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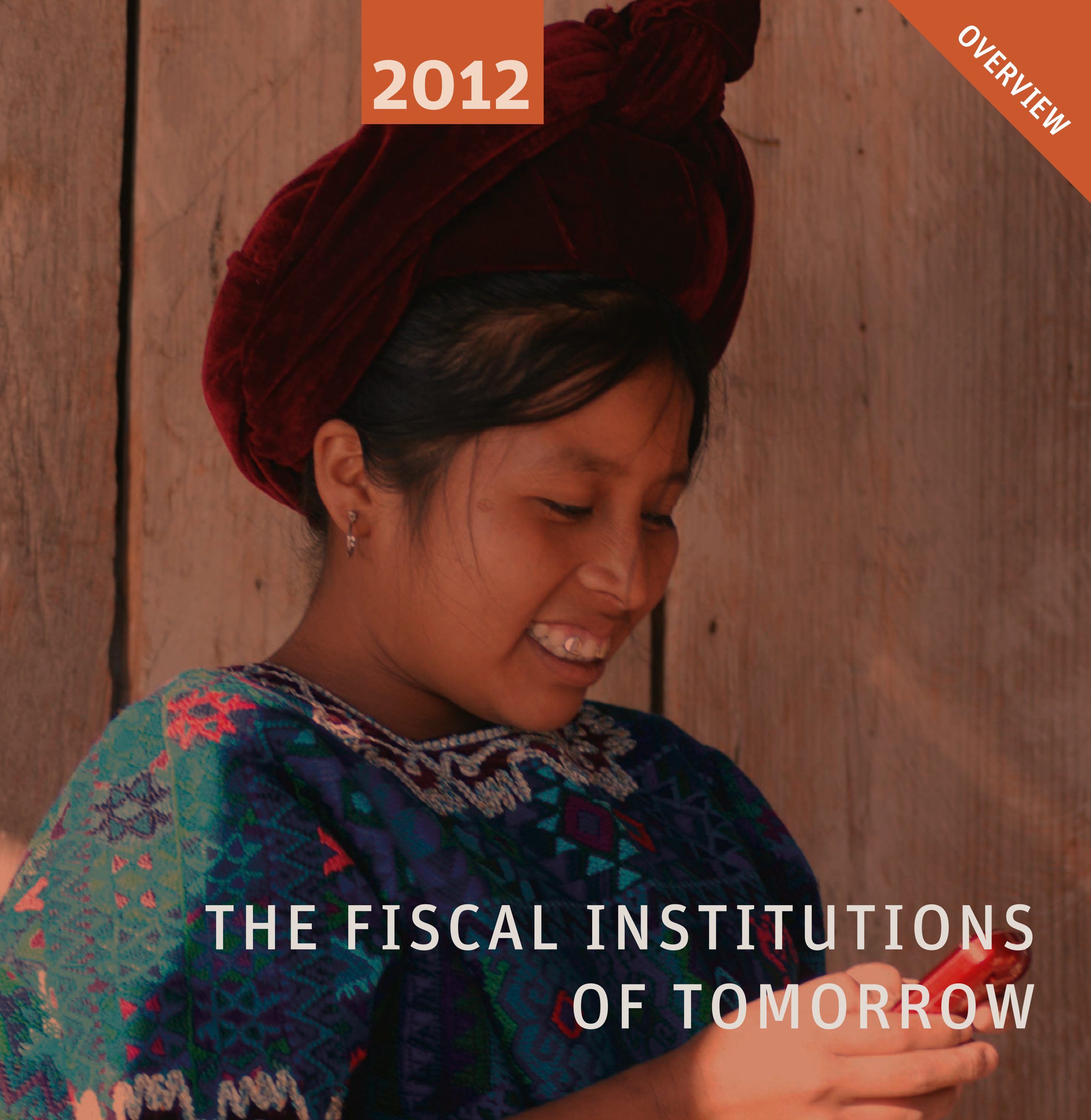
OVERVIEW



THE FISCAL INSTITUTIONS OF TOMORROW

Institutions for People

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INTER-AMERICAN DEVELOPMENT BANK

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Preface

The crisis of 2008–2009 made clear that countries of Latin America and the Caribbean (LAC) have, in general, learned from past harsh lessons about hyperinflation, fiscal adjustments, and mega-devaluations. The region surprised the rest of the world by its resilience and its vigorous recuperation. Today, LAC countries are ready to tackle the challenge of consolidating these achievements in a sustainable way.

