

INTER-AMERICAN DEVELOPMENT BANK

**Public Policy Management and Transparency Network: Development Effectiveness
and Result-Based Budget Management**

Off-Budget Operations

Report

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GLOSSARY

ADEFAS	Debts from previous fiscal years
AFP	Public Finances Act
AGD	Deposit Guarantee Agency
AI	Initial contributions
ANDA	Water Company
ANTEL	Telecommunications Company
APP	Public-Private Partnerships
ARE	Excess Revenues Levy
BANOBRAS	National Public Works and Services Bank
BB	Bank of Brazil
BCB	Central Bank of Brazil
BCCH	Central Bank of Chile
BCE	Central Bank of Ecuador
BCR	Central Reserve Bank
BDyFP	Development Banks and Public Funds
BEDE	Ecuadorian State Bank
BEV	Ecuadorian Housing Bank
BM	Bank of Mexico
BNF	National Development Bank
BR	Central Bank of Colombia (<i>Banco de la República</i>)
BT	Traditional Balance
CAF	Andean Development Corporation
CEF	Federal Savings Bank
CEP	Council of Public Enterprises
CEREPS	Special Account for Economic and Social Reactivation, Scientific and Technological Development and Fiscal Stability
CFE	Federal Electricity Company
CFN	National Finance Corporation
CG	Management Council
CGR	Comptroller General of the Republic
CNBV	National Banking and Securities Commission
CODELCO	Copper Corporation
CONFIS	Fiscal Policy Council
CONPES	Economic and Social Policy National Council
CORFO	Production Development Corporation
CUF	Unified Fiscal Account
DEEPC	Extraordinary Levy on Crude Oil Exports
DFE	Oil Levy for the Stabilization Fund
DIPRES	Budget Office
DOH	Ordinary Levy on Oil Products
DPN	National Planning Department
DRU	De-earmarking of Federal Revenues
ECOPETROL	Colombian Oil Company

EMGEA	Company for Asset Management
ENAMI	National Mining Company
ENAP	National Petroleum Company
FAC	Savings and Contingency Fund
FARAC	Trust Fund for the Rehabilitation of Concessioned Toll Roads
FARP	Support Fund for the Restructuring of Pensions
FCC	Copper Compensation Fund
FCCEE	Public Entities' Contractual Contingencies Fund
FCVS	Housing Mortgage Insurance/Subsidy Fund
FEIEF	Stabilization Fund for States and Municipalities' Revenues
FEIP	Petroleum Revenues Stabilization Fund
FEIIP	Stabilization Fund for PEMEX's Infrastructure Investment
FEIREP	Fund for Stabilization, Social and Productive Investment and Public Debt Reduction
FEP	Petroleum Stabilization Fund
FEPP	Petroleum Prices Stabilization Fund
FGP	Guarantee Fund for Public-Private Partnerships
FGTS	Severance Pay Fund
FI	Infrastructure Fund
FINA	National Sugar Financing Corporation
FIRA	Farm-Related Trust Funds
FINFRA	Infrastructure Investment Fund
FOBAPROA	Savings Protection Bank Fund
FONDEN	Natural Disasters Fund
FSE	Social Emergency Fund
GDP	Gross Domestic Product
GFSM	Government Finance Statistics Manual
GNP	Gross National Product
IADB	Inter-American Development Bank
IANCs	Noncommercial Autonomous Institutions
IEPS	Special Tax on Production and Services
IESS	Ecuadorian Social Security Institute
IFC	International Finance Corporation
IFP	Public Finances Report
IMF	International Monetary Fund
IMG	Minimum Guaranteed Revenues
IMSS	Mexican Social Security Institute
INDAP	Agricultural Development Institute
IPAB	Bank Savings Protection Institute
ISS	Social Security Institute
ISSFA	Armed Forces Social Security Institute
ISSPOL	Police Force Social Security Institute

ISSSTE	Government Workers Security and Social Services Institute
LA	Appropriations Law
LAFE	Law on Financial Administration of the State
LFC	Central Light and Power
LIF	Federal Revenues Law
LPVR	Least Present Value of Revenues
LRF	Fiscal Responsibility Law
LDO	Budget Directives Law
LGDP	Public Debt General Law
LOA	Annual Budget Law
MCC	Exchange Rate Cover Mechanism
MCI	Revenue Coparticipation Mechanism
MDI	Revenue Distribution Mechanism
MEF	Ministry of Economy and Finance
MFMP	Medium-Term Fiscal Framework
MF	Ministry of Finance
MHCP	Ministry of Finance and Public Credit
MIDEPLAN	Ministry of Planning
MOP	Ministry of Public Works
MP	Ministry of Planning
MPMP	Medium-Term Budget Framework
NESP	Public Sector Borrowing Requirements
NPV	Net Present Value
OCC	Oil Coordinating Committee
OECD	Organization for Economic Cooperation and Development
PAD	Debtor Support Program
PDPS	Development Plan
PE	Ecuadorian Petroleum Company
PEF	Federal Expenditure Budget
PEMEX	Mexican Petroleum Company
PF	Financial Plan
PGE	General State Budget
PGN	General Budget of the Nation
PI	Revenue Budget
PIDIREGAS	Projects with Deferred Impact in the Recording of Expenditures
PND	National Development Program
PPA	Multi-year Plan
PPS	Projects for the Provision of Services
PRODETUR	Program for the Development of Tourism in the Northeast
PRONAFIDE	National Development Finance Program
PV	Present Value
RCL	Reserved Copper Law

RFSP	Public Sector Financing Requirements
ROSC	Report on the Observance of Standards and Codes
RPI	Intertemporal Budget Constraint
SAFI	Financial Management System
SB	Superintendency of Banks
SCT	Ministry of Communications and Transportation
SEP	Public Enterprises System
SHCP	Ministry of Finance and Public Credit
SHRFSP	Historic Balances of Public Sector Financing Requirements
SIAFF	Federal Financial Integrated Management System
SII	Internal Revenue Service
SRI	Internal Revenue Service
Tesofe	Federal Treasury
UCC	Concessions Coordination Unit
VAT	Value Added Tax
WTI	West Texas Intermediate

PREFACE

This report on off-budget operations was prepared for the Inter-American Development Bank (IADB) for a meeting of the Public Policy Management and Transparency Network: Development Effectiveness and Result-Based Budget Management to take place in Washington D.C. on May 8-9, 2006.

The purpose of the study was to assess the planning, implementation, programming, budgeting and evaluation of extrabudgetary and tax expenditures in four countries in the region, and propose recommendations if necessary. The countries chosen were Brazil, Chile, Ecuador and Mexico, with Mexico being the country in charge of coordinating the study.

The study involved the preparation of a questionnaire on the subject which was sent to the four countries and follow-up visits to the countries. In Brazil, the consultant held meetings with government officials at the Ministries of Planning and Finance in the budget, internal revenue, public enterprises, and economic advisory areas. In Chile, the consultant met with officials from the Budget Office in the areas of economic studies, public finance statistics, management of the public finances, the copper reserved law, and direct loans to agriculture. In Ecuador, the consultant met with officials from the offices of the budget, economic planning, public debt and investment, as well as with the undersecretary of concessions at the Ministry of Public Works. In Mexico, the consultant met with officials from the Ministry of Finance and Public Debt in the areas of legal advisory (in charge of the coordination of this study), investment, revenues, public debt, trust funds, budget, statistics, and economic planning. The consultant received an excellent cooperation in all the countries for which she wishes to express her gratitude.

EXECUTIVE SUMMARY

1. The study sought to assess the mechanisms for the planning, budgeting, implementation, programming, and evaluation of off-budget operations used in four countries in the region, and to propose recommendations if deemed necessary. The countries selected were Brazil, Chile, Ecuador, and Mexico as the purpose was to obtain a representative sample of these practices in the region, both in regards to their use as well as to the reforms being implemented following the international trends in this area.
2. To attain the objectives of the study, the off-budget operations of these countries were analyzed against the best practices guidelines defined by the 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 ROSCs. 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.
3. The selected countries' experiences show that their off-budget practices are more diverse than those for which the OECD has defined best practices guidelines. Also, these countries present some characteristics in their handling of the budget process which require an adjustment of the OECD guidelines. In addition, some of the alternative guidelines proposed in the paper respond to differences on some conceptual points on which the OECD guidelines are based, which is the case for direct loans and guarantees. For all these reasons, the paper proposes and discusses guidelines which complement and/or substitute those defined by the OECD, and bases its recommendations on both sets of guidelines.
4. The paper shows also that the proliferation in the use of off-budget operations has depended to a large extent on the budget constraints faced by the 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 the same factors.
5. Another conclusion of the study was that sometimes the budgetary norms and practices themselves contribute to the use of extrabudgetary operations and weaken the role of the budget as the main instrument of fiscal policy. The approved budget ends not being a good indicator of the budget that is executed. These norms and practices include an optimistic revision of the revenue estimates by congress, excessive flexibility in the treatment of the float, and too much discretion is allowed for increasing or reallocating expenditures both by congress and the government. On the other hand, rules which seek to ensure compliance with the macroeconomic targets such as the 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 like the off-budget operations to be able to comply with the letter of the law, although not necessarily with its spirit.
6. Off-budget operations respond also to various motives. Guarantees may be used to circumvent short-term budget constraints. Others, such as quasifiscal activities

conducted through administered prices, credit requirements, tax surcharges and/or the appropriation of all the surplus of public enterprises, and the earmarking of revenues and expenditure requirements, may be justified on social grounds, on market failures, or because it is administratively impossible to implement a well targeted subsidy program. Finally, other off-budget operations such as tax expenditures may present an alternative to allocate resources without being subjected to the budget process and to circumvent the fiscal rules.

7. The study also shows that over the past few years, countries have recognized the need to tighten the rules which regulate off-budget operations. Brazil, Chile, and Mexico have made important progress in regularizing these operations, while Ecuador shows less progress experiencing some backpedaling as a result of the 1999-2000 economic crisis and political instability.

8. Three stages can be distinguished in the process to regularize off-budget operations. First they are made more transparent, then they are reduced, and finally they are integrated in the budget. To make them more transparent they are identified, quantified, and information is provided in the budget documentation. To reduce them, quantitative and qualitative limits have been imposed. To integrate them in the budget several mechanisms have been used, including the transformation of the off-budget funds into virtual funds, the compensation of the quasifiscal 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 piece of resistance, with none of the countries reviewed complying with more than two of the OECD guidelines.

9. The paper contains five chapters. Chapter I describes the conceptual framework used in the analysis. Chapter II lists the OECD guidelines and proposes alternative guidelines, which are used as the framework against which the practices in the selected countries are compared. Chapter III analyzes for each country the use of off-budget operations, assesses the existing situation, and provides recommendations to improve the handling of these operations. Chapter IV describes the practices in the other countries reviewed, and Chapter V concludes.

I. OFF-BUDGET OPERATIONS—CONCEPTUAL FRAMEWORK¹

1. The Budget

The budget is the law or collection of laws authorizing expenditures, and/or the incurrance of obligations to make expenditures, to be financed from taxes and other type of revenues that the government may have. Also, the sources of financing of government expenditures are part of the budget.

The budget is the main instrument for the management of the fiscal policy of a country. Consequently, it must be sought that in its preparation, approval, execution and evaluation, the fiscal policy objectives being pursued by the government are complied with (macroeconomic efficacy), and that there is efficiency in the allocation and use of resources, and transparency in the generation and application of public resources.

1.1. Budget functions

The proper functioning of the budget has to be analyzed in relation to the four functions of the budget:

Authorization function—that all money spent from the public treasury be subject to legislative authorization.

Allocative/distribution function—that the budgetary authorities (executive and legislative branches) be able to compare and trade off all changes in expenditures and revenues.

Macroeconomic function—that the budgetary authorities (executive and legislative branches) be able to decide on the impact upon the economy of totals and composition of expenditure, revenues and deficit.

Administrative function—that the budgetary authorities (executive and legislative branches) be able to control the cost efficiency of all public service delivery.

1.2. Budget principles

There are three principles which can be considered preconditions for the fulfilment of all budget functions:

Universality principle—all expenditures financed by taxes or levies and all revenues collected through taxes or levies should be in the budget.

¹ This section is based on OECD: “Best Practice Guidelines—Off Budget and Tax Expenditures”, May 2004.

Unity principle—all expenditures in the budget to be made during a certain period of time (usually a year or a few years) and all revenues in the budget to be collected during that period should be presented to the budgetary authorities for the purpose of decision making in a single document.

Specificity principle—expenditures and revenues should be specified separately in the budget (“gross recording”) and at a level of detail required by the budgetary authorities.

2. Off-budget operations

There are forms of government operations that are difficult to reconcile with the principles of the budget and thereby threaten the proper functioning of the budget. These operations can be forms of expenditures that are known as off-budget expenditures and “back door” expenditures. Also, in the countries included in this study there is a third venue to conduct these operations, which is to use the public enterprises to collect fiscal revenues through tax and dividend regimes different than those applied to the private sector enterprises.

2.1. Off-budget expenditures

Off-budget expenditures are expenditures financed by taxes or levies, but which are not in the budget (violating the universality principle).

The main forms of off-budget expenditures that can be found in OECD countries are the off-budget funds, direct loans, guarantees, and public-private partnerships (PPPs). Other forms of off-budget expenditures that are found in the countries included in the study and in emerging markets in general, are the budgetary funds and quasifiscal operations conducted through the public enterprises and sometimes the private sector, which are not covered by transfers from the budget.

In addition, the use of supplementary budgets, and of certain budgetary rules regarding the revision of revenue estimates and the adjustments permitted to the budget expenditure appropriations on account of larger/smaller revenues than budgeted; on the authority to exceed or reallocate budgetary expenditure appropriations; and, on the execution of expenditures committed but not paid (float) in the fiscal year, may also impede the proper functioning of the budget.

2.1.1. Off-budget funds

Off-budget funds are especial funds owned by the government, that are not part of the budget and that receive revenues from earmarked levies, possibly next to other sources such as fees and contributions from the general tax fund. Earmarked levies are different from fees in that they do not reflect the market value of the services that are financed from the revenues. In particular they may be lower or higher in view of social considerations (capacity to pay or equality regardless of costs).

2.1.2. Direct loans

Direct loans are loans financed from taxes or levies. In general the conditions of direct loans are more favorable to the borrower than those of bank loans in the private sector because otherwise there would be no reason for public lending. It may also be the case that the risk is so high that no loan could be obtained in the private sector at all. The subsidy element in public loans may result from interest rates below market rates or default risk and favorable repayment conditions in so far as they are not reflected in the interest rate or special risk fees (for instance acquittal under certain specified conditions, for instance in study loans).

2.1.3. Guarantees

Loan guarantees are guarantees by the government to non-governmental lenders in case of debtor default against an insurance fee.

The main reason why the government may prefer a guarantee program to a direct loan program is that a guarantee program can assign part of the risk associated with the loan in the first place to the private lender. The government steps in only if the risk is exceptionally high or of a nature that private lenders are not willing to cover.

2.1.4. Public-Private Partnerships (PPPs)

Public-private partnerships (PPPs) refer to arrangements where the private sector supplies infrastructure assets and services that traditionally have been provided by the government. PPPs offer an alternative to privatization in areas where the private sector is not interested in operating directly or because it is not legally permitted as is the case with some public utilities.

Through this mechanism, the governments seek to obtain resources to develop the productive infrastructure beyond the budget possibilities, contributing to increase the growth rate and improve the competitiveness of the economy. The principle on which this type of projects is based is that the private sector contributes with a better managerial capacity and technological innovation, resulting in more efficiency which translates in better quality services at a lower cost.

PPPs are contracts between the public and private sectors under which the private sector builds, finances, operates and maintains infrastructure or delivers services. PPPs are involved in a wide range of social and economic infrastructure projects, but they have been mainly used to build and operate roads, airports, ports, in the telecommunications and energy sectors, water and sanitation, prisons, schools, hospitals and public buildings.

In addition to the execution and financing of the project by the private sector, the PPPs are characterized by the emphasis that they place on the delivery of services as well as on the investment, and that a significant part of the risk involved in the project is transferred from the public to the private sector.

To obtain efficiency gains through a PPP relative to direct public investment, which more than offset the financing costs that are generally higher for the private sector than for the public sector, it must be possible to define in contractual terms the quality of the service to be delivered and to transfer risk to the private sector, and there has to be competition or regulation based on incentives and a proper legal and institutional framework.

2.1.5. Quasifiscal activities

The government may conduct fiscal operations through the public enterprises, nonfinancial as well as financial, and through the private sector. To the extent that the government compensates the entities and institutions that conduct these fiscal operations through transfers that are included in the budget, these operations do not affect the functioning of the budget as an instrument of fiscal policy.

2.1.5.1. Nonfinancial public enterprises

Government use different mechanisms to conduct quasifiscal operations. In the nonfinancial public enterprises one of the most common mechanisms used is the concession of subsidies to the private sector through administered prices, which do not reflect the production costs or the opportunity costs as represented by the international prices, as would be the case of electricity and public transportation rates, and the price of fuels.

The different forms of compensating the public enterprises for these activities is through granting them tax benefits to which the private enterprises are not entitled to, providing guarantees on their indebtedness, allowing them the use of public assets at no charge, or authorizing a tariff structure characterized by cross-subsidies. The latter implies that some users pay surcharges so that other users may be charged less or to finance social programs such as rural electrification.

In some cases, the public enterprises are allowed to compensate the cost of the quasifiscal operations against liabilities (unpaid taxes, loans) held by the central government. These offsets may occur in fiscal exercises different from those in which the quasifiscal operations and/or the liabilities occurred, and may even represent accumulated flows from several fiscal exercises. If both occur in the same fiscal period, the offset takes place against government revenue which is in the budget (and which disappears as a result) for expenditures that are not, reducing the size fiscal operations. To make the operations related to previous fiscal periods transparent, the offsets could be approved in the budget law.

2.1.5.2. Financial public enterprises

2.1.5.2.1. Central Bank

In some countries the government conducts quasifiscal activities through the central bank. The central bank is authorized to lend to the government at lower-than-market

interest rates. It may also play the role of a development bank, providing loans to the private sector at subsidized rates, or absorbing the costs of private banks' restructuring operations. The result of these quasifiscal activities is reflected in the operational losses and eventually in a negative capital for the central bank.

The mechanisms used to compensate the central bank for these operations may consist of no interest payments on the government deposits in the Unified Fiscal Account, or through high non-remunerated minimum reserve requirements.

The movement towards an independent central bank that has been taking place over the past few years has resulted in the elimination of this type of activities. As part of this process, governments have proceeded to recapitalize central banks.

2.1.5.2.2. Development banks

The most common mechanism used to conduct quasifiscal activities through the financial public enterprises is to impose credit requirements at subsidized rates. Eventually this requires the recapitalization of the public banks through the budget.

The public banks also provide loans to other public entities at below market interest rates and condone debts.

2.1.5.3. Private sector

The mechanisms that had been used to conduct quasifiscal operations through private sector entities have been credit requirements, administered interest rates, and high minimum reserve requirements rates on deposits in the private banking system which, are either not remunerated or remunerated at below market interest rates. The requirement to distribute a given percentage of private companies' profits to employees has also been used.

2.1.6. Budgetary norms and practices

The use of supplementary budgets and of certain budget rules related to the revisions of revenue estimates and the adjustments permitted to the budgetary expenditure appropriations can also impede the proper functioning of the budget.

Supplementary budgets are frequently not reviewed in the context of their global fiscal impact, and tend to reduce transparency both in terms of the control of the aggregates as well as the establishment of priorities.

In the case of budget rules regarding the adjustments to the expenditures relative to the budget appropriations the range of practices is wide, resulting in different degrees of transgression of the universality and unity principles.

The greater the flexibility permitted in the areas noted, the higher the probability that the role of the budget as an indicator of actual expenditure is reduced, and consequently also its role as the instrument of fiscal policy to be implemented in line with pre-established priorities will be weakened.

For example, optimistic revisions of the revenue estimates by congress as well as inconsistencies associated with the earmarking of revenues and expenditure requirements may force the use of supplementary budgets, the under-execution of the budget approved by the legislative, selective expenditure cuts, and measures to increase revenues temporarily. To protect the budget from ad-hoc revenue increases during the fiscal year, some countries prohibit the collection of revenues from a tax or a change in an existing tax in the same year that they have been approved by the legislature.

2.2. Back-door expenditures

Back-door expenditures are expenditures financed by public taxes or levies that are in the budget, but which are authorized by substantive laws outside the budget process (violating the unity principle).

The main forms of “back door” expenditures are expenditure obligations created through the earmarking of revenue, expenditure rules, and tax expenditures.²

2.2.1. Earmarking of revenues³

Revenue earmarking consists in establishing that a given percentage of the collection of a tax or a contribution must be used in a given sector, program or specific expenditure.

The earmarking of revenue introduces rigidities and makes it difficult to achieve an efficient resource allocation, as these revenues must be used for a purpose established in a law that is not the budget law. It also impedes the management of fiscal policy based on performance, because it is impossible to establish performance criteria for the programs or expenditures financed with these revenues as it can be done when these programs are included in the budget.

To the extent that the earmarked revenues represent a significant part of total revenues, the budget loses its effectiveness as an instrument of fiscal policy. The extensive use of revenue earmarking complicates the handling of the budget and reduces transparency. In some countries, the high level of earmarking produces excess resources in some entities while the government needs to borrow at high interest rates.

² Although entitlements and tax expenditures would not create a problem for the proper functioning of the budget if the budget procedure provides the opportunity in the course of the budget process to change the substantive laws creating them, this is not the case in any of the countries analyzed in this paper.

³ Alier (2006).

Revenue earmarking also negatively affects the quality of fiscal adjustment by amplifying the contractionary effect of revenue-based fiscal adjustments. Over the medium term, it is difficult to roll back the additional public expenditure generated by the increase in taxes, and the government also faces difficulties to cut taxes back to the pre-adjustment levels. It introduces also a bias in favor of revenues which have lower levels of earmarking and the government may try to rebalance the tax burden in that direction, even if it does not represent the most efficient alternative.

2.2.2. Expenditure rules⁴

In contrast with the expenditures associated with revenue earmarking, the expenditure rules establish that a given percentage of GDP or of total budgeted expenditure must be used in a given sector (education, health, social expenditure) or in a specific expenditure (subsidies).

The expenditure rules are superimposed on the budget and may result in inconsistencies that lead the authorities to their noncompliance be it in the preparation of the budget or in the execution of the budget. In addition, these obligatory expenditures make it difficult to evaluate the different programs and weaken the budget as an allocation and administration mechanism of public resources.

2.2.3. Tax expenditures

A tax expenditure can be defined as a transfer of public resources that is achieved by reducing tax obligations with respect to a benchmark tax, rather than by a direct expenditure. Tax expenditures can be used as an instrument of government policy and may substitute for direct expenditures.

2.3. Fiscal revenues from transfers by public enterprises

Another mechanism to conduct off-budget operations consists in the use of the public enterprises to collect fiscal revenues through tax and dividend regimes different than those applied to the private sector enterprises in the same sector. For example, a tax surcharge can be applied on their surplus, they may be required to transfer all or almost all of their surpluses to the budget independently of their investment plans, and 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 the public than from the private enterprises.

The result is that the public enterprises must borrow more than the private ones, which could increase their costs of financing, or reduce their investment levels, in turn affecting their competitiveness and production capacity.

⁴ Alier (2006).

The appropriation of these resources generated by the enterprises by the central government constitutes a source of revenue that is not discussed and analyzed in a proper fashion in the budget process, while at the same time there is no comparative analysis of the positive effects of the expenditures financed with these resources and the negative effects on the economy and the public enterprises of this appropriation.

3. Other

3.1. Role of Congress

The role played by congress in the budget process varies among the countries analyzed but appears to be less significant than the one it plays in the OECD countries. The period for the discussion and approval of the budget tends to be shorter; the authority of the congress in regards to the possibility of modifying revenues, increasing expenditures, and reallocating expenditures among entities is less; the level of aggregation of the expenditure categories in the budget is greater; and the rule that if congress does not approve a budget within a given period then the government's proposed budget prevails applies in most cases. If to this we add the fact that the executive may have the authority to exceed and reallocate budgetary appropriations without legislative approval, one can conclude that the role of the legislative in the budget process is of a secondary nature.

3.2. Fiscal Responsibility Law (FRL)⁵

Fiscal rules are a political declaration in regards of how the government will conduct the public finances over time. A properly designed fiscal rule can be a fundamental piece of a larger framework that assures macroeconomic consistency, transparency of fiscal management, and credibility of economic policy, and which provides a proper intertemporal planning horizon for public policies in general.

The design of fiscal rules must be such 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 budgetary estimates (if the rule is applied on the budget estimates rather than on the actual results), the use of ample contingency reserves, and creative accounting.

A proliferation of fiscal rules must be avoided even if they are considered key to achieve the macroeconomic objectives, because they can result in an excessive "armoring" that 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.

⁵ IMF, 2005, "Fiscal Responsibility Laws", SM/05/ 394.

The results obtained through the use of these laws have varied. While some countries have obtained good results, in others, particularly in Latin America, the laws have not been complied with or have been modified so as to comply with them.⁶

The main conclusion obtained from the analysis of the successes and failures of the different countries is that fiscal responsibility cannot be achieved only through legislation. To be successful, the legislation must be accompanied by wider and more profound processes of fiscal responsibility consolidation, ensuring both the proper design of the legislation as well as its implementation capacity.⁷

⁶ Marcel (2005a).

⁷ Marcel (2005a).

II. OFF-BUDGET OPERATIONS—BEST PRACTICE GUIDELINES

1. OCED Guidelines

1.1. Off-budget expenditures

1.1.1. Off-budget funds

Off-budget funds in the OECD countries mainly occur in the areas of social security, health care, transport, and pensions. Central and Eastern European countries report the establishment of off-budget funds to facilitate the privatization process.

Guideline 1

Off-budget funds should be avoided or only be allowed under strict conditions. These conditions are that they are exclusively or largely financed by earmarked levies, and that the expenditures and revenues of the funds are subjected to regular budgetary control.

Guideline 2

All expenditures and revenues of off-budget funds should be integrated in the budget documentation that is presented to the budgetary authorities. Regular expenditures and revenues and off-budget expenditures and revenues should be shown in this documentation side-by-side.

1.1.2. Direct loans

In traditional cash-budgeting all cash streams associated with the loans are recorded in the budget at the moment they are expected to occur and in the accounts at the moment they actually occur. The cash outflow includes the disbursement of principal and the cash inflows include interest, risk fees and repayments of principal. This procedure has important disadvantages: depending on the wording of the appropriations legislation loan programs can be continued on a revolving fund basis⁸ without legislative authorization; disbursement and repayment of loans have different macroeconomic effects than regular expenditure and receipts; the real subsidy costs of loan programs are not revealed so that such programs cannot be traded off against other programs on an equal basis; the real subsidy costs of loans cannot be scrutinized in the budget process for instance by cost-benefit analysis.

To solve these problems some OECD member countries have put credit programs in separate sections of the budget. Disbursements of loans and repayments are excluded

⁸ For revolving fund basis it is understood that the flows of revenues from interest payments, risk premiums, and repayments are not made to the treasury accounts, but remain as resources of the respective lending program, and can be lent without legislative authorization.

from the domain of the fiscal rule, not only if the fiscal rule is on an accrual basis but also if it is on a cash basis. In this manner, loan disbursements and repayments are in the budget and therefore are subject to budget control (albeit not at full cost). This system has solved the problem of different macroeconomic effects and has eliminated improper elements from the public deficit. It has also put an end to the automatic authorization of revolving funds. However, it does not reveal the real subsidy costs, impeding the allocative/distributive and administrative functions of the budget.

In the credit subsidy budgeting system implemented by some countries (New Zealand, United States), the expected incoming and outgoing cash flows during the lifetime of the loans are all discounted and the resulting balance is authorized as subsidy costs at the moment the loan is made. The financial account on which the cash flows related to the loan are recorded is excluded from the domain to which the fiscal rule applies. Although this system is the proper way of treating credit programs, in practice it is not always easy to execute because it requires the use of sophisticated methodologies, which at the same time must be easily understood by congress and the public.

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 robust estimation rules that are easily comprehensible for politicians and citizens. Additional appropriation of subsidy costs during the lifetime 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 amount 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 for each loan program during the fiscal year.

1.1.3. Guarantees

All countries that provided information report the amounts of loan guarantees in their budget estimates, but not so many report subsidy costs⁹ when the guarantees are made. The United States, Norway and New Zealand include the subsidy costs in the expenditure

⁹ The subsidy is defined as the difference between the expected value of the guarantee, i.e., the value of the guarantee multiplied by the probability that the guarantee will be triggered, and the premium paid for the guarantee, as this is the cost for the government to provide the guarantee.

estimates, while Germany includes a provision in the budget when there is a “strong possibility” that fees will not cover the default risk.

If subsidy costs are not reflected in the budget at the moment the guaranteed loans are made, guarantee programs cannot be traded off against other programs on an equal basis and the real costs of such programs cannot be scrutinized in the budget process for instance by cost-benefit analysis.

The same reasoning that motivates the methodology of budgeting the subsidized credit described above provides the motive for the methodology of budgeting the subsidy for guarantees. It requires similarly that the expected incoming and outgoing cash flows during the lifetime of the guarantee are all discounted and the resulting balance is authorized as subsidy cost at the moment the guaranteed loan is made by the private lender. Again, the financial account on which cash flows related to the loan are recorded is excluded from the domain to which the fiscal rule applies.

Likewise, this methodology requires that the guarantee programs are authorized at each occasion that new guarantees are made. Although this methodology is the proper way of treating guarantee programs, in practice it is not always easy to execute for the same reasons noted above.

Guideline 6

The budget should include the estimated subsidy costs of guarantees at the time the guaranteed loans are made by the non-governmental lender.

Guideline 7

Cost estimates of guarantee programs should be based on robust estimation rules that are easily comprehensible for politicians and citizens. Additional appropriation of subsidy costs during the lifetime of a guarantee should not be necessary unless costs increase exceed pre-established margins of fluctuation.

Guideline 8

Guarantee programs should be authorized by law. Budget documentation should provide information about the amount of guarantees outstanding for each program at the beginning and end of each fiscal year or budget period and about the new guarantees for each guarantee program during the fiscal year.

Guideline 9

Guarantee programs should only be considered if the design of the program attributes at least a part of the default risk to the private lender.

1.2. Back-door expenditures

1.2.1. Tax expenditures

Although there may be good reasons for tax expenditures, it is also important that they be subjected to budgetary control in the same way as regular expenditures are. A less rigorous control of tax expenditures than of other expenditures will create an incentive to enact subsidies and transfers in the form of tax expenditures, regardless of the objective considerations that could justify such a choice. This would jeopardize the allocative/distributive, macroeconomic and administrative functions of the budget and could endanger the primary revenue collection function of the tax system. The authorization function raises no particular problem because the tax side of the budget is subjected to annual budgetary review any way.¹⁰

For all functions of the budget it is important that all tax expenditures are estimated in addition to tax revenues and integrated in the expenditure documentation that is presented for consideration to the budgetary authorities. Most countries that provided information for this project provide tax expenditure estimates as part of the annual budget documentation, often including multi-annual estimates.

