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AULA 15 - 18:00 a 20:00 hs.

- **Managing Fiscal Policy in Latin America and the Caribbean: Volatility, Procyclicality, and Limited Creditworthiness.**

Orador: **Ernesto Talvi**
Discussant: **Mario Teijeiro**

- **Reforming Budgetary Institutions in Latin America: The Case for a National Fiscal Council.**

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Orador: **Ricardo Hausmann**
Discussant: **Mariano Tommasi**

- **Debate abierto a todos los participantes**

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REFORMING BUDGETARY INSTITUTIONS IN LATIN AMERICA: THE CASE FOR A NATIONAL FISCAL COUNCIL

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PREPARED BY THE
OFFICE OF THE CHIEF ECONOMIST*
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Reforming Budgetary Institutions in Latin America: The Case for a National Fiscal Council

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Executive Summary

The economies of Latin America have made tremendous strides in recent years. Economic growth has resumed and inflation has been brought under control. Trade has been liberalized and access to international capital markets, for the most part, has been restored. Yet problems remain on the fiscal front. First, a *deficit bias* exists and is reflected in a large stock of debt relative to the capacity to service that debt. Second, fiscal outcomes are excessively *volatile*. Third, fiscal responses are *pro-cyclical*, especially in downturns. Thus, fiscal policy has amplified, not dampened, the volatility of the economies. This problem is related to the *precarious creditworthiness of governments*, which have limited capacity to borrow, especially in bad years. Finally, adjustment to negative shocks is often *delayed*, creating instability and increasing the size of the adjustment that is ultimately required.

These basic problems are interrelated and reinforce each other. All four derive from political distortions in fiscal decisionmaking. The source of deficit bias lies in the fact that fiscal policy is decided collectively, so participants do not recognize the full social cost of the spending programs they support. This *commons problem* also affects the dynamic response to shocks: surpluses dissipate as soon as they arise, because everyone fears that his agreement to save them for times of shortages only increases another special interest's chance to grab them today. Delayed response reflects the attempt by each constituency to shift the burden of adjustment onto other groups. Precarious creditworthiness is related to the deficit bias, which generates a stock of debt that is large vis-à-vis tax capacity and the underlying volatility of the economies. Hence, markets expect that situations may arise in which a government will be unable to service its debt. Creditworthiness is also affected by the lack of a credible commitment to generate surplus revenues during economic booms and use them to retire the

debts accumulated in recessions, or by concerns that governments may be tempted to use fiscal policy strategically to promote their electoral interests.

We argue that institutional reform of the fiscal decisionmaking process can overcome these problems. In this paper, we propose the creation of an independent National Fiscal Council in each Latin American country.

Recent research shows that budgetary procedures strongly affect fiscal outcomes. Hence, procedural reform can be used as a strategy to promote improved fiscal performance. For example, strengthening the budgetary powers of the finance minister over the spending agencies, restricting the scope for off-budget spending, requiring a binding congressional vote on the amount of overall spending and size of the deficit at the beginning of the annual budget round, limiting earmarked expenditures, and empowering the executive branch to cut the budget unilaterally in the event of a revenue shortfall are all measures that contain problems of collective action (von Hagen and Harden, 1994; Alesina et al., 1995, Hausmann and Stein, 1996). We take the institutional approach to the logical consequences of these measures and propose the creation of a National Fiscal Council (NFC), vested with analogous powers but politically independent and therefore insulated from partisan considerations and short-term political pressures.

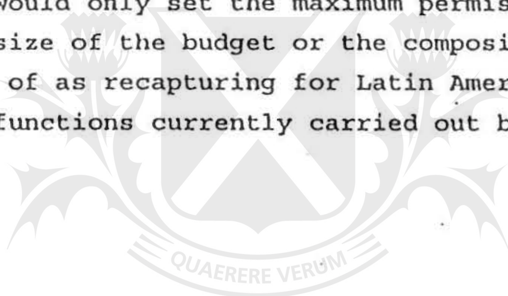
Using forecasts of revenues, expenditures, and general economic conditions generated by its staff, the NFC would set the maximum allowable annual increase in general government debt -- the debt change limit (DCL) -- at the beginning of the budget round. It would monitor macroeconomic developments, and in the event of unanticipated changes in economic circumstances, revise the DCL at specified intervals. If at any time it determined that the budget failed to conform to the DCL, an automatic procedure would be triggered. The government and congress would have a specified period from the NFC's announcement, say 30 days, to adopt measures eliminating the discrepancy. Failing that, the NFC could prohibit all new spending commitments or raise VAT and consumption taxes until corrective action is taken.

The NFC would address the commons problem by setting a binding ceiling for the deficit, which would force budget negotiators to recognize tradeoffs among programs and limit the success of special-interest coalitions pressing for additional spending. The dynamic commons problem would be limited because a ceiling on the deficit would prevent political groups from dissipating fiscal resources during booms. Neglect of the implications of current spending for future debt burdens would be offset by making members of the NFC independent of government and appointing them to long terms in office. The NFC's power to mandate a reduction in spending or an increase in taxes in case

congress and the executive do not act would speed up the conclusion of a negotiated solution through the political process. Finally, the NFC would address the problems of commitment associated with the fact that governments are in office for limited terms, because the NFC would be a permanent entity whose members serve long periods in office and can promise more policy continuity.

Our proposal extends to the fiscal domain the delegation of powers over monetary policy possessed by independent central banks. Other examples of the advantages of delegation include the assignment of fast-track authority over trade liberalization negotiations to the executive branch, and the delegation of decisions about what military bases to close to specially constituted commissions. In each case, delegation is justified by problems of commitment and collective action that hinder coherent decisionmaking in politicized environments.

The prerogatives of the NFC would be more circumscribed than those of an independent central bank. Whereas the central bank controls all aspects of monetary policy, the NFC would only set the maximum permissible increase in the public debt, not the size of the budget or the composition of spending or taxes. It can be thought of as recapturing for Latin American countries the monitoring and signaling functions currently carried out by the IMF.



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0. Introduction

The economies of Latin America made tremendous strides in recent years. Following the "lost decade" of the 1980s, economic growth has resumed. Trade policies have been liberalized, and the efficiency of tax systems has been improved. The most significant distortions associated with wage and price controls have been eliminated. Commercialization and privatization of public enterprises are proceeding at a good pace. High inflation has been brought under control, while access to international capital markets has for the most part been restored.

But the fruits of this progress remain to be consolidated. The political consensus supporting economic reform is not complete and the economies remain susceptible to destabilizing shocks. Even well-devised economic strategies economic can be thrown off course by internal or external disturbances.

Fiscal policy is a case in point. Although there have been significant improvements in the conduct of fiscal policy throughout the region, the budgetary position remains susceptible to a volatile economic environment. The recent crises in Mexico and Argentina epitomize the problem. Governments in both countries were forced to impose large tax increases and fiscal cuts in response to the devaluation of the peso. In a period when both economies were weakening, the operation of automatic stabilizers and countercyclical policies normally would have led to temporary increases in government budget deficits. Instead, the authorities in Mexico and Argentina and, to varying extents, governments elsewhere in the region, were forced to adopt contractionary fiscal measures in a highly procyclical manner.

The problem of procyclical policy is not limited to this episode, but is

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in fact quite general.[1] And it is only one of several problems with fiscal policy in the region. In some countries, budget deficits are excessively large, reflecting a strong deficit bias and leading to large debt burdens relative to fiscal capacity.[2] In other countries, the problem is the failure to deliver prompt and appropriate fiscal adjustments to economic disturbances. Generally in Latin America, fiscal outcomes are excessively volatile. Rather than being just the passive consequence of a volatile external environment, the volatility of fiscal outcomes is amplified by pro-cyclical fiscal responses, particularly during economic downturns. Thus, fiscal policy has increased economic volatility.[3] This problem is related to the precarious creditworthiness of governments, which have limited capacity to borrow in bad years.

These problems reflect the interaction of two factors. Internally, political distortions stand in the way of efficient policy formulation. Deficit bias results from a political environment in which decisionmakers are encouraged to disregard the full social cost of the programs funded with public money. This *commons problem* also affects the dynamic response to shocks: surpluses dissipate as soon as they arise, if everyone fears that his agreement to save them for times of shortages only increases another special

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[1] See the empirical evidence cited below and Gavin et al. (1996).

