

Institutional Rigidities and Budget Flexibility: Origin, Motivation and Effects on the Budget[†]

Juan Carlos Echeverry

Jorge Alexander Bonilla

Andrés Moya

jechever@uniandes.edu.co

jbonill@uniandes.edu.co

an-moya@uniandes.edu.co

Universidad de los Andes

School of Economics

Executive Summary and Conclusions

The discussion regarding the magnitude of commitment in the legal and contractual budget that the different governments need to stand by during each fiscal year is rapidly gaining momentum. These obligations reduce the policy authorities' ability to prioritize State actions and the execution of the government's central programs. The phenomenon of inflexibility impacts both the government and the elected representatives in their capacity to carry out government plans, identify expenditure priorities and allocate resources accordingly. Similarly, budget inflexibilities jeopardize macroeconomic stability, for they hamper the adaptation of fiscal magnitudes to the different current situations and macroeconomic perspectives; they result in higher expenditure commitments for the future and therefore put pressure towards a persistent increase of public debt.

In the light of certain regulatory criteria, budget inflexibilities may be considered a desirable phenomenon insofar as there is a set of budgetary sectors that remain immune

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to short-term contingencies. Inflexibilities should then be understood as a mechanism permitting to isolate these sectors from annual budget discussion, and promote a solid commitment by the State to fulfill these obligations.

But when faced with a significant number of budget inflexibilities, this argument loses power and encounters several objections. For starters, it is possible that some of the inflexible sectors are not an actual priority, and that their inclusion in the budget results from the entrapment of income by interest groups. Accordingly, the inflexibility issue may be regarded as one particular instance of what literature has come to call the “Tragedy of the Commons”. Besides, even if we are dealing with priority sectors that should remain unaffected by the ups and downs of annual budgeting, there are still some unexpected situations that may justify turning away from previous commitments in favor of broader objectives, such as the State’s financial viability. Lastly, the large amounts of revenue for specific purposes, transfers and special funds add considerable complexity to the budgeting process, set the ground for function overlap, and make it difficult to set priorities within public policies, on the one hand, and determine the resources to be destined every year to the different sectors of society, on the other.

The purpose of this paper is to analyze the budget inflexibility issue from a theoretical discussion on the reasons that make this phenomenon possible and to present four case studies: Argentina, Colombia, Mexico and Peru. Each one was analyzed with regard to the sources of budget inflexibility, its origin and magnitude, as well as the possible solutions or treatments implemented to overcome them.

“Inflexible” refers to any component whose inclusion in the budget is not dependent upon the discretion of policy authorities in the short term. Inflexibilities concentrate inside a group of budget items established by means of laws, decrees, or constitutional articles that organize state expenditure and are independent from the government.

The methodology used in this study is consistent with the inflexibility taxonomy proposed by Echeverry et al. (2004). This approach distinguishes three groups of sectors within the larger set of “inflexibilities”. The first group originates in a set of norms that mandate compulsory payment of a certain expenditure (expenditure inflexibility); the second group picks an income source and destines it by Law to some specific use (income inflexibility or Revenues for Specific Purposes); the third group refers to “other inflexibilities”, which include Parafiscal resources and tax exemption found outside the

