors' limited capacities;
- The budget is usually approved by a law approved by congress, which means that the executive does not always have control over its fate. This depends on the political context and the powers granted the executive in the constitution. The plan, however, is normally approved by the executive branch and the legislature gets to see it only because it is usually presented alongside the draft budget law (although in countries such as Brazil, congress must also approve the plan);
- The budget process is characterized by a higher level of involvement of social and political actors and greater conflict than the plan. Given the existing constitutional arrangements, the principle actors that formulate the plan, and their functions, are not the same as in the case of the budget;
- The judicial branch very often makes rulings that alter budget decisions and their effects, but, by definition, it never issues rulings about plans, given that they are yet to become "reality."
- Civil society has learned that whatever is not included in the budget (despite what anyone might say) is an illusion, properly belonging to a political speech expressing the desire to do "something." Only when the budget credit amounts are firmly allocated is that "something" a probability of more than zero of becoming reality, if existing regulations permit

and the necessary management capacity exists, which is often presumed incorrectly.

- Throughout recent history the budget has always existed. By contrast, plans have not always existed at times for ideological reasons. Planning is sometimes confused with the existence of an agency, a document or an instrument, instead of being understood as a natural function of government: that of anticipating events, thinking before acting and consciously choosing between alternative courses of action under circumstances of resource scarcity;
- Given the limited degrees of integration between the plan and the budget, and the fact that the budget, along with the control system, are what end up organizing the structure of essential incentives in the public administration, the plan is seen as a mere administrative formality, a procedure to be completed because the rules demand it, rather than a management tool, which is how the budget is seen. (In the cases where there is no definite mandate, there is often no plan at all);
- The persistent drafting of the budget year after year with its own sophisticated nomenclature (budget chains and codes, among other elements) has created a relatively stable bureaucracy in the finance ministry and other similar institutions, compared to the volatility of staff in the rest of the executive branch, including the chief planning agencies.
- The quantity of information needed to formulate a budget (given its marked incremental tendency) is generally much more readily available than that which is necessary to adequately structure an operational plan. The same is true for identifying performance indicators or defining objectives;
- The quantity, composition and quality of the technicians and officials inside the public administration who are knowledgeable of budget concepts is usually greater than those who are genuinely trained in policies and program structure, logical frameworks and other concepts and instruments associated with the planning process. The budget is such a stable (or inertial) process (in which substantial changes

are rare) and is carried out on a recurrent basis (in a periodic and systematic way), the operational mechanics of budget formulation have been fully learned by the public administration.

- Plan formulation necessarily requires a multidisciplinary approach, and is carried out in full view of citizens, as policy goals and objectives are defined that are easily understood by the various political, economic and social actors. By contrast, the budget, which normally belongs to the world of economics and accounting, is structured using a terminology pertaining to a “professional association of specialists.” Planning is taught in the universities, partly because it is common in the private sector, and this experience could easily be translated to the public sector (in fact, the planning methods currently most employed in the public sector come from developments made within the private sector). But, the nomenclature for doing budgets in the public sector is unique, not very similar to terminology used in the private sector and is not taught in university programs.

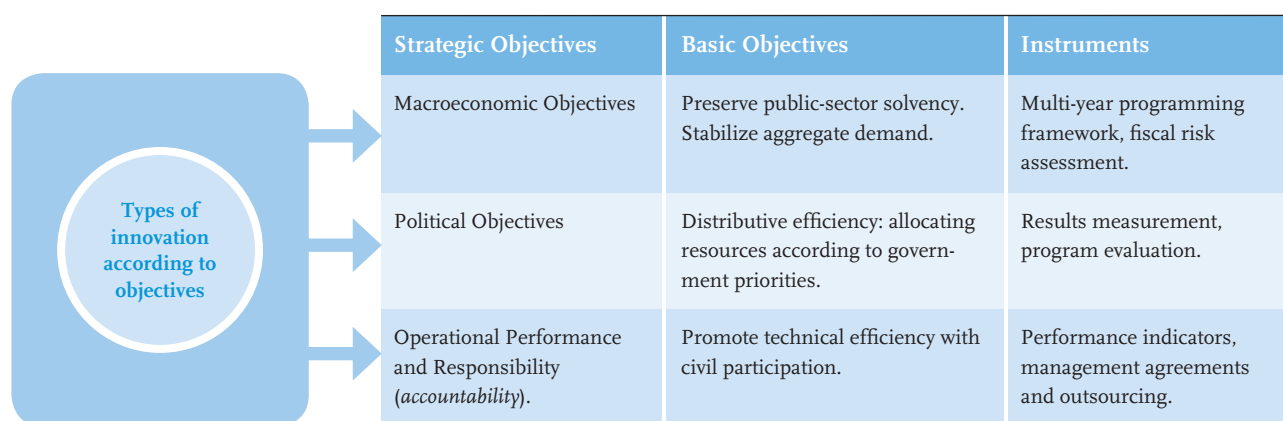
Given this reality, it seems clear that the integration of the plan and the budget requires a common space in which the individual nature of each process can be reconciled. It appears that the medium-term fiscal framework is the best arena in which the short-term and the long-term and expenditure desires and revenue possibilities can be reconciled within an intertemporal perspective that extends beyond a single year. Or, at least this is what the experience of countries such as New Zealand, Australia, Canada and the United States indicates.

### ***The Medium-Term Fiscal Framework***

As previously mentioned, the growing demands of citizens for increased effectiveness of public sector activity requires budget processes to combine fiscal discipline with effectiveness in allocating resources to fundamental policy priorities and operational efficiency in service delivery.

Much progress has been made in many countries in the region. In fact, in recent years a whole set of budget innovations has been designed, legally formalized and implemented. The *Instituto Latinoamericano y del Caribe de Planificación Económica y Social* (ILPES) (Latin American and Caribbean Institute for Economic and Social Planning) (2004) has classified them according to the objectives that they pursue:

- Macroeconomic objectives; innovations such as the implementation of macro-fiscal regulations (numerical, procedural and dealing with transparency), explicit estimation of contingent liabilities and tax expenditures, the establishment of fiscal stabilization funds and multi-year programming processes are placed in this category.
- Policy objectives, which includes strategic planning processes, program evaluation, results measurement, electronic government and participatory budgets.
- Operational objectives, such as the signing of management agreements, the creation of autonomous agencies, outsourcing of the provision of goods and services to the market and greater managerial discretion for optimizing the productive processes within the public sector.

**Figure 5. Fiscal governance: conceptual framework of budget innovations**

Source: ILPES (2004).

Among these innovations, perhaps the most important for achieving a harmonious and synergistic relationship between the planning and budgeting processes is multi-year programming, a process that translates into the drafting of a Medium-Term Financial Framework (MTFF). Such a framework results from a strategic process of expenditure projection and prioritization, through which annual budget decisions are governed by both the prevailing intertemporal fiscal restrictions and the priorities of government policy.

Summarizing the ideas put forward by Moreno (2005), one can conclude that the MTFF is an ongoing process of evaluation, adjustment and prioritization, within the framework of a comprehensive exercise of translating the country's vision and shared objectives set out by government policy (via the NDP, for example), in terms of financial and non-financial goals that reveal a strategy of public actions over time. As the MTFF goes beyond the current fiscal year, the fiscal impact on the future of decisions made in the present can be appreciated and the direct and opportunity costs of this or that course of action can be internalized in order to achieve the stipulated objectives.

An MTFF entails a number of benefits for fiscal management. It encourages public officials to think further ahead than the current financial year, puts a brake on spiraling costs and their impact over time,

induces greater caution in making decisions that affect future levels of revenue and expenditure, reduces the uncertainty in budget behavior, and permits the redirection of future savings towards present governmental priorities. In addition, an MTFF facilitates the monitoring of programs and projects whose period of execution extends beyond one year and, therefore, promotes the application of strategic planning processes and results-based management (Martinere, 2007).

An MTFF is not a system that legally pre-allocates annual expenditure ceilings by sector, function or any other budget category for coming years, as might happen in the case of the legally approved multi-annual budget given that under an MTFF the principle of the annual budget is maintained. The first year of the framework, however, is consistent with the annual budget for the year in course and the exercises for the following years are indicative and referential estimates that then become the baseline for subsequent programming.

Although a multi-annual budget (in the strictest sense of the word) does significantly reduce the uncertainty characteristic of the annual process, by formally committing budget allocations for the succeeding fiscal years, it also generates higher levels of restrictions than those already existing. It increases budget rigidity (when faced by the need, for example,

to make adjustments due to a fall in expected revenue) and it reduces the freedom of the fiscal and political authorities to introduce new expenditure initiatives or change public policy priorities, for example. Although its implementation might reduce the amount of work in annual budget formulation for public administration as a whole, it generally requires important legal and even constitutional, modifications. It might, therefore, seem preferable and more practical to take advantage of the benefits of the multi-annual budget by using a more flexible instrument: the MTFF.

In fact, in so far as the framework entails a stable, strong and believable restriction on the actors involved, such as the Advocates of Program Spending or agents of expenditure (Tavares y Beretta, 2006), and it contains fiscal regulations (numerical, procedural and in respect to transparency) accepted by them, it could contribute to the efficient solution of various problems, including: strategic borrowing and the electoral cycle or the short time horizon of political authorities' (inherent in the budget process). Such a framework can also facilitate strategic reallocations of expenditures in the medium-term, the internalization of the future opportunity costs of present spending decisions and the changing of actors' perceptions (which exacerbate demands for spending) that their spending proposals are so small in comparison to total expenditures that their approval would not affect the aggregate result. This perception increases the transaction costs associated with a collective process of resource distribution.

Similarly, from the perspective of effectiveness and efficiency, a framework such as the one described contributes to the provision of public goods and services by state entities at a reasonable cost. It does this by partially modifying information asymmetries in respect to costs that exist between those who allocate resources and those who execute them, by promoting dialogue and coordination mechanisms (from the bottom to the top and vice versa), and by providing predictions for the agencies regarding the volume of resources that they can expect in coming years (unless there is a change in either policy priorities or general conditions). This then reduces the marginal propensity to include new

expenditures in the budget, without previously having evaluated the degree of efficiency, or even, relevance, of the current policies.

In general, an MTFF contains three fundamental elements;

- i) an aggregate resource framework, determined from the top down, consistent with the sustainability of public finances and the general priorities of governmental policy, that includes quantitative goals at the macroeconomic level (inflation, production, depreciation) and at the fiscal level (revenue, expenditure and financing, according to an economic classification);
- ii) a combination of cost estimates, constructed from the bottom up, regarding the strategy of programmatic activities that each government sector will undertake over time to attain the specified general policy priorities and
- iii) a mechanism of coordination and interaction that promotes a decision-making process based on dialogue and cooperation.

In this sense, the different types of fiscal frameworks could be classified in the following way:

- i) first generation, which confine themselves to the general aspects, concentrating on the broad fiscal aggregates and declarations of governmental public policy;
- ii) second generation, that, in addition, include expenditure specifications following sectoral and functional classifications (meaning, establishing for the principal expenditures not only their content in economic terms, but also who will execute them and for what purpose) for each one of the years included in the framework and
- iii) third generation, characterized by the inclusion of performance indicators for outputs and results, (especially the latter) as a result of non-financial programming and the specification of goals for the principal investment projects and activities set out in the budget (Schack, 2004).

Finally, as Martierene (2007) correctly points out, the basic functions of an MTFF are to prevent, to allocate, to limit and to correct.

- i) Preventive function: at the beginning of the MTFF preparation process, the participating actors will begin to point out different problems. Some will be related to difficulties in the collection of tax revenues, or in obtaining sources of financing, and others will be related to pressures emanating from the spending sector, delays in the programs and projects, conflicting objectives, etc. Not finding the solution to these problems will undoubtedly cause undesirable harm to the state.
- ii) Allocation function: medium-term programming with a longer time horizon than just one fiscal term allows the allocation of resources to new programs and projects, or the strengthening of existing ones, using resources freed up from the completion of other programs, projects or public policies. The structure of expenditure can therefore be gradually oriented towards national objectives, diminishing the total level of rigid expenditures.
- iii) Limitation function: once formulated, the distribution of multi-annual spending by entities, programs, sub-programs, projects, funding sources and groups or sub-groups informs the decision-making process in respect to new expenditures in future years.
- iv) Corrective function: once the MTFF is implemented, an analysis of the deviations between the projected and actual data must be carried out. In this way,

lessons can be learned about the performance of variables, enabling adjustments in the assumptions and forecasting criteria to be made, thereby enhancing forecasting capacity.

### ***Experiences in Latin America***

Latin American countries have formulated medium-term fiscal frameworks with differing degrees of complexity and coverage. For this purpose, a combination of significant macroeconomic variables expressing the political economic and social context of each country are estimated, such as Gross Domestic Product (GDP), the balance of payments, consumption, investment, prices, wages, interest rates, exchange rates, employment, etc, based on future expectations in order to adjust goals, objectives and the allocation of resources to the formulated programs and budgets.<sup>3</sup>

In general, the need to establish macro fiscal rules that impose budget limits for various years is stressed, with the aim of moderating budget demands made by agencies in the present year. This contributes to maintaining public sector solvency and reduces undesirable biases in the management of fiscal policy (volatility, procyclical spending, excessive deficits, intergenerational inequality, among others).

3. In this sense, fiscal policy should consider a multi-annual framework, based on a long-term time horizon defined on the basis of structural balance, with rules that establish control over public finances in the medium-term, and a new budget planning regime, based on multi-annual allocation.

Table 36. Medium-term macroeconomic and fiscal frameworks

| Country     | Is there a medium-term fiscal framework or similar?                                                                                                                                         | What is the time horizon? | When is it revised and updated? | Are there macroeconomic forecasts? | Are there forecasts for social variables? (Education, health, poverty, others). | Are there performance indicators and goals for sectoral policies? | Is it published on the internet? | Is there an explicit reference in relation to the PND, the Strategy to Overcome Poverty, the National Accord or equivalent? |
|-------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------|---------------------------------|------------------------------------|---------------------------------------------------------------------------------|-------------------------------------------------------------------|----------------------------------|-----------------------------------------------------------------------------------------------------------------------------|
| Argentina   | There is the Multi-annual Budget Framework ( <i>Marco Presupuestario Plurianual</i> ).                                                                                                      | 3 years                   | 2 <sup>nd</sup> quarter         | Yes.                               | No.                                                                             | Partial.                                                          | Yes.                             | Yes.                                                                                                                        |
| Bolivia     | No.                                                                                                                                                                                         |                           |                                 |                                    |                                                                                 |                                                                   |                                  |                                                                                                                             |
| Brazil      | There is a PPA that is included in the annual budget law.                                                                                                                                   | 4 years                   | 3 <sup>rd</sup> quarter         | Yes.                               | Yes.                                                                            | Yes.                                                              | Yes.                             | Yes.                                                                                                                        |
| Chile       | No.                                                                                                                                                                                         |                           |                                 |                                    |                                                                                 |                                                                   |                                  |                                                                                                                             |
| Colombia    | There is an MTFF.                                                                                                                                                                           | 10 years                  | 2 <sup>nd</sup> quarter         | Yes.                               | No.                                                                             | No.                                                               | Yes.                             | Yes.                                                                                                                        |
| Costa Rica  | There is an MTFF, contained in the Explanatory Preamble of the Annual Budget ( <i>Exposición de motivos del Presupuesto Anual</i> ).                                                        | 3 years                   | 3 <sup>rd</sup> quarter         | Yes.                               | No.                                                                             | Partial.                                                          | Yes.                             | Yes.                                                                                                                        |
| Ecuador     | There is a Multi-annual Budget Framework, as well as a Macroeconomic Programming document.                                                                                                  | 4 years                   | 2 <sup>nd</sup> quarter         | Yes.                               | Yes.                                                                            | Partial.                                                          | Yes.                             | Yes.                                                                                                                        |
| El Salvador | No.                                                                                                                                                                                         |                           |                                 |                                    |                                                                                 |                                                                   |                                  |                                                                                                                             |
| Guatemala   | There is a Multi-annual Budget Framework.                                                                                                                                                   | 3 years                   | 2 <sup>nd</sup> quarter         | Yes.                               | No.                                                                             | Partial.                                                          | Yes.                             | Yes.                                                                                                                        |
| Mexico      | There is a macroeconomic framework in accordance with the General Criteria of Economic Policy ( <i>Criterios Generales de Política Económica</i> ) contained in the Draft Expenditures Law. | 6 years                   | 2 <sup>nd</sup> quarter         | Yes.                               | Partial.                                                                        | No.                                                               | Yes.                             | Yes.                                                                                                                        |
| Panama      | There is an Annual Economic Report ( <i>Informe Económico Anual</i> ).                                                                                                                      | 3 years                   | 2 <sup>nd</sup> quarter         | Yes.                               | Partial.                                                                        | No.                                                               | Yes.                             | Yes.                                                                                                                        |

| Country   | Is there a medium-term fiscal framework or similar? | What is the time horizon? | When is it revised and updated? | Are there macroeconomic forecasts? | Are there forecasts for social variables? (Education, health, poverty, others). | Are there performance indicators and goals for sectoral policies? | Is it published on the internet? | Is there an explicit reference in relation to the PND, the Strategy to Overcome Poverty, the National Accord or equivalent? |
|-----------|-----------------------------------------------------|---------------------------|---------------------------------|------------------------------------|---------------------------------------------------------------------------------|-------------------------------------------------------------------|----------------------------------|-----------------------------------------------------------------------------------------------------------------------------|
| Paraguay  | There is a Multi-annual Budget Framework.           | 3 years                   | 3 <sup>rd</sup> quarter         | Yes.                               | Partial.                                                                        | Yes.                                                              | Yes.                             | Yes.                                                                                                                        |
| Peru      | There is a Multi-annual Budget Framework.           | 3 years                   | 3 <sup>rd</sup> quarter         | Yes.                               | Yes.                                                                            | Partial.                                                          | Yes.                             | No.                                                                                                                         |
| Uruguay   | There is a Multi-annual Budget.                     | 5 years                   | 1 <sup>st</sup> quarter         | Yes.                               | No.                                                                             | No.                                                               | Yes.                             | Yes.                                                                                                                        |
| Venezuela | There is a Multi-annual Budget Framework.           | 3 years                   | 3 <sup>rd</sup> quarter         | Yes.                               | No.                                                                             | No.                                                               | No.                              | Yes.                                                                                                                        |

Source: Current regulations and related documentation published on various websites.

It would seem that El Salvador and Bolivia do not formulate a macroeconomic MTFF. In these countries, the definition of budget ceilings and policy guidelines is officially conducted in a time frame that does not extend beyond one financial year, though there may be some working or formal documents that contain macrofiscal projections compiled for the medium term.

In conclusion, three groups of countries can be identified in respect to the level of development (coverage and complexity) of their macrofiscal programming instruments:

- i) first generation countries, such as Panama and Venezuela;
- ii) second-generation countries, such as Colombia and Peru and
- iii) third-generation countries, such as Brazil and Argentina.

It must be stressed, however, that this classification is presented only for the purpose of illustration, since developing a full classification of types of MTFF and cataloging countries according to these types would be a complex task exceeding the limits of this paper, given the heterogeneous nature of the fiscal programming instruments displayed in the region.

There are many examples of why it may be difficult to assign countries to different types of MTFF. It might be the case that, strictly speaking, a framework is first generation, but second- and third-generation characteristics are present in some instruments (as in Chile); or that the nature of resources allocated to the framework is legal and normative and not indicative (as in Uruguay); or that the planning time horizon is fixed instead of temporary (as in Venezuela); or that a country (like Ecuador) finds itself immersed in a process of constitutional change that is so extensive that the planning and budgeting processes undergo complete revision and, consequently, the existence or lack of existence of a framework during that transitional period will differ in relation to what occurs during a period of institutional stability; or that the framework exists, but the different actors in the decision-making process have not taken ownership of it due to the fact that it was drafted in response to requirements of international financial or donor institutions; or that the level of participation by spending agencies in determining the inter-annual allocations has been very significant, or almost nonexistent; or that the framework is more mature (according to the number of continuous years of its existence and

application), among other considerations that complicate making precise and conclusive distinctions among the cases.

It should also be pointed out that macrofiscal rules vary considerably from country to country according to the variable set as the objective, their institutional coverage and the methods employed to implement them.

The majority of the countries studied have opted to approve fiscal rules that, in general, establish a certain relationship between the fiscal deficit and GDP. Some have gone even further, by making commitments in respect to levels of borrowing. Only Chile has advanced in defining rules in relation to the structural balance. In recent years, some countries have attempted to implement fiscal rules, principally oriented towards restricting debt levels in public accounts through agreements to comply with numerical restrictions and modifications of the budget process. To a lesser degree, the implementation of rules aimed at increasing transparency has also been considered.

Finally, in spite of the advances made in budget programming, the current fiscal policy rules in force in many countries in the Latin American region still tend to place emphasis on short-term goals, do not go beyond the annual cycle and do not include clauses that enable unforeseen events, which occur repeatedly, to be effectively addressed.

Although it is true that the MTFF is the natural mechanism for linking the planning and budgeting processes, the plan and multi-annual policies, and public management and annual financing, operationally this relationship exists primarily in the budget formulation phase, when the first year of the framework is prepared in detail so as to form the draft (proforma) budget.

### ***The Formulation of the Budget***

As Schack (2007a) points out, increasing the real degree of integration between plans and budgets, between the micro, meso and macro levels, between national priorities, programmatic strategies (sectoral and territorial) and institutional missions requires work processes (with actors and their associated roles), well-defined institutional spaces for interaction and specific tools (methodologies, information systems and instruments). Instructions, directives and even the laws in which such integration is regulated are not by themselves sufficient.

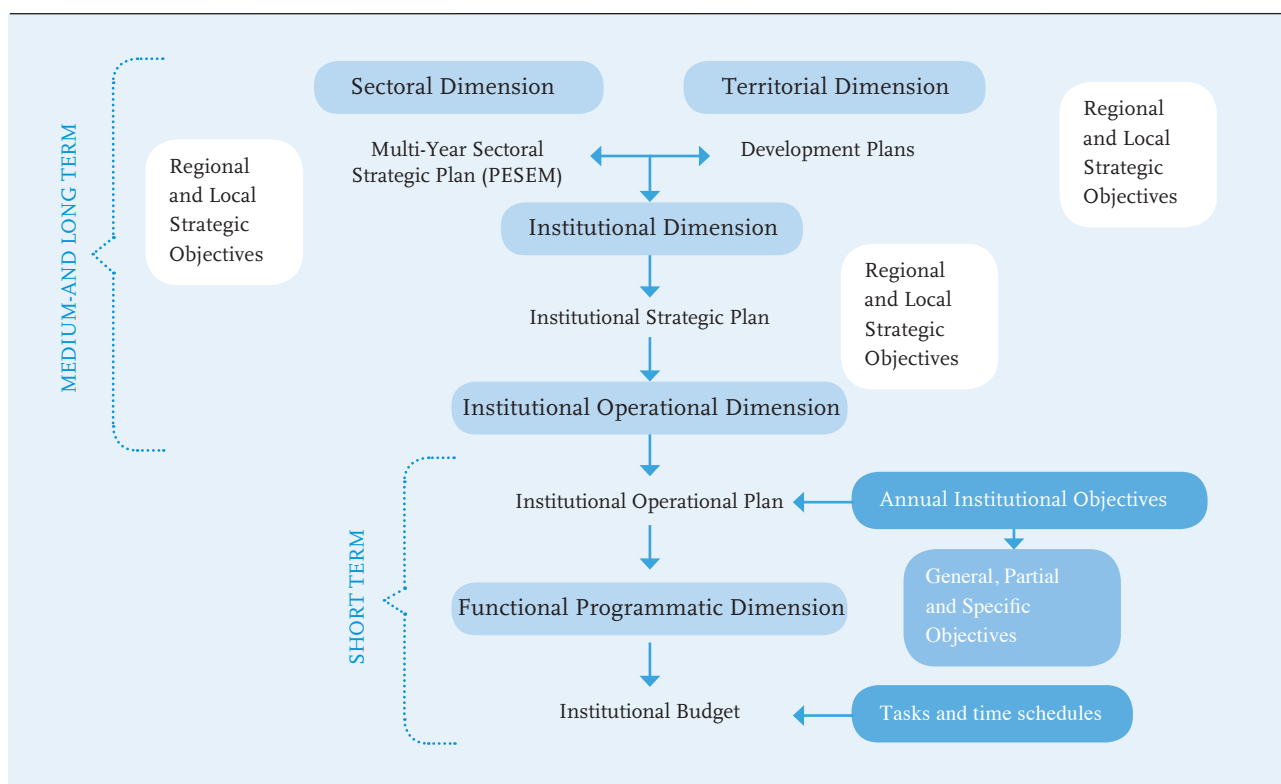
In short, integration between the plan and the budget happens in the context of a complex process of harmonization in which attention to citizen preferences, political economic considerations, technical proposals and management capacities are in continuous interaction. In this context, the characteristics of the political system are particularly relevant.<sup>4</sup>

All the Latin American countries analyzed have a presidential system and, in all cases, the fiscal year runs in parallel with the calendar year (January 1 through December 31) and the budget is yearly, except in Uruguay, where the constitution calls for a five-year budget (although in operational terms it is annual). The period of the government in Venezuela and Mexico is six years; in Bolivia, El Salvador, Paraguay, Peru and Uruguay, it is five years; and in Argentina, Brazil, Colombia, Costa Rica, Chile, Ecuador, Guatemala and Panama, it is four years.

In the budget process, as in any repetitive game, the players must interact at different moments in time. Depending on the rules and institutional spaces that frame the interaction, a better or worse institutional arrangement could be fostered for linking planning with budgeting.

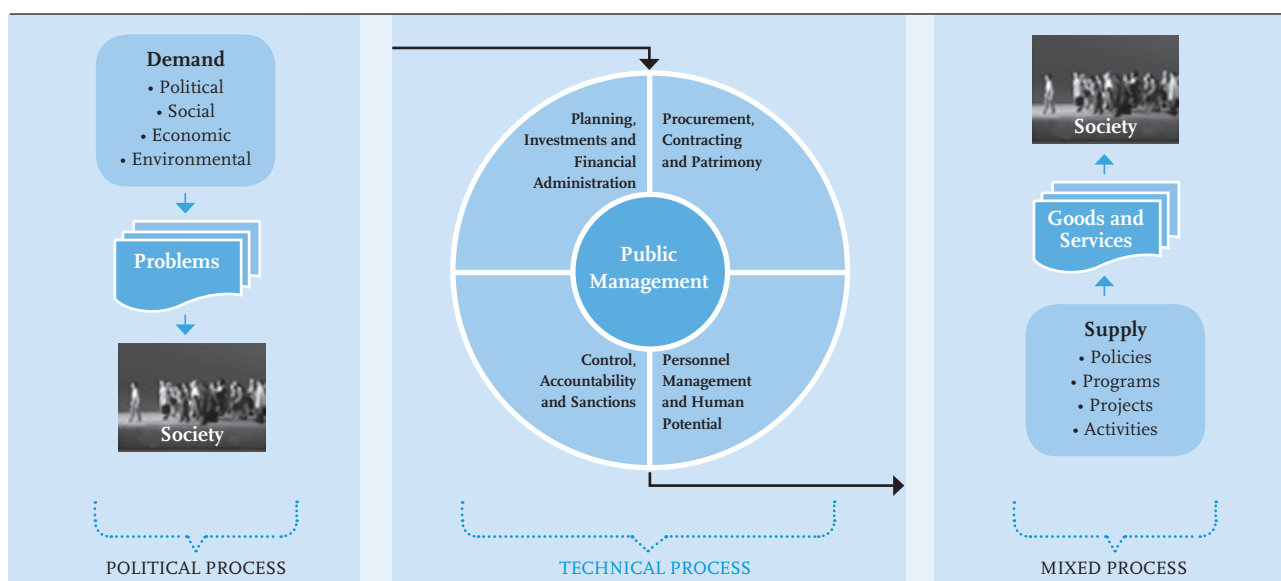
4. Tavares and Beretta (2006) point out that the existence of a presidential system causes greater tensions during the period of budget debate. In general, in the parliamentary political system found in most English-speaking countries, decisions are made by cabinet ministers who are collectively responsible to the parliament and the budget proposal is submitted to parliament, which can make amendments. These amendments must be decided by a vote; generally, the vote is won by the government party, which supports the proposal that the executive sent to parliament. If the opposition wins the vote, however, and the approved amended budget is not acceptable to the executive, this is understood as a vote of no-confidence and fresh elections must be called.

Figure 6. Diagram of the integration of objectives in the budget process



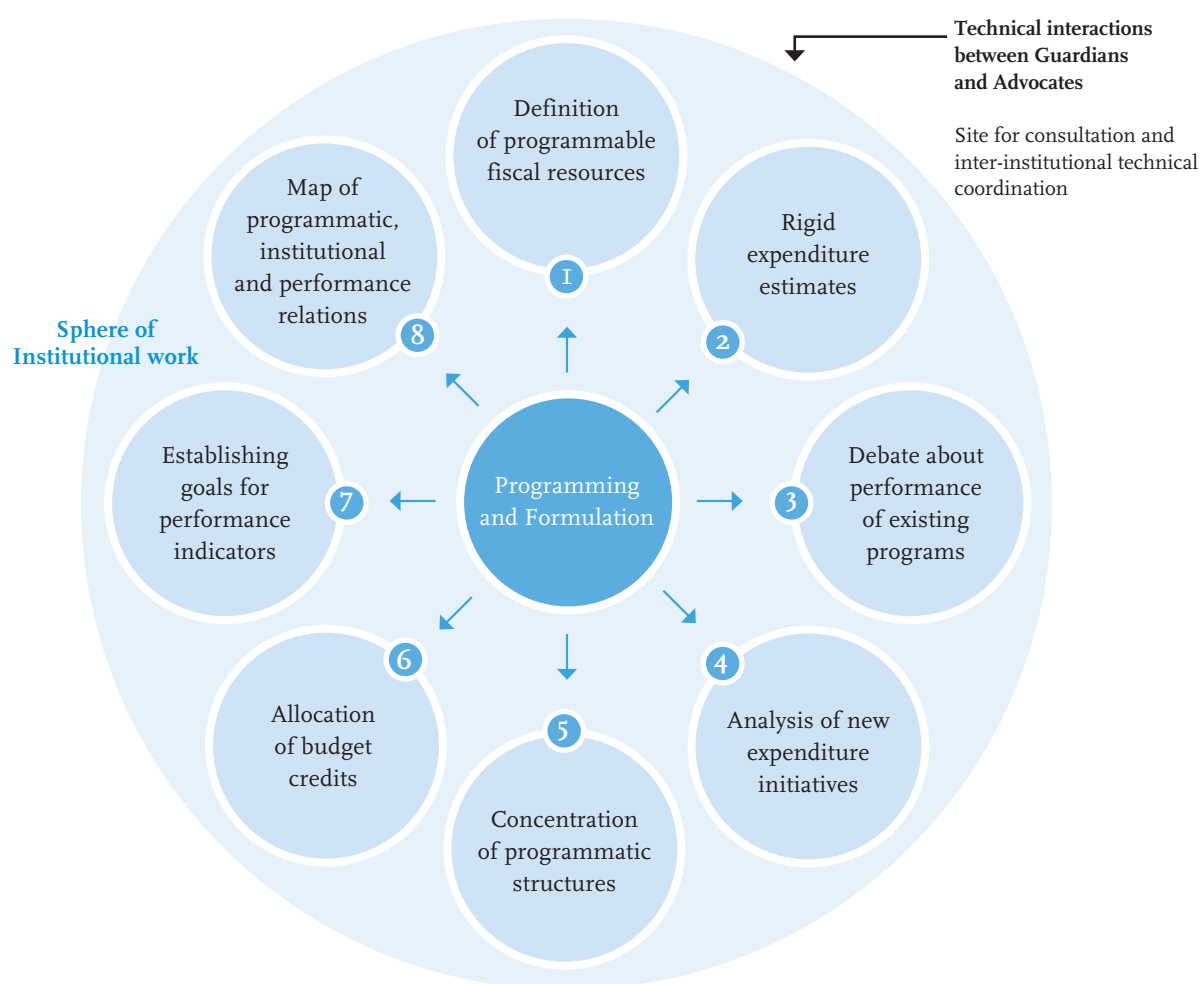
Source: Adapted from MEF (2006).

Figure 7. Attention to citizens' demands



Source: Authors.

Figure 8. The phases of budget formulation and programming



Source: Adapted from Schack (2007b).

One way to institutionalize this integration and make progress towards a form of management focused on the achievement of fiscally sustainable goals would be to formally and systematically establish working processes and the fulfillment of commitments in programming and budget formulation, which would be more or less complex according to the size and composition of the budget.

In general terms, according to Schack (2007b), a proposal for an ideal eight-stage structure for the budget cycle could be put forward with the form shown in Figure 8.

#### DEFINITION OF AVAILABLE FISCAL RESOURCES

The first stage of the budget cycle permits the annual operational budgeting process to be framed with the macrofiscal policy perspective taken into account (in the tactical multi-annual programming process) and the budget to be elaborated in two stages. The first, which is based on the macro-fiscal forecasts, sets the total amount of the national budget compatible with the government's economic program. The second determines the distribution of that total among the different spending alternatives.

*RIGID EXPENDITURE ESTIMATES*

Normally, at the outset of the programming process the budget authority sets “budget ceilings” for all entities based upon the estimates of the previous value, in order to provide a reference point so that the formulation of their respective institutional budget proposals can begin. However, these “ceilings” are modified so many times over the course of the process (particularly by the executive, but also by the legislature, during approval of the budget) that, in practice, they tend to be transformed into “floors.”

Similarly, there is no known and predictable rule that enables these “floors” to be accurately forecasted, but usually they are the product of bilateral (discretionary) discussion and negotiation between the entity and the agency directing the budget process. The formal establishment of a procedural algorithm should be considered, which would estimate the structural and inertial expenditures required for the following fiscal year at the level of all principal spending programs and all institutions receiving allocations from the public treasury, and would introduce, on a sliding scale of this estimate, a factor of overall efficiency (or efficiency dividend) which would be required of the public institutions for the following budget exercise.

According to Schack (2006), a classification of the levels of rigidity and flexibility of public expenditures could be established. The budget has a structural component and also a functional one. The former is comprised of forecasting obligations and public debt service. The latter, which is what finally enables the state, year after year, to fulfill its essential functions (by providing education, health, security, justice, economic infrastructure, etc.) can be divided, in turn, into an inertial component (e.g. civil service wage bill, continuation of public works, payment of public utility service tariffs to public entities) and a flexible one (e.g. new investments and non-essential goods and services). The rigidity of the budget in relation to expenditures is measured as the proportion of rigid expenditures (the structural component and the inertial part of the functional component) as a share of total expenditures.

In this respect, it should be noted that the overall efficiency factors in institutional management, which can generally oscillate between 1% and 5% in nominal terms, must differentiate between different organizational realities (given that it is not fair to submit an administrative organization to the same standards of efficiency as an organization that builds roads, for example). In this way, a volume of resources could be estimated that would be used to finance an increase of resources to improve the quality and coverage of current programs, as well as to implement new programs that will be established in the subsequent stages of the programming and formulation process.

*DISCUSSION ABOUT THE PERFORMANCE OF EXISTING PROGRAMS*

This should be the first moment of technical interaction between the Guardians of the Treasury and the Advocates of Program Spending, following the game set forth by Tavares y Beretta (2006). The purpose of the game is:

- i) to define the commitments for improving programmatic and institutional management based on the evaluations of the principal spending programs (i.e., those that are linked to the achievement of the Annual Budget Objectives (OPAs); and
- ii) to decide if it is advisable to increase, maintain, or reduce allocated resources based on the analysis of past (at least the previous financial year), present (for the current fiscal year) or immediate future performance (for the fiscal year of the draft budget proposal).

At this point, it is useful to analyze the logical frameworks that synthesize the state activities under discussion. The pertinence of achievements, their relation to the OPA, the fulfillment of commitments, the contrast of advances relative to the baseline, among others, are working practices that seem to belong naturally to this stage of interaction between the actors.

It is important that contacts between budget controllers and resource executives take place in a formal space of inter-institutional coordination. Contact should

be personal, and not merely of an administrative nature based on exchanging documents and correspondence. There is a need for conversation, debate, exchange of opinion and knowledge sharing in respect to the performance achieved by the activity, project, institution or unit that is the subject of the discussion.

#### *ANALYSIS OF NEW SPENDING INITIATIVES*

This stage can be the second explicit moment for interaction between actors. The idea is to introduce a specific mechanism of competitive grant funds that introduces greater economic rationality in the allocation of resources for new spending initiatives. As previously suggested, this mechanism should include in its design the application of an efficiency dividend for all of the administration.

A transparent procedure is needed to establish the eligibility criteria for the presentation of new initiatives (if not, there will be too many initiatives for the available resources, which will overwhelm the procedure and, probably, detract from its credibility), as well as criteria for assessing the initiatives in order to establish a ranking system enabling scarce available resources to be allocated to the best ones. At the same time, it should be recognized that it is not always feasible to make comparisons between different programs, and that the aim is to add additional elements of technical judgment to the policy discussion to support decisions on budget allocations.

#### *COORDINATION OF PROGRAMMATIC STRUCTURES AND PERFORMANCE*

The coordination of programmatic structures and performance can be considered a third moment for technical interaction between actors during the phase of budget programming. It is not only about precisely establishing

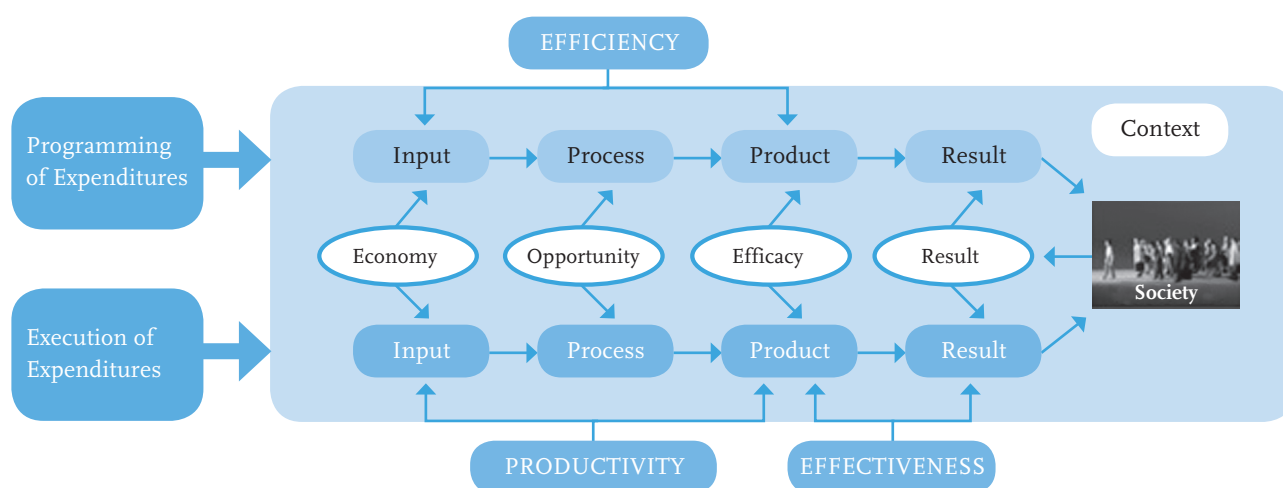
the respective budget chains,<sup>5</sup> but rather, above all, to define how the institutional and programmatic performance of public activity will be controlled, monitored and evaluated. This means establishing performance indicators, which must be derived from a strategic institutional planning process that directs measurement and evaluation efforts towards what is most important.

In this respect, a distinction should be made between performance measurement indicators and performance evaluation indicators, as well as between those indicators that, if not directly linked with the productive processes of an activity, project, program or policy, certainly influence them by characterizing the environment in which they are carried out. This latter form of indicator, according to Irrazaval (2004), can be classified as a contextual indicator (for example, a target indicator).

Performance measurement indicators are instruments for measuring the principal variables associated with the attainment of objectives, which in turn constitutes a concrete qualitative or quantitative expression of what is meant to be achieved. These have been defined as input, process, product and result indicators (IPPR).

Performance evaluation indicators are associated with judgments made once an activity or intervention is completed. These indicators address key questions about how the intervention has been undertaken in its distinct phases, if the objectives have been fulfilled (or the extent to which they have been fulfilled) and levels of satisfaction of the target population, among others. In short, it seeks to evaluate how good the performance of a given public agency has been in order to take the necessary measures to improve management. At present, there is a general consensus that effectiveness, efficiency and economy (EEE) should provide the analytical criteria for evaluating performance in the execution of public expenditures.

5. For this purpose the budget classification and its mapping to the new IMF manual is important because of its impact on the future availability of both financial and non-financial information during the entire budget cycle.

**Figure 9. Diagram of performance measurement and performance evaluation indicators**

Source: Adapted from Schack (2003).

The adequate construction of performance indicators, however, presupposes a certain clarity regarding the production function (and, therefore, the cost function) implicit in the provision of goods and services undertaken by a given program or entity. This implies knowing what is being done, how it is done, why it is done and how much it costs. These are elemental questions that we are often unable to answer with assurance due to the lack of logical framework matrices for the interventions, or baselines that could serve as reference points for subsequent comparisons, among other analytical elements.

#### *ALLOCATION OF BUDGET CREDITS*

This stage of the process is reserved for the highest decision-making levels of the executive. In this phase interaction between actors is highly political. The objective is to make the performance level (achieved, in progress and expected) one of the fundamental factors in the final allocation of funds to each program or institution. It is here that the “budget ceilings” are truly defined.

To the extent that the process is repeated with each budget exercise, those programs and institutions that are not strictly relevant to achieving the OPA will have a budget ceiling established that will end up being similar to the floor established by the budget authority at the beginning of this phase.

#### *ESTABLISHING GOALS FOR PERFORMANCE INDICATORS*

In this stage, the fourth instance of technical interaction between actors takes place. The aim is simple; in light of all the information analyzed up until that time, to determine the value of the performance indicators that the institution commits itself to obtaining in the subsequent fiscal year, on the basis of the budget credits already allocated to it by budget officials.

#### *THE PROGRAMMATIC, INSTITUTIONAL AND PERFORMANCE RELATIONS MAP*

Finally, the fifth moment in which the players can technically intervene occurs during this phase, when they participate in the elaboration of a map of programmatic, institutional and performance relations, taking the achievement of the OPA as a reference point.

A map of relationships is designed merely to explain the existing associations between the achievement of the OPA, the performance indicator goals for the principal spending programs (for which the performance measurement indicators have been constructed) and the resources allocated, in order to have an idea of what effects any redistribution of the anticipated level of budget credits would bring.

This instrument could be very important at various moments in the budget process:

- During legislative discussion of the budget proposal in the economic and treasury committees.
- At the time that changes are made to the anticipated levels of fiscal resources (as a result of the reallocations in the budget proposal or adjustments in the budget);
- For ensuring that public officials internalize the opportunity costs of such decisions (and that there is, therefore, political accountability with the possibility of a social audit);
- In the case of attainment of those OPA of a general nature that, due to their complexity and coverage, are broken down into various specific objectives that are not necessarily attributable to the activities of a single program or entity, but instead are defined multi-causally throughout the entire fiscal year.

It would appear that this kind of budget procedure would help, on the one hand, to promote greater integration between the plan and the budget and, on the other, to incorporate the use of information on the performance of governmental financial administration in a sustainable way, thereby advancing towards results-based management in the public administration.

### **General Conclusions About Integration**

We can now draw some general conclusions or hypotheses regarding the levels of integration between the plan and the budget.

### **Box 11. First Hypothesis**

*The level of integration between the plan and the budget is a continuum, in which various harmonization processes take place at different levels and in different phases of the cycle that characterizes the design and implementation of public policies.*

The effectiveness of this integration process has different connotations, depending on the level in which it is undertaken. At the macro level, for example, it might be expected that governmental priorities (the Government Plan) would receive real budget credits associated with the national budget law in the first year, enabling public management to work towards the achievement of these goals, and that the total demand for public resources necessary to satisfy the given priorities in a stipulated timeframe would be compatible with fiscal solvency over time.

In this particular case, it should be noted that governmental priorities always exist and are present to a greater degree than might seem apparent. They might arise from programmatic promises made in an electoral campaign and then be changed according to circumstances and stay within the mind of the president and his principal collaborators. They may also be made explicit in the presidential messages to the nation or in the debate over how the discretionary resources in the draft budget should be allocated. At the other extreme, they may be formally expressed in a PND or a similar document that is adequately designed, operational, compatible with the sustainability of public finances, and based on a consensus among the various social and political actors for which definitive goals are defined in terms of results (intermediate and final) that satisfy citizens' demands.

At the meso scale, it might be expected that the interface between plan and budget will occur where public policies translate strategic governmental priorities into the sectoral and territorial areas that have a multi-annual plan, which then allows for the specific allocation of adequate financial and non-financial

means to allow gradual progress, year after year, in the achievement of the proposed objectives.

At the micro scale, however, the logic of integration demands, on the one hand, that the strategic institutional plan (which, with different names, generally exists in the organizations of all countries) includes priorities that are aligned with the government's strategic orientations and the public entities' (often legally established) objective missions, and on the other hand, that the strategic institutional priorities are reflected in the annual operating plan that supports the combination of projects and activities to be financed by the budget during the fiscal term.

It is certainly on the meso level where the greatest deficiencies in the effectiveness of the integration process are found.

#### Box 12. Second Hypothesis

*The budget is always the financial reflection of a plan, which means that in the final instance, the latter decides the allocation of resources within the framework of restrictions imposed by the former.*

All the analyzed countries make use of budgets and these are always, among other elements, the financial reflection of a plan, the prioritized distribution of revenue and a reflection of the processes and culture of state organization (Schack, 2006). In this sense, despite their varying levels of formality, it is always the plans' strategic priorities that define the intertemporal allocation of public resources at the macro level.

The point is that it is not always clear which plan is being considered, due to the lack of formalization of government priorities, which means that as the plan moves from one extreme to another in terms of the degree of formalization, in practice the budget process replaces the planning process altogether, defining the orientation of public expenditures, and even strategy.

In effect, as Cunill and Ospina (2003) suggest, there are two main models for determining the programmatic orientation of expenditures in Latin American countries:

- A model plan, in which government policy priorities are explicitly set out in a PND, or equivalent instrument, that serves as a guide for determining expenditure priorities, above all in the medium-term, and in which the strategic planning exercises are diffused and integrated into the budget cycle's decision-making process;
- A model budget, in which the formulation of this instrument and its development throughout the budget cycle, generally annual, clearly show the definition of spending orientations, without there being a specific conditioning or reference to the objectives of a PND. Given the typical budget restrictions and institutional, or even methodological, inertia, the incremental nature of the budget is thereby perpetuated.

Incrementalism is not bad by definition. One might even ask: why substantially change the state of affairs in the developed countries if everything more or less functions well? The point is that, given the Latin American reality, with the growing gap in the satisfaction of citizens' social, economic, political and environmental demands, budget formulation and execution should tend towards substantial modification of the *status quo*, and therefore incrementalism should not be the only basis for the intertemporal allocation of public resources.

With increasing frequency, the countries of the region are, therefore, advancing towards multi-annual expenditure frameworks, that are not simple projections of the continuous financing of existing programs, but that genuinely allocate spending as a function of strategic thinking, translated into medium- and long-term public policy priorities and objectives. In this way, the countries can move progressively and sustainably along the path of efficiency and economic growth, social equity, political democracy, environmental sustainability and human development in general.

In short, the debate does not appear to be limited to whether or not integration is to be pursued, but rather about what is integrated on what; the plan on the basis of the budget or the budget on the basis of the plan.

Evidently, the platform for integration ends up defining the integration process, due to its own logic, approach and dynamic.

### Box 13. Third Hypothesis

*The degree of the plan's relevance in determining spending priorities in the budget cycle will depend upon the institutional arrangements in force.*

It is not the same to speak about this interaction when there is a formal administrative system than when there is not; or when, although such a system does exist, it is not an effective counterbalance to the finance ministry's capacity to shape the incentives that guide the behavior not only of the financial administration in particular, but also of public management in general.

The degree of formalization and effectiveness of the planning process<sup>6</sup> will depend on the constitutional arrangements and technical capacities found in the center (i.e. the highest levels of the executive, particularly the finance and planning ministries, or their equivalent) and on the periphery (the public executing agencies that make up the administration).

In effect, it is not just about having a plan or not, meaning a printed document called a plan. In order for the plan to have influence, it must not only have the characteristics mentioned above (WB, ECLAC and International IDEA, 2004) (i.e. that the statement of the country's vision and objectives is accompanied by a serious commitment from all actors (government, private sector and civil society) to implement the required reforms to put those objectives into practice), but also must be the result of a formal administrative process, because this is where, from an institutional perspective, a large part of the strength of the planning process lies.

When one speaks about the planning process, one usually thinks of an institutionalized process taking

place within the public administration that is not in a document or an information technology application but a combination of legally formalized procedures, techniques, methods and instruments with national presence and coverage, that technically regulate the administrative process (planning at all levels). In addition, one thinks of its relationship with other systems (in particular, budget, investment and evaluation systems), the relationships between the system's governing agency and the delegations of the public entities that depend, hierarchically and functionally, on it, and the impact that the planning system has on the reality of institutional management and the capacity for public organizations to learn.

Certainly, the location of the system's governing agency is of strategic importance in the context of the executive,<sup>7</sup> but its position and relative weight in the government will be of little significance if the system (meaning the governing agency and also all of the public entities that depend functionally upon it) does not have the recognized technical capacities, and the ruling body does not have the rule-making authority, or the legal and political authority to establish specific working processes. This means that answering the question of how to attract and retain highly-qualified personnel in the planning system that are above the average of those in the national bureaucracy, along with the quality of the leadership of the highest technical and political officials in the planning process, are part of the solution to the problem of the integration of the plan and the budget.

It should not be forgotten, however, that, in general, the leadership and power wielded by the budget system's governing body is usually significantly greater than the planning authority's, especially if it is at the same organizational level as the executive.<sup>8</sup> This occurs particularly when the planning system has no responsibility whatsoever for drafting the investment budget,

6. The budget, by definition, is the most formalized and institutionalized process found within the different countries.

7. Generally speaking, the ruling bodies in the region (when the planning body is not "absorbed" by the Treasury) are organizationally separated into two ministries (or high-ranking organisms); the Planning and the Treasury ministries. Only Brazil has an explicit constitutional arrangement that has the plan and the budget as an integral part of its organizational definition, by concentrating the ruling functions of both systems within a single ministry of Planning, Budgeting and Management.

8. Although this does depend on the nature of the authorities; it is rare for the planning ministry to compete with the finance ministry in the countries in the region.

meaning that it does not use the public investment system to prioritize, but rather to merely ensure the projects' technical and socioeconomic viability, in a restricted budget scenario. This means defining what projects (from which sectors and in which territories) are to be carried out first (so as to define an ordered sequence of programmatic investments) according to the plan's logic.

#### Box 14. Fourth Hypothesis

*Genuine and constant harmonization between the plan and the budget happens when, at each level, concrete results are brought about in the working processes that modify the budget cycle routine, and there is a minimum density of instruments.*

As Schack (2007a) points out, improvement in the traditional processes that regulate the budget formulation phase is essential so that information on strategic priorities, correctly expressed in operationally defined terms (meaning, the way in which the OPA will be delivered), can influence the decision-making process in respect to the use and allocation of budget resources.

What is required in reality is for the plan's influence to be extended beyond the budget preparation phase, which is sometimes broken down further into a programming and formulation phase, and to also be present during the phases of approval, execution and evaluation of the budget. This means, that throughout the entire budget process, even if it follows the logical pattern cited above, each country should make administrative adjustments to four or more phases with predetermined timetables, according to the current valid regulations.

The typical asymmetry that exists between budget and planning processes should be eliminated, because they do not coincide either "on time" or "in form" when budget decisions are made. Because the budget process is subject to a legally established (constitutionally stipulated), rigid calendar, with a regular and annual periodicity it often ignores the results of planning, which is generally less formalized and diffused, although more flexible.

In this sense, the presence of elements such as inter-institutional spaces and formal coordination procedures between the various actors in the center (governing bodies), and between these and the periphery (executing agencies (functional dependencies) of each public agency), on the basis of tools that promote such integration, is essential. The following non-exclusive list of elements might be suggested:

- Fixed timetables for the discussion of priorities, within the framework of a process of reviewing the government's multi-annual strategy and its annual impact on the budget exercise. The budget should be formulated with the most important public entities, from the perspective of achieving policy objectives of both the PND and the OPA;
- IT support applications for compiling and systematizing information about priorities and their level of achievement, including the evolution of output and outcome indicators related to performance;
- Comprehensive and validated logical frameworks, with participation from the agency governing the budget process, addressing public policy priorities and their principal programs;
- Matrices showing the relationship to the budget. These will enable the links between the budget's programmatic structure and the structure of the plan's objectives and priorities to be made more apparent and will help in the assessment of the non-financial impacts of obtaining targets in relation to output and outcome indicators and of financial decisions in the short term (during the year for which the budget is formulated) and in the medium-term.

#### Box 15. Fifth hypothesis

*The greater the development of systems for evaluating and monitoring governmental action (and public expenditure in particular), and the more developed the civil service, the easier the process of integration will be between the plan and the budget at every level, given the greater volume of available information and the enhanced capacity to employ it in decision-making.*

Table 37. The governing organs of planning and budgeting systems

| Country     | Governing Organ of the Planning System                                                                                                       | Governing Organ of the Budget System                                                                                                                                                   |
|-------------|----------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Argentina   | Ministry of Federal Planning, Public Investment and Services. ( <i>Ministerio de Planificación Federal, Inversión Pública y Servicios</i> ). | National Budget Office, Budget Sub-secretariat, Secretary of the Treasury. ( <i>Oficina Nacional de Presupuesto. Subsecretaría de Presupuesto, Secretaría de Hacienda</i> ).           |
| Bolivia     | Ministry of Planning and Development. ( <i>Ministerio de Planificación del Desarrollo</i> ).                                                 | Vice-Ministry for the Budget and Public Accounting, Treasury Department. VMPC ( <i>Viceministerio de Presupuesto y Contaduría</i> ).                                                   |
| Brazil      | Ministry of Planning, Budgeting and Management. ( <i>Ministerio de Planificación, Presupuesto y Gestão</i> ).                                | Federal Budget Secretariat, Ministry of Planning, Budget and Management. ( <i>Secretaria de Presupuesto Federal. Ministerio de Planificación, Presupuesto y Gestão</i> ).              |
| Chile       | Ministry of Planning and Cooperation. ( <i>Ministerio de Planificación y Cooperación</i> ).                                                  | Budget Directorate, Treasury Department. ( <i>DIPRES</i> ) ( <i>Dirección de Presupuestos</i> ).                                                                                       |
| Colombia    | National Planning Directorate, Presidency of the Republic. ( <i>Dirección Nacional de Planeamiento, Presidencia de la República</i> ).       | Ministry of the Treasury and Public Credit and National Planning Department (Investment). ( <i>Ministerio de Hacienda y Crédito Público and Departamento Nacional de Planeación</i> ). |
| Costa Rica  | Ministry of National Planning and Economic Policy. ( <i>Ministerio de Planificación Nacional y Política Económica</i> ).                     | General Directorate for the National Budget, Finance Ministry. (DGPN). ( <i>Dirección General de Presupuesto Nacional</i> ).                                                           |
| Ecuador     | National Secretariat for Planning and Development, Presidency of the Republic. ( <i>Secretaria Nacional de Planificación y Desarrollo</i> ). | Budget Sub-Secretariat, Ministry of Economy and Finance. ( <i>Subsecretaría de Presupuestos, Ministerio de Economía y Finanzas</i> ).                                                  |
| El Salvador | Technical Secretariat of the Presidency ( <i>Secretaría Técnica de la Presidencia</i> ).                                                     | General Directorate for the National Budget. (DGP), Finance Ministry. ( <i>Dirección General de Presupuesto, Ministerio de Hacienda</i> ).                                             |
| Guatemala   | Presidential Planning and Programming Secretariat. ( <i>Secretaria de Planificación y Programación de la Presidencia</i> ).                  | Technical Budget Directorate, Ministry of Public Finance. ( <i>Dirección Técnica de Presupuesto, Ministerio de Finanzas Públicas</i> ).                                                |
| Mexico      | Presidential Office for Government Innovation. ( <i>Oficina de la Presidencia para la Innovación Gubernamental</i> ).                        | Expenditure Sub-Secretariat, Treasury and Public Credit Secretariat. ( <i>Subsecretaría de Egresos, Secretaría de Hacienda y Crédito Público</i> ).                                    |
| Panama      | Ministry of Planning and Economic Policy. ( <i>Ministerio de Planificación y Política Económica</i> ).                                       | National Budget Directorate, Ministry of Economy and Finance. (DIPRENA) ( <i>Dirección de Presupuesto de la Nación</i> ).                                                              |
| Paraguay    | Technical Planning Secretariat. Presidency of the Republic. ( <i>Secretaria Técnica de Planificación, Presidencia de la República</i> ).     | General Directorate for the National Budget (DGP), Treasury Department. ( <i>Dirección de General e Presupuesto, Ministerio de Hacienda</i> ).                                         |

| Country   | Governing Organ of the Planning System                                                                                                                                   | Governing Organ of the Budget System                                                                                                                                                           |
|-----------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Peru      | General Directorate of Multi-Year Planning, Ministry of Economy and Finance. ( <i>Dirección General de Programación Multianual, Ministerio de Economía y Finanzas</i> ). | National Public Budget Directorate, Ministry of Economy and Finance. (DNPP). ( <i>Dirección Nacional del Presupuesto Público, Ministerio de Economía y Finanzas</i> ).                         |
| Uruguay   | Presidential Office of Planning and Budgeting. ( <i>Oficina de Planeamiento y Presupuesto de la Presidencia</i> ).                                                       | Office for Planning and Budgeting, Ministry of Economy and Finance and General Accounting of the Nation. ( <i>Oficina de Planeamiento y Presupuesto and Contaduría General de la Nación</i> ). |
| Venezuela | Ministry of People's Power for Planning and Development. ( <i>Ministerio del Poder Popular para la Planificación y Desarrollo</i> ).                                     | National Budget Office, Ministry of People's Power for Planning and Development. (ONAPRE). ( <i>Oficina Nacional de Presupuesto, Ministerio del Poder Popular para Economía y Finanzas</i> ).  |

Source: Different regulations and websites. Information valid for the 1<sup>st</sup> Quarter, 2007.