[2] One indicator of large debt burdens is the large share of interest payments in central government expenditures, which, on average from 1970 to 1994, were 22.0 percent in Latin America compared to 9.8 percent in the OECD, and on average from 1990 to 1994 were 37.0 percent in Latin America and 12.8 percent in the OECD.

[3] Volatility of output, real exchange rates, and fiscal outcomes are between two and four times higher in Latin America than in OECD countries. See IDB (1995) and Hausmann and Gavin (1996).

interest's chances to grab them today. Delayed adjustment reflects the lack of decisionmaking power of governments catering to diverse special interests.

The other factor is the combination of limited tax capacity and a volatile environment. High volatility means that the likelihood of a large negative shock leaving the government insolvent is significant. This implies that capital market access remains precarious. Lenders withdraw precisely when an adverse shock plunges the economy into recession and external finance is most desperately needed, thus accentuating the pro-cyclicality and volatility of fiscal policy. But the problem of precarious creditworthiness cannot be fully understood without recognizing the political weaknesses: The lack of credible commitment to sound future fiscal policies makes investors less willing to grant credit in times when current debt service capacity is already low. At the same time, the withdrawal of capital-market access magnifies the requisite policy adjustments and the difficulty of carrying them out. Thus, the two factors reinforce each other.

In this paper we propose an institutional reform -- the National Fiscal Council -- to allow Latin American countries to break out of this vicious circle. Institutional reforms are often thought of as choices in the trade-off between rules and discretion. Rules strengthen the ability to commit at the cost of flexibility; they would be appropriate for economies that place a premium on the credibility of the policy process and operate in a relatively stable environment. Discretion maximizes the responsiveness of policy; it would be attractive to economies that place a premium on flexibility in a volatile environment. But a credibility-flexibility trade-off is unattractive for Latin America: while the region's history of high inflation implies a high

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shadow price of credibility, the volatility of its economic environment implies a high shadow price of flexibility.

In view of this dilemma, an alternative is needed that combines credibility with sufficient scope for flexible response to shocks. The reform we propose achieves this by delegating the decision over the maximum permissible annual budget deficit to an independent national authority, the National Fiscal Council (NFC). The NFC would deliver credibility on the basis of its independence, and would retain flexibility because it is made up of human beings that can make responsible decisions rather than relying on numerical rules.

Our proposal is an extension of recent literature showing that certain existing budgetary procedures -- those which invest agenda-setting, monitoring, and enforcement powers with the finance minister, for example -- consistently yield superior fiscal policy outcomes. Empirical evidence for both European countries (von Hagen and Harden, 1994) and Latin America (Alesina et al., 1995, Hausmann and Stein, 1996) strongly supports this argument. Taking this approach to its logical consequence, we propose to vest the independent NFC with analogous powers.

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In doing so we build on the idea of a National Debt Board originally developed in the European context (von Hagen and Harden, 1994; Eichengreen, von Hagen, and Harden, 1995). But in comparison to proposals advanced for Europe, the NFC we recommend for Latin American countries would be able to deal more appropriately with the problems of precarious creditworthiness and volatility. Given the size of shocks in Latin America, serious inefficiencies could result if one attempted to set the maximum permissible deficit in July

without permitting any response to changing conditions before December of the following year (16 months). Furthermore, we vest the NFC with more responsibilities, such as forecasting economic outcomes and auditing the spending commitments of ministries, public enterprises, and provincial and municipal governments, than are vested in its European counterpart. Finally, in the event that the debt change limit (DCL) is violated, we give the NFC more discretion over the composition of subsequent adjustments.

The independence of the NFC, whose members would be appointed to long terms in office, would allow it to adopt a long-term perspective on fiscal policy. As an independent agency with monitoring capacity and enforcement powers, it would be able to provide the signaling functions for external creditors currently supplied by the International Monetary Fund. Specifically, the NFC could credibly commit that budget deficits now would be offset by surpluses in the future. Its statement that the government was in conformance with the DCL would therefore have the same the effect as an IMF agreement on a country's access to international capital markets. Moreover, this function would operate continuously, not just in crisis periods when countries typically seek recourse with the Fund. The creation of the NFC would thus contribute to a more permanent and hence more credible fiscal regime.

We emphasize that the NFC would not take the power over fiscal policy away from the executive and legislative branches of government. The NFC would be democratically accountable to parliament and unable to pursue its own fiscal agenda. Furthermore, the decisions over the total size of the public sector and the distribution of spending and taxes would remain under the authority of the government. The role of the NFC would be to improve the

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quality of the fiscal policy decisions of parliament and the executive.

ɪe remainder of the paper is organized as follows: Section I elaborates on the problems with fiscal policy in the region. Section II mounts the case for institutional reform. Section III presents the idea of a National Fiscal Council as a logical extension of the institutional approach, while Section IV provides comparisons to that and other approaches. Section V takes up various theoretical and practical problems of implementation that arise in the Latin American context. Section VI focuses on the issue of political accountability and legitimacy. Section VII concludes.

I. The Problem and Its Consequences

Standard theories of public finance (e.g., Musgrave, 1959; Barro, 1979) provide simple prescriptions for fiscal policy. The budget should balance the marginal returns to resources devoted to public and private uses. A shock that permanently alters income (a permanent change in the country's terms of trade, for example) should elicit a commensurate change in the level of public spending.[4] A purely temporary increase (reduction) in national income should have as its counterpart a temporary surplus (deficit) in the government budget to smooth tax rates over time. In the presence of demand shocks and nominal rigidities, automatic stabilizers and discretionary policy should be further used to stabilize aggregate demand.

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[4] Assuming no change in the relative productivity of resources in the private and public sectors and that public goods are neither superior nor inferior, public spending should fall by the same percentage as national income. Of course, when there are adjustment costs associated with changing the level of spending, there may be a case for smoothing the adjustment even to permanent shocks, as we describe below.

As indicated by Gavin et al. (1996), fiscal policy in Latin America has failed to conform to these dictates. To explain this failure, we identify several problems of commitment and coordination that have hindered efficient policy formulation.

A. The Commons Problem

Government revenue can be thought of as an inadequately priced common resource subject to over-utilization.[5] Concentrated interests tend to internalize the benefits of particular spending programs but not their full budgetary cost. Each group lobbies for spending on programs from which it benefits, but the costs of which, in the form of additional taxes -- current or future -- are borne by society a whole. Absent a mechanism to coordinate their actions, this lobbying will result in excessive spending, and, given a reluctance to raise taxes, excessive deficits.[6]

Overindebtedness is related to this issue. Since each domestic faction anticipates bearing responsibility of only a fraction of any future debt-service liability, it will happily incur additional debt now to finance the

[5] For discussion to this effect see Wildavsky, 1986, chapter 2.

[6] An analogy is the problem faced by the patron of a restaurant. The menu offers two courses: chicken for $10 and lobster for $50. An individual dining by himself might prefer chicken, feeling that lobster was not worth the $40 premium. But consider now the same individual going to the restaurant with nine companions. If he expects the others to choose chicken, he has the choice of also having chicken for $10 or instead having lobster for $14 ((9x10+50)/10). At this relative price he prefers lobster. If instead the others ask for lobster, he then can choose lobster for $50 or chicken for $46. At this relative price he again prefers lobster. So no matter what his companions prefer, he will order lobster if the decision is made in a collective context, while he would have ordered chicken had he chosen independently. This problem is endemic to public finance, where decisions are made about public goods, the consumption of which is not chosen independently and which cannot be financed through user charges.

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spending programs from which it currently benefits.[7]

Empirical evidence suggests the prevalence of excessive deficits in Latin American countries. On average between 1970 and 1994, countries in the region had a deficit-to-GDP ratio of 3.9 percent. This is surprisingly similar to the OECD which on average had a deficit ratio of 3.8 percent during that period. However, deficit-to-GDP ratios are deceptive, because they neglect the much lower capacity to tax and the lower financial depth of the economies in Latin America. Thus, the average ratio of deficits to government revenues was 21 percent in Latin America (25 percent without Brazil) compared to 14 percent in the OECD, indicating larger deficits relative to the size of government. During the same period, the ratio of government deficits to broad money (M2) was 14.2 compared to 5.1 in the OECD, indicating large deficits relative to the capacity to finance them. In sum, a close look reveals that deficits in Latin America are too large on average.