A central question of this challenge concerns strengthening institutions, those formal and informal constraints that—according to North (1991)—define a country's incentive structure, and whose evolution determines to a large extent the course of its progression or its decline. The fact that institutions matter greatly to development has been clearly demonstrated in the specialized literature. However, which institutional designs work best, how they can be implemented, and how their operation and implementation can be adapted to the reality of each country are key questions that have yet to be answered.

In the fiscal field in particular, institutions matter for a wide range of objectives, from the moderation of macroeconomic fluctuations to efficiency and effectiveness in public expenditure and to a country's vital economic growth. Which institutional design should be chosen if progress is to be made in each of these areas? What are the prior conditions necessary for each design? What have been the results of previous attempts at institutional change? In order to tackle these questions, we offer the first edition of the Inter-American Development Bank series *Institutions for People*. The series is a response to the Bank's mandate to construct and strengthen institutions for the benefit of all citizens in the region.

Throughout its five chapters, this volume sets out alternatives for building fiscal institutions with the potential to impact the opportunities of both current and future generations; fiscal rules that take the economic cycle into account, the performance-based budget, Integrated Financial Management Systems, polices to support Small and Medium-sized Enterprises, and fiscal incentives for innovation.

This publication contributes to the institution-strengthening agenda in the region in two ways. First, it is a reference textbook, given that it draws together, in an accessible yet educational form, diverse conceptual aspects regarding the fiscal institutions of tomorrow. Second, it can also become a beacon both for policymakers and economic analysts, given that its pages highlight successful institutional role models and areas of future research.

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Overview

The countries of Latin America and the Caribbean (LAC) are on the verge of a paradigm shift. Just a few short years ago, the region's name was blemished by its associations with "the debt crisis," "volatility," and "fiscal adjustment." Yet, in the present day, many of the region's countries have become examples of fiscal discipline in a way previously unthinkable. Without becoming complacent, LAC today has the opportunity to consolidate its gains and to form part of the modern debate about better fiscal institutions, about fiscal institutions with future vision, about the fiscal institutions of tomorrow. How can fiscal policy contribute to macroeconomic stability? What is the best way to allocate the State's scarce resources? How can public management be equipped to inform better policy making? And, further still, how can fiscal institutions promote private sector productivity and development?

At the present time, the countries of the region are not only seeking answers, but also providing them. Fiscal rules adjusted by the business cycle, progress made towards performance-based budgets, and the sophisticated financial management systems in place in various countries are all examples of good institutions that serve as an inspiration and model for the rest of the world. There are also numerous examples of successful fiscal institutions to promote private sector productivity—one of the region's pending challenges.

North (1991) wrote that institutions "evolve incrementally, connecting the past with the present and the future." This book seeks to illuminate the current state of this evolution in the field of fiscal institutions. The first part (chapters 1, 2 and 3) concentrates on their more traditional roles, such as macroeconomic stabilization, the allocation of budgetary resources, and public management; the second part (chapters 4 and 5) tackles the quest for productivity in private sector enterprises. In every case, the authors point to the progress made by diverse fiscal institutions in the region in recent years, describing their current state and recommending alternatives for their continued advance towards the fiscal institutions of tomorrow.