As far as the macroeconomic function is concerned, it is important that tax expenditures do not escape the control of the fiscal rule. The different fiscal rules that exist in the OECD countries offer opportunities to escape budgetary control through the use of tax expenditures.

Guideline 10

Tax expenditures should be identified by use of a benchmark tax which does not necessarily need to represent the normative tax base although it should be comprehensive and unique.

Guideline 11

All tax expenditures should be estimated and integrated in the expenditure documentation that is presented to the budgetary authorities for all significant taxes. Regular expenditures and tax expenditures should be shown in this documentation side-by-side 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 in so far as it originates in policy change.

¹⁰ This is not the situation for the countries reviewed in this paper.

Guideline 13

All tax expenditures should be reviewed in the same way as regular expenditures in the annual budget process.

Guideline 14

Tax expenditures should be assigned to 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 responsibility for tax revenue estimates should remain with the Ministry of Finance.

2. Alternative Guidelines

The alternative guidelines proposed in this paper respond to several reasons.

First, besides the type of off-budget expenditures which are common in the OECD countries, in the countries analyzed in this study several other mechanisms exist that impede the proper functioning of the budget such as the earmarking of revenue, expenditure rules, and quasifiscal activities.

Second, the use of supplementary budgets and of certain budgetary rules in regards to the revisions of revenue estimates and the adjustments permitted to the budgetary appropriations can also impede the proper functioning of the budget.

Third, the countries analyzed present some characteristics that require the modification of the OECD guidelines in order to comply with the universality, unity and specificity principles.

Finally, some of the modifications respond to differences in regards to conceptual points which are the basis of OECD guidelines in some areas.

2.1. Off-budget expenditures

2.1.1. Off-budget funds

The use of Funds (off-budget and budgetary) as an expenditure budgetary instrument is common practice in several of the countries included in this study. Their characteristics

and rules of operation vary from country to country, but they also present common features.

These characteristics and rules of operation include:

- The budget includes only the 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, the resources allocated to the fund are authorized only by the line ministry, or can be earmarked revenues, that may or may not transit through the budget.
- The authorization to use public resources is given when the funds are established, with the executing agencies requiring only authorization from the line ministry in charge of the fund to spend on the basis of the rules which defined the objectives of the fund. As a result, expenditure allocations are not clearly related with the global fiscal position and the fiscal policy objectives.
- In some cases the off-budget funds are authorized to issue debt, securitized or not with revenue inflows, with or without government guarantee.
- The managerial responsibility for the off-budget funds is defined in the laws governing each fund. The objectives of the fund may be broadened over time.
- The budget documentation does not contain information on the policies nor the financial situation of the funds.
- Through the use of the resources of the funds, implicit or explicit subsidies may be provided which are not identified in the budget. For example, the funds may contribute capital for private sector investment projects, lend at subsidized interest rates or condone nonperforming loans.
- In some countries the use of these funds is convenient from an administrative and operational point of view. For example, the funds can be constituted as trust funds without having their own structure and operate through the structure of a public financial institution.

On the basis of these characteristics, and in addition to the OECD guidelines 1 and 2, the following guidelines are proposed for off-budget funds:

Guideline 1

Require a law to establish an off-budget or budgetary 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. The budgetary funds must be integrated with the budget and must comply with all the budgetary requirements. These funds may transfer resources from one fiscal exercise to the next, provided that these resources are budgeted and executed in accordance with the existing budgetary procedures.

Guideline 3

Require a central government guarantee for the issuing of debt instruments by the off-budget funds.

In the event that it is not possible to comply with OECD guidelines 1 and 2 and guideline 2 of this section, implement guideline 4.

Guideline 4

Prepare an annual report on the funds that includes, by fund, the capital at the beginning and the end of the period, the revenue and expenditure flows during the fiscal period identifying origin and destination, description of the modifications introduced during the year to the objectives and operational rules of the fund, and the revenues and expenditures projected for the following fiscal year. Include the report in the budget documentation.

2.1.2. Direct loans

Two components must be distinguished for the budgetary treatment of the direct loans. One refers to the flows of resources involved and the other to the subsidy implicit in the operations.

In regards to the first component, both the OECD guidelines as well as the GFSM 2001 do not include direct loans with other expenditures and revenues. The OECD argues that they have a different macroeconomic effect and because of that they should not be included in the definition of the deficit, while the GFSM 2001 excludes these operations from the operational result because they correspond to financing operations that do not affect the government’s net worth, as they only affect 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 differentiation which is not present 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 do have an effect and therefore, the effect should be included

both in the fiscal rule as well as in relation to the allocation/distribution function of the budget. Furthermore, if their macroeconomic effect is different, the question arises as to different from what? Not all the components above the line have the same macroeconomic effects as for example, the macroeconomic effects of achieving the fiscal target through an increase in taxes are different from those of achieving it through an expenditure cut.

In addition, to classify the direct loans with the financing operations implies not only to ignore the policy objectives behind these operations, which the budget must authorize vis-à-vis other forms of achieving the objectives being sought, but implies mixing operations that do not have direct macroeconomic effects such as the financing ones with these that do have them. Also, they represent requirements of resources that should be included with the needs stemming from the deficit so as to be able clearly identify the financing requirements, which is particularly important in countries that face difficulties in accessing the capital markets.

Another argument against using the methodology proposed by the OECD and the GFSM 2001 is that this methodology allows to use direct loans to effect expenditure that does affect the fiscal target.¹¹

One additional argument to consider is that in many countries, these loans are not repaid or are repaid only in part, so they are more similar to transfers or subsidies than to loans, i.e., they do end up by affecting the net worth.

The second component refers to the subsidies associated with the direct loans.

If direct loans are classified as expenditure and revenues (repayments and interest and risk premium payments), an estimation of the implicit subsidy for the current fiscal exercise or for the present value of the subsidy should not be added as an expenditure. It is proposed that in this case the implicit subsidy both for the current fiscal year as well as for the present value of the subsidy be recorded as memorandum items. 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.

However, if direct loans are classified as financial operations, an estimate of the present value of the subsidy has to be included as expenditure as part of the operational result. As discussed before, this estimation requires the use of sophisticated methodologies that are difficult to apply in the countries included in this study.

Direct loans may be conducted through an agency of the corresponding line ministry or through 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.

¹¹ In Poland, where net direct loans are treated as financing of the deficit, there are numerous examples of direct loan operations, mainly to off-budget funds, that are used as a way to reduce the deficit.

In the first two instances, the subsidy is an implicit subsidy provided through the interest rate charged to the borrower (including the 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, because the sovereign risk premium could be substantially less than the cost of funds for the private banks.¹² It must be noted also that 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 the 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 the 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 budgetary 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 in 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. For explicit subsidies, these have to be identified separately in the budget and be included also as a memorandum item together with the implicit subsidies.

2.1.3. Guarantees¹³

The OECD guidelines refer to guarantees on loans granted by nongovernmental entities. In this paper, guarantees are considered in a wider sense, including 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 budgetary impact. Consequently, the treatment given to guarantees should seek to impose budgetary discipline so as to make the public entities 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 must be minimized.

¹² The question that arises then is which is the interest rate to be used in the calculation of the implicit subsidy.

¹³ IMF, 2005, "Government Guarantees and Fiscal Risk", SM/05/120.

Guarantees are a form of government intervention when it is in a better position to assume the risk, control it, and thereby minimize its cost. The objective is to compensate for a market failure but care must be taken to avoid replacing a market failure by a government failure. It is important to determine which is the market failure that has to be addressed and if a guarantee is the best way of doing it.

Although a guarantee may be the best way of addressing a market failure, they may create problems for fiscal sustainability. Their effects on the public finances only happen over time and it is not known beforehand which is the amount that will be triggered nor when it will be triggered. Because guarantees do not have an immediate budgetary impact they may not be subject to the same kind of scrutiny than that for expenditure or loans. Consequently, the public entities must define a framework to be applied to the provision of guarantees for which the reporting, contabilization, and transparency are key elements.

Guarantees are generally not provisioned in the budget to attend the cost of guarantees which are triggered, and no consideration is given to which would be the best way to reallocate expenditure or mobilize resources in the event that it is needed to cover these costs.

The key objective for a guarantee policy is to achieve complete transparency on the possible risks and fiscal costs. It is difficult to attain this objective because they constitute 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.¹⁴

Under cash accounting, guarantees are recorded in the fiscal accounts when a covered contingency occurs and a cash payment is made. If a premium is charged, it is recorded as a nontax fiscal revenue.

The 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 occurring. The contingent liabilities are registered as memorandum items to the balance sheet under GFSM 2001. If a provision is not made for guarantees, they are only recorded under accrual accounting when they are called. When a guarantee is called, according to the GFSM 2001 guarantee payments are registered as an expense in the operating statement, and a corresponding increase in liabilities is recorded in the balance sheet.

The guidelines proposed below seek to incorporate the points discussed in this section as well as to take into account the context which frames the budgetary practices of the countries reviewed in this paper.

¹⁴ These methodologies are still at a development stage. In Chile they are used only for guarantees provided under the road concession contracts.

Guideline 1

Centralize the provision of guarantees. The provision of guarantees must be approved by the ministry of finance, the cabinet or congress, within a well designed framework which includes the conditions to provide them, their design and an analysis of their implications.

Guideline 2

To the extent possible, guarantees provided to the private sector must 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 the amount of guarantees which must be approved in a permanent law or in the annual budget law. This ceiling creates a quasi-budgetary restriction, which generates more scrutiny and a better prioritization of the proposals for the granting of guarantees. The limit may be defined over the maximum value of the new guarantees to be provided, or as a percentage of the fiscal revenues or expenditure or in more advanced systems over the expected value of the guarantees. One limit can be set for the whole public sector or different limits can be set by entities.

Guideline 4

Incorporate the granting of guarantees into the annual budgetary cycle and into the analysis of sectoral policies and programs, so that the proposals for new guarantees are considered relative to other possible mechanisms and programs that seek similar objectives.

Guideline 5

Establish budgetary mechanisms to provide liquidity to the guarantees which are triggered. Because the maximum value of the guarantees can exceed by much their expected value, it is not possible or necessary to provision for their maximum value in the budget, but it is important to find a way to estimate their expected value to establish a contingency fund.

Guideline 6

Include the expected value of the 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

Budget annually the expected value of the guarantees for the fiscal year.¹⁵ This ensures that congress is informed about these expenses from the start, that other priority expenses are not crowded out during the execution of the budget or that they add to the fiscal deficit, and that they have been pre-authorized.

Guideline 8

Include in the budget documentation a detailed report on guarantees, identifying those guarantees that have been triggered. The report should identify all the 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 nonquantifiable contingent liabilities. The contingent liabilities which 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.

2.1.4. Public-Private Partnerships (PPPs)

Through PPPs the government may acquire expenditure obligations which are not included in the budget and which are not authorized by the legislative. Because of their characteristics (the payment and guarantee commitments may extend for many years), the PPPs can be used as a mechanism to circumvent budgetary constraints, affecting the 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, it is necessary to establish clear rules regarding their contracting and execution.

A series of guidelines are proposed below which seek to avoid that PPPs are used as a mechanism to circumvent budgetary constraints. These guidelines are based on a study prepared by Jul (2005) for Brazil, Colombia, Chile, Mexico, and Peru.

Guideline 1

Establish a legal and institutional framework with the objective to maximize the efficiency gains of these projects while minimizing the risks to the public finances.

¹⁵This appropriation may be a general contingency reserve to cover several contingencies and unexpected expenses. But in the countries where the payments associated with guarantees that have been triggered are significant, a separate appropriation improves transparency and fiscal responsibility. If the total appropriation is not used, it may be reassigned or it may expire at the end of the fiscal year. It will be necessary to define the point starting from which the payments under guarantees are treated as debt service instead of against a provision for guarantees.

Guideline 2

Define clear criteria for the assignment of risks to frame the design of the bidding process, which seek that the risk is assumed by whoever is in the best position to do so, optimizing the transmission of risk to the private sector. Define minimum risk capital requirements.

Guideline 3

Integrate the selection of projects to be executed as PPPs into the evaluation process for the projects to be executed as public direct investment to ensure that their economic and social viability is evaluated correctly, and that a PPP constitutes the best possible alternative to execute the project, independently of budgetary constraints. This enables to establish from the beginning a public comparator to evaluate the net benefits of implementing the project as a PPP and to identify the mechanisms required to make the project attractive to the private sector at a minimum fiscal cost.

Guideline 4

Incorporate the participation of the Ministry of Finance all along the process to ensure that the payment commitments and guarantees to be provided do not exceed the resource availability in the budget for the current fiscal year and for the duration of the contract.

Guideline 5

Strengthen the capacity of the line ministries and the ministry of finance to evaluate, design and monitor the implementation of the PPP contracts, and to quantify the fiscal costs and risks that they imply.

Guideline 6

Implement mechanisms to provide liquidity to the guarantees that are triggered, including the definition of the budgetary procedure under which a budgetary provision would be justified for these projects. Provision in the budget 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 as well as for the direct payments to be effected under these contracts. The limits should be placed on the cumulative flows of commitments and in relation to variables that are relevant from a budgetary point of view for the public entities involved.

Guideline 8

Establish budgetary mechanisms which clearly identify total commitments under these projects, and give them priority over new expenses. Include in a law a rule that establishes that resources committed for these projects may not be reassigned to other purposes. This rule serves the double purpose of identifying the effect of these projects on the fiscal space, independently of their quality as an investment project, and contributes to achieve fiscal credibility.

Guideline 9

Include the 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 in the budget documentation detailed information by project 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. Identify clearly the information on these operations in the public finance statistics, including the triggering of guarantees.

Guideline 11

Require congress approval of those projects that involve more than 70 percent of public financing of the project.

Guideline 12

Prohibit the use of fiscal benefits and/or public resources not contemplated in the contracts to compensate the private partner for a politically-induced freezing of tolls or to set tolls below the necessary level, in lieu of using direct payments.

2.1.5. Quasifiscal Activities

The guidelines that follow 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 quasifiscal 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 the quasifiscal activities conducted by the 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

The loans granted within the public sector should be conducted at market rates.

In the transition period for implementation of guidelines 1-3, implement guidelines 4-6.

Guideline 4

Prepare reports of all quasifiscal activities, including those conducted through nonfinancial and financial public enterprises, and those associated with the regulatory role of the government, to measure properly the fiscal activities of the government. The report must identify all forms of public support and the end beneficiaries of the support.

Guideline 5

Define limits on the quasifiscal operations to be conducted through the public financial institutions in the fiscal responsibility law or in the annual budget.

Guideline 6

Identify cross subsidies treating the subsidies as expenses and the implicit taxes as revenue, recording them as memorandum items.

2.1.6. Budgetary norms and practices

The budget norms and practices found in the countries reviewed in this study include:

- The budget laws differentiate between those expenses that may not automatically exceed the budgetary appropriations and those which may (debt service, pension payments, expenses required by special laws), with the latter allowed to result in a larger total expenditure than budgeted or having to be covered by a reallocation of expenditure in order to comply with the overall expenditure ceiling. In some cases, excess revenues, if they occur, 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 will be 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 a better rationalization of eventual budgetary modifications within the fiscal year.

- The rules regarding the margins that the government has to exceed the budgetary appropriations without congress 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 like investment outlays by a given percentage of those expenditures.
- The expenditures associated with earmarked revenue are obligatory but they do not have to be effected 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 the budgetary appropriations because of inconsistencies in the actual availability of resources (due to cash availabilities, payments on the float, obligatory expenses, expenses associated with earmarked revenues).
- In some cases the fiscal rules impose additional constraints to the margins by which expenses may exceed the budgetary appropriations. The flexibility in this respect depends on whether it is possible to exceed the limit on expenditure without an offset in revenues or if it 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 legislative does not impose limits on borrowing.
- In some countries the ceiling on borrowing is the one that effectively imposes a limit to the expenditure that may be executed without obtaining congressional approval. In those 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 which do not require 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 own resources.
- The rules that apply to 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 that 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 appropriations which

have not been spent may be transferred to finance certain commitments defined in the corresponding budget law and/or to reallocate them.

- Sometimes arrears are used to spend beyond the budgetary appropriations.
- Off-budget operations may be used to exceed budgetary appropriations. These may result from changes in the fiscal situation during the year, or caused by unrealistic assumptions in the budget.
- In some countries, although privatization receipts are pre-allocated in the budget for certain uses, the spending takes place whether the privatization receipts materialize or not.
- The undisbursed commitments (float) may also affect the functions of the budget depending of the mechanism through which these expenses are approved, the period of time during which the expenses may be disbursed, and against which budget they are executed. The budget may not necessarily identify an appropriation to accommodate these expenses. It may be the case that it is required that the float be cleared during the first two months of the next fiscal year, using if necessary, revenues collected during this period, or its clearing may extend to all of the fiscal year following that in which these 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 legislative.

Guideline 2

Avoid practices which result in an under-execution of the budget because they weaken the budget as a fiscal instrument.

Guideline 3

The expenditure of the autonomous agencies in excess of their budgetary appropriations should be reviewed by congress through supplementary appropriations presented by the ministry of finance (instead of being approved by the corresponding line ministries).

Guideline 4

Limit the size of the budgetary contingency reserve.

Guideline 5

Expenditure associated with earmarked revenues should take place in the same fiscal exercise in which the revenues were generated.

Guideline 6

Clear the float in the first month following 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.

2.2. Back-door expenditures

2.2.1. Earmarking of revenue¹⁶

The negative consequences associated both with the earmarking of revenues as well as with expenditure rules result 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 towards higher spending and taxation; limit the scope for countercyclical fiscal policy; and weaken the 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 budgetary appropriations.

2.2.2. Expenditure rules

Guideline 1

Incorporate in the budget discussion the expenditure associated with the expenditure rules so as to assess annually their relevance from the point of view of the government priorities and subject them to the same cost-benefit analysis than other expenditures.

2.2.3. Tax expenditures

¹⁶ Alier (2006).

There are no alternative guidelines to those proposed by the OECD in regards tax expenditures.

2.3. Fiscal revenue from transfers by the public enterprises

Guideline 1

Establish a tax treatment for public enterprises in line with that applied to the private sector enterprises.

Guideline 2

Define in the annual budget law or in the organic budget law the financial relations of the government with the public enterprises, establishing ex-ante a dividend policy or predetermined rates of return on the public enterprises' assets.

Guideline 3

Use market indicators to define the reference prices to be used to calculate the nonfinancial public enterprises transfers to the budget.

2.4. Other

2.4.1. Role of Congress

Guideline 1

Define clearly the role to be played by congress in the budgetary process. Prohibit the revision of revenue estimates by the congress.

Guideline 2

Limit the period during which the government may operate without having an approved budget.

2.4.2. Fiscal Responsibility Law (FRL)

Guideline 1

Keep the fiscal rules simple, limiting them if possible to one or two rules.

Guideline 2

Apply the fiscal rules both to the approved budget as well as to the actual outturns.

Guideline 3

Frame the FRL within the budget norms and practices to avoid an over-determination of the system, which results in an unrealistic budget and therefore, to an under-execution of the budget, a large float, significant reallocations of the budgetary appropriations, and the use of the cash budget as the mechanism to set priorities in the execution of the budget.

III. OFF-BUDGET OPERATIONS—SELECTED COUNTRIES EXPERIENCES

BRAZIL¹⁷

1. Legal framework

The legal framework of the budget is formed by the constitution, the Budget Framework Law (1964), the Multi-year Plan (PPA), the Fiscal Responsibility Law (FRL, 2000), the annual Budget Directives Law (LDO), and the annual Budget Law (LOA).

In recent years emphasis has been placed on the PPAs which are oriented towards the achievement of certain objectives. The PPA allows for greater fiscal transparency because it strengthens the link between the multi-year planning and the preparation and execution of the annual budget, integrating the long-term development policies with the sectoral short and medium-term objectives. The development plans which cover 8 years establish the indicative targets for the PPAs which cover 4 years. The PPA is submitted to congress for approval, and congress has to approve it before December 15 of the first year of a new administration. Once approved, the PPA is in effect until the end of the first year of the next administration.

The LDO sets the fiscal targets for the federal government and the nonfinancial public enterprises. In line with the FRL, the LDO provides information on the execution of the budget in the preceding two fiscal years as well as on total expenditure, revenues, and primary balance targets for the following three years (Fiscal Targets Annex). Starting in 2001, the LDO provides information on contingent liabilities and tax expenditures (Fiscal Risks Annex). The LDO has to be approved by Congress by June 30.

2. Budget coverage

The LOA is comprehensive, encompassing the operations of the executive, legislative, and judiciary branches of government, all government-controlled funds, the social security system, and all other federal entities, and the central bank's (BCB) operating result not associated with the conduct of monetary policy. The budget document also includes the investment budgets of the federal nonfinancial public enterprises. The LOA is based on the PPA, and on an assessment of fiscal sustainability focusing on targets for the public debt-to-GDP ratio. The LOA must be approved by congress by December 15.

¹⁷ Based on IMF, "Brazil: Report on Observance of Standards and Codes (ROSC)—Fiscal Transparency Module", Country Report No. 01/217, December 2001; on the answers to the questionnaire, as well as on information and documents provided by the authorities in the meetings held in Brasilia on January 16-18, 2006; and on Jul (2005).

3. Contingency reserve

The LOA includes a contingency reserve to cover contingent liabilities and other risks and unforeseen fiscal events. In the draft LOA bill, the executive includes a larger contingency reserve to accommodate legislators' amendments to the proposed appropriations, and in that manner have the budget suffer less modifications from the actions of congress than it had in the past.¹⁸

4. Role of Congress

The legislative branch may modify the LOA bill in line with the PPA and the LDO. In practice, congress revises the revenue estimates significantly although legally it is only authorized to do so in the event of estimation errors in the draft budget law. 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 by the beginning of the fiscal year, then the government may only execute key expenditures until there is agreement.

5. Fiscal indicators

The main fiscal indicator for the assessment of fiscal policy is the primary balance. The budget must be prepared and executed complying with a primary balance target set in the LDO. Also, the PPA establishes physical targets for each program, which constitute important indicators for government policies.

6. Fiscal rules

The FRL defines fiscal rules for all three levels of government to ensure fiscal sustainability in the medium term, and establishes strict transparency requirements to support the effectiveness and credibility of those rules. The PPA constitutes another pillar for fiscal management.

The FRL requires that no permanent expenditure be created without a corresponding increase in permanent revenues or cuts in other permanent expenditures. It also prohibits that borrowing exceeds investment expenditure, and rules that the effects on revenue of new tax expenditures must be recorded for the current fiscal year and the two following ones. 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.

¹⁸ The 2006 LOA draft bill included a contingency reserve equivalent to 2 percent of total expenditures, with 1 percent intended for the reserve itself and 1 percent for the expenditure amendments of the legislators, with at least half of the provision included in the draft bill to be counted as primary expenditure for the calculation of the fiscal result.

The 2006 LDO establishes that the federal government's net tax revenues may not exceed 16 percent of GDP, with measures to be adopted if necessary to comply with the limit. If the revenue estimates exceed the limit, a specific contingency reserve must be constituted with the excess, which may only be used, with legislative approval, to offset for the effects of measures taken to reduce taxes, increase the obligatory expenditures required by the budget law, and for investment. In turn, if actual revenues exceed the limit, the excess revenues may only be used for the same purposes as the specific reserve. The 2006 LDO also established a limit of 17 percent of GDP for the primary current expenditure.

In addition, the LDO established that the primary surplus target may be adjusted (one-fifth of the difference) for a higher/lower surplus in case GDP growth exceeds/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.

7. Off-budget operations

The budget is quite comprehensive and as a result it is rare that operations are not included in the budget. In practice what may occur is that an operation is included or not depending on whether it is determined to be a public sector transaction or not.¹⁹

7.1. Off-budget expenditures

7.1.1. Off-budget funds

There are no extrabudgetary funds. There are various budgetary funds, all of which require a specific law to be created. All budgetary funds enjoy earmarked revenue for their specific expenditures, but they are an integral part of the federal budget and must comply with all budgetary procedures during budget preparation and execution. Budgetary funds may carry over into the next fiscal year any financial surplus remaining from the current fiscal year, provided that it is properly budgeted and executed according to budgetary procedures.

In general, the budgetary funds are understood as specific revenues that finance specific actions of the government. For example, the Fund for the Universalization of the Telecommunication Services receives revenues earmarked from the taxes on telephone tariffs, which finance telephone services in remote areas of the country.

¹⁹ One example is the Severance Pay Fund (FGTS) which is constituted of individual accounts of the workers in the private sector financed through contributions from the employers required by law. In spite of the obligatory nature of the contribution to the fund, this Fund is treated as private capital of each worker, to be used in specific circumstances related to his employment, such as severance payments. For some, the obligatory nature of the contribution makes it public revenue; in all the majority of people understand the FGTS as being a private fund, not to be included in the budget.

7.1.2. Direct loans

The government does not provide direct loans but imposes credit requirements on the public banks to channel loans at subsidized rates to priority sectors which are not the subject of credit by the private banks. These operations are discussed below in the section on quasifiscal activities of the development banks.

7.1.3. Guarantees

Strict rules are applied to the provision of guarantees by the federal government. The FRL authorizes the public entities to provide guarantees for internal and external loan operations which comply with certain requirements and, for the federal government, within certain limits and conditions determined by the Senate. Also, the provision of a guarantee is conditioned to a collateral of equal or larger value, and that the borrower has no outstanding obligations to the guarantor. For loans from multilateral organizations, or from a federal credit and development institution for the onlending of foreign funds, the central government may provide guarantees only to an entity which complies with the legal requirements to receive voluntary transfers from the federal government. The guarantees are not defined by sectors but by lenders, and are granted on a case by case basis.

The guarantees to be provided for domestic credit operations need to be approved only by the Ministry of Finance (MF). Normally the treasury does not provide this type of guarantee and does it only in exceptional cases as for example for projects like Prodetur (Program for the Development of Tourism in the Northeast).

The FRL established that the LDO has to include an annex which assess the contingent liabilities and other risks that can affect the public accounts, and reports on the measures that would be adopted if these risks materialize.

The budget only includes a guarantee when it is triggered. As noted before, the budget includes a contingency reserve that may be used to cover guarantees which are triggered during the fiscal year as long as they have been previously defined as such. The guarantees which require a provision for debt issue in the future are included in the budget. There are no rules regarding guarantees to be provided to the private sector but these are not granted.

7.1.3.1. Contingent liabilities

The Fiscal Risks Annex distinguishes six types of contingent liabilities. The first type is related with issues derived from the indexation and price controls regimes used in the stabilization plans and with the solutions proposed for their compensation; with judicial actions against the BCB; and with the risks to the BCB assets associated with bank liquidations. The second type of contingent liabilities refers to judicial actions against the federal government, while the third type has to do with tax and social security judicial

actions. The fourth type of contingent liabilities includes judicial actions related to the administration of the government such as privatizations, liquidations or elimination of entities or companies and actions which affect personnel management. The fifth type of liabilities is related to the debts that are being recognized by the federal government (“skeletons”). Finally, the sixth type is related to guarantees provided by the federal government to funds, sub-national governments and others.

Within the third type of contingent liabilities, the maximum value of the contingent liabilities amount to about US\$18.5 billion. The so called “skeletons” are estimated at US\$44 billion as of February 2005. Of that total, the debts of the Housing Mortgage Insurance/Subsidy Fund—FCVS amount to about US\$37 billion. For 2006-2008, the payment of these liabilities with government paper would amount to US\$22 billion, which implies debt issues of US\$7.5 billion per year on average.

The sixth type of contingent liabilities consists of guarantees provided by the federal government. These guarantees amounted to US\$63.5 billion at end-2004. For the guarantees provided to the sub-national governments, almost one hundred percent is covered by collaterals, which consist of federal government transfers and own revenues. The risk of these operations for the federal government is close to zero.

7.1.4. Public-Private Partnerships (PPPs)

The philosophy behind the framework defined for the PPPs is that they respect the fiscal responsibility rules in their execution, to obtain transparency in the procedures and decisions, and to achieve an objective assignment of risks between the parties which ensures the financial sustainability and the exploitation of the socioeconomic advantages of the projects.

The PPP Law (the Law) approved in 2004 dictates the norms for the bidding and contract design of PPPs for all public administration entities. The Law establishes two types of concessions—*patrocinada* and *administrativa*. The *patrocinada* involves the payment of a tariff by the users as the financial counterpart from the public entity to the private investor, and there may be a payment of the public entity which complements the tariff charged to the user. The *administrativa* is a contract to provide a service used directly or indirectly by a public entity, even if it involves the construction or the provision and installment of assets, where the payment for the service is made by the public sector.

The Law establishes that concessions in which more than 70 percent of the remuneration of the private investor is paid by the public entity have to be approved by congress.

The PPP program at the federal level is managed by a Management Council (CG) composed of the ministers of planning (who coordinates it) and of finance, and by the head of the President’s cabinet. The CG is in charge of defining the criteria to select the projects and design the contracts. It will authorize also the auctions and will approve the bidding instruments and the contracts and their modifications. It will also approve the

PPP plan and will supervise and assess its implementation. The CG has a technical commission and an executive secretariat for technical and administrative support.

The initiative for the PPPs was given to the economic advisory unit of the Ministry of Planning (MP), creating a PPP Unit. Also, a PPP Work Unit was created at the MoF in charge of the macroeconomic aspects, including the fiscal and budgetary impact of the PPPs, and of dictating norms for the recording of these operations in the fiscal accounts. The objective is to have the MoF participate all along the implementation process of the PPP projects with an emphasis on the fiscal part. It is up to the line ministries and regulatory agencies to submit to the CG the terms of the contract, bidding terms of the project, and to monitor and supervise the implementation of the PPP projects.

The legislative branches of each level of government, assisted by the respective comptroller agencies, must monitor the compliance of the PPP projects with the fiscal targets and budget ceilings.

To execute a project as a PPP the entity that proposes it must demonstrate first that a traditional concession, i.e., without public support, is not viable and that a PPP is a better alternative to implement the project than direct public investment.

The Law establishes that the concession contracts must specify the assignment of risks between the parties, including those associated with force majeure. Contract models for the different sectors have yet to be developed, and in these they could establish a profile for the distribution of risks.

The Law creates a fund (FGP) which is to provide guarantees for the payments of the contractual obligations committed by the federal entities in the PPP contracts. The federal government and the entities adscribed to it are authorized to participate in the FGP up to a limit of about US\$1.5 billion. The FGP is a fund managed by the Bank of Brazil. Technically it is not a trust fund but a fund which may provide guarantees on behalf of third parties up to the total limit. The FGP is authorized to provide collateral to insurance companies, financial institutions, and international organizations which guarantee the financial obligations of the public entities in PPP contracts.

The Law limits the amount of resources that the federal government may commit on PPPs. The limit seeks to tie the fiscal part so that the way in which these operations are recorded in the fiscal accounts is not that important. The Law also seeks to define rules to prevent that the public entities increase expenditure through PPPs. It establishes that the federal government may contract PPPs only when the cumulative expenditure on the projects already contracted does not exceed 1 percent of the net revenue of the previous period, and the annual expenditure of the existing contracts does not exceed 1 percent of the net revenues in the following 10 years.