B. The Dynamic Commons Problem

Associated with the commons problem is an inter-temporal distortion which leads governments to squander the benefits of an economic boom. When the terms of trade improve or access to foreign capital is restored, it is efficient to spread increased consumption over time. But if different groups fear that others will grab the resources, they have an incentive to do so

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[7] Another instance of this problem arises in an intergenerational setting. Consider, for example, a pay-as-you-go social security system in which the current working-age generation pays the social security benefits of current retirees. Absent effective representation of the interests of future generations in current discussions, there may be a bias toward excessive benefits. Such problems will be especially acute where governments are short-lived, leading them to adopt high discount rates and to attach little weight to the deadweight loss associated with future debt burdens relative to current consumption.

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themselves. The difficulty of ensuring that resources will be carried over to another day leads to their immediate dissipation. Hence, when Latin American economies boom, the additional resources tend to be consumed immediately rather than carried over through public saving.[8] The welfare loss is especially pronounced in Latin America, because the environment is volatile and shocks are large.

C. <u>The Commitment Problem</u>

A government engaged in tax smoothing will wish to borrow following negative shocks and repay later, particularly in good times. But markets will lend during recessions only if the government can commit to raising additional revenues in the future. If this commitment is in doubt, the government will find itself rationed out of the markets in bad times. This accentuates the problem of fiscal pro-cyclicality.

It may be rational for a government under such circumstances to signal its commitment to sound finances by adopting policies more restrictive than those that would have been necessary if its commitment were known (Saint-Paul, 1994). The result is a more pro-cyclical fiscal policy than the optimal suggested by the public finance literature.[9]

There is, indeed, strong empirical evidence suggesting that fiscal policy in Latin America suffers from pro-cyclicality. Gavin et al. (1996) show

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[8] See Hausmann, Powell, and Rigobon (1993).

[9] Saint-Paul shows that this result is most likely to obtain in a volatile and highly indebted economy. When recessions are deep, the deficits associated with the optimal tax smoothing policy will be large. This delivers a higher stock of debt to the post-recession equilibrium. The advantages of lower interest rates will be greater when the debt burden is heavy; hence, it is precisely for governments in regions like Latin America that the incentive to seek credibility by acting pro-cyclically is large.

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that OECD countries on average let their deficit-to-GDP ratios increase by 33 basis points for each one percent decline in GDP. In contrast, Latin American countries on average manage to increase their deficit ratios by an insignificant amount. This suggests that the stabilizing function of fiscal policy is inefficiently low in Latin America. The effects are asymmetric over the business cycle. In the OECD, the stabilizing function of the deficit is about four times stronger in recessions than in upswings. In contrast, deficits in Latin American countries on average show a pro-cyclical response to recessions; the stabilizing function is there only during expansions.

Focusing on the major recessions, the evidence is even stronger. In the OECD, major recessions come with an average GDP reduction of 3.3 percent, accompanied by a rise in the deficit of 3.0 percent of GDP. In contrast, major recessions average a drop in GDP of 10.7 percent in Latin America, while the deficit moves in the wrong discretion, falling by 1.6 percent of GDP. This pattern reflects the difficulty Latin American countries have in borrowing during recessions, i.e., when fiscal stabilization is most urgently needed.

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D. The Strategic Use of Fiscal Policy

Another problem is the strategic use of fiscal policy by self-interested governments. A government anxious about its re-election may be inclined to tailor fiscal policy to the electoral cycle in the effort to maximize its share of the vote. Whereas the classic Nordhaus (1975) model of political business cycles assumes that deficit spending determines unemployment and that unemployment governs the incumbent administration's re-election prospects, modern variants add the filip that the electorate may be uncertain about

whether the pre-election boom is due to deficit spending or to the government's special economic competence. But either way, an approaching election may prompt an inefficient increase in deficit spending.[10]

Alesina (1989) conveniently summarizes the evidence on the connections between fiscal policy and elections in OECD economies. He tests whether fiscal policy (measured by the inflation-adjusted and cyclically adjusted budget deficit) is unusually loose in election years, and finds that in a majority of the cases considered, the budget deteriorated in the election year relative to the preceding year. There is evidence of similar patterns in some Latin American countries.

Another aspect of strategic behavior is that governments may manipulate revenue estimates and expenditure forecasts to increase their leverage in the fiscal debate. This possibility prompted the creation in the United States of the Congressional Budget Office to provide the Congress with independent forecasting capacity. The persistence of the problem is evident in the recent debate in the United States over whether to base deficit cuts on estimates constructed by the Republican-headed Congressional Budget Office (CBO) or the

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[10] See Alesina (1989), Hibbs (1977), and Nordhaus (1975). The subsequent literature has added a number of additional reasons why electoral considerations may lead to the strategic manipulation of fiscal policy. If control of the public sector is expected to pass to those favoring spending on different government programs, the incumbent administration may engage in excessive spending in order to tie the hands of its successor, bequeathing a heavier debt burden in order to limit subsequent spending options (Tabellini and Alesina, 1990). The popular illustration of this tendency is the Reagan Administration's policies of defense spending and tax cuts, which are said to have bequeathed a legacy of debt that constrained the spending aspirations of subsequent Democratic administrations. The incumbent administration of a country burdened by unstable governments may adopt an inefficient tax system as a way to deter future governments from pursuing spending programs from which the former will derive no benefit (Cukierman, Edwards, and Tabellini, 1989).

Office of Management and Budget (OMB) controlled by the Democratic Administration.

Evidence of such behavior in Latin America is provided by Aizenman and Hausmann (1995). These authors study budget forecast errors and find that as inflation and the volatility of economic activity rise, so does the systematic underestimation of the budget. They explain this observation as an outcome of the interaction between the finance minister and the spending ministers. Spending ministers, who know more than the finance minister about the true cost of government programs, will report only cost-increasing shocks to the latter and ask for additional funds, but will keep the windfall profits of cost-reducing shocks. Anticipating this, the finance minister has an incentive to underestimate the initial allocations in the budget, and this tendency increases when volatility rises.

E. Delayed Adjustment to Shocks

Imagine a decline in the permanent income of a commodity-exporting country due to a fall in world prices. Public finance theory suggests that this decline in income should be accompanied by a decline in public spending. But each interest group in the country concerned will resist cuts to its favored programs. If the competing groups are uncertain about the capacity of their counterparts to endure the costs associated with these dislocations, it may be rational for them to delay agreeing to concessions in the hope that their rivals will capitulate first.[11] Absent a mechanism to coordinate

[11] Alternatively, the different groups may be uncertain not about the cost-bearing capacity of their rivals but about their rivals' ability to take steps that inflict costs on others.

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adjustment, this war of attrition problem (Alesina and Drazen, 1991) can lead to excessive deficits and macroeconomic dislocations in the wake of shocks. The inability of the government to adjust quickly and appropriately to shocks will engender skepticism about its solvency in international capital markets and jeopardize its ability to borrow.

Gavin et al. (1996) find that much of the contraction in fiscal expenditures during recessions is not the consequence of fiscal decisions but of an accelerating inflation rate that reduces the real value of spending commitments. This indicates that the adjustment is not carried out through the budget process but through monetary policy. Practical examples of this dynamic abound. Venezuela, for example, was hit by a major deterioration in its oil tax revenues starting in 1992, but adjustment did not come promptly. Rising interest rates and declining financial confidence led to a banking crisis in early 1994, which further worsened the country's fiscal position. Even then, adequate fiscal adjustment was not forthcoming, and the country has seen its inflation rate accelerate from 31 per cent in 1991 to an annualized rate of 115 percent in the five months ending February 1996. Another case in point is Costa Rica, which in 1994 experienced a fiscal deficit complicated by rising inflation, interest rates, and current account deficits. Significant damage was done to the economy before a political agreement to adjust was reached in October 1995.