In effect, underlying the debate about the harmonious integration of the plan and budget is the ultimate concern about how to achieve a results-based budget (RBB), given that this is a *sine qua non* on the road to obtaining management based on development results (RBM). This is understood to be a management strategy centered on developmental performance and sustainable improvements in countries' results, which provides a coherent framework for development effectiveness in which performance information is used to improve decision-making and includes such practical tools as strategic planning, budget programming and execution, risk assessment and management and results monitoring and evaluation (IADB 2006).

As Schack maintains (2007c), RBB is a combination of methodologies, operational procedures and instruments that enable information on past, present and future performance (past performance, at least in the previous fiscal year; present performance, for the year in course and a provision for its close and for the immediate future, for the fiscal year for which the proposed budget is being drafted) to be incorporated in a systematic, transparent and explicit manner into each decision-making process and at each level of public

agencies, during each phase of the budget process. This leads to a change in the incentive structure shaping the behavior of actors, and strengthens the effective capacity of the state to generate public value, through the financing of governmental activities that contribute to solving the principal problems facing the community, and via a complex, but efficient, process of transforming inputs into outputs, results and impacts on the welfare of the population.

Therefore, given that information about performance (along with other elements such as the incentive structure) is the basis of every RBB and that such systematic, timely and reliable information is not available outside of a Monitoring and Evaluation System (MES) with its particular links to the budget and investment systems, the existence of this administrative system, and its degree of development, might substantially contribute to greater effectiveness in the process of integrating the plan and the budget at every level.

In this regard, it should not be forgotten that providing useful information for improving the planning processes (both global and sectoral) and the allocation of budget resources, is among the essential purposes of the MES (Schack, 2007d).

However, in order for a MES to facilitate the integration process, it should generate information that effectively influences public policy decisions and this, as Vera (2006) states, depends on various factors, which are often exogenous. These include: the maintenance of high quality standards (by relying on rigorous technical criteria, as well as credibility and transparency); adequate management of the use of information by actors; and sufficient attention to the context in which results are delivered, since however much effort is made to adapt information to facilitate its use in the decision-making process, it will not always be directly assimilated by the actors. Thus even when information is available, its impact in integrating the planning and budgeting processes might be less significant than otherwise expected.

Finally, it has been demonstrated that bureaucratic rigidity (understood as poor quality work of senior

officials and civil servants and excessive security for personnel that is not based on merit criteria) can become more severe and damaging than budget rigidity. It can powerfully condition the result (the success or failure) of the processes of integration between the plan and the budget.

The existence of sound integration processes and appropriate regulations does not in any way compensate for having poor quality public administrators (civil servants and public sector managers) if real integration is to be a success.

In this sense, the degree of integration between the plan and the budget will be more feasible as higher standards of institutional quality and stability are assured, in particular within middle management. At the end of the day, integration can only be achieved through a flexible and meritocratic civil service.

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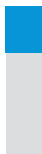
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## II Rigidities and Off-Budget Operations





# Off-Budget Operations<sup>1</sup>

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Ana María Jul\*

## Introduction

The purpose of this study is to assess the mechanisms of planning, implementation, programming, budgeting, and evaluation of extra-budgetary and tax expenditures in four countries of the region and to propose recommendations. The country cases considered are Brazil, Chile, Ecuador, and Mexico. These countries are chosen in order to obtain a representative sample of these practices both with respect to their use and to the reforms carried out in recent years in accordance with international trends in this area.

To achieve the study's objectives, off-budget operations in these countries are analyzed relative to the best-practice guidelines prepared by the Organisation for Economic Cooperation and Development (OECD) on Off-budget and Tax Expenditures, Budget Transparency, and Corporate Governance of State-Owned Enterprises, as well as the recommendations included in the IMF's Fiscal Reports on the Observance of Standards and Codes (ROSCs) prepared by the governments in the countries studied. The IMF's fiscal ROSCs for other countries in Latin America (Colombia and El Salvador), Asia (Korea and India), and Europe (Hungary, Poland, and Turkey) were also used.

The four countries' experiences show that their off-budget practices are more diverse than those for which the OECD has defined best-practice guidelines. In addition, these countries present some characteristics in their handling of the budget process which require an adjustment in the OECD guidelines. Some of the alternative guidelines proposed in the paper relate to differences on some conceptual points on which the OECD guidelines are based, which is the case with

respect to direct loans and guarantees. The paper proposes and discusses guidelines that complement and/or substitute those defined by the OECD, and bases its recommendations on both sets of guidelines.

The paper shows that the proliferation in the use of off-budget operations has depended to a large extent on the budget constraints faced by these countries, which in turn have been conditioned by political, economic, and social factors. Likewise, the reduction or elimination of these operations has depended mainly on these same factors.

Another conclusion of the study was that sometimes budget norms and practices themselves contribute to the use of extra-budgetary operations and weaken the role of the budget as the main instrument of fiscal policy. The budget approved by congress ends up not being a good indicator of actual budget implementation. These norms and practices include an optimistic revision of revenue estimates by congress, excessive flexibility in the treatment of the float, and too much discretion to increase or reallocate expenditures, both by congress and the government. On the other hand, rules that seek to ensure compliance with macroeconomic targets, such as fiscal rules, or to achieve a predetermined allocation of resources, such as those which earmark revenues or establish expenditure requirements, may result in inconsistencies and force the government to use mechanisms such as off-budget operations in order to comply with the letter of the law, although not necessarily its spirit.

Off-budget operations are used for a variety of purposes. Guarantees may be used to circumvent short-term budget constraints. Others, such as quasi-fiscal activities conducted through administered prices, credit

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1. This paper is a summary of a report prepared at the request of the Inter-American Development Bank (IDB) for the meeting of the Public Policy Management and Transparency Network: Development Effectiveness and Results-Based Budget Management, held in Washington, DC, May 8-9, 2006. The full versions of the report in Spanish and English can be found at [www.iadb.org/publications/search.cfm?query=Operaciones+Extrapresupuestarias&context=Title&lang=es](http://www.iadb.org/publications/search.cfm?query=Operaciones+Extrapresupuestarias&context=Title&lang=es) and [www.iadb.org/publications/search.cfm?query=Off.Budget+Operations&context=Title&lang=en](http://www.iadb.org/publications/search.cfm?query=Off.Budget+Operations&context=Title&lang=en), respectively.

requirements, tax surcharges and/or the appropriation of the surplus of public enterprises, and the earmarking of revenues and expenditure requirements, may be justified on social grounds, by market failures, or because it is administratively impossible to implement a well-targeted subsidy program. Other off-budget operations, such as tax expenditures, may present a way to circumvent fiscal rules and allocate resources without being subjected to the budget process.

The study also shows that over the past few years, countries have recognized the need to tighten the rules regulating off-budget operations. Brazil, Chile, and Mexico have made important progress in regularizing these operations, while Ecuador has shown less progress and in fact has backpedaled as a result of the 1999-2000 economic crisis and political instability in recent years.

There are three stages in the process of regularizing off-budget operations. First, they are made more transparent, then they are reduced, and finally they are integrated into the budget. To make them more transparent they are identified and quantified and information is provided in the budget documentation. To reduce them, quantitative and qualitative limits are imposed. To integrate them into the budget, several mechanisms have been used, including the transformation of the off-budget funds into virtual funds, compensation of quasi-fiscal activities through budget transfers, and the provisioning in the budget of contingent liabilities associated with the guarantees that have been given. The three stages may be implemented simultaneously for different operations, because it is easier to move faster for some of them than for others. Tax expenditures appear to be the last bastion of resistance, with none of the countries reviewed complying with more than two of the OECD guidelines.

This study presents the conceptual framework used in the analysis of the four countries' experiences. It lists the OECD guidelines and proposes complementary and alternative guidelines, to be used as the framework

against which the practices in the selected countries are compared. For each country studied, it also includes a description of the use of off-budget operations, assesses the existing situation, and offers recommendations to improve the handling of these operations.

## Off-budget Operations: Conceptual Framework<sup>2</sup>

### *The Budget*

The budget is the law or set of laws authorizing expenditures, and/or the incurrence of obligations to make expenditures, to be financed from taxes and other types of revenues that the government may have. The sources of financing of certain government expenditures are also part of the budget.

The budget is the main instrument for the management of a country's fiscal policy.

Consequently, its preparation, approval, execution, and evaluation should be consistent with the fiscal policy objectives being pursued by the government (macroeconomic efficacy), and it should seek to ensure efficiency in the allocation and use of resources and transparency in the generation and application of public resources.

### *BUDGET FUNCTIONS*

The functioning of the budget has to be analyzed in relation to its four functions, which are:

- i) Authorization: all expenditures from the public treasury must be subject to legislative authorization;
- ii) Allocation and distribution: budget authorities (executive and legislative branches) must be able to compare all changes in expenditures and revenues;
- iii) Macroeconomic: budget authorities (executive and legislative branches) must be able to determine the impact upon the entire economy and on the composition of expenditures, revenues and deficit; and

2. See OECD, 2004b.

- iv) Administrative: budget authorities (executive and legislative branches) must be able to control the cost efficiency of public services.

#### *BUDGET PRINCIPLES*

There are three principles which can be considered pre-conditions for the fulfillment of all budget functions:

- i) Universality: all expenditures financed by taxes or levies and all revenues collected through taxes or levies should be in the budget.
- ii) Unity: all expenditures in the budget that are made during a certain period of time (usually a year or several years), and all revenues collected during that same period should be presented to the budget authorities for their approval in a single document.
- iii) Specificity: expenditures and revenues should be presented separately in the budget (“gross reporting”) and at the level of detail required by budget authorities.

#### *Off-Budget Operations*

Some government operations are difficult to reconcile with budget principles and thus undermine the proper functioning of the budget. These operations can be types of expenditures that are known as off-budget expenditures and “back-door” expenditures. In the countries included in this study, there is also a third way of conducting such operations, which is to use public enterprises to collect tax revenues through tax and dividend regimes different from those applied to private sector enterprises.

#### *OFF-BUDGET EXPENDITURES*

Off-budget expenditures are expenditures financed by taxes or levies which are not included in the budget (violating the universality principle).

The main types of off-budget expenditures found in OECD countries are off-budget funds, direct loans, guarantees, and public-private partnerships (PPPs). Other types of off-budget expenditures found in the countries studied and in emerging markets in general are budget funds and quasi-fiscal operations conducted

through public enterprises and sometimes by the private sector which are not covered by budget transfers.

The use of supplementary budgets and of budget rules related to the revision of revenue estimates, and the adjustments permitted to budget appropriations in cases when revenues are either smaller or larger than expected, may impede the proper functioning of the budget. Such problems may also occur when rules provide authorization to exceed or reallocate budget appropriations and to execute expenditures committed but not paid (float) during the fiscal year.

#### *“BACK-DOOR” EXPENDITURES*

Back-door expenditures are those financed by taxes or levies that are in the budget but authorized by laws outside of the budget process (violating the unity principle).

The main types of back-door expenditures are obligations created through the earmarking of revenue, expenditure rules, and tax expenditures. Obligations created through earmarks and tax expenditures do not create problems for the adequate functioning of the budget if the budget process provides the opportunity to change the laws that originate them. However, this is not the case in any of the countries under study.

#### *FISCAL REVENUES FROM TRANSFERS BY PUBLIC ENTERPRISES*

Another mechanism to conduct off-budget operations is the use of public enterprises to collect fiscal revenues through tax and dividend regimes different from those applied to private sector enterprises in the same sector. For example, a tax surcharge can be applied on their surplus; or they may be required to transfer all or almost all of their surpluses to the budget, without considering their investment plans or needs; or the budget may use reference prices, which are different from market prices, to calculate their contribution to the budget. In these ways, the budget collects more revenue, *ceteris paribus*, from public than from private enterprises.

The result is that public enterprises must borrow more than private ones, which could increase their financing costs or reduce their investment levels, affecting their competitiveness and production capacity.

The central government's appropriation of resources generated by these enterprises is a source of revenue that the budget does not consider or properly analyze. Nor is there a comparative analysis of the positive effects of the expenditures financed with these resources and the negative effects of this appropriation on the economy and on public enterprises.

### ***Additional Considerations***

#### ***THE ROLE OF CONGRESS***

Congress' role in the budget process varies among the countries analyzed but is generally less significant than in the OECD countries. The authority of the congress determines to a greater or lesser degree the possibility of modifying revenues, increasing expenditures, reallocating expenditures among entities, and changing the level of aggregation of the expenditure categories in the budget. The period for discussion and approval of the budget tends to be shorter in the countries analyzed than in OECD countries. In addition, the rule applies in most cases that if congress does not approve the budget within a given period, the government's proposed budget prevails. If to this we add the fact that the executive in some cases has the authority to exceed and reallocate budget appropriations without legislative approval, one can conclude that the role of the legislative branch in the budget process is limited.

#### ***FISCAL RESPONSIBILITY LAW (FRL)<sup>3</sup>***

Fiscal rules are a political declaration about how the government intends to conduct public finances over time. A properly designed fiscal rule can be a fundamental piece of a larger framework that assures macroeconomic consistency, transparency in public management, the credibility of economic policy, and a proper temporal planning horizon for public policy in general.

Fiscal rules should be designed in such a way that they do not constitute an incentive to find ways to circumvent them through arrears (if the rule is defined on a cash basis), over- or under-budget estimates (if the

rule is applied to budget estimates rather than actual results), the use of ample contingency reserves, or creative accounting.

A proliferation of fiscal rules must be avoided even if they are considered key to achieving macroeconomic objectives because they can result in an excessive "shielding," which generates incompatibilities among the rules themselves and with the existing budget norms and practices. The result may be an under-execution of the budget that weakens the functions that it performs, while at the same time creating incentives to use off-budget operations.

The results obtained through the use of these laws vary. While some countries have obtained good results, in others, particularly in Latin America, compliance with the laws has been weak or they have been modified quickly to avoid a situation of noncompliance (Marcel, 2005a).

The main conclusion obtained from the analysis of the successes and failures in the countries studied is that legislation alone cannot guarantee fiscal responsibility. Legislation must be accompanied by broader and deeper processes of consolidation of fiscal responsibility, ensuring both the proper design of the legislation and implementation capacity (Marcel, 2005a).

### **Guidelines for Off-Budget Operations**

The guidelines proposed by the OECD for off-budget operations are the following:

#### ***Off-Budget Funds***

##### ***GUIDELINE 1***

Off-budget funds should be avoided or allowed only under the following strict conditions: that they are exclusively or largely financed by earmarked levies and that the expenditures and revenues of the funds are subject to budget control.

3. See IMF, 2005a.

*GUIDELINE 2*

All expenditures and revenues from off-budget funds should be incorporated in the budget documentation that is presented to budget authorities. Regular expenditures and revenues and off-budget expenditures and revenues should be shown together in the budget documentation.

**Direct loans***GUIDELINE 3*

The budget should include the estimated subsidy costs of direct loans at the time they are made (not at the time the cash flows occur).

*GUIDELINE 4*

Cost estimates of credit programs should be based on rules that are easily understood by politicians and citizens. Additional appropriations during the life of a loan should not be required unless cost increases exceed pre-established margins of fluctuation.

*GUIDELINE 5*

Direct loan programs should be authorized by law. Budget documentation should provide information about the amounts of direct loans outstanding for each program at the beginning and end of each fiscal year or budget period and about the new direct loans made during the fiscal year.

**Guarantees***GUIDELINE 6*

The budget should include the estimated subsidy costs of guarantees at the time the guarantees are made.

*GUIDELINE 7*

Cost estimates of guarantee programs should be based on rules that are easily understood by politicians and citizens. Additional appropriation of subsidy costs during the lifetime of a guarantee should not be necessary unless cost increases exceed pre-established margins of fluctuation.

*GUIDELINE 8*

Guarantee programs should be authorized by law. Budget documentation should provide information about the amounts of guarantees outstanding for each program at the beginning and the end of each fiscal year or budget period and about new guarantees made during the fiscal year.

*GUIDELINE 9*

Guarantee programs should only be considered if the design of the program assigns at least a part of the default risk to the private lender.

**Tax Expenditures***GUIDELINE 10*

Tax expenditures should be identified by the use of a benchmark tax which does not necessarily need to represent the normative tax rate, although it should be comprehensive and unique.

*GUIDELINE 11*

All tax expenditures should be estimated and integrated into the expenditure documentation presented to the budget authorities for all significant taxes. Regular expenditures and tax expenditures should be shown together in this documentation for the same number of years.

*GUIDELINE 12*

Tax expenditures should either be included in the total expenditure cap or in a special tax expenditure cap. Overspending on tax expenditures should be fully compensated, at least insofar as they originate policy change.

*GUIDELINE 13*

Tax expenditures should be reviewed in the same way as regular expenditures in the annual budget process.

*GUIDELINE 14*

Tax expenditures should be allocated by individual ministries.

**GUIDELINE 15**

Tax expenditures should be estimated by revenue foregone, corrected by an equivalent tax margin if expenditure transfers are taxed (or by outlay equivalence).

**GUIDELINE 16**

The Ministry of Finance should be responsible for tax revenue estimates.

**Alternative Guidelines**

This chapter provides alternative guidelines for several reasons.

First, in addition to the type of off-budget expenditures common in the OECD countries, in the countries analyzed in this study there are several other mechanisms that impede the proper functioning of the budget, such as the earmarking of revenue, expenditure rules, and quasi-fiscal activities.

Second, the use of supplementary budgets and certain budget rules regarding revisions of revenue estimates and adjustments permitted to budget appropriations can also hinder the proper functioning of the budget.

Third, some characteristics of the countries analyzed require modification of the OECD guidelines in order to comply with the principles of universality, unity, and specificity.

Finally, some of the modifications relate to differences in the concepts on which the OECD guidelines are based.

**Off-budget Expenditures**

The characteristics and operational rules of funds (off-budget and budget) vary from country to country but have some common features. These are:

- The budget includes only resources that are appropriated for the funds, which become part of the fund's capital and are not transferred back to the treasury if not used in the fiscal year when they are appropriated.

- In some instances, resources allocated to the fund are authorized only by the line ministry or can be earmarked revenues that may or may not pass through the budget.
- The authorization to use public resources is given when funds are established, with the executing agencies requiring only authorization from the line ministry in charge of the fund to spend based on the rules defining the fund's objectives. As a result, expenditure allocations are not clearly related to the overall fiscal situation and fiscal policy objectives.
- In some cases, off-budget funds are authorized to issue debt, securitized or not securitized with revenue inflows, and with or without a government guarantee.
- Laws governing each fund define the managerial responsibility for off-budget funds. The objectives of the fund may be broadened over time.
- Budget documentation does not contain information on the policies or financial situation of the funds.
- In using the fund's resources, implicit or explicit subsidies may be provided which are not made clear in the budget. For example, funds may contribute capital for private sector investment projects, lend at subsidized interest rates, or forgive nonperforming loans.
- In some countries, the use of these funds is convenient from an administrative and operational point of view. For example, funds can be constituted as trust funds without their own structure and operate through the structure of a public financial institution.

**GUIDELINE 1**

Require a law to establish an off-budget or budget fund.

**GUIDELINE 2**

Transform the off-budget funds into "virtual funds," i.e., consolidate them with the central government budget in the preparation, execution, reporting, and evaluation

of the budget. Budget funds must be integrated into the budget and must comply with all budget requirements. These funds may transfer resources from one fiscal exercise to the next, provided that these resources are budgeted and executed in accordance with existing budget procedures.

#### **GUIDELINE 3**

Require a central government guarantee for the issuance of debt instruments using off-budget funds.

When it is not possible to comply with OECD guidelines 1 and 2 and guideline 2 of this section, guideline 4 should be implemented.

#### **GUIDELINE 4**

Prepare an annual report on the funds that includes, by fund, the capital at the beginning and the end of the period; revenue and expenditure flows during the fiscal period identifying origin and destination; and a description of any modifications to the objectives and operational rules of the fund introduced during the year and the revenues and expenditures projected for the following fiscal year. Include the report in the budget documentation.

#### **Direct Loans**

Two components must be distinguished for the budget treatment of direct loans. One is the flows of resources involved and the other is the subsidy implicit in the operations.

With respect to the first component, neither the OECD guidelines nor the *Government Finance Statistical Manual* (GFSM) 2001 includes direct loans with other expenditures and revenues. The OECD argues that they have a different macroeconomic effect and thus should not be included in the definition of the deficit, while the GFSM 2001 excludes these operations from operational results because they correspond to financing operations that do not affect the government's net worth, only the composition of assets and liabilities. According to the GFSM 1986, they were classified as

part of the operational balance because they were operations that responded to policy objectives and not to liquidity needs, a distinction which is not made in the GFSM 2001.

In our view, disbursements and repayments should be included with the other expenditures and revenues because, even if it can be argued that they have a different macroeconomic effect, they still have an effect and therefore, the effect should be taken into account both in the fiscal rule and in relation to the budget's allocation/distribution function. Furthermore, if their macroeconomic effect is different, this begs the question, different from what? Not all components above the line have the same macroeconomic effects. For example, the macroeconomic effects of achieving the fiscal target by increasing taxes are different from when they are achieved by reducing expenditures.

In addition, classifying direct loans with financial operations means not only ignoring the policy objectives behind these operations, which the budget must authorize vis-à-vis other ways of achieving the objectives being sought, but also mixing operations that have no direct macroeconomic effects, such as the financial operations, with those that do have such effects. They also represent resource requirements that should be included with the needs stemming from the deficit so that financing requirements can be clearly identified. This is particularly important in countries facing difficulties in accessing capital markets.

The methodology proposed by the OECD and the GFSM 2001 also allows the use of direct loans to make expenditures so that they do not affect the fiscal target. Moreover, in many countries, these loans are not repaid or are repaid only in part. Thus, they resemble transfers or subsidies more than loans, in the sense that they end up affecting net worth.

The second component refers to the subsidies associated with direct loans.

If direct loans are classified as expenditures and revenues (repayments and interest and risk premium payments), a subsidy element cannot be added as a component of expenditure, neither for the current

fiscal exercise nor for the present value of the subsidy. In this case, the suggestion would be to record as memorandum items both the implicit subsidy for the current fiscal year and the present value of the subsidy. This would help the allocation/distribution function of the budget as it would provide a basis to evaluate the opportunity cost of these resources, both for the current fiscal year as well as in present value terms.

If direct loans are classified as financial operations, an estimate of the present value of the subsidy has to be included as an expenditure in the operational result. This estimation requires the use of sophisticated methodologies that are difficult to apply in the countries included in this study.

Direct loans may be made through an agency of the corresponding line ministry or a public financial institution, or with the public entity acting as a second tier bank with the resources being auctioned or used to rediscount private bank loans.

In the first two instances, the subsidy is an implicit subsidy provided through the interest rate charged to the borrower (including the nonpayment risk premium) which is lower than the market rate, although not necessarily less than the opportunity cost of the funds (including the administrative costs) for the government. This is because the sovereign risk premium could be substantially less than the cost of funds for the private banks. (In this case, it is important to determine the interest rate that should be used to calculate the implicit subsidy.) Moreover, due to market failure, private banks may not have developed financial instruments to address the needs of certain sectors at any price. In the third instance, the subsidy may be implicit or explicit, as the funds may be provided to private financial institutions at rates which are lower than their funding costs, or the government may cover the difference between the rate normally charged by banks (including the risk premium) and the rate they charge on these loans. In the latter case, the budget includes only this difference because there would be no use of budget resources for the loans.

#### *GUIDELINE 1*

Include the gross flows associated with direct loans with the regular expenditure and revenues of the budget, clearly identifying them on separate lines.

#### *GUIDELINE 2*

Include as a memorandum item an estimate, by loan program, of the implicit subsidy for the current fiscal year and its present value. Explicit subsidies should be identified separately in the budget and be also included as a memorandum item together with the implicit subsidies.

#### **Guarantees<sup>4</sup>**

The OECD guidelines refer to guarantees on loans granted by non-governmental entities.

In this paper, guarantees are considered broadly and include several types of guarantees that can be provided by the government, such as minimum pension guarantees and guarantees to concessions for the construction and operation of infrastructure investment projects.

The OECD does not take into account an important reason why a government may prefer to provide guarantees instead of direct loans or subsidies to decrease the cost for the borrower, which is that a guarantee does not have an immediate budget impact. Consequently, the treatment given to guarantees should seek to impose budget discipline on public entities so as to make them neutral in their choice between guarantees and other forms of fiscal support. Incentives to use guarantees as a way of transferring costs to the future should be minimized.

Guarantees are a form of government intervention when it is in a better position to assume risk, control it, and thereby minimize its cost. The objective is to compensate for a market failure. However, care must be taken to avoid replacing a market failure with a government failure. It is important to determine which market failure needs to be addressed and whether a guarantee is the best way to address it.

4. For more information, see IMF, 2005b.

Although guarantees might be the most efficient way of addressing a market failure, they may create problems for fiscal sustainability. Their effects on public finances only occur over time, and it cannot be known beforehand how much of the guarantee will be triggered or when. Because guarantees do not have an immediate budget impact, they may not be subject to the same kind of scrutiny as expenditure or loans. Consequently, public entities must define a framework to be applied to the provision of guarantees. Key elements of such a framework include reporting, accounting, and transparency.

Generally, guarantees are not provisioned in the budget to cover the cost of guarantees that are triggered, and no consideration is given to the best way to reallocate expenditure or mobilize resources in the event that these actions are needed to cover such costs.

The key objective of a guarantee policy is transparency regarding the possible risks and fiscal costs. It is difficult to attain this objective because guarantees pose a serious challenge from the point of view of fiscal accounting and reporting. Their contingent nature makes valuing them difficult. Over the past few years, analytical methodologies for the valuation of guarantees provided in the context of concessions have been developed and are being used in Chile and Colombia. These methodologies are still in the development phase. In Chile they are used only for guarantees extended to road concessions.

Under cash accounting, guarantees are recorded in the fiscal accounts only when a covered contingency occurs and a cash payment is made. If a premium is charged, it is recorded as nontax fiscal revenue.

GFSM 2001 does not consider provisions for guarantees either, because while international accounting standards rely on the likelihood of occurrence as a basis for recognizing contingent liabilities, statistical reporting (and GFSM 2001 in particular) relies mainly on actual events. Contingent liabilities are registered as memorandum items on the balance sheet under GFSM 2001. If no provision is made for guarantees, they

are only recorded under accrual accounting when they are called. According to the GFSM 2001, when a guarantee is called, guarantee payments are registered as expenses in the operating statement, and a corresponding increase in liabilities is recorded on the balance sheet.

#### *GUIDELINE 1*

Centralize the provision of guarantees. Guarantees must be approved by the ministry of finance, the cabinet or congress, within a well designed framework which includes the justification for them, their design, an analysis of their implications, and approval.

#### *GUIDELINE 2*

To the extent possible, guarantees provided to the private sector should be symmetrical, entail a cost, and be designed in such a way that they do not cover all losses. Partial guarantees limit moral hazard and problems of perverse selection. They also limit the government's exposure to risk and the fiscal cost of triggered guarantees.

#### *GUIDELINE 3*

Establish a ceiling to guarantee amounts which must be approved in a permanent law or in the annual budget law. This ceiling creates a quasi-budget restriction, which generates more scrutiny and better prioritization of proposals. The limit may be defined on the maximum value of the new guarantees to be provided, as a percentage of fiscal revenues or expenditure or, in more advanced systems, on the expected value of the guarantees. The limit may be set for the public sector as a whole, or by entity.

#### *GUIDELINE 4*

Incorporate the granting of guarantees into the annual budget cycle and into the analysis of sectoral policies and programs, so that proposals for new guarantees are considered in relation to other possible mechanisms and programs with similar objectives.

**GUIDELINE 5**

Establish budget mechanisms to provide liquidity to the guarantees that are triggered. Because the maximum value of the guarantees can considerably exceed their expected value, it is not possible or necessary to make provisions for this maximum value in the budget. However, a way should be found to estimate their expected value in order to establish a contingency fund.

**GUIDELINE 6**

Include the expected value of guarantees in the fiscal projections so that they are considered under the limits imposed by the fiscal rules.

As an alternative to guidelines 4-6, implement guidelines 7-8.

**GUIDELINE 7**

Annually budget the expected cost of guarantees for the fiscal year. The appropriation may be a general contingency reserve, but in countries in which payments for triggered guarantees are significant, a separate appropriation will improve transparency and responsibility. If the entire appropriation is not used, it can be reallocated or can expire at the end of the budget year. This methodology ensures that congress is informed about these expenses at the time when the budget is presented, that other priority expenses are not crowded out during the execution of the budget or that they are added to the fiscal deficit, and that they have been pre-authorized.

**GUIDELINE 8**

Include a detailed report on guarantees in the budget documentation, identifying those that have been triggered. The report should identify all contingent liabilities associated with guarantees that have been provided or are to be provided through different programs (loans, minimum pensions, concessions), including the quantifiable and non-quantifiable contingent liabilities. Contingent liabilities that can be quantified should be reported at their maximum and expected values if possible, and those which are not quantifiable should be described in qualitative terms.

**Public-Private Partnerships**

Through PPPs, the government may acquire expenditure obligations which are not included in the budget or authorized by the legislature. Because of their characteristics (the payment and guarantee commitments may extend for many years), PPPs can be used as a mechanism to circumvent budget constraints, which affects all four functions of the budget.

Given the volume of investment that they entail, the long duration of the concession contracts and the risks involved, the commitments assumed by the government under these contracts could in practice become a threat to fiscal sustainability. Consequently, clear rules regarding their contracting and execution should be established.

**GUIDELINE 1**

Establish a legal and institutional framework with the aim of maximizing efficiency while minimizing risks to public finances.

**GUIDELINE 2**

Define clear criteria for the allocation of risk to frame the design of the bidding process, so that risk is assumed by whoever is in the best position to assume it, optimizing the transference of risk to the private sector. Establish minimum risk capital requirements.

**GUIDELINE 3**

Incorporate the selection of projects to be executed as PPPs into the evaluation process as public direct investment to ensure that their economic and social viability is evaluated correctly and that a PPP is the best possible alternative, regardless of budget constraints. This facilitates the establishment, from the start, of a fiscal comparator to evaluate the net benefits of implementing the project as a PPP and the identification of mechanisms to make the project attractive to the private sector at the lowest fiscal cost.

*GUIDELINE 4*

Enlist the participation of the ministry of finance throughout the process to ensure that the payment commitments and provided guarantees do not exceed the availability of budget resources for the current fiscal year and for the duration of the contract.

*GUIDELINE 5*

Strengthen the capacity of line ministries and the ministry of finance to evaluate, design, and monitor the implementation of PPP contracts and to quantify the fiscal costs and risks involved.

*GUIDELINE 6*

Implement mechanisms to provide liquidity to the guarantees that are triggered, including the budget procedure that defines the assumptions under which a budget allocation for a guarantee would be justified for these projects. Provide resources in the budget for the contingent liabilities that could be triggered during the fiscal year at their maximum value.

*GUIDELINE 7*

Define limits both for the provision of guarantees and for direct payments to be made by the public sector. Limits should be placed on the cumulative flows of commitments made and in relation to variables that are relevant from a budget standpoint for the public entities involved.

*GUIDELINE 8*

Establish budget mechanisms that clearly identify total commitments under these projects, and give them priority over new expenses. Include in the law a rule establishing that resources committed for these projects may not be reallocated for other purposes. This rule serves the dual purpose of identifying the effect of these projects on the fiscal balance, regardless of their quality as investment projects, and contributing to fiscal credibility.

*GUIDELINE 9*

Include payment obligations and contingent liabilities in the fiscal projections so that they are taken into account in the limits imposed by the fiscal rules.

*GUIDELINE 10*

Include detailed project by project information in the budget documentation of all payment obligations, quantifying annual flows and present values, as well as the maximum and expected value of the guarantees that have been provided. Clearly identify the information on these operations in public finance statistics, including the triggering of guarantees.

*GUIDELINE 11*

Require congressional approval of projects for which public financing represents more than 70 percent of total financing.

*GUIDELINE 12*

Prohibit the use of fiscal benefits or public resources not contemplated in the contracts to compensate the private partner for a politically induced freezing of rates or to set rates below the necessary level, in lieu of using direct payments.

***Quasi-fiscal Activities***

The following guidelines are based on the OECD Guidelines for Corporate Governance of Public Enterprises and on the recommendations of the IMF's fiscal ROSCs.

*GUIDELINE 1*

Eliminate quasi-fiscal activities which cannot be compensated through budget transfers and those conducted through administered prices, credit requirements, and cross-subsidies.

*GUIDELINE 2*

Use budget transfers to cover quasi-fiscal activities conducted by public enterprises or the private sector. Identify these transfers separately in the budget,

including a description of the methodology used for calculating the cost to be covered in each case.

#### *GUIDELINE 3*

Loans within the public sector should be granted at market rates.

In the transition period for implementation of guidelines 1-3, implement guidelines 4-6.

#### *GUIDELINE 4*

Prepare reports of all quasi-fiscal activities, including those conducted through non-financial and financial public enterprises and those associated with the regulatory role of the government, to properly measure the government's fiscal activities. These reports must identify all forms of public support and their final beneficiaries.

#### *GUIDELINE 5*

Define limits on the quasi-fiscal operations to be conducted through public financial institutions in the fiscal responsibility law or in the annual budget.

#### *GUIDELINE 6*

Identify cross-subsidies, treating those granted as expenses and the implicit taxes as revenue, recording them as memorandum items.

### ***Budget Norms and Practices***

Budget norms and practices found in the countries reviewed in this study include the following:

- The budget laws differentiate between those expenses that may not automatically exceed the budget appropriations and those which may, such as debt service, pension payments, and expenses required by special laws. The latter may result in a larger total expenditure than budgeted or may have to be covered by a reallocation of expenditure in order to comply with the overall expenditure ceiling. In some cases, excess revenues, if any, have to be allocated to cover the larger obligatory expenses, if they have occurred.
- The budget may include a contingency reserve. This reserve reduces the need to reallocate expenses during the fiscal year. However, the larger the contingency reserve provision, the greater the incentives to use it as an alternative to a reallocation of expenses to cover contingencies. A relatively small contingency reserve, on the other hand, imposes the need for entities to assume the real opportunity cost of increasing a given expense through reallocations within their own budgets, resulting in greater rationality in the eventual budget modifications within the fiscal year.
- The rules regarding the margins that the government has to exceed budget appropriations without congressional approval vary from situations in which it can exceed the appropriations by a given percentage of the total budgeted expenditure to others in which it can exceed certain expenditures such as investment outlays by a given percentage of those expenditures.
- Expenditures associated with earmarked revenues are obligatory, but they do not have to be made in the year the revenues originate.
- It may be necessary to handle the financial management of the budget by establishing limits to discretionary spending which are below budget appropriations because of inconsistencies in the actual availability of resources (availability of cash, payments on the float, obligatory expenses, and expenses associated with earmarked revenues).
- In some cases, compliance with fiscal rules imposes additional constraints on the margins by which expenses may exceed the budget appropriations. The flexibility in this respect depends on whether it is possible to exceed the limit on expenditures without an offset in revenues or if this is possible only through a reallocation of expenditures.
- The golden rule imposes limits to the reallocation of expenditure between current and capital spending, including instances in which the legislature does not impose limits on borrowing.

- In some countries, the ceiling on borrowing effectively imposes a limit on the increases in expenditure that may be executed without congressional approval. In such cases, excess revenue may be used to increase expenditure without legislative approval. Sometimes the government is able to obtain large sums of financing through alternative channels without congressional approval.
- In some countries, there are no limits or requirements of prior authorization by the ministry of finance for the execution of larger-than-budgeted expenditure financed with an excess of their own resources.
- The rules on appropriations which have not been executed by the end of the fiscal year are also relevant. These may establish that the resources must be returned to the national treasury to be included in the next year's budget, or they may be spent by the corresponding agency or fund. The rules may also authorize the ministry of finance to decide what part of the unspent appropriations may be carried forward to the subsequent year to finance certain commitments defined in the corresponding budget law or to reallocate them.
- Sometimes arrears are used to spend beyond budget appropriations.
- Off-budget operations may be used to exceed budget appropriations. This may result from changes in the fiscal situation during the year, or they may be caused by unrealistic assumptions in the budget.
- In some countries, privatization receipts are pre-allocated in the budget for certain uses, but spending occurs whether privatization receipts materialize or not.
- Undisbursed commitments (float) may also affect the functions of the budget depending on the mechanism through which these expenses are approved, the period of time during which the expenses may be disbursed, and the budget against which they are executed. The budget may not necessarily identify an appropriation to accommodate these expenses. It may be required that the float be cleared during the

first two months of the subsequent fiscal year using, if need be, revenues collected during this period, or its clearing may extend to the whole fiscal year following the year in which those expenses were appropriated.

#### *GUIDELINE 1*

To ensure compliance with the universality principle for the budget as the main instrument of fiscal policy, all government expenditure must be approved in the budget or, if necessary, through a supplementary budget approved by the legislature.

#### *GUIDELINE 2*

Avoid practices which result in under-execution of the budget because they weaken the budget as a fiscal instrument.

#### *GUIDELINE 3*

Expenditure by autonomous agencies in excess of their budget appropriations should be reviewed by congress through requests for supplemental appropriations presented by the ministry of finance (rather than being approved by the corresponding line ministries).

#### *GUIDELINE 4*

Limit the size of the budget contingency reserve.

#### *GUIDELINE 5*

Expenditure associated with earmarked revenues should take place within the same fiscal exercise in which the revenues were generated.

#### *GUIDELINE 6*

Clear the float in the first month following the end of the fiscal year in which the expenditure was appropriated. These expenses should be executed against the budget of the fiscal year in which they are executed.

#### *GUIDELINE 7*

Establish a system to monitor the execution of the budget to prevent arrears.

**Earmarking of Revenue<sup>5</sup>**

The negative consequences associated with both the earmarking of revenues and expenditure rules arise from the fact that they limit the extent by which public spending can be reallocated in response to changing needs, introduce a built-in bias toward higher spending and taxation, limit the scope for countercyclical fiscal policy, and weaken incentives to improve the efficiency of public spending.

**GUIDELINE 1**

Include in the budget the flows of revenues and expenditure associated with these revenues in gross terms.

**GUIDELINE 2**

Substitute the earmarking of revenues not included in the constitution by budget appropriations.

**Expenditure Rules****GUIDELINE 1**

Incorporate the expenditure associated with the expenditure rules in the budget discussion so as to annually assess their relevance from the standpoint of government priorities and subject them to the same cost-benefit analysis as other expenditures.

**Tax Expenditures**

There are no alternative guidelines to those proposed by the OECD regarding tax expenditures.

**Fiscal revenue from transfers by public enterprises****GUIDELINE 1**

Establish a tax treatment for public enterprises in line with that applied to private sector enterprises.

**GUIDELINE 2**

Define the financial relationship between the government and public enterprises in the annual budget law or in the organic budget law, establishing ex-ante a dividend policy or predetermined rates of return on assets of public enterprises.

**GUIDELINE 3**

Use relevant indicators to define the benchmark prices to be used in the budget to calculate transfers from non-financial public enterprises.

**Role of Congress****GUIDELINE 1**

Clearly define the role to be played by congress in the budget process. Prohibit the revision of revenue estimates by congress.

**GUIDELINE 2**

Establish a limit to the period during which the government may operate without having an approved budget.

**Fiscal Responsibility Law****GUIDELINE 1**

Keep fiscal rules simple, limiting them if possible to one or two.

**GUIDELINE 2**

Apply fiscal rules to both the approved budget and the executed budget.

**GUIDELINE 3**

Frame the FRL within budget norms and practices to avoid an over-determination of the system, which results in an unrealistic budget and thus an under-execution of the budget, a large float, significant reallocations of budget appropriations, and the use of the cash budget as the mechanism for setting budget execution priorities.

5. See Alier, 2006.

## Management of Off-Budget Operations

### *Off-Budget Funds*

#### *BRAZIL*<sup>6</sup>

There are no off-budget funds. There are various budget funds, all of which require a specific law to be created. All budget funds enjoy earmarked revenue for their specific expenditures, but they are an integral part of the federal budget and must comply with all budget procedures. Budget funds may carry over any financial surplus remaining from the current fiscal year into the next fiscal year, provided that it is properly budgeted and executed in accordance with budget procedures.

#### *CHILE*<sup>7</sup>

There is an off-budget fund, the Petroleum Stabilization Fund, and two budget funds, the Copper Compensation Fund and the Infrastructure Fund (IF). The IF is currently a virtual fund, unregulated, and managed by the ministry of finance. Other off-budget operations are revenue and expenditures associated with the Reserved Copper Law (RCL) and interest accrued on bonds. The Public Finances Report and public finance statistics include off-budget expenditures with the central government budget aggregates to obtain the operational statements of the consolidated central government.

#### *ECUADOR*<sup>8</sup>

The Petroleum Stabilization Fund (FEP) is financed with petroleum revenues that exceed the revenues envisaged in the budget. Its resources are first used to offset lower-than-budgeted petroleum revenues.

The modification of the Fiscal Responsibility Law in 2005 created the Special Account for Productive and Social Reactivation (CEREPS), which is part of the budget, to deposit petroleum revenues derived from

heavy crude oil that are apportioned to the government, and 45 percent of the petroleum revenues above those envisaged in the approved budget. Twenty percent of CEREPS' resources are accumulated in the Savings and Contingency Fund (FAC), an off-budget fund, up to the limit of 2.5 percent of GDP, to stabilize revenue from petroleum and provide funding for national emergencies. Any remaining funds in the CEREPS which are not used by the end of the fiscal year are automatically transferred to the FAC.

#### *MEXICO*<sup>9</sup>

There are two off-budget funds which perform the function that in other countries is carried out by the contingency reserve: the Petroleum Revenue Stabilization Fund (FEIP) and the Natural Disasters Fund (FONDEN).

The new Federal Budget and Fiscal Responsibility Law (LFPRH) maintains the FEIP and the FONDEN and creates three other funds: the Stabilization Fund for State and Municipal Revenues (SFRSM), a Stabilization Fund for Investment in Infrastructure of PEMEX (FEIIP), and a Support Fund for the Restructuring of Pensions (FARP).

There are two additional off-budget funds: the Trust Fund for Rehabilitation of Concessional Toll Roads (FARAC), which was used to refinance the debt of road concessions in the 1990s, and the Infrastructure Investment Fund (FINFRA), which was created from resources from privatization for the purpose of providing seed capital to private infrastructure investment projects.

There are 21 trust funds with their own structure which operate as parastatals and more than 600 trust funds (reduced from 2000 over the past five years) with no structure but with their own capital. Over the past few years, the regulations on trust funds have been tightened to make their operations more transparent. The 2006 Federal Expending Budget (PEF) explicitly prohibits the creation of trust funds whose sole objective is

6. Based on IMF, 2001a; on answers to the questionnaire on the management of off-budget operations, as well as on information and documents provided by the authorities in the meetings held in Brazilia on January 16-18, 2006; Jul, 2005.

7. Based on IMF, 2003; 2005b; and information provided at meetings held in Santiago, Chile in January 2006; Jul, 2005.

8. Based on information provided in meetings held in Quito in January 2006.

9. Based on: IMF, 2002a; on answers provided by the Mexican authorities to a questionnaire on the management of off-budget operations, and on information provided in meetings held in Mexico City in January 2006; Jul, 2005.

to circumvent the budget cycle. In order to create a new trust fund or contribute to an existing one, it is necessary to go through the budget. These rules are included permanently in the LFPRH.

### **Direct Loans**

#### **BRAZIL**

The government does not provide direct loans. However, it imposes credit requirements on public banks to channel loans at subsidized rates to priority sectors unable to obtain credit from private banks.

#### **CHILE**

The government grants loans through only two lines, operating as a second-tier institution. One is the intermediation line of the Production Development Corporation (CORFO), for small and medium enterprises, where the risk is assumed by the private banks. It is a revolving fund but it is not budgeted in net terms, and the interest rates are not market rates. The other line of credit is loans to small farmers. The operating result excludes loans and repayments because they relate to financial operations that do not affect net worth, since they only affect the composition of assets and liabilities. Direct loan operations have decreased from the equivalent of 0.6 percent of GDP (2.8 percent of expenditures) in 1999 to 0.3 percent of GDP (1.5 percent of expenditures) in 2004.

#### **ECUADOR**

There is no direct lending by the government because direct loans are prohibited. The Ecuadoran Social Security Institute (IESS) does provide direct loans.

#### **MEXICO**

The federal government does not provide direct loans. To provide support to productive activities it considers a priority, it uses the development bank, which receives federal government guarantees, and development funds. The Public Sector Financing Requirements (RFSP) records these loans as if they were granted by the government and classifies them as above-the-line operations.

### **Guarantees**

#### **BRAZIL**

The federal government applies strict rules to the provision of guarantees. The FRL authorizes public entities to provide guarantees for internal and external loan operations that comply with certain requirements and, for the federal government, within certain limits and conditions determined by the Senate. The provision of a guarantee is conditioned on collateral of equal or larger value, and the borrower must not have any outstanding obligations to the guarantor. The budget only includes a guarantee when it is triggered. Moreover, the budget includes a contingency reserve that may be used to cover guarantees triggered during the fiscal year as long as they have been previously defined as such.

#### **CHILE**

There are three types of guarantees provided to the private sector: minimum pensions, PPP contracts, and guarantees on private bank loans for higher education. The impact of the triggering of guarantees appears separately in the budget. It does not need to go in the contingency reserve.

#### **ECUADOR**

The FRL establishes that the central government may not contract loans on behalf of entities and companies which are regulated under private sector companies' legal regimes, nor can it assume or guarantee the loans of these enterprises. However, it may provide guarantees to these enterprises if approved by a special law. In practice, guarantees are limited by the fiscal rule of the public debt-to-GDP ratio.

#### **MEXICO**

Guarantees may be provided for loan operations with international organizations or with national public or private entities as well as with foreign ones, provided that the loans are used for investment purposes or productive activities in accordance with social and economic development policies, that they generate sufficient resources to repay the loans, and that they have the proper guarantees.

### **Public-Private Partnerships**

#### **BRAZIL**

The PPP Law establishes limits on the amount of resources that the federal government may commit to PPPs. It also seeks to define rules to prevent public entities from increasing expenditures through PPPs. Expenditures generated or increased by PPPs are subject to the FRL requirement that no permanent expenditure may be created without a corresponding increase in permanent revenues or cuts in other permanent expenditure. The objective of the PPP contract must have been established in the Multi-Year Plan. The Law establishes that concessions in which more than 70 percent of the remuneration of the private investor is paid by the public entity must be approved by congress.

#### **CHILE**

The Ministry of Finance participates throughout the process, starting from the evaluation of the project from a macroeconomic and fiscal point of view, including the contingent liabilities associated with the guarantees provided. There is no legal limit on the resources that may be committed as subsidies and guarantees for concessions. What is being used is an Inter-temporal Budget Restriction (RPI) on the resources that may be used for these projects based on budget projections for the investment to be executed by the Ministry of Public Works (MOP). The congress is not involved in the identification or approval of projects implemented as PPPs.

#### **ECUADOR**

In the only project currently in operation, no public contribution was contemplated. It was based on the recovery of investments through tolls. However, the tolls were readjusted downward below the equilibrium rate to a socially acceptable rate for political reasons, with the difference being assumed by the MOP. Additional investments have been required and it has been necessary to adjust the design of the road because of new traffic. This led has to the accumulation of debt by MOP to the concessionaire.

#### **MEXICO**

There are three types of PPPs: Projects with Differing Impact in the Registry of Expenditure (PIDIREGAS), toll roads granted by concession to a private entity, and Service Provision Projects (PPS). Although there is no need for budget appropriations when a PIDIREGAS project is started, the proposals for these projects are part of the annual budget discussion and approval process in the Chamber of Deputies. PIDIREGAS expenditures have a *de jure* preferential status in future budgets. Commitments stemming from the PPS contracts both for the current fiscal year as well as for the following ones are included in the draft budget of Annual Expenditures of the Federation (PEF) of each fiscal year. The budget must also include the contingent liabilities associated with the PIDIREGAS and the PPS in which the entities may have to acquire assets under certain conditions. The government participates in toll roads concessions through FINFRA.

### **Quasi-fiscal Activities**

#### **BRAZIL**

Quasi-fiscal activities of non-financial public enterprises have been virtually eliminated.

Relations between the budget and the central bank are transparent. Nevertheless, minimum reserve requirements are high, constituting a source of revenue for the central bank which is not included in the budget.

Operations between the budget and the public financial institutions are also transparent; operations of a quasi-fiscal nature have apparently been largely eliminated. However, the complexity of the credit programs implemented through public financial institutions makes it difficult to estimate the cost of these programs as well as those conducted through funds and other programs. Subsidies may be provided through the equalization of interest rates and prices, the issuance of government paper, and direct payments.

*CHILE*

Some enterprises conduct activities with social content and do not cover their operating costs with their revenues, in which case the government covers their financing needs with transfers from the budget, guarantees on their loans, and direct payments of part of their loans. The policy is for the budget to reflect all quasi-fiscal activities of public enterprises so that it covers all fiscal activities, although there are some exceptions.

The only quasi-fiscal activity of the Central Bank of Chile (BCCCh) dates from the rescue of commercial banks in the early 1980s, which resulted in a deficit that persists to this day.

The government's participation in commercial banking activities is limited to the BancoEstado, which conducts quasi-fiscal activities that are not quantified. The BancoEstado may not lend to the government or to public enterprises, although it may participate in government leasing operations.

*ECUADOR*

PetroEcuador's (PE) quasi-fiscal operations are substantial because fuel prices have been frozen since 2003. It is estimated that the subsidies (calculated in relation to import prices) granted through the administered prices of fuels reached the equivalent of nearly 4 percent of GDP in 2005, compared to 1.8 percent of GDP in 2003.

The government also administers the tariffs of public enterprises in the electricity and telecommunications sectors. In the electricity sector, for example, the average tariff is lower than the average cost, and commercial and industrial users pay a 10 percent surcharge to cover the cost of rural electrification. The 2005 and 2006 budgets included appropriations for electricity subsidies of US\$80 million, but the actual cost of these subsidies was US\$179 million for 2005 alone.

The public enterprises of the Solidarity Fund also lack transparency. The purpose of the fund is human capital development in the most depressed areas of the country through expenditures on education, health, and public services.

The Ecuadorian Central Bank (BCE) does not provide loans to other government agencies, nor does it lend or provide guarantees to private financial institutions other than liquidity assistance loans. The BCE transfers 75 percent of its profits to the central government.

The central bank approves the budgets of the financial institutions subject to budget directives. The fiscal rule on the growth of operating expenses of public financial entities seeks to reduce wage pressures on these agencies which are not part of the national budget (PGE).

Public financial enterprises conduct quasi-fiscal activities through subsidized loans and debt forgiveness. This has gradually eroded the capital of these institutions, which the government has covered.

The FRL has identified quasi-fiscal operations that the CFN and the BNF will conduct through credit lines at preferential interest rates that petroleum revenues will finance. These credit lines will become revolving loan funds. The implicit subsidies as well as the costs stemming from these operations will not be quantified. The FRL sets a non-repayment rate of 18 percent as the ceiling to stop these operations.

One quasi-fiscal activity conducted through private sector companies stems from the requirement that 15 percent of profits must be paid to the workers.

*MEXICO*

Some non-financial public enterprises engage in significant quasi-fiscal operations. For example, electricity enterprises subsidize electricity for residential and farm consumption. The subsidy is estimated at about 0.8 percent of GDP. These enterprises do not receive any transfers from the federal government to cover these subsidies, and the PEF does not explicitly record gross flows between the government and the public enterprises on this score. The government has, however, established a compensation mechanism whereby the enterprises pay a fixed fee to the federal government for the use of its assets. The value of subsidies granted is deducted from this transfer: if the difference is negative, the enterprise absorbs the subsidy, and if it is positive, it is capitalized.

There are also implicit subsidies for water consumption, but no information is published on their amount or their distribution by type of user.

The price of fuels is an administered price. It has been kept constant in real terms, adjusting for expected inflation, but not changing in line with international price movements. The tax rate of the Special Tax on Production and Services (IEPS), which is a variable rate, is used as the adjustment mechanism between the spot price in the Texas market and the sale price in Mexico. Revenue from this tax has fallen from a peak of 1.8 percent of GDP in 2002 to 0.7 percent of GDP in 2004 and to a projected 0.2 percent of GDP in 2005.

For many years, *Petroleos Mexicanos*' (PEMEX's) investment had been relatively low, below the level required to maintain a stable level of proven reserves. After 1996, however, oil investments have grown steadily, through expansion of PIDIREGAS investments.

In October 2005 the Chamber of Deputies approved a new fiscal regime for PEMEX to make the relationship between the government and PEMEX transparent, while at the same time creating incentives for the company to become more efficient and ensuring that it has the resources needed to finance its investment, mainly for exploration purposes. The government will seek to reform the corporate governance rules for the company as the counterpart to the new fiscal regime.

Development banks conduct quasi-fiscal operations, which help explain their persistent losses, as well as the recurrent need in the past for the federal government to recapitalize them. Quasi-fiscal operations consist primarily of services provided on behalf of the federal government, and in some cases of loans at below-market interest rates.