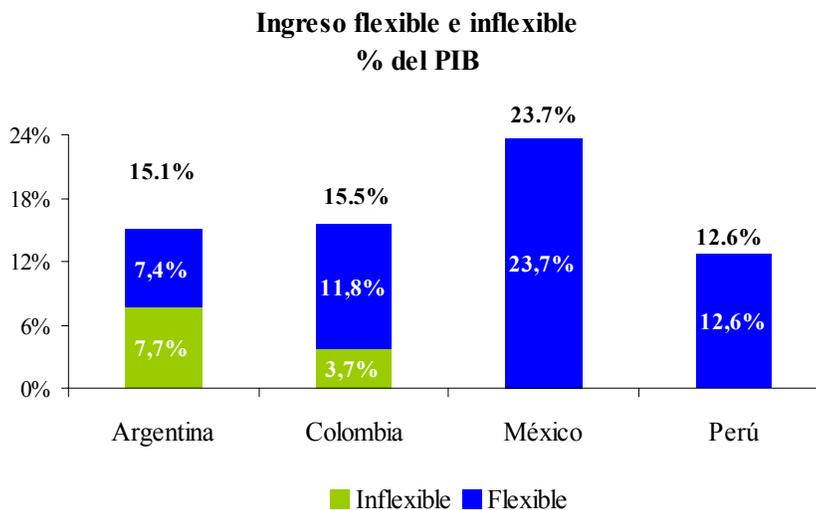
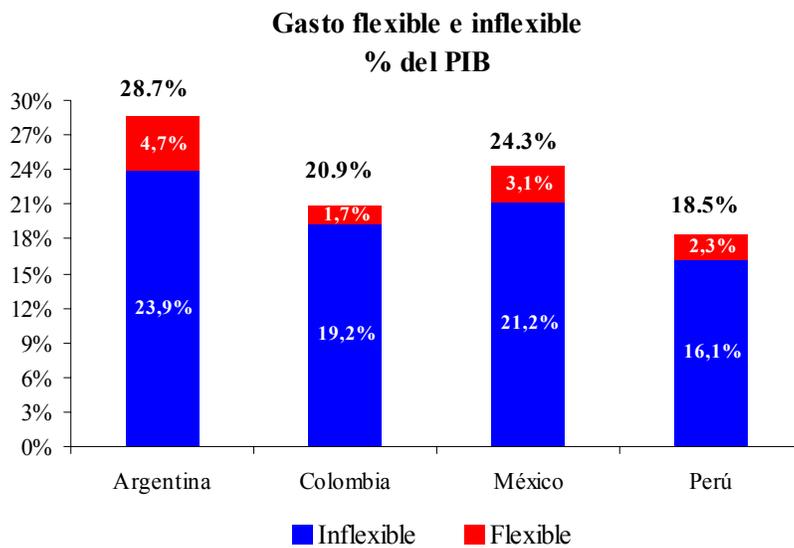
budget sphere that nonetheless reflect implicit or explicit budgeting decisions. These “parafiscal resources” consist of resources allocated to certain entities of private or mixed ownership for a specific goal that is not included in the budget, and therefore are not subject to the discretion of the Executive. In the case of Colombia and Argentina, they sometimes take the form of Special Funds and Extra-budgetary Organizations. On the other hand, tax exemption is defined as income surrendered to the private sector, which turns it into an important element of fiscal policy.

In addition, the analysis classifies these sectors according to their level of inflexibility: high, medium and low. One item will be considered “highly inflexible” if the executive and legislative branches have no influence over its nominal value during a fiscal period. Medium inflexibility implies a certain degree of discretionality from the authorities over the nominal amount of this sector in the short term. Finally, an item will present “low inflexibility” if the executive has ample discretionality over the nominal adjustments of the allocations or budgetary effects, or if the item’s unavoidable magnitude is not very significant. According to this methodology, if a sector falls into one of the first two categories, it will be considered exclusively inflexible. This is the type of analysis used for expenditure allocation and income assignment.

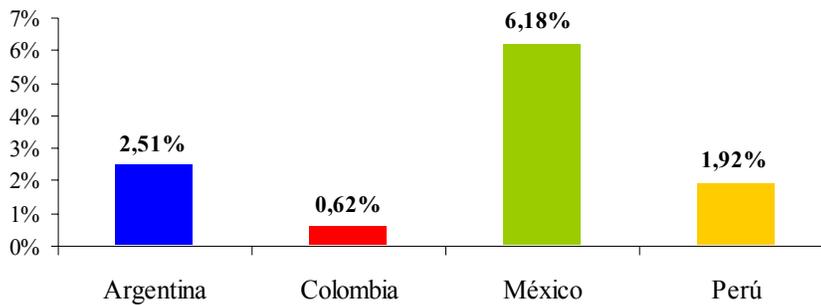
It is important to mention that the definition of inflexibility refers to a short-termed event, since the steering capability of the executive and legislative branches may grow in the medium and long-term. Although some sectors are inflexible in nature, or feature an important degree of inflexibility, under special circumstances the Government may gain discretionality over certain aspects of the budget, especially in times of economic crisis. For example, during the economic crisis of 2002, Argentina made the payment for interests and amortizations of the public debt “flexible” by falling into default and subsequently renegotiating the Government’s debt.