II. Reform of Fiscal Procedures as a Remedy

The traditional discretionary approach to fiscal policy suffers from the problems of commitment and collective action detailed above. Rigid fiscal

rules, on the other hand, are insufficiently flexible for shock-prone Latin American economies. In principle, the reform of budgetary procedures provides a third way of importing the advantages of rules without also importing their inflexibility. The essence of this approach is to overcome the commons problem and the shortsightedness and attrition of fiscal policy decisions by implementing decisionmaking procedures that limit the externality involved in the commons problem, while promoting long-term perspectives and prompt decisionmaking. While this can be achieved partially by strengthening existing institutions, the logical consequence of this approach is the creation of a National Fiscal Council, a new institutional body whose political independence gives it the capacity to overcome partisanship and develop a credible, long-term fiscal strategy.

A. Rules versus Discretion

The traditional approach to fiscal policy emphasizes discretion. The executive and congress have the power to adjust fiscal policy in response to economic conditions. But, as explained above, discretion is subject to abuse. Partisan governments can manipulate policy for their own interests; their efforts to pre-commit their successors can bequeath an excessive burden of debt. Policies can be distorted in socially inefficient directions by governments seeking to maximize their chances of re-election. Individuals who fail to internalize the costs of spending may lobby for additional programs to the point where excessive deficits result. Governments that are unable to commit to future policies may be unable to borrow efficiently.

Here, as elsewhere, rules are an obvious alternative. Statutory debt

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ceilings and balanced budget amendments have been suggested as ways to limit deficit bias and force rapid adjustment. But balanced budget laws can be hard to enforce; they encourage off-budget spending, the creation of semi-autonomous government agencies exempt from fiscal ceilings, and other forms of evasion (von Hagen, 1992). Furthermore, stringent rules are inflexible; they can prevent fiscal policy from providing automatic stabilization and discourage officials from stabilizing the economy through the use of counter-cyclical policies, hampering adjustment to shocks.[12]

In theory, contingent rules (rules with escape clauses) combine the advantages of the rules- and discretion-based approaches. Policy is constrained by rules except in the event of an observable, independently verifiable contingency not of the authorities' own making, in which case the rule may be abandoned or the escape clause may be invoked. In the context of fiscal policy, one can imagine a contingent rule requiring that the budget be balanced except in the event of an exogenous macroeconomic disturbance, in which case deficits are permitted.

In practice, it is difficult to satisfy the prerequisites for the operation of contingent rules. If the contingency cannot be observed and verified, politicians will be inclined to invoke it even when it has not occurred. If the contingency is manipulable, the authorities may provoke its occurrence in order to relax the rules-based constraint. Under these

[12] Eichengreen and Bayoumi (1994) document that U.S. states that are subject to stringent balanced budget restrictions do relatively little fiscal stabilization over the cycle.

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circumstances, an escape clause may be destabilizing (Obstfeld, 1993).[13]

B. Procedural Reform as a Solution

Public spending, taxation, and borrowing are determined through the government budget process. Formally, the budget is a list of revenues and expenses conveying what the government expects and is authorized to do during a certain time period. The budget process, in the broadest sense, is a system of rules, both formal and informal, governing the decisionmaking process, which leads to the formulation of a budget by the executive, its passage through the legislature, and its implementation. These rules divide this process into steps and determine when the steps are taken. The rules also assign roles and responsibilities to the participants and regulate the flow of information among them, thus distributing strategic influence and creating or destroying opportunities for collusion. Political economy views the budget process as a mechanism through which political interest groups bargain over conflicting interests.

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[13] Imagine, for example, that in a bad state of the world, when interest rates are high and hence employment is low, the authorities are permitted to abandon their balanced budget rule in order to reflate the economy. (This example is related to the model of Calvo, 1988.) Imagine further that deficit spending places upward pressure on interest rates, as in standard models, and that sales of government bonds by investors raise interest rates and widen the deficit. Under these circumstances, an escape clause may be destabilizing. At any point in time there may exist two equilibria, one in which investors hold onto their bonds and the government maintains a balanced budget, and another in which investors sell their bonds, driving up interest rates, in response to which the government validates their expectations of higher interest rates by increasing its deficit spending. It is thus possible for investors to destabilize the budget and drive the economy toward the deficit spending equilibrium in the absence of a shock to world interest rates, in anticipation of which the escape-clause provision was established. The outcome with an escape clause may be worse than that which prevails with a rigid balanced budget rule.

Recent work has advocated procedural reform as a solution to the political weaknesses of fiscal decisions. If giving discretion to policymakers opens the door to incentive problems, while forcing policymakers to follow rules gives rise to excessive rigidity, a third option is delegating policy to an authority with compatible incentives. An example is the independent central bank, which has an explicit mandate to pursue policies of price stability. Another is the delegation of authority from the U.S. Congress to the President to negotiate tariff reductions, to offset the logrolling for tariffs. Still another is the U.S. Base Closure Commission, to which has been delegated decisions about which military outposts to close.

In the context of fiscal policy, procedural reform involves strengthening the finance minister's budgetary powers over the spending agencies, restricting the scope for off-budget spending, requiring a binding vote on the size of the overall spending and deficit at the beginning of the annual budget round, limiting earmarked expenditures, and empowering the executive branch to cut the budget unilaterally in the event that the annual deficit ceiling is breached, again to contain problems of collective action (von Hagen and Harden, 1994; Alesina et al., 1995).[14] Giving a senior official power over the spending agencies on budgetary matters helps to internalize constraints on the size of the budget.

The empirical evidence supporting these arguments is compelling. Von Hagen and Harden (1994) show that cross-country differences in deficit and debt ratios among the members of the European Community can be explained to a

[14] We elaborate upon these points below.

large extent by differences in budgetary processes. The differences are economically significant: the three countries with weak budgetary processes showed average deficit ratios of 11 percent of GDP in the 1980s, while the three countries with the strongest processes had average deficit ratios of 2 percent. Similarly, in a study of 20 Latin American and Caribbean countries, Alesina et al. show that countries with strong budget processes tend to have significantly smaller deficits than those with weak budget processes. Specifically, the 6 countries with the strongest processes had primary fiscal surpluses of 1.8 percent of GDP on average from 1980 to 1993, while the 7 countries with the weakest processes had primary deficits of 2.2 percent of GDP. These observations suggest that procedural reform can combat deficit bias.

Moreover, differences in budgetary processes are accompanied by differences in dynamic responses to fiscal shocks. In Latin America, countries with relatively strong budgetary processes stand out as those few that are able to conduct anti-cyclical fiscal policies during recessions, an ability not shared by countries with weaker processes. This suggests that countries with stronger processes find access to capital markets even during recessions, i.e., markets honor the gain in credibility from better budgetary institutions. Furthermore, in countries with weak processes, above-average fiscal deficits are reversed within about two years, reflecting very strong adjustment pressure, while countries with stronger budgetary processes can spread the adjustment out over several years. On the other hand, fiscal surpluses tend to dissipate faster in countries with weaker budgetary processes. In sum, reforms strengthening the budget process promise to improve

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not only the deficit bias but also the efficiency of dynamic adjustment.

III. National Fiscal Councils as an Extension of the Preceding Argument

In this section we describe an institutional innovation -- the National Fiscal Council -- designed to address the problems described above. The NFC would be an autonomous body established by law or constitution, independent of the congress and the government. Members would be appointed to long, staggered terms in office. Their mandate would be to ensure the stability of public finances and advance the general economic strategy of the government and the nation. The NFC's central function would be to set the maximum allowable increase in government debt -- the annual debt change limit (DCL) -- at the beginning of the annual budget round. The failure of congress and the executive to adopt a budget conforming to NFC guidelines would place them in violation of the law.

The NFC could be expected to adopt a long-term perspective on policy; annual DCLs, rather than placing fiscal policy in a straitjacket, could take into account the need for appropriate response to changing conditions. But with its long-term outlook and insulation from immediate political pressures, the NFC would be able to credibly ensure that debt accumulation remains sustainable.