In the PEF, congress sets a ceiling for the financial intermediation levels. The net lending operations do not constitute a deficit but represent financing requirements to carry out public development and credit programs. In principle these resources may be recovered and the actual deficit generated by these operations will depend on the repayment rate.

### ***Budget Norms and Practices***

#### ***BRAZIL***

Budget allocations are not mandatory, and the budget is executed through presidential decrees that establish expenditure ceilings which are equal to or below the approved budget allocations, including those resulting from the previous year's undisbursed commitments.

Expenditures associated with earmarked revenues are obligatory, but they need not be implemented in the fiscal year in which they originate.

The expenditures which are required by the constitution and by special laws as well as those specified in the LDO are not subject to limits. The legislation allows for three forms of additional budget appropriations during the fiscal year. Supplemental budget appropriations can be enacted through presidential decrees, provided that the proposed increase in expenditure does not exceed a certain percentage, and can also be used for reallocating budget appropriations. Above the limit, which is set in the LDO, they have to be approved by congress. The special budget appropriations, which must be approved by congress, are for new expenditures not included in the budget. Finally, extraordinary budget appropriations, which may be enacted by a provisional measure and then approved by congress, are for unforeseen and urgent expenditures. The first two forms of additional appropriations require the identification of additional financing sources.

The budget includes a contingency reserve to cover contingent liabilities and other risks and unforeseen fiscal events. In the draft budget bill, the executive branch includes a larger contingency reserve to accommodate legislators' amendments to the proposed appropriations, so that the budget suffers fewer modifications due to acts of congress than it had in the past.

Undisbursed commitments are valid until December 31 of the following year and may be covered against an appropriation related to expenditures in previous budgets. The debt obligation regarding these payments expires in five years. These payments did not exceed 1 percent of the budget in 2003-2005.

*CHILE*

Actual expenditures of the central government may not exceed the totals established in the budget for current and capital expenditures, except in respect to expenses which the budget law defines as “excess”; when they are financed with cash balances existing at the beginning of the fiscal year or grants or own revenues of the public services; or when they are capital expenditures up to 10 percent above the amounts approved in the budget; and when they are authorized by a specific law. Supplementary budgets have not been used since 1975.

The contingency reserve in the budget includes funds to cover expenditures for draft laws that have a high probability of being passed and a second component to finance other contingencies. The amount of the contingency reserve has decreased from the equivalent of 10.1 percent of the total expenditure in 1991 to 2.2 percent in 2003. The use of the contingency reserve is reported in budget execution reports.

To increase the flexibility of the budget, the government has implemented some permanent mechanisms such as the Bidding Funds, a mechanism that seeks to reduce the idle component of expenditures to improve the allocation and use of public resources, and temporary ones such as the Provision for Supplementary Distribution. In order to provide the new Administration that took office in 2006 with some room for maneuver, the 2006 budget, approved in November 2005, contained a margin of flexibility of around 0.9 percent of expenditures as a Provision for Supplementary Distribution and authorization to reallocate resources among line items in the amount of 0.2 percent of total expenditure. The new administration made use of part of this provision in its second week in office in order to finance an increase in the minimum pension rate.

*ECUADOR*

The government may increase or decrease expenditures up to 5 percent of the budget appropriations approved by congress. Above this limit, the executive requires congressional approval. Expenditures may also exceed the budget appropriations because of emergency situations. The excess expenses may be on the

wage bill, goods and services, or debt service. However, current expenditures may be exceeded only if they are financed with excess current revenue, while excess investment may be financed with additional borrowing.

The President must authorize any modification of the composition of expenditure.

The Ministry of Economy and Finance (MEF) has the authority to correct changes to the budget introduced by Congress which it considers to be illegal.

The contingency reserve was eliminated because congress complained that there was no exhaustive back-up for this item, which was a cushion that could be used for other purposes.

A significant part of fiscal revenues does not pass through the budget. This is because part of the revenues are transferred directly to the user before they are recorded in the budget, just as the subsidies or transfers financed with these revenues are not recorded either. These operations are conducted through earmarking of revenues, subsidies to consumers via administered prices, and special funds.

The approved budget is not a good indicator of the budget that is finally executed. Although revenues are generally in line with budget estimates, expenditure execution differs significantly from the budgeted amounts. Expenditures are approved in a very aggregated fashion, allowing a great deal of flexibility in the execution of the budget, since reallocations within the same sector can be made without congressional approval.

*MEXICO*

Over the past few years, congress has largely respected the deficit ceilings proposed by the government. Actual budget execution has also been in line with approved deficit limits. However, the RFSP exceed the traditional balance by quite a significant amount and have also exceeded the level envisaged at the time of the budget discussion.

According to the constitution, spending cannot occur in the absence of approval of the budget or a separate law during the fiscal year. Non-interest expenditure can only increase above the approved budget appropriations to the extent that revenue in excess of that projected

in the Law on Annual Revenue of the Federation (LIF) is collected. While legally possible, supplementary budgets have not been a practice in Mexico.

The Ministry of Finance (SHCP) has broad powers to issue standards and set overall ceilings on expenditure, approve guidelines and mandatory timetables limiting payments during the execution of the budget, and authorize amendments to the budget within the limits established in the budget law.

The PEF does not include a contingency reserve. There are two off-budget funds: the Petroleum Revenue Stabilization Fund (FEIP) and the Natural Disasters Fund (FONDEN). These funds play the role that the contingency reserve plays in other countries.

Public entities must report undisbursed expenditure commitments to the SHCP by February 28. The ADEFAs are included in the ceiling on borrowing, which is authorized annually in the LIF.

### ***Earmarking of Revenues***

#### ***BRAZIL***

The budget is characterized by a high degree of earmarked revenues, many of which are defined in the constitution and others by law. All earmarked revenues and expenditures financed with these resources must be included in the budget. In 2003-2005, about 81 percent of the primary federal revenue was earmarked, more than 40 percent of which was for social spending. The states and municipalities received more than 22 percent of the earmarked revenues, while the health sector obtained 10 percent and the educational sector 5 percent.

#### ***CHILE***

The 1980 constitution prohibits the earmarking of revenues. Exceptions are the RCL and the rules of the Copper Compensation Fund FCC.

#### ***ECUADOR***

Revenue earmarking rules are extensive and cover both oil and non-oil revenues. In contrast with the other countries, where revenues are mostly earmarked for certain sectors, revenue earmarking for specific programs

is widely used in Ecuador. About 36 percent of the so-called traditional revenues and the total petroleum revenues are earmarked. There are more than 50 legal provisions mandating that pre-established percentages of particular taxes be given to particular levels of government, agencies, public institutions, or programs. About half of the earmarking of revenues is constitutionally mandated. Of the remainder, the main recipients are universities and local governments and municipalities.

#### ***MEXICO***

Revenues may be earmarked by law or authorized by the Ministry of Finance and are recorded in the LIF.

States and municipalities receive two types of transfers from the federal government: the revenue-sharing transfer, over which sub-national governments have spending discretion, and contributions, which are transfers earmarked for social services and infrastructure. Total transfers to the states represented about 6 percent of GDP for 2006, or about 44 percent of the federal government's primary revenues, half in the form of revenue-sharing transfers and half as contributions.

### ***Expenditure Rules***

#### ***BRAZIL***

There are expenditure requirements associated with the protection of acquired rights included in the constitution. As is the case with the earmarking of revenues, the objective of the expenditure requirements is to use part of the federal revenues for health and social spending as well as for welfare and pensions.

#### ***CHILE***

There are no expenditure requirements established in the constitution or in special laws.

#### ***ECUADOR***

There are numerous expenditure rules, including a rule that requires the government to devote at least 30 percent and 20 percent of its current revenues to education and health, respectively. There is also a rule that requires that health spending grow at least in line with

public expenditure. The central government is also required by law to cover 40 percent of the pensions paid by the IESS.

#### *MEXICO*

There are no spending requirements.

### ***Tax Expenditures***

#### *BRAZIL*

All tax expenditures must be approved by law. The granting or increase of a tax benefit must be accompanied by compensating measures in the period in which it will begin to apply and the following ones, through an increase in revenues either by raising tax rates, broadening the tax base, or increasing or creating a tax or contribution. The fiscal benefit may be implemented only after the compensating measures have been put in place. Tax expenditures are not discussed as part of the budget process. There are no periodic or systematic reviews of tax expenditures.

Tax expenditures represented the equivalent of 1.7 percent of GDP in 2005 and were projected to amount to 1.9 percent of GDP in 2006. With respect to revenues collected, tax expenditures amounted to 9.9 percent in 2005 and were projected to rise to 13.5 percent in 2006.

#### *CHILE*

The constitution requires that fiscal benefits affecting tax revenues be reported in the budget law. Tax expenditures are not discussed with the draft budget proposal. No periodic or systematic assessments of tax expenditures have been carried out. In 2004-2006, tax expenditures represented about 3.6 percent of GDP and 16 percent of revenues.

#### *ECUADOR*

There are no up-to-date estimates of tax expenditures. Four years ago, the United States Agency for International Development (USAID) estimated that for 2001, tax expenditures amounted to about US\$1 billion. A government-sponsored law passed in 2005 granted tax incentives to foster investment in various sectors. The

tax incentives provided by this law could increase tax expenditures by about one-half percent of GDP.

#### *MEXICO*

The LIF requires that the government submit a budget for tax expenditures before June 30.

In the period 2004-2006, tax expenditures have increased from the equivalent of 5.8 percent of GDP to 7.3 percent of GDP, from 34 percent of the federal government revenues to 46 percent and from 27 percent of the primary expenses included in the PEF to almost 40 percent.

To date, government initiatives to reduce fiscal expenditures have not prospered, although proposals to this effect have been part of the fiscal reform package submitted to Congress by the current administration on various occasions.

### ***Fiscal Revenues from Transfers by Public Enterprises***

#### *BRAZIL*

Nonfinancial public enterprises and mixed public/private enterprises may not be granted fiscal privileges which are not extended to the private sector.

#### *CHILE*

Some public enterprises must pay a 40 percent tax surcharge on their profits, which does not apply to private companies, and most public enterprises transfer all or almost all of their net profits to the government in the form of dividends. The Copper Company (CODELCO) also transfers 10 percent of its sales revenue to the armed forces. The degree of debt of some public enterprises appears high when compared with that of private enterprises both Chilean and foreign. This is due in part to the high level of dividends and tax surcharge that they pay, which prevents them from retaining profits to finance investment. In 2005, a new dividend policy was implemented which allows the petroleum public enterprise to retain part of its net profits if it exceeds a standard of efficiency measured by its before-tax profits. A similar mechanism is being studied for CODELCO.

*ECUADOR*

There is significant government interference in the management of the largest state-owned enterprise, PetroEcuador (PE). PE must transfer all its revenue to the state budget (PGE), after deducting its costs. The determination of these costs, however, lacks transparency and is subject to negotiation. The government may also arbitrarily cut PE's investment budget.

*MEXICO*

The new fiscal regime seeks to increase the resources left to PEMEX, which helps eliminate distortions in the company's investment decisions. The pending issue is the reform of the corporate governance rules for the company, which would seek to maintain PEMEX's management free from political interference; clearly establish the boundaries between the government and PEMEX's responsibilities and functions; guarantee greater operational efficiency through market discipline; provide the flexibility needed so that the company can operate according to the efficiency standards observed in the largest petroleum companies in the world; and ensure proper accountability and transparency in the management of the company.

***The Role of Congress****BRAZIL*

The congress can modify the budget law in line with the Multi-Year Plan (PPA) and the budget priorities (LDO). In practice, congress revises the revenue estimates significantly although legally it is only authorized to do so in the event of estimation errors. It can increase expenditures, but any amendments for additional expenditures have to be matched by canceling other expenditures (excluding the payroll, debt service, and transfers). If the draft budget law is not approved on time, then the government may only execute key expenditures until an agreement has been reached.

*CHILE*

The congress enjoys limited powers in the budget process. It cannot amend the macroeconomic assumptions

or the revenue forecasts used in the budget proposal, increase expenditure or reallocate it among programs. It may decrease expenditures not related to the obligations set out by law or place restrictions on individual appropriations. If congress does not approve a budget by November 30, the government's proposed budget becomes law.

*ECUADOR*

The congress cannot increase the budgeted amount of revenue and expenditure submitted in the draft budget, but it can alter the composition of revenues and financing as well as of expenditure, and it sets a limit on borrowing. Congress discusses and approves expenditures in the aggregate. The president may not veto the budget approved by congress because it is not a law, but rather a parliamentary resolution. Congress must approve the budget by November 30. If it does not do so, the government's proposal prevails.

*MEXICO*

The congress has the authority to reduce the budget, amend its composition, and even increase the budget ceiling, provided it approves the funds to finance the additional expenditure. Under the LFPRH, these funds may not be loans. The budget is approved in two stages. First, congress approves the LIF (which is a law) and then the Chamber of Deputies approves the PEF (which is a legislative decree).

***Role of the Fiscal Responsibility Law****BRAZIL*

The main fiscal indicator for the assessment of fiscal policy is the primary balance. The FRL defines fiscal rules for all levels of government and requires that no permanent expenditure be created without a corresponding increase in permanent revenues or cuts in other permanent expenditures. It also prohibits borrowing that exceeds investment expenditure, and stipulates that the effects on revenue of new tax expenditures must be recorded for the current fiscal year and two subsequent years. Also, the FRL limits central government personnel

expenses to 50 percent of net revenues, with individual limits set for each of the three branches of government.

The 2006 Budget Guideline Law (LDO) decrees that the federal government's net tax revenues may not exceed 16 percent of GDP. It also established a limit of 17 percent of GDP for primary current expenditures. In addition, the LDO established that the primary surplus target may be adjusted (one-fifth of the difference) for a higher or lower surplus in case GDP growth exceeds or is lower than that envisaged in the budget, with a maximum adjustment of 0.25 percent of GDP. This adjustment may be suspended if the reduction in the debt to GDP ratio is less than the average that occurred in fiscal years 2004 and 2005.

#### CHILE

The overall balance of the central government is used as the indicator of the fiscal position.

The fiscal rule is defined in terms of the structural balance, which involves a cyclical adjustment of tax revenues, determined by the gap between the actual and trend GDP and the elasticity of tax revenues with respect to GDP, and an adjustment of the revenues generated by the Copper Corporation (CODELCO) for the central government through taxes, transfers of profits, and transfers to the armed forces, which results from adjusting the value of copper sales by the difference between the actual price and the long-term price of copper.

Congress is discussing a draft Fiscal Responsibility Law. The draft law incorporates the annual calculation of the structural balance into the financial budget program but does not set a numerical rule. It establishes the obligation to provide information on guarantees and authorizes the Ministry of Finance to implement mechanisms to cover the costs associated with these guarantees; establishes a pension reserve fund and an unemployment contingency fund; requires payments from the entities using public assets for the use of those assets; and broadens the requirements of information in regards to the operations under the RCL.

#### ECUADOR

There are no clear fiscal indicators to define the fiscal targets. It appears that the emphasis is placed on those indicators on which the FRL applies. Fiscal rules are defined based on approved budgets rather than on results.

The FRL requires that the central government's primary expenditure (excluding capital expenditure) may not grow by more than 3.5 percent a year in real terms; that the non-oil deficit of the public sector must be reduced annually by 0.2 percent of GDP until it reaches zero; that current operating expenses of the public financial sector may not grow by more than 2.5 percent per year in real terms; and that the public debt must be reduced by 16 percentage points of GDP in each four-year presidential term until it declines to 40 percent of GDP, which may not be exceeded once it has been reached. The FRL also establishes that debt operations may be conducted only to finance investment.

#### MEXICO

There are two definitions of the operational result, the traditional balance (BT) and the Public Sector Financing Requirements (RFSP). The first includes only those operations which are in the budget, while the second also includes operations stemming from past financial banking and road concession rescues as well as public investment projects with deferred impact on expenditure or association with private investors, net financing needs of development banks, non-recurrent public revenues, and other adjustments. These transactions add between 2.5 and 3.0 percentage points of GDP to the traditional deficit.

There are two additional measures of public debt, the traditional measure and the Historic Balances of the Public Sector Financing Requirements (SHRFSP), which includes transactions associated with the RFSP. For 2004, the total adjustments to the debt added almost 18 percentage points of GDP, for a SHRFSP of 42 percent of GDP.

The LFPRH establishes that the economic package will be prepared on the basis of medium-term projections, defines a formula to determine the price of oil using technical rather than political criteria, and sets clear rules for the distribution of excess revenues. It also defines the adjustment mechanisms to be used in the event of shortfalls in revenues, establishes that new laws which result in larger expenditures must identify the revenue source to finance them, and limits, controls and provides transparency to personnel expenditures. It defines clear rules for the allocation of resources to trust funds and to finance ADEFAS (including a limit), and it strengthens the sanctions for noncompliance with the law. It also establishes a procedure with specific deadlines for the approval of the LIF and the PEF, advances the deadlines for submission to congress of the budget documentation, and provides tools to allocate expenditures more transparently and efficiently.

### ***Assessment of the Management of Off-Budget Operations***

#### ***BRAZIL***

In recent years, Brazil has achieved significant progress in public financial management. The cornerstone of this effort was the approval of the FRL in 2000. The reforms have improved the realism of the federal budget and its consistency with macroeconomic constraints as well as its effectiveness in allocating resources. The budget is characterized by broad coverage and by being backed by medium-term targets. There are no off-budget funds and although several budget funds exist, they are an integral part of the federal budget. Nevertheless, an excessive earmarking of revenues persists, which, when added to expenditure requirements, leaves little fiscal space for discretionary spending.

With respect to the use of non-financial public enterprises to conduct quasi-fiscal operations through administered prices or by appropriating their surpluses, Brazil is an exception. Quasi-fiscal operations have been reduced significantly, and the budget includes transfers to cover those that remain. However, the complexity of the credit programs implemented through public

financial institutions makes it difficult to estimate the cost and subsidies of these programs and the minimum reserve requirements on private sector deposits are high, constituting a source of revenue for the central bank which is not included in the budget.

Budget norms allow congress too much flexibility in estimating revenues and total expenditure, in executing discretionary spending and spending associated with earmarked revenues, in handling undisbursed commitments, in using supplementary appropriations, and with respect to the deadline for approval of the budget by congress. For example, because of the lack of definition of the deadline for approval of the budget by congress, the 2006 budget had still not been approved in mid-March.

Another area which may cause problems is the excessive “shielding” of the budget as a way of maintaining fiscal discipline through legal rules. For example, in addition to the primary surplus targets, in order to increase permanent expenditures other permanent expenditures must be cut or permanent revenues increased. In addition, primary expenditure cannot exceed 17 percent of GDP and the wage bill cannot exceed 50 percent of federal government net revenues, while tax revenues are not permitted to exceed 16 percent of GDP.

This same philosophy is present with respect to PPP contracts, which eventually could make it difficult to implement projects in this way. Furthermore, the government has tried to achieve certain objectives through legislation such as a reduction of the tax burden or the containment of public expenditures, which possibly require political consensus in certain areas to avoid creating distortions in the allocation and use of public resources while trying to attain these objectives. Although strict rules apply to the granting of tax expenditure, in practice it is possible to circumvent them.

#### ***CHILE***

According to the OECD, Chile has an outstanding record of fiscal responsibility and a sophisticated budget formulation process.

In recent years, Chile has introduced several reforms which integrated in the budget documentation and

public finance statistics off-budget operations equivalent, in 2004, to almost 3 percent of revenues and 4.5 percent of expenditure; incorporated the FCC operations in the budget as financing transactions; decreased the size of the contingency reserve; defined rules for the use of the contingency reserve, incorporated in permanent legislation a set of norms that had been included year after year in the annual budget law; and introduced accounting on an accrual basis (GFSM 2001).

Off-budget operations under the RCL were not only integrated into the budget documentation, but were also incorporated into the analysis of fiscal policy. The same was done with the interest accrued on bonds and the operations of the Petroleum Price Stabilization Fund (FEPP). The IFP and statistics on public finances incorporate off-budget expenditure to the central government's consolidated budget. The FI is now a virtual fund, unregulated by law and managed by the Ministry of Finance.

Off-budget operations are conducted mainly through public enterprises. Other types of off-budget operations include direct loans, guarantees, PPPs and tax expenditures. Budget norms and practices are not a significant source of diversion in budget execution.

The government has also made other off-budget operations more transparent, such as guarantees and subsidies committed under PPP contracts, contingent liabilities associated with the guarantee for minimum pensions, credit guarantees provided to public enterprises and others, and tax expenditures. The government has also implemented mechanisms to reduce the implicit subsidy on direct loans, with the government acting as a second tier institution. It has also sought to regulate the relationship between the government and public enterprises. However, the draft law rejected by congress did not contain provisions to align the budget regime and the dividend policy of public enterprises with those of private companies. Tax expenditures are a potential avenue to increase off-budget operations.

The fiscal rule on the structural balance has contributed to the achievement of important advances in budget policy. It increases the cyclical flexibility of

fiscal policy, enabling the automatic budget stabilizers to function fully. It guarantees continuity in the financing of key reforms with multi-year budget impact and stability in the financing of priority social programs.

The initiatives contained in the LRC project seek to complement counter-cyclical instruments, improve information on guarantees and provisioning for contingent liabilities, and broaden the information on operations carried out under the law.

#### ECUADOR

Ecuador has made progress in certain areas of budget management through the implementation of a FRL and the provision of information. However, the budget framework has deteriorated significantly in recent years. The coverage of the budget is limited. The central government's revenues and expenditures are recorded in net terms, with a significant part of the budget revenues and the expenditures associated with these revenues not included in the budget.

In addition, earmarking is extensive, covering both petroleum and non-petroleum enterprises. Moreover, budget norms and practices contribute to the creation of off-budget operations and reduce the role of the budget.

Off-budget operations are also substantial, which leads to an under-estimation of the size of government operations. These include mainly the quasi-fiscal activities of PetroEcuador, the electricity, telecommunication and Solidarity Fund companies, the development banks, the earmarking of revenues and expenditure requirements, and tax expenditures.

PetroEcuador must also transfer all its revenues to the budget after deducting its costs, the determination of which is done in a nontransparent fashion and subject to negotiation. Off-budget operations are also substantial, which leads to a significant under-estimation of the size of government operations.

Clear fiscal indicators are not used, and there are many fiscal rules. The fact that the fiscal rules apply to the approved budget and not to the executed budget in practice allows non-compliance with these rules *ex post*, except for the rule on public debt.

### MEXICO

Mexico has made important strides over the past few years to increase the coverage of the budget through diverse mechanisms. These include the identification and quantification of off-budget operations, the establishment of rules on trust funds, the enactment of a new fiscal regime for PEMEX, the definition of rules for concession and PPS contracts, the identification, quantification, and reporting of guarantees provided by the government, the preparation of a tax expenditures budget, and the approval of a new budget and fiscal responsibility law.

Certain off-budget operations have been quantified and incorporated into a fiscal indicator (RFSP) and in a debt indicator (SHRFSP), which are used in the macroeconomic framework and are reported to congress in quarterly reports. However, the management of fiscal policy does not include targets with respect to the RFSP, focusing only on the traditional balance.

The government has sought to identify, record, and inform congress on the trust funds, and it has tightened the rules regulating the creation of these funds, their functioning, and the fiscal transfers which they receive. Congress must also be informed on a quarterly basis about the contingent liabilities associated with guarantees.

Important changes have been made regarding the PPP contracts, and a framework has been defined for PPS contracts. In the budget framework, the rules require SHCP approval to commit resources on these projects, with the obligations reported in the PEF and granted *de jure* preferential status in subsequent budgets.

Important steps have been taken to manage PEMEX in line with corporate governance guidelines. As distinct from the previous regime, which taxed sales, the main tax in the new regime is a levy on revenues minus

costs. The LFPRH defined a formula to determine the petroleum price to be used in the budget using technical rather than political criteria. However, the policy of administered prices for fuels was maintained, adjusting them only for expected inflation, with the implicit subsidy paid by the federal government through a lower collection of the IEPS, which is the instrument used to compensate PEMEX.

Other public enterprises also engage in significant quasi-fiscal activities. The electricity companies subsidize residential and rural energy consumption but do not receive transfers from the federal government.

Although the government must submit an annual budget of fiscal expenditures, it is not incorporated in the budget discussion. The expenditures implemented through this mechanism are not only large, but they have increased substantially over the past few years and in 2006 represented nearly half of all federal government revenues and 40 percent of expenditures. Moreover, there are no periodic assessments of fiscal expenditures. To date, initiatives by the government to reduce tax expenditures, which were part of the fiscal reform package presented by the current government, have been unsuccessful.

The LFPRH promotes fiscal responsibility and transparency and accountability in the handling of public finances, transparency in accounting, order and certainty in the approval of the annual economic package, fiscal federalism, and modernization of the budget process. It also establishes a zero balance as the target for the BT. However, compliance with the BT targets loses relevance from a macroeconomic point of view and the other functions of the budget if at the same time there is an increase in off-budget operations and quasi-fiscal activities not included in the BT, and subsidies are granted through tax reduction. In addition, it is difficult to assess efficiency in the allocation and use of resources.

## Recommendations

### **Brazil**

#### *BUDGET MANAGEMENT*

In order to improve budget management, flexibility in the execution of the budget must be increased. To achieve this, it is recommended to:

- Gradually reduce the earmarking of revenues and minimum expenditure requirements;
- Modify the budget norms that allow expenditure appropriations of one fiscal period to be executed in subsequent fiscal periods;
- Restrict congress's power to increase revenues;
- Institute a rule that excess revenues must first be used to offset obligatory expenditures which exceed budget appropriations, with the remaining revenue being used to improve the fiscal result;
- Approve, prior to the budget discussion, both the minimum wage that will apply to the fiscal year and wage increases, or social security benefits that might have a significant impact on expenditures.
- Prohibit tax expenditures which have not been approved prior to the submission to congress of the LDO and which are therefore not included in the revenue estimates.
- Limit the use of supplementary budgets to cover emergency expenditure which exceed the appropriation for the contingency reserve.
- Make a provision in the budget for the guarantees expected to be triggered during the budget year and include estimates of the expected triggering of guarantees, as well as the contingent liabilities that are expected to materialize, in the fiscal projections so that the fiscal adjustment needs for achieving the fiscal targets can be anticipated.
- Review the fiscal rules with a view to simplifying them so as to avoid the over-determination of the system while maximizing their effectiveness for achieving fiscal policy targets.

#### *PPP PROJECTS*

Review the budget rules that apply to these projects, focusing on one direct limit such as one percent of net revenues, and on an inter-temporal budget restriction in relation to total public investment. Impose the condition that to make expenditures to implement these projects, other permanent expenditures must be cut at the same time, so as to avoid a compartmentalization of expenditures that does not lead to an efficient allocation and use of resources.

#### *PUBLIC ENTERPRISES*

Conduct an assessment of the credit programs and equalization of interest rates and prices, as well as of the constitutional funds and other programs, with a view first to simplifying them and later consolidating and reducing them. To the extent possible, the impact of these programs on the public institutions that conduct them should be quantified so as to compensate them adequately through budget transfers. The problems should also be limited to an equalization of rates, eliminating the credit requirements, and minimum reserve requirements should be remunerated at market rates, with the cost to the Brazilian Central Bank (BCB) covered by budget transfers.

#### *TAX EXPENDITURES*

It is recommended that tax expenditures be evaluated to determine whether they constitute in each case the best instrument to achieve their intended objectives. This assessment is particularly important at the regional level because the different regions are very dissimilar. Include an analysis of the use of tax expenditures in the LDO, giving them more importance in the budget discussion, and frame the concession of these benefits in a general model instead of assessing the initiatives in this area on a case-by-case basis. The FRL rules regarding the granting of new fiscal benefits should be enforced.

## Chile

### BUDGET MANAGEMENT

The executive branch should submit wage increases for public employees to congress prior to the budget discussion so as to include this cost in the draft budget law, avoiding the need to include a contingency reserve for it every year.

It should also assess the floor for CODELCO's transfers under the RCL to determine if it is necessary to reduce it, with the view to eliminating it in the future.

### PUBLIC ENTERPRISES

Recommendations:

- Define a tax regime for public enterprises in line with the one for private enterprises.
- Define the financial relations between the central government and public enterprises in the annual budget law or in the organic budget law, establishing *ex ante* a dividend policy or predetermined rates of return on their assets.
- Periodically assess the quasi-fiscal operations to identify the costs to the enterprises and establish proper compensation and/or to modify them.
- Adequately compensate public enterprises for the quasi-fiscal operations that they execute. Use budget transfers rather than dividends to cover these operations, as was done for ENAP, or tax exemptions, as is done for the postal service;
- Identify cross-subsidies, treating the subsidies as expenditure and the implicit tax as revenue, and record this information as memorandum items;
- Make the government's relations with BancoEstado explicit in order to render them transparent;
- Record as transfers the repayment by the government of guaranteed loans of some public enterprises, classifying them as expenditure in the operational statement and not as amortization payments in the financing items;
- Estimate the implicit subsidy in direct loans and in loan guarantees granted to the private sector and public enterprises;
- Include an analysis of public enterprises in the IFP.

### PUBLIC-PRIVATE PARTNERSHIPS

Institutionalize the Inter-temporal Budget Restriction mechanism currently used by the DIPRES. Or introduce budget mechanisms to provision both the capital subsidies and the contingent liabilities associated with the concession system.

### TAX EXPENDITURES

Recommendations:

- Assess tax expenditures to determine whether in each case they constitute the best instrument to achieve the intended objectives;
- Include an analysis of this instrument in the IFP, giving it more relevance in the budget discussion;
- Frame the concession of these benefits in a general model instead of assessing proposals in this area on a case-by-case basis.
- Establish rules for the concession of new tax expenditures within the budget framework.

## Ecuador

### BUDGET MANAGEMENT

Recommendations for improving budget management:

- Record budget transactions in gross terms, abolishing the practice of recording only net flows for tax and petroleum revenues and not recording expenditures associated with the earmarking of revenues;
- Reduce the flexibility to reallocate expenditures and increase the level of disaggregation of budget appropriations;
- Prepare information on off-budget activities, quasi-fiscal activities, contingent liabilities and tax expenditures that apply to the various taxes. Once the information is available, start putting in place the necessary mechanisms to incorporate them into the budget.

### FISCAL RESPONSIBILITY LAW

Suggestions:

- Assess the consistency of the various rules and norms (including those related to budget management and the FRL) that apply to the conduct of fiscal policy;

- Incorporate greater transparency into fiscal rules (including the definitions of target variables such as capital spending and the non-oil balance);
- Broaden the coverage of the rule on the rate of growth of primary expenditure to prevent the creation of incentives for creative accounting;
- Apply the fiscal rules to actual fiscal outputs so as not to create room to adhere to the letter of the law while violating its spirit. So far, only the fiscal rule on public debt has been consistently met *ex post*.
- Require more accountability on the part of the Ministry of Finance with respect to compliance with fiscal targets.

#### *PUBLIC ENTERPRISES*

##### Proposals:

- Define a framework for the appropriation of petroleum resources by the government, which could include a tax and dividend policy for PetroEcuador in line with the one applied to the private sector (excluding the tax benefits);
- Compensate PE for the losses incurred in domestic sales of petroleum products through direct transfers from the budget;
- Avoid using the reference price of oil as a mechanism to extract petroleum resources from the sector;
- Allow PE's board of directors to define the company's investment budget, avoiding expenditure cuts due to central government budget considerations; and
- In the transition period toward realistic rates, include the necessary transfers in the budget to cover implicit subsidies in the administered rates for electricity and telecommunication services.

#### **Public-Private Partnerships**

It is suggested that Ecuador develop a legal, institutional, and budget framework for the implementation of PPPs which maximizes efficiency gains and minimizes the risks to public finances.

#### *EARMARKING OF REVENUES*

Replace earmarked revenues not mandated by the constitution with budget appropriations and subsequently implement mechanisms to allocate these resources.

#### **Mexico**

#### *BUDGET MANAGEMENT*

##### Recommendations:

- Define the procedure to be followed in the event that congress does not approve the LIF and the Chamber of Deputies does not approve the PEF within the deadlines established in the LFPRH;
- Regulate the criteria under which congress may increase the revenue estimates of the draft LIF proposed by the government;
- Transform the five off-budget funds (FEIP, FEIEF, FEIIP, FONDEN y FARP) as well as the trust funds (with and without structure) into virtual funds, i.e., consolidate them with the central government in the preparation, execution and reporting of the budget;
- Include information on FINFRA activities in the PEF, such as the source of its revenues and the use of the resources, as well as its capital and the funds earmarked for road concession contracts, transforming it eventually into a virtual fund.
- Require the opinion of the Chamber of Deputies regarding the use of excess revenues greater than 3 percent of the revenues envisaged in the LIF for infrastructure investment and equipment programs and projects of states and municipalities and for investment programs and projects in the PEF; and
- Define indicative targets for the RFSP to make these operations more transparent and reduce incentives to use them as a mechanism to circumvent the budget restrictions imposed by the BT.

*PUBLIC ENTERPRISES*

- Establish a tax treatment for public enterprises in line with the one for private enterprises;
- Define the financial relationship between the government and public enterprises in the annual budget law or in the organic budget law, establishing an *ex ante* dividend policy or predetermined rates of return on their assets;
- Periodically assess implementation of quasi-fiscal operations to identify the costs to public enterprises and establish adequate compensation or modify them;
- Include the subsidies provided through the price of fuels in the PEF as transfers to PEMEX and include the gross collection of the IEPS in the LIF, instead of including only net IEPS collections;
- Include a tax treatment in line with the one applied to private companies in the reform to the corporate governance rules for PEMEX and define an *ex ante* dividend policy for the company or predetermined rates of return on its assets.
- Include subsidies on electricity consumption as transfers to the electricity companies in the PEF, and include payments for the use of government assets by these companies.

- Prepare an annual report on the operations of the development banks and public funds in order to identify and quantify their quasi-fiscal operations.
- Make the implicit subsidies provided through the development banks and public funds more transparent, recording them as memorandum items in the budget documentation; and
- Establish proper compensation through the budget of the implicit subsidies provided through loans granted by development banks and public funds.

*TAX EXPENDITURES*

## Suggestions:

- Evaluate tax expenditures with the aim of reducing them and substituting them with direct expenditures;
- Include an analysis of tax expenditures in the budget discussion, including a comparison with direct expenditures in the corresponding areas.
- Reduce tax expenditures, an urgent priority to restore the role of the budget as the main instrument for the management of fiscal policy.

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# Budget Inflexibility in Colombia<sup>1</sup>

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Juan Carlos Echeverry\*

## Introduction

One of the greatest challenges facing governments today is the narrow room for maneuver in formulating the budget. Their level of discretion in respect to the budget is low and is the object of continuous initiatives oriented towards making it still more inflexible. Numerous laws and constitutional articles determine the way in which governments should allocate their revenues in pursuit of specific goals. As a result, on the political front, the ability of the government and elected representatives to execute government plans, to define priorities and to allocate public expenditures according to these priorities is jeopardized. On the economic front, macroeconomic stability can be threatened; budget inflexibilities make it difficult to adjust fiscal variables according to different macroeconomic circumstances and entail future expenditure commitments that contribute to pressures to increase the public debt. Thus, public expenditures seem to acquire an independent dynamic that is divorced from considerations about the sustainability of the debt. The technical analysis of debt sustainability, based on revenue projections, is not what determines the amount of spending. On the contrary, various political and social groups define the level of expenditures and realize their aspirations through the establishment of legal or constitutional rules from which a predefined budget order is derived. This is the reason why in many countries the level and allocation of public expenditure are variables determined in an exogenous manner. In this situation, the level of debt is endogenous to expenditures, which is contrary to what rational budget administration would recommend.

However, inflexibilities in public expenditures have some basis in logic, and are, to a certain extent, desirable.

There are items such as wages and pensions, and education and health expenditures, among others, that should not be subject to short-term swings. The creation of laws that produce inflexibilities might be considered, therefore, as a mechanism to generate a solid commitment of the state towards certain, priority sectors by taking them out of the annual budget discussion. This tension between a public budget structure that is too inflexible, on the one hand, and the need for a rational budget that supports those items considered as essential by different countries, on the other hand, is the focus of this chapter.

Evidence collected for Colombia (Echeverry, Fergusson and Querubín, 2004) reveals that a great number of budget inflexibilities originate from processes other than a rational and democratic assessment of priorities. In fact, many inflexible items are not included in the national budget because they are really priorities, but due to the capture of rents by interest groups. Facing this fact, the authors of this study argue that such rigidities may reflect a lack of confidence about the action of future governments, which make some groups interested in guaranteeing their access to a particular revenue source by other means for fear of not receiving the attention they expect from the government. The result is a state of affairs with a high level of budget rigidity in which societal groups are trying to capture a “piece of the pie,” without considering the joint and simultaneous action of the rest of the public and private agents, which move in the same direction.

The consequence may be unsustainable levels of taxation or public debt.

For this reason, the problem of budget rigidity can be understood as a particular case of the “tragedy of the commons.” This refers to situations in which shared

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1. This working paper is the result of documents elaborated during the last four years, with the collaboration of Jorge Alexander Bonilla, Andrés Clavijo, Leopoldo Fergusson, Andrés Moya, Verónica Navas y Pablo Querubín, about a group of Latin American countries.

resources are over-exploited since each individual receives all of the gains from their use but the group as a whole suffers the damage from the commons' over-exploitation.

In addition, there is a practical difficulty derived from these rigidities. A large amount of rigid transfers to particular groups from special funds or earmarked revenues generates considerable complexity in the budget—giving rise to a redundancy of functions, difficulties in establishing clear public policy priorities and in allocating resources each year to different sectors in society—and facilitates corruption. For these reasons, the problem of budget rigidities has recently gained importance in the minds of policymakers, even though the problem has existed for a long time.

It is important to make clear that every component whose inclusion in the budget is not subject to the discretion of policymakers in the short term—that is, the annual fiscal period—will be considered *inflexible*. Within this broad definition of inflexibilities, also called “rigidities” or, in some cases, “unavoidable expenses,” are a group of budget items set by laws, decrees or constitutional stipulations that shape public expenditures that are not subject to the discretion of the executive branch.

The methodology adopted follows the taxonomy of inflexibilities suggested by Echeverry et al. (2004). According to this approach, three types of items stand out within the set of rigidities. The first originates in rules that require a form of expenditure (rigidities in expenditures). The second links a source of revenue and allocates it by law for a specific use (also known as *earmarking*). The third groups other inflexibilities, such as quasi-tax contributions (national revenues, collected and managed by private entities) and tax exemptions. This third component has a special feature: the resources administered are not included in the national budget, but they reflect implicit or explicit budget decisions. In particular, quasi-tax revenues are those that are

collected by public or mixed property entities for a specific purpose. Given that they are not included in the annual budget, they are subject to the discretion of the executive branch.

Budget items can be classified according to their degree of inflexibility: high, medium and low. An item is considered to be highly inflexible if the executive and legislative branch do not have discretion over its nominal value during the fiscal period. The inflexibility is medium when there is some discretion left for policymakers over the nominal amount of that category in the short term. Finally, the component has low inflexibility if the executive branch has wide discretion over the nominal adjustments of budget allocations or earmarks, or if the proscribed allocation for that item has little significance. Under this methodology, if an item is classified into any of the first two categories, it is considered inflexible or rigid. This analysis is used for expenditure allocations and revenue earmarks.

The definition of inflexibility refers to a short-term time horizon (one year), because it is possible that the room for maneuver of the executive and the legislative branches can increase in the medium and long term. Even in a context of high fiscal inflexibilities, under certain circumstances, such as an economic recession, the government may gain discretion in respect to some budget categories.

Later in the chapter, the inflexibilities in expenditures and revenues will be assessed in terms of their share of total expenditures and revenues, respectively, and as a percentage of gross domestic product (GDP). Tax exemptions will be measured in terms of their share of total revenues and their share of GDP. The source and origin of quasi-tax revenues will be described and their significance in terms of current and capital revenues and share of GDP will be analyzed. Then, some measures implemented to overcome the problem of inflexibility and some conclusions will be introduced.

## The Budget Process in Colombia: History and Rigidities

### **Historical Review**

Colombia's problems related to budget allocation and the inflexibilities generated by transfers and revenue earmarks are not new, and have been discussed since the beginning of the 20<sup>th</sup> Century by the different finance ministers. In the book *Aspects of Budget Policy in Colombia: 1886-1987*, Juan Guillermo Serna compiles sections of the reports by finance ministers related to the subject. The long history of this discussion of rent-seeking is essential for understanding the budget process and how the Colombian state functions.

### **The Political Origin of Budget Rigidities**

As highlighted in the previous chapter, the origin of the inflexibilities in the budget is linked to the political debate over the allocation of public expenditures. A great deal of the expenditures enacted by law and earmarks are the result of rent-seeking actions of diverse interest groups, which aim to guarantee their share of public resources. Former Finance Minister, Eduardo Wiesner, acknowledged this in his 1981-1982 report when he pointed out that:

*although many such interests are absolutely legitimate if considered individually, their satisfaction is not always compatible with the fiscal balance; therefore it is essential to ensure that policies are designed from a broader perspective with consistent attention to their long-term consequences.*

Then, in the same report, Wiesner adds that:

*it is derived from the above that the fiscal problem is, essentially, a political problem, given that its solution demands an agreement within the community about the development strategy which frames fiscal policies, as well as a minimum level of political support for the provisions through which the government guarantees fiscal discipline.*

*The national government addressed that essential point before the congress, the rest of the civil service and the public whenever it was necessary to gather political support and the solidarity of the citizens for its economic policy; first, in respect to the definition of the general strategy, and then, in the course of the administration of concrete measures aimed at balancing the budget (Serna, 1988: 350).*

However, the inflexible budget items adopted because of pressures from particular groups can be in contradiction with the priority expenditures and investments of governments and prevent them from being implemented. On this matter, Wiesner adds:

*To a certain extent, the political responsibility for the total welfare of the nation is divorced from the political responsibility for the partial and individual solutions that are inconsistent with the general welfare. That divorce between the political responsibilities can be derived from the lack of understanding of the way the economy functions, and, in particular, its fiscal dimension. But more frequently it derives from the claim to ignore that we are close to, if not already, exhausting the margin of possibility for specific, local or individual benefits to be obtained without a big loss for the general welfare (ibidem: 351).*

As mentioned previously, the problem is essentially a "tragedy of the commons" given that, as Wiesner points out,

*the essence of the political origin of the fiscal unbalance lies [...] at the level of perception that the community has in a particular moment about the risk to their collective assets. As long as the fiscal imbalance is perceived to be a remote danger, which today does not threaten the safety of anyone, it will be difficult to obtain political support for a thesis that puts emphasis on discipline, consistency, effectiveness in the allocation of resources, and the quality of economic policies despite the pressures of immediate and tangible interests (ibidem: 352).*

### **Parliamentary Initiative in the Budget versus Fiscal Policy Dictatorship**

The political origin of many inflexibilities leads to the analysis of the initiatives taken by legislators who represent different groups in society in the allocation of public resources. In fact, some of the expenditures that the government commits to making and the revenue earmarks are a result of parliamentary initiative, given that the congress passes laws that include benefits favoring particular groups.

The speeches and writings of the finance ministers of the past century have addressed this point. In 1911, former Finance Minister, Celso Rodríguez, referred to the increase of the level of indebtedness of the government and the implications this had for the budget balance. The minister, however, asserted:

*We should not attribute this problem to the government exclusively, because it is common that legislators enact auxiliary spending measures, tax amnesties or new services and avoid including the corresponding items in the budget law. This gap then has to be filled by providing additional credit, thus breaking the fictitious balance affirmed when the budget law was approved (ibidem:23).*

One year later, the next Minister of Finance, Carlos Rosales, added that although

*our Congress in each legislative period has shown a noble determination to balance the budget of revenues and expenditures by performing every arithmetic operation needed to obtain such a balance, [...] once the arithmetic operations are performed the same Congress issues laws that entail expenditures modifying the budget that was previously considered balanced. Given that in the execution of the budget the government has to determine which expenses it will favor, it is clear that without asking for this role it acts as a dictator over fiscal policy (ibidem:26).*

Esteban Jaramillo highlighted the problem of the fiscal “dictatorship” of the executive branch in respect to budget matters in his 1930 Treaty on the Finance Ministry.

*it takes on a more serious character because at first glance the essential powers of the Congress and its sovereignty over budget matters appears to be disputed, with the need to limit and curb parliamentary extravagance which, as seen already, is one of the main causes of the huge increase of public expenditures” (Serna, 1988:101).*

As a minister, Lleras Restrepo expressed in his 1939 report:

*What should happen is that the executive complies in full with the budget voted for and approved by the Congress, but this implies ending the parliamentary initiative in respect to expenditures” (Serna, op. cit.: 170).*

The adjustment of expenses on the part of the legislative branch creates the problem of interfering with and complicating the responsibility of the executive for balancing the budget. Finance Minister Carlos Rosales, warned about this in 1914:

*Most of the laws decreeing expenses tend to be enacted by the legislature, and are not included in the budget law. The requirements for a balanced budget should extend to all actions of the legislature, not just to the budget, but to all laws that give rise to expenditures. A sound fiscal orientation cannot be expected when a minister has to execute expenditures he has not approved and when the fiscal orientation depends on opposing interests and antagonistic wishes (ibidem: 26).*

Francisco de Paula Pérez made a similar remark in 1929:

*In each legislative session laws are approved which imply expenditures; new jobs are created and auxiliary*

*budget items are approved for public works desired by departments or municipalities. Usually, in the first year the laws are left out of the budget and not executed, but they remain an obligation of the Treasury, and sooner or later they will have to be included as an expenditure.*

*Many of the laws that strain the budget today were approved years before and only now we realize that they represent a charge that exceeds the available resources. Those who passed the provisions and decreed the expenditure are those who eventually are astonished by the excessive expenditures incurred.*

*The public, which views these matters from a simplistic perspective, places most, if not all, the responsibility upon the government branch that carries out the executive functions. Unfair complaints and comparisons are made, as is obvious. This is the result of the disorganized nature of investment programs (ibidem: 82, emphasis added).*

Finance ministers question the authority of the executive in the budget process since while it is responsible for the fiscal balance, it has little or no discretion over the execution of expenditures. The legislative branch enacts these expenditures, thereby contributing to budget inflexibility, insufficient revenues and an increase in the public debt.

#### **Violation of the Unitary Budget: Transfers and Earmarked Revenues**

One of the budget principles currently established in the Organic Statute on the Budget, which is threatened by the inflexibilities generated in revenues, is the unitary budget principle. In the explanation of the purpose of Law 110 in 1912, The Minister of Finance, Carlos Rosales, focused on that principle as an essential component of a sound budget. Rosales emphatically defended the principle, pointing out that making a single treasury from the revenues collected facilitated accounting, permitted the prioritization of each expenditure based on its costs and benefits, and facilitated the payment of obligations in the context of budget deficits:

*The budget does not accept the system of directing specific taxes or receipts from national assets to particular expenditures, nor of subordinating some expenditures to the quantity of specific revenues, a system that does not do anything other than complicate accounting as is typical in countries with broken down public finance systems.*

Colson, the French writer, expresses this point with great confidence:

*financiers unanimously acknowledge the vast superiority of the principle of budget unity, which permits the relevance of every expenditure and the quantity collected from each tax to be managed based only on the respective usefulness of each expenditure and on the comparative difficulties associated with the different taxes with no need to establish an artificial harmony between the outcome of a given tax and the expense of a service when they have nothing in common.*

*Budget unity has scarcely been obtained in modern nations. Under the old regime and today in those Asian countries which have only a primitive public administration, it is common to see expenses allocated on the basis of small loans using customs revenues, the tithes (diezmos) of a province or of a monopoly etc. When a state lacks resources it is not possible to guarantee the operation of an essential service or the payment of a debt unless it authorizes, first and foremost, the collection of the resources needed on the basis of money received in one form or another. A government in a difficult situation is not able to obtain money without giving their most secure revenue to their creditors, the same way a less solvent creditor has to mortgage their real estate or pawn their watch in the Mount of Piety (ibidem: 32).*

Likewise, in his Public Treasury Treaty, Esteban Jaramillo refers to the importance of the principle of a unitary budget, appealing to international experience. Jaramillo points out that budget unity is a “stable rule in every correct fiscal organization [which] concentrates in a joint fund all the revenues of the treasury and opposes

the targeting of particular revenues for specific services” (Serna, op. cit.: 111). According to the author, “this rule, followed by every country with sound finances, has been adopted by us through the reform of 1923” (ibidem: 111). In defense of this rule, Jaramillo concludes by affirming that

*Leaving aside the disorder introduced in the management of the Treasury, these revenue earmarks present the serious disadvantage of services insufficiently funded, at the same time that others are left with a surplus that they do not know how to spend (ibidem: 111).*

Years later, in his report as a Minister of Finance, Jaramillo refers again to this principle and regrets its violation:

*Article 16 of Law 64 established the principle of budget unity. All of the revenue of the national budget, it states, shall constitute a common fund with which general expenses will be paid, and no specific revenue source included in the budget is to be used in order to pay for specific expenditure items. Undoubtedly, the principle is the most technical. But, both before and after the Law was passed, the issuance of substantive laws that, either totally or partially, ordain a specific destination to a specific revenue source have, created situations not foreseen in the Organic Law. It is for this reason, that, in the presence of a deficiency in an appropriation in respect to the effective product of earmarked revenues, the choices are either to resort to the system of creating reserves on the excess of the national product, which is not consistent with the principle of a unitary budget, or to charge the nation with a debt that is not accounted for in the fiscal results of the budget in force, which interferes with the clear interpretation of the development of the budget and the situation of the treasury. As it seems difficult to get rid of all the revenue earmarks, it is convenient to anticipate the existence of extraordinary budgets, not only for the product of loans and the revenues allocated to service the public debt, but also for all the other targeted uses of public revenues. In this way the course of the ordinary*

*budget can be understood with greater clarity and the evolution of the fiscal situation will be more accurate (ibidem: 165).*

Critics of earmarks and special funds fault them for infringing the unitary budget principle and for the incentives generated for increasing expenditures. Regarding the harmful aspects of some earmarks, Finance Minister Gonzalo Restrepo pronounced in 1935-1936:

*The current administration has affirmed three basic principles during our term: a) budget unity, b) an increase of direct taxes, and c) an adequate distribution of taxes. So-called extraordinary budgets, financed with special resources related to earmarked revenues, and ordinary budgets have always coexisted in our fiscal system. [...] In addition, other reasons argue against extraordinary budgets. These budgets tend to conceal the real extent of public expenditures and they establish preferences among the different services that are sometimes arbitrary given that in practice it is very difficult to establish a clear separation between ordinary and extraordinary expenditures. Finally, they foster excessive spending because the general belief is that the funds targeted to a specific purpose have to be totally spent, without rates or measures (ibidem: 152).*

The explanation of the purposes for the Organic Budget Law, introduced in 1948 by Minister of Finance José María Bernal, includes a list of the problems associated with earmarks, many of which repeat arguments presented above:

*The second article of the law confirms the unitary budget principle established by Article 5 of Law 35 of 1944 and stipulates that funds shall not be designated for specific projects or purposes. A similar rule is recorded in Article 16 of Law 64 of 1931. However, in recent years, many laws have been adopted that designate a specific destination for a given source of funds. The procedure of allocating in the budget the amounts of specific revenue sources dedicated to particular expenses is detrimental to*

*the sound administration of the budget. It establishes unfair precedence in favor of expenditures that are not essential; it encourages waste in those departments with funds higher than their needs; it distorts the financial accounts of the treasury (given that it compels the General Comptroller to present as debts the special reserves corresponding to the biggest product of the revenues over the respective expenditures and prevents Treasury from having access to the numerous funds available that should freely merge with the rest of the state funds in order to allow them to cover all national government expenditures).*

*The vice of revenue earmarks has an impact not easily perceived. They segregate any budget program entirely, give preference and grant resources to certain services with no consideration for the essential needs of the administration and the government to the detriment of the budget balance and the solvency of Treasury to deal with the rest of the expenditure predicted for the year. In our concept, targeting revenues for specific purposes and good budget administration cannot coexist and keep balance all the time. Every country in the world, to a greater or lesser degree, has gone through that stage of error and inexperience, and, eventually, each has managed to have those allocations proscribed, bearing in mind that the right procedure is to consider the budget as an indivisible whole in which the total amount of revenues contributes to paying for all of the expenditures in the budget (ibidem:203-204).*

In a similar way, in 1949 the Minister of Finance, Hernán Jaramillo Ocampo discussed the inconvenience of establishing special allocations in the budget. He also explained their existence as the result of the fear that the payment of those expenditures would be interrupted. On this matter, he added that earmarked revenues made it difficult to reduce the level of appropriations in those cases in which the government's financial situation required it:

*earmarks, which are typical of a declining financial organization, are opposed to this [unitary budget] principle because every portion of revenue that is allocated for a*

*specific purpose ceases to finance the global mass of public expenditures that was supposedly voted for on the basis of rational criteria. Such practices not only narrow the range of government action but also leads to the establishment of unjustified predeterminations of priorities and also results in an incomplete picture of national fiscal conditions.*

*Special allocations have no other explanation than the fear that during a given financial period collected national revenues will not equal the level estimated, and some expenditures will not be paid for. But, it is obvious that this fear does not have to emerge if the system for calculating public revenues guarantees reasonable and honest estimations. Besides, if despite sound predictions, and because of uncontrollable causes, the revenues collected do not equal the estimates incorporated in the budget, the advisable thing to do would be to cut appropriations by the amount necessary to maintain the budget in balance. In other words, the possibility of earmarking revenues for specified purposes may be said to create an incentive for inflating revenues and for charging expenditures to revenues that would not be enacted if the financing via this mechanisms had not been guaranteed.*

In 1959, the Minister of Finance Hernando Agudelo Villa said that the universal budget principle:

*was aimed at getting rid of a form of corruption that was established and accepted until then. It consisted of the creation of small rotating funds with the product of receipts called reserved funds, which were not included in the budget, that stemmed from entities or legally decentralized companies or entities, based on the contention that the Budget Law deficiently provided for the services that such funds were going to serve. The minister added that "in addition to the fact that this procedure was unconstitutional, it hindered accountability and supervision by the Comptroller" (ibidem: 238).*

Two years later, in his 1961 report, Agudelo Villa criticized the violation of this principle because of the negative effect on budget accountability and

supervision and its tendency to increase rigidities that hinder the rational distribution of resources and allow public sector entities to be in surplus while the Treasury is in deficit.

*The budget that is submitted to the consideration of the Congress has been prepared in close harmony with the legal provisions in force, although such compliance may have limited the chance to apply this method more strictly, as in the case of the application of the income that is targeted to specific services. Article 2 of Legislative Decree number 00164 of 1950, established, with good reason, the principle of budget unity, banning the earmarking of revenues for specific purposes. However, after the law's enactment, a series of laws have reestablished such practices. The rigidity created by the allocation of funds for predetermined purposes hinders the rational distribution of public expenditures as well as its comprehensive planning. In many cases, tax revenues are allocated to entities that lack concrete plans for effectively investing the resources received. As a consequence, other sectors of governmental activity are given projects to undertake but lack the funds to carry them out. It also happens that, at the same time general difficulties are experienced with the Treasury, positive balances appear in the banks for those entities that receive funds exceeding their investment capacity (ibidem: 261).*

Finally, in similar terms, Minister of Finance Jorge Mejía Palacio, in his 1962 report states:

*In recent years, the habit of creating revenue resources targeted to specific purposes has been introduced. It is true that this practice contributes to ensuring that revenue instability will not compel withdrawing support that in a given moment is considered indispensable for a public works project or a given entity, but at the same time it creates an absolutely undesirable form of rigidity that limits the possibility for rationalizing the planning process (ibidem: 267).*

In summary, earmarks have many disadvantages, which those who have managed public finances in the country have recognized. Their statements show that these practices are the result of the fear that certain expenditures will not be included in the budget, in difficult fiscal contexts. However, these practices lead to a harmful inflexibility, which impedes the rational distribution of expenditures among priority objectives. Likewise, it establishes expenditures in non-essential sectors, forces fiscal adjustment to affect priority investment items in other sectors, hinders budget supervision and control by increasing the complexity of the process, creates the incentive not to rationalize expenditures and promotes fiscal deficits.