In addition, the expenditure generated or increased by PPPs is 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 FGP constitutes de facto another limit for the PPPs to be contracted by the federal government because an entity may not commit more payments if it has used its limit in the FGP, and the Law establishes a total limit which may not be increased. Furthermore, the objective of the PPP contract must have been established in the PPA.

Once the MoF has defined the recording criteria to be applied to these operations, the obligations contracted under concessions will have to comply also with the public debt ceilings. Furthermore, it will be decided on a case by case basis if the contract that is being proposed is compatible with the debt trajectory which is considered sustainable, with the MoF having the authority to veto a project on this basis alone even if all other limits are being complied with.

7.1.5. Quasifiscal activities

7.1.5.1. Nonfinancial public enterprises

The quasifiscal activities of the nonfinancial public enterprises have been largely eliminated, particularly at the federal level. For example, fuel prices used to be kept artificially low, resulting in significant losses to the Petroleum Company (PETROBRAS) which were reported in the “Petroleum Account”. In 1998, the cumulative losses were covered by a government debt issue to PETROBRAS. Although the fuel price structure introduced in 1998 still contained some cross-subsidies on oil derivatives at the consumer level, the automatic fuel-price adjustment mechanism introduced in 2000 aimed at ensuring that there was no overall subsidy. As a result, the Petroleum Account remained in approximate balance and was phased out when the domestic oil market was liberalized. At present, it is PETROBRAS that determines the level and structure of fuel prices without government interference.

7.1.5.2. Financial public enterprises

7.1.5.2.1. Central Bank (BCB)

Relations between the budget and the central bank are transparent. The BCB’s administrative budget is fully integrated into the federal budget, and the BCB surplus income is transferred to the treasury every six months; possible BCB losses have to be addressed through a transfer from the budget.

Nevertheless, minimum reserve requirements are high, constituting a source of revenue for the central bank which is not included in the budget because it is associated with the conduct of monetary policy.

7.1.5.2.2. Development banks

Operations between the budget and the public financial institutions are also transparent; operations of a quasi-fiscal nature have been apparently largely eliminated. However, the complexity of the credit programs implemented through the public financial institutions is such that makes it difficult to estimate the cost of these programs as well as those conducted through funds and other programs.

The 2006 LDO establishes that the government must submit to congress 15 days after submitting the draft LOA a plan indicating the loan program of the development agencies, which must specify what has been executed the two previous fiscal years, what was expected for 2005, and projections for 2006. The government must prepare a report showing the loans and financing sources of these institutions, including those at a loss, consolidated by development agency, and detailed by region, states, economic activity sectors, size of borrowers and origin of the resources used (own, treasury, other sources).

The Bank of Brazil (BB) and the Federal Savings Bank (CEF) are subject to credit requirements for agriculture and housing, respectively. The subsidy element associated with these loans is included in the budget.

The subsidies provided through several programs or funds may be explicit or implicit. The explicit ones may be granted through the equalization of interest rates and prices, issue of government paper, and direct payments. For example, the resources of the Social Housing Program are used to complement the paying capability of the borrower of loans for low income housing and to top up the payments received by the financial institution so that the loans are profitable for them.

The implicit or indirect subsidies granted through public funds or the opportunity cost of the resources assigned to these funds are calculated as the difference between the value of the net worth estimated as if it would have increased month to month at a market interest rate and its actual value. Budget transfers are used to compensate for these subsidies or implicit opportunity costs.

For 2005 it is estimated that the subsidies granted through the different programs and funds covered through budget transfers amounted to about 1 percent of GDP.

7.1.6. Budgetary norms and practices

Budgetary allocations are not mandatory, and the budget is executed through presidential decrees that establish expenditure ceilings which are equal or below the approved budget allocations, including those on account of the previous year's undisbursed commitments (*restos a pagar*). The undisbursed commitments are valid until December 31 of next year and may be covered against an appropriation for this purpose. The debt obligation regarding these payments prescribes in five years. These payments did not exceed 1 percent of the budget in 2003-2005. 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. The supplementary budget appropriations, which can be enacted through presidential decrees provided that the proposed increase in expenditure does not exceed a certain percentage, and can be also used for reallocating budgetary appropriations. Above the limit, which is set in the LDO, they have to be approved by congress. The special budget appropriations, which need to be approved by congress, are for new expenditures not included in the budget, while the 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 that the corresponding additional financing sources be identified.

In light of macroeconomic shocks and revisions by congress to the revenue estimates included in the LOA bill, the government has had to resort to additional budget appropriations, in-year revenue raising measures, selective budget cuts, and limits on commitments and payments. This has weakened the functions of the budget.

7.2. Back-door expenditures

7.2.1. Earmarking of revenues²⁰

The budget is characterized by a high degree of earmarked revenues, many of them defined in the constitution, others by law. All the earmarked revenues as well as the expenditures that are financed with these resources must be included in the budget. They must be used exclusively for the purpose for which they were earmarked although it may be in a different fiscal exercise than that in which the revenue occurred. At the end of the year, amounts earmarked for discretionary spending that are not authorized in the budget execution decree must be saved in a separate account to be eventually used for their intended purpose.

The Constitution mandates the federal government to transfer a substantial share of some tax revenues to states and municipalities.²¹ It also mandates universal access to *social rights* (including social security) and earmarks social contributions for this purpose.

In 1994, under the Social Emergency Fund (FSE), 20 percent of government revenues were exempted from sharing or earmarking. The FSE was intended to provide some room for the government to better manage the budget while a broader tax reform was considered by Congress. The tax reform was not approved, but the FSE has been extended until today under different names. In 1999, the De-Earmarking of Federal

²⁰ This section and the next one are based on Alier (2006).

²¹ At the same time, the Constitution introduced expenditure requirements for sub-national levels of government to ensure the adequate use of these resources.

Revenues (DRU) provision was introduced de-earmarking 20 percent of social contributions. The main difference between the DRU and its predecessors is that constitutional transfers to states and municipalities are not subject to de-earmarking. The 2003 tax reform extended the DRU until 2007.

In 2003-2005 about 81 percent of the primary federal revenue was earmarked, with more than 40 percent for social expenditure. The states and municipalities received more than 22 percent of the earmarked revenues, while the health sector obtained 10 percent and the educational sector a 5 percent.

7.2.2. Expenditure rules

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 expenses as well as on welfare and pensions. A constitutional amendment was approved in 2000, which required that health spending be 5 percent higher than in 1999, and that it should grow with nominal GDP thereafter, implying that health spending would be maintained at least at 1 $\frac{3}{4}$ percent of GDP.

7.2.3. Tax expenditures

All tax expenditures, which in Brazil are known as fiscal renunciations, must be approved by law. The concession 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 by rising tax rates, widening 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.

The tax expenditures are not treated as expenditure but as non revenue. The constitution establishes that congress must be informed on the tax expenditures and this requirement has been complied with since 1988. A report which estimates the tax expenditures for the corresponding fiscal exercise is included with the draft budget law, detailing the fiscal benefits by sector, region, type of taxes and budget function.

Tax expenditures are not discussed as part of the budget process. They are all based on laws such that, each year, when the budget revenues are estimated the existing legislation on this matter is taken into account to estimate the tax expenditure to be taken off the revenues.

There are no periodic or systematic assessments of tax expenditures. Any assessment done of a fiscal benefit in a given sector is made when there are changes in the legislation that established the benefit.

Tax expenditures represented the equivalent of 1.7 percent of GDP in 2005 and are projected to amount to 1.9 percent of GDP in 2006. With respect to tax revenues, tax

expenditures amounted to a 9.9 percent in 2005 and are projected at 13.5 percent in 2006. The largest fiscal benefits are given in regards the income tax, with these benefits representing almost 0.8 percent of GDP and more than 5 percent of the revenue collected, with corporations receiving 3.5 percent of the revenues collected as fiscal benefits. The fiscal benefits granted on the financing of the social security system are second in importance, and are the ones that explain the increase projected for 2006. These benefits increase from 1.7 percent of the revenues collected in 2005 to 3.4 percent in 2006.

7.3. Fiscal revenues from transfers by the public enterprises

Nonfinancial public enterprises and mixed public/private enterprises may not be granted fiscal privileges which are not extended to the private sector. In turn, the public financial enterprises may not receive fiscal privileges which are not extended to the private banks.

8. Diagnosis

Brazil has achieved significant progress in the management of the public finances over the past few years. The cornerstone of this effort was the approval of the FRL in May 2000. The reforms have improved the realism of the federal budget and its consistency with the macroeconomic constraints as well as its effectiveness for resource allocation. The budget is characterized by a wide coverage and by being backed by medium-term targets. There are no extrabudgetary funds and although several budget funds exist, they are an integral part of the federal budget and must comply with all the procedures of the preparation and execution of the budget. The budget documentation establishes fiscal targets for the federal government and nonfinancial public enterprises for the current fiscal year and for the following three years. It also provides information on budget execution for the preceding two fiscal years and on contingent liabilities and tax expenditures.

An excessive earmarking of revenues persists nevertheless, which together with the expenditure requirements leaves little space for discretionary spending. This constitutes a problem because the budget is exposed to shocks, both external and internal, which may force to under-execute the budget.

In turn, the budgetary norms are characterized for allowing too much flexibility to congress in the estimation of revenues and total expenditure, in the execution of the discretionary spending and that associated with earmarked revenue, for the handling of undisbursed commitments, for the use of supplementary appropriations, and in regards to the deadline for the approval of the budget by congress, all of which contribute to diminish budgetary discipline and to increase budget rigidities. A kind of vicious circle develops regarding the government's capability to implement the budget approved by congress, which weakens the allocation and administrative functions of the budget.

In view of the lack of definition regarding the deadline for approval of the budget by congress, the 2006 budget had not been approved by mid-March. The congress, as it does every year, increased the revenue estimates to accommodate larger expenditures. Half the difference between the estimates by congress and those of the government corresponds to expenditures or lower revenues due to tax expenditures approved by the federal government after it had submitted the draft budget law to congress. As a result, the government will have to block some expenditure in the implementation of the budget, a mechanism which is known as “contingenciamiento” which apparently is used every year.

Another area which may cause problems is the excessive “armoring” of the budget as a way of maintaining fiscal discipline through legal rules. For example, in addition to the primary surplus targets it is required that to increase permanent expenditures other permanent expenditures must be cut or permanent revenues increased; that the primary expenditure does not exceed 17 percent of GDP; and that the wage bill does not exceed 50 percent of the federal government net revenues; while requiring also that tax revenues not exceed 16 percent of GDP. The same kind of philosophy is present in regards the PPP contracts, which eventually could make it difficult to implement projects through this venue. Furthermore, the government has tried to achieve through legislation certain objectives 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 the public resources while trying to attain these objectives.

Brazil has sought to implement a framework for PPPs which prevents that these contracts are used to circumvent the budget. The philosophy behind the PPPs seeks to have the fiscal responsibility rules respected in their execution, to obtain transparency in the procedures and decisions, and to achieve an objective assignment of risks between the parties which ensures the financial sustainability and the exploitation of the socioeconomic advantages of the projects. Concessions in which more than 70 percent of the remuneration of the private investor is paid by the public entity have to be approved by congress.

Brazil has achieved significant progress in relation to quasifiscal activities and guarantees. The quasifiscal operations have been reduced significantly and the budget includes transfers to cover the ones that remain. In this respect, Brazil constitutes an exception to the use of the public nonfinancial enterprises as a venue to conduct quasifiscal operations through administered prices or by appropriating the enterprises’ surpluses. Public enterprises may not receive fiscal privileges which are not extended also to the private sector. However, the complexity of the credit programs implemented through the 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 revenues for the central bank which is not included in the budget. Strict rules apply to the granting of guarantees by the federal government and although there are no rules for the granting of guarantees to the private sector, these are not provided.

Regarding tax expenditures, the information presented in the LDO annex is very detailed, providing information by type of tax, regions, kind of benefit, and by budget function. The LDO does not include, however, a description of the methodology used to estimate the fiscal benefits nor does it explain their behavior year on year. Tax expenditures are not compared with regular expenditures, are not allocated by ministries and there are no sub-limits to its use, but the granting of new fiscal benefits is subject to specific rules and the estimation of the tax expenditures is done by the MoF. The fiscal benefits are not discussed in the budget process and there are no periodic assessments of their impact. In the past there have been some evaluations done seeking to assess the achievements of some regional programs. However, although the FRL defines strict requirements for the granting of fiscal benefits (tax expenditures), it appears that in practice it is possible to circumvent these restrictions.

9. Recommendations

9.1. Budget management

It is necessary to increase the flexibility in the execution of the budget. To achieve more flexibility it is recommended to:

- Gradually reduce the earmarking of revenues and the expenditure minimum requirements.
- Modify the budget norms that allow that expenditure appropriations of one fiscal exercise be executed in subsequent fiscal periods.
- Restrict the congress power to increase the revenue estimates.
- Rule that excess revenues must be used first to offset obligatory expenditures which exceed budget appropriations, with the remaining revenue be used to improve the fiscal result.
- Approve prior to the budget discussion both the minimum wage that will apply to the fiscal year as well as wage increases or social security benefits that 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 emergency expenditure which exceeds the appropriation for the contingency reserve.
- Provision for the guarantees expected to be triggered during the budget year and include in the fiscal projections estimates of the expected triggering of guarantees

as well as the contingent liabilities that are expected to materialize, so as to anticipate the needs for fiscal adjustment that will be required to achieve the fiscal targets.

- Review the fiscal rules with a view to simplify them so as to avoid the over determination of the system while maximizing their effectiveness to achieve the fiscal policy targets.

9.2. PPP projects

Review the budget rules that apply to these projects, focusing on one direct limit such as the 1 percent of net revenues and on an intertemporal budget restriction in relation to total public investment. To impose the condition that to implement these projects other permanent expenditures must be cut at the same time, results in a compartmentalization of expenditures that does not lead to an efficient allocation and use of resources.

9.3. Public enterprises

It is recommended to :

- Conduct an assessment of the credit requirements and equalization of interest rates and prices, as well as of the constitutional funds and other programs, with a view of simplifying them in a first instance and consolidating and reducing them in a second instance.
- Quantify to the extent possible the impact of these programs on the public institutions that conduct them so as to compensate them adequately through budget transfers.
- Limit the programs to an equalization of rates, eliminating the credit requirements.
- Remunerate at market rates the minimum reserve requirements, with the cost for the BCB to be covered with budget transfers.

9.4. Tax expenditures

It is recommended to:

- Assess the fiscal benefits to determine if they constitute in each case the best instrument to achieve the objectives being sought. This assessment is particularly important at a regional level because the different regions are very dissimilar.

- Include in the LDO an analysis of this instrument, giving it more relevance in the budget discussion.
- Frame the concession of these benefits in a general model instead of assessing the initiatives in this area on a case by case basis.
- Enforce the FRL rules regarding the granting of new fiscal benefits.

CHILE²²

1. Legal framework

The legal institutional framework of the budget is composed basically of the constitution and by the Law on Financial Administration of the State (LAFE). Law 19.896 from 2003 transferred to permanent legislation a set of norms which had been incorporated annually in the budgets.²³

The LAFE regulates the budgetary process, accounting, management of funds, financial control, and public credit. It establishes the principle of unified budgeting, and requires all revenues to be included in institutions' budgets on a gross basis. Expenditure financed by grants or external loans is subject to the same rules as other outlays and is fully recorded in the budget.

2. Budget coverage

The budget documents provide comprehensive coverage of the central government, with the exception of universities and research institutions,²⁴ military expenditures financed under the Reserved Copper Law (RCL), and the quasifiscal transactions of BancoEstado.

The budgetary central government is made up of centralized institutions (such as ministries), constitutional state bodies (congress, the judiciary, the comptroller general, and the electoral tribunal), and decentralized agencies (e.g., the national tourism service). Municipalities, public enterprises, the central bank and BancoEstado comprise the rest of the public sector.

²² Based on "Chile: Report on Observance of Standards and Codes—Fiscal Transparency", IMF Country Report No. 03/237, August 2003, and "Chile: Report on Observance of Standards and Codes—Fiscal Transparency Module—Update", IMF Country Report No. 05/262, July 2005; on information and documents provided by the authorities in the meetings that took place in Santiago on January 12-13, 2006; and on Jul (2005).

²³ These norms include global limits on the execution of public expenditure, regulations regarding the execution of public investment, rules on expenditures for publicity purposes and on the transparency and control of incompatibilities in contractual hiring.

²⁴ Universities and research institutes are part of the central government but have their own budgets.

3. Contingency reserve

The contingency reserve which is included in the annual budget law includes funds to cover expenditures stemming from draft bills which although have not been approved have a high probability of being approved, and for which it is possible to estimate the amount of expenses that they entail. For example, congress approves salary increases for public employees at the end December every year. Up until 1996, the MoF could decide on the use of all resources appropriated by the contingency reserve. Starting that year, the resources that could be freely used was limited, dividing the contingency reserve into two components. One part was tied to the financing of the draft bills for which there exists a high probability that they will be approved after the budget discussions have concluded, and a second component of free use which maintained its objective of financing contingencies which go beyond what can be foreseen at the time of the approval of the budget.

The size of the contingency reserve has decreased from the equivalent of 10.1 percent of total expenditures in 1991 to 2.2 percent in 2003. The part that may be used freely decreased from 4.4 percent of total expenditures in 1996 to 1.2 percent in 2003. The actual use of the contingency reserve is shown in the budget execution reports prepared by the Budget Office (DIPRES).

4. Role of Congress

Congress enjoys limited powers in the budget process. The Congress cannot amend the economic 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, for example, by mandating that a certain part of the total appropriation be spent on a specified activity. If Congress does not approve a budget by November 30, the original government proposal becomes law.

The Comptroller General of the Republic (CGR) is not an office of the legislature but is rather considered a co-equal branch of government. It acts not only as an audit office but also pre-approves all expenditures and personnel actions to ensure their legality.

5. Fiscal indicators

The overall balance of the central government is used as the indicator of the fiscal position together with the current account balance.

6. Fiscal rule

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 the tax collections with respect to GDP, and an adjustment of the revenues generated by the Copper Corporation (CODELCO) for the central government through taxes and transfer 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.

The fact that the fiscal target is defined in terms of the structural balance—instead of the actual balance—provides an important cyclical component to the fiscal policy, allowing for the automatic stabilizers of the budget to operate fully. It guarantees also continuity in the financing of key reforms which have a multi-year budgetary impact, and gives stability to the financing of priority social programs.

The rule of the structural balance is not based on legislation, but it is a policy commitment of the administration to which a high profile has been given.

6.1. Draft Fiscal Responsibility Law

Congress is discussing a draft bill on fiscal responsibility. The bill incorporates the annual calculation of the structural balance into the financial budgetary program but does not set a numerical rule; establishes the obligation to provide information on guarantees and authorizes the MoF to implement mechanisms to cover the costs associated with these guarantees; establishes a pension reserve fund²⁵ and an unemployment contingency fund;²⁶ requires payments from the entities using public assets for the use of those assets; and widens the requirements of information in regards to the operations under the RCL.

7. Off-budget operations

7.1. Off-budget expenditures

The off-budget operations are constituted by the revenues and expenditures associated with the RCL,²⁷ the interest obligations accrued on bonds issued on account of pension

²⁵ The Pension Reserve Fund would supplement the financing of the fiscal obligations stemming from the commitments with the pension system. The source of funds for it would be a 50 percent of the difference between the actual fiscal surplus and the deposits into the Copper Compensation Fund (FCC), supplemented by budget transfers if necessary to achieve a predetermined minimum established in the law. The law seeks to save all the actual surplus that exceeds the structural surplus in the FCC and in the Pension Reserve Fund.

²⁶ The Unemployment Contingency Program would be financed through budgetary reallocations and through excess expenditures limited to ½ percent of total expenditures.

²⁷ The RCL is off-budget because the law determines that it should be in this manner, and a legal authorization would be required to integrate it in the budget.

obligations, and the revenues and expenditures of the Petroleum Prices Stabilization Fund (FEPP).

The off-budget accounts are not part of the budget but are integrated in the budget documentation and incorporated in the fiscal policy analysis. The fiscal projections presented in the Public Finances Report (IFP) as well as the public finances statistics include the off-budget expenditures with the central government budget aggregates to obtain the operational statements of the consolidated central government.

7.1.1. Reserved Copper Law (RCL)

Starting in October 2003 information on CODELCO's transfers to the armed forces has been included in the fiscal accounts as off-budget operations. The official data shows the amounts transferred and their use for purchases of goods and services, interest and amortization payments, and increases in cash balances. However, information on the stock of debt associated with the RCL is still not available.

The use of the resources stemming from the RCL is in line with the fiscal policy and the existing legal obligations. This means that the annual expenses under the RCL in excess of the floor set by the law have been adjusted to a limit which is consistent with the long-term price of copper. The excess over that limit will be used to prepay debt associated with the RCL or will be saved to supplement resources when the actual price of copper falls below its long-term level. Methodologies to evaluate purchases and to record these operations have been developed also. The adjustments will be made for the estimation of the structural balance. This means incorporating CODELCO's transfers to the armed forces as part of the revenues that must be adjusted for the difference between the short-term and the long-term price of copper.

7.1.2. Bonds issued on account of pension obligations

The interest payments accrued on these bonds are the main reason why the balance of the off-budget operations is negative all along the 1997-2004 period notwithstanding the surplus shown by the RCL in this period.

7.1.3. Petroleum Prices Stabilization Fund (FEPP)

The FEPP, which had been reduced to a small operation since 2000, became operative again in 2005. The interest revenue from the larger resources deposited into the FCC in 2005 were deposited in the FEPP. Up to March 2006, the resources in the FEPP had doubled relative to the initial transfer as instead of providing subsidies a tax had been charged. The IFP provides information on the flows and stocks of the FEPP.

7.1.4. Off-budget funds

The IFP provides information also on the balance sheets of the other two funds which belong to the government which are the Copper Compensation Fund (FCC) and the Infrastructure Fund (FI).

7.1.4.1. Copper Compensation Fund (FCC)

The FCC is recorded in the budget as financing operations; it was off-budget up until the adoption of the GFSM 2001.

The FCC accumulates resources when the actual price of copper is above the reference price per unit of production. Its resources supplement the budget when the price of copper is below the reference price and are used also to prepay debt. For the latter, the MoF has the authority and flexibility to decide because it is financial management.

7.1.4.2. Infrastructure Fund (FI)

The FI was created in 1998 to deposit the payments (goods and rights) that were generated by the concession of the more profitable segments of route 5, while at the same time subsidies were granted to the less profitable segments that were to be paid with these revenues. The objective was that the subsidies were more or less equal to the revenues, leaving a margin for the government. The FI was to be used in such a way as to prevent that the revenues were spent instead of being used to pay the obligations that were contracted and that were to be paid in the future. Today it is a virtual fund, not regulated by law, managed by the MoF.

7.1.5. Direct loans

In contrast with the Public Sector Borrowing Requirements (PSBR) concept, the operational result excludes the net lending operations, because they correspond to financial operations that do not affect the net worth as they only change the composition of assets and liabilities. Net lending operations are now classified as financing operations while before they were classified as revenues and expenditures above the line as they originated in policy decisions, a distinction which is not present in the new methodology.

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), where the risk is assumed by the private banks. CORFO lends funds via auctions to the financial system, sharing the government's lower cost of borrowing with the private banks, which in turn lend to small enterprises. It is a revolving fund which requires authorizations for all its loans, as it is not budgeted in net terms, i.e., the revenues as well as the loans to be made with the payments is budgeted. The interest rates are not market rates, with an implicit subsidy stemming more from the risk of the loans than from the interest rate charged.

The other line of credit are loans to the small agriculture, there have been changes there also, as the government also operates as a second tier agency, operating directly only for the short-term loans, 1 to 2 years. The short-term loans are a quasifiscal operation because of non repayment; this activity has been retained by the government because the banking system has not generated financial instruments for this segment of the market, with lower recovery rates than the ones for private bank loans. The volume of these operations is relatively small. The amount of loans has been decreasing and they expect to be able to eliminate them eventually.

The second tier loans for the agricultural sector are conducted through the Agricultural Development Institute (INDAP) which subsidizes the administrative costs. It would be interesting to determine the cost of managing the loans for INDAP compared with those of the banks which are now administering the loans to the agricultural sector. It is a revolving fund and new loans are made depending on the amounts recovered.

The 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.

7.1.6. Guarantees

There are three types of guarantees provided to the private sector, minimum pensions, PPP contracts, and 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. The triggering of guarantees to the PPPs is easy to predict. They are triggered when the traffic flows are less than projected, and this can be anticipated with no problems, particularly because they are paid in the year following the year in which the guarantee was triggered. The minimum pension guarantees are somewhat more uncertain because they depend on the number of affiliates that retire. But projections can be made and they include them in the IFP, in the budget and in the financial projections.

The draft bill on fiscal responsibility includes rules on guarantees, authorizing the MoF that when guarantees are granted it may decide to make provisions for those guarantees and that it may charge for the provision of guarantees, as they charge the public enterprises and the PPPs for guarantees. In this way they would have a common umbrella.

The system of credit guarantees for loans for higher education envisages the auction of guarantees, with the annual budget law defining a limit for these guarantees. The guarantee is provided by the government and the corresponding university, and the loans are given by the banks. A portfolio of students is auctioned selected on the basis of their academic proficiency, and socioeconomic condition, from down up.

7.1.6.1. Unemployment Contingency Mechanism

Since 2001 the budget has contained an unemployment contingency item, which seeks to guarantee the government's capacity to respond to the cyclical changes in the rate of unemployment, through resources obtained in part via reallocations of expenditures. It is another mechanism to achieve the cyclical adjustment of the public finances. This budgetary item would be replaced by the Unemployment Contingency Fund discussed above.

7.1.6.2. Public enterprises

If a public enterprise borrows with an explicit guarantee from the government, it must sign an agreement with the Public Enterprises Secretariat (SEP) which establishes financial and physical targets. The SEP assesses the compliance with the targets and reports to the MoF twice a year, with the annual report submitted to the President and congress. The SEP may also sign agreements and monitor compliance with the targets of public enterprises which have not borrowed with explicit guarantee from the government. In those cases, the SEP assessments are submitted only to the MoF.

7.1.6.3. Information on guarantees

The information on contingent liabilities reported in the IFP includes a projection of the expenditures expected from the triggering of the government guarantee for minimum pensions for 2006-2020, including a description of the methodology used for the projection. It also presents projections for the contingent liabilities associated with concessions at present value from 2005 onwards, including the maximum as well as the expected values, and the methodology used for the calculations. It includes also information on the guarantees provided to the public enterprises and others, classified on the basis of the laws which authorized the guarantees and the respective limits and present situation.

7.1.7. Public-Private Partnerships (PPPs)

The Concessions Law of 1991 is the legal framework for PPP projects. The law defines the nature of the concession contracts, creates a competitive bidding system based on flexible arrangements to franchise projects, establishes the rights and obligations of the public and private entities, and defines mechanisms to resolve disputes.

The management of the PPP program is centralized in the Concessions Coordinating Unit (UCC), which is part of the Ministry of Public Works (MOP). The UCC has its own budget and the financial impact of the projects is reflected in this budget, which in turn is part of the MOP's budget.

The UCC evaluates the PPP projects in consultation with the Ministry of Planning (Mideplan), the MoF, and the corresponding line ministry. Congress is not involved in the identification or in the approval of the projects that are implemented as PPPs.

The MoF participates all along the process, starting from the evaluation of the project, having to approve the terms of the prequalification of bidders and of the auction, changes which are made to these, must ratify the contracts, the additions to the contracts, and the suspension and early termination of the contracts. The MoF is in charge of the assessment of the projects from a macroeconomic and fiscal point of view, including the contingent liabilities associated with the guarantees provided, of the valuation of the guarantees provided and to be provided, and prepares the information on the concessions program which is included in the budget documentation since 2004.

The private partner recovers its investment mainly through the revenues generated by the payment of tolls. However, for some concessions these payments are not enough to cover the investment that is required and are supplemented with direct subsidies from the government. In other cases, the tolls are more than enough to finance the project and the private investor pays the government.

The private investor pays for the right of way but the government assumes the expropriation risks, but does not assume the construction or the operation risks.

Insurance policies are required for liabilities to third parties and for force majeure. In some projects the government assumes the force majeure risks over a certain threshold. The demand risk is shared between the government and the concession firm through guarantees or subsidies. The exchange rate risks are shared through the provision of guarantees. Other financial risks are assumed by the concessionaire.

The government guarantees under the PPP contracts are centered in protecting the concession firms from the demand and exchange rate risks. The schemes that have been used include the Guaranteed Minimum Revenues (IMG), the Revenue Distribution Mechanism (MDI) and the Least Present Value of Revenues (LPVR). The demand guarantees are optional, and initially were provided in exchange for a co-participation of revenues (MCI) but at no explicit and direct cost for the concessionaire, and cannot be renounced. Starting in 2002, the demand guarantees are provided at a cost. The exchange rate cover (MCC) is optional, is provided at a cost and may be renounced.

The IMG is the pillar of the guarantees offered to cover demand risk. The government views this guarantee as key to obtain financing for the projects on terms that make them viable. The government compensates the concessionaire if the revenues from the tolls are less than a given minimum defined for the year. In exchange for the guarantee, the concessionaire shares 50 percent of the revenues that exceed the projected revenues by the same amount that was used to set the level of revenues to be guaranteed, being a symmetric guarantee. Starting in 2003, a premium is charged for the provision of the guarantee. The guarantees which are triggered are paid in the budget year following that in which they were triggered. The deferred payment together with only a partial

compensation of the difference with respect to the total projected revenues is one way of creating an incentive to reduce the moral hazard of the guarantee.

In 1998, due to the impact that the Asian crisis was having on the availability of financing for infrastructure projects and the lack of exchange rate cover mechanisms, the government offered an exchange rate guarantee for these projects. It is a symmetrical guarantee and the payments under the guarantee depend on the impact of the exchange rate on the debt service. Four projects have had exchange rate guarantee, with one of them having renounced the guarantee.

The Asian and Brazilian crises lowered demand at the end of the 90s. Traffic did not grow because GDP expanded at low rates creating a default risk. In 2002, the government introduced the MDI which sought to mitigate the effects of a possible decline in the revenues of the roads and airports that were being operated under a concession contract. The MDI transforms the fixed term contracts into variable ones, in which the term of the concession depends on the future demand levels.

The mechanism of variable term concessions has been used also under which the least present value of revenues constitutes the variable that is auctioned. Under this scheme, the concession ends when the concessionaire obtains the present value of revenues that was contracted.

In 2003 the government commissioned a World Bank study to analyze the risk exposure under the concessions program, value some of the main sources of risk and propose options to manage risks. The study focused on the IMG, MCI and MCC mechanisms. The estimates show that the NPV of the IMG and MCI for 2006-2030 is of the order of 0.15 percent of GDP and that the maximum value is 5 percent of the 2005 GDP. The MCC is a source of revenue for the government because the guarantee was offered at a time when the peso was undervalued.

There is no legal limit on the resources (be it as a percentage of GDP or of the revenues of the contracting entity) that may be committed in subsidies and guarantees for concessions. What is being used is an Intertemporal Budget Restriction (RPI) in regards to the resources that may be used for subsidies and guarantees granted to these projects on the basis of the budget projections for the investment to be effected by the MOP. The RPI is not established in a law, which is also the case of the structural balance rule that is being implemented since 2000, but was part of the budgetary practices put in place by the previous administration.