How would establishment of the NFC address the specific distortions identified above? The commons problem, in which the beneficiaries of public programs fail to internalize their costs, is addressed by empowering the NFC to set a binding ceiling for the deficit, which will force budget negotiators

to recognize trade-offs among programs and limit the success of special interest coalitions pressing for additional spending on their favored programs while ignoring the financial implications of this spending. The dynamic commons problem can be limited because a ceiling on the deficit forces governments to increase public saving during booms and prevents different political factions from dissipating the additional resources. Neglect of the implications of current spending for future debt burdens can be offset by making members of the NFC independent of government and appointing them to long terms in office.[15] The NFC's power to mandate a reduction in spending or an increase in taxes will speed adjustment to shocks, since the knowledge that such actions will occur after, say, 30 days if no political agreement has been reached should speed up the conclusion of a negotiated solution among the interest groups concerned.[16]

Finally, the creation of an NFC would address the problems of commitment. The fact that the NFC is a permanent entity whose members serve long, overlapping terms promises more policy continuity than can be offered by a government that may be out of office tomorrow. Its independence would insulate the budget deficit from strategic manipulation by politicians seeking re-election. This would moderate the tendency for interest rates to rise and for access to capital markets to become more precarious as elections approach and the survival of the current government is placed in doubt.[17] Finally, the

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[15] This approach can be thought of as analogous to appointing independent central bankers and giving them narrow mandates.

[16] This can be thought of as analogous to the impact of impending binding arbitration on the conduct of pre-arbitration labor-management negotiations.

[17] In Venezuela in 1993 and Ecuador more recently, incumbents were inclin toward policies of fiscal rectitude, but the markets were concerned about the

existence of the NFC would make it easier to credibly commit to offset deficits during recessions with surpluses during expansions. This would relax credit constraints on the government and enhance its ability to pursue counter-cyclical policies.

The NFC would not, however, have the authority to decide either the total size of spending and taxation, or the composition of taxes and expenditures. These competencies would remain in the hands of elected officials in the executive and legislative branches of government. We emphasize this to make clear that the purpose of the NFC is not to somehow *depoliticize* fiscal policy in a democratic society, but rather to improve the quality of democratic decisionmaking.

A. Structure

The NFC would have a board and a staff working for the Council members. The former would monitor the development of the country's public debt and the government's financial activities. The latter would provide Council members with data and analysis (forecasts of inflation, economic growth, etc.). The Council's decisions would convey more authority were it known that the decisions were based on forecasts uncontaminated by political bias or wishful thinking. This provides an argument for creating an economic staff within the NFC with the capacity to construct the forecast. In the United States, the Congressional Budget Office, which is responsible for formulating objective,

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possible inclinations of future presidents. Another example is the traumatic transition in Argentina between Alfonsin and Menem. Our argument is that an NFC would constrain any inclination of incoming governments toward deficits, thereby reducing pre-election uncertainty and fiscal jitters.

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bipartisan economic analyses, can be thought of in this light.[18]

Members of the Council could be nominated by the executive and be subject to congressional confirmation. In countries where the NFC is empowered to set ceilings on the change in state and provincial as well as central government debt, it might be desirable to empower groups of states to select representatives, analogous to the representatives of groups of German *Länder* who serve on the Bundesbank council. They would presumably serve alongside national representatives nominated by the executive and confirmed by the congress. Members could be appointed for a term of nine years, ensuring a longer term than the lifetime of a government.[19] Appointments would be staggered, with one member retiring each year to guarantee continuity and minimize partisanship. To prevent governments from being able to exchange the entire board in one electoral term, the number of Council members should be at least 1.5 times the number of years between regular elections. The NFC's statute would require the members to be independent of the government. NFC members could be prohibited from accepting employment in the executive branch of government for a specified period after their term expires.

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[18] Even there, the fact that the CBO is headed by a director appointed by the majority party in the Congress raises questions about whether CBO estimates are excessively sympathetic to the claims of that party. This gave rise, in the recent budget debate, to a battle over whether to use CBO or OMB forecasts of economic growth.

[19] Whether members would be eligible for reappointment could depend on the political culture and abundance of expertise in the country in question. The argument against reappointment is that members might "run for reappointment" by currying favor with politicians as the end of their term approached; the argument for it is that members would have an equally strong incentive to curry favor with nongovernmental interest groups if they were limited to one term. Scarcity of expertise may be another reason to justify the possibility of reappointment in some countries.

Members would be under no obligation to accept instructions given by or on behalf of government or congress, or any agency of government or congress, or from any natural or legal person. The relevant law would state that the NFC's mandate is to safeguard the soundness and stability of public finances, taking into account the economic objectives of the government and the nation. This would ensure that achieving sustainable and sound public finances is given a high priority when deriving the DCL, but that the NFC could not pursue an autonomous agenda that lacked democratic legitimacy.[20]

A statute or constitutional amendment that guarantees the NFC's budget (as a fixed percentage of public spending, for example) would ensure the NFC's power to undertake the requisite surveillance and prevent the congress from using that line item to threaten the Council in the event of a dispute.[21]

B. Procedures

The central responsibility of the NFC would be to set the maximum allowable annual increase in general government debt -- the debt change limit -- at the beginning of the budget round (say, July 1, six months before the beginning of the fiscal and/or calendar year). Any budget adopted by the congress and signed by the executive would have to conform with the DCL. Budget proposals would be costed by the Fiscal Commission to determine whether they satisfy this requirement. Attempts by the congress to pass and the

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[20] We return to the issues of legitimacy and democratic accountability in Section VI.

[21] There is an analogy in the power of the judiciary in some countries to determine its budget independently, and in the right of independent central banks to finance their activities off-budget, through seigniorage.

executive to sign a budget that breaches the DCL would place them in violation of the law. If the new fiscal year begins without the passage of a budget act that satisfies the DCL, the previous year's budget could continue to provide the basis for public sector functions.

In the event that the new budget violates the DCL, the NFC would trigger its enforcement powers, described below, to bring it into conformance. Even when the congress passes and the executive signs a budget act that conforms to the DCL, the NFC would continue to monitor macroeconomic developments and public spending and revenues. In the event that the NFC ascertains that spending is out-running or revenues are lagging behind projections, it would declare the government in violation of the DCL. The executive and congress would have a specified period of time from this announcement, say 30 days, to adopt actions eliminating the discrepancy. If the NFC determines that such measures are sufficient to prevent violation of the DCL, no further steps would be required. Otherwise, the NFC would trigger its enforcement mechanism. One option would be to empower it to raise consumption and VAT taxes by a uniform proportion sufficient to remove the discrepancy. Another would be to cut all forms of government spending by a uniform proportion. A third alternative, more realistic in countries where discretionary spending is a small part of the budget, would be to prohibit all new spending commitments until the impasse is resolved.[22]

Even if revenues and expenditures are running at expected levels, changes in macroeconomic conditions (including shifts in the country's terms

[22] In some countries, freezes on hiring and promotion mandated by the NFC may provide an alternative mechanism for dealing with a violation of the DCL.

of trade or access to foreign capital) might provide grounds for the NFC to revise the DCL within the fiscal year. One option would be to allow the NFC to revise the DCL any time there are unanticipated changes in economic circumstances. Another would be to review the DCL regularly at specific times, such as January 1st and July 1st, and to revise it when necessary. By making reviews and revisions regular events, the process will have more continuity in the public's perception and thus contribute to the positive signal of a long-term fiscal strategy.[23] If such revisions result in the budget in place being in violation of the new DCL, the procedure described above would be set in motion.

To prevent evasion through accounting gimmicks, a core responsibility of the NFC would be to define the relevant measure of the public debt. While a general definition should be included in the statute establishing the NFC, the power to decide what specific public obligations would be counted in its measure should be reserved for the Council.

C. Advantages and Drawbacks of In-Year Adjustments

The volatility of the economic environment in Latin America places a premium on policy flexibility. For example, the fiscal adjustments required of Argentina in the wake of the Mexican crisis had to be completed in a matter of weeks. Therefore, in contrast to the industrial countries, where an annual DCL might be sufficient, it would be desirable to allow the NFC in Latin

[23] Obviously, holding public reviews at specific times during the year would not prevent the NFC from preparing appropriate steps at other times and discussing them in public if necessary.

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American countries to revise the DCL within the fiscal year in response to new information.

A flexibility-credibility trade-off is involved, of course: scope for in-year adjustments will lessen the perceived likelihood that a given DCL will remain in force and therefore do less to focus attention on the magnitude of the requisite compromises. This problem can be contained by requiring the NFC to justify any revisions it undertakes on the basis of new information and by stipulating that any increase in the DCL could only be justified by unforeseen revenue shortfalls or clearly exogenous shocks. In this way, an increase in the DCL could never be used to make room for discretionary spending.