For all of these reasons, the secretaries of state affirm that this problem constitutes a “stage of error” which every country with sound public finance principles has overcome.

Thus, the historical record shows that since the beginning of the century, different finance ministers have spoken up about revenue earmarks and the excesses of legislators in enacting expenditures without previously putting in place the resources for financing them.

These problems, which finance ministers have been addressing for 100 years are the ones that affect the budget today, creating inflexibilities and imposing obstacles against the achievement of an efficient allocation of resources and a balanced budget. It is paradoxical that at different times, and as established in Article 359 of the Constitution, earmarked revenues have existed in spite of being “prohibited” and despite the fact that the unitary budget principle is expressly established in the Organic Budget Law (Decree 111, 1996, Article 12).

### **Extra-Budget Revenues**

The background for the use of extra-budgetary resources in Colombia were described in detail by Ferrer (1996) in his article “Use and abuse of extra-budgetary revenues in Colombia.” One of the first cases of the creation of such resources dates back to Law 126 in 1927, which established taxes on coffee growers for their own

benefit. However, the coffee export tax established through Decree 281 in 1967, as well as the value added export tax established on coffee exports through Decree 444 in 1967, are traditionally recognized as the first cases of extra-budgetary resources in the country.

At the same time, the extra-budgetary contributions to the National Training Service (SENA), the Colombian Institute of Family Welfare (ICBF), the Social Security Institute (ISS) and Compensation Funds, which today are perhaps the most significant cases of extra-budgetary revenues in quantitative terms, date back to the middle of the last century. Indeed, Law 90 of 1946 established that employers and employees must pay contributions to the ISS for medical and dental services and employee pensions. Later, Decree 118 of 1957 ordered employers to pay a percentage of their payroll to the SENA to contribute to the training of a skilled workforce. This decree ordered some business owners to grant a family subsidy to their workers through Family Compensation Funds. Finally, Law 75 of 1968 established the compulsory payment of contributions by employees to the ICFB in order to protect minors and the family.

In addition, similar to the contributions of the coffee growers, production quotas (cuotas de fomento) have been in place for cereals, rice and cacao (Laws 101 of 1963, 31 of 1965 and 51 of 1966) and for brown sugarloaf (panela), meat and milk (Law 40 of 1990 and Law 89 of 1993), among others. In fact, Law 101 of 1993 focusing on agriculture and livestock and fishing development expresses in Chapter V, section 29 that:

*For the purposes of this law, fiscal contributions applied by law to a particular agriculture and livestock sector or fishing subsector in special conditions and cases for purposes of the general interest in the benefit of these subsectors are extra-budgetary contributions. The agriculture and livestock and fishing sectors' revenues are not part of the national budget (Ferrer, 1996: 61).*

The concept of extra-budgetary finance was established explicitly in the 1991 Constitution, although it had been employed before. It was necessary to explicitly establish the concept of extra-budgetary resources in

the Constitution since the Supreme Court had in several instances ruled that such contributions lacked a legal foundation.

In fact, Alfonso Palacio Rudas, who was a representative to the constituent assembly, which approved the new Constitution in 1991, asserted the following (Ferrer, 1996):

*In a case related to the Coffee Retentions scheme, when distinguished jurists Carlos Restrepo Piedrahita and Rodrigo Noguera Laborde brought up the subject of extra-budgetary finance, the Supreme Court in its sentence on November 10 of 1977 ruled: "Due to that peculiarity, the opponents demand that those resources are considered as extra-budgetary, and according to fiscal doctrine, they can exist and persist outside the national budget administration. However, this is not legally possible in Colombia, because whatever the contribution, no matter its nature or name, both the Constitution (in articles 296 and 210-1) and the organic budget law do not permit it." That ruling, in our opinion, is the foundation of the need to introduce the concept of extra-budgetary financing in our constitution (ibidem: 62).*

Finally, the economic committee of the National Constituent Assembly approved the presentation by Hernando Yepes Arcila, together with Alfonso Palacio Rudas and extra-budgetary financing was explicitly established in the Constitution.

It is curious that the opposite solution, namely, to include all public sector revenue that has the quality of taxes was discarded for a more exotic one of granting constitutional status to extra-budgetary forms of income. By doing so, a curious dual system for allocating contributors' money was established as an organic rule. A large amount of resources were thereby left out of both the budget process and annual democratic scrutiny. Although the funds allocated to SENA, ICBF or to the Compensation Funds may be considered as a priority year after year, they should, like the rest of the taxes in Colombia, be subjected to a critical examination and allocated on the basis of the priorities of democratically elected officials.

### **Relations with the Congress**

A determining factor in the preparation of the budget and for fiscal outcomes in general is the relationship between the government and the congress. Although this link has many dimensions, one that has received little attention in the academic literature (especially if one compares with the attention that it is given in public discourse) is the problem of the so-called “auxiliary legislative funds” (“auxilios parlamentarios”), or the discretionary authority of legislators over the allocation of particular budget items. Varga’s work (1998) is an exception, since he considers that legislature funds are part of the “transaction costs” of the relations between the legislative and executive branches. Vargas classifies the auxiliary legislative funds into two categories:

- i) The general or predefined ones, allocated equally to every member of the Congress; and
- ii) The personalized or negotiated ones, allocated to certain members of the Congress in compensation for their support, or because of political affinity with those in power. The latter may be negotiated during the process of approving the budget or during its execution, but either way they are less transparent than the former, because they are not even identified as auxiliary funds.

According to Vargas’ estimations,

*Auxiliary legislative funds were fairly stable from 1968 to 1991, and they substantially increased subsequent to the approval of the 1991 Constitution, to such an extent that the contributions for regional development in 1997 were eight times higher than in 1990 (Vargas, op. cit.:25).*

This work concludes that

*“the constitutional attempt to abolish the legislative funds was a mistake, because it ignored the transaction costs involved in the executive-legislative relationship and the nature of these funds” (ibidem: 29).*

The abolition of the general (and visible) funds was replaced by personal funds, which are difficult to control. This decision ignored the fact that the problem of the auxiliary legislative funds is not their existence, but their lack of transparency. For this reason, the establishment of legislative funds with a predefined and universal amount for all legislators is proposed. Hommes (1996, 1998) agrees in general terms with this diagnosis when he asserts that

*the outlawing of the legislative funds did not reduce the appetite of politicians for budget items that could be allocated by legislators nor could the executive eliminate these items. Thus, the process of approving the budget is open season for clientelism practiced through the allocation of public expenditures (104).*

This episode of the history of budget policymaking in Colombia is illustrative, because the abolition of a budget institution multiplied its value by eight, turning it into an illegal procedure and left no choice but to carry it out under the table, without accountability or allocation of responsibilities. Instead of modifying the institution so as to improve public accountability and make it amenable to evaluation and oversight, a moralistic and shortsighted attitude was adopted that undermined the institutional practice. Besides, to a certain extent, the adoption of laws that allocate expenditures in multiple directions, thus again avoiding transparency and public accountability, can be attributed to the response of the Congress aimed at regaining control over a part of the budget. In the words of the budget analyst, Miguel Gandour, “[the abolition of the funds over which legislators have discretionary control] is one of the ideas that sound good in the University of Los Andes and does not work well in reality.”

### **Previous Empirical Works**

As in the international literature, those works addressing the Colombian case have put little emphasis on the problem of the inflexibility of public expenditures. However, some have examined the effect that the features of Colombian budget process have on fiscal performance. In this section some of these studies are reviewed.

In an empirical study focused on Latin America, Alesina and Perotti (1996) discuss the effect of budget institutions on fiscal performance. Attention is focused on the rules and procedures that relate to the formulation, approval and implementation of the budget. The paper examines if procedures that entail restrictions on legislative autonomy in respect to the budget and that are more “hierarchical” and “transparent” lead to a lower deficit. Consistent with the evidence found in developed countries, the results suggest that, in fact, hierarchical procedures generate a lower deficit. Among those procedures that the authors consider, for example, are those that limit the power of the legislative branch to expand the size of the budget and those which vest a single individual (usually the Finance Minister) with a strong leadership role in the budget negotiations within the government, thereby limiting demands for expenditures by the rest of the ministries. Collegial procedures, in which a wider group of agents involved in the budget process is granted greater powers, lead to higher deficit levels.

Although this paper is essential insofar as it highlights the importance of budget procedures and rules in fiscal performance, the approach is too “aggregated” for our purposes. In fact, the empirical analysis is carried out on the basis of an index which is intended to summarize the general characteristics of the budget process in Latin American countries. This index is constructed by the authors on the basis of responses by the countries’ budget directors to a series of questions related to the budget process. However, none of the components of the index, not even the one called “flexibility and execution,” deals accurately with the topics discussed here.

In addition, the definition of fiscal performance used in this study is also an aggregate measure: the fiscal deficit. In a subsequent paper, Stein *et al.* (1999) rely on the same methodology to examine the effect of budget and electoral institutions on fiscal performance. These authors modify the index introduced by Alesina and Perotti and also find that hierarchical and transparent procedures have positive effects on fiscal surplus. It is worth mentioning that, based on this index, Colombia is the country with the most hierarchical and transparent budget process for the 1990-1995 period.

In a paper which served as an input for the study on budget rules in Latin America carried out by Alesina and Perotti, Hommes (1996, 1998) focuses exclusively on the Colombian case and addresses some aspects of its budget process in further detail.

In general terms, this paper’s assessment of the characteristics of the budget process in Colombia is positive and highlights the changes introduced in the 1990s, which granted more hierarchy and transparency to the process. Little attention is given to rigidities in the budget, and their relevance is dismissed given that:

*There is not much flexibility for changing items of expenditure, but the government can reduce its effective spending because it has a strict control over the flow of the public purse by means of the financial plan [...]. The government is also authorized to reduce its expenditures when revenues are expected to fall below the amount approved in the budget [which represents] a useful tool for the executive that gives it flexibility in the case of a negative shock to revenues (Op. cit.: 95-103).*

Nevertheless, Hommes warns about the potential impact of the 1991 Constitution on the budget process:

*In addition, all the expenditures with a pre-determined allocation were eliminated, except those directed to social programs, but priority was given to social expenditures over all other types of expenditures (previously, debt service was the priority), and it was established that the social investment budget could not decline as a share*

*of the total budget. These two rules are going to contribute to increasing the size of the budget over time (ibidem: 105, emphasis added).*

Ayala and Perotti (2000) carry out an analysis of the Colombian budget process, focusing special attention on its degree of centralization, transparency, rules and inter-temporal characteristics. Some conclusions of this study are relevant for the purposes of this chapter. In particular, the study highlights the low transparency of the Colombian budget process that stems from the excess of documentation and rules. Undoubtedly, the numerous sets of rules supporting the rigidities of the budget analyzed in this chapter accentuate this lack of transparency.

On the other hand, the authors point out that, while it is true that during the discussion and implementation stage the Colombian budget has a high (desirable) degree of centralization (given that it grants a large amount of power to the Ministry of Finance), during the phase prior to the preparation stage the process is too decentralized. For these authors, this increases the demands on the part of pressure groups over the budget. For that reason, the alternative suggested is to make the National Development Plan (PND) a policy document, which establishes the general guidelines of the governmental program, but that lacks the legal implications in the budget process that it has at present. In addition, they suggest centralizing the preparation of the operations and investment budget in the Finance Ministry (currently, the latter is carried out by the National Planning Department). According to these authors, it is desirable and legitimate for the government to listen to the demands and needs of the country by giving voice to social actors, but this has to be a political process instead of an institutional one, because otherwise the inclusion of every item in the budget is favored without encouraging the necessary discussion about setting priorities.

Acosta and Ayala (2000) and Ayala (2001) review and analyze many of these in further detail. In fact, these limitations were pointed out at least since the publication of the report of the Commission on the

Rationalization of Expenditures and Public Finance (1997). That report also adds, as stressed in this paper, that:

*The reduced room for maneuver of the executive to manage public expenditures —due to the high proportion of budget resources that are allocated prior to or outside the budget process— threatens any attempt at rationalization (p.39).*

### **Budget Inflexibility**

This section introduces the main characteristics of the budget formulation, approval and implementation processes of the national central government of Colombia, based on information from fiscal year 2006. The formal process of design and other informal processes that occur in parallel, especially during the passing of the budget, as well as the different actors involved are examined. Based on this analysis, the following section introduces the taxonomy of budget inflexibility in Colombia and the nature of the rigidities, as well as their origin and magnitude.

In Colombia, the budget process comprises four stages: formulation, approval, execution and control. The branch in charge of budget formulation or design is the executive branch, and in particular the Ministry of Finance (MHCP) and the National Planning Department (DNP). In order to define the annual budget, the finance ministry, in consultation with the DNP, sets the macroeconomic guidelines expected for the implementation period, from which are derived the revenue forecasts, the growth of some expenditures tied to the level of economic activity or to variables like inflation and the exchange rate. Revenue and expenditure limits are derived from these estimations. Then, the MHCP and the DNP prepare the Financial Plan, which has to be evaluated by the Superior Council of Fiscal Policy (CONFIS) and approved by the Superior Council of Economic and Social Policy (CONPES, in which the president and the ministers from economic and social areas participate) and which contains the macroeconomic foundations for the budget (Ayala and Perotti,

2000). In accordance with the Financial Plan, the DNP prepares the Annual Operational Plan of Investments, which after being discussed with the MHCP has to be approved by CONPES and incorporated in the official national budget.

Simultaneously, the MHCP discusses the operational budgets with the different ministries and national decentralized agencies; and the DNP does the same for the investment budgets. This division of operational and investment expenditures between the different executive branch agencies is specific to Colombia. Based on these discussions, the sectoral and economic distribution of the budget is defined. Finally, the DNP defines the geographic distribution of the investment budget, which is an important step for discussion in the Congress.

This first stage in the formulation of the budget proposal occurs between January and June each year. The following stage, the approval of the budget, begins in the first ten days of the second legislative session of the Congress, which starts on July 20th. At this stage the budget proposal is debated; first in the economic committees of the Congress (the third and fourth of each chamber), where an agreement must be reached on the total level of expenditures. Then the proposal as approved by the committees is debated on the floor of both houses of congress; the final document has to be passed by October 20. If the project is not approved by October 20, the version approved by the committees is the one that is executed. If, however, the government does not submit the budget proposal by the date stipulated, or if the Congress rejects it, the budget of the current year is the one that is applied. The government can reduce the expenditures called for in this budget if revenues of the following year are insufficient (Ayala and Perotti, 2000: 9; Political Constitution of Colombia, articles 345 to 355).

The third stage is the budget execution phase. This phase is regulated by the most recent version of the Financial Plan, which is updated at the end of the fiscal period of the previous calendar year. During the budget term, the Finance Ministry is able to readjust some budget allocations, thanks to the inclusion of the provisions component in the Budget Law, which allows for the

financing of expenditures generated by new laws during the current fiscal year (Ayala and Perotti, *ibidem*: 9-10).

The budget process concludes with the control stage, divided into three types. On the one hand, the congress exercises political control. In exercising this responsibility, the congress can summon the ministers from the different areas and the directors of the administrative departments and study the reports produced by the president and the other members of the executive branch, as well as the report on budget execution and the one on public accounts submitted by the Auditor General of the Republic. On the other hand, CONFIS, the DGP in the MHCP and DNP carry out the financial and economic control of the budget process and the office of the General Auditor performs the fiscal control of budget execution (Ayala and Perotti, *ibidem*: 10). Finally, the constitution grants the DNP the task of ex post evaluation of the quality of budget execution, in particular in the investment categories, as well as of the impact of the policies and projects of the national government.

### ***Fiscal Rigidities in Colombia***

This section describes the main components of the 2006 national budget law, and particularly the part of the budget that refers to the revenues and the expenditures of the central government (GNC). Table 38 summarizes the budget execution of the GNC for 2006. Total revenues amounted to 17.7% of GDP, 91.4% of which are current revenues, while total expenditures reached 21.6% of GDP, 90% of which are current expenditures. This resulted in a fiscal deficit of 4.1% of GDP.

Most of the revenues are tax revenues (91.4%), which amount to 16% of GDP (Table 39). These taxes belong to the national level of government. Departmental and municipal taxes are collected by each of these levels of government. Within national tax collection, the income tax, which collects an amount equivalent to 6.7% of GDP, is the most important. Second in importance is the value added tax (VAT) collected at the domestic level that amounts to 4% of GDP. The collection of foreign taxes amounts to 3.7%

of GDP, among which the external VAT is the most significant (2.6% of GDP). The special funds represent a relatively small share —577 billions COP, or about 1% of GDP. Capital revenues, composed mainly of financial revenues from funds belonging to the central government and other funds administered by the General Treasury of the Nation, amount to 4,232 billion COP (7.5% of GDP).

Table 40 shows the composition of total expenditures executed during 2006. Total expenditures amounted to 69.4 billion COP, which is equivalent to 21.6% of GDP. Operating expenses make up the largest share with 49 billion COP, or 70.8% of the total. These include personnel, transfers and “other transfers.” The most important category is transfers, which includes the General Revenue Sharing System (SGP), through which resources are transferred to the regions (4.9% of GDP) and pensions are paid (4.1% of GDP). These categories represent two of the largest areas of inflexibility in the national budget, because they are protected by the constitution. A formula established by the constitution determines the amounts transferred to the SGP. This was modified in 2001 and again in 2007. On the other hand, the payment of pensions refers to the part of expenditures that must be made by the ISS which cannot be financed either with its own revenues (from the contributions of those that are part of the system), or with its reserves. The central government is obligated by the constitution to support these payments.

Another significant expenditure category is debt servicing. The total payment of interest for 2006 amounts to 4.2% of GDP, which represents 19.2% of total expenditures. The majority of these expenses, 2.9% of GDP, relate to the servicing of the domestic debt. This category is also considered as inflexible, given that it cannot be modified in the short term and depends on expenditures made in the past. Although in practice it is possible to not fulfill debt service obligations, this would have undesirable consequences for the economy, by undermining the credibility of the nation as a debtor and by making the debt more expensive to finance in the future due to the resulting increase in country risk.

### ***Classification and Quantification of Inflexible Share of Budget***

The Colombian government has little room for maneuver in preparing the budget each year given that, as mentioned before, a large number of constitutional laws and articles predetermine a high percentage of expenditures. This section focuses on the budget items fixed by laws, decrees or constitutional articles that structure public expenditures and which are not subject to the discretion of the executive branch. In current budget practice, this includes so-called “other transfers” and earmarked revenues.

In terms of the composition of public expenditures in Colombia, the sustained increase in the share of debt servicing, pensions and territorial transfers stands out. Together with personnel expenditures, these budget categories are inflexible by nature and continue to represent the largest part of the national budget. At present, the sum of these four categories adds up to 58.9 billion COP, or 85% of total expenditures.

In addition to these inflexible items, there are others for which constitutional or legal prescriptions determine their inclusion. According to the Finance Ministry, 50% of general expenditures and 67% of investment appropriations are inflexible. The inflexibilities in investment expenditures derive mainly from the commitments to future investments and special funds. Through these future commitments, part of the budget for subsequent years is committed in order to guarantee the execution or the continuity of particular investment projects. Therefore, in the strictest sense, such future commitments are equivalent to a debt.

According to Echeverry *et.al.* (2004), the inflexible percentage of the budget has remained steady in recent years at levels close to 95%, with a slight reduction in 2002 due to an increase in the inflexibility of the investment category. The most inflexible category, aside from debt servicing, is operating expenses, which include personnel expenses, transfers and general expenses.

**Table 38. Revenues and expenditures of the national central government, 2006.**

| Concept              | Billion COP | Percentage of GDP | Percentage of total revenues or expenditures |
|----------------------|-------------|-------------------|----------------------------------------------|
| Total revenues       | 56,347      | 17.6%             | 100.0%                                       |
| Current revenues     | 51,474      | 16.0%             | 91.4%                                        |
| Special funds        | 577         | 0.2%              | 1.0%                                         |
| Capital revenues     | 4,232       | 1.3%              | 7.5%                                         |
| Total expenditures   | 69,374      | 21.6%             | 100.0%                                       |
| Current expenditures | 62,427      | 19.5%             | 90.0%                                        |
| Capital expenditures | 5,898       | 1.8%              | 8.5%                                         |
| Others               | 1,049       | 0.3%              | 1.5%                                         |
| Outcome              | -13,027     | -4.1%             |                                              |

Source: Public Sector Year End, 2006, Superior Council of Fiscal Policy, Ministry of Finance, Republic of Colombia.

The next section describes four groups of inflexibilities distinguished by the way they appear within the budget: expenditure inflexibilities, revenue earmarks, extra-budgetary resources and tax expenditure or tax exemptions. Subsequently, they are classified according to the allocation of resources and the theoretical justification for their inclusion in the budget.

### ***Expenditure Inflexibility***

According to the Finance Ministry, 95% of the national budget was inflexible (Table 41). Most categories are totally inflexible, except for general expenditures and investment expenditures, whose degree of rigidity is estimated at 51% and 65%, respectively.

#### ***INVESTMENT***

In the case of investment, inflexibility is a consequence of the use of the tool of “future commitments,” through which resources of subsequent fiscal years are committed in order to guarantee the continuity of investment projects, generally in infrastructure. Future commitments in practice are equivalent to government debt,

given that they are real financial commitments. This mechanism allows part of the budget for subsequent years to be captured while avoiding a discussion about the use of the resources in the congress. Budget experts consider these resources too inflexible since they limit the government’s room for maneuver in formulating the budget.

In principle, future commitments should be restricted to the term of the current government. However, there are extraordinary future commitments that can transcend this period. This was the case of the financial rescue after the 1999 crisis. The total amount of the operation reached 6% of GDP during the crisis and the government assumed the cost through the future commitment of 13 billion COP to be paid over the following nine years. Each fiscal year these commitments are counted as investments, thus reducing the fiscal space for making expenditures within this category.

Another outstanding case of future commitments is those assumed by the central government with Bogotá D.C. for the building of Transmilenio, the mass transit system of the city. Through this mechanism, the national government covers 66% of the costs of

**Table 39. Total revenues of the national central government, 2006.**

| Concept                                     | Billion COP | Percentage of total revenues | Percentage of GDP |
|---------------------------------------------|-------------|------------------------------|-------------------|
| Total revenues                              | 56,347      | 100.0%                       | 17.6%             |
| Current revenues                            | 51,474      | 91.4%                        | 16.0%             |
| Tax revenues                                | 51,221      | 90.9%                        | 16.0%             |
| Domestic                                    | 38,139      | 67.7%                        | 11.9%             |
| Income                                      | 21,354      | 37.9%                        | 6.7%              |
| Domestic VAT                                | 12,878      | 22.9%                        | 4.0%              |
| Financial transactions                      | 2,672       | 4.7%                         | 0.8%              |
| Stamp                                       | 714         | 1.3%                         | 0.2%              |
| Assets                                      | 523         | 0.9%                         | 0.2%              |
| External                                    | 11,831      | 21.0%                        | 3.7%              |
| Tariffs                                     | 3,651       | 6.5%                         | 1.1%              |
| Foreign VAT                                 | 8,180       | 14.5%                        | 2.6%              |
| Others                                      | 1,251       | 2.2%                         | 0.4%              |
| Income other than taxes                     | 254         | 0.5%                         | 0.1%              |
| Special funds                               | 577         | 1.0%                         | 0.2%              |
| Capital resources                           | 4,232       | 7.5%                         | 1.3%              |
| Financial revenues from funds               | 476         | 0.8%                         | 0.1%              |
| Financial rendering of administrative funds | 361         | 0.6%                         | 0.1%              |
| Financial surplus                           | 3,066       | 5.4%                         | 1.0%              |
| Others                                      | 329         | 0.6%                         | 0.1%              |
| Caused income                               | 63          | 0.1%                         | 0.0%              |

Source: Public Sector Year End, 2006, Superior Council of Fiscal Policy, Ministry of Finance, Republic of Colombia.

urban infrastructure and of urban renewal and improvement. However, in this case there is the problem of incentives, given that the obligations of the national government are equivalent to a percentage of a cost total that is still uncertain. The project is scheduled to

take about 15 years to be completed and there are no pre-established designs for all the stages. Therefore, in each phase of the project a design is produced and the result of the competitive bidding process then determines the cost. Under this scheme, the city has the

**Table 40. Total expenditures of the national central government, 2006**

| Concept              | Billions COP | Percentage of total expenditures | Percentage of GDP |
|----------------------|--------------|----------------------------------|-------------------|
| Total expenditures   | 69,374       | 100.0%                           | 21.6%             |
| Current expenditures | 62,427       | 90.0%                            | 19.5%             |
| Interest             | 13,330       | 19.2%                            | 4.2%              |
| Foreign              | 3,974        | 5.7%                             | 1.2%              |
| Domestic             | 9,357        | 13.5%                            | 2.9%              |
| Operating            | 49,097       | 70.8%                            | 15.3%             |
| Personnel services   | 8,046        | 11.6%                            | 2.4%              |
| Transfers            | 37,591       | 54.2%                            | 11.7%             |
| SGP                  | 15,640       | 22.5%                            | 4.9%              |
| Pensions             | 13,169       | 19.0%                            | 4.1%              |
| Other transfers      | 8,782        | 12.7%                            | 2.7%              |
| General expenditures | 3,460        | 5.0%                             | 1.1%              |
| Investment           | 5,898        | 8.5%                             | 1.8%              |
| Net loans            | 412          | 0.6%                             | 0.1%              |
| Accrued payments     | 637          | 0.9%                             | 0.2%              |

Source: Year End of the Public Sector, 2006, Superior Council of Fiscal Policy, Ministry of Finance, Republic of Colombia.

incentive to increase the total sum of the investments in order to leverage more resources from the central government. This was the case with the infrastructure projects of phase II of Transmilenio.

#### OPERATING EXPENSES

As mentioned before, for 2006, 70.8% of total expenditures are comprised of operating expenditures, which, in turn, are composed of personnel expenses, general expenses and transfers. Transfers, which represented 54.3% of the total 2006 budget, are an inflexible category and, as such, they escape the necessary discussion about the priority of the different items of public expenditure. These are composed of the allocations made by the national government to the territorial entities

through the SGP, the state contribution to universities, pension payments, social benefits for teachers and other transfers of any nature. Although the transfers made through the SGP and the payment of benefits represent the most significant categories (4.9% and 4.1% of GDP, respectively) and represent 77% of total transfers, other transfers amount to 2.7% of GDP, which exceeds the investment budget for 2006 by 50%.

#### TERRITORIAL TRANSFERS

The inflexibility of territorial transfers is inherent to the decentralization policy put in place in the 1991 Constitution which establishes Colombia as a “social state ruled by law, under the form of a unitary, decentralized republic, with autonomous territorial entities.” The

**Table 41. Appropriations and inflexible expenditures in the 2006 budget**

| Concept                   | Appropriations<br>Millions COP | Inflexibility<br>Millions COP | Share<br>Inflex./Approp. | Share approp./<br>Budget total with<br>debt |
|---------------------------|--------------------------------|-------------------------------|--------------------------|---------------------------------------------|
|                           | (1)                            | (2)                           | (3) = (2+1)              | (3) = (2/1)                                 |
| <b>OPERATING</b>          | <b>49,274</b>                  | <b>47,712</b>                 | <b>97%</b>               | <b>50%</b>                                  |
| Personnel Expenditures    | 9,794                          | 9,794                         | 100%                     | 10%                                         |
| General expenditures      | 3,187                          | 1,625                         | 51%                      | 3%                                          |
| Transfers                 | 36,276                         | 36,276                        | 100%                     | 37%                                         |
| Commercial transaction    | 18                             | 18                            | 100%                     | 0%                                          |
| <b>DEBT SERVICE</b>       | <b>38,927</b>                  | <b>38,927</b>                 | <b>100%</b>              | <b>39%</b>                                  |
| Foreign                   | 10,618                         | 10,618                        | 100%                     | 11%                                         |
| Internal                  | 28,309                         | 28,309                        | 100%                     | 29%                                         |
| <b>INVESTMENT</b>         | <b>10,749</b>                  | <b>6,999</b>                  | <b>65%</b>               | <b>11%</b>                                  |
| <b>TOTAL WITH DEBT</b>    | <b>98,950</b>                  | <b>93,638</b>                 | <b>95%</b>               | <b>100%</b>                                 |
| <b>TOTAL WITHOUT DEBT</b> | <b>60,023</b>                  | <b>54,711</b>                 | <b>91%</b>               | <b>61%</b>                                  |

Source: Ministry of Finance.

constitutional provisions on decentralization in respect to the division of responsibilities and resources were initially developed by Law 60 of 1993, which defined the responsibilities of the municipalities and departments and the national level revenue sharing scheme, emphasizing principal social services like education, healthcare, and water and sanitation (Discussion of the justification for the Legislative Act Bill through which Articles 356 and 357 of the Constitution were modified).

In order for these services to be provided, the Constitution and Law 60 of 1993 laid out a mechanism for the participation of the territorial entities in the revenues collected at the central level. In this scheme a previously fixed proportion of current national revenues was allocated to sub-national entities so that they could pay for the expenses associated with the provision of the established services. According to the constitutional design, during the first years of the application of the

Constitution, the sub-national share (Fiscal Allocation and Municipal Participation in the Current Revenues of the Nation (Situado Fiscal y Participaciones Municipales en los Ingresos Corrientes de la Nación) was required to grow as a proportion of national current revenues. Thus, the transfers to sub-national governments constituted an inflexible category by definition.

The Fiscal Allocation (Situado Fiscal) (for departments and districts) was stipulated to increase from 23% of national revenues in 1994 to 23.5% in 1995 and 24.5% in 1996, after which this percentage was to remain constant. On the other hand, the municipalities' share of current revenues was scheduled to increase from 15% in 1994 to 22% in 2001. This scheme made any fiscal adjustment policy based on increasing revenues unviable, since this would necessarily involve a proportional increase in expenditures. In addition, it subjected departments and municipalities to a high level of volatility

in their revenues, thus putting in danger the achievement of social goals in health, education and household public services.

The Legislative Act 01 of 2001 temporarily reformed this system through the creation of the SGP. This reform temporarily stabilized the revenues oriented toward financing social investments in the territorial entities by disconnecting them from current national revenues. From an initial and higher base, a rule on the real rate of growth in the amount of the transfers was established. The rate of growth for the period between 2002 and 2008 was set at the rate of inflation plus 2% in the first four years and 2.5% in the three remaining years. However, given the fact that the reform was temporary in nature, after 2008 the system reverted to the one in force before the reform, so transfers went back to being equivalent to a percentage of current national revenues, not less than that in force in 2001.

Therefore, in 2007 the constitution was reformed again, and a new formula was created for the growth of transfers until 2016. According to the new formula, the transfers to the regions will grow 4% in real terms for 2008 and 2009, plus 1.3% allocated for the education sector exclusively. After 2010, the real growth of transfers will be 3.5% plus 1.6% for education. From 2010 until 2016, transfers will grow a total of 4.8% in real terms, of which 1.8% will be allocated to education. If the annual rate of economic growth exceeds 4%, the surplus is added to the rate of growth in transfers for the following year.

Thus, the growth of transfers to the regions is determined by the constitution until 2016; before the end of this period a new reform will be necessary. No matter what formula is used to determine the amount of transfers, these will remain an inflexible category by nature and protected by the constitution. Thus, some observers argue that decentralization has been restricted to the transfer of resources to the regions, while the principal expenditure responsibilities remain with the national government, thus increasing the inflexibilities in the spending of the central government. However, a detailed assessment of the effects of decentralization goes beyond the scope of this paper.

#### PENSION EXPENDITURES

In accordance with the aforementioned, another completely inflexible expenditure category, which is part of transfers, is pension payments. As mentioned before, this category increased to 4.1% of GDP in 2006 and is expected to grow continuously until it reaches a level of 4.8% of GDP between 2011 and 2014. This category represents the transfers made by the central government to the ISS, which is responsible for the management of the public pension system. This is a defined benefit pensions system (Pay as You Go), non-financed by definition. For many years now, the ISS pension payment has surpassed the contribution of taxpayers. Therefore, for many years the ISS has had to make up for the shortfall by using its stock of reserves. However, this stock ran out in 2004, which is why in 2005 expenditures on pension allowances jumped from 3.5% to 4.4% of GDP. In addition, every year, by law, the government has to save in the Territorial Pension Fund (FonPet). In 2006, the amount of this saving increased to 0.5% of GDP.

In both cases, the aim of budget inflexibility is to put aside resources to guarantee the timely payment of pensions. According to article 48 of the Colombian constitution,

*Social Security is a public service of a mandatory nature that shall be provided under the direction, coordination and control of the state, pursuant to principles of efficiency, universality and solidarity, in the terms established by law. The right to Social Security is an inalienable right of all citizens. The state, with the collaboration of the particular individuals, will progressively broaden the coverage of Social Security that will include the provision of services in the form determined by Law. Either public or private entities will provide Social Security in accordance with the law. No resources from Social Security institutions shall be used or allocated for any other purposes. Law will define the means to ensure that resources allocated for pensions will maintain their purchasing power.*

Likewise, according to Article 53 of the Constitution, "The State guarantees the right to timely payment and to periodical adjustments of the legal pensions."

In addition, Article 58 establishes that private property and the rest of the rights acquired pursuant to civil laws are guaranteed, and no subsequent laws shall ignore or violate them.”

Therefore, given that it is a constitutionally protected and acquired right, the government is obligated to finance the shortage faced by the ISS to fulfill the timely payment of pensions. As mentioned before, this implies allocating a high percentage of current tax collection to transfer resources to a small share of the population that benefited from burdensome pension contracts, for which the benefits were out of proportion to the contributions. Thus, pension expenditures constitute an intergenerational transfer, in which the current working population is obliged to pay with their taxes the pensions of the retired population. Pension expenditures then are the result of an intergenerational conflict, in which elder generations obtain a benefit at the expense of younger generations.

Colombian pension liabilities currently amount to 130% of GDP. The finance minister is responsible for determining how to pay that liability: through higher taxes or a higher fiscal deficit, and, therefore, through larger indebtedness. The balance between these two alternatives determines whether current or future generations will pay for most of the pension liability. The Colombian government has opted for the first alternative, so the fiscal deficit of the central government has decreased in spite of the substantial increase in pension payments. This implies that a great deal of the increase in tax revenue collection associated with the recent economic expansion has been allocated to the payment of pensions.

“Other transfers”, which are composed of a great number of budget items allocated to a large variety of sectors, is the category that follows in significance within total transfers. It is worth underlining that this amount of transfers detracts from the transparency of the budget process, given that it makes it difficult to determine the amount of resources that are allocated for different social purposes. This is why it is impor-

tant to classify, generally, which sectors are allocated resources via transfers. To that end, Table 42 classifies total transfers into the following categories: territorial transfers, social security and insurance, education and sports, control and justice, transfers to the finance ministry, defense sector, finance sector, social transfers, fuel and infrastructure transfers, and “others”.

45% of total transfers is allocated to the regions through the SGP and another 44% is allocated to the social security sector. Within the latter, the most important category, naturally, is the payment of pensions. Education, which in 2006 received transfers amounting to 1.4 billion COP, follows these two categories in importance. The amount of resources allocated to education is even higher considering that 58.5% of territorial transfers must be allocated to that sector. In 2006, the resources transferred to the education sector through the SGP amounted to 9.2 billion COP. One of the most important categories within education expenditures is the payment of salaries to teachers, which to a large extent determines the regional distribution of the SGP education resources. The historical distribution of teachers follows patterns defined by criteria such as political power and the teachers’ desire to live in capital cities instead of inhospitable and violent places. Despite the government’s intention for the transfer of resources to be proportional to the population served, according to Alejandro Gaviria, these efforts have been unsuccessful.

Another significant item within transfers is military expenditure, which amounts to 570 billion COP. This category does not capture all of military spending since the government classifies a large part of it as investment. In 2006, the total budget of the defense sector amounted to 12.9 million COP. Military investment has grown significantly in recent years due to its strategic importance for the Uribe administration. In particular, investment on defense and security is projected to rise about 0.6% of GDP per year in the next two years, because of an assets tax that is aimed at strengthening the armed forces.

A large portion of the inflexibilities associated with defense spending derives from the inertial component associated with expanding the number of persons in the force. Usually, the hiring of soldiers or police is calculated and budgeted for the fiscal year, but the eventual costs for pensions and health care that will affect future budgets on an ongoing basis are not included.

Another significant component of transfers is the resources allocated to the control and justice sector. The transfers in this sector amount to 566 billion COP in 2006.

#### INCOME INFLEXIBILITIES

The inflexibilities based in revenues are due to rules that allocate part of national revenues to a specific use. Those that stand out include the resources that must be allocated to the National Royalty Fund, the share of the VAT that goes to the departments created by the 1991 constitution (formerly municipalities and provinces), and the resources allocated to teaching and the building of industrial schools and technical institutes.

Most of the revenues with a predetermined purpose were created in the 1990s. This supports the hypothesis that was previously introduced that inflexibilities fulfill the role of capturing income in order to ensure public resources in the future and prevent these from being cut either because of new government expenditure priorities or requirements to limit spending. As mentioned previously, former Minister of Finance Eduardo Wiesner, pointed out that while such interests seem legitimate when considered individually it is necessary to design policies from a broader perspective to ensure that their long term impact on the fiscal balance is taken into account.

During the nineties, because of a higher degree of political participation and polarization, the emergence of fiscal difficulties and the adoption of reforms that favored some social groups over others, the importance for particular groups of ensuring their participation in the budget may have grown (Echeverry *et al.*, 2004).

The sectoral composition in the use of these earmarked revenues reveals that the most important beneficiaries are public institutions, social security and military spending. Expenditure inflexibilities increase the amounts allocated to these sectors.

Table 43 shows a list made by the National Budget Directorate of the expenses financed with earmarked revenues and the law that specified the purpose to which the revenues were to be directed. As Table 43 shows, the main source of earmarked revenues used for financing operating expenses is the General Revenue Sharing System (16.32 billion COP). Although this was classified above as an expenditure inflexibility, it should be taken into account that this expenditure is associated with particular revenues that have been captured to cover them. In 1996, these revenues represented 24.5% of national revenue. At present, although they do not represent a set percentage of national revenues, as explained above, they have increased through a formula based on the amount transferred in 2001. Therefore, some observers consider that the resources transferred through the SGP also represent a form of revenue earmarking.

Within operating expenses, the resources allocated to the Territorial Pension Funds also stand out. According to Law 549 of 1999, 70% of the revenues from the national stamp tax imposed on public and private documents must be saved in the FonPet to cover pension liabilities of the territorial entities. In 2006 this amounted to 426 billion COP and represents a forced saving which the national government has to make in order to guarantee the pension payments at the national level.

Relatively few revenue earmarks apply to investment. By 2006, they amounted to 297 million COP. Within these, the revenue allocated to financing social investment stands out. According to Law 633 of 2000, 20% of the additional points in the VAT over the general tariff of 16% must be allocated to social investment. By 2006 this represented resources estimated at 146.2 billion COP.

Table 42. List and classification of transfers, 2000-2006

| Billion pesos                                                     | 2000             | 2001             | 2002             | 2003             | 2004             | 2005             | 2006             |
|-------------------------------------------------------------------|------------------|------------------|------------------|------------------|------------------|------------------|------------------|
| <b>1. TRANSFERS</b>                                               | <b>16,964.13</b> | <b>19,267.22</b> | <b>22,025.51</b> | <b>22,717.64</b> | <b>28,288.78</b> | <b>33,335.00</b> | <b>36,275.54</b> |
| <b>1.1 Territorial</b>                                            | <b>9,155.89</b>  | <b>10,227.60</b> | <b>11,459.64</b> | <b>12,927.69</b> | <b>14,207.31</b> | <b>15,292.67</b> | <b>16,357.73</b> |
| 1.1.1 Territorial transfers                                       | 9,012.08         | 10,120.57        | 11,435.84        | 12,901.30        | 14,170           | 15,249           | 16,308           |
| 1.1.2 VAT share older provinces and municipalities                | 18.58            | 21.70            | 23.80            | 26.39            | 37               | 44               | 50               |
| 1.1.3 Loans to territorial entities                               | 98.61            | 80.32            |                  |                  |                  |                  |                  |
| 1.1.4 Tax revenue compensation coffee growing areas               | 26.61            | 5.00             |                  |                  |                  |                  |                  |
| <b>1.2 Social Security and Insurance</b>                          | <b>5,284.98</b>  | <b>6,636.47</b>  | <b>8,153.97</b>  | <b>7,574.59</b>  | <b>10,819</b>    | <b>14,554</b>    | <b>15,901</b>    |
| 1.2.1 Pensions                                                    | 3,732.27         | 4,564.64         | 5,320.56         | 6,062.83         | 9,025            | 12,281           | 13,770           |
| 1.2.2 Social Benefits for Teachers                                | 759.55           | 1,265.88         | 854.01           | 690.93           | 593              | 664              | 626              |
| 1.2.3 Territorial pension fund                                    | 322.54           | 252.95           | 837.43           | 224.99           | 210              | 527              | 426              |
| 1.2.4 Social benefits and military medical services               |                  |                  | 207.80           | 212.46           | 262              | 278              | 310              |
| 1.2.5 Unemployment compensation                                   | 156.60           | 210.34           | 189.20           | 136.68           | 429              | 297              | 294              |
| 1.2.6 Medical service railroad and ports                          | 47.77            | 52.63            | 55.63            | 52.18            | 55               | 53               | 54               |
| 1.2.7 Social services health sector                               | 199.01           | 51.79            | 50.37            | 50.39            | 53               | 56               | 104              |
| 1.2.8 Severance fund for professional soldiers                    |                  |                  | 46.00            | 47.09            |                  | 81               | 22               |
| 1.2.9 Public service vehicle insurance                            |                  | 30.00            | 37.97            | 40.00            |                  |                  |                  |
| 1.2.10 Subsidy for nurses caring for leprosy                      | 25.00            |                  | 14.54            | 14.59            | 17               | 18               | 19               |
| 1.2.11 Life insurance                                             |                  |                  | 10.60            | 12.17            | 11               | 9                | 13               |
| 1.2.12 Professional risk insurance                                |                  |                  | 12.64            | 10.35            | 10               | 10               | 8                |
| 1.2.13 Health system in prison system                             | 5.08             | 5.92             | 6.46             | 7.30             | 10               | 13               | 13               |
| 1.2.14 Pension fund for professional soldiers                     |                  |                  | 0.07             | 5.89             |                  |                  |                  |
| 1.2.15 Unemployment insurance for home debtors of social interest |                  |                  | 8.20             | 5.20             |                  |                  |                  |
| 1.2.16 Health support programs                                    | 37.16            | 202.33           | 2.47             | 1.55             | 0                | 3                | 3                |
| 1.2.17 Loans to decentralized entities                            |                  |                  | 500.00           |                  | 144              | 266              | 241              |
| <b>1.3 Education and sports</b>                                   | <b>1,046</b>     | <b>1,195</b>     | <b>1,245</b>     | <b>1,327</b>     | <b>1,315</b>     | <b>1,372</b>     | <b>1,455</b>     |
| 1.3.1 Universities                                                | 981.73           | 1,122.16         | 1,192.17         | 1,271.09         | 1,315            | 1,372            | 1,455            |
| 1.3.2 Technical institutes                                        | 64.53            | 72.41            | 53.00            | 55.65            |                  |                  |                  |
| 1.3.3 Loans paid to sub-national teachers                         |                  |                  |                  |                  |                  |                  |                  |
| <b>1.4 Control and Justice</b>                                    | <b>286</b>       | <b>304</b>       | <b>330</b>       | <b>245</b>       | <b>445</b>       | <b>599</b>       | <b>566</b>       |
| 1.4.1 Inpec. food for prisoners                                   | 55.19            | 65.69            | 68.69            | 64.48            | 92               | 117              | 125              |
| 1.4.2 Sentences and settlements                                   | 175.37           | 158.32           | 146.27           | 59.80            | 174              | 284              | 231              |
| 1.4.3 Protection for persons whose lives are threatened           | 3.77             | 23.04            | 29.20            | 29.00            | 31               | 48               | 50               |
| 1.4.4 Public defense                                              |                  |                  | 19.89            | 17.90            | 19               | 31               | 36               |
| 1.4.5 Audit allowance                                             | 52.05            | 56.48            | 65.70            | 57.00            | 119              | 108              | 114              |
| 1.4.6 Guarantee rights of prisoners                               |                  |                  |                  | 16.50            | 10               | 10               | 10               |

| Billion pesos                                                   | 2000   | 2001   | 2002   | 2003  | 2004 | 2005 | 2006  |
|-----------------------------------------------------------------|--------|--------|--------|-------|------|------|-------|
| <b>1.5 Finance Ministry</b>                                     |        |        |        |       |      |      |       |
| 1.5.1 Mixed accounts Finance Ministry                           | 124    | 97     | 123    | 206   | 72   | 154  | 169   |
| 1.5.2 Provision for wage increase adjustment                    | 15.00  | 14.18  | 6.57   | 78.36 | 42   | 82   | 120   |
| 1.5.3 Modernization of state programs (Finance and Others)      | 59.57  | 16.32  | 58.60  | 77.60 |      |      |       |
| 1.5.4 Inter-ministerial Fund                                    | 48.25  | 19.16  | 51.18  | 40.26 | 22   | 71   | 23    |
| 1.5.5 Public bank finance                                       | 1.19   | 9.00   | 6.50   | 10.00 | 8    | 1    | 26    |
|                                                                 |        | 38.42  |        |       |      |      |       |
| <b>1.6 Military</b>                                             |        |        |        |       |      |      |       |
| 1.6.1 Transfer to Central Military Hospital                     | 119    | 142    | 145    | 156   | 272  | 410  | 570   |
| 1.6.2 Solidarity Fund for Health, Defense and Police            | 76.84  | 89.39  | 84.46  | 91.25 | 105  | 108  | 113   |
| 1.6.3 Reintegration to civilian life Program                    | 21.73  | 30.87  | 29.79  | 32.43 | 38   | 41   | 43    |
| 1.6.4 Special peace programs Fund                               | 20.71  | 22.21  | 23.95  | 23.60 | 56   | 74   | 98    |
| 1.6.5 Demobilization program                                    |        |        | 7.24   | 9.04  | 32   | 45   | 109   |
| 1.6.6 National Fund of Security and Social Peace                |        |        |        |       | 21   | 122  | 185   |
|                                                                 |        |        |        |       | 20   | 21   | 22    |
| <b>1.7 Others</b>                                               |        |        |        |       |      |      |       |
| 1.7.1 Rest of national government transfers                     | 647    | 548    | 528    | 124   | 801  | 732  | 1,030 |
| 1.7.2 Funding for political parties and election campaigns      | 237.02 | 381.34 | 60.40  | 75.10 | 765  | 634  | 814   |
| 1.7.3 International organizations                               | 23.59  | 6.91   | 47.11  | 29.16 | 34   | 24   | 145   |
| 1.7.4 Mechanisms for foreign trade promotion                    | 118.35 | 97.81  | 107.37 | 16.06 |      |      |       |
| 1.7.5 Direct campaigns contributions                            | 250.90 | 60.00  | 301.82 | 3.53  | 2    | 74   | 70    |
| 1.7.6 Cooperative guarantees fund (seed capital)                |        |        |        | 0.43  |      |      |       |
| 1.7.7 Financing                                                 |        |        | 11.63  |       |      |      |       |
| 1.7.8 Tourist development certificates                          | 17.47  | 1.71   |        |       |      |      |       |
| <b>1.8 Financial</b>                                            |        |        |        |       |      |      |       |
| 1.8.1 International Financial Organizations Fund (FOFI)         | 261.3  | 78.2   | 0.4    | 121.3 | 312  | 151  | 165   |
| 1.8.2 Mortgage portfolio                                        | 210.00 | 67.79  | 0.38   | 68.32 | 143  | 111  | 118   |
| 1.8.3 Two for a Thousand Resources (FOGAFIN, FOGACOOP, FOSADEC) | 50.80  | 10.00  |        | 52.95 | 130  | 41   | 47    |
| 1.8.4 Savers and Depositors Solidarity Fund                     | 0.47   | 0.42   |        |       |      |      |       |
| 1.8.5 Contributions FOGAFIN                                     |        |        |        |       | 40   |      |       |
| <b>1.9 Social</b>                                               |        |        |        |       |      |      |       |
| 1.9.1 Agriculture and livestock Development Programs            | 41.74  | 39.33  | 39.98  | 34.94 | 45   | 71   | 61    |
| 1.9.2 Disaster and emergency assistance. National Disaster Fund | 36.74  | 35.83  | 37.33  | 30.83 | 32   | 48   | 37    |
|                                                                 | 5.00   | 3.50   | 2.65   | 4.11  | 13   | 22   | 24    |
| <b>1.10 Social</b>                                              |        |        |        |       |      |      |       |
| 1.10.1 Energy provision for those areas outside of the grid     |        | 0.18   |        | 0.92  |      |      |       |
|                                                                 |        | 0.18   |        | 0.92  |      |      |       |

Source: Finance Ministry, sectoral classification by the authors.

Table 43. Budget inflexibilities due to earmarked revenues 1998-2006 (continues)

| Expense concept                                                                                                                                      | Annual cost (billion pesos) |         |         |          |          |          |          |          |          | Source of revenue                                                                                                                                                                                       |
|------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------|---------|---------|----------|----------|----------|----------|----------|----------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|                                                                                                                                                      | 1998                        | 1999    | 2000    | 2001     | 2002     | 2003     | 2004     | 2005     | 2006     |                                                                                                                                                                                                         |
| <b>A. OPERATING</b>                                                                                                                                  |                             |         |         |          |          |          |          |          |          |                                                                                                                                                                                                         |
| 1. Democratic security expenses. Extraordinary Decree 1838/2002                                                                                      |                             |         |         |          | 376.0    | 1,097.2  | 145.2    | 139.8    | 0.0      | Tax imposed on assets greater than 1 69 million COP, one time at a 1.2% rate.                                                                                                                           |
| 2. FonPet (National Stamp Tax, 70%) Law 549/1999                                                                                                     |                             |         |         | 157.3    | 108.7    | 182.0    | 210.9    | 528.2    | 426.0    | Tax on National Stamps on public instruments and private documents at 1.5% rate.                                                                                                                        |
| 3. Expenditure associated with Reserve tax (Frech) 1/ Law 546/ 2000                                                                                  |                             |         | 210.0   | 67.8     | 0.383    | 52.9     | 129.8    | 40.8     | 47.3     | Tax over Bank Reserve Revenue. In 2000 it includes 159 billion COP of Bank of the Republic's surpluses.                                                                                                 |
| 4. New departments created with 1991 constitution. Law 12/86                                                                                         | 15.4                        | 17.3    | 18.6    | 21.7     | 23.8     | 26.3     | 37.2     | 43.9     | 49.6     | 0.5% of VAT. General tariff of 16%.                                                                                                                                                                     |
| 5. Department of San Andrés and Providencia Archipelago and Santa Catalina Law 1/72                                                                  | 9.7                         | 4.4     | 6.1     | 10.0     | 12.0     | 12.1     | 14.4     | 9.4      | 12.2     | National taxes collected in San Andrés and Providencia Archipela allocated to these departments.                                                                                                        |
| 6. Expenses associated with the Tax on Gold and Platinum Tax; its revenues are allocated to municipalities that produce these metals. Decree 2173/92 | 1.8                         | 3.3     | 2.6     | 2.1      | 3.9      | 3.1      | 3.4      | 4.1      | 3.6      | Tariff of 4% and 5%, respectively, on the price paid by traders.                                                                                                                                        |
| 7. Territorial transfers                                                                                                                             | 6,697.9                     | 8,050.4 | 8,589.2 | 10,120.6 |          | 10.0     | 50.0     | 388.7    |          |                                                                                                                                                                                                         |
| Share of current national revenues                                                                                                                   | 2,593.0                     | 3,053.9 | 3,570.7 | 3,641.7  |          | 10.0     | 50.0     | 388.7    |          | 15% of current national revenues (ICN) in 1994, increases 1% per year up to 22% of ICN in 2001. Through Legislative Act 01 of 2001 is included in the General Revenue Sharing System (SGP) in 2002.     |
| Transfer payments                                                                                                                                    | 3,382.0                     | 4,496.5 | 4,197.4 | 5,576.2  |          |          |          |          |          | 23% of ICN in 1994, 23.5% of ICN in 1995, 24.5% of ICN in 1996. By Legislative Act 01 of 2001 is included in SGP in 2002.                                                                               |
| Education compensation fund                                                                                                                          | 722.9                       | 500.0   | 821.1   | 902.7    |          |          |          |          |          | Complementary transfer for covering the deficiencies in the allocation to education relative to costs.                                                                                                  |
| 8. General Revenue Sharing System                                                                                                                    |                             |         |         |          | 11,018.2 | 12,901.3 | 14,170.1 | 15,248.7 | 16,329.0 | Legislative Act 01 of 2001 and Law 715 of 2001. From 10 962 billion COP in 2001 it increases at a rate of 2% above annual inflation rate until 2005 and 2.5% between 2006 and 2008 (transition period). |
| Operating subtotal                                                                                                                                   | 6,724.7                     | 8,075.4 | 8,826.5 | 10,379.4 | 11,543.0 | 14,284.9 | 14,761.0 | 16,403.6 | 16,867.7 |                                                                                                                                                                                                         |

Tax imposed on assets greater than 169 million COP, one time at a 1.2% rate.

Tax on National Stamps on public instruments and private documents at 1.5% rate.

Tax over Bank Reserve Revenue. In 2000 it includes 159 billion COP of Bank of the Republic's surpluses.

0.5% of VAT. General tariff of 16%.

National taxes collected in San Andrés and Providencia Archipela allocated to these departments.

Tariff of 4% and 5%, respectively, on the price paid by traders.

15% of current national revenues (ICN) in 1994, increases 1% per year up to 22% of ICN in 2001. Through Legislative Act 01 of 2001 is included in the General Revenue Sharing System (SGP) in 2002.

23% of ICN in 1994, 23.5% of ICN in 1995, 24.5% of ICN in 1996. By Legislative Act 01 of 2001 is included in SGP in 2002.

Complementary transfer for covering the deficiencies in the allocation to education relative to costs.