SAVING DURING THE GOOD TIMES TO AVOID SUFFERING IN BAD TIMES

When making reference to macroeconomic performance in LAC, the word "volatile" has been one of the adjectives most frequently used. Periods of robust growth have been succeeded by crises without parallel in other regions of the world. Fiscal policy has been at the epicenter of these crises. In many countries, instead of helping to smooth macroeconomic fluctuations, fiscal policy has often just added fuel to the fire, amplifying volatility with disastrous results for the business climate and, above all, for people's wellbeing.

How can fiscal institutions promote economic stability and development over the long term? Chapter 1 describes the possible advantages and drawbacks of fiscal rules. These are institutional arrangements that impose limits on certain fiscal aggregates, such as public borrowing, expenditure, or the budget balance. They were originally established to reduce authorities' discretion and reinforce the sustainability and credibility of fiscal policy. Thereafter, their role in contributing to macroeconomic stability gained importance.

The author, Gustavo García, describes in detail four kinds of rules in light of these objectives: fiscal rules that establish obligatory balanced budgets or fiscal outcomes; rules that fix limits on the level of public expenditure; rules that instate revenue collection goals; and rules based on the structural fiscal balance or adjusted by the business cycle.

Although each kind of rule has its *pros* and its *cons*, those based on the structural fiscal balance are the only ones that simultaneously comply with the main fiscal policy objectives, especially with the one related to macroeconomic stability. In effect, these rules enable public expenditure to be stabilized within the level of structural fiscal revenues, demanding savings during the more prosperous times of the business cycle and allowing deterioration in the fiscal balance during the bad times.

But this type of rules also has its limitations, García warns. First, they are vulnerable to non-compliance or suspensions that might significantly damage their credibility. Second, the stabilizing capacity of fiscal policy might be seriously limited when the budgetary allocations that react automatically to the economic cycle (the so-called automatic stabilizers) are small, the transfers to subnational governments are large, or significant fiscal revenues are derived from natural resources with very volatile prices. Third, rules based on structural balance can sometimes be too rigid, for example, in the presence of natural disasters. Finally, viewed from the technical perspective, these are very complex rules, which means they are challenging to use and difficult to communicate transparently to the public at large.

Could any country establish a rule based on the structural fiscal balance? García identifies two classes of conditions that must first be satisfied: macroeconomic conditions and institutional conditions. The first group of conditions includes a sustainable public debt, good coordination with the monetary authorities, a solid financial and banking system, and adequate automatic stabilizers. The second group of conditions includes coherence between the rule and the budgetary system, alignment of the public sector administration and financial information systems, and compatibility with a federal system. Fiscal rules based on the structural fiscal balance can also be complemented with other institutional arrangements, for instance medium- and long-term fiscal frameworks and fiscal watchdogs such as congressional budget bureaus.

In LAC, the Chilean structural balance rule stands out for markedly reducing public spending volatility and contributing to the stabilization of the Gross Domestic Product (GDP) against a backdrop of sizable external shocks. Most other countries in the region have some way to go to improve fiscal and institutional aspects before implementing a structural balance rule, but some are not far off from compliance with the prior necessary conditions. Progress in meeting these conditions is a fundamental piece of the pending fiscal reform agenda in many countries, either to implement a structural fiscal balance rule or more generally to improve fiscal policy to make it an ally of stability, rather than its enemy.

SPENDING ON WHAT IS IMPORTANT

The impact that public policies can have on people's wellbeing is strongly related to the public budget. The budget is the result of political and technical processes that do not just organize and regulate short-term public expenditures, but also support the whole spectrum of future government activities.

The importance of establishing clear objectives in the budget is highlighted in Chapter 2, by Mario Marcel, Juan Pablo Martínez, and Mario Sanginés, which deals with the performance-based budget (PBB). The authors discuss the role of the budget as a fundamental institution and enumerate clear objectives for the budget process: macroeconomic effectiveness, efficiency in allocation and use of resources, and transparency in budget management.