One of the main problems with discretion, in practice, is that governments tend to interpret all positive shocks as permanent and all negative shocks as transitory. The NFC would be less likely to abuse flexibility, since it has no incentive to misinterpret shocks in this way. Based on a more objective characterization of the events, the NFC could deliver a more appropriate response to permanent and transitory shocks as they arise.

D. Enforcement

The NFC would be responsible for verifying the accuracy of reported figures for deficits and debts. This would require that principles and standards of accounting and reporting practice be established for the preparation of government financial statements. It would also require close monitoring of the financial activities of government-owned financial institutions and parastatals. Like bank inspectors employed by the government

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agency responsible for prudential supervision of the banking system, inspectors employed by the NFC would be empowered to undertake unannounced inspections of the accounts of spending agencies. Evidence that these agencies are exceeding their budgets would provide grounds for the NFC to warn that the DCL is in jeopardy. This would ensure that the effectiveness of the constraint would not be undermined by creative administration. IMF missions undertake similar auditing functions; the fact that this is generally accomplished by a small number of economists suggests that it could be undertaken without creating a large bureaucracy.

IV. Comparisons with Alternative Approaches

In this section we compare the NFC with the recent literature on procedural reform of budgetary processes, with the National Debt Board proposed for Europe, with Latin American commodity stabilization funds, and with IMF programs.

A. Advantages over Partial Procedural Reforms

Partial approaches to reforming the way fiscal policy is created recommend procedures that concentrate power in the hands of the finance minister or the president.

The problem with this approach is that the finance minister is still a member of the executive. As such, he is not insulated from adverse political incentives as completely as the members of the independent NFC would be. Furthermore, a finance minister trying to impose discipline on the executive can be removed too easily. Our proposal is more robust in that it builds an institution that is not easily circumvented.

Previous authors have stressed the desirability of an authority independent of both the executive and the congress to construct the economic assumptions underlying the budget and to forecast nondiscretionary spending. By preventing willful mis-estimation of revenues and expenditures and promoting budgetary transparency, this will facilitate negotiation and compromise. Under our proposal, the NFC would have such functions. The NFC would further enhance budgetary transparency by publishing, at the beginning of the annual budget round, forecasts of government revenues, expenditures, and general economic conditions constructed by the staff. The NFC would generate supplementary forecasts as needed in the course of the fiscal year. Thus, measures to ensure budgetary transparency would be regularized even more effectively than under piecemeal/procedural reform.

The literature on budgetary processes emphasizes that establishing a deficit target prior to budget preparation encourages negotiators to internalize the global budget constraint. The NFC would force that target to be taken seriously.

While the NFC could not prevent congress or the finance minister from underfunding spending programs, it would identify such discrepancies early on and point out their implications for the global budget constraint. It would revise upward the government's or parliament's estimate of the deficit when it concludes that expenditures have been underfunded. It would add to its estimate of the budget any off-budget items and supplementary appropriations. By publishing its independent estimates of projected revenues and outlays, it could ensure that congressional debate over the budget is predicated on realistic assumptions. In particular, by highlighting discrepancies between

its revenue and expenditure projections and those of the executive or congress, publication of the NFC's independent forecasts would increase the transparency of the budgetary process and shape the fiscal debate in a constructive way. If its warnings of excess deficits do not lead to revisions in appropriation and tax bills, passage of the latter would provide grounds for declaring that the government is in violation of the DLC, setting in motion the responses required by law.

B. Comparison with National Debt Boards

Our proposal for establishing National Fiscal Councils is inspired by and has parallels with suggestions for the creation in Europe of National Debt Boards (von Hagen and Harden, 1994; Eichengreen, von Hagen, and Harden, 1995). At the same time, our proposal differs in significant respects, in response to distinctive features of the economic and political environment in Latin America.

First, we give the NFC more freedom to adjust the DCL in year. Given the huge size of fiscal shocks in Latin America, grave inefficiencies could result if one attempted to set the maximum permissible deficit in July without permitting any response to changing conditions over the succeeding 16 months. The scope for fiscal policy to act as a shock absorber would be eliminated. We recommend allowing the NFC to revise the DCL, so long as it provides a justification for its action based on unanticipated exogenous changes in the variables underlying its forecasts.

Second, we vest the NFC with additional responsibilities such as auditing the spending commitments of ministries, public enterprises, and

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provincial and municipal governments and forecasting economic outcomes. Information on the activities of spending ministries, enterprises to which the federal government has explicit or implicit obligations, and subnational governments is less complete than in the European context, making it necessary for the NFC to have its own audit capacity. Similarly, the NFC may not be able to rely on the government or other sources for unbiased forecasts of economic developments; we therefore recommend the creation of its own forecasting capability.[24]

Third, in the event that the DCL is violated, we suggest giving the NFC more discretion over the composition of subsequent adjustments. In the European context, where deficits are thought to predominantly reflect common-resource problems which give rise to excessive spending, and where tax revenue is less responsive to changes in tax rates, the recommended course of action is an automatic across-the-board spending cut. In Latin America, as we have shown, distortions and disturbances leading to problems with fiscal policy are more diverse. Whether an increase in taxes or a reduction in spending is desirable to make the budget conform with the DCL will depend on the problem that gave rise to the imbalance in the first place. There may be an argument for giving the NFC the discretion to choose whether to cut spending, raise taxes, or both, rather than always requiring adjustment on one margin or the other.

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Given the need to vest the NFC with discretion over the nature of compulsory adjustments of spending and taxes, we are inclined to give the

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[24] Again, these functions are usually carried by the IMF during Fund-supported programs without the need for a large bureaucracy.

executive and congress more control over the appointment of council members. In the European literature it has been suggested that appointments could be made by the government from a list of names submitted by the National Debt Board itself. Greater discretion over the formulation of compulsory adjustments heightens the need for accountability, which in turn suggests that eligible nominees not be limited to those specified by the NFC itself. Similarly, depending on the federal structure of the state, and the structure of fiscal responsibilities, there is an argument for allowing at least some members of the Council to be appointed by the governors and legislatures of those entities, again to ensure accountability.[25]

Finally, we erect fewer barriers to communication between the NFC and the government, reflecting the obstacles to information flows that exist in Latin America and the special importance of new information in a volatile economic environment. Following the definition of independence in the Maastricht Treaty, the proposal for a National Debt Board suggest prohibiting the Debt Board from receiving information or advice from the government without placing it in the public record. In the Latin American context, where alternative channels for conveying information are relatively scarce, such measures could be very inefficient.

C. Comparisons with Commodity Stabilization Funds

One purpose of the NFC is to solve the dynamic commons problem which leads Latin American countries to dissipate the benefits of an economic boom.

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[25] We take on this issue in more detail below.

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By limiting the increase in public spending that follows an improvement in, inter alia, the commodity terms of trade, the NFC should help to solve the collective action problem which leads the benefits of that favorable shock to be dissipated.

Some Latin American countries already possess institutions designed to address this problem. For example, the Chilean Copper Fund is designed to stabilize fiscal spending out of copper export receipts by automatically accumulating a balance when prices are favorable and running it down when they are not. The problem with this type of mechanism is fungibility: the rest of the government can run larger deficits at the same time that the Copper Fund is running surpluses. (Indeed, it can do so partly because the surpluses of the Copper Fund enhance the creditworthiness of the government.) The NFC, by installing a similar mechanism at the level of overall government spending rather than for a particular source of revenue, should work to solve this problem.

D. Comparisons with IMF Programs

IMF programs have many of the same functions as the NFC. Thus, our institutional reform can be thought of as producing domestically the monitoring and signaling functions previously imported from the Fund. The NFC would audit the commitments and disbursements of the spending ministries in much the manner of an IMF mission. Given its independence from politics, monthly or quarterly press releases in which the NFC announces whether or not the government is in conformity with the DCL would have much the same signaling function as an IMF performance review. By providing a credible

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signal to the markets, the NFC could help the government secure access to domestic and foreign capital in the manner of an IMF program.