Legislative Act 01 of 2001 and Law 715 of 2001. From 10,962 billion COP in 2001 it increases at a rate of 2% above annual inflation rate until 2005 and 2.5% between 2006 and 2008 (transition period).

| Expense concept                                                                                                                       | Annual cost (billion pesos) |       |       |         |       |       |         |       |         | Source of revenue                                                                                                                                                                       |
|---------------------------------------------------------------------------------------------------------------------------------------|-----------------------------|-------|-------|---------|-------|-------|---------|-------|---------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|                                                                                                                                       | 1998                        | 1999  | 2000  | 2001    | 2002  | 2003  | 2004    | 2005  | 2006    |                                                                                                                                                                                         |
| <b>B. INVESTMENT</b>                                                                                                                  |                             |       |       |         |       |       |         |       |         |                                                                                                                                                                                         |
| 1. Expenses associated with Democratic Security                                                                                       |                             |       |       |         | 270.1 | 324.0 | 258.0   | 0.0   | 0.0     | Tax imposed on assets greater than 169 million COP, at 1.2% applied just once.                                                                                                          |
| 2. Social investment programs (20% of the percentage of VAT above 16%) Law 633/00. Section 113                                        |                             |       |       | 87.2    | 74.9  | 90.9  | 117.6   | 135.3 | 146.2   | 20% of the additional percentage point applied to VAT. General tariff of 16%.                                                                                                           |
| 3. Prevention and assistance for displaced persons (10% of the additional percentage point applied to the VAT) Law 633/00 Section 108 |                             |       |       | 43.6    | 10.5  | 20.4  | 58.8    | 67.7  | 73.1    | 10% of the additional percentage point applied to the VAT. General tariff of 16%.                                                                                                       |
| 4. VAT to TMC (Section 35 Law 788/02)                                                                                                 |                             |       |       |         |       |       |         |       |         | 4% additional VAT rate applied to cellular phones (from 16% to 20%).                                                                                                                    |
| Liquidation Sectoral Plan Recreation and Sports                                                                                       |                             |       |       |         |       | 16.0  | 50.0    | 21.8  | 35.9    |                                                                                                                                                                                         |
| Program in departments and the Capital District                                                                                       |                             |       |       |         |       | 10.0  | 14.0    | 7.3   | 12.0    |                                                                                                                                                                                         |
| 5. Development Fund for Guajira, Law 677/2001                                                                                         |                             |       |       |         | 11.6  | 0.0   | 14.1    | 12.0  | 12.5    | Goods imports to the Special Customs Regime Zone for Macicao, Uriibia and Manaure subject only to the payment of the tax on the entry of goods at a rate of 10% as of December of 2002. |
| 6. Universities                                                                                                                       |                             |       |       |         |       |       | 40.9    |       |         | Law 30 of 1992. Increases contributions of the national government to public universities as of 1993.                                                                                   |
| 7. Science and Technology                                                                                                             |                             |       |       |         |       |       | 4.4     |       |         | Law 29 of 1990. The government provides resources to promote Science and Technology.                                                                                                    |
| Subtotal investment                                                                                                                   | 13.0                        | 16.5  | 9.8   | 148.9   | 373.0 | 462.1 | 513.0   | 244.0 | 279.7   |                                                                                                                                                                                         |
| <b>C. SPECIAL FUNDS</b>                                                                                                               |                             |       |       |         |       |       |         |       |         |                                                                                                                                                                                         |
| 1. Funds for Social Benefits for teachers. Law 91/ 89                                                                                 | 742.8                       | 557.7 | 759.5 | 1,045.6 | 373.5 | 823.5 | 483.3   | 539.1 | 598.9   | Teachers income fund.                                                                                                                                                                   |
| 2. National Royalties Fund. Section 361 Law 141/ 94                                                                                   | 79.5                        | 407.2 | 453.0 | 1,023.5 | 771.7 | 333.0 | 258.5   | 175.4 | 315.2   | Specific allocation of all the royalties for the exploitation of natural non-renewable resources.                                                                                       |
| 3. Subaccount Solidarity and Health Guarantee, Law 100/ 93                                                                            | 718.2                       | 702.4 | 576.1 | 771.0   | 689.2 | 591.8 | 1,001.4 | 969.3 | 1,419.9 | An additional percentage point on the social security tariff in Health.                                                                                                                 |

| Expense concept                                                               | Annual cost (billion pesos) |       |       |       |       |       |       |       |       |                                                                                                                                                                            | Source of revenue |
|-------------------------------------------------------------------------------|-----------------------------|-------|-------|-------|-------|-------|-------|-------|-------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------|
|                                                                               | 1998                        | 1999  | 2000  | 2001  | 2002  | 2003  | 2004  | 2005  | 2006  |                                                                                                                                                                            |                   |
| 4. Military Health Fund, Law 352/97                                           | 113.5                       | 128.4 | 155.1 | 196.4 | 201.3 | 220.9 | 246.6 | 269.4 | 299.2 | Contributions to the Social Security in Health of the armed forces.                                                                                                        |                   |
| 5. Police Health Fund, Law 352/97                                             | 134.3                       | 168.0 | 165.6 | 193.3 | 198.2 | 218.4 | 263.4 | 275.7 | 307.0 | Contributions to the Health Social Security of the police.                                                                                                                 |                   |
| 6. Citizen Security and Coexistence Fund, Law 418/97                          |                             | 20.0  | 16.0  | 33.0  | 21.3  | 42.8  | 26.9  | 24.2  | 51.5  | Contribution of 5% by natural and legal persons contracted to work on public works with public rights entities.                                                            |                   |
| 7. Pension Solidarity Fund, Law 100/93                                        | 96.1                        | 150.3 | 150.0 | 153.8 | 160.0 | 169.6 | 191.4 | 218.0 | 249.0 | Additional contribution of one point to the general pension regime rate.                                                                                                   |                   |
| 8. General Comptroller Office of the Republic. Law 106/93                     | 104.5                       | 120.8 | 129.6 | 134.2 | 143.6 | 145.2 | 155.4 | 176.1 | 190.2 | Audit quota to entities audited by the General Comptroller Office of the Republic.                                                                                         |                   |
| 9. Justice Sector Financing Law 86/93; Law 55/85; Law 6/92                    | 70.1                        | 91.8  | 85.1  | 117.4 | 104.1 | 86.4  | 135.3 | 142.2 | 168.6 | Part of the rights for registration of public debt instruments, plus finance returns on judicial deposits after drawing reserves and 10% of Notary's offices gross income. |                   |
| 10. Internal Funds Defense Department, Decree 2350/71                         | 92.6                        | 97.8  | 112.7 | 136.0 | 127.2 | 141.5 | 181.0 | 133.3 | 188.2 | Revenue from teacher promotion of the Military University, from inter-administrative contracts with EcoPetrol and others.                                                  |                   |
| 11. Internal Funds National Police, Decree 3250/71                            | 35.5                        | 40.7  | 65.5  | 93.0  | 77.8  | 74.6  | 84.8  | 84.6  | 93.9  | Leasing, alarm systems contracts, sales of documents for contracts, and security service contracts.                                                                        |                   |
| 12. Industrial Schools and technical Institutes Law 21/82                     | 33.6                        | 44.2  | 64,5  | 72.4  | 53.0  | 85.7  | 53.0  | 82.4  | 60.0  | Transfers from the national government, the departments, districts and the municipalities of 1% of the respective payrolls.                                                |                   |
| 13. Surcharge to ACPM Fund Law 488/98                                         |                             | 28.0  |       | 54.0  | 51.0  | 30.9  | 47.7  | 58.0  | 262.6 | 3% of the surcharge to ACPM.                                                                                                                                               |                   |
| 14. Electricity Sector Solidarity Fund                                        | 25.0                        | 20.0  | 31.9  | 35.1  | 89.2  | 36.5  | 124.1 | 60.2  | 85.2  | Surplus of solidarity contributions for subsidies liquidated by the entities providing public services.                                                                    |                   |
| 15. Funds for Financial Support to zones not connected to the grid Law 142/94 |                             |       |       | 40.0  | 15.0  | 16.8  | 50.5  | 63.4  | 29.5  | 1 COP for every kilowatt/hour dispatched in the energy exchange , collected by the manager of the trade exchange system.                                                   |                   |
| 16. Super contribution Industry and Trade Decree 297/68                       | 9.8                         | 13.1  | 18.1  | 19.7  | 22.7  | 23.0  | 22.0  | 22.4  | 23.7  | Collection for procedures related to registration of trademarks, patents, extensions, tariffs in carrying out functions.                                                   |                   |

| Expense concept                                                            | Annual cost (billion pesos) |      |      |      |      |      |      |      |      | Source of revenue                                                                                                                |
|----------------------------------------------------------------------------|-----------------------------|------|------|------|------|------|------|------|------|----------------------------------------------------------------------------------------------------------------------------------|
|                                                                            | 1998                        | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 |                                                                                                                                  |
| 17. Fund of Environmental Compensation Law                                 | 13.4                        | 13.0 | 17.0 | 21.2 | 17.4 | 9.0  | 15.0 | 25.0 | 23.3 | Revenues from 20% of the resources collected by the Autonomous Corporations except of those of development.                      |
| 18. Fund for National Defense Law 1/45 and Law 20/79, Law 48/93            | 20.4                        | 33.0 | 31.6 | 45.8 | 43.3 | 49.9 | 61.6 | 46.6 | 54.6 | Military compensation quota paid by those who do not serve in the military.                                                      |
| 19. CVC PensionsDecree Law 1275/94                                         | 9.2                         | 11.0 | 11.9 | 13.1 | 13.8 | 14.9 | 15.7 | 16.8 | 17.5 | Product of the sale of assets of the national government to EPSA.                                                                |
| 20. General Directorate of Foreign Trade Decree 2553/99                    |                             |      |      |      | 12.2 | 10.9 | 12.9 | 12.0 | 12.5 | Income from sale of databases, publications, forms.                                                                              |
| 21. Professional Risk Fund (Sect. 87 Dec 1295/94 Law 100/93                | 5.8                         | 7.0  | 16.7 | 19.0 | 12.7 | 10.3 | 10.0 | 10.5 | 8.0  | 1% of the amount collected for bills charged to employers of professional risk insurance companies.                              |
| 22. Fund for Research in Health Section 335 CP and Law 643/2001            |                             |      |      | 7.0  | 7.0  | 7.0  | 21.0 | 6.0  | 21.0 | Percentage of resources from the monopoly on gambling and games of chance.                                                       |
| 23. Funds of Superintendent's Office Pensions (FOPEP) Decree 3116/97       |                             | 1.2  | 5.5  | 5.8  | 6.3  | 6.9  | 21.5 | 10.3 | 11.0 | Superintendent's office resources transferred to FODEP to pay pension duties of former officers.                                 |
| 24. Energy and Gas Regulation Commission Law 142/94                        | 3.7                         | 4.1  | 3.8  | 6.0  | 8.1  | 6.6  | 6.4  | 7.9  | 9.1  | Contribution of audited entities.                                                                                                |
| 25. Super National Contribution of Securities Law 32/79                    | 1.5                         | 1.5  | 4.0  | 4.3  | 5.3  | 13.0 | 14.5 | 13.3 | 16.4 | Rights for the Registration in the National Registry of Securities and Rights to bid for public works.                           |
| 26. Fund for Comptroller Finances Law 106/93                               | 6.8                         | 2.4  | 2.3  | 2.4  | 11.3 | 12.1 | 10.9 | 0.1  | 0.2  | The revenues of the Fund come from the partial and definitive suspension of employees of the Comptroller Office of the Republic. |
| 27. Commission for the Regulation of Drinking Water Law 142/96             | 2.5                         | 3.0  | 3.1  | 3.9  | 3.8  | 4.3  | 4.8  | 6.6  | 12.0 | Contribution of the audited entities.                                                                                            |
| 28. Fund for the defense of the collective rights and interests Law 472/98 |                             | 0.2  | 0.0  | 0.0  | 6.2  | 5.0  | 5.0  | 5.0  | 5.0  | Donations by private organizations that manage public resources, compensations for popular group actions and others.             |
| 29. Super contribution Harbor Law 1/91                                     | 12.8                        | 19.8 | 18.2 | 8.5  | 7.4  | 4.4  | 8.1  | 2.6  | 3.0  | Surveillance rates charged by the Superintendence of Harbors to the Port operators.                                              |
| 30. Commission for Telecommunications Regulation Law 142/94                | 4.3                         | 6.2  | 5.4  | 6.1  | 5.8  | 4.0  | 4.9  | 5.9  | 6.7  | Commission of the entities subject to their control.                                                                             |

| Expense concept                                                                       | Annual cost (billion pesos) |       |       |      |      |      |       |       |       | Source of revenue                                                                                                                                                                |
|---------------------------------------------------------------------------------------|-----------------------------|-------|-------|------|------|------|-------|-------|-------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|                                                                                       | 1998                        | 1999  | 2000  | 2001 | 2002 | 2003 | 2004  | 2005  | 2006  |                                                                                                                                                                                  |
| 31. Funds of Narcotics                                                                | 2.1                         | 3.1   | 3.1   | 3.1  | 3.5  | 4.0  | 4.2   | 4.4   | 5.0   | The resources of the Fund come from the sale of medicine and the import of raw materials of special control.                                                                     |
| 32. Super Contribution Family Subsidy Law 21/81                                       | 3.1                         | 4.2   | 3.4   | 3.7  | 3.9  | 3.4  | 4.4   | 4.7   | 9.0   | Contribution from the Family Compensation Account. 5% of the resources that the departments collect from the surcharge on gasoline.                                              |
| 33. Subsidy fund from the surcharge on gasoline Law 488/99                            |                             | 4.1   | 0.0   | 3.5  | 3.2  | 12.3 | 3.3   | 3.4   | 12.6  | Registration quota public accountants have to pay to practice as professionals.                                                                                                  |
| 34. Central Board of Accountants Law 43/90                                            | 0.7                         | 0.3   | 1.2   | 1.6  | 1.6  | 1.7  | 1.5   | 1.5   | 1.6   | Fees and other items paid by students.                                                                                                                                           |
| 35. Institute of Studies of the Public Prosecutor's Office Law 201/95; Law 223/95     | 0.8                         | 0.8   | 1.2   | 1.3  | 1.8  | 1.3  | 1.9   | 2.0   | 2.4   | Income from the issuance of Professional registration card, certificates and proofs.                                                                                             |
| 36. National Professional Council of Engineering and Related Professions. Law 435/98  |                             | 0.0   | 1.1   | 1.1  | 1.1  | 1.2  | 1.2   |       |       | Income from cultural activities and events related to museums.                                                                                                                   |
| 37. Fund for the Conservation of Museums and Theaters Law 397/97                      |                             |       |       |      | 1.0  | 0.6  | 0.7   | 0.5   | 0.5   | Income from payment of licenses for mine exploitation, rental of equipment rent, and sale of tendering documents.                                                                |
| 38. Rotating Fund of Mining and Energy Law 141/94                                     | 0.8                         | 0.9   | 0.5   | 0.2  | 0.1  | 0.1  | 0.1   | 0.0   | 0.1   | Income from sale of goods and services provided by the School.                                                                                                                   |
| 39. National Sport School Fund Decree 1746 of 2003.                                   |                             |       |       |      |      | 0.2  | 4.6   | 4.8   | 5.0   | Charges for services provided by ICFES.                                                                                                                                          |
| 40. Funds of Resources of Monitoring and Supervision Higher Education Law 635 de 2000 |                             |       |       |      |      | 2.4  | 8.3   | 12.5  | 3.8   | Transfer actuarial estimates of teachers paid with own resources of territorial entities.                                                                                        |
| 41. Fund-FONPET- Teachers. Section 2 ff Law 549/99, Section 4ff Law 715/2001          |                             |       |       |      |      |      | 100.0 | 100.0 | 100.0 | Contribution from Audited Entities.                                                                                                                                              |
| 42. Bank Superintendence Contribution                                                 | 46.3                        | 53.4  | 0.0   | 0.0  |      |      |       |       |       | Public Establishment as of 2000.                                                                                                                                                 |
| 43. Contribution for Decentralization Art. 46 Law 6a/91 and Art. 58 of Law 223/1995   | 154.0                       | 206.6 | 289.8 | 0.0  |      |      |       |       |       | Global tax on gasoline, allocated to the partial coverage of the transfers to municipalities. The Sentence C-1545/00 declared the distribution of this global tax unenforceable. |

| Expense concept                                                                  | Annual cost (billion pesos) |          |          |          |          |          |          |          |          | Source of revenue                                                                                                                                                                                                 |
|----------------------------------------------------------------------------------|-----------------------------|----------|----------|----------|----------|----------|----------|----------|----------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|                                                                                  | 1998                        | 1999     | 2000     | 2001     | 2002     | 2003     | 2004     | 2005     | 2006     |                                                                                                                                                                                                                   |
| 44. Fund for Prison Infrastructure                                               |                             |          | 9.5      | 11.0     |          |          |          |          |          |                                                                                                                                                                                                                   |
| 45. Special Administrative Unit of Foreign Trade. Decree 2553 of 1999.           |                             |          |          | 38.4     |          | 107.0    | 40.0     |          |          | Income from registration of imports, exporters, importers, national production and for the sale of import, origin and previous license forms.                                                                     |
| 46. FOGAFIN Contributions on Financial Transactions. Decrees 2331/98 and 3813/03 |                             |          |          |          |          | 2.0      | 45.0     | 45.0     | 30.0     | Capacity of expired terms Resources from Economic Emergency Financial Crisis.                                                                                                                                     |
| 47. Financial Support Fund in Interconnected Rural Areas Law 788/2002            |                             |          |          |          |          |          | 60.0     | 210.0    | 320.0    | One COP for every Kilowatt-hour dispatched in the energy market, collected by administrator of the system of commercial exchange.                                                                                 |
| 48. Special Social Energy Fund (FOES Sect. 118 of the Law 812 of 2003)           |                             |          |          |          |          |          |          |          | 7.0      | Resources come from the 80% of the joint management derived from the exportation of energy estimated by ASIC. To cover up to 40 COP by Kilowatt-hour of the electric energy price for difficult management areas. |
| 49. Pension Fund Notary and Registry (Sect. 4 of Decree 2773 of 2001)            |                             |          |          |          |          |          |          |          |          | Transfer of the Super Notary's Office and Registry to the Finance Ministry.<br>Funds for the payment of pensions in case of shortage.                                                                             |
| 50. Special Fund National Search Commission (Sect. 18 Law 971/05)                |                             |          |          |          |          |          |          |          |          |                                                                                                                                                                                                                   |
| Subtotal Special                                                                 | 6,539.6                     | 6,987.1  | 7,212.2  | 8,327.1  | 7,279.7  | 7,341.1  | 7,820.5  | 7,861.2  | 9,051.9  |                                                                                                                                                                                                                   |
|                                                                                  |                             |          |          |          |          |          |          |          |          |                                                                                                                                                                                                                   |
| 1. Total Public Establishments                                                   | 3,926.2                     | 4,863.0  | 4,180.0  | 4,769.0  | 5,055.3  | 4,896.2  | 6,951.7  | 7,619.1  | 6,973.0  |                                                                                                                                                                                                                   |
| Grand Total (A + B + C + I)                                                      | 17,203.5                    | 19,942.0 | 20,228.5 | 23,624.4 | 24,251.0 | 26,984.3 | 30,046.3 | 32,128.0 | 33,172.3 |                                                                                                                                                                                                                   |
| 2. Total budget of revenues and capital resources —without debt—                 | 24,000.8                    | 28,909.3 | 32,614.3 | 38,204.5 | 43,882.3 | 46,117.2 | 54,717.5 | 61,729.4 | 66,993.0 |                                                                                                                                                                                                                   |
| 3. Share % (I/2)                                                                 | 71.7                        | 69.0     | 62.0     | 61.8     | 55.3     | 58.5     | 54.9     | 52.0     | 49.5     |                                                                                                                                                                                                                   |

In addition, the same law establishes that 10% of the additional percentage points of the VAT must be allocated to fund programs for prevention and assistance to displaced persons, which in 2006 represented resources that amounted to 73.1 billion COP. Surprisingly, the National Budget Directorate also classifies these resources as investments.

Most of the revenue earmarks concentrate on financing special funds. The total of those revenues amounted to 9 billion COP in 2006. Next in importance, the revenues allocated to public institutions amount to 6.9 billion COP for the same year.

Among the specific revenues allocated to special funds, the resources allocated to the sub-account of Solidarity and Insurance in Health stand out. Law 100 of 1993, which regulates the public health system, establishes that the payroll contribution to the mandatory health system must charge an additional percentage point in order to finance a health subsidy for the persons that are outside of the system. In 2006, these contributions amounted to 1.4 billion COP. Next in importance is the Social Benefits Funds for Teachers, to which the teachers allocate 100% of their contributions, pursuant to Law 91 of 1989. These resources amounted to 598 billion COP. Most of the earmarks allocated to special funds are concentrated in the social security and insurance sectors. More than 3 billion COP, or nearly 1% of GDP, were allocated to the social security sector in 2006 through the same method. Most of these resources represent savings to cover pension liabilities.

Although giving up resources in the present to cover future expenditures, as in the case of pension liabilities, sounds reasonable, it only makes sense in an economy with a fiscal surplus. It does not make financial sense in the case of an economy like the Colombian one, in which the fiscal deficit is equivalent to about 4% of GDP per year, to save more than 1% of GDP for the payment of future pensions. This provision implies that the government must seek financing for a deficit, at market rates, and increases its debt to be able to splurge on saving these resources as required by law.

Another important item of revenue earmarking is composed of royalties. The total royalties from the exploitation of non-renewable natural resources, which in 2006 represented 315.2 billion COP, are transferred to the National Royalty Fund, which then distributes them among the regions.

Altogether, earmarked revenues, including the territorial transfers to the SGP, amount to 33,172 billion COP in 2006. Taking into account that the total budget of income and capital resources, excluding debt, amounts to 66.9 billion COP, the earmarks represent an inflexibility equivalent to 49.5% of total revenues. This reveals the substantial degree to which the government's hands are tied in its decisions about how to use revenues.

The revenue inflexibilities infringe on one of the budget principles established in the Organic Statute of the Budget: budget unity.

The historic evidence summarized in the previous section suggests that since the beginning of the century different finance ministers have commented on revenue earmarking and the recklessness of the legislators in mandating expenses without first establishing the resources with which to finance them.

However, the legal foundation for the income inflexibilities currently included in the budget is also provided by the Constitution. Article 359 establishes that:

*There shall not be revenue earmarking [and follows:] except for: 1. The share provided by the Constitution in favor of the departments, districts and towns. 2. Those allocated for investment. 3. Those with a basis in previous laws in which the national government allocates to social welfare entities and the departments created by the 1991 constitution from former municipalities and provinces.*

This exception to earmarking is wide enough to validate all types of inflexibilities in the use of revenues, especially if they are justified as social investment that the constitution does define.

### QUASI-TAX REVENUES

The third sub-group of inflexibilities considered in this chapter is quasi-tax revenues. Quasi-tax contributions are:

*Those tariffs or contributions that, by operation of law, certain economic or social sectors are forced to pay in support of a public or a private entity so that the benefits are received by those contributors, either in the form of social services or the application of economic regulation mechanisms (Lleras de la Fuente, et al., 1992).*

The 1991 Constitution, in articles 150 and 338, establishes that the congress, the department assemblies and the town and district councils have the power in times of peace to establish fiscal and quasi-tax contributions. Given that these are public resources over which the executive branch has no discretion and that are allocated to a specific entity or purpose, they fit the criterion of budget inflexibility previously defined. According to Lleras de la Fuente *et al.* (ibidem) (cited in Ferrer, 1996), these contributions have turned into a “technique” for the implicit appropriation of earmarked revenues:

*Quasi-tax contributions are techniques for generating and managing public resources outside the central budget, which are directed at a specific social or economic purpose and established by public corporations, but administered by autonomous public or private agencies, with directed economy, of either labor unions or professional organizations. Therefore, although Article 359 bans national government revenues from being allocated for a specific purpose, quasi-tax contributions are excluded from this prohibition based on what the Article stipulates. There are plenty of quasi-fiscal charges of different types, such as social security deductions and quotas; the family subsidy, national learning service, coffee retention, rice incentive, etc., that did not abide by basic regulatory principles.*

The discussion about the advantages or disadvantages of quasi-tax contributions and their implications for the formulation of the budget should consider more

closely the definition of quasi-tax contributions. The Constitutional Court’s Ruling C=308/94, considers such contributions

*as a levy that is managed outside the budget. [...] However, it is not a form of national revenue, and that explains why it is not included in the national budget. This does not imply that it ceases to be a product of tax sovereignty, such that only the government through the constitutional mechanisms designed to that end (the law, by-laws and agreements) can impose this kind of contribution as occurs with other taxes. [...] Quasi-tax contributions are public resources but they are not current revenues of the national government (Ferrer, 1996).*

Another significant characteristic of quasi-tax contributions has to do with the apparent relation between the contribution and the benefit received by those who contribute. This is a crucial criterion to understand the difference between quasi-tax revenues and fees and taxes. As Ferrer points out (ibidem), it is usually argued that every payment to the public administration that does not imply a direct, immediate and reasonable benefit in turn constitutes a tax and not a quasi-fiscal resource. However, an analysis of the most significant quasi-tax contributions made by employers to SENA and ICBF shows that quasi-tax contributions do not need to be directly and immediately related to the benefit received. Many businesspersons contribute to the SENA although they do not need skilled labor and, in many cases, in spite of needing it, they do not have access to it. Something similar occurs in relation to the dues paid to ICBF since many employees of a company may not need the services of this agency (when they do not have any kids, for example) but still the employer has to contribute for them. All this implies that a levy, in order to be considered as a quasi-tax resource and not as a tax, should provide compensation in return to contributors, but this compensation does not have to be immediate or proportional. According to Ferrer (ibidem), quasi-tax revenues are closer to taxes than to tariffs/fees (in fact, contributions to SENA and ICBF are sometimes called payroll taxes).

**Table 44. Collection of quasi-tax revenues, 1998-2003 (percentage of GDP)**

| Years | Social Security | ICBF | SENA | Coffee Fund | Other entities | Total Quasi-Tax Revenues |
|-------|-----------------|------|------|-------------|----------------|--------------------------|
| 1998  | 3.87            | NA   | NA   | 0.15        | NA             | 4.83                     |
| 1999  | 3.58            | 0.53 | 0.28 | 0.08        | 0.02           | 4.49                     |
| 2000  | 2.85            | 0.48 | 0.26 | 0.08        | 0.02           | 3.69                     |
| 2001  | 2.86            | 0.52 | 0.27 | 0.00        | 0.02           | 3.67                     |
| 2002  | 2.64            | 0.51 | 0.27 | 0.01        | 0.03           | 3.47                     |
| 2003  | 2.47            | 0.49 | 0.27 | 0.06        | 0.03           | 3.32                     |

Source: CONFIS.

The national budget does not include all quasi-tax revenues given that many of these go directly to the entities (as in the case of the Family Compensation Fund). This results in the consideration of an alternative approach of not including quasi-tax revenues in the budget and thus restoring the inflexible nature of these resources. The Constitutional Court, in sentence C-046 quoted by Ferrer (ibidem), points out that:

*It should be made clear that the most reasonable approach is for quasi-tax revenues to not be included in the national budget, but the fact that the law that created them says something different, this does not imply that the quasi-tax revenues are transformed into national tax revenues.*

Ferrer (ibidem), in turn, asserts that quasi-tax contributions have to be included in the national budget, since according to Article 345 of the Constitution, “in peacetime no contribution or tax can be collected that is not included in the revenue budget, nor can any expenditure charged to the Treasury be made that is not included in the expenditure budget.” Thus, it is unconstitutional to exclude some quasi-fiscal revenues from the budget, given that every tax or quasi-tax contribution must be included in the budget in order to be collected.

The aforementioned confirms the inflexible nature of these resources, which should be included in the budget, but at the same time the government is not free to spend. At the same time, it should be taken into account that the collection of quasi-tax revenues increases the tax burden like any other tax, creating labor market distortions. The collection of quasi-tax revenues rose to 3.32% of GDP in 2004, which represented 22.6% of total national revenue collection for the same year (Haindl, 2005). The weight of quasi-tax revenues is significant and has a bearing on the total tax burden.

Table 45 shows the evolution of the contributions to SENA and ICBF from 2000 to 2006. These two items represent the two most significant quasi-tax revenues, and together amount to more than 2.5 billion COP in 2006.

The last point discussed by Ferrer is related to the “abuse” of quasi-tax resources to “disguise” some earmarked revenues. In analyzing the 1994 budget, Ferrer finds that a series of resources called quasi-tax revenues then, really are fees for services (like the Funds from Publications of the Comptroller’s Office, the New Granada Military University, the income of the Accountants Central Board and the Industrial Schools and Technical Institutes).

**Table 45. Contributions to SENA and ICBF, 2000-2006  
(million pesos)**

| Years | SENA      | ICBF        |
|-------|-----------|-------------|
| 2000  | 446,941.8 | 842,596.8   |
| 2001  | 504,633.0 | 981,719.3   |
| 2002  | 548,375.9 | 1,044,603.5 |
| 2003  | 606,996.1 | 1,116,168.9 |
| 2004  | 667,023.5 | 1,247,393.4 |
| 2005  | 753,906.8 | 1,425,935.3 |
| 2006  | 890,034.3 | 1,632,071.8 |

Source: National Budget Directorate.

In contrast, items like the compensation for regional radio stations and the contributions that the notary's offices must make for the administration of justice, which appeared as quasi-tax revenues in the 1994 budget, are revenues allocated to a specific purpose given that, according to Ferrer, there is no compensating benefit. However, a reason for disguising some national revenues as quasi-tax resources may have been the governments' incentive to reduce the amount of revenues used as the basis for the calculation of the amount of territorial transfers until the approval of Legislative Act 02 of 2001. In this case, the presence of a type of inflexibility in the budget, i.e. territorial transfers, would have resulted in the creation of another type of inflexibility to avoid the transfer, thus resulting in greater budget inflexibility.

#### TAX EXPENDITURE

The last group of budget inflexibilities studied in this section is tax expenditures, which are the tax exemptions granted to different economic sectors that result in lower levels of tax collection for the national government, and, therefore, they are equivalent to a direct transfer of resources to certain actors.

Preferential tax treatments are justified in theory as a mechanism to generate incentives for certain economic sectors considered as having strategic importance. However, this is not always the case; interest groups seek to put in place tax expenditures in order to capture rents through a favorable tax treatment. The result of an excessive accumulation of exemptions is a tax system that lacks transparency and equity and that facilitates evasion and elusion through the reduction of revenue collection.

The Colombian tax structure includes a large number of preferential treatments through exemptions, discounts, deductions and differential rates. These have resulted in a high level of tax complexity that is costly, inequitable and inefficient.

The tax benefits granted through the income tax during 2006 amounted to 17,575 billion COP, which is equivalent to a cost in lost taxes of 4,536 billion COP, which represents 1.4% of GDP (Medium Term Fiscal Framework, 2007, Ministry of Finance). The tax benefits that stand out in importance are the following: the non-taxable income of individuals and corporations that entail tax benefits, such as special deductions (e.g. donations to non-profit organizations and cultural and art foundations); the deduction of local taxes; exempt income (such as spending of judges and their prosecutors, labor payments, distilleries and lotteries); and tax discounts (e.g. discounts for reforestation, as well as the tax benefits on labor income (Explanation of Purpose, Tax Reform Law Proposal of 2006). Within the latter, the different expenses that are exempt from income tax are the most significant. Among these expenses are contributions to the Saving and Promotion of Construction—created to provide incentives for the purchase of housing after the economic recession and, by this means, reactivate the construction sector and voluntary saving in pension funds—a measure adopted to promote pension savings. In addition, there are deductions for the payment of home mortgage interest, or alternatively for spending on education or prepaid health care.

In 2006, among the main tax benefits granted through the income tax, the most significant is the 30% deduction for investment in productive real fixed assets. This deduction was meant to encourage private investment, so that greater production in the future would balance the initial tax cost of the policy. By 2006, 5,752 taxpayers had filed for this benefit, for a total value of \$Col 4,829 billion. The sector making greatest use of this deduction (\$Col 1,221 billion) was the mining sector.

Exempt income reached 12,555 billion COP in 2006, which implies a fiscal cost of 2,553 billion. As Table 46 shows, the majority of these exemptions are concentrated in the financial services sector (877 billion COP) and the mining sector (865 billion COP).

On the other hand, there are also tax discounts that directly affect the value of the tax paid by the taxpayer, unlike exempt income, which affects the tax base. The amount of these discounts is substantially less, given that many of these have been eliminated in recent years. By 2006, the fiscal cost of tax discounts amounted to 191 billion COP.

As indicated by the evidence presented above, tax expenditures result in an effective tax rate which varies significantly between different economic sectors. According to Table 47, the average income tax rate varies between 30.2%, charged to the wood industry, and 42.6% charged to the wholesaler subsector.

The current VAT structure also implies significant distortions and inequities between the different economic sectors. Data on sales declarations for 2005 suggest that preferential treatments represent close to half of total sales. The effective VAT rate, which averages 8%, is compatible with this information. Electricity, gas and steam were the subsectors in which exemptions and exclusions in the VAT had the greatest importance in 2005, while the coverage of the VAT is almost complete in the manufacturing of textiles and the production of mineral products (Explanation of Purpose, Tax Reform Project, 2006). As shown in Table 48, in 2006 the effective VAT rate was lower than in 2005 (7.5%) and 44% of total sales were exempt or

excluded. The subsectors most favored by this form of tax expenditure are wholesalers and retailers and the electricity, gas, steam, and construction sectors. The total of all exemptions and exclusions amounted to \$Col 247,228 billion in 2006.

Although the detailed analysis of the origin of each form of preferential treatment reflected in total tax expenditures is beyond the scope of this chapter, it is evident that the presence of these benefits represents a type of budget inflexibility that results in an inequitable treatment of the different economic sectors. Because of a greater capacity to lobby the government or due to their strategic significance, some sectors have become the recipients of rents transferred by the state in the form of exemptions. Despite the fact that some of these sectors lose significance over time and the exemptions become unnecessary, it is almost impossible to eliminate them, as shown by the failure of the tax reform effort in 2006. In this case, the government proposed eliminating almost every exemption in exchange for a lower income tax rate in order to move towards a more equitable tax system, but the Congress did not welcome the proposal. This illustrates the fact that once a sector or economic group captures a form of rent from the state, it is unlikely to give it up. Thus, the tax system has become increasingly complex, with an increasing number of distortions that benefit various actors, without any relation to the priorities of each government.

#### SECTORAL COMPOSITION OF BUDGET INFLEXIBILITIES

Table 49 reflects a partial consolidation of the results for Colombia in terms of budget inflexibilities. This table groups the inflexibilities related to spending, earmarked revenues, and quasi-tax revenues by economic sector. The table excludes tax expenditures since their sectoral classification relates to economic activities and, therefore, differs substantially from the one shown in the table, which makes them not comparable.

Table 49 also does not include investment items, given that the sector composition of investment committed in future fiscal years in 2006 is not available, nor debt service since the sector distribution does not apply.

**Table 46. Exempt income of corporations, by type of taxpayer (in billions of pesos), 2006**

| Economic subsector                                                         | Contributors | Contributors N.º | Special regime | Non classified | Total        | Share         |
|----------------------------------------------------------------------------|--------------|------------------|----------------|----------------|--------------|---------------|
| Other services                                                             | 125          | 495              | 552            | 36             | 1,208        | 27.1%         |
| Financial services                                                         | 613          | 49               | 214            | 1              | 877          | 19.7%         |
| Mining                                                                     | 863          | 0                | 2              | 0              | 865          | 19.4%         |
| Wood, cork and paper industry                                              | 280          | 13               | 1              | 1              | 295          | 6.6%          |
| Food manufacturing                                                         | 206          | 2                | 46             | 0              | 254          | 5.7%          |
| Mineral products manufacturing and others                                  | 230          | 4                | 2              | 0              | 236          | 5.3%          |
| Chemical products manufacturing                                            | 197          | 0                | 22             | 0              | 219          | 4.9%          |
| Transport, storage and communications service                              | 97           | 0                | 34             | 1              | 133          | 3.0%          |
| Wholesaler trade                                                           | 19           | 1                | 54             | 0              | 74           | 1.7%          |
| Sports and entertainment activities                                        | 17           | 1                | 41             | 3              | 63           | 1.4%          |
| Agriculture and livestock, forestry and fishing                            | 50           | 1                | 7              | 1              | 59           | 1.3%          |
| Construction                                                               | 33           | 1                | 8              | 0              | 42           | 0.9%          |
| Retail trade                                                               | 4            | 1                | 33             | 0              | 38           | 0.9%          |
| Electricity, gas and vapor                                                 | 33           | 0                | 2              | 1              | 36           | 0.8%          |
| Textile, clothes and leather manufacturing                                 | 28           | 0                | 1              | 0              | 29           | 0.7%          |
| Hotel, restaurants and similar services                                    | 23           | 0                | 0              | 0              | 24           | 0.5%          |
| Automotive, accessories and related products wholesaler and retailer trade | 2            | 0                | 4              | 0              | 7            | 0.2%          |
| <b>Total</b>                                                               | <b>2,823</b> | <b>568</b>       | <b>1,024</b>   | <b>45</b>      | <b>4,459</b> | <b>100.0%</b> |
| Share within the total of all taxpayers                                    | 63%          | 13%              | 23%            | 1%             | 100%         |               |

Source: Directorate of Economic Studies, Directorate of Taxes and National Customs.

**Table 47. Average effective income tax rate, 2004**

| Economic Subsector                             | Effective Rate |
|------------------------------------------------|----------------|
| Wholesaler trade                               | 42.59%         |
| Vehicle and related items trade                | 41.46%         |
| Hotels, restaurants and similar service        | 41.13%         |
| Electricity, gas and vapor                     | 40.55%         |
| Agriculture and livestock                      | 39.14%         |
| Transport, storage and communications service  | 39.04%         |
| Sport and entertainment activities             | 38.34%         |
| Financial services                             | 38.25%         |
| Manufacturing of mineral products and others   | 38.17%         |
| Construction                                   | 38.15%         |
| Manufacturing of textiles, clothes and leather | 37.79%         |
| Food manufacturing                             | 37.65%         |
| Other services                                 | 36.41%         |
| Chemical substances manufacturing              | 36.27%         |
| Mining                                         | 34.77%         |
| Retailer trade                                 | 34.76%         |
| Wood industry                                  | 30.20%         |
| <b>Total</b>                                   | <b>37.32%</b>  |
| <b>Weighted deviation</b>                      | <b>2.16%</b>   |
| <b>Maximum rate</b>                            | <b>42.59%</b>  |
| <b>Minimum rate</b>                            | <b>30.20%</b>  |

Source: National Administrative Department of Statistics.

**Table 48. Exemptions and exclusions in the VAT, 2005-2006 (billion pesos and percentages)**

| Economic subsector                                    | 2005                                   |                                                       |                                      | 2006                                   |                                                       |                                      |
|-------------------------------------------------------|----------------------------------------|-------------------------------------------------------|--------------------------------------|----------------------------------------|-------------------------------------------------------|--------------------------------------|
|                                                       | Exemptions and exclusions <sup>1</sup> | Percentage of exempted or excluded sales <sup>2</sup> | Effective rate in sales <sup>3</sup> | Exemptions and exclusions <sup>1</sup> | Percentage of exempted or excluded sales <sup>2</sup> | Effective rate in sales <sup>3</sup> |
| Agriculture and livestock, forestry and fishing       | 6,052                                  | 81.5%                                                 | 2.4%                                 | 6,745                                  | 86.5%                                                 | 2.5%                                 |
| Mining                                                | 7,173                                  | 42.4%                                                 | 8.7%                                 | 8,927                                  | 20.6%                                                 | 4.2%                                 |
| Food manufacturing                                    | 10,832                                 | 33.2%                                                 | 8.1%                                 | 12,421                                 | 34.8%                                                 | 8.3%                                 |
| Textile, clothes and leather manufacturing            | 695                                    | 7.1%                                                  | 15.5%                                | 853                                    | 5.9%                                                  | 11.7%                                |
| Chemical substances manufacturing                     | 2,107                                  | 24.3%                                                 | 12.7%                                | 2,374                                  | 23.7%                                                 | 12.0%                                |
| Chemical products manufacturing                       | 5,961                                  | 27.5%                                                 | 11.4%                                | 6,828                                  | 24.1%                                                 | 9.3%                                 |
| Manufacturing of mineral products and others          | 2,650                                  | 10.3%                                                 | 15.6%                                | 4,054                                  | 10.0%                                                 | 12.2%                                |
| Electricity, gas and steam.                           | 20,010                                 | 88.0%                                                 | 1.2%                                 | 21,887                                 | 96.2%                                                 | 1.0%                                 |
| Construction                                          | 10,759                                 | 79.1%                                                 | 2.3%                                 | 16,610                                 | 85.9%                                                 | 2.2%                                 |
| Automotive vehicles, accessories and related products |                                        |                                                       |                                      |                                        |                                                       |                                      |
| wholesaler and retailer                               | 6,188                                  | 31.6%                                                 | 13.5%                                | 7,398                                  | 24.2%                                                 | 11.4%                                |
| Wholesaler trade                                      | 30,984                                 | 46.0%                                                 | 8.6%                                 | 39,487                                 | 44.1%                                                 | 7.6%                                 |
| Retailer Trade                                        | 16,207                                 | 31.5%                                                 | 10.6%                                | 18,584                                 | 32.8%                                                 | 11.0%                                |
| Hotels, restaurants and similar services              | 686                                    | 17.4%                                                 | 12.1%                                | 760                                    | 16.8%                                                 | 12.8%                                |
| Transport, storage and communications services        | 12,372                                 | 41.1%                                                 | 9.5%                                 | 13,149                                 | 40.0%                                                 | 9.8%                                 |
| Financial services                                    | 45,459                                 | 81.7%                                                 | 2.7%                                 | 44,348                                 | 83.1%                                                 | 3.2%                                 |
| Other services                                        | 35,768                                 | 66.3%                                                 | 4.8%                                 | 39,675                                 | 67.0%                                                 | 5.6%                                 |
| Sport and other entertainment activities              | 2,592                                  | 43.9%                                                 | 5.3%                                 | 2,392                                  | 40.6%                                                 | 5.8%                                 |
| Wage-earning employees (only for individual income)   | 126                                    | 64.8%                                                 | 4.2%                                 | 190                                    | 68.7%                                                 | 4.4%                                 |
| <b>Total</b>                                          | <b>216,619</b>                         | <b>48.4%</b>                                          | <b>8.0%</b>                          | <b>247,228</b>                         | <b>44.4%</b>                                          | <b>7.5%</b>                          |

Source: Economic Studies Office, Directorate of Taxes and National Customs.

1. Addition of the income from exempt and excluded activities.

2. Exempt and excluded sales with respect to total sales without including exports in this total.

3. Sales tax relative to the total sales without including exports in this total.

Therefore, excluding tax expenditures, the sector that benefits the most from budget inflexibilities, or, in other words, that represents the largest burden on the central government is the territorial one. That is to say, regional governments capture the most rents, followed by public establishments and the social security sector. Given the exclusion of investment, the inflexible budget allocated to military expenditures and infrastructure, and social expenditures, could be underestimated.

#### IMPACT OF BUDGET INFLEXIBILITIES ON THE FINANCIAL SITUATION

As described so far, the Colombian budget is highly inflexible. 95% of total “appropriations” are determined prior to the time of budget formulation. On the other hand, 45% of national government revenues are committed from the moment of their collection because

their end purpose is already defined. In addition, in 2006 tax expenditures generated a financial cost (that is, a greater deficit) of 1.5% of GDP, counting the tax benefits in both the income tax and the VAT.

In spite of this, the fiscal situation in Colombia has improved notably in recent years. The fiscal deficit of the central government went from representing 6.1% of GDP in 2002 to 4.1% in 2006. According to estimates, the deficit may have decreased to 3.2 % in 2007. Likewise, the deficit of the consolidated public sector decreased from 3.6% in 2002 to 0.8% in 2006.

As a result, the central government has experienced a primary surplus in the last four years, thus contributing to a reduction in the level of the debt from 55.7% to 48.3% of GDP. This decreasing tendency in the debt level is also the result of a substantial appreciation of the peso since 2003, which has reduced the foreign debt.

**Table 49. Total inflexibilities by sector, leaving out tax expenditures, 2006 (billion pesos)**

| Sector                        | Inflexibilities on the expenditure side | Revenue earmark <sup>1</sup> | Quasi-tax revenues | Total     |
|-------------------------------|-----------------------------------------|------------------------------|--------------------|-----------|
| Territorial                   | 16,357.73                               | 849.16                       |                    | 17,206.90 |
| Social security and insurance | 2,131.61                                | 3,038.61                     |                    | 5,170.22  |
| Education and sports          | 1,455.19                                | 119.02                       | 890.03             | 1,574.21  |
| Control and justice           | 566.43                                  | 359.04                       |                    | 925.47    |
| Department of the Treasury    | 169.30                                  |                              |                    | 169.30    |
| Military                      | 570.00                                  | 461.28                       |                    | 1,031.28  |
| Other                         | 1,029.75                                | 33.67                        |                    | 1,063.42  |
| Financial                     | 164.85                                  | 47.30                        |                    | 212.15    |
| Social                        | 61.15                                   |                              | 1,632.07           | 61.15     |
| Infrastructure and fuel       |                                         | 1,062.30                     |                    | 1,062.30  |
| Public establishments         |                                         | 6,973.00                     |                    | 6,973.00  |
| Contributions                 |                                         | 61.77                        |                    | 61.77     |
| Total                         | 45,012.02                               | 13,005.15                    | 2,522.11           | 60,539.27 |

Source: National Budget Directorate. Sector classification by the authors.

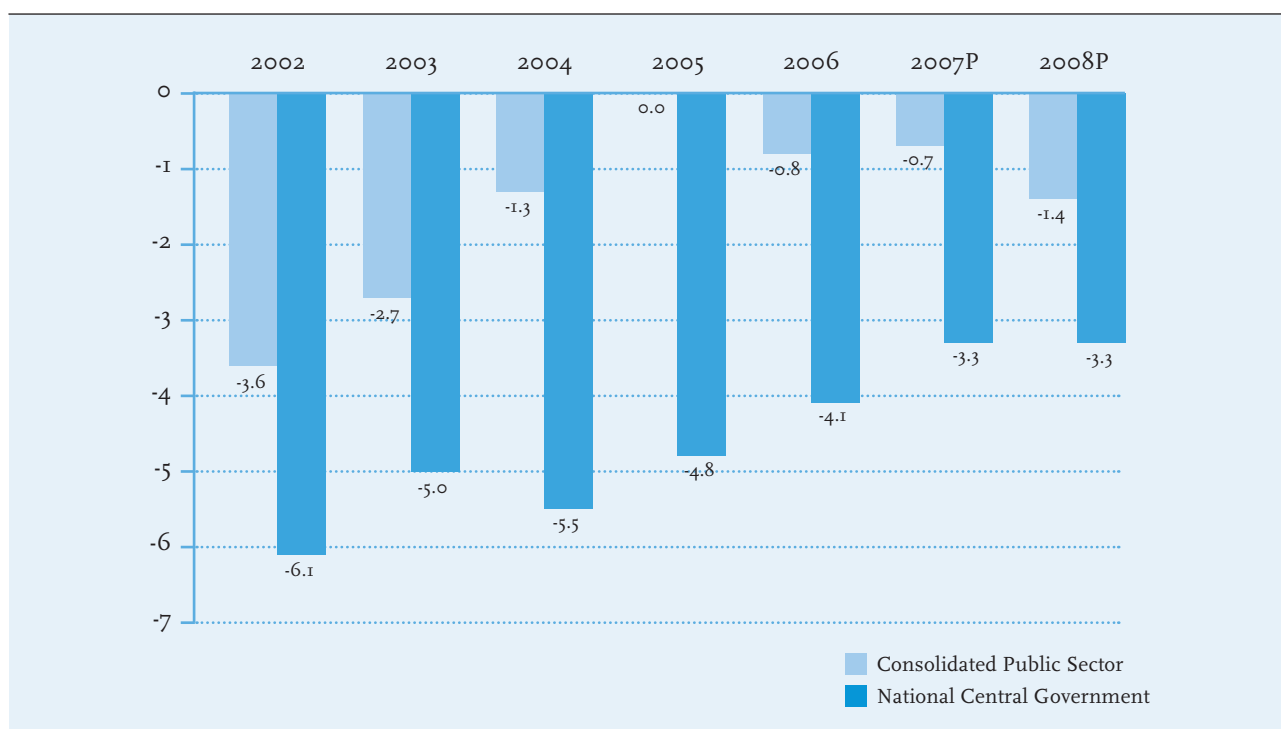
1. Amount of the revenues by exempt and excluded activities.

However, this improvement in fiscal outcomes does not imply that budget inflexibilities are not a significant restraint for fiscal adjustment. In evaluating the progress observed in reducing the fiscal deficit one must consider the fact that this has occurred during a period of economic expansion. The economic growth in Colombia in recent years has resulted in a substantial increase in tax revenue collection. The latter went from 10.6% of GDP in 2000 to 16% in 2006, which contributed to a reduction of the fiscal deficit without any reduction in expenditures.

Therefore, fiscal adjustment has occurred on the revenue side and not on the expenditure side. The bonanza in terms of tax collection has made it possible to postpone the need for expenditure adjustments. However, this situation will not last forever.

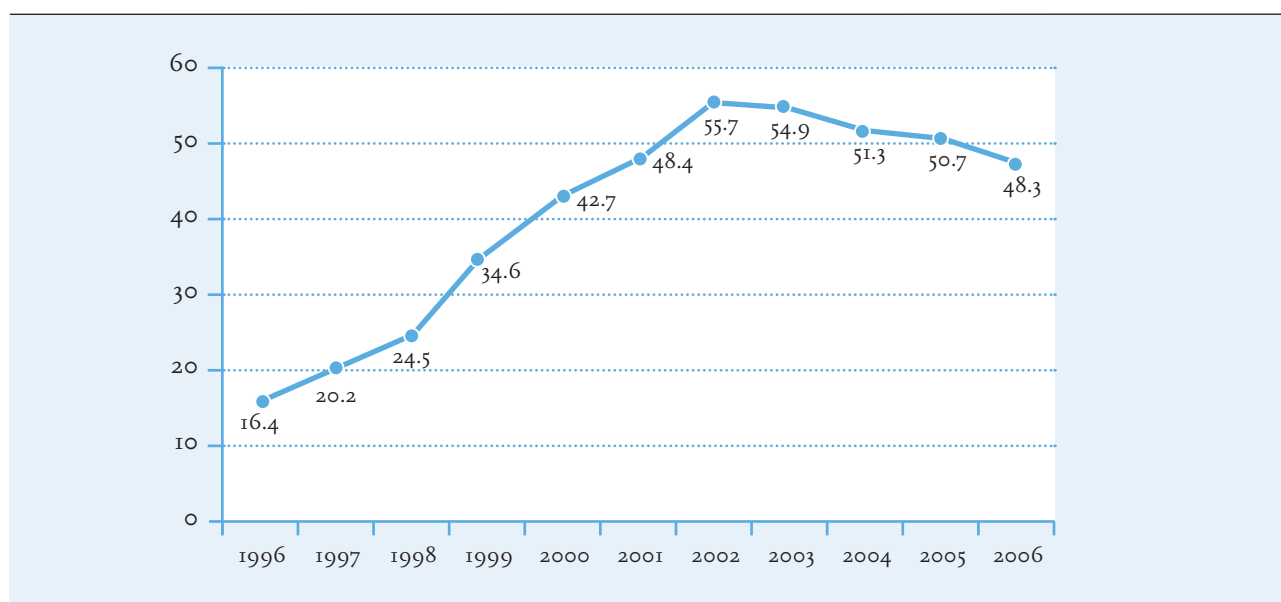
Tax revenue collection will fall steadily after 2008 due to the expiration of a number of temporary taxes. Given the inflexibility in expenditures, this will naturally lead to an increase in the fiscal deficit. Therefore, in the years to come the debate about how to adjust public expenditures will erupt out into the open again. So far, the suggestions in this respect are limited to proposing a reduction in investment expenditures, given that this item remains the most flexible within the budget. Although investment has been increasing at high rates (30% in 2007), it would not be optimal for investment to bear the full weight of the burden of fiscal adjustment. That is why the government will face a difficult situation in the coming years, when the budget inflexibilities are likely to emerge as the principle obstacle for reducing the deficit and guaranteeing the sustainability of the public debt.

Figure 10. Fiscal deficit, 2002-2008 (% of GDP)



Source: Ministry of Finance.

Figure 11. National central government debt, 1996-2006 (% of GDP)



Source: Ministry of Finance.

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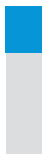
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### III

## The Revolution in Performance Budgeting





# Results-Based Budgeting: Bureaucratic Fashion or New Public Management Paradigm?

229

Mario Marcel\*

## Introduction

For many, the public budget may be a rather dry subject; others associate it with restrictions, pressures, frustrations, or bureaucratic routines. This does not, however, exempt it from being the subject of analysis, fashion, and paradigmatic changes over time.

During the past 50 years, ways of thinking about and making public budgets have changed significantly. Such changes have been the product of transformations in the setting within which public financial management takes place, in the intensity of macro-fiscal constraints and in the role of the public sector. On occasion, these modifications translated into the design and implementation of specific techniques for budget preparation and administration. In the 1960s, the demands of an expanding state and the growth of planning favored the emergence of the budget-by-program method. A decade later, when the first oil crisis put a halt to what then appeared to be an unstoppable process of state expansion, the zero-based budget came into being.

Much the same seems to be happening nowadays with what is known as “performance budgeting.” For over a decade, this term has been used to describe a varied set of practices by means of which a number of governments in the world have sought to ensure greater effectiveness in the use of public resources. These experiences attracted the attention of analysts and international organizations, which in turn gave rise to a growing body of literature on the subject. Evidence of this is that in 2007, three prestigious international bodies published books on the issue (OECD, 2007; Robinson, 2007; and Shah, 2007).

But what does performance budgeting (PB) really consist of? This paper seeks to answer that question not only in terms of the concept per se, but also from a practical perspective. The budget is a specific tool,

structured on processes designed to generate decisions with regards to resource allocation over limited periods of time. As a consequence, any new notion of what constitutes a budget will only become real once it is expressed in concrete changes in procedures and outcomes.

Currently, efforts are being made to establish a relationship between budget formulation and execution on the one hand and the outcome of the application of public resources on the other. In order to define PB in conceptual and practical terms, it is necessary first to specify what is special about this relationship. With that goal in mind, the next section of the paper contains a set of propositions regarding how to translate these general concepts into actual processes and instruments that are applicable and verifiable in the day-to-day practice of public financial management. In particular, it is proposed that any PB regime consists of at least four elements, as follows:

- i) a monitoring and evaluation (M&E) system capable of producing information concerning results;
- ii) an adjustment of budget decision-making processes so that they incorporate the information;
- iii) incentives capable of guiding public institution management toward the achievement of results; and
- iv) sufficient room for flexibility in institutional management to allow for the efficient use of public resources. These four elements may serve as referents both for governments that are trying to build results-based budgeting systems and for analysts attempting to evaluate their performance.

The section titled “Performance Budgeting in the Developed World and in Latin America” contrasts these concepts with practical experience accumulated over the past years in three countries. A study of these experiences confirms not only that there is no uniform PB method in use, but that in each country the process of

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adapting and implementing this approach is still evolving. Further, it is argued that the important differences observed among these experiences indicate that the way in which PB is applied in each country depends in large measure upon the features of its budget institutions, as well as the needs and constraints imposed by the state's capability at this point in history.

The paper concludes with some reflections on the potential of PB in Latin America and on how this approach and the methodologies derived from it may dovetail with the fundamental processes linked to the building of a democratic state and the promotion of economic and social development. While warning against the risks involved in attempting to transfer to Latin American countries the PB methodologies and techniques employed in industrialized countries operating in the Anglo-Saxon administrative tradition, it argues that performance budgeting represents an opportunity to increase the capacity of states to contribute to the achievement of fundamental development objectives. The paper emphasizes the importance of showing respect for the essentially political nature of the main decisions made regarding the budget, and allowing technical considerations to inform the political process.

The author wishes to acknowledge the participation of Marcela Guzmán in the elaboration of these reflections, which are rooted in an effort to improve the Chilean budget system and the analysis of other Latin American experiences. However, the opinions set forth in this paper are the sole responsibility of the author and in no way compromise the institutions with which he is currently involved or has been in the past.

## What is Performance Budgeting?

### **Basic Definitions**

Many governments in the developed world and in Latin America currently declare their intention to develop a system based on performance budgeting. At first glance, the idea of linking the budget to outcomes in the application of public resources is an attractive one, and contrasts with a long incremental tradition in the formulation and parliamentary discussion surrounding budgets. That said, and beyond these intuitive notions, what does performance budgeting really consist of?