For each country, the budget characteristics and generalities for the 2003 fiscal year are presented. The analysis focuses on the budget at the national or federal levels of government: The National Administration of Argentina, the National Central Administration of Colombia and Peru, and the Federal Public Sector in Mexico. The first step is a brief introduction about the origin and political economy of budget rigidity in each country. Then, the study presents and analyzes expenditure and income inflexibility, the magnitude of tax exemption and parafiscal resources, and lists some of the measures implemented in order to overcome the problem of budget rigidity.

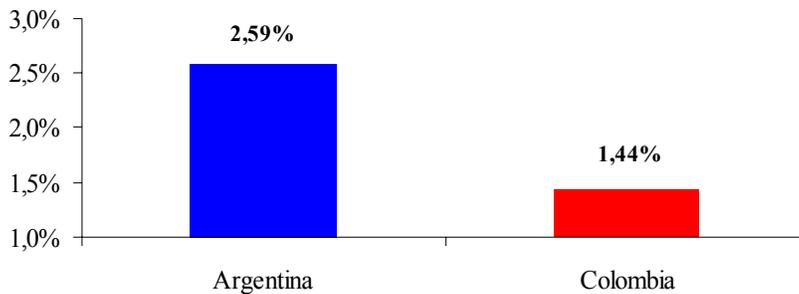
This article also presents a comparative analysis between Argentina, Colombia, Mexico and Peru with regard to the quantification of budget inflexibilities, and proposes some recommendations extracted from the models used by each country, which may apply to other nations of the same study group. The next four charts show, in the same dimension, the levels of flexible and inflexible expenditure and income, tax expenditure and the collection by parafiscal entities as a percentage of the GDP, which summarize the degree of budget rigidity.



Gasto Tributario % del PIB



Recaudo de entes parafiscales % del PIB



Source: Argentine Ministry of Economy and Production, Colombian Ministry of Finance and Public Credit, Mexican Ministry of Finance and Public Credit and Peruvian Ministry of Economy and Finance.

The charts show that Argentina bears the highest levels of inflexible expenditure and income in relation to its Domestic Gross Product, with nearly half of its total income being affected. Colombia, on the other hand, is the country with the highest degree of expenditure rigidity, with nearly 92% of its expenditure being already committed. Expenditure inflexibility in these countries is generally accounted for by items linked to personal services and pensions.

As regards income, Mexico appears as an exceptional case. Besides the fact that its resources are 100% flexible, it presents the highest magnitude of perceived income in terms of GDP. Peru also features total flexibility of its income. These results reflect the

application of the cash unity principle to the budget and a low magnitude of revenues for specific purposes. For its part, Colombia has the lowest magnitude of tax exemption of the group under study, while in Mexico the value of the preferential fiscal treatments reaches as much as 6.18% of the GDP. With regard to identified parafiscal funds, these resources are notoriously higher in Argentina (2.59% of the GDP) than in Colombia (1.44% of the GDP).

Of the four countries, Argentina is perhaps the most critical in terms of rigidity. Its expenditure and income are highly inflexible, its resources are barely equivalent to half its expenditure, and the amount of parafiscal revenue is quite significant. Mexico also presents some rigidity in its expenditure, but its income practically equals its expenditure.

The studies conducted on Argentina, Colombia, Mexico and Peru lead to a number of conclusions pertaining to the most interesting topics of budget inflexibility. The following paragraphs deal with the similarities and divergences found in these four Latin American countries and a few recommendations.