The MOP commitments (subsidies and payments in the supplementary contracts) measured as a percentage of its investment in the period 2006-2030 reach their highest level in 2006 and 2007 (around 28 percent) to fall afterwards to levels which are less than 10 percent starting in 2015 and practically disappear in 2023. This pattern reflects the fact that the commitments, particularly those from the supplementary contracts stemming from a renegotiation of the contracts, have been phased over shorter periods than those of

the concessions to reduce the financial costs of longer periods and to avoid generating significant liabilities to future administrations.

The present value of the total payments and contingent commitments of the system of concessions as of September 2005, including projects which are being auctioned, represent a 2.8 percent of the 2005 GDP, and a 17 percent of the net tax revenues of the central government for 2005.

The PPP contracts specify a minimum risk capital requirement, generally a 20 percent of the value of the project. In practice, the amount of risk capital depends on the availability of financing from other sources, which in turn have depended on the guarantees provided by the government (especially of the IMGs). Given that the IMGs have been on average a 70 percent of the projected revenues, the private sector has contributed with about a 30 percent of the value of the project as risk capital, which has been obtained mainly from the international firms that participate in the projects. Locally, risk capital has been obtained from investment funds.

The budget and fiscal accounting rules do not require that the present value of the payment commitments or of the contingent liabilities stemming from the concessions program be recorded, that budget appropriations be made for the contingent liabilities, or that budgetary appropriations are made for future payment commitments. The FI is integrated with the budget.

The expenditures are recorded in the budget of the public entity which has commissioned the concession. The subsidies are recorded as capital expenditure in the year that they occur. If a guarantee is triggered, the expense is recorded as a capital expense in the year in which it is paid.

7.1.6. Quasifiscal activities

7.1.6.1. Nonfinancial public enterprises

The MoF approves via a decree the annual budgets of the public enterprises and regularly informs congress of their financial results. The public enterprises require authorization from the MoF to borrow; if they require a guarantee from the central government, the loan must be approved by law. There is a limit on the value of the guarantees which the central government may provide to the public enterprises.

The government appropriates the profits of the public enterprises through taxes and dividends and compensates for quasifiscal activities through budget transfers. In this manner it integrates in the government accounts the net financial effects of most of the activities of the public enterprises.

Some enterprises conduct activities with social content and do not cover their operational 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 their loans. The policy is to reflect all the quasifiscal activities of the public enterprises in the budget so that it covers all fiscal activities.

Some quasifiscal activities persist in ENAMI, an enterprise which sells processing services to small and medium mining firms, and in Correos, where the universal postal service is cross-subsidized. The cost of universal access is not explicitly evaluated in the budget documents. Correos' services (but not those of its competitors) are exempted from the VAT as a compensation for the provision of universal postal services.

Faced with a large jump in the international prices of oil in 2005, the government introduced certain mechanisms to contain fluctuations in the domestic fuel prices. In May it introduced a band for the price of diesel, and then increased the margins for the operation of the FEPP—both being temporary measures, but which have an adverse impact on ENAP finances. The government will compensate ENAP by requiring a lower transfer of dividends rather than through a direct transfer.

In addition, ENAP has been asked to take the lead in responding to the energy crisis created by the reduction in Argentina's gas exports to Chile, including through the construction of a terminal to import liquefied gas. It is not clear at this point what will be the impact of this on ENAP's finances.

7.1.6.2. Financial public enterprises

7.1.6.2.1. Central Bank (BCCH)

The only quasifiscal activity of the BCCH dates from the rescue operation of the commercial banks in the early 80s, which resulted in a deficit that persists until now.

7.1.6.2.2. Development banks

The participation of the government in commercial banking activities is limited to the BancoEstado, that has a market participation of 12 percent, and which conducts quasifiscal activities that are not quantified. The BancoEstado is not covered by LAFE, or included in the budget. It may not lend to the government or to the public enterprises, although it may participate in leasing operations of the government.

The BancoEstado administers the Unified Fiscal Account (CUF) and seeks some social objectives with its profits—although these activities do not appear to be a mandate from the government. The social role that the BancoEstado can play is limited by the need to comply with the same prudential requirements as the rest of the banking system. The government has discontinued the practice of keeping idle balances in the CUF. Now the cash balances are applied in liquid instruments which are traded in the secondary market.

7.1.7. Budgetary norms and practices

The budget rules establish that actual expenditures may not exceed the totals appropriated in the budget for current and capital expenditures other than expenses which the LAFE defines as “*excedibles*”; which are financed with cash balances existing at the beginning of the fiscal year, and with grants or own revenues of the public services; are capital expenses up to a 10 percent in excess of the amounts approved in the budget; and when they are authorized by a specific law.

The LAFE allows certain expenses to exceed the budget appropriations, with the excess being financed with resource reallocations or excess revenues. These expenditures correspond to obligations stemming from judicial rulings, tax returns or other government returns, and the pension payments established by law. These excess expenses generally have not resulted in the total expenditures exceeding the expenditures appropriated in the budget, because in practice they are offset with the under-execution of other expenses. However, in 2005 actual expenditure exceeded the budget appropriation by close to 2 ½ percent, and was financed through an excess of structural revenues.²⁸ Supplementary budgets have not been used in Chile since the enactment of LAFE in 1975.

Line ministries do not play a proactive role in the preparation of the budget. The internal reallocations among different agencies of the ministries are extremely rare. This is the legacy of a very centralized budget system which is being modified, with the Budget Office centering its discussions with the ministries instead of talking directly with the agencies.

To increase the flexibility of the budget, the government has implemented some permanent mechanisms such as the Bidding Funds²⁹ and temporary ones such as the Provision for Supplementary Distribution included in the 2006 budget.³⁰

7.2. Back-door expenditures

7.2.1. Earmarking of revenue

The 1980 constitution prohibits the earmarking of revenues. One exception is the RCL discussed above. Another exception to this prohibition is the rules of the FCC.

²⁸ Structural revenues are those which do not depend on the price of copper or the rate of growth of real GDP.

²⁹ Biddable funds seek to reduce the inertial component of the expenditures so as to improve the allocation and use of the public resources.

³⁰ The 2006 budget was the last one prepared by the outgoing administration and the first budget for the administration that took office in March 2006, for which the almost ten months of 2006 covered by this budget represent a fifth of its period in office. To allow some maneuvering space for the new administration, the budget includes a flexibility margin equivalent to about 0.9 percent of the total expenditure in the form of a supplementary appropriation and the authorization to reallocate resources of about 0.2 percent of the total expenditure. The new administration used part of the supplementary appropriation in the second week after taking office to finance an increase in the minimum pensions.

7.2.2. Expenditure rules

There are no expenditure requirements established in the constitution or in special laws.

7.2.3. Tax expenditures

The constitution requires that the budget law reports on the fiscal benefits which affect the government tax revenues.

The Internal Revenue Service (SII) estimated the tax expenditures for the first time in 2002 and has continued to do so since, including information and the methodology used in the IFP. The estimations are done separately for each item, i.e., assuming that the rest of the benefits are not changed. However, the totals, which are the ones presented in the IFP, include the joint effects or the effects of a simultaneous elimination of the benefits, which results in a total tax expenditure which is not equal to the sum of the individual tax benefits. Also, the calculations assume a behavioral change by the taxpayers, that of a constant total expenditure. According to this, the elimination of a benefit translates into a lower disposable income for the taxpayers and consequently in less consumption and VAT payments.

The IFP includes information on the tax expenditures for the corresponding fiscal year, including the methodology used. The tax expenditures represent about 3.6 percent of GDP and a 16 percent of the revenues in 2004-2006.

Tax expenditures are not discussed with the draft budget proposal. Also there have been no periodic or systematic assessments of the tax expenditures.

7.3. Fiscal revenues from transfers by the public enterprises

7.3.1. Tax and dividend regimes

Some public enterprises must pay a tax surcharge on their profits of 40 percent which does not apply to the private companies, and most public enterprises transfer to the government all or almost all of their net profits as dividends. Also, as it was discussed above, CODELCO transfers 10 percent of its sales revenue to the armed forces.

The leverage of some of the 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 (these mechanisms assure revenues to the government, and they also make it easier for it to control the investment of the public enterprises).

7.3.2. ENAP

ENAP is subject to all taxes and to the tax surcharge of 40 percent on its profits. Normally it does not receive subsidies or effects extraordinary transfers to the budget. The policy was that it would transfer to the government as dividends all of its net profits. However, starting in September 2005 a new policy was adopted that allows the company to retain part of its net profits if it exceeds a given efficiency standard measured by its profits before taxes.

7.3.3. CODELCO

There have been discussions on a capitalization plan for CODELCO that involves large investments which would be highly leveraged. There have been discussions about implementing a dividend policy for CODELCO along the lines of the one implemented for ENAP, but its situation is more complex because profits depend on the price of copper, so it is necessary to define a mechanism from the cost side to provide incentives to the enterprise to be efficient.

7.3.4. Draft bill on the Management of Public Enterprises

There is a draft bill in congress on the management of private and public enterprises based the same as the OECD guidelines in this area, on the principle of applying to the extent possible the same norms to the public enterprises as those which have been designed for the private enterprises.

The government's policy with respect to the public enterprises is to maximize their economic value. Over the past 5 years several adjustments to the institutional infrastructure have been implemented to support the attainment of this objective, including the creation of a council with the characteristics of a holding (SEP), some reforms related to the appointment and performance of directors, and the issuance of instructions and directives on management.

The reforms implemented regarding the management of the public enterprises have not been enough. Despite the creation of SEP and some other legal reforms, the public enterprises sector is still regulated by too many laws, with the specific norms of the laws which created each of the main public enterprises dominating those norms of a more general character. In contrast, the international standards and the experiences of the developed countries point to the need for the public enterprises to operate under a common institutional framework, geared to ensure their effectiveness and transparency.

In particular, the draft bill establishes that when the government mandates quasifiscal operations to a public enterprise it must cover the social benefit. Directors will not be responsible for the costs of the fiscal or quasifiscal operations executed by the enterprises when ordered by the government. These operations and the funds to be transferred must be determined previously through a decree issued by the MoF. The enterprises should

have the information required to identify the costs of these fiscal or quasifiscal operations to allow for periodic assessments.

8. Diagnosis

According to the OECD,³¹ Chile has an outstanding record of fiscal responsibility and a sophisticated budget formulation process.

Over the past few years Chile has introduced several reforms which integrated in the budget documentation and public finance statistics off-budget operations by the equivalent (in 2004) of almost 3 percent of the revenues and a 4.5 percent of the expenditure; incorporated the FCC operations in the budget as financing transactions; decreased the size of the contingency reserve from 3.1 percent of the expenditure in 2000 to about 2 percent in 2003; defined rules for the reserved expenses³² which for 2006 amounted to 0.02 percent of expenditure, less than a third of their size in 1999; 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 through the adoption of the GFSM 2001.

The use of the structural balance as the fiscal target has allowed to separate the cyclical component of the revenues, both from the copper operations as well as from taxes, while at the same time identifying the structural component of the excess revenues that are generated during the fiscal year. Only the latter may be used to finance additional expenses not appropriated in the budget. Given that the budget norms permit larger than budgeted amounts for certain expenditures without legislative approval, whether discretionary spending as for example investment outlays or obligatory ones from commitments established in contracts or laws, to restrict the use of excess revenue to that from structural revenues prevents the use of cyclical revenues to finance permanent expenditures. Also, having a panel of experts project each year the reference long-term price of copper and potential GDP prevents the use by the government of the price of copper as an instrument to appropriate CODELCO's revenues.

In turn, the operations under the RCL were not only integrated in the budget documentation but were incorporated in the analysis of fiscal policy.³³ Also, the expenditures under the RCL are managed in line with the principles of the structural balance rule and methodologies have been developed to assess the acquisition projects

³¹ See OECD, "Budgeting in Chile", May 2004.

³² Laws on the remunerations for high government officials and on a registry of recipients of public funds were approved in 2003. A central component of these reforms was the regulation of reserved expenses. A consistent and homogeneous regulatory framework was established for these expenses, defining their objective, the institutions which are eligible to administer them, and making them accountable to the CGR. The transparency of the reserved expenses of the defense institutions was also increased and the publication of the statistics on the RCL was authorized.

³³ Previously the expenditures in a given fiscal year under the RCL could be larger or smaller than the resources transferred in that exercise, and the government did not have that information included in the budget.

and for the accounting of these transactions. There is one point in this area, however, which needs to be resolved. The RCL establishes a floor to the volume of resources to be transferred annually by CODELCO. If the 10 percent of the copper sales is less than this floor, the government must cover the difference. Although this has not been necessary in the past few years, it has happened in the past and the risk that transfers will be required in the future is not small. Not only is the value of the floor adjusted every year by the United States Wholesale Price Index, but CODELCO's sales may fall because of a decline in prices, lower volume of production, as well as lower sales on account of an accumulation of inventories if CODELCO decides to withhold sales as part of its commercialization policy, as it occurred in 2002.

The government has also made more transparent other off-budget operations such as the guarantees and subsidies committed under the PPP contracts, the contingent liabilities associated with the guarantee for minimum pensions, the credit guarantees provided to the public enterprises and others, and the tax expenditures, through publication of information in the IFP, including the description of the methodologies used in the calculations.

The government has implemented also mechanisms to reduce the implicit subsidy on direct loans, with the government acting as a second tier institution through CORFO or INDAP and auctioning the resources to the private banks, which assume the loan risks; and granting guarantees, which are shared with the corresponding educational institution, on loans to finance higher education granted by the banks by auctioning loan packages constituted of students identified by their academic credentials and socioeconomic situation.

The government has sought also to implement permanent as well as temporary mechanisms to increase the fiscal space for discretionary spending such as the Bidding Funds and the Supplementary Distribution Provision in the 2006 budget.

In addition, the initiatives included in the draft fiscal responsibility bill seek to complement the anti-cyclical instruments through the creation of an unemployment contingency fund and the incorporation of the structural balance concept as part of the budget framework, without defining a numerical rule; to improve the information on guarantees and the provisioning of contingent liabilities stemming from guarantees in general, and in particular the provisioning of the contingent liabilities associated with the state guarantee on minimum pension payments; and increase the information on the operations effected under the RCL.

Regarding the public enterprises, the draft bill which seeks to improve the management regimes of the private and public enterprises introduces changes in the management system for the public enterprises, including rules on the composition and attributions of directors, absolves directors from the responsibility of losses caused by quasifiscal operations, and establishes the obligation of the government to compensate the public enterprises for the cost of these operations through an ex ante and transparent mechanism.

However, it does not contain provisions to align the tax system and the dividends policy for the public enterprises with those of the private enterprises.

The off-budget operations are effected mainly through the public enterprises. There are quasifiscal operations conducted by ENAP, ENAMI, the METRO, Public Railways (EFE) and Correos. ENAP's quasifiscal activities were compensated in 2005 through a reduction of the transfer of dividends to the government by the enterprise, while those of METRO and EFE are offset through government guarantees on their borrowing, and government direct repayment of their foreign loans. Correos is exempt from the payment of the VAT and grants cross-subsidies. Also, the tax regime of most of the major public enterprises applies a 40 percent tax surcharge on their profits, while at the same time the dividend regime (with the exception of ENAP since 2005) requires that the enterprises transfer all or almost all of their profits to the budget.

Direct loans constitute another form of off-budget operations. The implicit subsidy is not calculated nor recorded in the budget, which does not include the net lending operations because when recording transactions on an accrual basis and according to the GFSM 2001, these transactions are classified as financing items because they do not affect the government's net worth.

Tax expenditures constitute another potential venue to increase the off-budget operations. The IFP includes a description of the methodology used to estimate the tax expenditures and an estimate by taxes (VAT and income tax) and by sector and beneficiaries, as well as the most important lines of tax expenditures. However, it does not compare them to the regular expenditures, does not allocate them by ministries and there are no sub-limits or rules for their concession. The tax expenditures are not discussed in the course of the budget process and no periodic assessments are conducted on their impact.

9. Recommendations

9.1. Budget management

- Approve by congress prior to the budget discussion the wage increases for public employees so as to include this cost in the draft budget law, avoiding the need to include every year a contingency reserve for it.
- Assess the floor for CODELCO's transfers under the RCL to determine if it is necessary to reduce it, with the view of eliminating it in the future.

9.2. Public enterprises

Some points are noted in which it would be necessary to act to avoid using the public enterprises as instruments of fiscal policy. Some of these points are included in the draft bill being discussed by congress.

It is recommended to:

- Define a tax regime for the public enterprises in line with that applied to the private enterprises.
- Define in the annual budget law or in the organic budget law the financial relations between the central government and the public enterprises, establishing ex ante a dividend policy or predetermined rates of return on their assets.
- Assess periodically the quasifiscal operations to identify the costs for the enterprises and to establish proper compensation and/or to modify them.
- Compensate the public enterprises adequately for the quasifiscal operations that they execute. Use budget transfers to cover these operations and not the dividends policy as it was done for ENAP or tax exemptions as it is done for Correos.
- Identify cross subsidies treating the subsidies as expenditure and the implicit tax as revenue, and record this information as memorandum items.
- Explicit the government relations with BancoEstado in order to make them transparent.
- Record the repayment by the government of guaranteed loans of some public enterprises as transfers, classifying them as expenditure in the operational statement and not as amortization payments in the financing items.
- Estimate the implicit subsidy in the direct loans and in the loan guarantees granted to the private sector and the public enterprises.
- Include in the IFP an analysis of the public enterprises.

9.3. Public-private partnerships

It would be important to give a legal foundation to the Intertemporal Budget Restriction mechanism used by the DIPRES. Or introduce budget mechanisms to provision both the capital subsidies as well as the contingent liabilities associated with the PPPs.

9.4. Tax expenditures

It is recommended to:

- Assess tax expenditures to determine whether they constitute in each case the best instrument to attain the objectives being sought.

- Include in the IFP an analysis of this instrument, giving it more relevance in the budget discussion.
- Frame the concession of these benefits in a general model instead of assessing the proposals in this area on a case by case basis.
- Establish rules for the concession of new tax expenditures within the budget framework.

ECUADOR³⁴

1. Legal framework

The budget framework includes the constitution, the Organic Law for Financial Management and Control, the Public Sector Budget Law, and the Organic Law for Fiscal Responsibility and Transparency (FRL). These laws establish the principles of legality, universality, unity, prudence in the estimates of revenues and expenditures, and budget equilibrium, but do not regulate others such as budgeting in gross terms and not on net terms.

The legal and administrative framework for budget management is very fragmented, ambiguous and incomplete. Approval of successive rules has resulted in Ecuador going from having an exemplary Organic Law regulating all major aspects of government finance (budget, public borrowing, cash management, government accounting, audit and control) to a situation where a different set of rules governs each of these areas and may not have the appropriate rank in the legal hierarchy.

2. Budget coverage

The General Budget of the State (PGE) contains the budgets of the central government budget, of the noncommercial autonomous institutions (IANCs) and decentralized agencies (universities), and of the social security system.³⁵ The central government revenues and expenditures are presented in net terms, with a significant part of the budget revenues and the expenditures associated with them not included in the budget. Off-budget operations are also important, all of which results in a significant underestimation by the PGE of the size of the government operations. The PGE does not include projections although the FRL requires that investment expenditures are presented in a multi-year form.

³⁴ Based on information and documents provided in the meetings held in Quito on January 30-31 and February 1, 2006.

³⁵ The Armed Forces Social Security Institute (ISSFA) and the Police Social Security Institute (ISSPOL) were included only recently in the PGE.

3. Contingency reserve

The contingency reserve was eliminated because from a political point of view the budget proposal appeared too large because an estimate was included for contingencies. Congress would complain that there was no backing for that appropriation, that it was an appropriation which could be used for other type of expenditures.

A provision has been in the PGE for labor issues and it is put in year after year because as long as the judicial processes are going on a budgetary appropriation cannot be created. There are no provisions for contingent liabilities associated to guarantees that may be triggered; every institution must create a reserve.

4. Role of Congress

The legislative branch has the power to approve the PGE and oversee its execution. It cannot increase the budgeted amount of revenue and expenditure submitted in the draft budget, but may alter the composition of revenues and of the financing as well as of the expenditure and sets a limit on borrowing. Once the limit is reached, the government must freeze its expenditures or may request congress to increase the limit. Congress discusses and approves expenditures at a very aggregated level (by sectors and groups of expenditures).

The President may not veto the PGE approved by congress because it is not a law, it is approved by a resolution of congress. Congress must approve the budget by November 30; if it does not approve it the government's proposal prevails.

5. Fiscal indicators

There are no clear fiscal indicators such as for example the overall balance or the current account balance or the financing requirements to define the fiscal targets. It appears that the emphasis is placed on those indicators on which the FRL applies.

6. Fiscal rules

The FRL was approved in 2002 and modified in mid-2005. The reform included in the budget the revenues from the heavy crude oil by eliminating an off-budget fund (FEIREP) and creating a special account (CEREPS), and reallocated resources that previously were to be used to prepay debt to social expenditure and loans to reactivate the economy. It also excluded investment for the purpose of applying a ceiling to the rate of growth of primary expenditure. The fiscal rules are defined in terms of the budgets that are approved instead of on the outturns.

In its present version, the FRL applies the following rules: (i) the central government primary expenditure (excluding capital expenditure) may not grow by more than 3.5 percent a year in real terms; (ii) the non-oil deficit of the public sector must be reduced annually by 0.2 percent of GDP until it reaches zero; (iii) the current operational expenses of the public financial sector may not grow by more than 2.5 percent a year in real terms; and (iv) the public debt³⁶ must be reduced by 16 percentage points of GDP in the 4-year presidential period until it declines to 40 percent of GDP, which may not be exceeded once it has been reached. The FRL establishes also that debt operations may only take place to finance investment.

The modification of the FRL in 2005 created a special account (CEREPS) which is part of the PGE and is separate and independent of the CUF, to deposit the petroleum revenues from the heavy crude that belong to the government, and a 45 percent of the petroleum revenues not envisaged or larger than those envisaged in the approved budget.

The resources in the CEREPS must be distributed as follows:

- A 35 percent to (i) credit lines at preferential rates for the financing of projects in certain sectors through the National Financing Corporation (CFN) and the National Development Bank (BNF) which are two public financial institutions. These funds increase the capital of these institutions and the loan recoveries and returns on the loans will be used also for loans by the same institutions; (ii) the payment of the government's debt with the Ecuadorian Social Security Institute (IESS); (iii) the repayment of external and domestic public debt; and (iv) infrastructure projects for up to 10 percent of the total resources;
- A 30 percent for social investment projects, with half in the education sector and the other half in the health sector;
- A 15 percent, in equal shares, for scientific research, for the improvement and maintenance of the national road network, and for the environmental and social repairs of the effects caused by the government's petroleum activities; and
- A 20 percent to stabilize petroleum revenues up to a 2.5 percent of GDP, and for national emergencies. The Savings and Contingency Fund (FAC) was created to accumulate and administer these resources as a trust fund managed by the central bank (BCE). The stabilization resources can be used exclusively when the actual petroleum revenues are less than those envisaged in the PGE and the resources in the Petroleum Stabilization Fund (FEP) have been used fully. The use of FAC resources must be recorded in the budget as revenues. All the funds in the CEREPS which are not used by the end of the fiscal year are automatically transferred to the FAC.

³⁶ For this purpose it is understood that public debt stands for the external and domestic public debt which must include the government's debt to the IESE and all the obligations which entail debt assumed by the government according to the law, except for the liabilities of the Deposit Insurance Agency (AGD).

The FRL establishes also that the Ministry of Economy and Finance (MEF) must make a preliminary projection to serve as the basis for the distribution of the resources in the CEREPS to be included in the budget proposal of the following year, in line with the Development Plan (PDPS).³⁷ In this projection, the MEF will make explicit the distribution of resources among the preferential credit lines, the payment of debt to the IESS, the prepayment of public debt, and the implementation of infrastructure projects.

The FRL establishes certain conditions for the use of the CEREPS resources which include:

- Regarding the preferential credit lines, the maximum amount of financing for each project may not exceed 90 percent. The BNF and CFN will determine the minimum and maximum amounts of the loans, with the Economic Front being authorized to set maximum amounts for such operations. The CFN and the BFN must submit to the MEF a monthly report detailing these operations. If the information is not submitted or if the ratio of nonperforming loans provided with these funds exceeds 18 percent of the total, no more resources will be transferred.
- The investment projects must be submitted to the MEF before June 30 of the year prior to their execution of the projects so that those considered viable by the MEF can be included in the PGE.
- The health and education investment projects must follow the guidelines, parameters and criteria defined in the PDPS.
- The multi-year projects will be given priority in the PGE in the following years until they are completed, and will be financed with resources from the CEREPS.
- An executive decree is required to authorize the use of these resources, specifying the amount and use of the funds. These decrees are to be published with the exception of the ones which authorize the prepayment of public debt which will be published when the operations are concluded.
- The reprogramming of the use of the CEREPS resources during the execution of the budget must be authorized via an executive decree with a prior report from the MEF.
- The MEF must submit to the President and congress detailed information regarding the revenues and expenditures of the CEREPS every three months.

The FRL establishes that if in the first three quarters of the year petroleum revenues are lower than envisaged in the PGE for that period, the shortfalls may be offset using FEP resources in the first instance. However, if the non-petroleum current revenues are lower

³⁷ The Economic Front must prepare the PDPS before May 31 of the preceding year in which this plan will be implemented.

than envisaged in the budget, the MEF must reduce expenditures, including transfers and participations, by the same amount of the shortfall. These reductions do not apply to those expenditures established in the constitution.

7. Off-budget operations

The off-budget operations are large and there is not much information available on them. The central government budget proposal for 2006 includes annexes detailing the earmarking of revenues and an economic classification of the transfers, earmarking of revenues and subsidies for the 2003-2006 period. There is no information on guarantees or the contingent liabilities associated with the guarantees, on the quasifiscal activities of the public enterprises and on tax expenditures. Also, a significant percentage of the tax and petroleum revenues are not included in the PGE.

7.1. Off-budget expenditures

7.1.1. Off-budget funds

7.1.1.1. Petroleum Stabilization Fund (FEP)

The FEP is financed with the petroleum revenues that exceed the revenues envisaged in the budget. The FEP funds are used first to offset for lower petroleum revenues than budgeted. The remaining funds are distributed for the CEREPS (45 percent); the construction of the Amazon Highway (35 percent); a 10 percent for development projects in those provinces with international borders; and a 10 percent for the National Police during 5 years, of which half must be spent in the Amazon region. Over the past few years, the FEP resources have not been enough to compensate the budget for lower petroleum revenues caused by the increase in the subsidies to the domestic consumption of fuels.

7.1.1.2. FEIREP

The FEIREP was created by the FRL in June 2002 and abolished by the reform to the law in June 2005. It was replaced by a special account that is independent and autonomous from the CUF which is included in the PGE while the FEIREP was not. The transfers to the FEIREP were 14 percent of total transfers and subsidies in 2005, or about 1.8 percent of GDP.

7.1.1.3. FAC

All unused resources of the CEREPS are transferred automatically to the FAC at the end of the fiscal year.

7.1.2. Direct loans

There is no direct lending by the government because direct loans are prohibited. The IESS does provide direct loans.

7.1.3. Guarantees

The FRL establishes that the central government may not contract loans on behalf of entities and companies which are regulated under the private sector companies legal regime (which is the case for the electricity companies, which although are public companies they are regulated by the law on open companies), and it may not assume or guarantee the loans of these enterprises. However, it may provide guarantees to these enterprises if they are approved by a special law.

The FRL establishes that the annual budgets should include annexes with information on, among others, the contingent liabilities and fiscal risks which may affect the public resources. This requirement has not yet been complied with.

There are contingent liabilities associated with guarantees triggered in the past such as those of the AGD and National Airline Company. There are also debts that the government has assumed from sub-national governments and universities. There are CFN loans of about US\$400 million which were assumed by the government prior to the enactment of the FRL. The issue is no longer relevant because the FRL establishes that collaterals must be sought prior to providing a guarantee.

The government is authorized to provide guarantees to the Petroleum Company (PE), CFN, BNF, the Ecuadorian Housing Bank (BEV), and the port authorities. There are restrictions which apply to the provision of these guarantees, but the indicators are not defined in the FRL, they must be defined by the MEF, on a case by case basis, both for the nonfinancial public enterprises as well as for the financial public sector. The FRL establishes that the guarantees and the borrowing must be related to investment projects. The annual and 4-year plans for the public debt, both external as well as domestic, determine the amount of disbursements which may be authorized.

The judicial sentences constitute another source of contingent liabilities which may have a significant impact on the budget.

7.1.4. Public-Private Partnerships (PPPs)

PPPs are regulated by the Law on the Modernization of the State. The operation and maintenance of a wide range of infrastructure services may be conducted through concessions. All concession contracts must be subject to public bidding.

To date there is only one concession, Panavial, which covers about half of the Sierra Panamericana Highway. At the provincial level there are two roads under concession, one in the Guayas province, the other one in the Pichincha province.

The contract with Panavial was signed in 1996. It is based on a recovery of the investment through tolls and a reasonable rate of return as established by the law. The 1999-2000 crises and the dolarization of the economy had an adverse impact on the concession. Another important impact on the concession has been the setting of the tolls on the basis of achieving political objectives and not just technical ones, whereby the equilibrium tariff rate of the contract is affected by the so-called socially acceptable rate, impacting the economic-financial equilibrium of the contract. As a result, the toll for each 50 kms is US\$1 when it should be US\$1.6, with the difference being assumed by the MOP. The MOP has accumulated a debt of US\$35 million in four years. Also additional investments have been required which were not included in the contract and it has been necessary to adjust the design of the road because of new traffic. These have impacted the level of investment and the rate of return of the project.

The contract included clauses for force majeure and fortuitous risks, whereby damages are verified, assessed and the costs of repairs included in the additional investment which is required. Strikes, destruction of the roads, are some the causes of the damages, the repairs have been identified and are recorded in a separate account. There is no contingency fund for this concession.

One of the solutions which are being considered to cover the costs of the additional investments stemming from force majeure damages is to exempt the toll from the payment of the VAT (12 percent). The MOP has contacted the Internal Revenue Service (SRI) to obtain the exoneration. Another area that is being explored is that of road security. In the contract, the concessionaire is to pay for road security. The MOP is trying to reduce the concession costs by using the national police for this service.

There were no requirements for risk capital in the contract, only the private investor's commitment to seek financing, initially with an international financing entity but in the end from the domestic market. The contract does not include guarantees for financing risks.

Another concession was the Costa one which was not successful and is being liquidated. The Costa concession was also signed in 1996, at the same time as Panavial. Costa had problems and it was decided to accelerate the termination process by mutual agreement because while there is a concession contract in place, the MOP cannot intervene and the roads are deteriorating. They have reached agreement, but they need the support of the MEF to pay the concession. There was investment only, tolls were never charged. The Andean Development Corporation (CAF) and the International Finance Corporation (IFC) financed the project with loans of US\$12 million, and although there were step-in-rights they were not interested in taking over the project.