The most recent definitions have come from international organizations that have informed, analyzed and, in some cases, promoted the concept over the past few years. Each of these organizations published specialized books on the subject in 2007. Thus, Marc Robinson of the International Monetary Fund (IMF) defines performance budgeting as:

*“Public sector funding mechanisms and processes designed to strengthen the linkage between funding and results (outputs and outcomes), through the systematic use of formal performance information, with the objective of improving the allocating and technical efficiency of public expenditure.”*

In its latest publication, the Organisation for Economic Co-operation and Development (OECD), which has been dealing with the issue for over a decade, reiterates its 2005 definition regarding performance budgeting:

*“A form of budgeting that relates funds allocated to measurable results.”*

For their part, Shah and Shen, in a book edited by the World Bank, define performance budgeting as:

*“A system of budgeting that presents the purpose and objectives for which funds are required, costs of programs and associated activities proposed for achieving those objectives, and outputs to be produced or services to be rendered under each program.”*

As can be seen, each of these definitions places the focus on different points of the link between budgets and outcomes. While Robinson highlights the intention of achieving greater levels of public efficiency, the OECD concentrates on the process that attempts to establish this link. Finally, Shah and Shen emphasize the logical relation between purposes, objectives, outputs and resources.

Such nuances notwithstanding, all three studies acknowledge the existence of differing versions of performance budgeting, ranging from those that stress the use of information for presentation purposes, to those that directly and automatically link the activity or the results with financing.

For the purposes of this paper, I shall adopt a definition of performance budgeting that in some way reflects the specific demands upon the budget in developing countries, acknowledges the political nature of the main budget decision, and considers the public budget to be a highly structured and regulated process.

In particular, I define PB as a set of methodologies, processes, and instruments that allow the decision-making involved in devising a budget to systematically incorporate considerations regarding its past and future results into the application of public resources, while simultaneously motivating and facilitating the attainment of such results by public institutions.<sup>1</sup>

In accordance with the proposed definition, for there to be PB, it is necessary that four conditions be met, as follows:

- i) comprehensive information exists regarding performance as a basis for the budget preparation process;

- ii) the budget preparation process is capable of incorporating this information into the decision-making process;
- iii) the budget system originates from, or is complemented by, a structure of incentives that motivates public institutions to achieve better results; and
- iv) the regulations concerning financial administration generate the necessary flexibility for resources belonging to the institutions to be used efficiently in the effort to achieve results.

One way of facilitating an understanding of the concept of PB is to contrast it with its alternatives—that is, knowing what does not constitute PB.

This differentiation can be made, in the first place, by considering certain rather simplistic views of the idea. For instance, there is a tendency to think that PB means conditioning budget allocations directly to the achievement of certain management goals. This notion is inadequate, however, as it ignores the essentially political nature of budgets, a fact that mandates consideration of the political priorities established and the commitments made by government in its public policy. To link resource allocation for particular programs exclusively to the performance of those who administer it means not only to overlook the priority that the objectives of such a program may have for the government and the citizens, but also to punish program beneficiaries for the failings of its administrators.

Furthermore, conditioning budget allocations to past performance overlooks the fact that the interest in formulating the budget centers on what is to be done with these resources during the coming fiscal year and not on what happened in the past. While what can be done with the resources at hand should certainly take into account past performance, this is not always a good predictor of future performance. Finally, the decisions involved in the budget process are not limited to resource allocation. There is also a review of the design of public programs aimed at achieving the government's programmatic objectives and goals,

1. This definition in good measure corresponds to what Shah and Shen (2007) and the OECD describe as a “performance-informed budget” (PIB).

where conditions must be established for its execution, and explicit or implicit commitments made concerning how resources are to be used. Experience shows that PB may exert greater influence on these aspects than on the budget allocations themselves.

Thus, PB does not imply a mechanical conditioning of budget allocations to past performance. For PB to function properly it is necessary to structure a discussion around the budget that integrates information on results, past and future, into the decisions involved in their formulation and execution.

Along the same lines, PB is not a budget accompanied by indicators or any other information regarding results. While such information is certainly useful for reasons of transparency or in order to strengthen the budget as an instrument of accountability, PB requires using this information mainly in the budget decision-making process.

PB can be contrasted with traditional practices and techniques for budget formulation, meaning incrementalism, budget-by-program techniques (BBP), and zero-based budgeting (ZBB).

PB shares with BBP and ZBB the objective of achieving greater efficiency in the allocation and use of public resources, but differs from the former in that its points of reference are not the levels of production or activity, but rather the goals pursued by public policies. In this regard, PB would appear to be more similar to ZBB, whose objective is to increase efficacy in the attainment of policy objectives. It also has in common the need to work with clear and prioritized objectives. However, PB takes a substantially more realistic stance regarding the process of budget formulation, as it acknowledges that it is more than a scientific or historical process; budgeting constitutes a repetitive “game” that must be adjusted within a tight timeframe that cannot be separated from its immediate past, and requires negotiations and agreements in order to be truly effective.

Based on the foregoing, we may conclude that PB is based upon, and in large measure exploits two essential features of the budget instrument. The first is that the budget, while it must respond to programmatic priorities and commitments that are politically determined,

allocates resources to organizations and programs that reflect technical-institutional vehicles by which to reach certain results. PB is mindful of that distinction and lays emphasis on results and on the capacity to exert influence upon the functioning of institutions and programs, without attempting to delve into terrain that is fundamentally political.

The second feature exploited by PB is that budgets are, in essence, a repetitive game, structured around an annual fiscal cycle in which pretty much the same actors participate year after year. They negotiate and make decisions during the same time periods regarding the budget for the coming cycle. PB seeks to influence the rules, the information, and the contents of this process, in such a way that the incentives and learning process inherent to a repetitive game allow for enhancing the outcome. PB, then, involves a gradual and cumulative process of improvement. For this very same reason, it requires perseverance and a systematic approach if it is to have a real impact.

## Components of Performance Budgeting

### *Information on Performance*

The functioning of a PB system requires sufficient and timely information to undergird the set of decisions involving the budget. This information must be gathered in the regular and systematic fashion demanded by such a structured routine as is budgeting. In order to provide such information, many countries have set up veritable information-generating arrangements, usually referred to as monitoring and evaluation (M&E) systems.

Such systems have become a fundamental component in modern public administration, capable of conciliating effectiveness and transparency in the management of institutions, policies, and public programs. In fact, they have become a fundamental element of the reform processes undertaken by countries with different administrative traditions and varying levels of development.

Even when an M&E system might be justified merely on grounds of transparency, as a response to the obligation of informing citizens and their representative bodies on the use of public resources, in practice its objectives and applications go much further. In particular, it highlights the importance that the latter be linked to decision-making, whether at the programmatic, institutional, or governmental level. For this reason, the fundamental requirement for an M&E system is that it be capable of providing pertinent, timely, summary, and reliable information on the different dimensions and spheres of performance in public management for decision-making purposes. Given that there is not one single type of information that brings together all these requirements, the M&E system must be structured as real systems, meaning that they consist of several instruments able to provide the answers needed in key public management processes.

Thus, the monitoring instruments allow for regular follow-up on the performance of institutions and programs at the level of processes and outputs. The evaluations serve to establish the link between such outputs and the achievement of the ultimate objectives of public policies and programs.

M&E systems are essentially management instruments that can be considered part of the state control infrastructure, insofar as they are internal control structures, administered by the executive branch itself, as well as merit control methods that oversee the achievement of objectives and goals set by the political process. Monitoring and evaluation are parts of the management of an organization, and thus also of the public sector, given that they provide information useful for government decision-making, regardless of the entity at which this occurs.

From this central objective, five values basic to an M&E system can be derived, as follows:

- i) Pertinence. The information provided must be relevant to the well-founded decisions being made;
- ii) Veracity. The information delivered must correspond to the reality (even if partial) of the project, program, or institution being evaluated;
- iii) Opportunity. The information must be provided in

a timely manner, at the moment it is needed in the decision-making process;

- iv) Legitimacy. The information and the judgments produced by the system must be respected by relevant actors and serve to shore up the decisions that are based on them; and
- v) Efficiency. The information must be furnished at the lowest possible cost.

M&E systems are concrete constructions, structured on instruments, procedures, and applications that reflect the balance of values described above.

As concerns instruments, these systems can be based on performance indicators, evaluations, and standards. Procedures may be organized in the shape of external or internal analyses, whether reserved or public. The applications may feed into sectoral or budget-related decisions, as well as into the formulation of plans and programs.

The two main instruments of an M&E system are performance indicators and evaluations.

The performance indicators reflect mathematical algorithms or measurement formulas that provide a quantitative assessment of performance. However, by themselves they do not explain the results. These indicators answer the question regarding how the performance of a program or institution is evolving: its referent is the immediate past and the commitments established as goals to be measured.

Through these indicators, it is possible to periodically monitor performance or results from different perspectives, such as efficiency, effectiveness, and economy, as well as the spheres of process and output control, intermediate and final outcomes. In practice, these are easier to obtain in the sphere of processes, outputs, and intermediate results, and constitute a useful instrument for internal systems used to monitor the programmatic management of institutions, although it is also possible to incorporate those most relevant to budget process analysis.

The most prominent constraint in respect to performance indicators is that they give no indication of what causal relations may exist between activities and the components of a particular program (design elements),

their management processes and the results observed. This limits the feedback needed to improve performance.

For their part, the evaluations consist of studies, exams, or technical reviews. Based on sets of organized information related to each other according to a methodological framework, these seek to build assessments of specific aspects in a particular sphere of activity in public policy and find explicative factors for these assessments or evaluative judgments.

Evaluations are thus different from monitoring processes. The latter tend to be part of internal programmatic management processes, more regular and carrying out measurements by means of indicators, mainly concerning processes and outputs. Obviously, monitoring and evaluation complement each other and are both indispensable to improving the quality of institutions and the programs they implement.

### ***Adjustment of the Budgeting Process***

As has been pointed out earlier, a PB is far more than a set of performance indicators. It implies, in reality, a change in the way of thinking and acting in public administration, in the behavioral functions that guide the processes of making decisions and taking actions among politicians and bureaucrats, and ultimately in the quality and nature of oversight relations that are established between the executive branch, the legislative branch, and civil society.

In this regard, a systematic analysis on how to advance toward results-based management (RBM), particularly as concerns the effectiveness of the development process, must include, among other things, the specific modification of current interrelationships between

- i) the budget system, the planning system, and the establishment of government priorities in the short, medium, and long term;
- ii) the budget system and the other systems that make up the government financial administration—treasury, debt management, and accounting; and
- iii) the budget system and management administrative systems such as procurements, contracting, and personnel.

Management for results ultimately implies that the state, its authorities, policies, public administration, and civil society sensibly introduce to their decision-making processes, the results of their actions and their alignment and progress towards the achievement of the objectives they wish to maximize by means of public policies.

This is why the effectiveness of development is linked to the articulation of the budget process with other administrative systems on which the state operates. These relations encompass harmonizing priorities; allocating the budget and resources at the micro-institutional level; determining how these are related to medium and long-term priorities—the process of governmental planning at both the macro-global and meso-sectoral levels; evaluating how the funds are to be disbursed and how these mechanisms affect the varying degrees of freedom with which managers administer the resource (treasury system); determining the incentives an administration has to cease focusing only on procedures and, instead, also concentrate its actions on the achievement of results (personnel system); and, finally, recognizing the costs of public actions and the way in which spending is recorded on an accrual basis (accounting system).

The budget is a structuring process of public sector management, because its operation constitutes the common ground for several administrative processes that are essential to the functioning of the state as an organization. The existence of this set of processes incorporated in the budget cycle means that in practice the link between budget and result can be established at several levels and in different ways, not only by means of resource allocation.

Among these alternative applications are:

- i) the generation of public information concerning the purpose, goals, and standards committed to the use of public resources, and the results of its past applications;
- ii) sectoral programming in ministries and public institutions, linking their activities, resources, and goals;

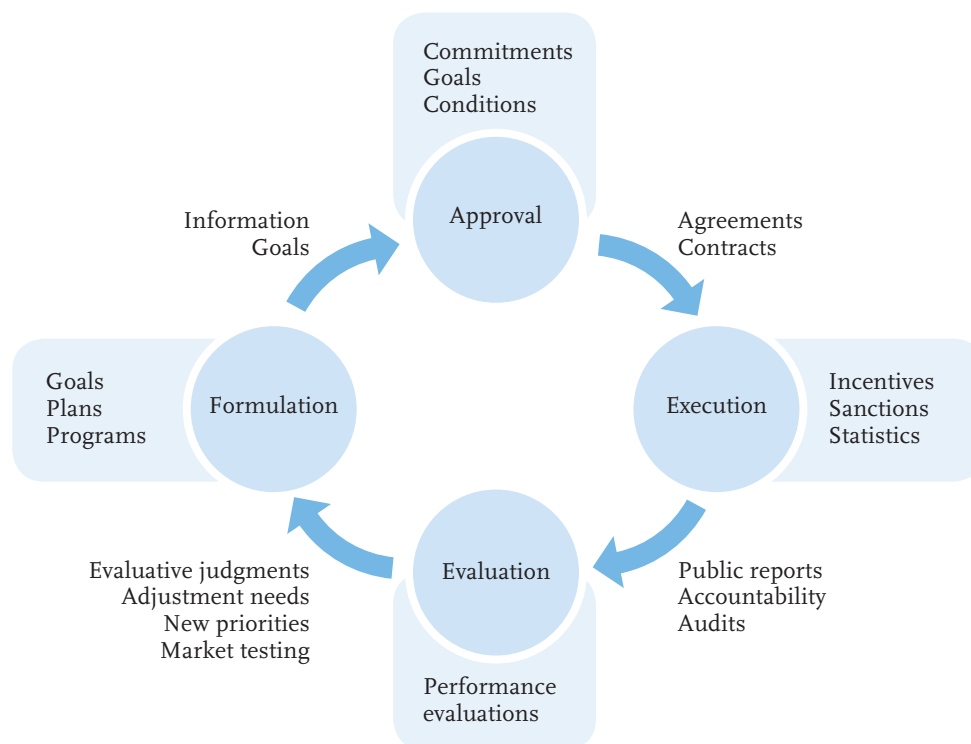
- iii) the design, adjustment, and implementation of programs and projects geared toward reaching programmatic objectives and goals necessary to justify budget proposals;
- iv) the conditioning of resource delivery to compliance with certain prerequisites related to its design and preparation;
- v) the establishment of performance agreements by means of which goals and/or processes to which a ministry or agency has committed for the fiscal year are specified;
- vi) the signing of formal contracts between ministries and entities or between entities and private agents regarding levels and standards for the delivery of the services required in exchange for resources from the budget;
- vii) the testing on the market of the costs of providing certain inputs, processes, or services;

- viii) the application of performance-related retribution and recognition schemes, such as incentives, monetary or otherwise, but in any case with a fiscal cost; and
- ix) accountability to citizens or their representative organs regarding the results obtained as an output of the application of public resources.

As Figure 12 illustrates, these applications may operate in different phases of the budget cycle. Thus, the budgeting process may be conceived of as a sequence of work cycles. Each has a specific objective, commits specific actors, requires a set of inputs, and generates concrete outputs. These, in turn, constitute inputs for the work cycle in the next phase of the budgeting process.

Experiences such as those of Australia, New Zealand, and Chile indicate that the implementation of a PB system may require significant changes in the methodology and procedures corresponding to key phases in the budget process.

**Figure 12. The results-based budgeting system in the budget cycle**



### ***Incentives for Public Institutions***

The implementation of these new instruments and processes around the budget, and the demand for more interaction between agencies, has made financial administration more complex. In response to this situation, it is necessary to create mechanisms and incentives that promote a new and more adequate integration between the different system components. The linkage with these agencies through contractual or semi-contractual mechanisms, as well as the establishment of economic and non-economic incentives, are concrete expressions of the foregoing.

To recognize the need for an incentives scheme that motivates cooperation in public institutions, is one of the significant contributions made to policy design and public management systems by the new institutional economy. This approach is founded on the acknowledgment that organizations and persons do not function only according to regulations, but rather respond to motivations linked to their own organizational and personal objectives. Officials participate in public entities motivated by the search for professional fulfillment, recognition, identification with the organization's goals, economic security, or, quite simply, a salary. If the organization is not capable of recognizing these motivations and using them for its own ends, it is bound to operate inefficiently, due to its incapacity to mobilize its organizational resources in accordance with its potential. What is more, it risks being captured by special interests or being destroyed by entropy.

A good incentive system must, therefore, understand the existence of diverse motivations and proceed to align them with institutional objectives. Insofar as these motivations are not based exclusively on income, an incentive system is not necessarily synonymous with economic stimuli.

Depending upon the main factor on which the desired conduct is based, the incentive system currently applied in the public sector can be grouped into four large categories:

- Recognition. Belonging to a prestigious institution may be a source of compensation for its members.

The recognition of institutional achievements can be transformed into a powerful incentive mechanism if officials are committed to and identify with the successes of the institution. To that end, it is fundamental that the recognition mechanisms be legitimate.

- Transfer of responsibilities. The transfer or devolution of responsibilities from the central level to the implementing agencies may be perceived by the latter as a sign of trust, while affording them greater quotas of power. For this reason, it can be conceived of as an institutional incentive. Perhaps this type of scheme is the one with the greatest potential in terms of improving management, but at the same time it is the most complex to implement.
- Economic incentives. In theory, the incentives that operate through the remuneration system, whether individual or institutional, can promote an improvement in performance, as long as they are able to overcome the practical barriers that emerge during implementation. That said, economic incentive schemes run the risk of losing credibility if they do not discern among different levels of performance and achieve legitimacy in the eyes of those involved.
- Dissemination of results. Another way of encouraging public institutions is by providing adequate and timely information on results regarding the organization that is being managed. This can be understood as a type of acknowledgement of what has been achieved in terms of public resources administration. Exposure to public scrutiny is an especially important source of stimuli and sanctions in public administrations that have historically had only a distant relationship with citizens.

### ***Flexibility in Financial Management of Public Agencies***

A rigorous examination of the functioning of budget systems in several countries indicates that they not only fulfill an economic and political-institutional function, but also a managerial one. In effect, the way in which budgets are formulated and executed significantly

conditions the performance of state agencies or public entities. The budget system exerts influence on the management of state agencies by:

- i) providing a financial foundation for their functioning;
- ii) generating incentives for institutional performance based on how resource allocation decisions are made; and
- iii) regulating the way in which agencies may use the resources allocated in the budget.

In respect to this third dimension, regulations dealing with the financial administration of states normally cover issues such as the arrangement of the institutional budget, the availability of cash, the transfer of resources between budget items and fiscal years, procurements and contracting, contingencies, control of administrative acts, accounting, and accountability.

The existence of this set of controls and the specific shape they take are a product of the demand for transparency and predictability regarding actions taken by the administration, but also reflect the levels of mistrust in the capability and honesty with which institutions administer their resources.

Regulation of the financial administration of state agencies are part of the broader picture concerning regulation and procedures that were identified in the public management bureaucratic model, and have been the target of scathing criticism over the past twenty years. For this reason, the reforms applied in developed countries during the past few years with the aim of promoting more results-oriented management have included a review, or even scrapped, some of these regulations.

Among the main measures in this regard were the following:

- i) the aggregate of operational spending in institutional budgets, which allows for greater flexibility when reallocating resources within the institution itself;
- ii) multiannual financial programming in order to extend the planning horizon of program and institutional planning;
- iii) the transfer of institutional budget resources between fiscal years, whether to advance or postpone fund disbursements;

- iv) the flexibility of cash availability, while maintaining legal budget restrictions;
- v) the creation of centralized funds or reserves for contingencies; and
- vi) the devolution of responsibilities for procurements and the contracting of personnel.

In some countries, these initiatives were linked to the establishment of a special type of organization, known as “executing agencies.” The agencies were keyed to the implementation of policies and programs, and had greater administrative autonomy for doing so. They were also accountable for outcomes.

It can therefore be said that the budget provides the material base for the operative management of government agencies. This type of results-based management requires, in the first place, a stable and predictable financing base, and secondly, the flexibility to administer the resources of that base in such a way that institutional objectives and goals are met.

## Performance Budgeting in the Developed World and in Latin America

### *Performance Budgeting in Developed Countries*

The first notions of PB emerged in the late 1980s among developed countries. The most well-known experiences are those of the United Kingdom, New Zealand, Australia, and Sweden.

In these countries, the linkage between budget and results is expressed in:

- i) the devolution of financial authority to executing agencies, as reflected in the structuring of more aggregated budgets and powers to reallocate funds among alternative uses and budget years;
- ii) the massive and systematic generation of information on performance, in the shape of indicators and different types of evaluations;
- iii) the adjustment of public accounting from a cash to an accrual basis; and
- iv) the link between resources and results through semi-contractual mechanisms as a definition of

frame documents, the preparation of performance agreements, and the signing of contracts among ministries and agencies that specified commitments and goals regarding outcomes.

As mentioned earlier, the implementation of PB in developed countries was not an isolated phenomenon, but rather formed part of a wider reform process guided by the New Public Management approach. This approach emerged as a response to the crisis of the bureaucratic state organization model and the fiscal crises of the 1980s, and aimed at granting more power to public officials—now called “managers”—in exchange for their taking more responsibility for the achievement of results. The reforms included not only adjustments to their budget systems, but also:

- i) the transfer of executive functions to agencies endowed with greater administrative autonomy;
- ii) the development of management and accountability control systems; and
- iii) the treatment of users as customers, endowed with demandable individual rights.

To be sure, the New Public Management approach is not applied equally in all countries, nor with the same zest. For example, it is carried out more forcefully in countries with a British administrative matrix, while in France, it is applied only to administrative decentralization policies. In the United States, on the other hand, the link between the approach and private management theories is extreme. In the northern European countries, its impact is more limited because their institutional structure historically included a considerable degree of devolution of executive responsibilities to autonomous agencies.

Thus PB may be considered part of a wider movement toward results-based management, where it is needed in order to complete the autonomy-accountability-resource allocation chain.

### ***Performance Budgeting in Latin America***

In Latin America, the concept of performance budgeting not only arrived considerably later, but for a different reason than in the developed countries. In effect, the countries in the region are characterized by having pre-bureaucratic states, in which the problems associated with influence peddling, centralism, and informal administration are more relevant than those concerning the inadequacy of a particular administrative model. In this reality, the interest in the concept of PB appears to be motivated by the search for ways in which to improve the performance of public resources after years of fiscal adjustments and a reactivation of social demands.

In general, the efforts to apply PB in Latin America have been defined by their implementation as structured processes, incorporated early on into the legislation as fiscal responsibility laws or reforms to financial administration laws, while its practical application concentrated on the building of financial management information systems and the preparation of performance indicators. Unlike in developed countries, these experiences generally have not been accompanied by adjustments to the organic structures, the devolution of authority, or changes in management practices.

The relative delay found in developing countries—and those of Latin America in particular—in building the institutions inherent to a bureaucratic state, provide a setting and motivations that are substantially different as regards reforms in public management and budgets. These differences are summed up in Table 50 below.

In terms of the relationship between transparency and effectiveness, countries in Latin America that start from a pre-bureaucratic institutional reality have the possibility—and face the challenge—of advancing both in terms of transparency and effectiveness. However, their more precarious institutions also increase the risk that setbacks will take place along the way.

These opportunities and risks are also present in public financial management. As indicated in Table 50, the gap between resources and needs in the region transform financial management and the budget into

**Table 50. Context for reform of budget systems in developed countries and in Latin America**

|                                                                         | Developed Countries                                                                           | Latin America                                                                                  |
|-------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------|
| Prevailing political system                                             | Parliamentary                                                                                 | Presidential                                                                                   |
| Administrative tradition                                                | Bureaucratic                                                                                  | Personal influence and patronage                                                               |
| Size of state<br>(public spending/GDP)                                  | 45%                                                                                           | 22%                                                                                            |
| Dependency upon natural resources<br>(participation in fiscal revenues) | 2%                                                                                            | 15%                                                                                            |
| Population living in poverty                                            | 7%                                                                                            | 23%                                                                                            |
| Elderly /<br>working age population                                     | 36%                                                                                           | 9%                                                                                             |
| Transparency<br>(avg. position in TI ranking)                           | 23                                                                                            | 69                                                                                             |
| Pressure for change                                                     | Crisis of the bureaucratic state                                                              | Development needs                                                                              |
| Strategic challenge                                                     | Effectiveness                                                                                 | Legitimacy, trust                                                                              |
| Main objectives                                                         | Maintain standard of services,<br>comply billions commitments,<br>respond to individual needs | Reduce poverty and inequality,<br>increase competitiveness,<br>transparency, and dependability |
| Means                                                                   | Empower public managers                                                                       | Create public managers                                                                         |
| Requirements                                                            | Responsibility, accountability                                                                | Governance, motivation                                                                         |
| Key decision-making processes                                           | Internal contracts, departmental<br>plans, international agreements                           | Planning, budgeting, passage of<br>changes to the legislation                                  |

a central component rather than an appendix of state reform. Latin American countries cannot, however, simply rest on the expansion of areas of flexibility in financial management for public managers, because they are not yet fully trained, nor exempt from the risk of incurring practices based on influence peddling or patronage. For this reason, the financial management

reform agenda and the very concept of PB cannot be a simple reproduction of what has thus far been observed in developed countries.

In Latin America, the countries have become used to regulating the financial management of public agencies in a far more detailed manner than is the case in developed countries, due in large measure to the higher

degree of mistrust toward managers. Nevertheless, it is likely that the greatest problem for institutions is not these regulations, but the high volatility of institutional budgets. It is common that:

- i) the budget proposal sent by the executive branch undergoes significant changes in the legislature;
- ii) once the budget is passed, the executive branch again modifies it significantly; and
- iii) continues to change it in the course of its execution, because of the volatility in fiscal income, changing priorities, and programming errors. Some countries that have faced important restrictions in respect to liquidity even manage budget execution directly from the Treasury, thus rationing it based on availabilities.

## Some Latin American Experiences

### *Chile*<sup>2</sup>

The PB system in Chile was inserted into a budget system marked by a high degree of institutional hierarchy. This is expressed in the fact that the executive branch concentrates most of the power over public resource management, while the Congress has only scarce powers it can use to modify temporary legislation proposals (the budget), or for that matter permanent laws regarding financial matters. Within the executive branch, regulatory powers over financial administration are, for the most part, concentrated in the Ministry of Finance.

This concentration of powers is, in turn, accompanied by a clear identification of executive branch responsibilities for public finance management vis-à-vis the community. With the aim of avoiding the perception that this concentration of powers is merely discretionary, and to reduce uncertainty among economic agents, the authorities have rolled out a set of mechanisms intended to strengthen executive branch accountability and fiscal transparency before the citizenry.

In Chile, the PB system was first introduced in the mid-1990s, and reached significant levels of progress and consolidation in the first decade of this century. Currently, it is made up of a set of information and expenditure evaluation instruments. These instruments and processes are expressly geared towards ensuring that evaluative information is taken into account when making decisions on the allocation and application of public resources. For this reason, the establishment of a PB system has meant adjusting the budget process and its institutions.

The set of instruments currently being applied in Chile include the following:<sup>3</sup>

- A national investment system that includes a social evaluation of all public sector investment projects and the incorporation of those projects that satisfy minimum profitability rates to an integrated projects bank. These then become eligible for financing with budget resources. This system began to be applied in the 1980s.
- A system of performance indicators, made up of approximately 1,500 indicators distributed among 136 institutions, with their respective annual goals. These indicators encompass dimensions such as efficiency, efficacy, economy, and quality (the latter can also be incorporated into the efficacy dimension), and take into account the various phases in the process of generating value in the public sector.
- An evaluation system that has evaluated over 200 programs and 21 institutions since 1997. These evaluations are carried out by panels of experts and independent consultants, selected through a public competitive process. The evaluations take place based on pre-established methodologies and are followed up through agreements that specify the measures to be taken by executing agencies in respect to incorporating the recommendations made by the evaluation team.
- Management improvement programs, which constitute an original system of benchmarking administrative

2. For evaluations of the Chilean experience by external observers, see OECD (2004), World Bank (2005), MacKay (2006), and Zaltsman (2006).

3. For a more detailed description of this background information, see Guzmán (2005).

systems. Based on these, bonuses for institutional performance are awarded to personnel at central government institutions. This system is based on a uniform matrix for all institutions that identify stages of development at 11 systems in seven management areas.

- A competitive common fund of public programs applied from 2001 to 2003, for the purpose of increasing efficiency in resource allocation. This was achieved through the evaluation of proposals for the allocation of incremental funds in the budget, formulated based on a logical framework methodology. The form continues to be used when introducing budget initiatives, as well as in significant and predetermined numbers for certain types of projects.
- Comprehensive management balances, which were set up as a mechanism for mandatory accounting for all central government institutions. These balances must be issued in April of each year in order to reflect budget execution and compliance with the various goals and commitments in force at the institutions during the previous year.

The unfolding of the Chilean PB has required persistence over time and reflects an essentially evolutionary approach, in which instruments are added on gradually, demands on institutions increase over time, and the fundamental public routines are adjusted. As part of the process, there has been growing involvement by the Congress, opinion leaders, and the press. Nonetheless, it took years until the various actors in the executive branch governing entities began to take the evaluative information into account and use it. Likewise, the introduction of the system has been based fundamentally on already existing administrative powers, with the legislation being used to consolidate and deepen the process rather than to initiate it.

After more than 10 years of this effort, the main achievements of the Chilean PB system are as follows:

- The system is fully operational and encompasses all central government institutions. It has moved beyond the design and experimentation stages, thus allowing for an evaluation of its functioning and results.
- In addition, it contributed to the application of the agenda of President Lagos's government, which was marked at the outset by a major external shock that considerably reduced the availability of resources in relation to what had been planned. In this context, the PB system supported the reallocation of resources and the effort to increase their yield. This contributed to the administration's meeting its main policy goals and allowed it to complete its period in office with public finances in order and high citizen approval ratings.
- The introduction of the system over time has supported decision-making, particularly concerning the budget process. This, in turn, has meant not only the adjustment of requirements and the information opportunity generated by the system, but also an adaptation to the process of budget formulation, discussion, execution, and evaluation. Such adjustments constitute meaningful achievements in the incorporation of new practices that are fundamental to the functioning of a PB.
- As an expression of the foregoing, a reasonable coupling between the budget process and the government planning process was achieved. The former is coordinated by the Budget Directorate at the Ministry of Finance, the latter by the Ministry-Secretariat of the Presidency. Both processes are reasonable substitutes for government planning, which was discontinued in the mid-1970s.
- All the information produced by performance budgeting is public. The information is used not only when making decisions, but also for purposes of accountability to citizens.
- The system is simultaneously based on a number of different instruments, seeking complementarity in the type of evaluative information these generate. Likewise, several of these instruments provide each other with mutual assistance, thus in part avoiding the risk of overloading the institutions that gather information.
- While the system can be described as highly centralized, due to the governing role played by institutions such as the Budget Directorate, the Ministry of

Planning, and the Ministry-Secretariat of the Presidency, it is based on a network of experts and there is a systematic effort at dissemination and training at the institutional level.

Along with these achievements, the Chilean experience is also characterized by a number of limitations and challenges. Among these, the following stand out:

- There is insufficient definition of the strategic goals linked to the final effects being pursued by government actions. Thus, the application of performance indicators is centered mainly on outputs. This feature reflects a bottom-up perspective on public action analysis, in contrast with the top-down rationale typical of planning models. Recognizing the advantages and disadvantages of both models, it is likely that a combination of both would be more appropriate.
- The high degree of centralization means that the development of capacities and the integration of instruments at the institutional level is still insufficient. Thus, in some institutions the administration of management control instruments is allotted to different officials or units, thus limiting the involvement of high-level authorities. In more general terms, it can be noted that some areas in the system are growing, mainly due to stronger commitments by the ministries to control the management of the services their different units deliver.

To sum up, it may be deduced from the foregoing that in the PB concept guiding the Chilean system, the information regarding performance not only accompanies the budget, but also is directly integrated into it, while avoiding the pitfall of mechanical relations in budget allocations. As this is a more complex challenge, the available evidence indicates that the objective has been met in a satisfactory manner, although there are still areas in which undoubtedly there is room for improvement. The Chilean experience demonstrates that it is possible to establish a world class PB system in an emerging country, but that this requires consistency and perseverance over a long period of time.

## Colombia

The efforts to link public management to results in Colombia can be traced back to the second half of the 1990s, with the creation of the National System of Evaluation and Results-Based Management (Sinergia). This system has fundamentally guided the evaluation of public programs, with the goal of feeding information to the national planning system.

Under the evaluation system prevailing in Colombia, the ministries carry out impact evaluations coordinated by the National Council on Economic and Social Policy (CONPES), following directions emanating from an inter-ministerial committee. This committee defines methodologies, assigns responsibilities, and receives results. The evaluation system is a responsibility of the National Planning Directorate (DNP).

Since its creation in the late 1990s, Sinergia has undertaken several dozen evaluations, obtaining information valuable to the central government in the formulation of public policies and the design of programs. More limited, however, has been the system's impact on the allocation of resources in the budget process.

In good measure, the difficulties faced by Sinergia in exerting influence on budget decisions, are derived from the rigidities that characterize the financial administration system in Colombia. These rigidities have three fundamental causes. The first is the thoroughgoing process of decentralization promoted by the 1991 Constitution, by virtue of which a high percentage of fiscal resources are automatically transferred to sub-national governments, which, for their part, are not made to account for how they use these funds under the same conditions as the central government must. The second source of rigidity—as well as of coordination problems—comes from the division of the public budget into two components: an investment budget, which also includes high-priority public programs under DNP responsibility; and an operating budget that includes operations and other recurrent expenses,

which is a responsibility of the Ministry of Finance. A third cause stems from the influence exerted on budget resource allocation by other branches of government. In the case of the judiciary branch, these reflect findings by the constitutional court, based on the inclusion of policy priorities established as citizen rights in the 1991 Constitution. As for the legislative branch, decisions relate to the creation of benefits that are financed by certain tax revenues.

The lack of a link between Sinergia and the budget led to the weakening of the instrument in the early 1990s. However, the system revived under President Uribe, who used it as a fundamental source of support in providing citizens with information on government activities. With a view toward strengthening this function, the Government Goals Information and Follow-up System (SiGob) was created. It generates performance indicators to which the public has access. Currently, the president uses the information intensively in weekly public meetings, which lends it a high public profile. Even so, the link between the system and the allocation of resources continues to be weak.

For these reasons, the government is currently working on strengthening Sinergia, extending monitoring and evaluation to subnational governments and institutionalizing its linkage to the budget. Among the main initiatives being considered in order to reach these aims are:

- i) the diversification of evaluation methodologies;
- ii) the creation of joint work entities between the DNP and the Budget Directorate at the Ministry of Finance;
- iii) the rationalization of the various existing information systems and their respective data bases; and
- iv) the development of methodologies applicable at the sub-national level.

### **Mexico**

During the past few years, Mexico has worked to develop a results-based budget (RBB) whose most immediate referent are the budget system reforms (RSP) that got under way in 1998. These reforms sought to devise a budget that would adopt techniques that, until then, were considered to be peculiar to the private sector —such as strategic planning, customer service systems, performance indicators, and administration by objectives.

The reforms were introduced as one of the strategic lines in the 1995-2000 National Development Plan, with the aim of increasing efficiency in the use of public resources for the benefit of the country's development. This strategic line was part of the sectoral program titled National Public Modernization Plan (ProMaP), which set forth concrete objectives and strategies intended to improve the efficiency of public services delivered to citizens. The RSP included among its components a new programmatic structure (NEP), whose purpose was to redefine the categories and programmatic elements in order to align the strategic functions of the federal government with the programs, activities, and objectives described in the National Development Plan. The RSP began to be implemented in 1997, by means of a set of pilot programs to which more branches had been added. In 1998, a process of budget deregulation got under way using performance agreements.

During the 2000-2006 period, the federal administration kept the NEP in place and decided to implement two unfinished RSP projects: the Performance Evaluation System (SED) and the Career Professional Service (SPC). The program structure was refined and improved and the budget process was transformed into a comprehensive programming and budgeting process (PIPP). Progress was also made in budget deregulation by simplifying the number of provisions in the *Budget Regulations Manual*.

Parallel to this, the Fox administration introduced a presidential goals system, through which the heads of

agencies or public organizations committed themselves to comply with performance goals by signing an agreement. These goals were set jointly by the presidency and the agency in question. Based on the result, the agency was held accountable, if it failed, and rewarded with bonuses if it attained the goal. These goals were set independently from the budget system, and thus could not be linked to performance. In fact, on occasion there were contradictions between the budget and presidential goals.

Perhaps the greatest advance in the budget system during that six-year period was the passage in 2005 of the Federal Budget and Financial Responsibility Law. This piece of legislation allowed for systematizing and rationalizing a set of regulations that had been included in the Budget Expenses Decree since the late 1990s, as well as structuring a coherent regulatory framework for financial administration in public administration. The law expressly notes the link between results and the budget as one of the purposes for having a financial administration system.

The reforms promoted in Mexico since the late 1990s took place in a setting of political change and governments without a parliamentary majority. This led to congressional initiatives aimed at demanding more information and accountability from the executive branch.

Toward the end of President Fox's six-year term, multiple information systems coexisted. In addition, there were at least three indicator and two evaluation systems in place. Despite this, there was little evidence that the information generated was being taken into account by the Federal Public Administration when time came to make decisions, including on the budget. It can therefore be said that the emphasis placed on technical definitions, programmatic structures, and indicators contrasted sharply with the practice of incrementalism when making budget allocations.

For their part, the demands for information coming from the central level came up against public agencies with relative autonomy and significant technical capacities. This translated into a defensive attitude by these agencies, which routinely complied with the information delivery requirements, but kept parallel programming

and management control systems that were considerably more sophisticated.

The current efforts to consolidate the RBB system in Mexico are geared toward rationalizing and simplifying M&E, using the systems in a constructive relation between the central level and the agencies, and adjusting the budget process. The initiatives currently being carried out encompass four work areas:

- i) structuring an integrated M&E system;
- ii) adapting the budget process so it incorporates information on results;
- iii) strengthening incentives for agencies; and
- iv) adjusting regulations on financial management to facilitate the achievement of results in the agencies.

It can thus be noted that even as the Latin American experiences in PB are in a state of full development, certain features can already be distinguished that differentiate them from those in the Anglo-Saxon world. Of these, it is worth underlining four in particular. The first refers to the centrality of budgets as the coordinating and organizing mechanism of public management. In the experiences of the three Latin American countries studied, it can be observed that the budget occupies a prominent space in the functioning of the public apparatus. It therefore bears responsibility for obtaining the maximum possible yield from the limited resources available. This centrality of the budget is in turn expressed in strong budget authorities, with the capacity to promote major reforms or hinder the best-intentioned efforts at change.

The second feature is the importance of planning as a guiding process for medium-term government actions. Both in Mexico and in Colombia, the National Development Plan provides the fundamental framework of objectives and goals for the medium term, which are then related to the allocation of resources and production of goods and public services through the budget. Chile is a notable exception to that norm, which may explain the bottom-up orientation of the management control system linked to the budget. The predominance of development plans, the budget, and the possible rivalry this generates in respect to the planning and programming exercises at the ministerial level makes it so

that the latter play quite a limited role in the operation of PB systems in Latin America. This constitutes a factor that restricts its effectiveness and sustainability in the long term.

The third feature is the growing importance of evaluations in the three Latin American experiences reviewed. While in the developed countries evaluation has played a secondary role in the results-based management and budgeting models, in Latin America these appear to be gaining space in the structure of its PB models. The importance placed on evaluation probably reflects two factors: for one, the centrality of the budget function and the search for instruments that facilitate the reallocation of resources; and for another, the distrust of central organizations in the executive and legislative branches toward the sectoral entities and executing agencies.

Finally, attention should be drawn to the scarce advances made in the three countries analyzed in respect to the devolution of responsibilities to executing agencies. This situation also stands in contrast to the experiences in developed countries, where the New Public Management approach has prevailed. This, no doubt, is due to the existence of practices based on patronage and deficiencies concerning transparency that are typical of Latin American states. This situation makes it risky to grant more responsibilities and areas of flexibility to public managers.

### From Fashion to Paradigm

A number of lessons relevant to the development of PB systems in the region can be inferred from the analysis and review of the literature on the subject, both in its technical-conceptual aspects and that of international experiences. Among the most important such lessons, the following stand out:

- PB has gone from being a lofty ambition to having a concrete expression in a significant number of countries, based on the development of a set of instruments expedient for intervening in fundamental programming, budgeting, and execution processes.

- An effective PB model requires four fundamental elements:
  - i) the development of broad performance M&E systems in public institutions;
  - ii) an adjustment of the budget process in order to incorporate the information on results into decision-making;
  - iii) the elaboration of institutional mechanisms capable of motivating management to work toward the attainment of results; and
  - iv) the generation of areas of flexibility in financial administration that facilitate the management of entities so the desired outcomes are achieved.
- From the foregoing it can be inferred that PB implies an effective link between the information on performance and decision-making. However, the precise shape such a vehicle might take and its specific weight in each of the four components of the system must be such that it is capable of responding to the institution and reality of each country. This is borne out by the existence of alternative PB models in the different countries where it has been implemented.
- The specificity of the PB model to the reality of each country is also reflected in the main experiences thus far in the Latin American countries. When it is applied to states that have not yet reached the same level of maturity as its political systems and bureaucratic structures, reforms must be able to combine an emphasis on effectiveness, which is typical of the New Public Management approach, with additional advances on matters of transparency.
- In order to implement a PB system it is necessary to motivate changes in the behavior of the agents intervening in the budget process. To that end, it is necessary to intervene in the various sub-processes and stages of the budget cycle.
- PB achievements are related mainly to transformations in the organizational culture of the states. In order to produce these changes, all practical experiences have required an extensive implementation process, as well as complementary reforms of public financial administration, planning systems,

public accounting, and the distribution of management responsibilities, among others.

- The extent and depth of these conversions do not necessarily call for a comprehensive plan capable of accounting for every detail in the model and its implementation process. Rather, conceptual clarity is required regarding the objectives being pursued and the capacity to evaluate and make corrections, as needed, once under way.

These observations suggest that the differences described in the design and implementation of the most advanced PB models in Latin America reflect not only differences in the level of sophistication of these models or the stage of development of a particular country, but also the structural inequalities in the public management and budget framework. This should serve as a warning about the risks involved in attempting to transfer to Latin American countries the PB methodologies and techniques of industrialized countries operating in the Anglo-Saxon administrative tradition.

In those states in which the main concern is to mobilize public resources for development rather than provide massive and uniform services under a bureaucratic model, there will be a tendency to lay greater emphasis on planning as a tool for identifying goals and priorities, on the budget process as a mechanism for

inter-institutional coordination, and on evaluation as an instrument of management control, and there will be reticence to expanding the sphere of flexibility to include executing agencies.

In such a setting, PB makes it possible to increase the capacity of states to contribute to the achievement of the most substantial goals in development and the deepening of democracy. In order to reach this potential, it is indispensable to acknowledge that the public budget is far more than a technical instrument at the service of economic rationality. Rather, it is in essence an institutional mechanism capable of conciliating public priorities with the availability of resources. Therefore, the creation of PB systems must respect the essentially political nature of the main budget decisions and leave technical considerations to informing the political process and ensuring that the decisions forged contribute to general well-being.

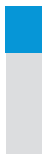
The mere acknowledgement of the role of politics in the grand decisions taken on how to allocate resources, and of the information needed to feed into those decisions and support their implementation, will allow performance budgeting to cease being a fashion imported from the Anglo-Saxon world and become a paradigm relevant to the needs of the development process in the region.

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# Results-based Budgeting: A Pillar of Management for Development Results in Latin America and the Caribbean

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Roberto García López\*

## Introduction

During the 1970s, developed countries enacted reforms to combat the fiscal crisis of the moment and to address dysfunctions that the welfare state had generated. These reforms, which were known as New Public Management (NPM) and inspired by private sector management models, aimed to modify the *bureaucratic model* of the state. The latter was anchored in a series of principles, including the standardization of procedures and processes, technical and professional merit as a factor in the recruitment and promotion of civil servants, the rationality of institutional structures for the division of labor, and the establishment of a hierarchical structure of authority. In time, this model evolved into rigid, centralized, and pyramidal institutional structures oriented toward procedures that did not address the demands of the new socioeconomic context or citizens.

In the 1980s, Latin America and the Caribbean (LAC) countries began a process of reforming the state triggered principally by:

- i) the exhaustion of the import substitution model, prevalent since the 1950s, that spurred the development of industrial capacity through state intervention,
- ii) the external debt crisis that seriously affected the region's economies,
- iii) the spread of globalization, and
- iv) the initiation of democratic processes in the majority of the countries in the region. These reforms—enacted within the context of the emergence of the neoliberal model and the state reforms taking place in developed countries—prioritized the financial dimension of the crisis and initiated changes oriented towards fiscal adjustment, the reduction of the state, and the opening of markets.

Neither the import substitution model nor the ensuing reforms resulted in enough improvement to endow Latin American states with the capacity for administrative management consistent with the functions they needed to perform and the principles of the rule of law. In effect, the application of the bureaucratic model permitted developed countries to professionalize the civil service, separate public matters from private, and establish a merit-based system for the recruitment and promotion of personnel. By contrast, LAC countries were not able to complete the construction of Weberian bureaucratic models according to the paradigm of the developed countries (CLAD, 1998:10). The bureaucracies prevalent in the region generally exhibit fragmented employment systems, promotion based more on patronage than merit, senior officials subject to political appointment and removal, the absence of a career system, among other distortions resulting—with very few exceptions—from the political electoral logic that dominates public institutions (Iacoviello and Pulido: 2008, 90).

In addition to these characteristics related to the rationality of administrative systems of countries in the region, states have been confronted by changes in their functions as well as in the demands and expectations of citizens. The achievement of universal coverage in basic education in the majority of the countries has resulted in better informed voters than was the case a quarter-century ago. The expansion of human rights for children, women, indigenous persons, and persons with disabilities has required the creation of new public policies. And, concerns for the sustainable management of the environment have, among other things, forged new areas of governmental intervention. Additionally, advances in communication

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and information systems have permitted global information to be more easily accessible to citizens. These factors have generated demands for more equal access to public resources and for higher quality services. This has put pressure on political leaders and directors of public sector institutions to manage in a more efficient and effective manner.

As one can observe, the starting point for LAC in respect to state reform is very different than for developed countries: on the one hand, there remain elements of “patrimonialism” —that is, a lack of distinction between the public and the private— that coexist with inflexible structures and rationales centered on procedures, and on the other, there are new demands from citizens and new functions that are created as a result of the globalization of markets and the expansion of social rights. These limitations in respect to the structure of the state and its relationship to society need to be considered also in the context of the resource scarcity that is typical in the region and that constrains the capacity for action by the state.

This starting point affects the manner in which the process of reforming the state should be initiated and managed. In particular, it requires a comprehensive view that allows an assessment of the compatibility and integration of the different systems that make up the public administration (planning, budgeting, financial management, monitoring, and evaluation) and the analysis of the chain of processes that flows from the promises made by politicians to the services actually delivered to citizens.

### ***Management for development results***

As mentioned previously, the NPM is a school of thought that arose in the developed countries in the 1970s that promotes the application of a managerial perspective in the *public administration*. That is, it encourages changing the focus of public administration to one of public management, replacing the traditional model of organization and public service delivery —based on principles of a bureaucratic hierarchy, planning, centralization, and

direct control— with public management based on economic rationality that aims to enhance efficiency and effectiveness. The countries which were pioneers in the introduction of these concepts were the United Kingdom, Australia, and New Zealand. It should be noted, however, that the NPM is not a homogeneous school of thought with one dominant perspective. Two currents that are not necessarily opposed but not exactly the same can be distinguished: the first emphasizes managerial aspects of state restructuring while the second focuses on introducing market mechanisms or instruments and competition (Larbi, 1999).

Management for results (MfR) is one of several instruments and approaches generated by NPM with the goal of strengthening the capacity of the state in order to promote development. MfR is defined as:

*a framework whose function is to facilitate public organizations in achieving an effective and integrated management of their process of creating public value (results) with the goal of optimizing it, assuring maximum efficacy, efficiency, and effectiveness of public organizations' performance, the achievement of government goals and the continuous improvement of their institutions (IDB and CLAD, 2007).*

Although inspired by the transformations of businesses, the focus of management for results takes on characteristics specific to the state like the processes for decision-making and accountability in a democratic regime and the public interest as a focus for management.

MfR originated in developed countries to confront fiscal and financial crises and to maintain the level of development already achieved. However, in developing countries the goal is to accelerate the pace of development. Management for development results (MfDR) is defined in this context as a management framework in which information is used to achieve sustainable results that benefit all citizens.

The concept of MfDR is centered on the idea of *public value* which refers to observable and measurable

social changes that the government implements as a response to social needs or demands established through a process of democratic legitimization, and therefore with meaning for citizens. These changes constitute the results the public sector strives to achieve. The ultimate objective of MfDR is, therefore, to generate the capacity of organizations to obtain the results identified as the objectives of government programs by managing the process of creating public value. In this manner, the notion of *results* in MfDR is associated with social change as a result of actions by the state and not only with activities or products that contribute to this change, frequently taken as parameters for evaluating government action. Accordingly, management results for the education ministry would not be measured solely by the number of schools built, the number of educators trained, or even the number of children that advance to the next grade, but by actual learning achieved by the students and, in the long run, by the caliber of employment obtained due to the education received.

Social change does not refer solely to issues of social policy like health and education, but also to matters related to other public policies such as citizen security, agriculture, energy, employment, judicial administration, or market regulation. This last aspect is considered key: the state generates public value when it creates internal or external markets that permit its citizens to access goods and services at lower costs, which translates into improvements in the quality of life.

MfDR is a management strategy that involves making decisions based on reliable information on the effects of governmental actions on society. Therefore, a key element for its implementation is the measurement of change produced by those actions. This means having instruments to capture these variations, systems to process the information, and procedures to include data analysis in decision making, elements which are not always present in public administration.

Implementation of MfDR involves substantial innovation in public-sector management and requires a continuous effort in the medium- and long-term. These innovations may require modifications to the legal and

institutional framework of national public management systems, the search for consensus among state goals, ongoing training for civil servants, and the alignment of the different components of the management cycle. All of this brings with it complex processes of trial and error involving multiple actors. Above all, MfDR requires transforming the prevailing institutional culture based on following procedures into a new one oriented toward results. For this reason, the implementation of MfDR should be seen not only as a challenge of a particular government but also as an ongoing commitment of the state.

In addition, MfDR forces managers and institutions to assume responsibility for achieving results and not simply for the completion of processes. This promotes more solid and substantive accountability, based on evidence and subject to the verification of civil society. It involves an important change in the traditional style of public management and therefore, requires more explicit political will at the highest level and from champions of change that have the power to influence the public sector as a whole. Although MfDR is principally a managerial framework and, as such must be implemented by senior public managers, its gradual appropriation by mid-level officials and those responsible for delivering services is key.

Finally, it should be noted that MfDR allows for comprehensive and integrated analysis of the public sector. This is because it focuses on the way that national public management systems align with each other to achieve the goals a government has set out, avoiding an isolationist and biased approach that, as we have seen, has characterized state reform efforts in LAC.

### ***The Conceptual Model***

The conceptual model for MfDR was based on the work *Modelo abierto de gestión para resultados en el sector público* (*Open Model for Results-based Management in the Public Sector*) undertaken jointly by the Inter-American Development Bank and the Centro Latinoamericano de Administración para el Desarrollo (Latin American

Center for Development Administration) (IDB and CLAD, 2007). Two aspects have been considered: first, the specific characteristics of the public sector in LAC—the existence of an organizational culture based on the logic of control and procedure, the pressure on the state from the demands of citizens for more and better services and for a more transparent government, and the international context which requires the development of systems with globally agreed-upon standards—and the adoption of the country, not the institution, as the unit of analysis of the proposed model. For this reason, the model takes into account elements which are different from those generally found in the analysis of institutional capabilities.<sup>1</sup> In effect, it is based on the analysis of the public management cycle and on the different systems and instruments it comprises.

The model distinguishes four principal areas: planning, budgeting, the execution of programs and projects, and monitoring and evaluation. In MfDR these areas are not isolated categories but they are intertwined. For example, in this manner, planning and budgeting are part of a continuous and complementary process, since one cannot plan without knowing what resources are available, nor what must be budgeted without basic inputs from planning; in other words the *what* and the *how* are indivisible. Also, monitoring and evaluation benefit as much from the planning process as the production of goods and services. In practice, however, these elements are often disconnected.

Based on this model, the principal systems, instruments, and mechanisms involved in the functioning of the management cycle components that are utilized in LAC and that contribute to orienting the operation of the public-sector towards the achievement of results were identified.

Each one of these systems or instruments can be seen as a gear that allows the chain of results to function sufficiently well that the social changes stipulated in the strategic plan are realized. But, the sole existence of the system or instrument does not guarantee effective or efficient management. Indeed, several of these

systems function in institutional environments that are not structured according to MfDR. For example, national plans are developed in most countries in the region, but they are tied to the budget and a monitoring system in only a few countries. This deficiency hinders the effectiveness of national plans in the chain of results. From this perspective, the greatest challenge consists of aligning all instruments so they perform in a coordinated and complementary fashion so that they can then contribute to the achievement of results.

In addition to the systems mentioned thus far, there is another one that naturally cuts across the whole management cycle: the human resources system. In a MfDR context, the directors and public managers need to be informed about the expectations for the performance and results of employees, and the consequences of achieving or failing to achieve these results (Iacoviello and Pulido, 2008: 107). Effective personnel management requires clearly establishing a results chain and a follow-up procedure that verifies whether or not production goals are being met. Without these requirements, a form of human resource management oriented towards achieving results cannot be fostered.

### *Use of methodology*

Based on this conceptual model, an instrument was designed that allows for the analysis of the institutional capacity of countries in the region for implementing results-based public management. This instrument, called the PRODEV Evaluation Tool (PET), divides the management cycle into five pillars:

- i) strategic planning
- ii) results-based budgeting (RBB)
- iii) financial, accounting, and procurement management
- iv) management of programs and projects and
- v) monitoring and evaluation (M & E). The only difference in comparison with the conceptual model is that the evaluation system treats the systems of financial management, accounting, and public procurement as a separate pillar. Even though these

1. One example of this type of instrument is UNDP. 2007. *Capacity Assessment Methodology, Users Guide*.

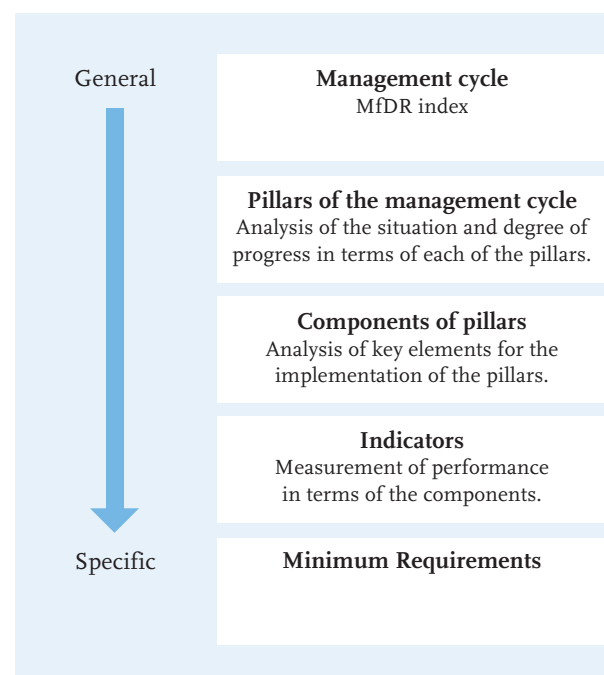
are part of budgeting and managing programs and projects, they are very important for the efficient and transparent management of public resources. Indeed, without strong systems in these areas it would be very difficult not only to obtain results but also to manage the state. Figure 13 illustrates the pillars considered in the instrument.

**Figure 13. Pillars of the management cycle in the public sector**



These five pillars examine the elements that must be present in a management cycle in order for it to be aligned with MfDR. These elements can be organized into three categories: components (16), indicators (37), and minimum requirements (139) according to the chart in Figure 14. The minimum requirements receive a rating of zero to five, as do the indicators and pillars (see criteria in the Annex). The average of all the indicators results in an index that measures the capacity for MfDR for a given country.