To achieve these objectives, the budgetary process develops in a permanently evolving cycle, which involves budget planning, its formulation, its approval, its execution, and its evaluation. This process, in turn, needs to be considered in planning the subsequent budget. The budgetary models, such as "incrementalism", the program-based budget, or the zero-based budget have all evolved towards greater alignment with the objectives of the budgetary process in building the PBB.

Marcel, Martínez, and Sanginés document that the PBB must be based on four pillars to ensure correct implementation and operation. The first pillar is information regarding performance, which is obtained through the monitoring and evaluation systems. The second pillar is the alignment of the budgetary process, at each one of its stages, so that it can incorporate said information. The third pillar consists of institutionalizing incentive mechanisms so that the activities of civil servants are consistent with the expected results. The fourth and final pillar is the development of institutional management capacity.

In LAC, there are common challenges on the road to building the PBB, in particular the persistent macroeconomic volatility (examined in Chapter 1), the gap between resources and the needs of the population (that exercise significant pressure on the public purse), and certain dysfunctionalities in the budgetary structure (such as spending floors or an ineffective division of powers). In spite of these difficulties, some countries have made notable progress towards implementation of the PBB, which has opened the way towards better budgetary institutions and ultimately better public services for the benefit of people.

TOWARDS INTEGRATED PUBLIC EXPENDITURE MANAGEMENT

Many countries in the region developed Integrated Financial Management Systems (*Sistemas Integrados de Administración Financiera*, or SIAF) as a way to improve the registration and control of public expenditure when faced with financial crises of past decades. At present, the SIAFs continue to be predominant in the region, and they are still evolving in response to a paradigm shift in fiscal management towards greater requirements in terms of efficiency and transparency and to the technological transformations that have made these requirements possible.

Chapter 3 concentrates on the importance of a good platform for public expenditure management. In this chapter, Pedro Farías and Carlos Pimenta begin by defining a SIAF as an information system that automates the financial procedures needed for registering public sector expenditure and revenue.

A typical SIAF has four components: a budgetary component to coordinate resource allocation and spending execution; a treasury component that covers all transactions related to proceeds and payments and cash management in general (usually via a Unique Treasury Account that includes all public institutions); an accounting component to register and process transactions, monitor revenue, and expenditure via the general ledger, and produce basic financial statements; and a public debt component that includes the administrative procedures to capture indebtedness.

To guarantee a more homogenous flow of information and provide better support for decision making, a SIAF can also be integrated into other systems, such as public procurement, payroll, the administration of property or public investments, and revenue administration. The way in which these multiple functions are related and complement each other will determine the scope of the SIAF.

As with fiscal rules, SIAFs need certain conditions before they can function adequately. These include, among others, a high and sustained level of political support, a well-defined conceptual design, efficient project management, an adequate implementation sequence, and appropriate technology planning.

In effect, Farías and Pimenta set out in detail the technology planning that a SIAF demands. For example, it has evolved from a monolithic programming architecture to client-server, then to a multi-level system, and more recently to a Service-Oriented Architecture (SOA). The architecture can also be comprised of centralized or distributed databases. Moreover, decisions must be made between in-house technology development and outsourcing, between an integrated management solution such as Government Resource Planning (GRP) or other solutions, and between using patented or open source software.

What do SIAFs in LAC look like? Regarding their interoperability with other systems, the general level of integration is low, with the exception of Bolivia and Brazil. Regarding technology choices, the majority of countries have developed a multilevel technology with increasing use of open-source software.

As far as SIAF quality is concerned—and this holds true for public administration in general—the region displays a wide degree of heterogeneity.

The remaining challenge is to keep advancing towards systems that are committed to supporting effective management and decision making. As Farías and Pimienta warn, SIAFs should not be seen merely as information technology tools, but as instruments that can fulfill a wider strategic role in modernizing public management in the region and in supporting other fiscal institutions, such as the structural fiscal rules or PBBs described in Chapters 1 and 2.