The provincial councils will auction Costa to obtain private investment. They are studying the scheme that will be used which must be approved by the MOP. It will be a toll road. They are seeking financing from the IDB, for this project as well as for Panavial where two lanes are not enough, and public support. Using the concession contract, the widening of the road to four lanes would be done by the concessionaire, who will also be in charge of the maintenance and operation of the road.

7.1.5. Quasifiscal activities

7.1.5.1. Nonfinancial public enterprises

The government's operations cannot be clearly distinguished from those of the rest of the nonfinancial public sector and quasifiscal activities are particularly important in the energy sector.

The budgets of the public enterprises, except those of the enterprises of the sub-national governments, are sent to the MEF for analysis and approval, prior to their submission to congress for information purposes only.

7.1.5.1.1. PetroEcuador (PE)

PE's quasifiscal operations are substantial because fuel prices have been frozen since 2003. This has resulted also in a fast increase in the consumption of fuels, partly because of smuggling to Peru and Colombia, which together with a refining capacity which has not increased, has forced PE to double its imports of fuel products in the last four years. It is estimated that the subsidies (calculated in relation to the import prices) granted through the administered prices of fuels reached the equivalent of close to 4 percent of GDP in 2005 compared with 1.8 percent of GDP in 2003.

7.1.5.1.2. Electricity sector companies

The government administers also the tariffs of the public enterprises in the electricity and telecommunications sectors. In the electricity sector for example, the average rate is less than the average cost once the technical losses and unpaid bills are taken into account. Also, a surcharge of 10 percent is paid by the commercial and industrial users to cover the costs of rural electrification. This has resulted in important losses for the electricity distribution companies, which have been unable to pay the generating companies. The contracts of the distribution companies with the generating companies carry a central government guarantee, and therefore the government has periodically assumed that debt or granted subsidies to the thermoelectric plants through PE.³⁸ The distribution companies' debt to the generating plants amounted to US\$ 1.25 billion at end 2005.

³⁸ Until September 2005 the electricity sector paid the international price for its fuel, while the rest of the companies paid a lower price set by the government. After that date, the price of fuel was unified at the subsidized level. Because PE is the only fuel importer it is the government that assumed the lower cost for the electricity companies through the petroleum revenues received from the domestic sales of fuel.

The 2005 and 2006 budgets have included appropriations for electricity subsidies of US\$80 million. However, the deficit stemming from the subsidized rates is estimated at US\$179 million for 2005 alone.

On account of the low electricity rates, the government owed the distribution companies, if congress approves the reform of the electricity sector, US\$875 million at end-2005. The difference between this debt and the amount owed by the distribution companies to the wholesale electricity market of US\$1.25 billion results from other factors such as the technical and black losses caused by theft of power above the 12 percent rate assumed in the setting of the electricity tariffs, as this may amount up to 40 percent for some companies.

The electricity generating companies have lost capital as a result of the debt owed to them by the distribution companies. There are three pending suits against the government from these companies. The generating plants, both public and private, also owe PE accumulating debts of more than US\$340 million since 2003.

The end result is that there has been little investment in electricity generation. There are only two projects being built, one which is expected to be completed by end 2006 and the other in 2008.

7.1.5.1.3. Solidarity Fund

The public enterprises of the Solidarity Fund also lack transparency. The Solidarity Fund which was created in 1995 is an agency under public law with its own legal personality, capital, and administrative system, reporting to the Office of the President. It was created to handle human development, primarily targeting the most depressed sectors in the country, through expenditure on education, health, and public services. It is the sole shareholder of five power generating plants, one electricity transmission company, 19 electricity distribution enterprises, and two telephone companies.

7.1.5.2. Public financial enterprises

The central bank approves the budgets of the financial institutions subject to the budget directives set by the MEF. The fiscal rule imposed on the growth of the operational expenses of the public financial entities seeks to reduce the wage pressures on these agencies which are not part of the PGE.

7.1.5.2.1. Central Bank (BCE)

The 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.

7.1.5.2.2. Development banks

The independence of the financial public enterprises is limited and they conduct fiscal activities for the government. The norms which regulate the government relations with these enterprises are not transparent. The assets of the financial public enterprises account for a 14 percent of the total assets of the financial system. The quasifiscal activities are conducted through subsidized loans and debt pardons, which have gradually eroded the capital of these institutions and have been covered by the government. In recent years, the government has recapitalized the public banks to the tune of US\$240 million. The BNF operates mainly in the rural areas and receives transfers from the treasury on a regular basis (US\$24 million in the 2006 budget), and the State Bank (BEDE) which channels financing for the local governments is financed with loans from multilateral organizations guaranteed by the government.

The FRL has identified quasifiscal operations to be conducted by the CFN and the BNF through credit lines at preferential interest rates, which will be financed with petroleum revenues deposited in the CEREPS. These credit lines will constitute revolving funds to provide loans. Consequently, the budget appropriation will be recorded when the credit lines for the CFN and the BNF are approved but actual loans nor the interest payments and repayments will not be recorded. The implicit subsidies as well as the costs stemming from these operations will not be quantified either. The FRL sets a non-repayment rate of 18 percent as the ceiling to stop these operations.

The main party in congress is sponsoring a bill which seeks to channel more loans to productive activities and to reduce the cost of financial intermediation. If approved, the banks will have to lend at least 75 percent of their deposits to productive sectors and deposit the rest at the BCE. The BCE would determine the allocation of the loans by sectors based on their participation in the generation of GDP according to the National Income Accounts. Stiff penalties would be imposed for noncompliance with these rules. The draft bill also defines limits on the intermediation margins of 300 basis points over the BCE reference rate—the three-month interest rate for the corporate sector—and a floor to the deposit rates equivalent to 70 percent of the reference rate. All levies and commissions on loans would be eliminated.

7.1.5.3. Private sector

One quasifiscal activity conducted through the private sector companies stems from the requirement that 15 percent of their profits must be paid to the workers.

7.1.6. Budgetary norms and practices

The government may increase or decrease expenditures up to a 5 percent of the budgetary appropriations approved by congress. Above this limit, the executive requires congress approval. It may also exceed the budget appropriations on account of emergency situations. The excess expenses may be on the wage bill, goods and services, and 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 the modification of the composition of expenditure. The MEF has the authority to correct changes to the budget introduced by congress which it considers to be illegal.³⁹

The initial budget is not a good indicator of the budget that is finally executed. Although the performance of revenue collection tends to be in line with the 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.

7.1.6.1. Gross versus net flows

A significant part of fiscal revenues does not transit through the budget. This occurs because part of the revenues are transferred directly to the user before they are recorded in the budget, while at the same time the subsidies or transfers financed with these revenues are not recorded either. These operations are conducted through the earmarking of revenues, subsidies to consumers via administered prices, and special funds.

For example, the 2003 budget did not record expenditures for the equivalent of 6 percent of GDP.⁴⁰ Of these, 2.4 percentage points of GDP were earmarked revenues required by special laws and not by the constitution; 1.5 percentage points represented subsidies on the domestic consumption of fuels, and 2 percentage points were funds deposited in the FEIREP. As a result, more than half of the subsidies and transfers, about a fifth of the tax revenues, and almost half of the petroleum revenues did not transit through the budget in 2003.

7.2. Back-door expenditures

7.2.1. Earmarking of revenues⁴¹

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.

³⁹ For example, in the 2006 PGE congress eliminated US\$400 million for debt service and the MEF had to reinstall the appropriation.

⁴⁰ This situation may have changed significantly. For example, subsidies on fuel consumption which do not transit through the budget are estimated at about 4 percent of GDP for 2005. Also, the changes to the FRL approved in 2005 have altered the figures related to the FEIREP, which was abolished and replaced by a special account which is included in the PGE.

⁴¹ This section and the next discuss information presented by Alier (2006).

The FRL establishes that the basis for defining the price of a barrel of oil to estimate the revenues for the budget proposal is the projected future price for the *West Texas Intermediate* (WTI) or the reference price for the Ecuadorian crude published by agencies or international organizations which specialize in these matters.

About 36 percent of the so-called traditional revenues and of 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.

The earmarked revenues are used partly for expenditures included in the PGE (for example, pension funds, health, education) and partly for transfers to sub-national institutions (local governments, regional development funds, universities). A substantial portion of petroleum revenues is earmarked for educational expenditures.

7.2.2. Expenditure rules

There are also extensive expenditure rules, including a rule that requires the government to dedicate to education and health at least 30 percent and 20 percent of its current revenues, 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.

Excessive budget rigidity combined with the financial difficulties of recent years has made difficult the handling of the budget. The extent of non-compliance with the legislation underpinning the budget rigidities is significant. Extensive rules governing transfers within the public sector have also led to a significant accumulation of funds for some agencies while others cannot comply with their obligations.

An important point is the availability of information and the scrutiny of spending associated to subsidies and transfers, including those that do not transit through the budget. Transfers and subsidies increased from the equivalent of almost 10 percent of GDP in 2003 to more than 13 percent in 2005. For 2006 they are projected to decline to 11.8 percent of GDP, a decline which is more than explained by the integration of the FEIREP to the budget through the CEREPS. The subsidies for fuel consumption increased from the equivalent of 1.8 percent of GDP in 2003 to 3.4 percent of GDP in 2005. The agencies receiving these funds can be classified in three categories:

- Agencies with expenditure included in the PGE, which received funds for the equivalent of 2.1 percent of GDP in 2005, are the ones subject to the most budgetary control.

- Agencies within the NFPS, but not covered by the PGE, which received transfers equivalent to 6.4 percent of GDP in 2005, for which there is incomplete information about their spending commitments.
- Consumers and agencies outside the NFPS which received 5 percent of GDP in 2005, for which information about expenditure is deficient, or subsidies are allocated mainly through non-market prices for public services (3.4 percent of GDP).

7.2.3. Tax expenditures

There are no up to date estimates of tax expenditures. Four years ago the USAID estimated that for 2001 tax expenditures amounted to about US\$1 billion.

A government-supported law granting generous tax incentives to foster investment in various sectors was approved by congress in 2005. The law would provide a 10-12 year tax holiday (on income taxes, custom duties, and municipal taxes) for new companies undertaking a minimum investment of US\$2-7 million in strategic sectors, including hydroelectricity generation, oil refining, and production of high technology instruments. The tax incentives provided by this law could increase tax expenditures by about ½ percent of GDP.

7.3. Fiscal revenue from transfers by the public enterprises

There is significant government state interference in the management of the largest state-owned enterprise, PetroEcuador. PE must transfer all its revenue to the PGE, after deducting costs. The determination of these costs, however, lacks transparency and is subject to negotiation. The government may also cut PE's investment budget in an arbitrary fashion. Also, the government uses the company as a vehicle for granting subsidies to the domestic consumption of fuels and part of the costs of production is used to finance excess staff at PE. After accounting for costs, subsidies through administered prices and earmarking, the remaining revenue is transferred to the PGE.

8. Diagnosis

Ecuador has made progress in certain areas of the handling of the budget through the implementation of a FRL and the provision of information. The integration in the budget of the petroleum revenues from the heavy crude oil as well as the identification of the use of these resources are important steps in this direction, unlike the increase in the earmarking in the use of these resources.

However, the budget framework has deteriorated over the past few years because of changes in the budget rules which have resulted in a fractioned legal framework; the

intensification of the earmarking of revenues and expenditure requirements; and an increase in the size of the off-budget operations (mainly through administered prices for fuels and electricity).

The budget framework in Ecuador requires substantial reforms. The starting point could be the approval of an organic budget law of the type the country had years ago before the enactment of different norms led to a situation in which there are different rules, without a clear hierarchy, for the different aspects of the financial management of the government.

The coverage of the budget is limited. The revenues and expenditures of the central government are recorded in net terms, with a significant part of the budget revenues and the expenditures associated to these revenues not included in the budget. This, together with substantial off-budget operations, result in a budget which significantly underestimates the size of the government operations. The budget does not include projections despite the requirement established in the FRL that investment expenditures are presented in a multi-year form.

Also there are no clear fiscal indicators while at the same there are many fiscal rules. Fiscal indicators such as for example the overall balance or current account balance, or financing requirements are not used to set fiscal policy targets. The emphasis appears to be on those indicators on which the FRL imposes rules such as the growth rate of primary expenditure (excluding investment), the non-oil deficit, the rate of growth of the operational expenses of the development banks, and the ratio of the public debt to GDP. The fact that the fiscal rules apply to the approved budget and not to the actual fiscal outturns allows in practice that these rules, except for that on the public debt, have not been complied with ex post. Also, the fiscal rules together with the earmarking of revenues and expenditure requirements create incompatibilities and inconsistencies in the use of resources which lead to an under-execution of the budget.

The handling of the budget is characterized by substantial off-budget operations. These include mainly the quasifiscal activities of PetroEcuador, the electricity, telecommunication and Solidarity Fund companies, and 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 with the determination of these done in a nontransparent fashion and subject to negotiation. The government is also able to cut the investment budget of PetroEcuador arbitrarily. The subsidies on the consumption of fuels which are granted through administered prices are large and growing rapidly and are offset through lower payment of taxes. The implicit subsidies granted to the consumption of electricity are also significant and growing, with the budget identifying only a part of them starting in 2005. Although there is no quantification of tax expenditures, it is estimated that they are not only significant but increasing.

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.

The budgetary norms and practices contribute to the creation of off-budget operations and to weaken the role of the budget. The budgetary norms allow the government to exceed total expenditure budget appropriations by 5 percent without congressional approval. In addition, congress approves the expenditures at a very aggregated level which together with the fact that it may modify the composition of the expenses and that the government may reallocate expenses without congressional approval may result in an approved budget which is not a good indicator of the budget that is executed in practice.

9. Recommendations

9.1. Budget management

- Record the budget transactions in gross terms abolishing the practice of recording only the net flows for the tax and petroleum revenues and not recording the expenditures associated with the earmarking of revenues.
- Diminish the flexibility to reallocate expenditures and increase the level of disaggregation of the budgetary appropriations.
- Prepare information on extrabudgetary 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 in the budget.

9.2. Fiscal Responsibility Law

- Assess the consistency of the various rules and norms (including the ones related to the handling of the budget and those of the FRL) that apply to the conduct of fiscal policy.
- Incorporate greater transparency in the fiscal rules (including in the definitions of target variables such as capital spending or the non-oil balance).
- Widen 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 the actual fiscal outturns 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 met consistently ex post.

- Require a stronger accountability of the MEF on the compliance with the fiscal targets.

9.3. Public enterprises

- Define a framework for the appropriation of petroleum resources by the government, which could include a tax and dividend policy for PE in line with that applied to the private sector (excluding the tax benefits).
- Compensate PE for the losses incurred in the domestic sales of petroleum products through direct transfers from the budget.
- Avoid using the reference price of oil as a mechanism to extract resources from the sector.
- Allow PE's board of directors to define the company's investment budget avoiding expenditure cuts because of central government budgetary considerations.
- In the transition period towards realistic rates, include in the budget the transfers necessary to cover the subsidies implicit in the administered rates for electricity and telecommunication services.

9.4. Public-Private Partnerships (PPPs)

Develop a legal, institutional and budgetary framework for PPPs which maximizes efficiency gains and minimizes the risks for the public finances.

9.5. Earmarking of revenues

Replace earmarked revenues not mandated by the constitution with budget appropriations and subsequently implement mechanisms to allocate these resources.

MEXICO⁴²

1. Legal framework

The legal framework is extensive but the main laws and decrees are the constitution, the Budget, Accounting and Federal Public Expenditure Law,⁴³ the National Program for the Financing of Development (PRONAFIDE), the General Public Debt Law (LGDP), the annual Federal Revenues Law (LIF), and the annual Federal Expenditures Budget (PEF).

The budget documentation includes the PRONAFIDE which is the economic program by sectors with a 4 to 5 year horizon which is not updated (fixed horizon); the Economic Policy General Criteria Report which incorporates projections for more than one year and a diagnosis of the world economy, sets the annual macro targets and is revised every year; the LIF which projects the tax and nontax revenues, sets a ceiling on net borrowing by the federal government, and one for the financial intermediation of the development banks; and the PEF which includes all the federal government expenditures and the fiscal targets. The objectives set for the sectors in the PEF must coincide with the medium-term strategy defined for the public sector in the PRONAFIDE.

2. Budget coverage

The LIF and PEF cover the budgets of the autonomous entities, dependencies of the centralized administration, those entities under direct budgetary control, which include the petroleum company (PEMEX), the Federal Electricity Company (CFE), Central Light and Power Company (LFC), the Mexican Social Security Institute (IMSS), the Public Workers Social Security and Services Institute (ISSSTE), as well as transfers to the remaining entities of the parastatal public administration or entities under indirect budgetary control. Draft budgets of entities under indirect budgetary control are approved by their coordinating ministries and the Ministry of Finance and Public Credit (SHCP). The Chamber of Deputies receives a forecast of cash flows from each of those bodies for information purposes only.

The budget document includes only limited information on past fiscal performance and no budgetary forecasts for future years except for investment projects.⁴⁴

⁴² Based on “Mexico: Report on Observance of Standards and Codes—Fiscal Transparency Module”, IMF Country Report No. 02/200, September 2002; on the answers to the questionnaire as well as on the information and documents received in the meetings held in Mexico City on January 26-28, 2006; and on Jul (2005).

⁴³ A new Federal Budget and Fiscal responsibility Law (LFPRH) was approved on February 28, 2006, replacing the Budget law which had been in effect since 1976.

⁴⁴ This will change with the LFPRH which establishes that the economic estimates—revenues, expenditures and debt—should cover the previous 5 years, the year that is being budgeted, and the following 5 years.

3. Contingency reserve

The PEF does not include a contingency reserve. There are two off-budget funds which seek to perform the function that in other countries is carried on by the contingency reserve which are the Petroleum Revenue Stabilization Fund (FEIP) and the Natural Disasters Fund (FONDEN). Part of the resources of the FEIP may be used to buy petroleum options and in this way ensure a stable price throughout the year. In 2005 there were no shortfalls in the petroleum revenues so the only expenses covered by the FEIP were the purchase of petroleum options.

The FONDEN is activated when an official emergency is declared at the request of a local authority (Governor). The unused resources in a fiscal year are kept in the FONDEN. Annually the PEF appropriates about 4 thousand to 6 thousand million pesos to attend these contingencies. In 2005 they were used mainly to repair infrastructure and there was support also to repair housing.

Resources in FONDEN and FEIP (in millions of pesos)		
	Natural Disasters Fund	Petroleum Revenues Estabilization Fund
4° Quarter 2003	4.657,6	6.276,4
4° Quarter 2004	5.764,6	11.607,7
3° Quarter 2005	6.071,2	10.239,1

Source: SHCP, Reports on the Economic Situation, Public Finances and Public Debt.

The new LFPRH maintains the FEIP and the FONDEN and creates three other funds which are the Stabilization Fund for the Revenues of the States and Municipalities (FEIEF), a Stabilization Fund for the Investment in Infrastructure of PEMEX (FEIIP), and a Support Fund for the Restructuring of Pensions (FARP).

4. Role of Congress

The legislature has the authority to reduce the budget, amend its composition, and even increase the budgetary ceiling, provided it approves the funds to finance the additional expenditure. However, it is not clear whether those funds refer to additional tax revenue or other sources of financing. Under the LFPRH these funds may not be loans because to

be able to adjust the budget equilibrium target established by the law both congress and the government must justify the need for a deficit and define the period and actions to be followed to return to equilibrium.

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). The fact that the PEF is approved by legislative decree, and not by law, creates uncertainty as to the extent of the President's constitutional veto powers. This legal vacuum was put to the test for the 2005 budget. The President vetoed the budget and the Supreme Court ruled that he had the power to do it.⁴⁵ In the execution of the budget the SHCP adjusted the expenditure. An agreement for part of the discrepancy was subscribed in the end between the government and the Chamber of Deputies, agreeing with the legislative on the veto.

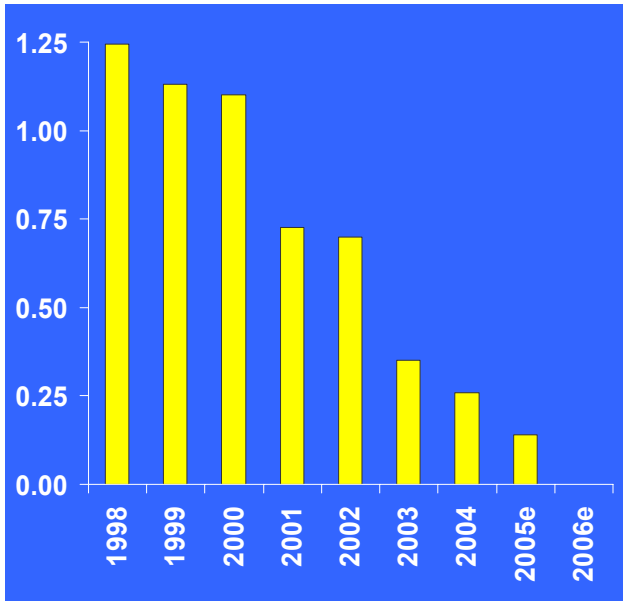
5. Fiscal indicators

There are two definitions of the operational result, the traditional balance (BT) and the Public Sector Financing Requirements (RFSP). The first includes only the operations which are in the budget, while the second includes also the operations stemming from the financial-banking and road concessions rescues of the past, as well as the public investment projects with deferred impact on expenditure or association with private investors, the net financing needs of the development banks, non-recurrent public revenues and other adjustments. These transactions add between 2.5 and 3 percentage points of GDP to the traditional deficit.

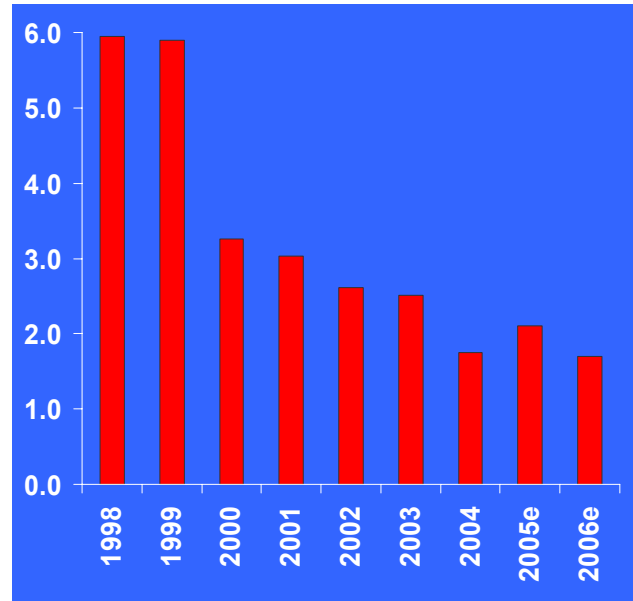
The graphs in the following page show the behavior of the traditional deficit and the public sector financing requirements for 1998-2006.

⁴⁵ The Supreme Court resolution creates judicial certainty but not jurisprudence because the vote was with a small margin of only 6 to 5 of the justices. In principle it could be possible to veto parts of the budget but the judicial consequence of this would be that the rest of the budget would not be approved. A partial veto means that the whole document is returned and a part of it cannot be published.

Traditional Deficit*
(% of GDP)



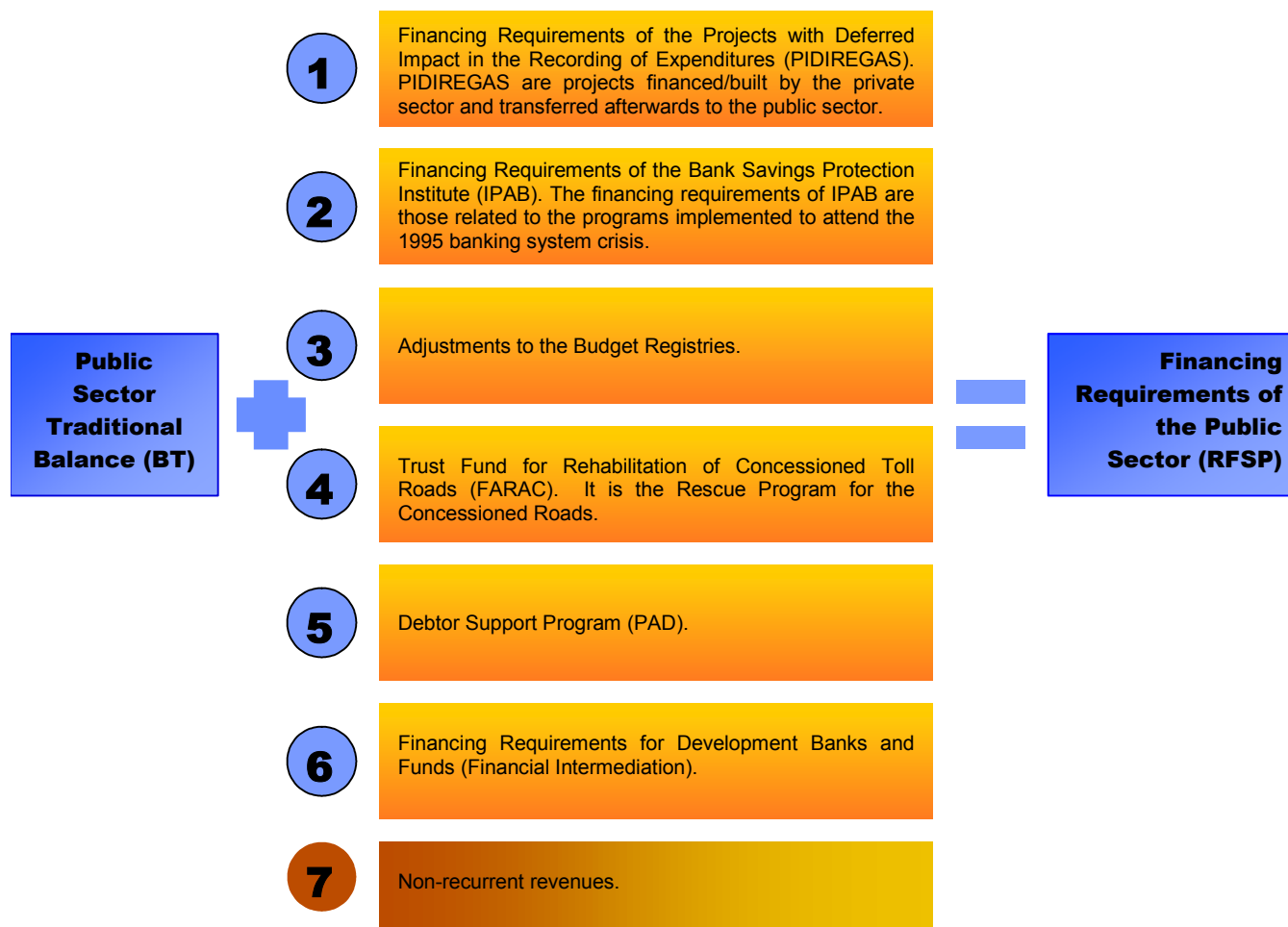
Public Sector Financing
Requirements
(% of GDP)



Source: SHCP.

*The traditional deficit for 2002 excludes the operations with FinRural. The RFSP for 2004 exclude the effects of the PCCC (Papers for the Capitalization and Portfolio Purchases Program) exchange. The data includes the costs of the Voluntary Separation Program (PSV).

The graph in the following page shows the relationship between the Traditional Balance and the RFSP.



Two measures exist also of the public debt, with the second one known as the Historic Balances of the Public Sector Financing Requirements (SHRFSP) which includes the transactions associated with the RFSP. For 2004 the total adjustments to the debt add almost 18 percentage points of GDP, for a SHRFSP of 42 percent of GDP.

6. Fiscal rules

Before the approval of the LFPRH the annual budget law defined automatic mechanisms to adjust expenditures when the actual revenues differed from the budget estimates, but no permanent rules existed—except for the prohibition of foreign borrowing and the borrowing limits for the states. The PEF regulated the use of excess revenues (more expenditure or a reduction of debt) and determined the adjustments that could be made in the expenditures so as to comply with the target for the budget deficit when, on the other hand, actual revenues were smaller than the revenues projected in the LIF.

For the fiscal year 2006, the target for the BT is zero. In case of a national emergency, the federal government may not comply with this target, informing the Chamber of Deputies. The target has been set in line with the 2002-2006 PRONAFIDE. The budget maintains the flexibility and autonomy for PEMEX, abolishing certain procedures it had to comply with in relation to the SHCP in exchange for compliance with its operational, primary and financial balances. The rest of the entities under direct budgetary control (except the IMSS) define their own primary, operational, and financial balances targets.

A 25 percent of any excess in petroleum and tax revenues, together with contributions from previous fiscal exercises, and part of the levies are deposited in the FEIP, another 25 percent of excess revenues is used to improve the traditional balance, and a 50 percent is used for investment expenditure by PEMEX and the states and municipalities.

Before using the excess revenue for the above mentioned purposes, excess revenues must cover any excess in the non-programmable⁴⁶ expenditure on account of earmarked revenues for the states and municipalities, financial costs due to changes in the interest or exchange rates, undisbursed commitments from previous fiscal exercises (ADEFAS), and, if necessary to attend to natural disasters.

Likewise, they may be used to compensate the CFE for an increase in the price of fuel, through an automatic increase of the budgetary appropriations financed with these excess revenues. This increase applies only to the cost increases which cannot be transferred to the electricity rates.

In the event that during the 2006 fiscal exercise revenues fall short of those envisaged in the LIF, lower petroleum revenues will be offset with funds from the FEIP according to the operational rules of the fund. If the resources in the FEIP are not enough then the expenditures will be adjusted. The lower-than-budgeted non-petroleum revenues will be offset with a reduction in the approved expenditures in the budgets of the agencies, entities, funds and programs, in a selective fashion, starting with the social communication expenses, followed by the wage bill, budget savings, communication expenses, and expenses not directly related with services provided to the population.

In the event that these reductions are not enough to compensate for the lower revenues, adjustments may be made to other expenses. The social programs are not especially protected, so they may be cut if necessary. However, efforts will be made not to affect it.

If the revenues shortfall is less than 15 billion pesos (US\$1.5 billion), the government will submit to the chamber of deputies a report detailing the amount of programmable expenditure to be cut and the composition of the cuts by agencies and entities.

⁴⁶ The non-programmable expenditure stems from the compliance of legal obligations or obligations defined in the PEF, which do not correspond directly to programs that provide goods and services to the population. The programmable expenditure stems from programs to provide goods and public services to the population.

If the shortfall in revenues exceeds 15 billion pesos, the government should submit to the chamber of deputies, for its opinion, a report detailing the amount of programmable expenditure to be cut, and a proposal of the composition of the cuts by agencies and entities.

The LIF defines a ceiling for net borrowing by the federal government and one for the financial intermediation of the development banks.

6.1. New Federal Budget and Fiscal Responsibility Law (LFPRH)

The LFPRH seeks to attain responsibility, transparency and accountability in the handling of the public finances, order and certainty in the annual approval of the economic package, and promote federalism and the modernization of the budgetary practices.

Regarding fiscal responsibility, the Law establishes that the economic package will be prepared on the basis of long-term projections; defines a formula to determine the price of oil under technical and not political criteria and sets clear rules for the distribution of excess revenues. It defines also 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.