**Figure 14. Levels of analysis of the PET**



Given that the analysis of the management cycle requires obtaining information on a broad range of subjects, the instrument focuses only on those aspects directly related to MfDR or that are indicators of MfDR capacity. Thus, this instrument does not offer an analysis of each of the pillars with the depth and detail of instruments specific to a single subject, as in the case of public financial management diagnostics.

As can be seen in Table 51, on average the countries of LAC are not even halfway through the process of institutionalization of MfDR since the average is 2 and the scale goes from 0 to 5. Nevertheless, the status of countries varies considerably: some are more advanced in their degree of MfDR institutionalization while others are in the initial stages. The level of development of the different pillars is also unequal: while financial management has advanced more, results-based budgeting has lagged behind.

**Table 51. MfDR pillars according to their level of development, in 18 Latin-American and the Caribbean countries**

|                                             | Advanced   | Medium-high | Medium-low | Initial phase | Average    |
|---------------------------------------------|------------|-------------|------------|---------------|------------|
| Strategic planning                          | 3.3        | 2.8         | 2.1        | 0.4           | 2.3        |
| Budgeting for results                       | 2.9        | 2.0         | 1.1        | 0.1           | 1.5        |
| Financial management, audit and procurement | 3.9        | 3.0         | 2.3        | 0.4           | 2.6        |
| Program and project management              | 3.2        | 2.3         | 1.8        | 0.7           | 2.0        |
| Monitoring and evaluation                   | 3.8        | 2.0         | 1.1        | 0.4           | 1.7        |
| <b>Average</b>                              | <b>3.4</b> | <b>2.4</b>  | <b>1.7</b> | <b>0.4</b>    | <b>2.0</b> |

The financial management, audit, and procurement pillar is the most developed of all of them. This reflects the priority that governments and international financial and donor institutions have placed on improving the management and administration of public finances, as well as the efforts to improve the systems in this field. In fact, important advances in terms of legislation and institutional development related to this pillar can be observed. Nevertheless, there is still much to be achieved in areas such as auditing, procurement systems, fiscal risk management, etc.

The strategic planning pillar is also at a higher level relative to the other pillars due to the fact that the majority of countries have once again started to elaborate national development plans, particularly for the medium-term, after having abandoned these as an instrument for organizing national priorities during the 1980s and 1990s.

The rating obtained in the program and project management pillar is low for two main reasons. One is the relatively low quality of the public investment systems that focus on the ex-ante evaluation of programs and projects. After great efforts were devoted to them in the 1970s, many of these systems were abandoned or became outdated, and now there is a need to reestablish or strengthen them.

The second has to do with management in the key chosen areas (the social sectors and infrastructure). Although LAC countries have put in place a

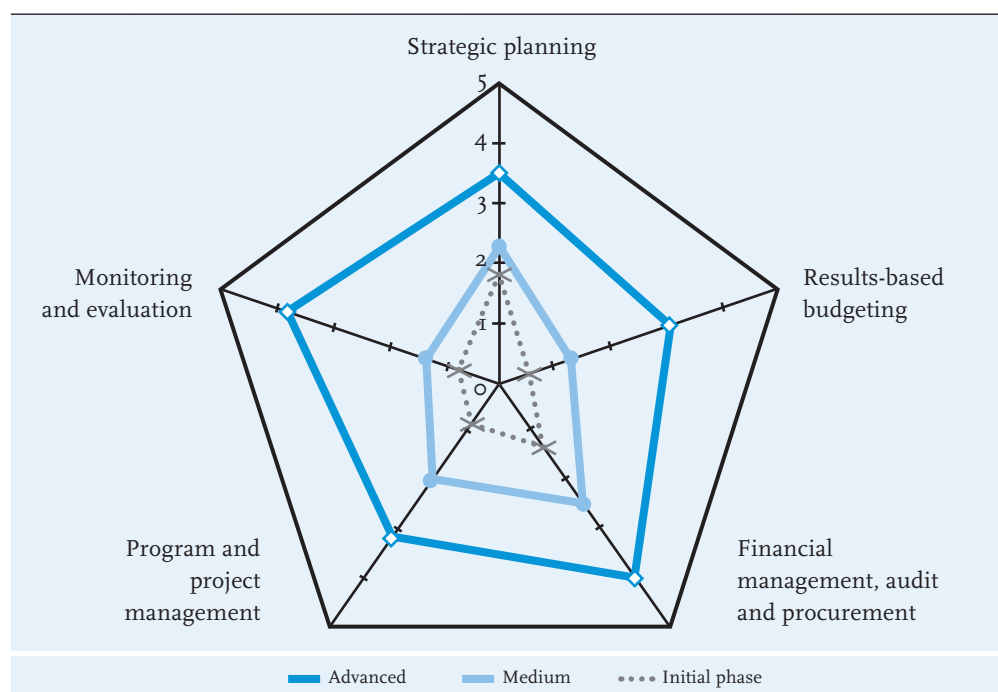
great variety of social programs aimed at alleviating poverty during the past two decades, monitoring and management systems have not developed sufficiently. In other words, these programs have been unable to modify the management culture of sectoral ministries that was based on the development of activities and products and not oriented toward achieving results.

The pillars obtaining the lowest point totals were those of RBB and monitoring and evaluation. There is a very close link between these two pillars since RBB is based on information provided by the monitoring and evaluation mechanisms that assess the results of governmental actions. In the case of RBB, there was little progress in the region in areas such as the analysis of the effectiveness of public spending, incentives for implementing RBB or evaluations, especially external and independent evaluations of the programs incorporated in the budget. Only the most advanced countries exhibited progress in these areas.

Figure 15 presents the index in the form of a pentagon: the darker line represents those countries in which MfDR is at higher levels of development, whereas the lighter line indicates those at intermediate levels and the dotted line those in the initial phases of the process.

As can be seen in the figure, as progress is made in the development of management for results, the pentagon's sides become more equal because the five pillars of MfDR are interdependent, with a feedback process between them.

Figure 15. MfDR index by groups of countries



For example, effective results-based budgeting is not possible without previous efforts at strategic planning. It would be difficult for RBB to achieve an adequate level of effectiveness if financial management is not efficient and the allocation of resources is not timely. If financial management is sound but the selection of programs and projects does not adhere to the principles of cost-effectiveness, activities with little or no social value would be financed. It is also impossible to know the outcomes of programs and projects without an adequate system for monitoring and evaluation. Likewise, you can not have an effective monitoring and evaluation system if reliable indicators based on robust information systems and basic statistics are lacking. The process of strategic planning can not receive feedback without a system for monitoring and evaluation that identifies deviations from the original objectives in order to propose the necessary improvements.

#### *Analysis by country group*

The most advanced countries with respect to the institutionalization of MfDR are Chile, Mexico, and Colombia with an average index of 3.4 while upper-middle level countries include Argentina, Costa Rica, Ecuador, Guatemala, and Peru with an index of 2.4. The group with the largest number of countries, with a score of 1.7, is the lower-middle level group. Belize belongs to the group of countries in the initial phase of developing MfDR with values of less than one.

As can be observed in Table 52, some countries are listed in parentheses. In these countries the discussion of the results with the government has concluded and the results were approved and diffused, making them public information. In countries listed without parentheses, results can not be made public until the discussion process has concluded.

The countries in the advanced group are further along than the other countries in relation to all the pillars. Those of the middle group mainly differentiate themselves in the area of financial management, auditing,

and procurement. On the other hand, advanced countries demonstrate a better balance among the different pillars which suggests a deliberate effort to establish management for results.

**Table 52. Country groups according to their PET index of MfDR**

| Level of progress | Countries                                                                                                             |
|-------------------|-----------------------------------------------------------------------------------------------------------------------|
| Advanced          | (Chile), (Colombia), (Mexico).                                                                                        |
| Medium-high       | (Argentina), Costa Rica, Ecuador, Guatemala, (Peru).                                                                  |
| Medium-low        | Dominican Republic, El Salvador, Honduras, (Nicaragua), (Panama), Paraguay, Suriname, (Trinidad and Tobago), Uruguay. |
| Initial phase     | (Belize).                                                                                                             |

***An unmet challenge: the link between planning and budgeting***

Although governments of the region have worked to strengthen their planning capacity, the lack of coordination and integration between planning and budgeting limits the degree to which plans are translated into results and is one of the greatest challenges for MfDR. In the majority of countries there is a competitive relationship rather than one of cooperation or integration among institutions responsible for planning and budgeting. This competition is one of the main obstacles holding back the development of better MfDR practices.

One of the factors limiting effective coordination between planning and budgeting is the different political weight assigned to the two functions. In many countries, the real discussion about the allocation of resources takes place during the budget process rather than in the planning process since the model from prior decades that emphasizes short run goals is still in place. The fact that legislatures discuss budgets but not plans is evidence of this. In addition, few countries have established national agreements that grant a long-term perspective to government activity and mandate orientations for public activities and resources. Without this mandate, there is no reason for the budget to coordinate with the plan.

At the same time, normative, institutional, and technical development of planning entities is comparatively inferior to that of those agencies in charge of the budget. Economic and finance ministries enjoy a higher status in the majority of countries and their methods and mechanisms have been continually evolving in the past decades. In addition, employees in these ministries tend to have higher salaries than those in the rest of the public service. By contrast, planning officials do not always have cabinet rank and, in several countries, planning entities have been created very recently and thus have little experience.

Added to this is the fact that in several countries the planning process remains normative and centralized: the plan is the product of the planning agency while the spending ministries executing the plan provide inputs but are not co-authors. Thus, the planning exercise lacks a strategic perspective and is not a function that cuts across the entire public sector and becomes ingrained in the real dynamic of institutions.

In summary, although the majority of countries of the region abandoned planning following the structural adjustment policies adopted in response to the debt crisis, many countries have reinstated it since the late 1990s. They have reestablished laws and institutions with a less centralized approach than the previous model, and that recognize the market as an important

element in development. The strength of these systems is closely associated with each country's political structure: where there is higher social consensus on strategic policies and more institutional stability, planning systems have progressed further. In this case, they use a variety of planning instruments, sometimes in a complementary fashion with each other, such as a long run vision, a national plan, a presidential agenda, poverty reduction strategies, and sector plans. From the perspective of MfDR, the biggest challenge in the region in respect to these systems is to strengthen operational planning. This means solidifying the programmatic structure of plans, linking the medium and short term, and coordinating planning with budgeting. In addition, it is necessary to develop a more inclusive planning process that involves the legislative branch and civil society with the goal of establishing strategic objectives that reflect the thinking of the whole society and therefore have a better chance of being continued from one administration to the next.

#### ***Management for development results and Results-based Budgeting***

Without results-based budgeting it is not possible to institutionalize and consolidate management for development results, but budgeting for results is not a sufficient condition.

In a MfDR framework, it is imperative to take into consideration the results of policies, programs, and projects to decide on their financing. RBB fills this purpose since it is a combination of systems and procedures with the capacity to integrate considerations regarding the results of public management in the process of budget decision making. In this manner, RBB promotes more integration between planning and the allocation of resources.

If public policies, especially social policies, are to succeed in changing the present situation and improve the quality of life of citizens, it is important to implement RBB. The pursuit of greater efficiency and effectiveness in the allocation of limited public resources has fostered

interest in results-based budgeting in Latin America and the Caribbean. When resources are scarce, it is more important to increase the effectiveness of their use. In some cases, this interest has led to the establishment of structured processes and their incorporation into legislation (e.g. fiscal responsibility laws, multiyear fiscal frameworks, performance programs, among others). In RBB, results include not only the final impact of programs but also all contributions made at any point along the chain of public value generation.

Results-based budgeting is a combination of methodologies, processes, and instruments that allow decisions related to budget formulation to systematically incorporate considerations about the results of using public resources. Four conditions are required to implement RBB:

- i) the existence of comprehensive information about the results of actions financed by the budget;
- ii) that this information be taken into account during budget formulation;
- iii) that the budget system originate from or complement an incentive structure that motivates public institutions to achieve their goals; and
- iv) that financial administration guidelines allow for the flexibility necessary for agencies to efficiently utilize resources to achieve results (Marcel, 2007).

It is important to clarify that the results that should be considered in the budget process are those that are established during strategic and operational planning. Thus one of the principal challenges in implementing RBB lies in coordinating planning with budgeting, a process that in the majority of countries in LAC is executed by different institutions with little coordination among them.

In addition, information on the results obtained through the spending of budget resources should be derived from the performance indicators created to monitor programs. These indicators should consider not only the outputs (goods and services) generated by programs but also the effect they have on the population. The analyses generated by the evaluation of policies, programs, and projects are also important

inputs into the budget process given that they complement data from monitoring systems by contributing criteria for assessing the effects and impacts of governmental activities.

RBB requires information about results to be incorporated in the decision making process related to the allocation of resources. This prevents these allocations from being made on the basis of traditional mechanisms that do not take into account the effectiveness and efficiency of public spending. These mechanisms include the clientelistic allocation of resources and incrementalist practices in which resources are increased for each agency by the same proportion year after year. Incorporating information about outputs or effects in

the process of resource allocation is the central challenge in Latin America and the Caribbean since budget systems only take into account data related to financial execution and the inputs used.

RBB ties resources to results based on the analysis of three factors:

- i) estimations of expenditures and results if current policies were continued without change,
- ii) analysis of the trends of social outcomes in the context of current policies, and
- iii) proposed changes in the budget or policies and how they would affect the trends (Schick, 2008). These issues need to be debated by political and societal actors.

#### Box 16. Budget reforms and the management environment

*The following quotes from Schick (2008) illustrate the vision on budget reforms:*

*Budget reforms fail due to multiple causes, but they never succeed when governing and managerial conditions are inhospitable to improvement. Specifically, governments cannot budget for results unless they manage for results. Budgeting is embedded in the norms, traditions, culture, practices and relationships of public management. Governments budget the way they manage, which is why it typically is necessary to modernize management practices in order to reform the budget process.*

*Confirmation of the interdependence of governance, management and budgeting comes from the fact that countries that have made most headway in results-based budgeting have been among the best managed in the world. They are reputed to have low corruption, efficient public administration, effective accountability arrangements, political and administrative channels for citizens to express preferences and grievances, and procedures for monitoring the quality of public services. An incomplete list of these countries would include New Zealand and Australia in the Pacific region, Sweden and the Netherlands in Europe, Singapore in Asia and Chile in Latin America.*

Incentives are a central element of RBB since they create synergy between the interests of public servants and institutions and the interests of the country as expressed through governmental strategic objectives. Types of stimuli that can be applied in the public sector include:

- i) accreditation of the quality of an institution, which provides it societal recognition and provides incentives for citizens to associate with it,

- ii) empowerment or transferring responsibilities from higher levels to lower ones,
- iii) individual or institutional financial rewards, and
- iv) the dissemination of institutional management results (Marcel, 2007).

Macroeconomic-level budget innovations, such as medium-term fiscal frameworks (MTFF) and fiscal responsibility rules, are necessary for results-based budgeting to function properly. The former extends

the horizon of fiscal policy beyond the annual budget calendar by means of a projection of revenues and expenditures for a period of generally three years. By looking at the medium-term, MTFF allows the annual budget to be made with a more strategic vision.<sup>2</sup> Fiscal responsibility rules set limits, sometimes in quantitative terms, on variables one wants to control, such as debt, the fiscal deficit, or public spending. In general, these rules are reflected in special laws called fiscal responsibility laws.

On the other hand, RBB also assumes significant coordination between the entity in charge of national budgets and the agencies that execute expenditures. As discussed, budget decisions are made by analyzing the different possible solutions to the country's problems. This requires specialized technical knowledge that is possessed only by the officials in the sector institutions that execute the programs.

The pillar of RBB considers the following components:

- i) the structuring of budgets based on programs,
- ii) a medium-term budget perspective,
- iii) the evaluation of spending effectiveness,
- iv) incentives for effective management, and
- v) the diffusion of information.

As seen in Table 51, of the five pillars in the index for the institutionalization of MfDR, RBB appears to be the least developed with a value of 1.5. This puts it below the average of 2.

The majority of countries in the region still develop their budgets incrementally; that is, each year they apply a similar increase in the expenditures for all programs and institutions. Frequently, particular political interests are given special attention in budget decisions to the detriment of the public good. This generates inefficiency, ineffectiveness, and lack of transparency in management. Inefficiency results because this neither rewards nor punishes institutions for good or bad

performance: all receive resources independent of the quality of the work done. This promotes apathy among public servants and does not encourage effective management by public officials.

### ***Program-based budgeting***

Countries that base their budgets on programs have an advantage in transitioning to RBB since the structure that facilitates the calculation of indicators and results already exists. Nevertheless, this does not mean that a program budget is a prerequisite for RBB. Of the 18 countries studied, nine have budgets structured around programs but, of these, only Brazil, Chile, and Mexico exhibit coordination between programs in the budget and those in the plan (national in the cases of Brazil and Mexico and sectoral in the case of Chile). Eight other countries have budgets that include some programs, generally in the context of a functional structure and as part of the investment expenditure budget. The index value of this group of countries is 2.4 as can be seen in Table 53 below.

### ***The medium-term perspective***

As mentioned previously, one important aspect in constructing a RBB is using a medium-term budget framework since this permits the budget to be viewed in a longer term time horizon than the traditional annual budget does. This perspective is important in budgeting because expenditures made one year can affect revenues and expenditures the following year or may be dependent on future revenues. Of the 18 countries studied, 13 (Argentina, Barbados, Brazil, Chile, Colombia, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Paraguay, Peru, and Uruguay) use a medium-term budget perspective with different degrees of disaggregation<sup>3</sup> and of detail in their projections and

2. There are three types of MTFF: 1) the most basic medium-term fiscal framework (MTFF) which contains aggregate projections of revenues and expenditures, 2) a MTFF with more disaggregated projections of revenues and expenditures, and 3) a MTFF composed of spending projections for institutions and programs. This last type allows for the most coordination with planning. For a review of these instruments in LAC, see Filc and Scartascini in this volume.

3. Depending on the level of disaggregation of information, MTFF can be divided into medium-term fiscal frameworks, medium-term budget frameworks, and medium-term spending frameworks. For more information, see the chapter by Filc and Scartascini in this volume.

with time horizons of three to six years. Although the proportion of countries that work within medium-term fiscal frameworks is large, not all countries effectively use them in annual budget preparation so that in several cases they are a formal exercise and merely serve as a reference point. In their chapter in this volume Filc and Scartascini identify some common problems associated with the use of MTFF:

- i) they are devised without the participation of ministry officials in charge of spending, congress, and civil society which results in a lack of interest and commitment from them in meeting goals established in the MTFF;
- ii) they are conceived without sufficient coordination with sub-national governments which execute a large proportion of the budget resulting in imprecise and untimely provision of information;
- iii) they base projections on statistics of sometimes questionable quality. Improving the formation and use of MTFF will give countries more capability for management oriented towards obtaining results.

### ***Fiscal responsibility laws***

Fiscal responsibility laws aim to improve discipline in the management of public resources, making it more predictable and reducing the amount of discretion by authorities. They are comprised of procedural and numerical rules. The former, which refer to the budget process and those responsible for it, seek to give more authority to those in charge of establishing fiscal discipline. Numerical rules establish goals for variables such as spending, the level of debt, and the deficit, with the purpose of preventing excessive fiscal spending and pro-cyclical behavior (spending heavily when resources are more plentiful during periods of strong economic growth without saving for times of scarcity).

Fiscal responsibility laws are in place in eight countries of the region while two countries have laws that are not specifically of this type, but contain numerical rules.

It should be noted that the existence of these laws does not guarantee that they will be respected in practice and, by the same token, there are countries which have maintained good fiscal discipline without these laws as was the case in Chile until 2006. The English-speaking countries of the Caribbean, like Barbados and Trinidad and Tobago, have also demonstrated a culture of fiscal responsibility without these laws.

A culture of fiscal responsibility is the basis for the efficient management of resources, an indispensable factor in the economic stability necessary to achieve goals designated during strategic planning.

### ***Evaluating spending effectiveness***

Spending evaluation is at the heart of RBB and what differentiates it from traditional budgeting. It consists of analyzing the manner in which public spending has affected the results chain, particularly outputs and outcomes. It aims to analyze the efficiency, efficacy, economic cost, and effectiveness of governmental management, which requires instruments for monitoring and evaluation. The monitoring mechanism consists of indicators that quantify progress and the achievement of strategic objectives of the country with the use of allocated resources. The majority of these indicators are produced by the same entities that implement programs and projects. As a result, their development requires coordination and inter-institutional cooperation. There are different types of evaluations which aim to explain the manner in which actions have affected social reality and why. The evaluation of spending effectiveness is based on the monitoring and evaluation mechanisms for government objectives, strategies, and programs. This system is used for improving the allocation of resources as well as for optimizing program management. The only country in LAC with a system for the evaluation of spending effectiveness is Chile. Other countries, like Mexico and Peru, are progressing in the design and development of such a system.

### *Incentives for management effectiveness*

Incentives play an important part not only in RBB, but also in MfDR since they facilitate the creation of a culture based on achieving results. This new culture is formed by rules of the game that guide persons and institutions to act with the goal of realizing institutional objectives. Reliable and timely information on the performance of institutions and personnel is required for these rules to function properly. Without this information generated by the expenditure evaluation system, it would not be possible to implement new rules since there would be no points of reference for their application. Since Chile is the only country with such a system, it is also the only one in which mechanisms solidly anchored in performance information help determine expenditure allocations in the budget, thereby encouraging efficiency and efficacy in the management of institutions. Nevertheless, some countries, including Brazil and Costa Rica, are starting to develop systems of this type.

Finally, a system of stimuli that compel institutions and individuals to work towards the results the government establishes is also necessary in order to develop RBB. Little has been done in this field: only three countries have developed any systematic actions. Chile has had the richest experience because its system is already oriented to providing performance incentives to both agencies and their personnel. Peru and Costa Rica have developed pilot programs but these are not yet widespread.

In sum, the pillar of RBB is the least developed of all and still has a long road ahead before it becomes institutionalized, as can be seen in Table 52. Countries in the region are interested in moving in this direction but efforts are just beginning. In Table 53, the components of the pillar with their corresponding values are listed from largest to smallest

**Table 53. PET index: results-based budgeting**

|                                        |      |
|----------------------------------------|------|
| Results-based budgeting                | 1.5* |
| Program budgeting                      | 2.4  |
| Medium term fiscal framework           | 2.3  |
| Fiscal responsibility law              | 2.0  |
| Expenditure effectiveness evaluation   | 1.0  |
| Incentives to management effectiveness | 0.6  |

\* Weighted average using each component's weight.

If the results of the pillar of RBB are compared with those of the pillar of financial management (Table 54), which focuses on the budget process and the accountability of the budget, one can observe that values are considerably higher in the latter.

**Table 54. PET index: financial management**

|                                       |     |
|---------------------------------------|-----|
| Financial management                  | 2.6 |
| Budget transparency                   | 4.3 |
| Parliamentary approval                | 4.1 |
| Accounting system                     | 3.5 |
| Budget expenditure classification     | 3.1 |
| Budgeted expense/actual expense ratio | 2.7 |
| Risk analysis                         | 1.7 |

It can be inferred that more progress has been made in the field of accountability than in the quality and results of spending. For example, the indicator for transparency in budgeting is 4.3; this shows that much progress has been made in improving budget transparency through publications on the Internet and actions related to improving the quality of information and its diffusion to congress as well as to citizens.

The region is also doing relatively well with respect to the compliance with the timetables established by law for legislative approval of budgets. The same can be said in regard to accounting practices and classification of budget spending. The majority of the 18 countries adhere to international standards and thus results are fairly reasonable.

Nevertheless, discrepancies can be found in the relationship between budget spending and actual spending. Some countries show significant deviations between the budget as programmed and the budget as implemented. This is a clear signal that there are still challenges to overcome in correcting these deviations. In the case of risk analysis, the value is 1.7 since there are few countries in the region that are performing an adequate level of fiscal risk analysis on a regular basis.

In conclusion, results-based budgeting is the least developed of all the pillars. Latin America and the Caribbean countries still have a long way to go in institutionalizing this dimension. A large majority of countries still budget on the basis of inputs and allocate resources incrementally so that management results are absent during the process of analysis and budget preparation. Nonetheless, several countries can be observed to be using budget practices that are gradually improving the credibility of this instrument and are laying the groundwork for reforms that deepen it. These practices include structuring the budget on the basis of policies, linking the budget to planning, devising medium-term frameworks, and establishing fiscal responsibility laws with numerical rules.

## Conclusions

The institutionalization of MfDR in Latin America and the Caribbean is, for the most part, at an initial stage. However, most countries in the region are interested in moving in the direction of results-oriented management.

Regarding available instruments, it is very important to achieve progress in RBB management, not just because it is one of the least developed pillars, but also because, as noted earlier, without RBB there cannot be MfDR.

In implementing a RBB, two complementary fronts must be addressed: the political-institutional aspect and the development of technical instruments. These are actually two sides of the same coin.

To advance in the construction of a RBB in the political-institutional context it is necessary to involve various actors in the executive branch: the budget offices and the ministries of finance, and the sectoral budget offices. Moreover, countries that have established planning systems must involve the technical strategic planning areas in the process. In other words, the important task of “horizontal coordination” in the executive branch of the administration is weak in most countries and needs to be improved. Congress and control or audit agencies must be involved in the process too. Finally, civil society participation would ensure the medium term sustainability of RBB reforms.

Leadership backing changes is needed, as without it there is no possibility for transformation. Change requires political leadership, but also, and at the same time, technical leadership with deep knowledge of tools and instruments that make transformation possible.

Political leadership may originate in the executive branch, either at the highest level or at an intermediate level. The higher the political level, the greater the impact on the rest of the administration. This leadership may also be developed and consolidated in congress.

Parliament can function as an engine for change and influence the executive by demanding better quality management and effectively complying with its oversight and balancing responsibilities. In order for this to be possible, legislatures must have greater technical capacity. In more developed countries and in three countries in the region legislatures have technical budget offices with permanent professional staff providing

technical assistance to legislators in both houses. The creation of these technical budget offices is an important challenge for most countries in the region.

Technical leadership may be present in either the budget or planning areas, although it is preferable that it be present in both simultaneously and that there be close coordination between them. Some countries have resolved the issue of plan-budget coordination by placing both responsibilities in a single ministry. One country that has done this in the LAC region is Brazil, while Korea is an example in Asia.

An organized civil society can also be a significant contributor in the institutionalization of MfDR by demanding better quality government. In the region there are several initiatives of this type, but a greater number of participating NGOs and broader thematic coverage are still needed.

The selection of an implementation strategy (gradual or shock) at the technical level is another key element for the operationalization of a RBB. Although, in general, when a gradualist strategy is adopted, the process is more sound and sustainable over time, it is also important to take advantage of opportunities when political and leadership conditions allow for faster progress.

Civil service training and incentives, not just in the area of budgeting but in all the areas related to MfDR in sectoral ministries and at the sub-national level is of great importance for the application of available instruments.

Reliable information systems are another requirement. If reliable information is not available, evaluations and results can hardly be reliable and, in turn, the credibility of the system will erode.

Integrating the strategic plan and the RBB is essential to consolidate the latter.

In this respect, it is also important to have medium term fiscal exercises. Countries that lack such exercises

must develop them and those that already have them must perfect them through greater integration of the budget and the medium term plan.

Program budgeting, on the other hand, is not a prerequisite to proceed with a RBB. It is possible to transition directly from a budget based on expense classification to a RBB, but countries that have program budgeting can change over more quickly. Some countries have adopted program budgeting as an intermediate step; this more gradual process may be justified in some cases.

Analysis of the quality or the effectiveness of expenditures is central to a RBB and there is a need for progress in this area in the region. It is important that the main spending agencies adopt this kind of approach and for that they must develop indicators relevant to each sector. It must be underlined that it is not necessary to have a large number of indicators, just enough to conduct evaluations properly. Indicators must be a product of the interaction between the central and the sectoral areas of the budget. For this reason, there is a need to ensure that the set of indicators selected reflects the interests of both sides.

When designing and implementing a RBB the system of incentives linked to it must be considered. There are various kinds of stimuli (monetary and non-monetary) suitable for different purposes. Thus, an appropriate combination of these incentives, corresponding to each country's current situation, ensures proper operation of the RBB. Without incentives, RBB is unfeasible.

In summary, right now is a good time to undertake the consolidation of RBB in Latin America and the Caribbean. Whether this will become a reality or simply turn out to be a passing trend will depend on the commitment of the main actors.

## Annex

Table 55. Validation matrix

|                                                                                                                                                                                                           |   |
|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---|
| <b>Proposed:</b> It has been formally proposed through a legal provision, a decree, a law, a resolution or an approved project.                                                                           | 1 |
| <b>Incipient:</b> It is in its initial phase of implementation.                                                                                                                                           | 2 |
| <b>Under development:</b> It is in a developmental phase, all of its elements are not yet operational, or do not operate fully, or it is affected by problems or weaknesses that hinder good performance. | 3 |
| <b>Implemented:</b> it has been implemented, all of its elements operate at full capacity, but performance could improve.                                                                                 | 4 |
| <b>Consolidated:</b> the requirement is in optimal operation, its performance is satisfactory and it is expected to be sustainable.                                                                       | 5 |

|                  |   |
|------------------|---|
| 0%               | 0 |
| From 1% to 20%   | 1 |
| From 21% to 40%  | 2 |
| From 41% to 60%  | 3 |
| From 61% to 80%  | 4 |
| From 81% to 100% | 5 |

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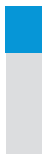
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## IV Fiscal Decentralization





# Decentralization and Intergovernmental Resource Transfers in Latin America: Argentina, Brazil and Colombia

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Fernando Rezende\*

## Introduction

As highlighted in recent studies carried out by the Inter-American Development Bank (IDB), the enthusiasm generated for the process of fiscal decentralization in Latin America that began in the mid-1970s cooled off considerably by the middle of the 1990s, at which point the idea of decentralization became the object of serious doubts.

The economic crisis that ravaged the continent in the 1980s is an important factor in the relative disenchantment with this process. Decentralization, which was based excessively on transfers from the central government to sub-national institutions, had not delivered the expected results, especially in respect to the effectiveness and efficiency of public expenditures and the accountability of governments to citizens. At the same time, in a context in which the crisis affecting regional economies called for a greater commitment to macroeconomic stability and fiscal discipline, excessive transfers made crisis management even more difficult for national governments.

Notwithstanding the more cautious approach recently adopted by governments, the matter is still high on the agenda of the issues requiring renewed attention, considering the importance that local government has acquired across the globe, and the need to make progress in modernizing public management and in enhancing society's control over the actions of the state.

The IDB studies indicate that disenchantment with the decentralization process does not arise from problems directly related to the process, but rather with the *modus operandi*, or the way in which it has been put into practice. In order to place the issue in its proper perspective, it is necessary to describe the failings that gave rise to the instruments used in the past and to indicate

the possible paths that should be followed, by taking into account the principles that should be followed in the design of transfer systems, as well as the principal objectives that such systems seek to achieve.

In the case of the countries considered in this paper, the recently adopted changes in intergovernmental revenue transfer systems were influenced by two important forces exerting appreciable effects on the quality of the fiscal decentralization process. One of these has its roots in requirements related to macroeconomic policy, including especially the promotion and maintenance of fiscal discipline. The other force, which was stimulated by advances in the democratization processes, relates to society's demand for priority to be given to policies aimed at reducing social inequalities. The reaction of governments to these forces took place in the absence of a new strategy aimed at reconciling the challenges inherent in these macroeconomic and social pressures with an effectively structured process of fiscal decentralization. This reaction, which was conditioned by the current constitutional framework and political realities, gave rise to a notable retreat from the path previously followed, in which efforts had been made to make intergovernmental transfer systems more stable and transparent.

In respect to macroeconomic policy demands, attention was concentrated on the need to reduce the rigidity of regulations determining the amount of resources national governments must transfer each year to sub-national governments. In respect to social policy, the pendulum swung towards a greater emphasis on national policies aimed at reducing inequality in individual incomes relative to the inequalities existing at the regional level. Responses to these joint concerns were channeled in different ways. In Argentina, the federal government devolved certain responsibilities to the

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provinces and withdrew a certain portion of the revenues collected from the value added tax (VAT) from the revenue sharing fund. Brazil took steps to increase taxes that were not part of the pool of shared revenues in order to achieve similar results. Meanwhile, in Colombia, the only viable measures were abandoning constitutional provisions and increasing the dependence of sub-national jurisdictions on the center. The differing paths also led to different results: from a macroeconomic perspective, in Brazil's case there was a greater reduction of rigidity, whereas in Colombia's case there was a significant loss of sub-national autonomy.

The emphasis placed on social policy was accompanied by two parallel developments: the preference for policies oriented towards reducing the differences in social development opportunities across regions, and greater intervention by the national government in sub-national budgets. As a consequence, financial difficulties experienced in tackling shortcomings in terms of the coverage and quality of urban services, including infrastructure, increased, in a context in which urbanization was increasing the pressure exerted by the principle cities on their governments.

The reduced supply of resources for satisfying local demands should have been accompanied by increased managerial efficiency. But the absence of criteria that might have contributed to adapting horizontal resource allocation to the territorial concentration of demands, along with the adoption of fixed percentages for allocating revenues to the sub-national levels, produced the opposite effect. The difficulties experienced in improving management quality became more acute, mainly in the most densely-populated urban areas, due to the overlapping of activities carried out by different political jurisdictions and the lack of adequate arrangements to promote or motivate the necessary inter-jurisdictional cooperation.

The most important explanation for the different paths chosen has to do with the differences in the structure of the state in the three cases. In the Argentine federal system, the municipalities have a very limited

role and are subordinate to the provincial governments, whereas in Brazil, the municipalities are fairly autonomous and they play a very important role that has been reinforced by the decentralization of social policies. In spite of the fact that Colombia has adopted some initiatives to augment the departments' sphere of action, in this country the municipalities are the principal focus of decentralization policy.

The different state structures also explain differences in the scale of the changes—for example, the decreasing importance of non-conditional transfers in the total volume of transfers—and the variety of regimes for transferring resources to the sub-national governments. This does not diminish the negative effects that changes in transfers have on public management, or on the quality of the decentralization process, but it does mean that such effects differ significantly and vary according to the functions that most depend upon transfers.

As previously mentioned, the changes promoted under extenuating circumstances in these three countries meant that the transfer systems were diverted from their past orientations. Flexibility in the definition of amounts to be transferred was favored and priority was given to national policies in respect to the use of resources administered by the sub-national governments at the cost of their efficiency and accountability. In this process, no attention whatsoever was paid to the need to correct horizontal imbalances, which, therefore, became more acute.

The decisions made in tackling such pressures caused greater instability and uncertainty about the future, reducing the time horizon of local officials and influencing other decisions that were important for the quality of the decentralized management of public policies. This was especially the case for social policies, which require a predictable flow of resources to finance current spending, and whose investments rely upon the future guarantee of new resources to finance the operation of services. Likewise, the fact that sub-national budgets had less margin to respond to local preferences undercut one of the principal advantages

associated with fiscal decentralization: the increased accountability of governments to citizens.

There is no need to discuss here whether there are better options, or if the paths that each country followed could have been different. The discrepancies between the ideal model and the solution that the countries in fact adopted (the feasible model) are due to political-institutional factors, which often shape the implementation of rules guided by technical considerations. Politically viable agreements can engender distortions whose correction depends upon institutional evolution, with advances, revisions and successive changes of direction.

The temptation to provide a menu of recommendations about how the examined countries should reform their transfer systems in order to correct the defects identified and to achieve a greater balance among the five dimensions that shape the quality of any transfer system, has been deliberately resisted in this paper.

Instead of recommendations, the chapter focuses on identifying the principal aspects that should be taken into consideration when choosing a given resource transfer option. One of the principal lessons arising from the literature, international practice and the experiences analyzed is that the formulation of precise questions, the examination and clear and transparent presentation of the repercussions of the options adopted, and the attainment of an agreement based around convergent solutions that is consistent with the principal attributes of a fair process of fiscal decentralization is more important than the search for a unique model.

Moreover, in a world in which economic shocks are propagated at high speed and cause different effects across geographical areas, both within the Latin American region and within individual countries, flexibility in adjusting the transfer system is needed in order to prevent changes dictated by a financial crisis from being adopted without first carefully determining their repercussions on the quality of fiscal decentralization. The establishment of a permanent forum with the necessary powers to perform its function is a key recommendation that should be seriously considered. Another

recommendation points to the need to abandon the reactive attitude that was characteristic of the recent past, and to evolve towards a strategy that enables the necessary changes to be formulated, while considering the possible repercussions.

These are the considerations that influenced the conception and organization of this chapter. It is divided into two parts. The first part examines both the principles, concepts and objectives that should be considered during the design of the transfer system as well as the actual practices and experiences, in order to provide the basis for drafting a guide on how to evaluate the options available in different circumstances. The framework of analysis developed in the first part sets the foundation for an analysis of the experiences of Argentina, Brazil and Colombia in the second part.

The first part begins with a synthesis of the principles and objectives that should be observed when formulating a transfer system, bearing in mind the results that are to be expected from a fiscal decentralization process. Then, the principle forms of transfer systems are analyzed and the principal compensation factors that should be considered are presented. Third, a deeper analysis of these solutions is provided by examining the different aspects to consider during their evaluation. Then a method for carrying out this evaluation is presented, and the results of its application to the comparative analysis of the experiences in Argentina, Brazil and Colombia is summarized. The first part concludes with a proposed guide for the design or reform of transfer systems, conceived in light of the literature and international practices and based on lessons learned from these cases.

The second part analyzes the country cases and provides an assessment of the different experiences in the light of the compensation factors discussed in the previous part.

### ***Principles and Objectives***

The potential benefits arising from a process of fiscal decentralization have been amply studied in the existing literature on public finances. Tiebout (1956) and Oates (1972), among others, mention the following benefits:

- i) local governments and representatives can allocate resources in a way that better satisfies local preferences;
- ii) the proximity between electors and local executive officials and legislative representatives makes it easier to control the latter's actions and favors the exercise of accountability;
- iii) democratic institutions and channels are reinforced the more that citizens perceive that the process of participation is fundamental for having their social preferences represented and
- iv) better solutions to many of the problems stemming from market failures or externalities can be reached in decentralized countries. This is the case for environmental protection and urban service provision, for example.

The principle of subsidiarity, according to which public expenditure should be the responsibility of the lowest possible level of government, is supported by the points made in the previous paragraph. The highest levels of government should only be in charge of expenditures that entail considerable economies of scale or significant externalities. Similarly, taking into account the need to avoid conflict between decentralization and macroeconomic stability, the instruments used to promote subsidiarity, including intergovernmental resource transfers, should include incentives for sub-national institutions to maintain fiscal discipline.

Thus, the realization of benefits depends upon the degree to which the various decentralization processes in the public sector, in both federal and unitary countries, allocate resources to the sub-national institutions at a level which is commensurate with their responsibilities. The ideal situation is that in which the responsibilities assigned to local governments can be entirely financed with resources coming from their own communities, through the collection of tax revenues

and fees charged for services. In the real world, however, this situation rarely is feasible given the disparities that exist in the spatial distribution of production and revenues, which influence a community's capacity for financing its expenditures, as well as factors such as the size or the demographic profile of the respective populations, which shape the nature and level of the demands made on the state.

Expanding local governments' own resources runs into various obstacles. On the one hand, the taxes that usually fall under these governments' control, such as real estate property taxes, do not, by their nature, offer much capacity for income generation, and their base is concentrated in just a few communities. On the other hand, raising revenues from public service fees is limited by the problems of income concentration and the low incomes of the majority of service customers. The alternative would be to share broader-based taxes, such as those on income or consumption, between the state or national government, by applying the principle of derivation (whereby the local government retains a portion of the tax collected within its jurisdiction). This option, however, neither responds to the needs of the majority of the sub-national jurisdictions, nor does it establish a direct link between the persons funding and benefiting from services. As a consequence, intergovernmental transfers are needed to fill the gap between resources and responsibilities, so as to ensure the best possible outcome in terms of the effectiveness and efficiency of state activities.

These gaps are manifested in two dimensions: the vertical, which represents the imbalances between the responsibilities at each level of government and the resources available to carry them out, and the horizontal, which refers to the disparities in resources and responsibilities within each level of government, across states, provinces, departments or municipalities.

In his summary of the alternatives in respect to the vertical dimension, Bahl (2000) analyzes three possibilities: a specified share of federal or state revenues, defining the transfer amounts on an *ad hoc* basis, and reimbursing previously approved expenditures. In respect to the method of horizontal distribution, the

options that he mentions are: sharing through the principle of derivation, using formulas for allocating revenues among the sub-national jurisdictions, total or partial cost refunds and the application of *ad hoc* methods.

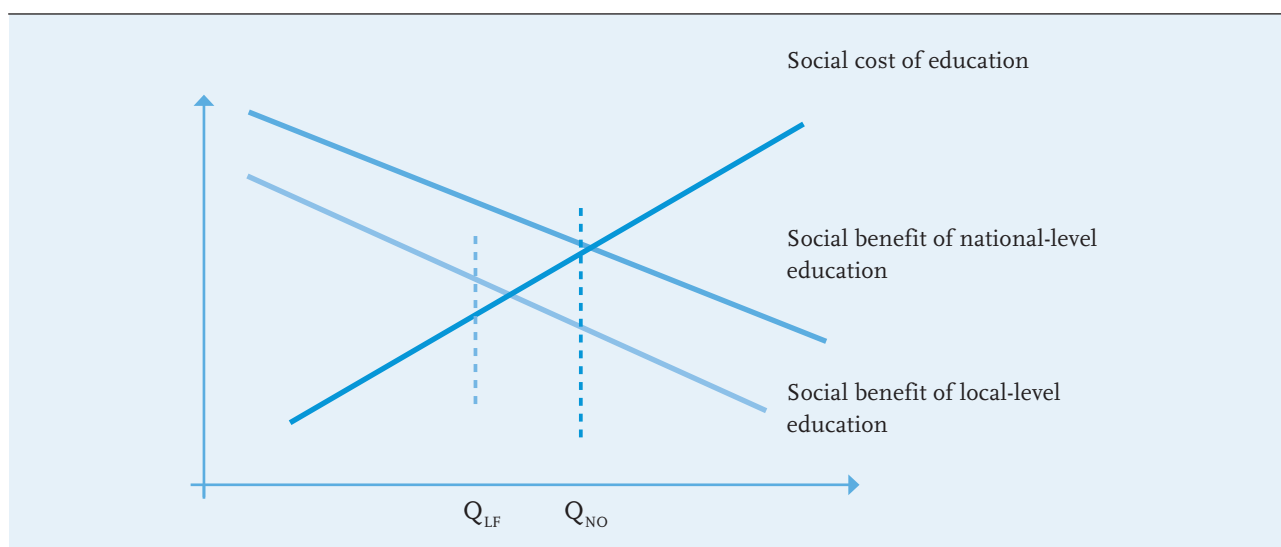
A list of the potential approaches from the combination of these dimensions will permit the defects and virtues of each one to be evaluated. Obviously, from the point of view of the objectives of fiscal decentralization, the worst combination is the one that implies the adoption of *ad hoc* procedures in two separate dimensions, even though from the central government's perspective this may be the most appealing option because it permits greater flexibility in decision-making and does not lead to difficulties in those situations in which a more rigorous fiscal adjustment has to be applied for macroeconomic reasons.

Another important concern in the formulation of transfer systems has to do with the balance between national priorities and local preferences. In principle, decentralization is the best way to adjust public resource allocations to the preferences of the respective communities. But, this can sometimes conflict with the objective of ensuring that all citizens have access to the goods and services that are fundamental to their social development opportunities, such as a good-quality education, for example. Moreover, the presence

of externalities, both positive and negative, can result in local interests differing from national interests. For example, if investments in education are the responsibility of one level of sub-national government, this level of government might have an interest in reducing education spending to a point below the national optimum, since some of the benefited children will eventually emigrate and then the investment in education undertaken by the local government might benefit another locality. Thus, education is a positive externality since it does not only benefit the locality which directly makes the investments.

In Figure 16, it can be seen that the national optimum level ( $Q_{NO}$ ) differs from local expenditure ( $Q_{LF}$ ) because the local government underestimates the benefits of education. This happens because the social cost curve intersects the local benefits curve before it joins the national benefits curve. The position of the national benefits curve to the right of the local benefits curve is explained by the fact that, in the former, the benefits obtained by the locality where the spending takes place are added to the benefits that the same spending engenders in other jurisdictions. Thus, when formulating transfer systems it is necessary to take into account the importance of ensuring a reasonable equilibrium between national priorities and local preferences.

**Figure 16. Externalities in education and local spending**



Another objective that needs to be considered is that of reducing regional disparities in economic and social development. Fiscal equity arrangements and the adoption of regulations that seek to respond to national priorities are not in themselves sufficient to stimulate development in economically backward areas, which need public actions to eliminate barriers such as infrastructure deficiencies in order to encourage private investment. Eliminating these deficiencies requires arrangements that promote or stimulate intergovernmental cooperation for the adoption of initiatives that reduce restrictions on regional economic growth.

In an ideal model, the scope of these objectives should be subject to certain principles. First, in order for decentralization to be successfully carried out, transfers must be transparent and predictable. Second, the transfers must have a reasonable degree of flexibility so that they can be adjusted to changing circumstances. Third, transfer recipients must have the necessary autonomy to make decisions about a significant proportion of the transferred resources.

In the real world, however, there are other aspects still to consider. An excess of transfers might encourage recipient governments to be fiscally irresponsible. The guaranteed availability of external resources represents a strong disincentive for local governments to increase revenues by fully exploiting their own tax base, since this would negatively affect their constituents.

In general, the distinct intergovernmental transfer arrangements typically fulfill, to a greater or lesser degree, the requirements of transparency, predictability, resource autonomy, and flexibility. It is difficult, therefore, to achieve an optimum combination of different approaches that would give rise to a reasonably balanced system of transfers, because the majority of the approaches examined in light of these requirements show both positive and negative aspects, and some of them exhibit qualities which are in contradiction with each other. It is important to point out that the optimum combination for each country has distinct characteristics and, therefore, there is no solution that can be universally applied.

In order for the virtues of decentralization to be fully realized, it is generally believed that the transfer system

- i) must provide for a regular, transparent and predictable flow of resources;
- ii) must balance local government financial needs and responsibilities;
- iii) must not discourage collection of those taxes that are already the responsibility of those governments and
- iv) must allow sub-national governments the flexibility to allocate the resources according to the diversity of conditions and preferences of the community they are intended to serve.

Given that the ideal world almost never coincides with the real world, and that the choice among alternative transfer systems is subject to the influence of various conflicting interests, the degree to which a possible solution approaches an ideal model will depend on the degree to which a better understanding of the consequences of different options can contribute to the management of such conflicts.

### ***Transfer Systems and Factors of Compensation***

In the existing literature and in international practice transfers are divided into two main groups depending on how the resources are used: unconditional and conditional. Both are characterized by a large degree of variation in respect to the definition of their bases, the number of forms they take, allocation criteria, and so on, but they are really differentiated by the degree of autonomy granted in the allocation of resources.

Unconditional transfers (Stiglitz 1988) imply greater autonomy because they are not assigned a specific use and the recipient government can use them in the way it finds most beneficial.

Conditional transfers, on the other hand, allow recipient governments far less autonomy in respect to their use. There is a greater variety of types of conditional transfers than unconditional transfers. Among them are matching grants, unlimited matching grants

and non-matching grants. All represent central government intervention in local spending decision-making, to a greater or lesser degree.

Matching grants guide local resource allocations to sectors selected by the central government, but they leave to recipient governments the power to decide the respective amounts. These transfers can be considered as a subsidy towards the cost of the public service offered. If, for example, the federal government is willing to transfer one dollar to sub-national governments for every dollar that the latter spends on education, sub-national governments' perception will be that the cost of providing these services is only 50% of the real cost. This kind of transfer is often employed so that the provider government can internalize the externalities arising from a given public good or service.

Unlimited matching grants represent a fiscal risk for the federal government, which cannot foresee with complete accuracy the amounts it will have to transfer in order to complement local spending. This does not happen with limited matching grants which, though similar to the former, differ by establishing in each case a maximum contribution from the resources that the central government must transfer in each case. In this option, therefore, sub-national governments wishing to increase their spending in a given sector or function over and above the established limit can do so but without additional financial support from the federal government.

Non-matching grants leave no option to beneficiaries, who are obliged to employ these resources for predefined functions, thereby establishing the predominance of central over local government preferences. However, local governments could potentially exercise some freedom over the way the resources are distributed within the sector receiving the grant, which would allow for some representation of local preferences.

The bases for transfers can be defined in *an ad hoc* way or through a legal mechanism, in some cases through the constitution. The revenue system can be composed of shared revenues or by constituting local tax bases. Distribution among beneficiaries can either follow a specific formula that automatically adjusts the

amount allocated to each jurisdiction, or be the result of an *ad hoc* procedure. In this case beneficiaries have full autonomy regarding the use of resources and, therefore, no concerns about the safeguarding of national interests will arise. If the base for the transfers is predetermined by law, it can give rise to problems for the maintenance of fiscal discipline and, if it is not, the efficiency of sub-national government service provision is jeopardized.

Conditional transfers generally refer to resources that are transferred with conditions that put emphasis on either the sector or the nature of the expenditure, thus interfering in the use but not the result. Shah (2007) classifies these transfers as being input-based, as opposed to other transfers that are output-based. In the latter mode, the transfers would be associated with temporary contracts rather than permanent rules, being subject to revision whenever results for beneficiaries do not match the mutually agreed commitments.

In spite of the diversity of options in respect to the form of transfers and their respective qualities, in the evaluation of specific experiences and in the formulation of recommendations for change, there are three principle factors of compensation that should be taken into consideration:

- i) fiscal discipline versus sub-national autonomy;
- ii) national priorities versus local preferences and
- iii) service provision efficiency versus equity in access to services.

The preoccupation with fiscal discipline and the predominance of national interests, along with the rigid conditions governing their use that aim to ensure that fiscal discipline is not jeopardized during moments of financial crisis can give rise to a preference for greater flexibility in defining the amounts of transferable resources. By contrast, an emphasis on the virtues of decentralization can lead to the opposite orientation being recommended; the adoption of clear and stable regulations regarding the transfer of federal funds to sub-national governments, and less interference by the federal government in local decision-making on expenditure (preferably, total autonomy).

While autonomy in the allocation of resources might guarantee better attention to local preferences, it can accentuate the differences between local and national interests. Moreover, the quality of institutions can also affect the determination of the optimum level of autonomy. In those cases in which institutions are weak and local management capacity is clearly deficient, less autonomy and more rigid fiscal rules need to be considered. The weaker the institutions, the greater the need to adopt models that lend themselves to periodic rule revision, in order to avoid distortions being perpetuated.

Greater autonomy can also enter into conflict with the principle of equity in the access to state services, especially when there are important regional disparities. Therefore, the greater the regional and social disparities, the greater the weight that national priorities will have within the transfer system to the detriment of concerns related to the satisfaction of local preferences.

In order to ensure governmental accountability towards citizens, transfers need to be transparent and the origin and amounts of the resources received by the sub-national units must be precisely known. Sub-national governments should also have a free hand in allocating the resources.

When the predictability of the flow of resources is high governments are able to adopt a more precise, rational and less risky financial program, thus facilitating the execution of long-term actions and programs, especially investments, without which efficiency in local public service provision is undermined.

But when the rules regulating transfer systems are more predictable, greater difficulties are likely to arise in ensuring commitments to fiscal discipline during economic crises. Flexible rules contribute to fiscal behavior supporting macroeconomic stability but they go against the spirit of decentralization.

Table 56 compares some of the characteristics of the transfer regimes that give rise to the two compensation factors mentioned above.

Fiscal discipline is not incompatible with decentralization, but compatibility depends upon the strength of institutions, transparent fiscal rules and a clear

distribution of responsibilities and powers, thus making effective social control of governments possible. It also depends on a strong general commitment to accountability in the case of the inadequate management of public accounts, meaning that there will be no rescue operations in the hypothetical case of a lack of financial control by sub-national governments.

It is possible that national interests and local preferences could be considered not as antagonistic, but rather as complementary, aspects. In this case, the degree of regional and social inequality is a factor that affects the evaluation of what approach to adopt. If these inequalities are significant and likely to increase, and if the state's action in the field of social and regional policy is an important instrument for reducing them, then national interests tend to prevail. This, in turn, reduces the margin within which actions carried out at the local level can respond to the preferences of their respective communities.

These considerations reinforce the impossibility of applying a single model, either for evaluating existing systems or for formulating reform proposals. Each model should be interpreted within the context in which it was formulated in order to better understand the motive behind the decisions that led to its adoption. This does not mean it is not possible to establish the necessary parameters for evaluating known systems, but it does reflect the importance of analyzing each individual case, by taking into account the factors of compensation that should be considered before advancing towards making recommendations. The following subsection examines these factors of compensation.

### ***Evaluation of the Factors of Compensation***

Evaluation of the factors of compensation depends on:

- The way in which transfer amounts are defined;
- The methods and criteria that are applied to the distribution of transferable resources;
- The number and the nature of the conditions established for the use of transferable resources;
- The stability and predictability of the flow of transfers;

**Table 56. Transfers: principles and factors of compensation**

|                           | Fiscal Discipline                                                                                        | Virtues of Decentralization                                                                                                   |
|---------------------------|----------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------|
| <b>National interests</b> | Flexibility in determining funds; conditional transfers; uniform regulations.                            | Rigidity and stability of funds; asymmetrical regulations; stimulus for intergovernmental cooperation.                        |
| <b>Local preferences</b>  | Flexibility in determining funds; autonomy and transparency in the use of resources; fiscal regulations. | Rigidity and stability of funds; autonomy and transparency in the use of resources; incentives for exploiting local tax base. |

- The relation between transfers and local resources in the composition of the sub-national budget;
- The transparency of the rules governing intergovernmental fiscal relations.

An improved balance between fiscal discipline and a more efficient decentralization process depends on the solution adopted to determine transfer amounts. It would be ideal if transfer values were defined on the basis of a clear definition of responsibilities at each level of government and of the resources which each level should count on to adequately fulfill those responsibilities, taking into account regional differences in respect to the cost of service provision. The discrepancy between the sub-national governments' need for resources and their capacity to obtain them by collecting taxes within their jurisdiction measures the extent to which they depend on transfers.

This is a proposal that is very difficult to apply in reality, especially in those countries where there are large regional disparities and significant internal differences in respect to the quality of public institutions. These problems can be mitigated if the territorial distribution of resources follows asymmetric rules, but this inevitably leads to conflict about the intensity and degree of asymmetry.

In the absence of objective criteria to determine the right transfer amounts, it would be advisable to adopt a solution that permits the introduction of frequent readjustments to limit either excessive levels, which lead sub-national governments to under-exploit their

potential tax bases, or deficient levels, which result in the lack of capacity to provide services in a decentralized way.

But, the uncertainties derived from frequent revision generate pressures in the opposite direction by promoting the incorporation of guarantees through specific laws or new constitutional provisions. Those guarantees might consist in transfers being based on a percentage of national tax revenue, or in the setting of minimum values, which would be valid for pre-established time periods.

These options do provide guarantees from the standpoint of the vertical distribution of resources, but there is a second problem that is even harder to solve: the distribution of the amounts assigned to each sub-national institution. The ideal model suggests the adoption of a system of spending capacity equivalence, in which the difference in the cost of service provision is taken into account, but even in those places where this solution has been officially adopted (e.g. Australia) its operation is extremely complex and it has been subject to harsh criticism.

The alternative consists of adopting a distribution formula that benefits the economically underdeveloped units and places greater weight, for example, on the extreme inverse of *per capita* income in determining respective contributions. It is easy to appreciate that negotiations over the components of this formula, and the weight of each of them in determining individual contributions, imply a high degree of conflict.