The advantages of the NFC relative to relying on the IMF are twofold. First, unlike IMF programs, which tend to be negotiated only in times of crisis, the NFC would monitor the budget continuously, making fiscal policy less disruptive and the commitment to sound public finances more credible. Second, any restriction placed on the fiscal prerogatives of the congress would be domestic in origin rather than imposed from outside. For Latin American countries that have been forced to resort to IMF programs, the NFC can be thought of as a mechanism for recapturing domestic responsibility and control over fiscal policy.

V. Issues of Implementation in the Latin American Context

In this section we address a number of conceptual issues related to the operation of the NFC.

A. How Should the NFC Deal with State and Local Governments?

The DCL, as we envisage it, would apply to the central or federal government. But macroeconomic conditions depend on the consolidated public sector deficit, not just on that of the central government. Mechanisms limiting the spending autonomy of state and municipal governments would be the simplest solution to this problem, but it is not consistent with current constitutional arrangements in all Latin American countries. Some federations, such as Venezuela, prohibit states from borrowing without the permission of federal authorities. Others, such as Argentina, allow much more autonomy. In the former, imposing borrowing limits at the federal level would be enough. In

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the latter, the question is whether the NFC should play a role restricting the borrowing capacity of state governments.

The problem is that expanding the powers of the NFC in this way would intensify political resistance. And it is in any case unclear whether the NFC needs to worry about the deficits of state and local governments to the same extent that it worries about those of the federal authorities. State and local deficits are constrained by the relatively limited debt-carrying capacity of these entities. State governments, which cannot print money to backstop the market in their debts, tend to be rationed out of the credit market relatively quickly.[26] The mobility of their tax bases and constitutional limits on their capacity to tax reduce their ability to credibly promise to raise taxes in the future to service additional debts incurred now. Goldstein and Woglom (1994) show that state governments in the United States tend to get rationed out of the capital market when their state debt/state product ratios hit nine percent.

Still, many state governments acquire debts, and the danger that they will default raises the possibility that the federal government will feel obligated to assume their obligations. The recent problems of state banks in Brazil illustrate the point. The NFC can take this contingency into account by forecasting the likelihood of default and computing its cost to the federal government in the event that it occurs. This contingent liability could

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[26] See McKinnon (1995). However, in the Latin American context, states and provinces often possess their own banks, and may be able to create highly liquid liabilities or force the central banks into bailing them out. The argument for separating the central bank from the finance ministry at the national level could justify eliminating state-controlled financial institutions.

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factor into its calculation of the DCL just like the contingent liabilities of the federal government itself.

If the federal government is expected to assume the obligations of a state or municipality in default, the latter encounter very severe moral hazard problems, and efforts at fiscal control at the federal level may be jeopardized. The argument for statutory or constitutional restrictions on the ability of subnational governments to borrow is strongest under these circumstances.

The question is then under what circumstances would the central government tend to assume the liabilities of subcentral governments that are unable to pay. Eichengreen and von Hagen (1995) argue that this bail-out risk depends on the vertical fiscal structure of the federation. If the subcentral government has more scope to raise taxes or cut public spending to make available the resources needed to service and retire their debts, then the federal government can more credibly resist pressures for a bail-out. If states have restricted fiscal capacities because they cannot tax and depend on federal government transfers, then it will be hard to enforce a no bail-out rule. Thus, bail-out risk depends on the vertical fiscal structure. The stronger the dependence of subcentral governments on central government resources, the greater the bail-out risk. Where this dependence is great, it may be desirable constitutionally to limit borrowing capacity of subnational governments. If the bail-out risk is low, the problem may be small and the NFC need only take account of the behavior of state and local governments when it sets the DCL.

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B. How Should the NFC Deal with Public Enterprise Debt?

It may or may not be appropriate to think of public enterprise borrowing as part of overall public sector borrowing. If the government extends an explicit guarantee to public enterprise debt, then the associated debt should be formally recognized as part of public sector debt, and any increase should count toward the DCL. However, most guarantees are implicit and the NFC will have to assess their expected value. In turn, those outlays will affect the NFC's determination of the DCL. Public enterprises that face hard budget constraints entail no liability for the government, and the NFC will have nc reason to factor that borrowing into its calculations. However, when management, employees, and customers of the enterprise are politically powerful, when high economic costs result from disrupting the flow of services provided by the enterprise (as with power, water, telecommunications sanitation and transportation companies), and when the government has capped the prices charged by the enterprise, preventing it from generating an adequate cash flow, bail-out risk is much larger. Hence, enterprise borrowing can be thought of as a contingent liability for the government, the value of which should be factored into NFC forecasts of outlays.

Hence, there is no general argument for empowering the NFC to limit public enterprise borrowing. A contingent liability incurred by the government as a result of borrowing by a public enterprise simply affects the composition of public spending. Since the composition of public spending falls in the domain of the congress and the executive branch, not the NFC, any measure designed to limit borrowing by public enterprises should be adopted separately, not as part of the statute creating the NFC.

C. How Should the NFC Deal with Public Investment?

Some countries account separately for current and capital spending by the public sector. They exempt capital spending from budgetary ceilings on the grounds that public investment projects generate revenues that will ultimately offset their cost. Should the DCL similarly exempt spending associated with public investment?

Capital budgeting, which is essentially what this procedure implies, is subject to both conceptual and practical problems. While teachers' salaries are typically included in the ordinary budget and the construction of school buildings are included in the capital budget, it is hard to argue that the second necessarily contributes more than the first to future productivity and has a larger public investment component. There is obvious scope for abusing the distinction between ordinary and capital spending and an incentive for politicians to shift onto the capital budget items for which the social return on investment is low.

The solution to this problem is for the NFC to apply the DCL to the budget as a whole, but in addition, to monitor the composition of spending. If, for example, it sees that the share of productive public investment in total spending has increased, this may be grounds for revising upward its forecasts of economic growth or future tax revenues and for tailoring the current year's DCL accordingly. This will be the case especially when the deficit is related to investment projects that are likely to generate large additional cash resources in the near future, so that cutting them would

reduce fiscal solvency.[27]

D. How Should the NFC Treat Deferred Commitments?

By publishing projections of the revenue- and growth-generating capacity of public investment projects, the NFC will be able to shape the congressional debate over public investment in a constructive way. The same will be true of spending programs -- social security, for example -- that imply spending commitments in the future. Elected officials, who are unlikely to still be in office when the bills come due, tend to put off the adjustments required for sound funding of such commitments. By publishing its estimates of those future spending commitments and explaining how they figure into its decisions of where to set the current DCL, the NFC can encourage, and if necessary force, speedier adjustments to anticipated future fiscal developments.

E. Dealing with Arrears

A widespread problem in Latin America is budgetary arrears. Governments pass laws authorizing public expenditures but also specifying permissible issues of public debt. When revenue turns out to be lower than expected, or spending turns out to be higher, the gap shows up as arrears. How would NFCs handle them?

In principle, it is not necessary to take special account of arrears. It is only important that obligations taking the form of arrears be included for accounting purposes in tabulations of public spending and debt.

In practice, arrears pose a number of further problems. The NFC will

[27] A bridge, upon completion, will allow the government to collect tolls from users. Meeting the DCL by cutting spending on an almost completed bridge will affect future revenues.

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have to take special steps to ascertain their existence, since it may be in the interest of spending ministries to hide them. In addition, arrears sometimes threaten to the stability of banking systems. Banks extend loans to contractors on public projects. When the budgetary out-turn is unexpectedly bad and arrears accumulate, contractors are forced to default on their debts, threatening the stability of intermediaries. This dynamic is likely to place special pressure on the NFC to accommodate the needs of contractors and their creditors. Given the vulnerability of Latin American banking systems and macroeconomies to bank failures, governments often respond by paying arrears with bonds, thus effectively refinancing them. They do so outside the normal budgetary process.[28] For the DCL to be effective, arrears must be counted as part of the deficit in the year in which they are incurred. In this case, refinancing would not involve any NFC decision, since the arrears were already counted as part of the debt.