Regarding transparency and accountability, the law defines clear rules for the appropriation of resources to trust funds, to finance ADEFAS (including a limit), and strengthens the sanctions for noncompliance with the law.

It establishes also a procedure with specific deadlines for the approval of the LIF and PEF, advances the deadlines for submission to congress of the budget documentation, and foresees tools to allocate expenditures in a more transparent and efficient manner.

The LFPRH establishes that the LIF and PEF should be in balance (it refers to the BT) and that if it is necessary is possible to incur a deficit. For the latter, the SHCP must inform congress on the amount of financing required, the reasons that justify the deficit, and the time and actions needed to recover the budgetary balance. Congress may also modify the fiscal target but needs to provide the reasons why it is making the change.

The remaining excess revenues (after compensating for the excess non-programmable expenditure, attending to natural disasters, and offsetting CFE cost increases, with the excess earmarked revenues used for their specific purposes) will be distributed in line with the new fiscal regime for PEMEX (approved October 2005) in the following manner: a 25 percent for the FEIEF, a 25 percent for the FEIIP, a 40 percent for the FEIP, and a 10 percent for programs and infrastructure and equipment projects of the states and municipalities.

The Funds must attain an optimal level of reserves (defined in the Law) and will be used to compensate for shortfalls in revenues in the corresponding areas for which they were

created. Once the optimal level of reserves has been achieved, a 25 percent of the excess funds will be used to finance investment programs and projects of the PEF, prioritizing those which attend the needs of the states and municipalities; a 25 percent will be used to fund the investment programs and projects of the states and municipalities; another 25 percent to finance the investment programs and projects of PEMEX; and 25 percent will be deposited in the FARP.

The Funds will receive resources according to the rules of the new fiscal regime for PEMEX and the LFPRH. Once the reserves attain their maximum level, the resources in the Contingency Funds will go to the FARP. When outflows occur against the reserves the restitution of these will have priority in relation to the uses.

Revenue shortfalls in some areas may be offset with excess revenues in other areas (except for those which have a use predetermined by law—rights—or correspond to the parastatals).

Shortfalls in petroleum revenues are offset with resources from the FEIP. If these are not enough, then the expenditure is adjusted. Shortfalls in the earmarked revenues for the states and municipalities are compensated with resources in the FEIEF, while shortfalls in PEMEX's own resources are offset with funds in the FEIP. If these are not enough, then PEMEX's budget is adjusted.

Shortfalls in non-oil revenues are compensated with expenditure cuts if excess revenue in other items is not enough. Cuts in expenditure to offset revenue shortfalls which are larger than 3 percent of the budgeted revenues require an opinion from the Chamber of Deputies.

7. Off-budget operations

7.1. Off-budget expenditures

7.1.1. Public Sector Financing Requirements (RFSP)

The RFSP seek to identify the total borrowing needs stemming from both the budget operations as well as from some which are not included in the budget.⁴⁷ Some of the latter are expenses such as the investment expenditure under PIDIREGAS, IPAB transfers, and operational expenditures by the Development Banks and Public Funds (BDyFP). Other are loans to the private sector (at preferential rates) provided by the BDyFP as well as the payment of liabilities associated with the road concessions. This category constitutes an example of loans by public financial entities on account of the government, which are included in the RFSP as if they were regular central government expenditures and revenues because they require resources. This is important in a country which has had difficulties accessing capital markets and is seeking to reduce the public debt ratio to GDP.

⁴⁷ The non-recurrent revenues are in the budget but given their once-and-for all nature are added to the RFSP to obtain an indicator of the underlying financing requirements of the public sector.

Information on the off-budget operations is submitted to congress from the beginning of the budget process, they are reported quarterly, and are included in the macroeconomic framework through the RFSP and SHRFSP indicators. Most of these operations seek to encapsulate debts or investments and ensure and make transparent their sources of revenues, this being the logic and general rule under which they are handled. These operations are not included in the SIAFF, but their results are consolidated.

These operations correspond to PIDIREGAS which is infrastructure investment in the petroleum and electricity sectors; IPAB which corresponds to the banking sector rescue operations; FARAC which relates to the rescue of road concessions; the Debtors Support Program (PAD) stemming from the 1994 crisis; and BDyFP which are loans for agricultural, financing, and infrastructure needs. In general these operations have specific mandates so they are really like legal expenditure requirements. The other two types of operations consist of adjustments to budget registries and non-recurrent revenues.

Congress authorizes annually the discretionary spending of some of these operations through different mechanisms. The only one which is not tied by limits is the FARAC and to some extent IPAB.

7.1.1.1. Projects with Deferred Impact in the Recording of Expenditures (PIDIREGAS)

For the calculation of the BT, the direct investment PIDIREGAS are recorded when the asset or parts of it are handed over to the public entity, but only the payments corresponding to two years, the present fiscal year and the next one, and are recorded in the same way in the public debt, with the rest of the obligations recorded as contingent liabilities. However, for the calculation of the RFSP the total amount of the investment and the corresponding financing are recorded when the investment takes place, the SHRFSP includes the total amount of obligations, and there are no contingent liabilities.

Although there is no need for budgetary appropriations at the beginning of a PIDIREGAS project, the Chamber of Deputies must approve their contracting in the context of the annual discussion of the budget, and these expenses have a de jure preferential status in future budgets. Starting in 2002, the SHCP has established limits to the investments that can be implemented through PIDIREGAS scheme.

7.1.1.2. Bank Savings Protection Institute (IPAB)

The total amount of financing required by IPAB is not included in the BT, which includes only the fiscal transfers required to cover the real component of the financial cost of IPAB operations. IPAB's financing requirements included in the RFSP correspond mainly to the inflation component of the financial cost of its operations for which it is authorized to issue debt.

7.1.1.3. Adjustments to the Budget Registries

These operations refer to the financing requirements stemming from compensations or virtual operations, such as the inflation component of an item or debt catalogue; revenues generated by the prepayment of debt or a debt exchange; and actuarial reserves both by the IMSS as well as the ISSSTE.

7.1.1.4. Trust Fund for Rehabilitation of Concessioned Toll Roads (FARAC)

The FARAC was created in 1997 with the assets and liabilities of the concessioned roads. This off-budget fund may be financed only through the tolls collected by the fund. Consequently, there are no transfers in the budget for this fund. It may also issue debt instruments securitized with the revenue from the tolls and guaranteed by the federal government.

7.1.1.5. Debtor Support Program (PAD)

Only part of the PAD obligations is included annually in the PEF. The final cost of these programs depends on the results of the audits conducted by the National Banking and Securities Commission (CNBV) on the banking institutions in relation to the correct implementation of the programs, and on the future behavior of real interest rates.

7.1.1.6. Development Banks and Public Funds (BDyFP)

These are financial intermediation operations conducted on behalf of the federal government by the public development banks and funds. They are included in the RFSP because although they are not public expenditures they do represent financing requirements. A ceiling on these operations is defined every year in the LIF. The ceiling is imposed on the net credit provided to the private and social sectors as well as on the operational deficit of these institutions and funds.⁴⁸ The ceiling may be adjusted by the Administration Council with the favorable opinion of the SHCP, with congress being informed quarterly of these modifications. Fiscal transfers for this purpose were authorized in the past only in exceptional circumstances (rescues or collaterals).

7.1.1.7. Non-recurrent revenues

These are once-and-for all revenues which are highly volatile. They include privatization revenues, assets recovered from trust funds and funds, the redemption of guarantees or collaterals of Brady Bonds, and excess revenues generated by public entities. By placing these revenues as part of the RFSP they are no longer considered part of the revenues above the line but as a financing item below the line, so that the RFSP indicate the underlying financing needs of the public sector.

⁴⁸ This ceiling was set in the equivalent of almost US\$3.5 billion for 2006.

7.1.2. Off-budget funds

7.1.2.1. Trust Funds

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. The trust funds which issue debt are not many, previously they were more.

Over the past few years the regulations on trust funds have been tightened to make their operations more transparent, which contributes to strengthen the allocation/distribution, administrative and possibly the macroeconomic functions of the budget.⁴⁹ The 2006 PEF prohibits explicitly the creation of trust funds which have the sole objective of circumventing the periodicity of the budget. At present, the funds to constitute a new trust fund or contribute to an existing one must transit through the budget. Before only the initial contribution to the fund was in the budget but not the following ones. Also, private trust funds which received public funds were not in the budget.

The 2006 PEF rules that the public trust funds whose main objective is to finance investment programs and projects must be subjected to the general rules which on investment matters are issued by the SHCP. Also, the entities which are in charge of managing the trust funds must, before June 30, 2006, act to extinguish those trust funds which have attained their objectives, those where it is impossible to achieve them, and those which have not been active over the past year, unless their existence can be justified. The unused public resources in these trust funds must be returned to the Federal Treasury (Tesofe).

The decisions on the expenditures to be conducted through the trust funds are taken by their Technical Committees, which are constituted by officials of the line ministry responsible for the trust fund.

For the private sector trust funds, the total public resources contributed to the fund may not exceed at any moment more than 50 percent of the fund's capital.

Information on the trust funds is provided to congress in the Quarterly Reports on the Economic Situation, Public Finances and Debt prepared by the SHCP. The report includes the type of activity conducted by the trust fund (pensions, labor compensations, public infrastructure, supports and subsidies, financial supports, and others), its revenues and expenditures, the objectives sought by the fund in the period, and the availability of resources at the end of the period. The resources may correspond to revenues from more than one fiscal period, because trust funds are not obliged to spend the resources in the same year that they receive them and fiscal resources are not the only source of revenue of the trust funds.

⁴⁹ The LFPRH makes these rules permanent.

The total availability of resources in the trust funds was US\$21 billion as of December 31, 2005, with the trust funds which provide financial support representing almost 40 percent of the available funds, followed by those which are related to pensions with a 21 percent of the total, and those the deal with public infrastructure with 19 percent of the total.

7.1.2.2. FARAC

It is a trust fund in the National Public Works and Services Bank (BANOBRAS) created to refinance the debt incurred by the roads concessioned in the 90s. The government took over the liabilities and the roads from the concessions, and paid the private investor with discounted promissory notes issued by FARAC with government guarantee, and FARAC subsequently issued long-term bonds to be repaid with the tolls charged on the roads. These bonds were not recorded as public debt because legally there is an exception for trust funds without their own structure. The RFSP and the SHRFSP do include FARAC's operations and liabilities.

7.1.2.3. FINFRA

It is a trust fund constituted in BANOBRAS with privatization revenues. FINFRA's operations are not subject to annualization, it is allowed to have multi-year projects, and is not included in the PEF. FINFRA's objective is to contribute seed capital. One type of support is not recoverable, similar to a subsidy, while the other type is risk capital. FINFRA may contribute up to 49 percent of the capital required by a project and by law they must recover the capital support to projects that are not road concessions.

FINFRA receives contributions from the Ministry of Communications and Transport (SCT), unused budget appropriations that SCT transferred to FINFRA until 2004, because unspent funds must be returned to the Tesofe. Starting in 2005, SCT may not transfer these funds to FINFRA unless they are used to finance investment projects which are implemented as concessions. SCT has also transferred to FINFRA funds obtained from the sale of its airport shares.

FINFRA's technical committee is presided by the SHCP, with the SCT and BANOBRAS also having a representative. It is a requirement that all projects which are being financed by FINFRA, although they are not in the budget, must be in the portfolio of public investment projects, having being assessed, and found profitable from a social point of view.

Resources transferred from the budget to FINFRA are recorded as capital transfers in the fiscal accounts, but the Initial Contributions (AI) from FINFRA to the road concessions are not recorded as expenditure.

There is a contingency fund in FINFRA with the funds to be used to finance the early termination of the new concessions, with contributions of about US\$10 million per project.

7.1.3. Direct loans

The federal government does not provide direct loans. To provide support to productive activities it considers a priority it uses the BDyFP as was described above. These receive government guarantees on their borrowing and lend mainly to private borrowers, public or private enterprises, and the states and municipalities, among others. The RFSP record these loans as if they were granted by the government and classify them as above the line operations.

7.1.4. Guarantees

The LGDP regulates the provision of guarantees by the federal government. The law authorizes the SHCP to contract and manage the federal government's debt and to provide government guarantees. These 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 for productive activities included in the social and economic development policies, that they generate enough resources to repay the loans, and have the proper guarantees.

The other types of guarantees provided by the federal government may be implicit or explicit. The implicit guarantees stem from government obligations which may be of a political or moral nature, which in some instances are the result of past expenditure commitments such as for example the expenditures associated with pensions.

Explicit guarantees on the other hand refer to those guarantees provided by the federal government through laws or contracts, for example, to facilitate the implementation of investment projects, exports, or support bank savings protection schemes.

The explicit guarantees must be subscribed by the federal treasurer and an official of the SHCP appointed by the minister for this purpose, normally the head of the Public Credit Unit. Similarly, the Service Law of the Federal Treasury establishes that the role to be played by the Tesofe in the provision of guarantees is to verify that the collaterals are adequate and sign the loan documents.

Although the law authorizes the federal government to provide explicit guarantees to public and private institutions, this mechanism has been used only in emergency situations.

Every year the LIF requires the federal government to provide quarterly information to congress regarding the contingent liabilities that the government has taken over on account of guarantees. In the quarterly report there is an annex which provides information on the explicit guarantees provided by the federal government in the corresponding period, and information on the value of the stock of guarantees at the end of the period. These guarantees refer to those liabilities which are not included in the public debt. Consequently, these operations are not included in the budget documents,

although they are recorded in the corresponding accounting sub-systems. The Tesofe manages the registry of these guarantees.

The following table shows the existing stock of explicit guarantees provided by the federal government.

STOCK OF OBLIGATIONS GUARANTEED BY THE FEDERAL GOVERNMENT
(Millions of pesos)

ITEM	Stocks at:		
	Dic-31-03	Dic-31-04	Dic-31-05
TOTAL ^{1_/}	<u>444,797.3</u>	<u>234,415.9</u>	<u>238,684.3</u>
IPAB	224,914.9	4,284.0	4,517.0
FARAC	146,737.9	162,642.4	170,674.3
Trust and Development Funds ^{2_/}	59,542.8	54,269.6	50,028.7
Development banks ^{3_/}	12,064.6	11,973.5	13,079.5
Oher ^{4_/}	1,537.1	1,246.4	384.8

Source: Ministry of Finance and Public Credit.

1_/ Preliminary data subject to revision. Excludes the guarantees provided in the organic laws of the development banks which amount to 468,606 million pesos, 436,075 million pesos and 417,321 million pesos at end 2003, 2004 and 2005, respectively.

2_/ Includes mainly FIRA.

3_/ Corresponds mainly to the liabilities of the National Sugar Financing Corporation.

4_/ Includes mainly the CFE.

When a guarantee is called, the government records it as a liability, takes it over as a loan and serviced. At the same time, the Tesofe registers it as an asset so as to be able to claim it from the original lender.

The PEFs do not appropriate resources to cover contingent liabilities. For some contingent liabilities, such as pension expenses or obligations arising from legal rulings, some entities include in their annual budgets contributions to reserve funds or other similar expenses. When a guarantee is triggered that requires the use of resources in the following fiscal exercise for some government agency, it has to include an appropriation for this purpose in its budget.

A methodology to estimate the expected value of the guarantees does not exist. Guarantees are recorded at their maximum value.

There is a quantification for ISSSTE's implicit contingent liabilities. There are recent studies on the subject because they want to reform the system and in that case they will have to budget the contingent liabilities. These amount to about 13 to 15 percent of GDP.

7.1.5. Public-Private Partnerships (PPPs)

7.1.5.1. PIDIREGAS

PIDIREGAS may be direct investment or conditioned. Direct investment PIDIREGAS are projects awarded through bidding, under which the private sector builds and finances infrastructure, and the public sector pays for the investment once the projects are completed using the revenues that they generate.

In the conditioned PIDIREGAS the assets that are used belong to the private investor and are built under technical specifications provided by the public entity. The private sector keeps the assets unless some eventuality materializes (noncompliance of payments by the public entity or force majeure) which has been written into the contract. It is the conditioned acquisition which is the one susceptible of receiving the treatment of a PIDIREGAS project.

PIDIREGAS have a stricter legal framework for their approval, execution and monitoring than the direct public investment projects because they involve high levels of investment, and accountability is required for each project.

Although there is no need for budgetary appropriations when a PIDIREGAS project is started, the proposals for these projects are part of the discussion and approval process of the annual budget by the Chamber of Deputies. PIDIREGAS expenditures have a de jure preferential status in the budget.

The SHCP is in charge of monitoring the implementation and financing of these projects and prepares the information that is submitted to congress as part of the budget documentation. The SHCP authorizes the direct PIDIREGAS contracts because it has to authorize the loans required by the contracting entity, and approves the conditioned PIDIREGAS. The SHCP has to authorize PEMEX's provision of guarantees to the trust fund (*Master's Trust*) in charge of providing financing to the private sector for the execution of the projects.⁵⁰ It regulates also the issue of bonds so that there is no conflict between two bond issues and reviews the terms of the financing which is being obtained.

Starting in 2002, the SHCP sets limits to the investment to be executed under the PIDIREGAS scheme.

For direct investment PIDIREGAS, the private investor assumes the financial risk during the construction period while the public entity assumes the risk related to the operation of the asset. The demand and financial risks related to the payment of the investment is assumed by the public sector.

⁵⁰ PEMEX has used the trust fund mechanism to finance projects in the construction stage, with the trust issuing bonds or contracting loans with a guarantee provided by PEMEX. These resources are onlent to the private sector which executes the investment, and PEMEX assumes the debt once the project is handed over. A similar trust fund was created to borrow in the domestic financial market.

In the conditioned PIDIREGAS the private sector assumes the financial risk during the construction and operation periods as well as part of the risk of operation. The demand risk is assumed by the public entity.

The amount of PIDIREGAS' contingent liabilities depends on the fiscal balance concept that is being used. Under the BT concept, the direct investment PIDIREGAS are recorded when the asset or parts of it are handed over, but only the obligations corresponding to two years, the present fiscal year and the next one, and are recorded in the same way in the public debt, with the rest of the obligations recorded as contingent liabilities. However, for the calculation of the RFSP the total amount of the investment and the corresponding financing are recorded as the investment takes place, while the SHRFSP includes the total amount of obligations, and there are no contingent liabilities.

For the conditioned PIDIREGAS the contingent liabilities correspond to the PV of the fixed payments which have been committed and not yet paid, because in the event of having to purchase the asset that is the amount to be paid.

Annually, the LIF authorizes the amount of new direct PIDIREGAS projects and the PEF the amount of new conditioned projects which may be contracted.

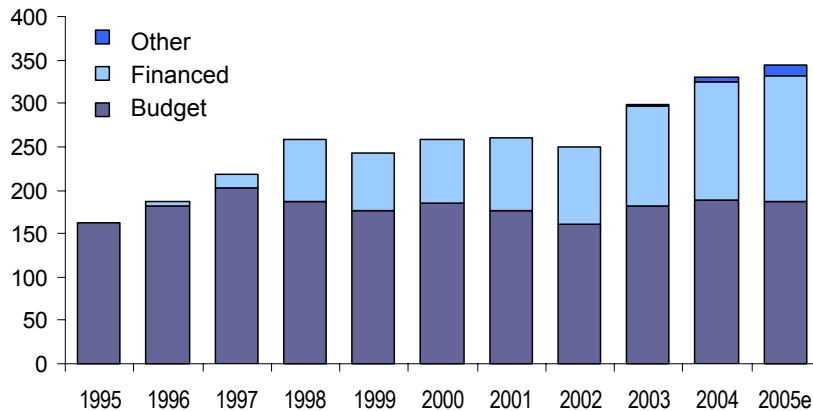
PIDIREGAS have a separate accounting to be able to identify the revenues as well as the costs and debt repayments associated with each project. This information is included in the budget documentation.

In recent years, debt repayments associated with PIDIREGAS projects has increased significantly, reducing the room for traditional public investment, which decreases from a 67 percent of total public investment in 2000 to only 35 percent in 2005, while the payments for PIDIREGAS projects increase their participation from 4 percent to 26 percent of the total over that period.

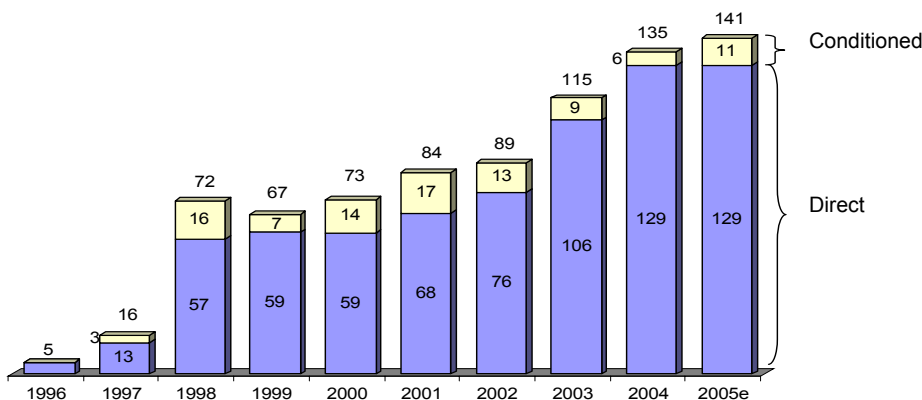
The investment financed in the energy sector via PIDIREGAS is estimated at US\$13.7 billion for 2005, while the net direct public investment amounts to a little more than US\$2 billion. The investment executed under the PIDIREGAS scheme has allowed the doubling of the investment in the energy sector in 1996-2005. In the electricity sector, the PIDIREGAS projects have increased the generation, transmission, and distribution capacity. In the oil sector, the PIDIREGAS projects contributed with an 85 percent of the production of crude oil and 98 percent of the production of natural gas.

The cumulative cost of the projects authorized through 2004 amounts to US\$115.7 billion, with direct PIDIREGAS representing about 91 percent of the total, about 78 percent in the oil sector and a 13 percent in the electricity sector.

Public Sector Investment Billion pesos at 2005 prices



Investment financed via PIDIREGAS (Financed Investment) Billion pesos at 2005 prices



7.1.5.2. Service Provision Projects (PPS)

The government signs a contract with a private investor for the provision of services for a long period of time. Once the provision of services begins, the government makes the corresponding payments according to performance. There must be a clear assignment of risks between the public and private sectors, which must be written in a long-term service contract. The assets used to provide the services may belong to the private investor or to the government. The project prepared by the public entity is a conceptual project which specifies the service requirements and there are no minimum requirements of risk capital.

The private investor designs, builds, finances and operates support infrastructure to provide in an integral form services to government agencies and entities, which in turn, provide the public services. In contrast with the traditional concession contracts, in the PPSs the government retains the responsibility for the deliver of the services. The

participation of the private investor is limited to the provision of auxiliary and support services required for the provision of a public service.

An interministerial work group as well as a specialized team in the SHCP was formed to manage the PPS projects. The SHCP has to decide if a project is viable to be executed as a PPS or as traditional public investment, and then approve the prefactibility and factibility assessments and the terms of the contract. Once it receives these authorizations, the executing entity may proceed to auction the contract.

From the start of the implementation of the PPS contracts, the entities and agencies must report, through the Integrated Federal Financial Management System, the information specified by the SHCP in order to assess compliance with the objectives and targets established in the project proposal.

The draft PEF for every fiscal year must indicate the commitments stemming from the PPS contracts both for the current fiscal year as well as for the following ones. It must also include the contingent liabilities associated to the long-term service contracts under which the entities may have to acquire assets under certain conditions.

An investment of about US\$2 billion in PPS is estimated for the 2006 fiscal year.

7.1.6. Quasifiscal activities

7.1.6.1. Nonfinancial public enterprises

The public enterprises must report their activities and their earnings statements to the SHCP. Some of these nonfinancial public enterprises engage in significant quasifiscal activities. For example, the Federal Energy Commission (CFE) and the Central Light and Power (LFC) subsidize electricity for residential and farm consumption on behalf of the federal government. The subsidy is estimated at about 0.8 percent of GDP. The CFE and the LFC, however, receive no transfers from the federal government, 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 must 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. To keep the public better informed, household electricity consumption bills began to identify the amount of the subsidy in 2001. There are also implicit subsidies for water consumption, but no information is published on their amount or their distribution by type of user.

7.1.6.1.1. PEMEX

The domestic price of fuels is an administered price. It has been kept constant in real terms, adjusting it for expected inflation, not reflecting the 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 on 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. If the IESP is not enough to absorb the subsidy then the VAT would be used, and if these two taxes are not enough then the Ordinary Levy on Oil Products (DOH) may also be used.

For many years, 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. The fact that PEMEX's budget is part of the federal budget assures that any quasifiscal activity by PEMEX will be reflected in the fiscal statistics, but this relationship may at times constrain the company's ability to maximize its value. Moreover, the ban on private equity financing requires PEMEX to have relatively high debt.

Starting in 2002 an annual limit has been set for the investments that are authorized under the direct PIDIREGAS scheme on a rolling basis, for the current fiscal year and the next three years, updating the limit every year for four years. The limit is set in pesos as a percentage of GDP (within a range which has varied between 0.7 and 0.9 percent of GDP) for new investments plus the repayments already committed. The reason to establish limits responds to the fact that on the basis of the investments projected by PEMEX and the CFE the payment obligations would attain close to 2 percent of GDP in 2010 compared with ½ percent of GDP in 2005. The authorities seek to stabilize the investments implemented under this scheme because they believe that the large impact of the existing commitments could affect the country's investment grade.

In October 2005 the Chamber of Deputies approved a new fiscal regime for PEMEX to make transparent the relation between the government and PEMEX, 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. The main levy under the new regime, in contrast to the existing one which is a tax on sales (at an equivalent rate of 60.8 percent), the DOH is a levy on revenues minus costs.

In addition to the DOH, the new regime includes two levies to constitute stabilization funds:

- The Oil Levy for the Stabilization Fund (DFE) which is applied when the price for the Mexican export oil mix exceeds US\$22 per barrel; and
- The Extraordinary Oil Levy on Crude Oil Exports (DEEPC) which applies when the oil price exceeds the reference price set in the LIF (US\$36 per barrel in 2006). This levy substitutes the levy on excess revenues (ARE) and in the same manner as the ARE, the revenues collected by the DEEPC are deposited in the FEIEF and distributed on the basis of the rules defined in the PEF.

To graduate the impact of the new regime on the public finances, maximum limits were imposed on costs that may be deducted from the revenues for the calculation of the DOH, which will be in effect during 2005-2009. In the event that the reform on the corporate governance rules for PEMEX is not approved by 2010, congress will be able to maintain these limits past 2009. A guaranteed floor on the level of production was set for the states and municipalities so as to guarantee a minimum revenue for these entities in the event that oil production falls below its minimum targets.

In addition, while the corporate governance reform is pending, PEMEX must implement a program to rationalize its operational and administrative costs.

7.1.6.2. Financial public enterprises

7.1.6.2.1. Central Bank (BoM)

The asymmetric treatment of the BoM profits and losses—whereby profits are transferred to the government while losses are assumed by the BoM—could erode the BoM's capital, as occurred in 2001. While distribution of profits may not take place if it reduces the BoM's capital in relation to nominal GDP, this restriction is insufficient in the case the BoM incurs in operational losses. Nonetheless, the future distribution of profits could only take place after the capital to GDP ratio had been fully reestablished. The BoM is temporarily absorbing the implicit subsidies involved in the pre-1993 credits extended to public trust funds that it administers as well as losses from the write-off of loans granted to the Bank Savings Protection Fund (FOBAPROA now IPAB) during the bank crisis. There is, however, a mandate to offset a pre-specified fraction of these expenditures against annual profits prior to transferring the residual to the government.

7.1.6.2.2. Development banks

The financial public enterprises attend sectors of the population which are not subject of credit for the private banks and also support strategic investment projects which require preferential terms. It is difficult to establish the extent of the quasifiscal activity involved because of their role as financial intermediaries and their funding costs. Public resources have been used to capitalize the entities or to finance specific programs. The rules that apply to public banks have been harmonized with those applied to the private banks.

The development banks conduct quasifiscal operations which help explain their persistent losses, and also the recurrent need in the past for the federal government to recapitalize them. Quasifiscal operations consist primarily of services provided on behalf of the federal government, and in some cases of loans at below-market interest rates. The financial statements of the development banks are published by the CNBV but without identifying noncommercial activities on behalf of the government. The banks do not receive transfers from the PEF to fully compensate them for such activities.

The LIF sets a ceiling on external borrowing for the federal government, PEMEX, CFE and the BDyFP. In the PEF, congress sets a ceiling for the financial intermediation levels

of the BDyFP. The net lending operations do not constitute a deficit but represent financing requirements to carry out the 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.

In 2005 there was financial disintermediation as a result of the operations of the BDyFP of about 0.1 percent of GDP, explained by an operational surplus of 6.8 billion pesos, fiscal transfers for 3.8 billion pesos, and net credit of 11 billion pesos. The ceiling established in the LIF for 2006 for these operations is the equivalent of 0.4 percent of GDP. At end-2005, the BDyFP had an off-budget debt which amounted to about 2 percent of GDP compared with 2.2 percent of GDP at end-2004.

IPAB off-budget operations (including the PAD) were the equivalent of about 0.3 percent of GDP in 2005 and its off-budget debt at end-2005 amounted to 8.5 percent of GDP compared with 8.6 percent of GDP at end-2004. Government transfers to IPAB for 2006 amount to about 0.4 percent of GDP.

7.1.7. Budgetary norms and practices

Over the past few years, congress has largely respected the deficit ceilings proposed by the government. Also, actual budget execution has been very close to the approved deficit limits. However, the RFSP exceed the BT by quite a significant amount and have also exceeded the level envisaged at the time of the budget discussion by congress.

According to the constitution, spending cannot occur in the absence of approval by congress in the PEF or in a separate law during the fiscal year. Non-interest expenditure can only increase above the approved budgetary appropriations to the extent that excess revenue is being collected. While legally possible, supplementary budgets have not been a practice in Mexico.

The Federal Law on Budget and its rules give the SHCP 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 to authorize amendments to the budget within the limits established by law.

7.1.7.1. ADEFAS

The public entities must report to the SHCP the undisbursed expenditure commitments by February 28. Expenses duly accounted for and committed by December 31 may be treated as liabilities (ADEFAS).⁵¹ The ADEFAS are included in the ceiling on borrowing which is authorized annually in the LIF. In the central government all that is reported as ADEFAS and is authorized by the SHCP can be paid in the following fiscal year. The parastatals have their own cash flow so they pay their float using the cash flow of the following year.

⁵¹ The LFPRH sets a limit for the ADEFAS.

FEDERAL EXPENDITURE BUDGET 2003-2005

Debts from Previous Fiscal Years
(million pesos)

Item	Actual				Approved					
	2003		2004		2003		2004		2005	
	Value	% of ADEFAS	Value	% of ADEFAS	Value	% of ADEFAS	Value	% of ADEFAS	Value	% of ADEFAS
Total Net Expenditure	#####	1.20	#####	1.61	#####	0.46	#####	0.65	#####	0.40
Public Sector Programmable Expenditure	#####	1.62	#####	2.18	#####	1.64	#####	0.91	#####	0.55
Debts from Previous Fiscal Years (ADEFAS)	20,060.10		28,938.40		7,037.20		10,711.80		7,250.00	

7.2.1. Earmarking of revenues

Revenues may be earmarked by law or authorized by the SHCP and are recorded in the LIF.