IN SEARCH OF THE LATIN SMES

In the last two decades, LAC has made significant social and economic progress. However, from a longer term perspective, economic growth has been less dynamic than in other emerging market regions. Low levels of productivity underlie this phenomenon. For LAC to really "take off," the region's potential for productivity must be unleashed. What is the role of public institutions to make this ambition a reality?

In Chapter 4, Martin Chrisney and Joan Oriol Prats tackle the subject of the small and medium-sized Enterprises (SMEs). As the authors illustrate, low levels of productivity in LAC are linked to a bias towards informal microenterprises and the absence of formal SMEs. This limits the availability of good-quality employment, the operation of competitive markets, and the fiscal entrepreneurial space.

Two kinds of factors can limit SME development: institutional factors and structural factors. The former impact business transaction costs, as well as the relative price of capital versus labor. The latter are related to a country's sectoral, demographic, and human capital structures.

Fiscal policy, along with the business climate and access to credit, is one of the institutional factors that can hamper SME development. In effect, tax systems and revenue administration shape the incentives that enterprises have to declare sales and profits, and can encourage them to keep production levels low, limiting the advantages of economies of scale and growth in productivity.

Based on a sample of 210 countries, Chrisney and Oriol Prats present a spectrum of factors that limit the development of SMEs. With respect to fiscal policies in particular, the tax rate estimated for a typical SME in LAC is comparable to the global average, even though it is situated 11.9 percentage points above the Asian average and surpasses North America by 5.5 percentage points. The authors also describe the results of impact evaluations of diverse reforms aimed at SME development. In the case of fiscal policy, a common reform has been the creation of simplified tax regimes for small enterprises. These regimes have generally increased the number of formal enterprises, but they have also encouraged the phenomenon of "fiscal dwarfism," that is, the use of diverse strategies on the part of businesses to remain in a low production scale and qualify for the simplified tax regime.

The authors conclude that there is a clearly identified relationship between SMEs and productivity. Yet, there remains a vast agenda of analysis to determine which policies are more effective in promoting productivity growth via SME development.

INNOVATING FOR GROWTH

Innovation is the main driver of productivity growth. Unfortunately, private sector firms in LAC display levels of investment in innovation that are lower than optimum. In Chapter 5, Gustavo Crespi examines the challenge of achieving high productivity growth through the use of fiscal incentives to stimulate enterprise innovation.

But why promote innovation through public policy? Crespi elaborates on three main factors that constitute the *raison d'être* of pro-innovation policies. First, innovation has the characteristics of a public good. Second, there are problems of asymmetric information in the financing and development of innovative ideas. Finally, there are both coordination and institutional failures in the innovation process.

When faced with scant investment in innovation by the private sector, two institutional approaches can be considered: direct knowledge production by public institutions and fiscal incentives for greater production by the private sector. Crespi concentrates on fiscal incentives, in particular direct grants and tax breaks, describing their advantages and disadvantages.

The numerous impact evaluations highlighted in Chapter 5 indicate that both types of fiscal incentives are effective in augmenting investment in innovation by private enterprises, although different results emerge depending on the fiscal incentive employed or the type of beneficiary. Moreover, Crespi warns of the challenges of managing tax incentive programs in a transparent and effective manner. Furthermore, the impact of pro-innovation policies on variables most directly associated with growth in productivity is not so clear, in part because a longer time frame is necessary to properly evaluate these impacts.

Finally, Crespi puts forward various topics that can help advance knowledge and public policies on innovation: the impact of subnational pro-innovation policies within a federalized country; the relationship between policies of innovation and entrepreneurial incentives; and the factors that determine innovation in the services sector. Given the positive results of existing pro-innovation policies, knowledge about new areas of impact could have an enormous potential for future innovation policies in both LAC and the world at large.