As to the existence of one or more laws required to approve the nation's budget, it is important to note that the Mexican budgeting process draws a line between the Federal Public Sector's expenditures and its income. Two legal documents are submitted to Congress for approval (one Decree for expenditure and one Law for income), which are discussed by two different legislative bodies (expenditure is overseen by the Mexican Chamber of Deputies while income is reviewed by the Congress of the Union). Peru has a similar system. In contrast, Colombia and Argentina have only one Law to oversee income and expenditure. Neither system can be said to be superior in design, but it is certainly interesting to examine whether this scheme grants greater flexibility to the Mexican Federal Sector and the Peruvian Central Administration, since it prevents the discussion on expenditure from being interfered by the expenses actually or fictitiously expected by the Congress. Nevertheless, and even though income and expenditure are approved in very disparate scenarios, it is crucial that they be approved with sufficient anticipation to the expenditure budget as a way to allow legislators to better analyze the proposal.

As to the chronology and the actors responsible for the budgeting process in Colombia, Echeverry et al. (2004) proposed to redefine the powers of the Ministry of Finance over

the budget process and chronology, as well as those individuals within the Executive that are responsible for the discussions concerning the amount and allocation thereof. As stated before, the process will differ by country, although the Mexican and Peruvian cases are of special interest, for the income and expenditure laws are clearly separated. Although no design has proved to be “optimal” or more efficient ex-ante from a political or political-economic standpoint, we want to emphasize that trying to involve the Ministry of Finance in all phases of the process (i.e. determining the amount, discussing its sectoral and regional allocation within Executive circles, discussing its amount and allocation with the Legislative, and its execution along its period of effectiveness) may lead the entity to an internalization of elements that may undermine its primary role. In other words, its discipline in complying with budgetary restrictions.

Increasing the budget during its period of effectiveness is another relevant point. Once the budget has been approved and execution during its effectiveness has commenced, there are several options available to increase it in the event incurring more expenditure becomes necessary and funding can be justified via greater collection or indebtedness. In Colombia, Congress must approve a Law of budgetary addition, while in Mexico the Ministry of Finance and Public Credit (SHCP) has the power to issue additional authorizations and increase expenditure during the fiscal year, provided these adhere to the provisions set forth in the Federation Budget Extracts Decree, particularly when surplus resources or income are obtained. Unlike Colombia, this procedure does not call for an Addition Law. In the Peruvian case, the Executive may introduce amendments to the expenditure budget by resorting to Executive Branch Urgency Decrees, which bypass Congress approval. If the ultimate goal is flexibility, then the Mexican and Peruvian cases appear to have greater advantages, but at the expense of democratic scrutiny, which is well worth considering. One of the limitations of the Colombian process is the fact that expenditure increase approval may be tied to new demands by the Legislative branch, whereas these demands are virtually non-existent in the Mexican and Peruvian models. Assessing the application of such a model in Colombia would also be interesting.

In response to the lack of consensus regarding the new budget, the different political constitutions define the manner to determine it as a whole, and how certain important sectors are to be defined. This is particularly relevant, since in the event a disagreement between the Legislative and Executive blocks congressional approval of the budget, the

constitution defines either the continuity of the current budget and therefore its political-economic structure, or the automatic approval of the budget presented by the government. In Colombia, this is clearly stated under Article No. 348 of the Constitution: “Should Congress fail to issue the budget, the one presented by the Government shall be adopted...; should the budget fail to be presented within the period stated, the previous year budget shall remain in vigor, but the Government may reduce expenditure and, therefore, eliminate or merge jobs in accordance with the revenue calculations of the new fiscal year.” In Mexico, Article No. 75 of the Constitution includes similar provisions, particularly with regards to the critical point of the state payroll: “Upon approving the Expenditure Budget, the Chamber of Deputies shall state the compensation corresponding to a job established by Law; should such remuneration fail to be stated for any reason, then the compensation in vigor shall be that contained in the previous Budget or in the Law that created the job post.” Of course, these provisions will only apply in extreme cases, where non-approval of the budget may be indicative of more serious governance problems. Therefore, they may not deserve too much attention as “technical” norms requiring any special amendments.