The most technically sophisticated formulas, that attempt to adapt the horizontal distribution of resources to the importance of respective responsibilities, end up by broadening the conflicts, as well as also presenting difficulties for implementation. The simplest formulas reduce the possibility of disputes, but they also generate significant distortions.

At the same time, socio-economic change means that whatever solution is adopted at any given moment will accumulate distortions over the course of time, which will require revisions and revive the conflicts over territorial resource distribution. In the absence of a new agreement, the solution normally consists of establishing fixed coefficients, based on patterns observed in the recent past, which obviously deepens the distortions, especially considering that the original solution already implied a high degree of inefficiency.

In the case that guarantees are fully respected, the horizontal imbalance between resources and needs is accentuated (mainly when resources are lacking in those places where the greatest problems occur) and resources can be freely allocated, sub-national government concern for fiscal responsibility will be lower, because wasteful spending is likely where there is an excess of resources and borrowing is encouraged where there is scarcity. An excess of resources likewise discourages local tax collection, including in those cases in which it is necessary, since a demonstration effect from other jurisdictions inhibits public authorities from applying effort in this respect.

This tendency leads to the imposition of controls on sub-national government management of their finances. On the one hand, conditions are imposed on the use of resources so as to reduce waste and, on the other, rigid controls on borrowing are put in place. Moreover, given that for political reasons it is difficult to adopt asymmetric solutions, uniform national rules finally prevail, which satisfies the demands for macroeconomic discipline but this in turn causes problems in terms of the efficiency of public management at the sub-national level.

Generally speaking, the conditions established are of two kinds. The first focuses on the nature of expenditures, and its objective is to limit administrative

or superfluous costs by way of, for example, personnel salary caps and restrictions on the possible level of borrowing for new investment through the adoption of fiscal responsibility laws. The second kind of condition implies alternatives that differ in respect to their effects. As previously mentioned, these alternatives include the approach of non-matching transfers (allocating part of the transfers to spending in sectors that are considered priorities from the point of view of national concerns regarding improvements in the standard of living of the population) and matching transfers (the transfer of funds equal to the level of sub-national government spending in those same sectors).

The allocation of part of the resources received by sub-national governments to certain sectors could alleviate pressure on the federal budget and have positive effects in terms of fiscal discipline, but it is also harmful from the standpoint of the efficacy of the decentralized fiscal regime, especially when the rules regulating the transfers are not transparent.

An efficient system must grant reasonable autonomy to sub-national governments in the use of transferred resources, be predictable and allow periodic adjustments to the rules. If there is flexibility, then autonomy and predictability might not cause problems for maintaining fiscal discipline, but this will not be the case if the rules are rigid. Symmetrical rules also create their own particular problems in terms of efficiency, because they do not allow adjustment between the territorial distribution of resources and the corresponding distribution of the demands on the state. At the same time, greater autonomy only results in efficiency when it is accompanied by the imposition of rigorous budget restrictions preventing the irresponsible management of public accounts at the sub-national level.

It is always difficult to reconcile the aspects of fairness and efficiency. If emphasis is placed on fairness in respect to the distribution of personal income, then transfers will include conditions on resource use that reduce sub-national autonomy and generate problems in terms of the efficiency of expenditures, especially when the rules are too rigid and the criteria for distributing transfers are symmetrical.

If there are no barriers to the internal mobility of the factors of production, the regional dimension of fairness is no longer important from an economic point of view, but it is difficult to imagine that policies ignoring this perspective would be politically viable. The expansion of regional disparities creates tensions and conflicts that demand attention, independent of the economic arguments about interpersonal fairness or efficiency. The classic systems of fiscal equalization adopted by the mature federal regimes (Germany and Canada) attempt to reconcile the individual and territorial dimensions of fairness by giving all units of the federation the necessary capacity to provide essential services, with the aim of giving all citizens the same access to them, regardless of where they live. This solution is difficult to apply in developing countries, where regional disparities are very pronounced, because the resources needed to put an efficient fiscal equalization system into practice would be very substantial, thereby jeopardizing fiscal management from a macroeconomic perspective.

The aim of the previous argument is to reiterate the scant reward for developing universal recommendations regarding the way in which countries should structure their transfer regimes to obtain desired results and to avoid exacerbating regional conflicts. For the recommendations to be useful, they should focus on the aspects that must be taken into consideration when deciding to what degree each system should confront the various problems described, so that the decision can be based on an analysis of the respective factors of compensation, and all stakeholders made clearly aware of the possible repercussions.

The degree of rigidity of the rules adopted to determine the amounts of the transfers and the freedom granted to sub-national governments in the use of the resources they receive are the principle variables that should be considered when evaluating a compromise solution between fiscal discipline and sub-national autonomy. Obviously, the maximum degree of rigidity is reached when the constitution determines the volume of resources to be transferred and the government does not have the opportunity to circumvent constitutional

rules by making use of taxes that are not part of the resource base for the transfers. At the same time, autonomy is at its maximum level when the imposition of any condition whatsoever on the use of transferred resources is prohibited.

The degree of rigidity is lower when the revenue base for the transfers does not cover the total of national tax revenues and when it is easier to alter the rules that regulate the calculation of the amounts to be transferred. This is most difficult when the rules are based in constitutional provisions and easiest when the rules are based on decisions adopted during the annual budget process. Between the two extremes, and on a scale of decreasing difficulty in altering the rules, are those regimes established by laws requiring a special quorum to approve their modification, ordinary laws and *ad hoc* negotiations. In any case, rigidity is moderated when the current regulations anticipate periodic adjustment of the amounts to be transferred.

The degree of autonomy, therefore, varies between absolute freedom and its total absence. The gradations between the two extremes derive from the significance and nature of the conditions imposed upon the use of resources. Obviously, freedom increases the more that the proportion of conditional transfers in the total volume of local budgets diminishes, but that is not all: the nature of the conditions also matters. Even if the share of conditional transfers is the same, there is less autonomy when conditions are imposed in the form of non-matching grants than if matching grants are employed. Moreover, whichever form is applied, autonomy increases when conditions are generic (by function or by sector) and diminishes when they are specific. When national government intervention in decisions about local expenditures takes the form of unlimited matching grants, this can cause difficulties for the maintenance of fiscal discipline.

In theory, greater autonomy results in more efficient decentralization and enhances governmental accountability, although it does put fairness at risk. Nonetheless, other factors must be taken into account when evaluating solutions that attempt to balance efficiency and equity considerations. The most important

has to do with regional disparities. From a strictly financial point of view, the conflict between autonomy (efficiency) and fairness could be solved through the adoption of an adequate system of fiscal equalization. But even if that were possible in developing countries with sharp regional disparities, there are other aspects that must be considered.

Among these aspects are incentives. Autonomy is important for efficiency, but it must be accompanied by the correct incentives. It cannot be mainly based on transfers because it is essential that sub-national governments have a reasonable capacity to collect tax revenues, and that transfers do not discourage their incentives to build this capacity. In addition, national autonomy must be accompanied by rigorous budget restrictions so that fiscal discipline is not put in jeopardy, and it contributes to governmental accountability. Fairness, however, does not solely depend on giving each sub-national institution the necessary financial capacity to fulfill its responsibilities, but also on adopting national standards regarding the quality of essential services, for example, in the areas of healthcare and education, with the aim of providing equality of opportunity in social development.

The imposition of national standards limits the adaptation of sub-national expenditure to local preferences, which implies that a compromise solution should be considered in this case as well. In principle, the adoption of national standards seeks to eliminate the disadvantages faced by the inhabitants of the poorest regions in gaining access to essential services provided or financed by the state. If these disadvantages are not corrected, then they will jeopardize social development possibilities and the greater they are, the greater will be the negative effect of the lack of policies designed to solve the social inequality problem.

The importance that access to education, healthcare and decent housing hold in the new development strategies aimed at reducing income inequalities has focused the state's attention on these sectors. This affects the adoption of measures that impose or affect the allocation of public resources administered by sub-national governments.

From this perspective, the sharper the regional differences in terms of the capacity and standards in service provision, the greater the need will be to allocate resources to these sectors and, as a consequence, there will be less margin for sub-national governments to adjust budgets to address local preferences. In this case, whenever disparities are pronounced, the pendulum that marks the desired balancing point will tilt towards heavy conditioning of transfers in support of equity-oriented policies, and in the other direction when these disparities are lower.

Given the limitations in the availability and quality of the existing information required for assessing differences in standards of access to and quality of social services, it can turn out to be impractical to evaluate a compromise solution on the basis of these considerations. One way of avoiding this problem would be to choose a variable that is easier to analyze that somehow synthesizes the effects of the differences obstructing social development opportunities, such as the Gini index for measuring the inequality of regional *per capita* income. If the index reaches very high values, it indicates the presence of very large shares of resources allocated to these sectors in the sub-national budgets, and vice versa.

The means adopted for allocating resources administered by sub-national governments will also affect the point at which a greater balance between national priorities and local preferences will be reached. If the allocation is carried out through matching transfers, then the provincial or municipal governments will be responsible for deciding the amount applicable, which will vary according to the size of the matching amount; the greater the matching amount, the greater the stimulus to spending in the mentioned sectors (if the balancing entry is limited, this incentive will be lower). If the option is a non-matching grant, the sub-national governments will not have the necessary autonomy to decide the applicable amount but they might, as in the case of matching grants, have a certain freedom to decide the way in which resources are allocated within each sector.

It is worth mentioning that national interference in sub-national spending can also take place through

constitutional or legal provisions (when this is possible) which stipulate that a portion of a sub-national government's own resources must be allocated to address national policy priorities. In this case, a certain degree of freedom can also be exercised when the rules that define the benefited sectors are ill-defined. Another way of obtaining a similar result is to transfer responsibilities from the central government to other levels of government, but without a corresponding transfer of resources. This option, however, might cause problems for the adequate functioning of the service or lead to the sacrifice of other services to make fulfillment of the new responsibilities possible.

It is clear that the basic variables that define when a particular case strikes the right balance between autonomy and fiscal discipline are the same ones that intervene in the evaluation of the other factors, although from different perspectives. As is the case for rules related to macroeconomic goals, overly-rigid rules applied to the horizontal distribution of resources also impair efficiency by hindering the adaptation of this distribution to changes in the regional distribution of service demands provoked by socioeconomic change and they also have negative effects on fairness. If on top of being rigid, the rules are also uniform, the difficulties of obtaining a territorial resource distribution pattern that satisfies the objective of reducing differences in social development opportunities will increase.

As far as autonomy is concerned, efficiency is promoted when transfers can be freely used, but this runs counter to concerns about fairness, as well as demanding other requisites to foster efficiency without jeopardizing fiscal discipline. This interdependence is what makes the evaluation of the factors of compensation more complex, even though deeper examination does reveal important elements that can inform the policy decisions determining to what degree each case approximates a solution that might reconcile the differing dimensions of such decisions.

## Procedures for Evaluating the Factors of Compensation

### *Fiscal Discipline*

As previously mentioned, the degree of rigidity with which the amount of national revenue to be transferred is defined is the principal aspect to be observed when evaluating the difficulties that a transfer system creates in terms of fiscal discipline. The greater the rigidity of the rules and the lower the possibility of introducing adjustments, the worse the quality of the system will be from the point of view of macroeconomic discipline.

This degree of rigidity is a function of two variables: the breadth of the base for calculating transfer amounts, and the nature of the rules that regulate this kind of system. Rigidity is more pronounced when the rules are of a constitutional character and the distributable amount affects total revenue. Rigidity is lower, however, when the transfer base does not affect total national revenue, when the rule is based on a law and when there are automatic mechanisms for revising the transferable amount.

The coverage of the base is measured by the relationship between the revenue raised from taxation making up the transfer base and the total volume of national tax revenue. In respect to the rules, the difficulties they cause for the maintenance of fiscal discipline range from relatively high in the case of constitutional provisions to low in the case of decisions adopted during the budget process through special and ordinary laws. For the same type of rule, difficulties decrease when the rule stipulates that periodic revisions will be made to allow adjustments to the changes in socioeconomic conditions (the Indian model). In Table 57, the diversity of possible combinations is presented, along with their implications for the difficulty of maintaining fiscal discipline.

**Table 57. Evaluation of the degree of rigidity of transfer amounts**

| Percentage of national tax revenue transferred |              |       |       |      |
|------------------------------------------------|--------------|-------|-------|------|
| Nature of the rules                            | More than 60 | 40-60 | 25-40 | 0-25 |
| Constitution                                   | VR           | R     | M     | L    |
| Special law                                    | R            | R-    | M-    | L+   |
| Ordinary law without previous adjustment       | R-           | M     | L     | VL   |
| Ordinary law with previous adjustment          | M            | M-    | L+    | VL+  |
| Annual Budget                                  | L            | L-    | VL    | VL++ |

References: VR, very rigid; R, rigid; M, medium; L, low; VL, very low.  
 The sign next to some concepts denotes reinforcement (+) or attenuation (-).

### **Sub-National Autonomy**

The basic variable defining the degree of autonomy is the proportion that allocated resources represent relative to the sub-national government's total budget revenue. This share depends on allocations included in the transfers, and on the importance of own revenues in the composition of sub-national budgets. Autonomy also varies according to the nature of allocated revenues, even if these revenues represent the same share.

If non-matching grants are chosen, autonomy will be less than if transfers are made through matching grants. In any case, autonomy increases when allocations are assigned to large sectors and it decreases when assigned to specific programs. If the matching grants are of an unlimited character, the problems they pose for fiscal discipline must be borne in mind. The correlation of these variables enables the degree of autonomy to be evaluated, as shown in Table 58.

**Table 58. Degree of autonomy in the use of tax revenue by sub-national governments**

| Percentage of revenues allocated as a share of total tax revenues |          |        |       |       |      |
|-------------------------------------------------------------------|----------|--------|-------|-------|------|
| Nature of allocations                                             |          | 80-100 | 60-80 | 30-60 | 0-30 |
| Non-matching                                                      | Sectors  | VL     | L     | M     | VH   |
|                                                                   | Programs | VL+    | L+    | M-    | H-   |
| Matching                                                          | Sectors  | M-     | L-    | M+    | VH   |
|                                                                   | Programs | VL++   | L--   | M--   | VH+  |

References: VL, very low; L, low; M, medium; VH, very high; H, high.

## Efficiency

Efficiency depends on autonomy, but also on predictability. Efficiency, therefore, can vary as a function of the guarantees that regulate resource transfers and their predictability, even if the degree of autonomy resulting from a combination of these conditions is the same. Guarantees are greatest when transfers adhere to perfectly known and easily applied formulas, and less when rules are changeable or non-existent. Predictability, in turn, is greater when transfers are automatic, but is nearly absent when they are subject to the control of the national government. Therefore, for the same degree of autonomy, efficiency is greater when guarantees and predictability are high and less when they are insignificant. The aggregate data corresponding to

each layer of government reveal little or nothing about a system's efficiency. It is necessary to analyze the situation from a horizontal perspective, that is, in terms of how autonomy and predictability vary as a function of the degree of development and the size of the different sub-national governments. For the same degree of autonomy and predictability, efficiency can vary according to whether or not rigorous budget restrictions are in place. In this case, evaluation should be carried out in two stages, as shown in Table 59.

Among the prerequisites for rigorous budget restrictions, the relationship between transfers and own revenue, and incentives to exploit sub-national government tax collection potential are of great importance.

**Table 59. Evaluation of the efficiency of transfer systems**

| I - Degree to which autonomy and predictability enhance efficiency |                                            |    |   |    |      |
|--------------------------------------------------------------------|--------------------------------------------|----|---|----|------|
| Predictability                                                     | Degree of autonomy in the use of resources |    |   |    |      |
| Automatic transfers                                                | VH                                         | H  | M | L  | VL   |
| Formula                                                            | M                                          | G  | M | L  | VL   |
| Fixed coefficients                                                 | G                                          | G- | M | L  | VL   |
| Non-automatic                                                      | G-                                         | M  | L | VL | VL++ |

References: VH, very high; H, high; G, good; M, medium; L, low; VL, very low.

| II - Favorable conditions and degree of efficiency of the system |                                     |     |   |    |     |
|------------------------------------------------------------------|-------------------------------------|-----|---|----|-----|
| Rigorous budget restrictions                                     | Favorable conditions for efficiency |     |   |    |     |
|                                                                  | VF                                  | F   | M | U  | VU  |
| Yes                                                              | VE                                  | VE- | E | I  | VI  |
| No                                                               | VI                                  | VI- | I | I- | I-- |

References: VF, very favorable; F, favorable; M, medium; U, unfavorable; VU, very unfavorable; VE, very efficient; VI, very inefficient; E, efficient; I, inefficient; VI, very inefficient.

### Fairness

If the criterion for evaluating equity is taken to be the contribution of the transfer system to offering all citizens access to the same pattern of essential services (thus equalizing social development opportunities), then the principle variable that indicates the degree of fairness of the system is the proportion of resources assigned to national priorities in the field of social policy (healthcare, education and housing) in relation to the total sub-national budget. In principle, the greater the regional disparities in terms of income, the greater the need to allocate transfers to those sectors, to ensure the same standard of service provision in the poorest regions and to provide equal opportunities for all citizens.

Therefore, the higher the index of regional inequalities (the Gini coefficient, for example), then the greater the allocations to the social sectors should be, and vice versa. But that is not all. For the same degree of

allocation, the system's fairness varies according to the form of transfer employed. In light of this criterion, specific non-matching grants are preferable to those of a generic nature, although part of their effect might be canceled out in cases in which the volume of local revenue is such that it can take the place of transferred funds. On the other hand, matching grants can have negative effects from the perspective of fairness, especially when the national shares are uniform, generous and unlimited (in which case, their macroeconomic repercussions should be taken into consideration).

Just like efficiency, the equity of the system should be evaluated from a horizontal perspective, according to the disparity of the conditions found across the national territory. Depending on socioeconomic development factors, symmetric and overly-rigid rules are unfavorable from the point of view of equity. In Table 60, the possible combinations are summarized.

**Table 60. Evaluation of the degree of equity under conditions of sharp regional disparity**

| Percentage of revenue allocated to national programs in the sub-national budget |           |        |       |       |      |
|---------------------------------------------------------------------------------|-----------|--------|-------|-------|------|
| Forms of transfer                                                               |           | 70-100 | 50-70 | 30-50 | 0-30 |
| Non-matching                                                                    | Sectors   | VH     | M     | VL    | VL   |
|                                                                                 | Programs  | H      | H     | M     | L    |
| Matching                                                                        | Sectors   | M      | H     | VL    | VL+  |
|                                                                                 | Programs  | H      | M     | L     | VL   |
|                                                                                 | Unlimited | H      | M     | L     | VL   |
|                                                                                 | Limited   | M      | H     | VL    | VL+  |

Note: Symmetrical rules reduce equity, principally in the case of transfers with matching grants, which do not take into account differences between sub-national governments.

### Accountability

Accountability at the sub-national level depends to a large extent on the governments' room for maneuver in allocating their budgets according to the preferences of their respective communities, as well as on the transparency of the decisions adopted. Therefore, one of the variables defining the possibility of responding to local preferences is the degree of autonomy of sub-national governments in allocating their revenues. Another variable has to do with the nature of that autonomy. If it results from a greater capacity to generate own revenue and an adequate exploitation of this potential, its effects from the perspective of accountability are better than in the case of greater autonomy derived from non-allocated transfers. For the same degree of autonomy in the use of budget resources, the conditions for accountability are favored to a greater extent when the autonomy is obtained by way of the sub-national governments' own revenue rather than through transfers.

Even though the suggested evaluation could be carried out by using the objective factors mentioned above, the evaluation should not be centered in these to obtain the best solution possible. From the point of view of fulfilling the five principles, a balanced transfer regime is not necessarily that of the medium position in relation to the previously analyzed factors of compensation, but rather depends on the importance that society attributes to each one of the principles that should be observed, as well as the degree of existing social and regional disparities and the quality of institutions.

The procedure that is suggested here, therefore, does not pretend to have normative value or to be able to indicate what the best options are in each case. What it aims to do is to highlight those aspects that must be taken into account in making decisions about the design of a particular system, or introducing changes in existing systems, such that the repercussions of given decisions can be appropriately understood by all those who benefit from them, or must face their consequences.

**Table 61. Evaluation of the system in respect to accountability**

| Relationship between own revenue and free transfers | Degree of autonomy in the use of resources |        |        |      |
|-----------------------------------------------------|--------------------------------------------|--------|--------|------|
|                                                     | Very strong                                | Strong | Medium | Low  |
| Greater than 3                                      | VG                                         | G      | M+     | B    |
| Between 2 and 3                                     | G                                          | G-     | M-     | B+   |
| Between 1 and 2                                     | M+                                         | M-     | B      | B++  |
| Between 0.5 and 1                                   | B                                          | B-     | VB     | VB+  |
| Less than 0.5                                       | VB                                         | VB+    | VB++   | VB++ |

VG, very good; G, good; M, medium; B, bad; VB, very bad.

## Distinctive Characteristics and Lessons Learned from the Cases of Argentina, Brazil and Colombia

In recent decades, the resource transfer systems of the countries analyzed have been subjected to the influence of two clearly distinguishable forces: the demands to promote and maintain macroeconomic fiscal discipline derived from the more globalized nature of the economies, and demands from society, stimulated by advances in the democratization process, in the sense of greater priority being assigned to policies oriented toward reducing social inequality.

These forces produced two principal consequences: they increased the control of national governments over both the amount of the resources transferred as well as their use. The rules regulating transfers became more unstable and resources with no strings attached lost significance relative to total transfers, thus reducing sub-national autonomy.

Based on the procedures discussed in the previous section, a first evaluation of the transfer systems currently operating in the countries analyzed indicates that the principal consequences of reactions to these dual pressures was the erosion of two of the important transfer system attributes that shape the quality of a fiscal decentralization process: autonomy in the management of resources, and government accountability.

### **Argentina**

In Argentina, the national tax revenue sharing system, established in 1973 by Law 20,221 was replaced in the next decade by a regime that, although considered temporary at the time, has been in place since 1983. This was the reason why the central element of the country's intergovernmental revenue transfer system lost stability and transparency. It also lost importance in the overall amount of transfers from the national government to the provincial governments, especially in recent years, given the increase in revenues coming from foreign trade taxes.

The adoption of a provisional regime interrupted the tendency observed in previous decades for a growing share of national revenue to be transferred to the provinces. In 2002, the provinces' share of national revenue declined by nearly 40%, a level far below the previous decade's average. At present, the provinces receive approximately 57% of the so-called *masa coparticipable neta* (net revenue sharing fund).

The losses suffered by the provinces resulted from two complementary measures: the transfer of greater responsibilities, especially in the sectors of education and health care, and the use of revenues from the revenue sharing fund to support the financing of social security. In the former case, the federal government reduced its costs by transferring the management of hospitals and schools to the provinces. In the latter, the goal was to stimulate the competitiveness of the Argentine economy by assigning a part of the revenues collected from the VAT to social security to make possible a reduction of payroll taxes. When the provisional revenue sharing regime was adopted in 1987 (Law 23,548), the previous rules were replaced with values that were set through the new negotiations. The previous formula for revenue sharing was substituted by fixed percentages, defined on the basis of the average resources received by the provinces during the period 1985-1987. This brought instability to intergovernmental financial relations and problems for public management at the sub-national level.

The transfer of responsibilities to the provinces in the social policy area increased the pressure for financial resources to cover the costs of these service responsibilities. The solution entailed the expansion of the resources that form the base of the revenue sharing regime and the increase of discretionary transfers. The net revenue sharing fund is made up of different percentages of various taxes, thus expanding the possibilities for modifying the amount from which the percentage distributed among the provinces was taken. Figure 17 illustrates the structure of this financing arrangement.

**Table 62. Intergovernmental transfers in Argentina, Brazil and Colombia: factors affecting the quality of fiscal decentralization**

| Evaluation Criteria                                                                                                                                                                                                                                                  | Argentina                                                                                                                                                                                                                                                                                                                                              | Brazil                                                                                                                                                                                                                                                                                                 | Colombia                                                                                                                                                                                                                                                                              |
|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Degree of macroeconomic rigidity</b><br>(Depends on the percentage of national revenues transferred and the difficulty of altering established rules).                                                                                                            | Provisional regime. Through revenue sharing, the high degree of rigidity caused by assigning more than 50% of national revenues to the provinces is attenuated.                                                                                                                                                                                        | The exploitation of non-shared taxes enabled the Brazilian regime to be the most flexible of the three countries analyzed even though formally its system is rigid.                                                                                                                                    | The adoption of a provisional regime also moderated the high rigidity of constitutional rules, but flexibility is still conditioned by the performance of the economy.                                                                                                                |
| <b>Degree of autonomy of sub-national governments</b><br>(Depends on the conditions imposed on the use of transfers and the importance of own revenues).                                                                                                             | Formally very high, because transfers are unconditional, but the transfer of responsibilities and the minimum expenditure level for education reduced provincial autonomy, although it still remains high.                                                                                                                                             | The great capacity for revenue generation maintained a reasonable level of autonomy, despite the significant increase in previously assigned transfers.                                                                                                                                                | The high degree of conditional transfers and the scant capacity for generating own revenues contributed to a low level of autonomy. This is the least favorable situation in this matter.                                                                                             |
| <b>Efficiency of management</b><br>(Depends on the degree of autonomy, of the relation between own revenue and free transfers and the existence of rigorous budget restrictions. Also depends on the rules applied to the horizontal distribution of the transfers). | The predominance of transfers in relation to own revenues and the optional application of the <i>Ley de Responsabilidad Fiscal</i> (Fiscal Responsibility Law) means that the system is less efficient. Horizontal disparities, made worse by fixed coefficients, also limit efficiency, although the situation is more favorable than that of Brazil. | Generally, significant autonomy and a strong relation between own revenue and free transfers, reinforced by rigorous budget restrictions, favor efficiency, but this evaluation is undermined by the enormous horizontal disparities aggravated by the importance of the municipalities.               | The combination of scarce autonomy and a very weak relation between own revenue and transfers lead to an outcome that is not favorable for efficiency. However, the rules to distribute resources in the territory in accordance with internal demand reduces the horizontal problem. |
| <b>Equity in access to services that are essential for social mobility</b><br>(Depends on the percentage of resources assigned to education and health care, and the adoption of minimum national standards).                                                        | The redistributive character of the revenue sharing regime should enable the poorest provinces to improve the level of access and the quality of the services they are expected to provide, which would result in a favorable outcome if this happened.                                                                                                | The evaluation improved due to new allocations of resources for healthcare financing and the application of new rules for the distribution of resources allocated to education, but the horizontal disparities cause imbalances between the available resources and demand, thus diminishing fairness. | The changes carried out in the rules governing resource distribution for education were a positive contribution, but the existence of differentiated regimes for access to health care, on top of the subsidy granted by the government, reduced its effects.                         |

| Evaluation Criteria                                                                                                                                                                                                               | Argentina                                                                                                                                                                                                  | Brazil                                                                                                                                                                                                                                                                          | Colombia                                                                                                                                                       |
|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Governmental accountability</b><br>(Depends on the importance of a government's own revenue in sub-national budgets, on the transparency of rules governing the transfers and the degree of autonomy in the use of resources). | The negotiation of pre-established values reduced the system's transparency and this, along with the loss of autonomy and the lower significance of own revenue, translates into an unfavorable situation. | From an aggregate perspective, the system would be favorable because the degree of autonomy is significant, own resources are fairly substantial and the principal component of the transfers is transparent. However, the horizontal disparities go in the opposite direction. | Although the rules are relatively transparent, the scant autonomy and the low importance of own revenue also leads to an unfavorable evaluation of the system. |

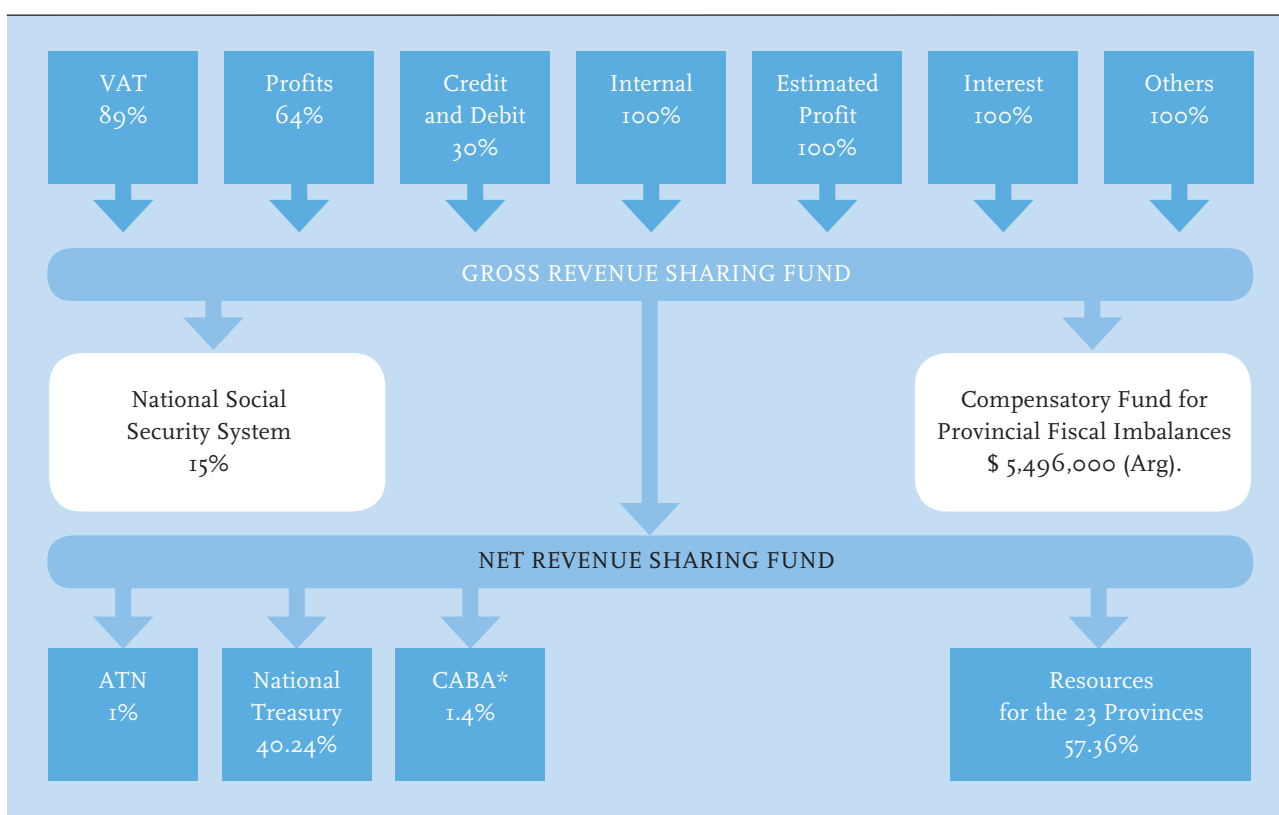
Although the revenue sharing regime does not establish conditions for the use of transfers, the transfer of responsibilities and the adoption of rules defining minimum levels of provincial spending on education reduced the autonomy of sub-national governments over their budgets, thereby causing differential effects. Whereas the poorest provinces were the ones that most benefited from transfers, in the richer provinces the cost of education and health care service provision is much higher, which means that expenditure autonomy is adversely affected. This can even cause problems in respect to the financing allocated to other sectors, especially urban service provision. This reduced autonomy, on the one hand, and the greater dependence on transfers, on the other, created conditions that did not favor the accountability of the sub-national governments to their citizens.

The 1994 constitution included arrangements aimed at protecting the provinces; one example of this is the requirement to include all new taxes established by the federal government in the total amount of federal resources available for distribution, as well as the prohibition of unilateral transfers of responsibilities without the corresponding transfer of the resources necessary to finance them. It also established that the new resource distribution regime within the federation should be regulated by a new law, the *Ley Convenio* (Covenant Act), which in the end was not enacted due to the requirement that it be approved by both the national legislature and all of the provincial legislatures.

The conflicts over the distribution of public resources intensified after the *Plan de Convertibilidad* (Convertibility Plan) was abandoned. The multiple amendments introduced in respect to the distribution of revenues accentuated the distortions mentioned above and contributed to intergovernmental fiscal relations being further diverted from the principles that contribute to a fair decentralization process. According to Cetrangolo and Jiménez (2004), the changes observed during this period point towards an incipient process of recentralization.

An important fact that should be highlighted is the absence of direct sharing by the municipalities in the transfers of resources from the pool of national tax revenues. Indirectly, a municipality benefits through revenue sharing with its particular province (either from the province's own revenue, or from its participation in national revenue). There is, however, no general rule in place in this respect. Each province, instead, adopts different rules, which leads to great disparity in the role that Argentine municipalities play in the decentralization process.

In terms of macroeconomic considerations, the maintenance of a provisional regime does favor fiscal discipline, although it also creates uncertainty and instability that jeopardizes the efficiency of public management and government accountability. Due to the freezing of the transfer percentages for each province, the system's efficiency is still suffering from the reduction in provincial autonomy and the worsening horizontal imbalance in the distribution of resources.

**Figure 17. Argentine tax revenue sharing regime**

Source: *Ministerio de Economía y Finanzas Públicas de la República Argentina* (Ministry of Economy and Public Finance of the Republic of Argentina).

\*CABA: *Ciudad Autónoma de Buenos Aires*.

Viewed from another perspective, however, the strongly redistributive character of the transfers carried out through the regime, along with the greater orientation of these resources toward satisfying national priorities, seems to have contributed to a reduction in social inequalities. This is evident in the decreasing differences between the provinces in terms of the Human Development Index (HDI) at the same time that the dispersion in per capita GDP remained about the same.

In general, the Argentine provisional regime did contribute to reducing rigidity in respect to the transfer amounts and to enhancing equity. But, by reducing autonomy, it also helped to maintain uncertainties and by ignoring horizontal imbalances, it negatively affected efficiency and sub-national government accountability.

Although the 1994 Constitution did shape the creation of a new regime in 2006, the rules envisaged for its enactment meant that it was unviable, despite repeated commitments in this direction. The prolonged period of application of the provisional regime became an obstacle for change, by exacerbating the conflicts between the provinces. This is the principal obstacle that must be tackled if such changes are to be adopted.

### **Brazil**

In Brazil, sub-national government participation in federal taxes maintained the guarantees and stability conferred by the constitutional reform, in spite of the macroeconomic policy demands for fiscal constraint,

but the constitutional funds' loss of significance as a proportion of total revenue transfers to the states and municipalities was much greater.

Contrary to the trends generally observed in the region, the Federal Constitution of 1988 expanded the transfers of revenues collected from the principal federal taxes, but without the transfer of equivalent responsibilities. The decentralization of revenue was accompanied by an increase in the state's responsibilities in the area of social security but, in the absence of clear definitions about their distribution, the task of taking charge of financing those new responsibilities fell to the federal government.

These changes gave rise to significant distortions in the Brazilian revenue sharing system. In order to generate the necessary resources to cover the costs of the social security system, the federal government depended on new contributions created by the constitution which, due to the expansion in social security expenditures, increased so rapidly that they now exceed the total resources collected by the federal government that are shared with the states and the municipalities.

The expansion of contributions might have reduced the level of rigidity within the Brazilian system and, consequently, made it more favorable from the point of view of fiscal discipline, but it also made the system extremely imbalanced from the point of view of horizontal resource distribution, and entailed less autonomy for sub-national governments over their expenditures.

Part of the revenues collected from social contributions is transferred to the states and municipalities in order to finance the social security system, but the increase in transfers carried out with non-constitutional funds was counterbalanced by the growth in the number of resource transfer arrangements and the growing imposition of conditions governing the use of transfers by the state and municipal governments. Moreover, the large number of revenue sources, and the abandonment of rational criteria for apportioning revenues between the states and the municipalities, converged to generate enormous disparities between the resources and the responsibilities assigned to each one of the jurisdictions.

Two factors contributed to the growth of these disparities: the replacement of the previous apportionment formula determining the state and municipal share of federal tax revenues with fixed coefficients (adopted in 1989) and the absence of a common logic to channel the distribution of the remaining transfers. In a context of important demographic changes, the use of fixed coefficients entailed significant imbalances in respect to the territorial concentration of responsibilities and resources. These imbalances were exacerbated by the multiple layers of transfers, each one distributed according to different criteria.

The imbalances manifest themselves in the form of important differences in terms of sub-national autonomy. In particular, the small municipalities and the less-developed states, in general, enjoy a higher level of autonomy because they receive a higher proportion of unconditional transfers. However, given that this autonomy results from greater access to unconditional transfers, it does not translate into a favorable situation overall because of concerns related to efficiency and accountability.

In order to improve efficiency, changes were incorporated into the criteria adopted for distributing the resources assigned to the financing of health care and education, which attempted to introduce greater predictability in the level of transfers, and to target the territorial distribution of those resources according to the demand for such services. The best results were achieved in the case of education, by using levels of enrolment in the state or municipal public-sector schools as the basic criteria for distributing funds for primary education. This change, along with the allocation of the largest share of the resources to improving teachers' salaries, brought notable benefits.

An important peculiarity of Brazilian federalism—the autonomy that municipalities possess and their growing relationship with the federal government—complicates matters still further. Following in the wake of the changes promoted from the beginning of the 1990s onwards, the states have witnessed a gradual decline in their importance within Brazilian federalism, whereas the federal government has recuperated from the financial

losses it sustained due to the proclamation of the new Constitution in 1988, and the municipalities have expanded their share of total public sector resources.

Another factor that deepens disparities and accentuates distortions is the adoption of symmetrical rules within a context of strong asymmetries. Although the municipalities as a whole have obtained significant financial benefits, the resources are not distributed among them in a manner commensurate with their respective responsibilities, which principally harms the metropolitan areas and the biggest cities. The same situation holds true for the states; scarcely-populated units with a low population density exhibit per capita budgets many times greater than those of units with the opposite characteristics. In such a situation, the vice of transfers corrupts the virtues of decentralization.

If all of the five dimensions discussed previously are taken into account when evaluating the Brazilian case, the significant influence of decisions aimed at compensating the effect of the rules stipulated in the 1988 Constitution in respect to fiscal discipline can be fully appreciated. The rigidity of the rules governing transfers was reduced as a consequence of the reduction in the weight that shared taxes have in total transferred revenues. This change was accompanied by greater federal government intervention in sub-national budgets in order to improve the system's equity. This intervention does not harm efficiency when this is evaluated from an aggregate perspective, but serious differences are evident when this is evaluated from a horizontal point of view. Moreover, when the evaluation is focused on government accountability, the results are very poor.

The greatest difficulty that the Brazilian system faces in reconciling fiscal discipline with efficiency has to do with the horizontal dimension. The distortions generated by the formula for apportioning resources among the states and the municipalities, began to accumulate starting in 1989, when the previous formula was abandoned and the fixed coefficients that have been in place since this time were adopted. The main distortion has to do with the divergence between the territorial distribution of resources and the distribution of responsibilities. The system benefits the smaller municipalities and

the under-developed states, but socio-economic forces concentrate the problems on the larger and more developed municipalities and states. Asymmetric rules could reduce the distortions, but the adherence to asymmetry is based in political factors that are difficult to eliminate.

### **Colombia**

In Colombia, decentralization is a recent phenomenon that has been implemented fairly rapidly. The sub-national governments' share of national revenues increased from 13% in 1973 to 51.1% in 2003, a remarkable achievement for a centralized country.

Despite the political autonomy gained by the departments and some measures designed to provide them with better operating conditions, decentralization in Colombia centers on the municipalities and its main focus is on social policies, which have been strengthened by the transfer of a large share of the resources to health and education.

The speed with which decentralization evolved in Colombia is due to the succession of measures adopted from 1973 onwards, which were substantially reinforced with the enactment of the 1991 Constitution. However, as was the case in Argentina and Colombia, the fiscal and macroeconomic crisis dampened the initial enthusiasm and provoked changes that generated greater uncertainties in respect to its evolution in the near future.

These uncertainties were due to the abandonment of the rules governing the percentages of national revenue to be transferred, and their substitution by provisional measures. In this particular case, the measures adopted do not significantly differ from those adopted in Argentina and, in a somewhat different form, those in Brazil. However, given that Colombia does not have a federal system, its decentralization was largely based upon the transfer of resources, which makes the count more vulnerable to a reduction in the guarantees that sub-national governments need in order to be able to finance their responsibilities.

As a consequence of the changes put into place in 2001 (Act 715), the amount of the transfers was no

longer defined on the basis of a percentage of national revenue, but was based on a pre-established value. By making these changes, the national government achieved greater flexibility in fiscal policy management, as well as increased the predictability in respect to the distribution of resources among the departments and municipalities. But at the same time, it subjected the decentralization process to greater future instability and uncertainty.

Instability and uncertainty do not go well with a decentralization process that emphasizes social policies and whose management requires predictability in respect to the availability of the resources needed to finance highly rigid current expenditure. To these obstacles can be added the high level of resources allocated to policies defined by the central government, which favors social equity, but does not favor efficiency.

Unlike in Argentina and Brazil, in Colombia transfers are first distributed on a sector basis, and then in a second stage on a territorial basis. The territorial distribution of resources assigned to each sector is based on factors that attempt to measure demand, such as the number of students enrolled (in the case of education) and the size of the resident population included in the subsidized system (in the case of health). Although this option does generate better results in respect to the equilibrium between resource distribution and the respective financing needs, it is not viable in the case of federal systems, in which the territorial principle prevails.

On the other hand, concentrating on one sector implies a low degree of autonomy in the execution of transferred resources. This argument is the basis for the conclusion reached by Acosta and Bird (2004) that, despite the increase in transfers, the decentralization registered in Colombia has not been capable of delivering the real benefits that was expected of it.

Some changes were introduced in the transfer regime in the past two decades in an attempt to improve efficiency and accountability. Education transfers began to be based on the number of pupils enrolled instead of the number of teachers as was the case in the past.

This tended to reduce horizontal imbalances and to promote greater equality in the teacher/pupil ratio between departments and municipalities. In the health sector different mechanisms were introduced to increase efficiency in service provision. But, despite these improvements in the transfer system, it still lacks favorable conditions for achieving efficiency in decentralization and government accountability. It might be useful in this case to place more emphasis on outcomes, as well as to incorporate incentives for sub-national governments to increase their own revenues.

In general, the Colombian system clearly reflects the option of granting less autonomy in the use of transfers and placing greater emphasis on the equity of revenue distribution. Obviously, this translates into less favorable conditions for efficiency and accountability. Moreover, even if the provisional regime did moderate the system's rigidity, momentarily reducing the difficulties of fiscal adjustment, the absence of definitive rules might generate problems in the near future if, as in Argentina's case, the obstacles to abandoning the provisional regime led to a gradual postponement of the return to the regime put in place by the 1991 Constitution.

### ***Similarities and Differences***

Observation of the distinct characteristics of the fiscal decentralization experiences in these three countries shows a great deal of similarity in respect to the general orientation of the changes introduced in recent years, but also significant differences.

It is evident that the similarities in the changes introduced in recent years are due to a common force: the importance of fiscal discipline as a part of macroeconomic stabilization policies. As a result, and because of the general perception that the rigidity introduced by previous rules was constraining macroeconomic fiscal management, the solution was to obtain greater flexibility in defining the amounts of the resources transferred each year to sub-national governments.

Along with measures aimed at limiting transfers, the predominance of macroeconomic considerations in fiscal policy decision-making also led to a transfer of expenditure responsibilities to sub-national governments, as a way of reducing pressures on the national budget. In this case, attention was centered on the social area, especially on the education and health sectors, that were also the focus of attention in the decentralization experiences of all three countries.

The same objectives were sought through different paths in the different countries. In Argentina, the federal government transferred responsibilities to the provinces and withdrew a part of the revenue collected from the VAT from the revenue sharing fund pool. In Brazil, the government took advantage of the opportunity to increase taxes not subject to revenue sharing in order to obtain similar results. By contrast, in Colombia the only viable measures were the abandonment of constitutional rules and the increase in allocations. The differing paths also led to different results. From a macroeconomic perspective, the reduction of rigidity was much greater in Brazil's case, while the loss of sub-national autonomy was greatest in the case of Colombia.

The emphasis placed on social sectors was accompanied by two parallel developments: the preference for policies oriented towards reducing disparities in social development opportunities, and greater interference by national governments in sub-national budgets. This led to an increase in financial difficulties in tackling shortcomings in urban service quality and coverage, including infrastructure, in a context in which the rate of urbanization contributed to increase pressure on the governments of the principal cities and large metropolitan areas.

The lower volume of resources available for meeting local demands should have been accompanied by changes to increase managerial efficiency, but the abandonment, or the absence, of criteria that might have helped to adjust the horizontal distribution of resources to the territorial concentration of demands placed on sub-national governments, along with the adoption of fixed percentages instead of formulas,

had the contrary effect. This increased the difficulties impeding the improvement of expenditure quality, principally in the most densely-populated areas, due to the overlapping actions of different political jurisdictions and the absence of adequate arrangements to promote or encourage the necessary cooperation.

These problems were most strongly felt in the case of Brazil, due to the importance of the municipalities and the variety of transfers carried out by the states and the federal government. This variety of transfers generates large horizontal disparities due to the absence of a common logic applicable to the apportionment of the resources (Prado, Quadros and Cavalcanti, 2003). In Argentina, the horizontal balance was affected by the prolonged application of a provisional regime that maintained the share of each province in the total transfers unaltered (which also happened in Brazil), and also due to different effects on the provinces caused by the transfer of social service responsibilities. In Colombia, those same imbalances did not arise from the way in which transfers were distributed, but from the different categories of departments and municipalities with respect to the nature of the responsibilities they can assume in the formulation and management of the policies for which they are responsible.

The most important explanation for the differences detected in these three cases relates to the organization of the state. In the federalist system in Argentina, the municipalities have a very limited role and are subordinate to the provinces, whereas in Brazil, the autonomy and role of the municipalities are significant and have even been reinforced by the decentralization of social policies. In Colombia, the municipalities are the focus of the decentralization effort, although there have also been some initiatives adopted to expand the departments' sphere of action.

The different forms of state organization also explain the differences in respect to the scale of the changes, such as the declining importance of unconditional transfers in relation to the total volume of transfers, and the large number of regimes for transferring resources to sub-national governments. This does not alter the

conclusion regarding the negative effects that the changes to the transfer regimes have had on public management and the quality of the decentralization process, but it does mean that such effects differ greatly and vary according to the nature of the functions that most depend on those transfers.

### ***Contributions to the Debate on Transfer Systems and their Formulation***

The principal lessons from the literature, international practice and the experiences of the three countries analyzed that can be offered to the politicians and public sector managers who participate in decisions about the formulation and change of intergovernmental revenue transfer regimes is the following: more important than attempting to obtain a unique model is to ask the right questions, examine the consequences of the options chosen, present them in a clear and transparent manner and work to reach an agreement in respect to solutions that reconcile the principal attributes of a fair decentralization process.

This paper examined the principal factors of compensation that are relevant to the decisions shaping the quality of a given decentralization process. As observed, there are some decisions that condition the rest in such a way that a course of action can be initiated that guides the negotiating process towards the attainment of the best possible results.

This course of action begins with an evaluation of the existing conflict between the importance of adopting flexible rules to facilitate fiscal management and the demand for guarantees and autonomy with respect to the amount and use of the transferred resources on the part of sub-national governments (the formulation of the transfer regime is considered to be the step that follows the definition of the amount of resources to be transferred).

Flexibility has its advantages, but it also has its risks. Whenever negotiations over the amount to be transferred are revisited, the possibility arises that transfers will be augmented, usually when negotiations coincide with a period of economic growth. A greater margin for

macroeconomic management is not the only possible advantage. There is also the possibility that rules stipulating periodic adjustments can facilitate negotiation and limit the volume of transfers.

If the risks and the advantages are to be reconciled, flexibility must be accompanied by a schedule spelling out the frequency of the revisions, and procedures for reaching new agreements about transfer amounts must be established. One option to be considered is the Indian model, in which a commission of independent experts is assigned the task of proposing a revision every five years.

Greater autonomy can be the counterpart of less rigidity. In a context of high levels of rigidity, financial difficulties faced by national governments can be moderated by the transfer of responsibilities to sub-national governments. Without the transfer of financial resources to match these responsibilities, however, as in Argentina's case, problems of fairness and efficiency are generated within the system. The nature of the guarantees should also be evaluated. One usual way of doing this is to define a percentage of all, or some, national tax revenues that will be automatically transferred to the sub-national governments.

Obviously, the guarantee is greater if the share is determined as a percentage of total national revenues, since otherwise the national government might opt to increase taxes that are not part of the transfer base. Argentina and Colombia adopted the former of these two options and Brazil the latter. In a period of economic difficulties during the past two decades, the former two countries abandoned this option and adopted provisional systems in order to escape from the trap caused by national fiscal adjustment, whereas Brazil followed the path of exploiting non-shared taxes to achieve a similar goal.

There are other repercussions that must also be borne in mind. The solution adopted by Colombia, which fixes the value of the transfers just until 2008, leaves some leeway for the national government in the event that the economy, and therefore national tax revenue, grows more than the percentage of the agreed adjustment. If this does not occur, though, then the

opposite adjustment could be made. When values are fixed, sub-national governments are given solid guarantees regarding what they will receive during that period, but they also face future uncertainties due to the absence of well-defined procedures about the solutions to be adopted further down the road.

The Argentine experience would seem to indicate that the greater the duration of the provisional system, the greater will be the resistance to modifying it later, since the distortions that accumulate over the course of time increase the conflicts that will have to be resolved in order for a broad revision of the system to be politically viable. The Brazilian case reveals that escaping from the rigidity trap is simple when the shared revenues do not cover all national taxes, but this happens at the cost of a sharp deterioration in the economic efficiency of the tax system, an exacerbation of conflicts within the federal system and a reduction in the efficiency of decentralization.

As previously mentioned, the options chosen in respect to the degree of rigidity of national transfers and the degree of autonomy possessed by sub-national governments influence the rest of the decisions that define the quality of decentralization, by establishing the conditions under which decisions will be taken in the second phase of the chosen course of action. It seems clear that the magnitude of social and regional disparities will influence the decision about the degree of autonomy, because wide disparities tend to accentuate the demand for national policies aimed at reducing them.

Once the degree of autonomy has been established, the dividing line for imposing conditions on the use of transferred resources will automatically be drawn. Conditions will also be created for more efficient decentralization, although not automatically. The same level of autonomy may produce different results with respect to efficiency, depending on the existence of strict and effective rules that promote responsible management of sub-national budgets (rigorous budget restrictions).

The experiences of Brazil and Argentina illustrate the problems that arise in the context of a reasonable degree of autonomy (higher in Argentina than in Brazil)

and the absence of rigorous budget restrictions, which stimulates irresponsible borrowing and the recurrent need to fall back on financial help from the federal government. The recent experiences in Brazil and Argentina likewise show that the adoption of rigid fiscal rules helps to reconcile autonomy with fiscal accountability.

Therefore, during the second phase of the chosen course of action, the authorities and the politicians participating in the formulation of a transfer regime (or in the reform of the existing model) are faced with a novel array of options. They must decide how to use that portion of the transfers that is under their control to promote national policies. This includes allocations to specific sectors or programs (non-matching grants) in which case, depending on the rules applied, there will be noticeable variations in sub-national government autonomy in managing the received resources, or a central government offer to match the amount that the other levels of government assign to national priorities (matching grants).

Before continuing, however, it is necessary to stop at this point and evaluate the problem from the point of view of its horizontal dimension. The same aggregate level of autonomy in transfers can translate into varying degrees of autonomy for different sub-national government units. The units enjoying the greatest economic potential can avoid the limitations imposed on the use of transferred resources by assigning their revenues to other ends, as seems to have happened in Colombia (Chaparro *et al*, 2004). In addition, if the option of matching grants is chosen, the poorest jurisdictions might not be in a position to provide the necessary resources to receive the matching funds, especially when the demands are large and uniform, and cause problems in terms of the system's fairness.

These problems always emerge when symmetrical rules are adopted within a context of large asymmetries, not only in financial terms, but also in terms of the quality of human or physical resources. These differences can be tackled by assigning different mandates, according to the jurisdiction's capacity to assume responsibilities in any given sector. Examples of this practice can

be seen in the measures adopted in Brazil in the area of health care, and in Colombia, in the education sector. In these cases, the advance of the municipalities' role in service provision envisions different categories of municipalities. The most competent among them are accorded total managerial control over services, whereas the others operate under the guidance of the state or departmental governments.

The distortions provoked by symmetrical rules are particularly serious in Brazil, where the small and less-populated municipalities enjoy a greater capacity to spend and greater autonomy in the execution of resources than the larger municipalities because they benefit from the distribution formula applied to their share of federal revenue, whereas the others receive a greater volume of previously allocated transfers. The reverse happens in Colombia. Due to the large share of conditional transfers in national revenue, the smaller municipalities are the ones which enjoy less autonomy.

None of the countries analyzed in this chapter use matching grants. On a scale ranging from the least to the greatest degree of national government intervention in sub-national expenditures, Argentina would be placed at the beginning of the scale and Colombia nearer the end. The Argentine regime imposes few conditions on the use of transfers and has opted to intervene in provincial budgets by transferring responsibilities for programs of interest to the national government (and also recently establishing a minimum threshold for spending on education), whereas the Colombian regime imposes rather detailed conditions that leave little leeway for local administrators to decide how to assign transferred resources. In Brazil, the fulfillment of national priorities is carried out through sector-based transfers for education and health, as well as the constitutional allocation of percentages of the state and municipal budgets to those same sectors. However, changes have been made recently in the transfers to education aimed at redirecting resources to specific programs in this sector.

One of the basic deficiencies in all three cases is that, generally speaking, the conditions established attempt to allocate resources without establishing prerequisites

in terms of outcomes (the transfers are designed to increase inputs, and to not improve results, according to the terminology adopted by Anwar Shah). In only two cases were changes promoted that attempted to improve national policy management at the sub-national level. These were the establishment of the *Fondo de Desarrollo de la Enseñanza Primaria de Brasil* (FUNDEF) (Primary Education Development Fund of Brazil) in 1998, which was recently modified in 2007 to extend its reach to the entire primary education sector, and the new finance regime for education adopted in Colombia in 2001.

In both cases, new rules on the horizontal distribution of resources were adopted, based on the number of students enrolled at the various levels of education and in different geographic areas (rural and urban), in order to distribute transfers to promote better resource application to spending needs, and to include other prerequisites, such as making improvements in teachers' salaries a priority target for resources.

The enactment of fiscal responsibility laws opens up new perspectives for progress towards reconciling sub-national autonomy with responsible management of public accounts. As previously shown, autonomy is important for an efficient decentralization process, but it is not sufficient by itself. It must be accompanied by predictability in respect to the amount and timing of the flow of resources and rules that impede irresponsible borrowing and contribute to maintaining the balance in public accounts. As greater experience in the application of more rigid fiscal rules is gained, it will then be possible to revise the tendency to increase the conditions imposed on the use of resources transferred to sub-national governments.

Consequently, the recommended course of action for guiding decision-making is of a circular nature. It begins and ends by considering the level of autonomy, and it is therefore advisable that decisions made at the beginning of the process are evaluated at the end, if the best possible solution in each case is to be found. During this process, the factors of compensation must be carefully weighed, the flexibility necessary to allow

adjustments sought, the existence of asymmetries recognized and abrupt changes of direction that cause uncertainty and accentuate antagonisms avoided.

In a world in which economic clashes proliferate at high speed and cause a variety of territorial effects, both in the Latin American region and within individual countries, flexibility to adjust the intergovernmental transfer

system depends on constant evaluation to avoid being forced into adjustments by a fiscal crisis, without appropriate analysis of the repercussions of such changes on the quality of the decentralization process. The creation of a permanent forum with powers to carry out this function is a step that should be considered.

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