THE FISCAL INSTITUTIONS OF TOMORROW

The themes discussed in these chapters cover a wide spectrum of fiscal institutions and their contribution to numerous objectives, ranging from macroeconomic stabilization and public resource allocation and management, to economic growth through higher productivity and private sector innovation. A combination of the fiscal institutions highlighted in the first three chapters would stimulate fiscal policies that would be: i) stable and sustainable; ii) focused on providing better public services for people; and iii) supported by modern information technology platforms that facilitate efficient and transparent public management. But the role of the fiscal institutions of tomorrow does not stop there. The challenge of productivity in LAC requires new institutional arrangements to promote the formalization of SMEs and investment in innovation, and thereby unleash the region's potential for development. Against this background, although there is still a long way to go, LAC has become a pioneer in the debate on better fiscal institutions, institutions with a vision of the future, the fiscal institutions of tomorrow.

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CHAPTER 1

Fiscal Rules for Stability and Sustainablity

Gustavo García

- Macroeconomic and financial stability is a vital requisite for robust and sustained growth.
- The stability and sustainability of fiscal policy are the fundamental anchors of macroeconomic stability.
- Fiscal rules based on the structural fiscal balance can support a stable and sustainable fiscal policy. However, for these rules to be effective and credible, certain economic and institutional conditions must be in place.

CHAPTER 2

The Performance-Based Budget: A Way to Improve Public Expenditure

Mario Marcel, Juan Pablo Martínez, and Mario Sanginés

- The performance-based budget (PBB) seeks to enhance efficiency and transparency in public policy and resource management, and to strengthen State institutions.
- The PBB is based on four pillars: the generation of information for evaluating performance; adjustments to the budgetary process; incentives for public sector officials; and the development of institutional capacity.
- In Latin America and the Caribbean, there have been many obstacles in the development of the PBB, which include fiscal volatility, budgetary rent-seeking by sector or regional interests, and uneven division of State powers. Despite this, some countries have successfully managed to progress towards PBB implementation.

CHAPTER 3

Integrated Financial Management Systems Oriented Towards Modern Public Management

Pedro Farías and Carlos Pimenta

- Integrated Financial Management Systems (SIAFs) are computerized systems that automate the financial procedures to register the collection of public revenues and apply them to the achievement of public sector goals.
- In Latin America and the Caribbean, the SIAFs have contributed significantly to economic stability and fiscal responsibility in recent decades, and they have evolved by keeping pace with the conceptual and technological advances that have affected work processes in the public sector during this period.
- The challenge for the future is to continue advancing towards systems even more firmly committed to supporting public management and decision making.

CHAPTER 4

Where Are the Formal SMEs? The Role of Structural and Institutional Factors

Martin Chrisney and Joan Oriol Prats

- The low levels of productivity in the region are linked to the bias towards informal microenterprises and the absence of formal small and medium-sized enterprises (SMEs), which limits opportunities for good quality employment, the competitive operation of the market, and the fiscal entrepreneurial space.
- Institutional factors, such as the business climate, access to finance, and fiscal policies, determine the incentives that enterprises have to invest, grow, and become formal. Such factors decisively influence the structure and, in particular, the emergence and growth of SMEs.
- The most recent evaluations point to the limited impact of isolated institutional reforms and stress the importance of taking into account the synergies between complementary reforms, the differences among types of SMEs, and the medium- and long-term effects of financial and enterprise development policies.

CHAPTER 5

Fiscal Incentives for Business Innovation

Gustavo Crespi

- Fiscal incentives in Latin America and the Caribbean have been effective in increasing investment in intangible assets by enterprises and in leveraging private resources for these investments. With respect to the effects on the financial results of enterprises, the impact appears to be positive when sufficient time has elapsed since the approval of the aid.
- The various financing mechanisms have different impacts on the diverse beneficiary groups. These findings must be particularly borne in mind for the design of these programs in the future to enhance their effectiveness and minimize moral hazard.
- Further analysis is needed before a balanced judgment can be made on the efficiency and social cost-benefit ratio of these interventions.

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