The specific-purpose revenue issue –see Echeverry et al. (2004)– has given Colombian Ministers of Finance more than one headache over the last 100 years. The violation of the cash unity principle derived from the inclusion of specific uses for the whole or part of an income revenue has become the most frequent source of inflexibility. Legislators devote a good deal of their imagination to creating specific uses for new or already existing revenue without analyzing the associated economic and budgetary distortions. The amount of resources the intended beneficiaries eventually receive is often only a fraction of their necessities and ends up being rigidized, thus encouraging the beneficiaries to begin lobbying in the future to defend that particular purpose of the revenue. Similarly, there is no specific follow-up on the evolution of the necessities and resources, or any amendments to or possible wilting thereof. This also reflects the Budget Directorate authorities’ lack of knowledge about the real needs of some institutions and funds, and this ignorance is eventually replaced by mushrooming new budgetary items. Examples of a more reasonable system can be found in Mexico and Peru. In the first place, the amount of revenue for specific purposes is very small in these two countries. In Mexico, the percentage of budget income from conventional revenue used for specific purposes obtained from rights and profits is estimated in 0.3

(0.07% of the GDP), while in Peru such amount represents 0.2% of the GDP. Mexican SHCP has taken the initiative to suggest temporality in new revenues sharing this characteristic and specify a decreasing graduality for them. Secondly, Mexico has a system of surplus income that represents 8% of the budget income (2% of GDP), for which a specific use is proposed. This scheme can be considered virtuous, as it respects cash unity over the “normal” or “projected” amount of state income or a certain system (e.g. pensions), and also suggests a specific use in the event positive surprises appear in the collections. This seems to be an interesting methodology to follow in Colombia, which may be approved by the legislative branch, because it does not entail the elimination of specific-purpose revenues; instead, it makes them marginal. One problem with such a scheme under deficit conditions is that surplus income must simply reduce public deficit and the need for indebtedness. For this reason, great caution should be exercised when applying such a mechanism in Colombia, although adopting it as a replacement for the current specific revenue system would be greatly beneficial for the country’s budget process.

One of the greatest inflexibilities in all four countries is payment of retirement pensions in a defined benefit regime. Here making a good actuary’s valuation of the State’s pension liabilities is key. In Colombia, it originally amounted to 206% of the GDP but dropped to 147% of the GDP as a result of recent reforms. Today, the annual payments for which the National Budget is responsible amount to 4.7% of the GDP. In Argentina, expenditure on retirement, pensions and other social assistance programs accounts for 5.4% of the GDP, which makes it greatly important. This expenditure includes the resources allocated to the General Retirement and Pension Regime, as well as the Armed and Security Forces Pension Regimes. If this amount is supplemented with the resources the government must spend to finance deficits in the retirement funds transferred within Fiscal Pacts, the result is an increase of the retirement expenditure to six points of the GDP. In Peru, expenditure on retirement funds accounts for 3.2% of the GDP, which has raised many a controversy, since it reveals an unequal system known as “Cédula Viva” that represents an increasing burden for the State. Despite the inconvenience of maintaining such a regime, some congressmen –led by political and, to a certain extent, demagogic interests– have opposed the elimination of this system. In Mexico, the expenditure on pensions and retirement for the year 2003 amounted to 2.1% of the GDP. The trends of this sector indicate that such amount will continue on

an upward path to reach approximately 2.4% of the GDP in 2008. One characteristic of retirement remunerations is the fact that in “a defined benefit regime the responsibility of the state ends when the rights of the beneficiaries expire, so the full amount of the responsibility remains largely unknown. (SHCP, 2005)”; in addition, the State ignores how many public servants plan to retire on any given year, so since this figure is variable and uncertain, the budget is based on estimates. This front appears to be critical both in current value and in annual flows, and therefore immediate attention should be paid to producing more precise actuary’s valuations. The reason for this is that the demographic changes that took place a few decades ago (like the baby boom of the 60s, the increase of female social participation, and a pension system that has typically favored women with lower retirement ages) may represent significant differences in the final cost of pension liabilities and in the flow of expenditure during each fiscal year. These liabilities are rather inconspicuous, dispersed across many entities that have adopted very different and costly systems, often with insufficient provisions.