F. Should the NFC Oversee the Composition of Taxes and Spending?

The NFC should monitor the composition of taxes and spending, and factor into its forecast their impact on economic growth, unemployment, tax revenues, and so forth. Using that forecast, it could tailor the current year's DCL to provide optimal adjustment to shocks, counter-cyclical stabilization, and tax-

[28] In practice, contractors typically ask for a loan rollover, and the banks renew and increase the extent of the obligation in expectation of future payment. This can create a spiral of continuously increasing nonperforming loans, which are hidden by rollovers for an extended period of time. Often these pre-existing debts are refinanced at longer terms by issuing government bonds. Contractors receive those bonds and give them to banks, thus canceling bank loans. Typically this refinancing occurs outside the budgetary process, since it takes place in response to arrears developed in previous budgetary rounds. This allows arrears to effectively undermine fiscal ceilings.

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smoothing services. Beyond that, however, there is no reason why the NFC needs to be endowed with the power to determine the composition of taxes and spending.

G. <u>Should the NFC be Responsible for Debt Management?</u>

The distinction drawn above between responsibility for setting a ceiling on the overall budget deficit, which falls under the purview of the NFC, and setting the level and composition of taxes and expenditures, which remains in the domain of the congress and the executive, applies here as well. Debt service can be thought of as part of the composition and level of public spending and as such, falls logically within the domain of the executive branch and the congress.

But the NFC could offer recommendations concerning this matter without possessing the power to mandate debt-management policies. Countries in Latin America have limited access to multilateral and bilateral lending at relatively long and inexpensive terms. Beyond that, the supply curve of credit steepens, often very significantly. When issuing its forecast of revenues and expenditures and providing justification for the DCL, the NFC would make explicit its assumptions about the availability of finance. It would need to pay attention to the relatively large impact of additional borrowing on the interest rate.[29] This will raise the cost of servicing not only that

[29] In addition, the NFC needs to worry about the tendency for international bank loan agreements to feature grace periods. The presence of a grace period means that the cost of debt service is back-loaded, depressing current spending obligations relative to future ones, ceteris paribus. The NFC will want to publish its spending forecasts to encourage the congress to take this into account, and reduce the current DCL to build up a surplus to use later for additional debt service obligations.

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additional debt but also any short-term debt that has to be rolled over. The NFC will need to take this into account when projecting the impact of current deficits on future debt service obligations. The existence of short-term debt also increases the danger of a *tesobono*-style debt run, in which investors refuse to roll over maturing obligations, forcing the government to buy them up to prevent a financial crisis. When large amounts of public debt are short term, the NFC may decide that prudence requires smaller deficits to guard against this contingency. The point is that the NFC need not be empowered to manage debt. Its ability to determine the DCL provides enough leverage to keep the public finances sound.

VI. Credibility, Accountability and Legitimacy

There are reasons to think that a congress and its constituency would embrace such a scheme. As explained above, countries have acknowledged the advantages of delegating authority to independent central banks in the presence of incentive problems, to trade negotiators representing the national rather than sectoral interests, and to base closing commissions. Delegation stems from the recognition that political competition may compromise the future and limit cooperative solutions. Why should the principle not carry over to fiscal policy?

It would be more likely to carry over the more less authority over fiscal policy is delegated. It is therefore important to emphasize that the NFC would not control fiscal policy. It would set a ceiling on the size of the deficit, but the level of spending and taxes, and the composition of both, would remain in the control of elected officials. The NFC's influence over

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fiscal policy would thus be more limited than an independent central bank's control over monetary. It is not clear why something that is acceptable in the monetary realm should not also apply to fiscal policy.

Independent central banks are required to publish documents justifying their policy actions. Members of their boards are required to testify before congress. If their governors are found to have pursued agendas at variance with the public interest, they can be dismissed. The authority of the NFC ·ould be lent legitimacy by similar provisions. The NFC would be required to .iblish a statement explaining and justifying its determination of the DCL for he coming year. It could be required to submit a retrospective commentary of ;ne preceding fiscal year to congress at an early stage of the subsequent udgetary round. Memb..rs of its board could be required to testify before :ongress at regular intervals and provide justification for their policy decisions. It is even conceivable that the members of the NFC would be dismissed if a sufficient majority of the congress so resolved so long as the DCL for the year would remain in effect.

Since the basis for the NFC would be provided by simple or constitutional law, congress would be able, with an appropriate majority, to pass a law abolishing the NFC and the budget process for which it provides. This is the ultimate sanction that would prevent the NFC from pursuing its own agenda without democratic legitimation. However, such an action would call into question the commitment of the executive and congress to stable and sound public finances. The history of independent central banks suggests that a congress would not take such an action lightly. The danger of making dismissal too easy is that it would undermine the credibility of NFC policy.

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Making council members subject to ready dismissal might leave them reluctant to exercise their independent judgment. Hence, the threshold for dismissal should be set sufficiently high to avoid undermining the independence and autonomy of the NFC, but the super-majority should not be higher than that required to revoke the law establishing the NFC itself. Countries with differing preferences for trading fiscal policy credibility for political accountability will wish to set this threshold at differing levels.

Ultimately, the proof of the pudding is in the eating: if the NFC demonstrably improves the conduct of fiscal policy, it will gain credibility, legitimacy, and respect. We emphasized above that measures recommended in the European context to buttress credibility may backfire if too mechanically applied in Latin America; requiring automatic across-the-board spending cuts when the DCL is violated, for example, may be so costly politically and economically as to undermine rather than enhance credibility. In Latin America, where international organizations have played a prominent role in the process of economic reform, there may be a role for the IMF in buttressing the credibility of the NFC by supporting its establishment and endorsing its DCL. If the DCL receives the Fund's stamp of approval, the government's precarious credit market access will be strengthened even more dramatically than by the simple creation of the NFC. This will reinforce the advantages of the new fiscal institution and thereby help to cultivate political support.

VII. Conclusion

> "[B]efore prescribing the budgeting procedures of rich countries for poor ones, it might be well to bear in mind the obstinate waywardness often displayed by institutions when

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transplanted from their native habitat."
(Wildavsky, 1986, p. 147)

In this paper we have taken Wildavsky's warning to heart. Rather than recommending for Latin America budgetary arrangements that have worked well in the United States or Western Europe, we have advocated the creation of National Fiscal Councils of a sort that do not exist in the advanced industrial countries. Their structure is intended to redress specific problems that arise in the Latin American context. The NFC is designed to deal with the consequences for deficit spending of political fragmentation and instability; it is fashioned to superimpose on the budgetary process a medium-term planning horizon where governmental instability creates a bias toward dealing with problems in the short term. It is structured to relax financial constraints and enhance access to international credit markets for governments whose access is precarious because of their inability to commit to balancing the budget over the credit cycle. The NFC is constructed to encourage adjustment to shocks in a macroeconomic environment buffeted by swings in inflationary expectations, international terms of trade, and real interest rates. In other words, the institutional innovations we recommend are expressly designed to take into account important features of the Latin American habitat.

The reform of fiscal institutions, by itself, will not solve all problems of macroeconomic instability in Latin America.[30] The pro-

[30] The policy agenda to reduce volatility is discussed in IDB (1995) and in Hausmann and Reisen (1996).

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cyclicality, and the bias toward deficits and slow adjustment displayed by fiscal policies, are but one set of factors contributing to macroeconomic volatility in the region. Monetary stability and a climate of low and stable inflation are also needed to minimize disruptions to economic activity. An exchange rate regime that prevents the need for major adjustments in a climate of crisis would buttress both real and financial stability. Adequate capital requirements and prudential supervision of banks would prevent financial crises from disrupting economic activity. Prudent borrowing on international capital markets would insulate economies from destabilizing capital market shocks. Greater export diversification would help to reduce terms of trade risk. And heightened political stability would enhance the credibility of policy commitments and allow governments to formulate economic strategies in light of medium-term targets.

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By itself, the reform of budgetary institutions cannot achieve all of these goals. But there are important synergies between fiscal reform and reform in other domains. Improved fiscal policies will strengthen the central bank's capacity to pursue stable monetary policies, just as low inflation will simplify fiscal planning. Stable fiscal policy will prevent swings in government spending from destabilizing the exchange rate, while a realistic exchange rate will avoid disrupting fiscal planning with forced devaluations. Minimizing the increase in public spending when capital flows in will limit the need for fiscal adjustment when capital flows out. Above all, fiscal and political stability promise positive feedback to one another, with the capacity to create for Latin America a virtuous circle of economic growth.

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