States and municipalities receive two types of transfers from the federal government: the revenue-sharing transfer (*participaciones*), over which sub-national governments have spending discretion, and the contributions (*aportaciones*), which are earmarked transfers for social services and infrastructure. Total transfers to the states are estimated at about 6 percent of GDP for 2006, or about 44 percent of the federal government primary revenues, half in the form of revenue-sharing transfers and half as contributions.

The federal contributions are specifically earmarked for seven budgetary funds (basic education, health services, social infrastructure, social assistance, municipal strengthening, technical education, and public safety). To access funds for basic education and health services, the states sign contracts with the federal government that define the expenditure responsibilities of each level of government. The remaining revenues are allocated in accordance with the operating rules of each of the funds.

7.2.2. Tax expenditures

The LIF requires that the government submits before June 30 a budget for tax expenditures. This budget comprises the amounts that the government will not collect on account of differentiated tax rates for several taxes, exemptions, subsidies and fiscal credits, tax pardons, incentives, deductions, and special regimes established by law. A detailed account of these expenditures must be included.

Fiscal expenses are calculated using the loss of revenue methodology prescribed by the OECD. Because of that, the estimates do not include behavioral effects.

Fiscal Expenditures Budget 2004

Item	2004		
	% of GDP	Millions pesos	% of total
Total	<u>5.7457</u>	<u>407,142.0</u>	<u>100.0</u>
Income tax (ISR)	3.2036	227,011.9	55.8
Corporate	1.6662	118,074.2	29.0
Personal	1.5374	108,937.7	26.8
Value Added tax	2.0112	142,517.7	35.0
Special taxes	0.3299	23,369.5	5.7
Fiscal Incentives	0.2010	14,242.9	3.5

Fiscal Expenditures Budget 2005-2006

Item	2005			2006		
	% of GDP ^{1/}	Millions pesos	% of total	% of GDP ^{1/}	Millions pesos	% of total
Total (A+B+C+D)	<u>6.6657</u>	<u>528,873.5</u>	<u>100.0%</u>	<u>7.2487</u>	<u>617,285.0</u>	<u>100.0%</u>
A. Income tax (ISR) (A.1+A.2)	4.2454	336,841.6	63.7%	4.8517	413,153.9	66.9%
A.1 Corporate	2.7056	214,675.6	40.6%	1.1096	94,488.7	15.3%
A.2 Personal	1.5398	122,166.0	23.1%	3.7421	318,665.2	51.6%
B. Value Added tax	1.9992	158,624.6	30.0%	1.9992	170,245.4	27.6%
C. Special taxes^{2/}	0.1821	14,445.2	2.7%	0.1821	15,510.4	2.5%
D. Fiscal Incentives	0.2390	18,962.1	3.6%	0.2157	18,375.3	3.0%

1/ GDP of 7.9 trillion pesos for 2005 and a projected GDP of 8.5 trillion pesos for 2006 were used. These GDP numbers are those included in the Economic Policy General Criteria Report for 2005.

2/ Includes the Special Tax on Production and Services (IEPS), the tax on new cars (ISAN) and the tax on the use or ownership of vehicles (ISTUV).

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 a 34 percent of the federal government revenues to a 46 percent, and from a 27 percent of the primary expenses included in the PEF to almost 40 percent. Government initiatives to reduce fiscal expenditures have not prospered to date, although proposals to this effect have been part of the fiscal reform submitted to congress on several occasions.

7.3. Fiscal revenue from transfers by the public enterprises

The new fiscal regime seeks to increase the resources left to PEMEX,⁵² to contribute to eliminate the distortions present in the investment decisions of the company. At the same time, the government sought to graduate the impact of the new regime on the finances of the three levels of government, federal, state and municipal.

The pending issue is the reform of the corporate governance rules for the company which would seek to maintain the independence of PEMEX's management from political interference; clearly establish the boundaries between the government and PEMEX's responsibilities and functions; guarantee a 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.

8. Diagnosis

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 tightening of rules on the 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 the guarantees provided by the government, the preparation of a tax expenditures budget, and the approval of a new budget and fiscal responsibility law.

The off-budget operations conducted through PIDIREGAS, IPAB, FARAC, and PAD are quantified and included in a fiscal indicator (RFSP) and a debt indicator (SHRFSP), which are used in the preparation of the macroeconomic framework and are reported to congress in the quarterly reports. At the same time, the government has sought to control these operations through limits set in the budget documents and approved by congress. Nevertheless, the management of the fiscal policy does not include targets with respect to the RFSP, focusing only on the BT.

Likewise, the government has sought to identify, record, and inform congress on the trust funds, while at the same time it has tightened the rules that regulate the creation of these funds, their functioning, and the fiscal transfers which they receive. For example, the PEF for 2006 explicitly prohibits the creation of trust funds for the sole purpose of circumventing the periodicity of the budget. Also, the number of funds has been reduced, consolidating some, liquidating others which had already complied with their objectives, while some new ones have been created. However, although there is more information and control over the expenditures conducted through these funds, they are still not subject to the budget rules and process.

⁵² It is estimated that PEMEX's contributions to the federal government (taxes, levies and others) will be reduced by 9 percent in 2006 relative to 2005, falling to the equivalent of 0.6 percent of GDP.

The LIF requires that the government informs congress on the guarantees provided by the government on a quarterly basis. The contingent liabilities associated to the guarantees correspond mainly to the banking and road concessions rescue operations, and the debt of the development banks. The guarantees to the private sector in the context of the direct PIDIREGAS are provided by PEMEX with authorization from the SHCP.

In addition, there have been important changes regarding the PPP contracts and a framework has been defined for the PPS contracts. Following the experience with concessions in the 90s, Mexico has reactivated these operations establishing a legal, institutional and budgetary framework which seeks to exploit the benefits of these projects while protecting the public finances. In the budget framework, the rules require SHCP approval to commit resources on these projects, with the obligations reported in the PEF, and granted a *de jure* preferential status in the budget.

Important steps have been taken to manage PEMEX in line with corporate governance guidelines. A new fiscal regime was approved for PEMEX which reduces and limits PEMEX transfers to the government. In contrast with the existing regime which taxed sales, the main tax in the new regime is a levy on revenues minus costs. As a counterpart to this fiscal regime, the government will seek to enact a reform to the corporate governance rules of PEMEX. At the same time, the new budget and fiscal responsibility law defines a formula so that the price of oil to be used in the budget is determined by technical and not political criteria, combining the average historical price with market futures prices. However, the policy of administered prices for fuels was maintained by which they are adjusted 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 engage also in significant quasifiscal activities. The electricity companies subsidize the residential and rural consumption of energy but do not receive transfers from the federal government. The government has, however, established a compensation mechanism whereby the enterprises must pay a fixed fee to the federal government for the use of its assets. There are also implicit subsidies for water consumption, but no information is published on their amount or their distribution by type of user. The asymmetrical treatment of the BoM profit and losses—by which the profits are transferred to the government while the losses are absorbed by the BoM—could erode the BoM's capital, as occurred in 2001. The development banks conduct quasifiscal operations which contribute to explain their persistent losses and their recurrent need in the past for recapitalization by the federal government.

The government must submit an annual budget of fiscal expenditures but this is not incorporated in the discussion of the budget. The expenditures implemented through this mechanism are not only large but have increased substantially over the past few years to represent almost half of the federal government revenues and a 40 percent of the expenditures. Although part of the increase may revert in the future, fiscal expenses will continue to represent an allocation of resources conducted off-budget which is too large not to be included in the budget discussions. Moreover, there are no periodic assessments

of the fiscal expenditures, which should be a priority because of the size and trends presented by these expenditures.

The new budget law approved recently introduces significant improvements in the handling of the budget and establishes a zero balance as the target for the BT. The Law promotes fiscal responsibility and transparency and accountability in the handling of the public finances, order and certainty in the approval of the annual economic package, fiscal federalism, and the modernization of the budget process. The Law establishes that the economic package will be prepared based on medium-term projections, defines a formula to determine the price of oil on the basis of technical and not political criteria, and includes clear rules for the distribution of excess revenues. It also defines the adjustment mechanisms to be used in the event of revenue shortfalls, establishes that new laws which result in additional expenditures must identify the source of the revenues to pay for those expenditures, and limits, controls, and clearly identifies the personnel expenses of the government. In addition, it establishes rules for the allocation of resources to trust funds and to pay for delayed expenses, increases the sanctions for noncompliance with the law, advances the deadlines to submit the budget documentation to congress, and foresees instruments to allocate expenditure in a more efficient and transparent fashion.

It is important to note that the systematic compliance of the BT targets set in the PRONAFIDE 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 the off-budget operations and quasifiscal activities not included in the BT, and subsidies are granted through the reduction of taxes. Also, it makes it difficult to assess efficiency in the allocation and use of resources.

9. Recommendations

9.1. Budget management

- Define rules regarding 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.
- Define rules regarding 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 earmarked funds for the concessioned roads. Transform FINFRA into a virtual fund.
- Request the opinion of the chamber of deputies regarding the use of excess revenues larger than a 3 percent of the revenues envisaged in the LIF for investment and equipment programs and projects of states and municipalities and for investment programs and projects in the PEF.
- Define indicative targets for the RFSP to make these operations more transparent and reduce the incentives to use them as a mechanism to circumvent the budgetary restrictions imposed by the BT.

9.2 Public enterprises

- Establish a tax treatment for the public enterprises which is in line with that for the private enterprises.
- Define in the annual budget law or in the organic budget law the financial relations between the government and the public enterprises, establishing an ex ante dividends policy or predetermined rates of return on their assets.
- Periodically assess the quasifiscal operations to identify the costs for the public enterprises and establish adequate compensation and/or modify them.
- Include in the PEF the subsidies provided through the price of fuels as transfers to PEMEX and include the gross collection of the IEPS in the LIF, instead of just including the net IEPS collections.
- Include in the reform to the corporate governance rules for PEMEX a tax treatment which is in line with that applied to private companies and define an ex ante dividends policy for the company or predetermined rates of return on its assets.
- Include the subsidies on electricity consumption as transfers to the electricity companies in the PEF, while including also payments for the use by these companies of government assets.
- Prepare an annual report on the operations of the development banks and public funds seeking to identify and quantify their quasifiscal operations.
- Seek to identify the implicit subsidies provided through the development banks and public funds and record them as memorandum items in the budget documentation.

- Define a proper compensation through the budget of the implicit subsidies provided via the loans granted by the development banks and the public funds.

9.3. Tax expenditures

- Assess tax expenditures so as to reduce them and substitute them with direct expenditures.
- Include in the budget discussion an analysis of tax expenditures, including a comparison with the direct expenditures in the corresponding areas.
- The reduction of the tax expenditures constitutes an urgent priority to devolve to the budget its role as the main instrument to conduct fiscal policy.

IV. OFF-BUDGET OPERATIONS—EXPERIENCES OF OTHER COUNTRIES

The information on the country experiences described in this chapter was obtained from the fiscal ROSCs prepared by the IMF. Most of these reports were prepared several years ago and as a result, the situation at present in these countries may differ greatly from the one described in this paper. The purpose is not to assess these experiences but to show the use made in other countries of off-budget operations to serve as background for the analysis of the practices used in the countries which are the object of this study.

COLOMBIA⁵³

1. Legal framework

The legal and administrative framework for fiscal management is highly complex. Each new administration must submit to Congress at the beginning of its four-year term, which roughly coincides with the four-year term of the new legislature, a National Development Plan (PND). The General Budget of the Nation (PGN) is prepared within the framework of the administration's PND. The current expenditures budget is prepared by the Ministry of Finance and Public Credit (MHCP) and the investment budget by the National Planning Department (DPN). The Council of Fiscal Policy (CONFIS)⁵⁴ plays a coordinating role. The preparation of the PGN is centralized in the DPN which must reconcile the Financial Plan (PF), the Annual Cash Plan prepared by the National Treasury, the Annual Investment Operations Plan, the Debt Service estimates, and the draft budgets of each of the entities covered by the PGN.

2. Budget coverage

The allocation of responsibilities between the executive and legislative branches in the budgetary process is, formally, well established in the law. The PGN consists of the Revenues Budget (PI) and the Appropriations Law (LA). The PI contains the estimate of tax and non-tax revenues collected by the national government, the parafiscal contributions administered by national public establishments, the special funds, and resources obtained from borrowing, which are called capital resources. The LA includes the budgets of the constitutionally autonomous entities, the agencies of the central sector and the public establishments at the national level. The PGN does not include an estimate of tax expenditures.

⁵³ Based on IMF, "Colombia: Report on the Observance of Standards and Codes—Fiscal Transparency Module", Country Report No. 03/128, May 2003, and Jul (2005).

⁵⁴ An interministerial body presided by the Minister of Finance.

3. Role of Congress

Congress must request a written authorization from the MHCP to modify the draft PGN for increasing an expenditure item, introducing a new one, or increasing revenues. The MHCP also has an important role in executing the PGN since it is the only body authorized to propose to congress the modification of PGN appropriations.

4. Fiscal rules

The Fiscal Responsibility Law (FRL), which applies to all levels of government, requires the preparation of a Medium-Term Fiscal Framework (MFMP) that includes a Financial Plan, a multi-year macroeconomic program, targets for the primary surplus as well as the public debt level and a fiscal sustainability analysis. The national government defines a primary surplus target for the next year's fiscal exercise and indicative primary surplus targets for the following 10 years.

5. Off-budget funds

Little information is disclosed about the various trust funds that administer public funds. An example is the trust that manages the pension fund of ECOPETROL. The below-the-line estimate of the nonfinancial public sector calculated by the central bank (BR) includes the net variation of financial assets and liabilities in these trusts. Nonetheless, no information is provided to the public regarding the nature of the programs of these entities, the non-commercial component, and relationships with the government.

6. Guarantees

A law which regulates the budgetary handling of the contingent liabilities of the public entities was approved in 1998. The law requires that the MHCP approves the valuation of the contingent obligations of the state agencies and provisions them in their budgets, so that they constitute deposits in a Contingency Fund for the Public Entities' Contractual Obligations (FCCEE) established by that law. There are no budgetary appropriations to be used for obligations stemming from judicial sentences against the national government.

The FRL requires that all contingent liabilities associated with concessions, guarantees on public sector loans, and judicial suits be reported annually to congress as part of the MFMP. This requirement is applied retroactively to contingent liabilities incurred prior to the enactment of this law. An estimate of these liabilities was included in the first MFMP submitted to congress in mid-2004. The FRL also requires the reporting of the quasifiscal activities.

The expected value of the contingent liabilities was estimated at the equivalent of 4.3 percent of GDP for 2005, with more than half represented by contingent liabilities associated with judicial suits and 40 percent with the loan guarantees provided by the government to other public entities. Value at Risk estimates increase the present value of these contingent liabilities to the equivalent of 6 ½ percent of GDP, with the increase explained by the loan guarantees. The Value at Risk of contingent liabilities associated with the PPP contracts amounted to 0.8 percent of GDP for 2005, with their maximum value amounting to 3.4 percent of GDP. TELECOM's contingent payments to its partners in joint venture contracts (about 1 percent of GDP), and those associated with the long-term energy purchase contracts with some public distribution companies are not included in these figures.

7. Public-Private Partnerships (PPPs)

The PPP projects have played a key role in the development of infrastructure which would not have been realized otherwise because of budgetary constraints. However, due to optimistic assumptions on demand and a limited transfer of risk to the private sector in the first phase of the program, the cost of these projects ex post was much higher than envisaged. Using this experience, the authorities identified areas for improvement, mainly with respect to the definition and allocation of risks. The allocation of risks between the private and public investors is one of the most important features of the present PPP policy in Colombia, which seeks to establish the incentives for the private investor to assume the corresponding risks.

In 1994 the authorities introduced a mechanism known as "*vigencias futuras*" which allows the public entities to reserve future flows of budget appropriations. This mechanism allows, for example, ensuring the availability of revenues required to pay the private investor in PPPs, subject to approval by the MHCP.

The MHCP must approve the payments and guarantees committed under the PPP projects, having to authorize the necessary *vigencias futuras* for these payments, as well as approve the valuation of the contingent liabilities and define and budget the contribution plans to cover guarantees. A special unit was created in the MHCP to perform these two tasks.

Congress does not have an explicit role in the approval of these projects.

8. Public enterprises

The CONFIS approves the budgets of the nonfinancial public enterprises in which public ownership exceeds 90 percent. These enterprises do not form part of the PGN, but their budgeting must comply with the requirements of the Organic Budget Law.

The relationship between the central government and the nonfinancial public enterprises is clearly regulated, and the latter must report to CONFIS regarding their activities and profits on their operations. Some of them carry out important quasifiscal operations.

ECOPETROL sells oil derivatives at subsidized prices to distributors, who must operate with a maximum retail price. It also sells diesel fuel at subsidized prices to electricity service providers in areas not covered by the electricity network. ECOPETROL receives no transfers from the national government for these operations.

Some nonfinancial public enterprises are implicitly required to act according to public service and guaranteed coverage criteria. For example, TELECOM must ensure the supply of telephone services in rural areas. Another example is the Social Security Institute (ISS), which is ultimately responsible for providing health services to population groups that are not profitable for private providers. Estimates are prepared of the value of these subsidies but are not submitted to congress with the PGN. Sometimes the nonfinancial public enterprises receive transfers from the government for these operations, but they are insufficient.⁵⁵

In most of the regulated sector there is quite a complicated cross-subsidy system according to which low-income users receive a subsidy through the regulated rate and high-income users, as well as industrial and commercial users, pay a contribution as a percentage of the regulated rate. The Superintendencies are responsible for monitoring compliance with the cross-subsidy system on the part of the provider agencies. Except for the electricity sector, no information is published on the amount and distribution of these cross-subsidies by type of user. In general, the surcharge to high-income users is not sufficient to finance the lower prices to low-income users, so that there is a transfer from the central government to the system, which appears in the PGN.

The public banking system, which represents close to 30 percent of banking system liabilities, carries out quasifiscal operations, maintains significant contingent liabilities, and has access to financial resources under non-market conditions. For example, 23 percent of the liabilities of the Agrarian Bank are judicial deposits, which it administers in exclusivity. In addition, it must carry out 70 percent of its operations in the agricultural sector, and maintain commercial offices in areas of the country where there are no other financial institutions. The financial statements of public banks are supervised by the Superintendency of Banks (SB), but such statements do not identify the non-commercial activities that public banks carry out on behalf of the government. Public banks generally do not receive transfers from the government to fully compensate them for these activities.

⁵⁵ For example, all long distance operators must contribute 5 percent of their billings to a fund administered by the Ministry of Communications. The fund is meant to expand the population's access to telephone service, but the payment that TELECOM receives from this fund is insufficient to compensate it for its serving rural areas.

9. Budgetary norms and practices

Given that the PGN is approved on October 20, it may have to be modified by the executive branch. The government may submit to congress, for approval, proposals of supplementary appropriations as well as reallocations of appropriations between expenditure items without altering the composition of spending among operations, investment and debt service. Any supplementary appropriation must be accompanied by a certification of the availability of funds. The existence of a considerable amount of earmarked revenues and the high proportion of committed spending (entitlements) distort congressional deliberations on the PGN.

CONFIS coordinates the budgetary activity of the entire nonfinancial public sector by preparing the Financial Plan (FP), which establishes the financial goals of the public sector as a whole. However, the FP is not sent to congress with the PGN. Congress does not receive detailed information on the fiscal deficit, nor the budgets of the nonfinancial public enterprises and of the territorial entities.

The budget did not reflect the expected expenditure during the year. Due to the existence of a significant volume of payable bills and outstanding commitments, which in some years reached 2.5 to 3.0 percent of GDP, actual expenditures in cash terms used to be quite different from the level of appropriations for the year. This was the result of unrealistic programming, which was then corrected in the course of the year through rationing of cash to spending units, which in turn was offset by the possibility of deferring budget execution appropriations up to December 31 of the following year. To solve this problem, the 2003 FRL included transitory clauses to end with this practice in the 2005-2006 fiscal years.

10. Fiscal revenues from transfers by the public enterprises

The National Council of Economic and Social Policy (CONPES)⁵⁶ determines the transfers which the nonfinancial public enterprises must make to the PGN. The nonfinancial public enterprises in which public ownership is at least 90 percent may retain at least 20 percent of their profits. Otherwise, CONPES determines how profits should be distributed.

⁵⁶ An inter-ministerial body presided by the President.

EL SALVADOR⁵⁷

1. Budget coverage

The relevant definition of government used both in the General Budget of the State (PGE) and in fiscal reporting is the nonfinancial public sector, which consists of the general government sector (central government, nonentrepreneurial decentralized public institutions, and local governments), and four nonfinancial public enterprises.

2. Role of Congress

The executive is responsible for preparing the draft revenue and expenditure budget and the legislature is responsible for amending and approving it. It may reduce or reject appropriations requested, but not increase them.

3. Fiscal rules

The budget documentation contains a declaration of medium-term fiscal policy goals which serves as a framework for preparing the annual budget, and the preamble of the budget document includes fiscal projections for the budget year and two additional years. There are no fiscal rules.

4. Extrabudgetary activities

Extrabudgetary activities consist of resources not included in the PGE approved by the legislative assembly, although their management and accounting adhere to SAFI procedures, and are included in the State Financial Management Report that the government submits to the assembly within three months following the end of each fiscal year. These activities that represented 13.3 percent of the nonfinancial public sector in 2003, escape scrutiny by the assembly during the approval stage.

The main extrabudgetary activities are classified as extraordinary resources, special activity funds, and the budgets of autonomous bodies.

4.1. Extraordinary resources

The extraordinary resources consist of the economic recovery budget, the extraordinary institutional resources and the public investment budget. The first of these is financed by the Ministry of Foreign Affairs using external resources mainly from technical assistance and counterpart funds. The second, funded from transfers from the PGE, is used to develop electric infrastructure. The third, which expired in 2003, was financed from the

⁵⁷ Based on “El Salvador: Report on the Observance of Standards and Codes—Fiscal Transparency Module”, IMF Country Report No. 05/67, February 2005.

proceeds of the privatization of the telecommunications company, for use in specific projects other than those already included in the PGE investment budget.

Extraordinary resources accounted for about 4 percent of the PGE in 2002. The ratio was much higher in 2001 when exceptional revenues and expenditure amounted to 16 percent and 11 percent of the PGE income and expenditure, respectively, reflecting the larger flows of foreign funds in response to the earthquakes.

4.2. Special activity funds

Special activity funds are financed from revenues earned by budgetary entities from the sale of certain goods and services; they must be used for a specific pre-established purpose approved by the MoF.

4.3. Autonomous agencies

In addition, there are a number of decentralized agencies, called autonomous agencies, whose charters exempt their budgets from legislative approval (for example, the Armed Forces Social Security Institute). Their budgets are approved either by the government or by their board of directors.

5. Guarantees

There is no published information on contingent liabilities, tax expenditure, or quasi-fiscal activities.

The provision of information on certain contingent liabilities, essentially those of public financial institutions, is impeded by the absence of relevant information in the corresponding financial statements.

6. Public enterprises

The nonfinancial public enterprises have traditionally been regulators and administrators of legal monopolies, and some of them have carried out significant quasi-fiscal activities. However, the privatization in 1998 and 1999 of the telecommunications company (ANTEL), along with the thermal generation and some of the distribution arms of the electricity company (CEL) has resulted in increased competition, lower utility charges and the suppression of quasi-fiscal activities in these sectors. Two of the three remaining nonfinancial public enterprises hold monopolies for water, port, airport and railroad services. Of these, only the water company ANDA carries out major quasi-fiscal activities as the average tariff it charges is 25 percent lower than its unit cost.

The Central Bank (BCR) is legally independent of the government, but carries out fiscal functions on the government's behalf mainly related to restructuring and financial strengthening operations and development activities.

Government activities are not always clearly distinguished from the activities of public financial institutions. The financial public sector consists of two banks which in 2001 accounted for 4.5 percent of the assets of the banking system, in addition to nonbank public financial institutions created for various purposes. Of the latter, some perform development functions, not always under market conditions; one is an armed forces social security organization, and two were created to address problems of bank restructuring.

In 2003-2004, both public banks suffered losses as a result of the development activity that has been legally assigned to them. Of the nonbank public financial institutions, one grants mortgage loans at subsidized interest rates to affiliates of the pension system (public or private), with its resources having come basically from pension funds and another is a second-tier bank that channels funds to eligible credit institutions, essentially private banks, to lend for private sector investment.

7. Budgetary norms and practices

The president holds the right of veto on laws passed by the assembly, which can only be overturned by a two-third majority. The executive branch can transfer appropriations between budgetary items within a given sector of the public administration, provided they are not classified as nontransferable (investment, debt service, and appropriations of the budgets of the decentralized agencies). Transfers of appropriations between different sectors, and any increase (reduction) of the overall budgeted level of expenditure (revenue) must be approved by the assembly, specifying the funding sources for their financing or replacement.

8. Tax expenditures

Tax expenditures are negligible.

HUNGARY⁵⁸

1. Budget coverage

The general government encompasses the central government, the social security funds, two extrabudgetary funds, and the local governments.

⁵⁸ Based on IMF, "Hungary: Report on the Observance of Standards and Codes (ROSC)", FAD, April 2001.

2. Role of Congress

If there is no approved budget by January 1, the AFP provides for continuation of government business at the same nominal level as authorized by the previous budget law.

3. Contingency reserve

The annual budget contains a general reserve that can be appropriated by parliament within the range of $\frac{1}{2}$ to 2 percent of total budgeted spending. In addition, specific reserves can be appropriated, though typically, the total of both reserves has fallen within the range prescribed.

4. Fiscal indicators

The overall balance, the primary balance, and the government gross debt as a ratio to GDP are used as the primary indicators of fiscal policy stance.

5. Extrabudgetary funds

The extrabudgetary funds are the Labor Market Fund (funded by payroll tax contributions with no direct link to benefits and paying social benefits, funding training schemes, and investing to create new jobs), and the Central Nuclear Fund. All such funds are required to be presented with the annual budget, their accounts are handled by the central treasury, are included as annexes to the government final accounts, and are subject to the same basic rules and procedures as budget institutions.

6. Guarantees

The government is required to provide the legislature with details of the guarantees issued, the legal authority for providing such guarantees, and any payments related to calls on such guarantees. Guarantees are bound by an overall limit set by the legislature in the annual budget law and by individual ceilings for certain public financial institutions; guarantees issued above this limit must be explicitly approved by parliament prior to issuance. The overall ceiling was 2.2 percent of total budget expenditures in 2001, and can be changed in the annual (or biennial) budget document or, as in 2000, as a supplementary authorization approved by parliament.

Guarantees include individual guarantees issued directly by the government and also guarantee programs that are managed by authorized public financial institutions. The annual budget law also makes provision each year, based on unpublished sectoral risk analyses, for expected payments on guarantees called. The government may charge the borrower up to 0.5 percent of the guaranteed amount (but is authorized to dispense with

the fee) and issuance of all guarantees is required to be reported case by case to the State Audit Office.

7. Public enterprises

Some public enterprises, financial and nonfinancial, are required to undertake noncommercial activities on behalf of the state. The public financial institutions operate to support state infrastructure, agriculture, housing, foreign trade practices, and medical practices. Support for such activities is provided either directly in the budget, by the Privatization Company, or through the issuance of government guarantees.

Regulation is sometimes used as a mechanism for quasi-fiscal activities such as price regulation of energy and telecommunications, which provides implicit subsidies to consumers (although there have been recent efforts to rebalance tariffs to reflect costs).

Some fiscal activities of enterprises are covered by direct appropriations, but quasi-fiscal activities of the government are not comprehensively reported in budget documents.

7.1. Privatization Company

The privatization operations are generally transparent and subject to scrutiny by the legislature, but some discretionary spending of privatization receipts are permitted. The activities of the Privatization Company are outside the Hungarian State Treasury. Some of the expenditures of the agency are approved by parliament as an annex to the annual budget law, and their execution is reported in an annex to the Report on the Fulfillment of the Annual Budget Law (although the detail of the expenditures are lacking). Other expenditures, covering various regulatory and contractual obligations, are not appropriated by the legislature, but are regulated by the annual budget law and paid out of a special reserve created for this purpose. This reserve is financed by explicit budgetary transfers to the agency and by those privatization revenues which exceed the levels envisaged in the Budget Law. The government also has legal authorization to instruct the agency to make capital transfers without prior parliamentary approval.

8. Budgetary norms and practices

From 1999, the timetable has incorporated the elements of a medium-term budget framework, which is approved by cabinet and adopted by the government through a parliamentary resolution. On the basis of the guidelines, the ministries and state organs prepare their budget requests and submit them to the MoF.

The Act on Public Finances (APF) delegates considerable authority to the government and to budget institutions to make decisions on expenditures, to conduct financial management within their budget limits, to utilize past year's surpluses, and reallocate among budget items. The MoF has flexibility to decide which unspent appropriations

may be carried over outside of the budget year to cover contractual commitments as detailed in the APF. Autonomous budget institutions (about half of the central budget institutions and 60 percent of local budget institutions) are able to use higher-than-forecast revenues to fund above-budget expenditure. Furthermore, additional expenditure appropriation authority can be approved at the time of the Report on Fulfillment of the Annual Budget, or also by government resolution when government revenue comes in above budgeted levels. The government can also make decisions on allocating privatization receipts.

The government has put in place a system of two-year budgeting and multi-year planning. These two-year budgets apply to the central government, the social security funds, and the two extrabudgetary funds. The two-year budget essentially strengthens the role of the medium-term budget framework (MTBF) by making the second year of the MTBF projections into actual appropriations (rather than simply technical projections), and thus allows the government to return to parliament only every other year for budgetary approval. However, the biennial budget continues to provide a separate appropriation for each year and the government is required to submit final reports after the end of each calendar year. The APF also provides discretion to the government to submit a supplementary budget at any time during the two-year period should there be significant deviations in the macro-fiscal outlook.

9. Tax expenditures

The report on the budget outturn provides partial information on tax expenditures. Information is provided in the Final Report on Fulfillment of the Budget on exemptions under the personal or corporate income tax laws insofar as they can be quantified. The size of the indirect income tax exemptions is not reported however.

INDIA⁵⁹

1. Budgetary norms and practices

Budget data are a generally reliable guide to central government operations. However, there are three supplementary budgets a year which can lead to sizable expenditure increases. While there has been progress in making supplementary budgets self-financing, they can still undermine the realism of the initial budget approved by parliament.

⁵⁹ Based on IMF, "India: Report on the Observance of Standards and Codes (ROSC)", FAD, February 2001.

A comprehensive set of central government budget and accounting documents is published that cover all central government accounts (the consolidated fund, the contingency fund, and the public account).

2. Fiscal indicators

In addition to the overall fiscal deficit, the revenue deficit (i.e., the difference between current revenue and current spending) and the primary deficit are used as summary indicators of fiscal policy in the budget documents. Data on arrears are not routinely provided by the accounting system.