On the other hand, and although payment for interest and amortization of the public debt has been considered a rigid component, the case of Argentina reveals that under certain extraordinary circumstances it is possible not to fulfill certain commitments. In particular, during the economic crisis of 2002, Argentina became a model of “flexibilization” of payments for interests and amortizations of the public debt by falling into default and subsequently renegotiating its debt.

With regard to fiscal expenditure, tax expenditure or tax exemption –labels used in Mexico, Argentina, Peru and Colombia to refer to exemptions granted to certain sectors or types of economic agents– the Mexican figures for the period analyzed, 6.8% of the GDP, stand out among the other countries under study. Eliminating exemption has turned out to be a task involving a high political cost. Besides, even though they are considered another face of inflexibility, trying to eliminate the possibility of having these preferred fiscal treatments may seem unreal, especially given their clear correlation with each country’s political economy. Whether or not one or more exemptions may arise in the future cannot be guaranteed. In this respect, it is important to discuss that new expenditure along these lines should consider a previous technical assessment of its design and fiscal cost, as well as the application of temporality and decreasing graduality, which may be useful in the case of revenue for specific purposes. On the other hand, in Argentina tax expenditure amounts to 22.1% of all tax income and

2.51% of the GDP. Nevertheless, there is no evidence of any efforts tending to reduce tax expenditure; in fact, the trend points at generalizing some of the exemptions and deferent treatments given to a certain type of basic commodities. For this reason, attention should be paid to the proposal to link their application to accurate studies conducted by the executive and to a “quarantine” process as a way to fully ascertain their fiscal and economy distortion effects.

Argentina has a considerable amount of items that are not included in the budget. These resources are equivalent to 2.59% of the GDP and 16% of the current and capital income of the National Administration. In order to overcome the limits on free availability income, Argentina has applied a number of measures that impose contributions from the Funds to the National Treasury by means of the Budget Law. Similarly, resources have been transferred towards general revenues in years when the income of these organizations has exceeded the forecasted resources. Restrictions on expenditure have also been established, which have resulted in budget surplus that, despite their immunity to appropriation by the National Treasury, have been used to compensate the deficit presented by other organizations or subsectors. Finally, the Law of Financial Administration created the Single Treasury Account, which centralizes public funds from the national organizations and points to the necessity to achieve Cash Unity. In the Argentine case, then, we have seen an effort to expand the budget scope, include Funds in the Budget, and take steps towards cash unity in order to decrease some of the inflexibilities affecting the budget.

In the case of Colombia and Argentina, there is a large number of Special Funds for very diverse purposes that make up revenue for specific purposes as well as expenditure determined by laws. These funds create mini-budgets appropriate by sector (e.g. army, infrastructure, etc.) that hinder a unified and intelligent discussion of the budget, and are beyond the decisions concerning prioritization and allocation of limited resources among subsectors with very urgent needs. These funds should at least produce thorough yearly reports on the use of its resources so that they can gradually be submitted for assessment by the executive and legislative branches.

All these elaborations and discussions prove that budget inflexibility is a common problem for countries, sometimes with generalized characteristics, others with different nuances that make it more or less strict. We hope this paper will contribute to the recent discussion and the need to pay attention to public finance, and that it will come as an aid

in promoting management and transparency of public policy as well as effectiveness in the development of these Latin American countries.

LEYENDA DE LOS CUADROS

Cuadro 1

Flexible and Inflexible Expenditure

% of the GDP

Cuadro 2

Flexible and Inflexible Income

% of the GDP

Cuadro 3

Tax Expenditure

% of the GDP

Cuadro 4

Collection by Parafiscal Entities

% of the GDP