3. Fiscal rules

A Fiscal Responsibility and Budget Management Bill submitted to parliament in December 2000 is intended to provide a framework for the formulation and implementation of fiscal policy by the central government in a manner consistent with achieving long-term macroeconomic stability and intergenerational equity. It also would require that contingent liabilities should be disclosed. The Bill also requires the elimination of the revenue deficit (followed by revenue surpluses), and reduction in the overall fiscal deficit and government debt to specific target levels, by stated dates.

4. Guarantees

The budget documents include information on all central government guarantees. In addition, the central government has recently created a Guarantee Redemption Fund, while some states have set up sinking funds to recognize and provide for the budgetary implications of guarantees.

5. Public enterprises

The public financial and nonfinancial enterprises play an important role in India. The Code, however, does not apply to these entities, nor there is it required under the Code for the central government to systematically provide information about public sector finances. However, the quasifiscal activities of the financial and nonfinancial public enterprises are covered by the Code. There is no information on quasifiscal activities.

The nonfinancial public enterprises are subject to policy directives regarding pricing and employment which result in significant quasifiscal activities, and in particular extensive subsidies at both the central and state levels. There are significant subsidies on selected petroleum products provided through an administered price mechanism operated by the Oil Coordination Committee (OCC).

The banking and financial sector is predominantly under government ownership and it engages in quasifiscal activities. Public sector banks (along with private and foreign banks) have to meet quantitative norms for priority sector lending. While much of this lending is at market-related interest rates, constraints on portfolio choice give rise to credit risk that is not reflected in interest rates. There are interest rate caps on small loans. Public insurance companies provide subsidized insurance and benefit from lower taxation in return.

Over Manning of the nonfinancial public enterprises (as well as of public sector banks and public financial institutions) is also an important quasi-fiscal activity.

6. Tax expenditures

There is no information on tax expenditures.

KOREA⁶⁰

1. Budget coverage

The consolidated central government is made up of 1 general account, 5 public enterprise special accounts, 18 other special accounts and 43 extrabudgetary funds. The number of extrabudgetary accounts changes from year to year, but a list of them is published in the budget documents. Coverage of the operations of the consolidated central government in the annual budget is partial; around 31 percent of spending is covered by the extrabudgetary funds and not subject to ex-ante legislative approval. The activities of the 18 other public funds are not included in the consolidated central government but their activities are reported to the public or to the National Assembly annually.

2. Fiscal indicators

The overall balance of the consolidated central government is the main indicator of the financial position of the government.

3. Fiscal rules

The government is not bound by any formal fiscal rules approved by the legislature although it can only issue debt up to the limits approved annually by the legislature. However, the government is able to finance significant sums through alternative channels without the approval of the Assembly.

⁶⁰ Based on IMF, "Korea: Report on the Observance of Standards and Codes (ROSC)", FAD, January 2001.

4. Extrabudgetary funds

For the extrabudgetary funds, the legal authority to use public funds is provided when funds are established, but spending agencies do not need to get legislative approval for spending on an annual basis (a resolution of the State Council and approval of the President is sufficient). The 18 public funds outside the consolidated central government, however, require authorization for their spending only from the line ministry in charge of the fund. While resorting extensively to the use of supplementary budgets following the financial crisis, the government now intends to move away from them.

5. Direct loans and guarantees

The government extends loans and guarantees for commercial operations through the budget, but it also provides such support outside the budget, which amount to hidden subsidies to loan and guarantee recipients. Intra-government transactions are also not always transparently conducted as is typified by nonmarket financing of the budget by the extrabudgetary funds.

Information on the total size of guarantees is reported separately to the legislature on an annual basis. There is no quantification of the likely liability resulting from such guarantees. Other implicit liabilities of the government, for example the debts of the occupational pension plans, are not disclosed.

6. Public enterprises

Nonfinancial public enterprises are, on the whole, run on a purely commercial basis although certain public enterprises perform roles that are essentially fiscal in nature (mainly in executing public infrastructure spending). The budget does not include information on the quasifiscal operations.

7. Budgetary norms and practices

The budget is guided by an underlying medium-term framework that is revised and published on an annual basis, although the budget itself does not contain medium-term projections of fiscal aggregates. Fiscal management is covered by comprehensive laws and rules that apply to budgetary and extrabudgetary activities.

The responsibility for the management of budgetary and extrabudgetary activities is split between the Ministry of Planning and the Ministry of Finance. The MoF is responsible for revenue projections and for constructing the macroeconomic framework, while the MP is responsible for spending and privatization aspects of the budget.

The proliferation of extrabudgetary funds, each managed by different line ministries, and the extensive use of earmarking of various revenue sources, has complicated the handling of overall public finances.

8. Tax expenditures and earmarking of revenues

Tax legislation is unnecessarily complex with a plethora of statutory tax preferences that serve to erode the tax base and decrease transparency. There is also extensive earmarking of revenue sources to the special accounts and extrabudgetary funds controlled by the line ministries.

The MoF began to report direct tax expenditures to the assembly from 1999 and plans to include indirect tax expenditures from 2000.

POLAND⁶¹

1. Budget coverage

The boundary between the general government and the rest of the economy is, for the most part, clearly specified. There is however some confusion on whether the activities of particular extrabudgetary funds and state agencies are of a fiscal character. The central government—making about two-thirds of the general government—is defined as comprising the state budget, 9 special purpose social security funds, 7 other extrabudgetary funds, and a number of budgetary enterprises, auxiliary units, cultural entities and public universities.

There is a clear legal and administrative framework for budgetary and extrabudgetary operations but, in practice, the framework is not always adhered to.

The annual budget covers all central government operations in detail while activities of the extrabudgetary funds are appended as annexes to the state budget. The gross flows through some public sector agencies are not reported in budget documents, but this accounts for a small portion of total spending.

2. Fiscal indicators

The main indicator of fiscal policy currently used by the government is the consolidated general government economic deficit. This represents the general government overall balance on a cash basis adjusted for transfers to the second pillar of the social security

⁶¹ Based on IMF, “Poland: Report on the Observance of Standards and Codes (ROSC)”, FAD, February 2001.

system, the sale of mobile phone licenses, and the payments to compensate workers for the loss of wages suffered due to past high inflation.

3. Fiscal rules

The central government is bound by two primary fiscal rules. One rule is that the annual budget nominal deficit cannot be exceeded without parliamentary approval. This, however, has led to overly conservative revenue projections and the inclusion of spending reserves in the budget, as well as circumvention of the limit through complex accounting procedures. For example, transfers made to meet shortfalls in the state pension fund in 1999 were treated as financing, and thus did not affect the reported budget deficit on a cash basis. The nominal deficit rule may also lead to the build-up of arrears and nontransparent debt practices to show a lower cash deficit (e.g., by using discount instruments).

The other fiscal rule is that the national public debt has a constitutional limit of 60 percent of GDP. The debt limit is accompanied by a gradual increase in borrowing restrictions when the debt ratio rises above 50 percent of GDP. The limit applies to public sector debt including warranties and guarantees of the government.

4. Extrabudgetary funds

Transactions outside the budget and the extensive use of earmarking, mainly in the revenues for the extrabudgetary funds, are tolerated; hence the universality of the budget as the principal instrument of fiscal control is not adhered to. The proliferation of extrabudgetary funds at both central and local levels serves to complicate transparency in the roles of various public institutions.

5. Direct loans

Net lending is treated as financing of the deficit. There are numerous examples of net lending activities, mostly to off-budget funds, being used to reduce the deficit as measured by the government. For example, in 1999 the government needed to pay higher-than-budgeted amounts for miners' severance pay but, rather than seeking an explicit budget authorization, the spending was conducted by the Labor Fund lending the required amount to the Industrial Restructuring Agency who then made the severance payments.

There is also an inconsistent treatment of arrears between fiscal years and an unclear treatment in budget statistics of European Union grants and cofinancing. For example, compensation payments to pensioners and civil servants for previous nonpayment of

wages and benefits are treated as financing despite the budget being presented on a cash basis.

6. Guarantees

The budget does not contain a statement of the stock of contingent liabilities, although the government intends to report the stock of guarantees as part of the budget (and, since May 2000, has published this information in quarterly reports).

7. Public enterprises

The government's holdings in nonfinancial public enterprises are run on commercial grounds or with clear state subsidies. The budget does not include information on quasifiscal activities.

8. Budgetary norms and practices

Some spending authorizations do not expire at the end of the fiscal year, in particular, spending financed by foreign credits, foreign grants, or spending as specified by the Council of Ministers, and some spending is executed on the basis of the previous year's budget (although it is subject to a separate financial plan).

Funds and agencies can unilaterally reallocate spending among budget items and some do so without informing the MoF of their actions. It is not clear that the budget provides for the full cost of all programs (evidenced by past arrears and the systematic use of budgetary reserves) and complete information on costing assumptions is not included in budget documentation.

9. Tax expenditures

The budget does not include information on tax expenditures.

TURKEY⁶²

1. Budget coverage

Fiscal management is hampered by the limited coverage of the budget. A sizeable portion of public spending takes place outside the budget, with little or no control and reporting. Until 1999 there were 13 extrabudgetary funds, accounting for 15 percent of the central government primary expenditure or about 3 percent of GNP, not subject to parliamentary review within the budget process.

The coverage of the budget subject to parliamentary approval excludes revolving funds and extrabudgetary funds operated by central government agencies and social security institutions. The budget includes transfers to social security institutions, state-owned enterprises, extrabudgetary funds, and revolving funds, but budget documents contain no information on their policies and on their financial situation. A large portion of foreign-financed projects are not included in the budget.

2. Fiscal indicators

The main fiscal policy indicators are the overall balance and the primary balance of the central government budget. Budget documents do not include any quantitative or qualitative assessment of medium-to long-term fiscal sustainability, or an analysis of the stance of fiscal policy by focusing, for instance, on the operational balance. Although a five-year Development Plan is prepared, it is not updated on a yearly basis.

3. Budget funds

The central budget incorporates a large number of so-called budgetary funds, such as the Mass Housing Fund, which in practice operate as off-budget institutions since the budget only accounts for the transfer of appropriations but not for their total revenue and expenditure.

4. Extrabudgetary funds

There are some 3,000 revolving funds and agencies with special accounts, mainly concentrated in the health and education sectors, conducting off-budget operations amounting to more than 1 percent of GNP. An increasing portion of public activities, notably social security services, take place through public foundations set up within budgetary agencies without being subject to regular accounting and reporting requirements.

⁶² Based on IMF, "Turkey: Report on the Observance of Standards and Codes (ROSC)", FAD, June 2000 and IMF, "Turkey—Update to the Report on the Observance of Standards and Codes, 2002", April 2002.

Moreover, social security institutions' expenditures accounting for about 8 ½ percent of GNP in 1999 are outside budget coverage; they report to their respective line ministries and are audited by the High Auditing Board, which is under the Prime Minister's Office, but their reports are not publicly available.

5. Guarantees

Public guarantees are extended to state-owned enterprises, local governments, extrabudgetary funds, public and private development banks, and universities. Information on contingent liabilities, most notably government loan guarantees, has been made publicly available since late 1999. This information is available on the treasury website. However, the information does not indicate the aggregate maturity of the guarantees nor does it provide an overall analysis of the probability of realization. Thus, their potential budgetary cost cannot be assessed.

In addition, the sizeable contingent liabilities arising from guarantees in the context of build-operate-transfer operations are not yet published.

6. Public-Private Partnerships (PPPs)

Under these arrangements, a private sector entity is given a permit to operate a facility for a specified period during which it is responsible for capital improvement and maintenance, while being entitled to a financial return. To this end, government guarantees are issued to ensure determined levels of product sales and/or input use, and final payments in connection to returning the facility to the government, as well as to provide short-term loans.

7. Public enterprises

Government involvement in the economy through state-owned enterprises and banks takes numerous forms which are not always reflected in budget documents.

The government budget does not fully reflect the costs of noncommercial activities conducted by the nonfinancial public enterprises. One of the main aspects of the relation between government and nonfinancial public enterprises are the so-called "duty losses" incurred in providing goods and services below cost or purchasing agricultural products above world market prices (mostly tobacco, cereals, and sugar beets). Until recently, these operations went unreported in the central government budget or were significantly underestimated. As a result, the nonfinancial public enterprises run arrears on their tax liabilities and social security contributions.

In this context, tax offsetting and consolidation have been a constant practice in the past. In 1999, the duty losses amounted to about 1 ½ percent of GNP, of which only a marginal

share was appropriated for in the central government budget while about 1 percent of GNP (of a 2 percent of GNP which the government owed the enterprises) was allowed to be offset against liabilities (on-lent or guaranteed credit) due to the central government. Tax offsets were granted in annual budget laws in a limited number of cases.

Until recently, the government budget did not fully reflect the cost of state-owned banks' noncommercial activities. The two largest state-owned banks provide subsidized credits to farmers and small and medium enterprises. The outstanding stock of duty losses reached 12 ½ percent of GNP at end-1999 because of these operations. The 2000 budget included an explicit appropriation for the cost of credit subsidies extended by public banks while at the same time fazing them out, and the outstanding stock of duty losses is envisaged to be securitized and remunerated.

8. Budgetary norms and practices

Fiscal management responsibilities are fragmented among various institutions. Three institutions are involved in budget preparation, execution and control: the MoF, the Planning Organization (SPO), and the treasury, each headed by a different minister. The MoF is responsible for budget preparation, execution, accounting and reporting, and revenue collection. The SPO is responsible for preparing the public investment program and the macroeconomic framework, and for reporting public sector statistics. The treasury is responsible for cash and debt management, most extrabudgetary funds, and state-owned enterprises. In some instances—interest payments, transfers to social security institutions—budget execution is in practice controlled at the payment stage by the treasury, with discretion in prioritizing cash requests from spending units.

Budget preparation is principally driven by line ministries' bids for increased spending (bottom-up approach) and downward reviews by the MoF.

Because of high volatility of the macroeconomic environment and of inadequate consideration of fiscal risks, deviations between budget estimates and outcomes have been substantial in the past. On average, nominal primary expenditure exceeded budget estimates by some 20 percent during 1989-97, leading to the adoption of supplementary budgets.

Accounts are kept open for an additional period ("offset period") after the end of the fiscal year, during which accounting of transactions in connection with the previous period continues. Some liabilities (deferred payments, non-cash generating loans) and assets that do not generate cash are recorded. Commitments are not recorded and monitored so that arrears on unpaid bills may accumulate without being detected.

9. Tax expenditures

The budget documentation does not include information on tax expenditures.

V. CONCLUSIONS

1. The off-budget operations of the countries reviewed for this paper require some alternative guidelines to the ones defined by the OECD. The experiences of these countries show that their off-budget practices are more diverse than those for which the OECD has defined best practices guidelines. Also, these countries present some characteristics in their handling of the budget process which require an adjustment of the OECD guidelines. In addition, some of the alternative guidelines respond to differences in regards to some conceptual points on which the OECD guidelines are based, which is the case for direct loans and guarantees. For all these reasons, the paper proposes and discusses guidelines which complement and/or substitute those defined by the OECD, and bases its recommendations on both sets of guidelines.
2. The proliferation of off-budget operations has depended on the budget constraints faced by a country. The analysis of the off-budget practices shows that the proliferation in their use has depended to a large extent on the budget constraints faced by the countries, which in turn have been conditioned by political, economic and social factors. Likewise, the reduction or elimination of these operations has depended mainly of the same factors.
3. The budget norms and practices themselves have contributed to the use of off-budget operations and to weaken the role played by the budget as the main instrument of fiscal policy. The approved budget ends not being a good indicator of the execution of the budget. These norms and practices include an optimistic revision of the revenue estimates by congress, excessive flexibility in the treatment of the float, and too much discretion is allowed for increasing and reallocating expenditures both by congress and the government. On the other hand, rules which seek to ensure compliance with the macroeconomic targets such as the 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 use of mechanisms like the off-budget operations to be able to comply with the letter of the law, although not necessarily with its spirit.
4. The use of the off-budget operations responds to various motives. Guarantees may be used to circumvent short-term budget constraints. Others, such as the quasifiscal activities conducted through administered prices, credit requirements, tax surcharges and/or the appropriation of the profits of the public enterprises, and the earmarking of revenues and expenditure requirements, may be justified on social grounds, on market failures, or because it is administratively impossible to implement a well targeted subsidy program. Finally, other off-budget operations such as tax expenditures may present an alternative to allocate resources without being subjected to the budget process and to circumvent the fiscal rules.

5. Over the past few years, countries have recognized the need to tighten the rules which regulate off-budget operations. Brazil, Chile, and Mexico have made important progress in regularizing these operations, while Ecuador shows less progress experiencing some backpedaling as a result of the 1999-2000 economic crisis and political instability.

6. Three stages can be distinguished in the process to regularize the off-budget operations. First they are made more transparent, then they are reduced, and finally they are integrated in the budget. To make them more transparent they are identified, quantified, and information provided in the budget documentation. To reduce them, quantitative and qualitative limits have been imposed. To integrate them in the budget several mechanisms have been used, including the transformation of the off-budget funds into virtual funds, the compensation of the quasifiscal 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 piece of resistance, with none of the countries reviewed complying with more than two of the OECD guidelines in this respect.

BRAZIL

7. Brazil has achieved significant progress in the management of the public finances over the past few years. The cornerstone of this effort was the approval of the FRL in May 2000. The reforms have improved the realism of the federal budget and its consistency with the macroeconomic constraints as well as its effectiveness for resource allocation. The budget is characterized by a wide coverage and by being backed by medium-term targets. There are no extrabudgetary funds and although several budget funds exist, they are an integral part of the federal budget and must comply with all the procedures of the preparation and execution of the budget. The budget documentation establishes fiscal targets for the federal government and nonfinancial public enterprises for the current fiscal year and for the following three years. It also provides information on budget execution for the preceding two fiscal years and on contingent liabilities and tax expenditures.

8. An excessive earmarking of revenues persists nevertheless, which together with the expenditure requirements leaves little space for discretionary spending. This constitutes a problem because the budget is exposed to shocks, both external and internal, which may force to under-execute the budget.

9. In turn, the budgetary norms are characterized for allowing too much flexibility to congress in the estimation of revenues and total expenditure, for the execution of the discretionary spending and that associated with earmarked revenue, for the handling of undisbursed commitments, for the use of supplementary appropriations, and in regards to the deadline for the approval of the budget by congress, all of which contribute to diminish budgetary discipline and increase budget rigidities. A kind of vicious circle

develops regarding the executive's capability of implementing the budget approved by congress, which weakens the allocation and administrative functions of the budget.

10. The budget process is characterized by excessive "armoring". The fiscal rules are numerous and seek to attain several objectives simultaneously, which together with an extensive earmarking of revenues and expenditure requirements contributes to a compartmentalization and possibly inconsistencies in the allocation and use of resources. The PPP contracts may be an example in which this excessive armoring may be delaying the actual implementation of projects.

11. Brazil has sought to implement a framework for PPPs which prevents that these contracts are used to circumvent the budget. The philosophy behind the PPPs seeks to have the fiscal responsibility rules respected in their execution, to obtain transparency in the procedures and decisions, and achieve an objective assignment of risks between the parties, which ensures the financial sustainability and the exploitation of the socioeconomic advantages of the projects. Concessions in which more than 70 percent of the remuneration of the private investor is paid by the public entity have to be approved by congress.

12. Brazil has achieved significant progress in relation to quasifiscal activities and guarantees. The quasifiscal operations have been reduced significantly and the budget includes transfers to cover the ones that remain. In this respect, Brazil constitutes an exception to the use of the public nonfinancial enterprises as a venue to conduct quasifiscal operations through administered prices or the appropriation of the enterprises' surpluses. Public enterprises may not receive fiscal privileges which are not extended also to the private sector. However, the complexity of the credit programs implemented through the public financial institutions makes it difficult to estimate the cost and subsidies of these programs, and the minimum reserve requirements on private deposits are high, constituting a source of revenues for the central bank which is not included in the budget. Strict rules are applied for the granting of guarantees by the federal government, and although there are no rules for the granting of guarantees to the private sector, these are not provided.

13. The practice on tax expenditures does not appear to follow the legal rules. Although the FRL defines strict requirements for the granting of fiscal benefits, it appears that in practice it is possible to circumvent these requirements. The fiscal benefits not only are increasing relative to the tax revenues collected on the taxes for which they are granted, but systematic assessments of these benefits have not been conducted nor are they discussed as part of the budget process.

CHILE

14. The structural balance rule has contributed to obtain significant progress in the handling of the budget. The use of the structural balance concept as the fiscal target has been crucial for the handling of the budget because in addition to its importance from a macroeconomic point of view, it has served as the framework to incorporate in the budget the extrabudgetary operations conducted under the Reserved Copper Law. The interest obligations accrued on the bonds issued to cover pension liabilities and the operations of the Stabilization of Petroleum Prices Fund have also been integrated in the budget. In turn, the Copper Compensation Fund was integrated in the budget as a financing item and the Infrastructure Fund was transformed into a virtual fund.

15. Chile has made progress also in relation to the direct loans, guarantees and reserved expenditures. It has sought to reduce the volume of direct loans and has taken measures to increase the efficiency of the lending operations, with the government acting as a second-tier institution and the private banks assuming the loan risk. Also, guarantees and contingent liabilities have been made more transparent by providing information on them in the budget documentation. In turn, methodologies have been developed to estimate the expected values of the guarantees provided under the PPP contracts. Reserves expenditures as well as the size of the contingency reserve have been reduced also. Presently, congress is discussing a draft fiscal responsibility law which seeks to institutionalize the structural balance rule, tighten the guarantee regime, and create a Pension Reserve Fund and an Unemployment Contingency Fund.

16. There has been progress also in regards the activities of the public enterprises. There is a draft bill on corporate management for private and public enterprises being discussed by congress, which seeks to harmonize certain principles for both types of companies. This law would regulate also the quasifiscal activities conducted by the public corporations, with directors of these enterprises not responsible for the costs of these activities, provided that before proceeding with their implementation they have received the authorization of the ministry of finance via a decree which specifies, among other, the transfers to be received to cover the estimated costs of the operations. However, the bill does not contain provisions to align the tax regime and the dividends policy of the public companies with those of the private companies.

17. Budgetary norms and practices do not constitute an important source of distortions in the handling of the budget process. The role played by congress is secondary to that of the government as it may not increase revenues or total expenditures, or reallocate expenditures among programs. Normally the approved budget is a good indicator of the budget which is executed, although the budget norms permit that some expenditures exceed their budget appropriations automatically and that the government exceeds by a given percentage certain expenses such as investment. The discretionary contingency reserve (about 1 percent of total expenditures) permits also to effect expenses not authorized in the budget. The government has sought to implement temporary as well as permanent mechanisms to increase the fiscal space for discretionary

spending such as the Supplementary Distribution Provision in the 2006 budget and the Bidding Funds.

18. The off-budget operations are implemented mainly through the public enterprises. Quasifiscal activities are conducted by ENAMI, METRO, the State Railways (EFE) and Correos (the Post Office), and in 2005 by ENAP. ENAP's quasifiscal operations were offset in 2005 through a lower transfer of profits, while those of METRO and EFE are offset through government guarantees on their loans and government direct repayments of their external debt. Correos is exempt from the VAT and grants cross-subsidies. Also, the tax regime of most of the more important public enterprises applies a 40 percent tax surcharge on profits, while the dividends policy requires the public enterprises (except for ENAP since 2005) to transfer to the government all or almost all of their profits after taxes.

19. Another form of extrabudgetary operations is direct lending. The implicit subsidy of the direct loans is not estimated or included in the budget, which does not include also the flows of loans and payments because according to the GFSM 2001 and the accrual budget accounting being used, these operations are classified as financing as they do not affect the government's net worth.

20. Tax expenditures potentially constitute a venue through which off-budget operations could be increased. Starting in 2003, tax expenditures are estimated and the information is included in the budget documentation together with a description of the methodology used in the estimation. However, there is no analysis of these operations, they are not discussed in the budget process, and no periodic assessments are conducted either.

ECUADOR

21. Ecuador has made progress in certain areas of the management of the budget through the implementation of a FRL and the provision of information. The integration in the budget of the petroleum revenues from heavy crude oil as well as the identification of the use of these resources are important steps in this direction, unlike the increase in the earmarking in the use of these resources.

22. The budget framework has deteriorated over the past few years. This deterioration reflects changes in the budget rules which have resulted in a fractioned legal framework; the intensification of the earmarking of revenues and expenditure requirements; and an increase in the size of the off-budget operations. The starting point to reform the budget framework could be the approval of an organic budget law of the type the country had years ago, before that the enactment of different norms led to a situation in which there are different rules, without a clear hierarchy, for the different aspects of the financial management of the government.

23. The coverage of the budget is limited. The revenues and expenditures of the central government are recorded in net terms, with a significant part of the budget revenues and the expenditures associated to these revenues not included in the budget. This, together with substantial off-budget operations, result in a budget which significantly underestimates the size of the government operations. The budget does not include projections despite the requirement established in the FRL that investment expenditures are presented in a multi-year form.

24. Also there are no clear fiscal indicators while at the same there are many fiscal rules. Fiscal indicators such as for example the overall balance or current account balance, or financing requirements are not used to define fiscal policy targets. The emphasis appears to be on those indicators on which the FRL imposes rules such as the growth rate of primary expenditure (excluding investment), the non-oil deficit, the rate of growth of the operational expenses of the development banks, and the ratio of the public debt to GDP. The fact that the fiscal rules apply to the approved budget and not to the actual fiscal outturns allows in practice that these rules, except for that on the public debt, have not been complied with ex post.

25. The management of the budget is characterized by substantial off-budget operations. These include mainly the quasifiscal activities of PetroEcuador, the electricity, telecommunication and Solidarity Fund companies, and the development banks; earmarking of revenues and expenditure requirements; and tax expenditures. PetroEcuador must also transfer all its revenues to the budget after deducting its costs, with the determination of these done in a nontransparent fashion and subject to negotiation. The government is also able to cut the investment budget of PetroEcuador arbitrarily. The subsidies on the consumption of fuels which are granted through administered prices are large and growing rapidly, and are offset through lower payment of taxes. The implicit subsidies granted to electricity consumption are also significant and growing, with the budget identifying only part of them starting in 2005. Although there is no quantification of tax expenditures, it is estimated that they are not only significant but increasing.

26. 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.

27. The budgetary norms and practices contribute to the creation of off-budget operations and weaken the role of the budget. The budgetary norms allow the government to exceed total expenditure budget appropriations by 5 percent without congressional approval. In addition, congress approves the expenditures at a very aggregated level, which together with the fact that it may modify the composition of the expenses and that the government may reallocate expenses without congressional approval, may result in an approved budget which is not a good indicator of the budget that is executed.

MEXICO

28. 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 tightening of the 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 the guarantees provided by the government, the preparation of a tax expenditures budget, and the approval of a new budget and fiscal responsibility law.

29. Some off-budget operations are included in a fiscal indicator and a debt indicator which are used in the preparation of the macroeconomic framework and are reported to congress. The extrabudgetary operations conducted through PIDIREGAS, IPAB, FARAC, and PAD are quantified and included in the RFSP and in the SHRFSP to be used in the macroeconomic analysis, and reported to congress in the quarterly reports. At the same time, the government has sought to control these operations through limits set in the budget documents and approved by congress. Nevertheless, the management of the fiscal policy does not include targets with respect to the RFSP, focusing only on the BT.

30. Likewise, the government has sought to identify, record, and inform congress on the trust funds, while at the same time it has tightened the rules that regulate the creation of these funds, their functioning, and the fiscal transfers which they receive. For example, the PEF for 2006 explicitly prohibits the creation of trust funds for the sole purpose of circumventing the budgetary constraints. Also, the number of funds has been reduced, consolidating some, liquidating others which had already complied with their objectives, while some new ones have been created. However, although there is more information and control over the expenditures conducted through these funds, they are still not subject to the budget rules and process.

31. The LIF requires that the government informs congress on the guarantees provided by the government on a quarterly basis. The contingent liabilities associated to the guarantees correspond mainly to the banking and road concessions rescue operations, and the debt of the development banks. The guarantees to the private sector in the context of the direct PIDIREGAS are provided by PEMEX with authorization from the SHCP.

32. There have been important changes regarding the PPP contracts and a framework has been defined for the PPS contracts. Following the experience with concessions in the 90s, Mexico has reactivated these operations establishing a legal, institutional, and budgetary framework which seeks to exploit the benefits of these projects while protecting the public finances. In the budget framework, the rules require SHCP approval prior to the commitment of resources on these projects, with the obligations to be reported in the PEF, and being granted a de jure preferential status in the budget.

33. Important steps have been taken to manage PEMEX in line with corporate governance guidelines. A new fiscal regime was approved for PEMEX which reduces and limits PEMEX's transfers to the government. In contrast with the existing regime

which taxed sales, the main tax in the new regime is a levy on revenues minus costs. As a counterpart to this fiscal regime, the government will seek to enact a reform to the corporate governance rules of PEMEX. At the same time, the new budget and fiscal responsibility law defines a formula so that the price of oil to be used in the budget is determined by technical and not political criteria, combining the average historical price with market futures prices. However, the policy of administered prices for fuels was maintained by which they are adjusted 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.

34. Other public enterprises engage also in significant quasifiscal activities. The electricity companies subsidize the residential and rural consumption of energy but do not receive transfers from the federal government. The government has, however, established a compensation mechanism whereby the enterprises must pay a fixed fee to the federal government for the use of its assets. There are also implicit subsidies for water consumption, but no information is published on their amount or their distribution by type of user. The asymmetrical treatment of the BoM profit and losses—by which the profits are transferred to the government while the losses are absorbed by the BoM—could erode the BoM's capital, as occurred in 2001. The development banks conduct quasifiscal operations which contribute to explain their persistent losses and recurrent need in the past for recapitalization by the federal government.

35. The government must submit an annual budget of fiscal expenditures but this is not incorporated in the discussion of the budget. The expenditures implemented through this mechanism are not only large but have increased substantially over the past few years, to represent almost half of the federal government revenues and a 40 percent of the expenditures. Although part of this increase may revert in the future, fiscal expenses will continue to represent an allocation of resources conducted off-budget which is too large not to be included in the budget discussions. Moreover, there are no periodic assessments of the fiscal expenditures which should be a priority because of the size and trends presented by these expenditures.

36. The new budget law approved recently introduces significant improvements in the handling of the budget and establishes a zero balance as the target for the BT. The Law promotes fiscal responsibility and transparency and accountability in the handling of the public finances, order and certainty in the approval of the annual economic package, fiscal federalism and the modernization of the budget process. The Law establishes that the economic package will be prepared based on medium-term projections, defines a formula to determine the price of oil on the basis of technical and not political criteria, and includes clear rules for the distribution of excess revenues. It also defines the adjustment mechanisms to be used in the event of revenue shortfalls, establishes that new laws which result in additional expenditures must identify the source of the revenues to pay for those expenditures, and limits, controls and clearly identifies the personnel expenses of the government. In addition, it establishes rules for the allocation of resources to trust funds and payment of delayed expenses, increases the sanctions for noncompliance with the law, advances the deadlines to submit the budget documentation

to congress, and foresees instruments to allocate expenditure in a more efficient and transparent fashion.

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