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## The Role of Fiscal Transparency in Sustaining Growth and Stability in Latin America

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**The Role of Fiscal Transparency in Sustaining Growth and Stability in Latin America\***

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**Abstract**

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Latin America has experienced a resurgence in growth in recent years. However, it is also a region that has been prone to crises while growth has not delivered a significant reduction in poverty and inequality. Maintaining a strong and stable macroeconomic performance in Latin America will depend on further cuts in public debt, identification and reduction of fiscal vulnerabilities and improvements in the quality of public spending. Improvements in governance and the business environment will also aid in attracting investment. This paper draws on assessments of fiscal transparency in twelve countries in Latin America to highlight good fiscal management and improvements in fiscal transparency that might enhance the prospect for sound fiscal performance and a more favorable investment environment. This would be an important step toward sustaining stable, higher quality growth in the region.

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## I. INTRODUCTION

This paper examines the role of the Code of Good Practices in Fiscal Transparency in promoting fiscal management practices that could ultimately contribute to greater stability and quality of economic growth in the Latin American region. Notwithstanding a decade or more of important structural reforms in Latin America, this region experienced an extended economic downturn from 1999 through 2002.<sup>1</sup> Many countries were adversely affected by financial crises of key countries in the region<sup>2</sup> as well as by the economic slowdown worldwide in 2001. Despite a sharp rebound in growth in recent years,<sup>3</sup> concerns have been raised over the ability of the region to sustain strong and stable growth into the future. One concern is that, although the last three years have shown the most vigorous growth for the region since the 1970s, the pace of growth still lags behind other emerging market and developing countries (Zettelmeyer, 2006; IMF, 2007). Another concern is that periods of rapid growth in the region have historically tended to be followed by sharp slowdowns<sup>4</sup> (Krueger, 2006). Stability is more fragile and debt burdens remain higher in Latin America than in emerging market countries in other regions. As the IMF Managing Director noted in 2006, fiscal priorities for the region include reducing debt and vulnerabilities, improving the equity of the tax systems, and promoting a fairer and transparent business environment.<sup>5</sup> This paper argues that strengthening fiscal transparency can play a critical role in meeting these challenges.

Nearly all of the Latin American countries have completed a fiscal transparency Report on the Observance of Standards and Codes (ROSC)<sup>6</sup>, though some are becoming outdated as countries have implemented improvements in response to the ROSC assessment. The findings from these assessments provide some insights for the region as a whole for improving fiscal transparency and governance.

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<sup>1</sup> Experience varies markedly by country, however: Brazil, Chile, and particularly Mexico registered strong growth in 2000, Ecuador showed strong growth in 2001 and Peru showed strong growth in 2002 while Argentina, Uruguay and Venezuela experienced sharp recessions during this period.

<sup>2</sup> Mexico (1995), Brazil and Ecuador (1999), Argentina (2001) and Uruguay (2002)

<sup>3</sup> The average real GDP growth rate for the region was 2.2 percent in 2003, 5.7 percent in 2004, 4.6 percent in 2005, and 5.5 percent in 2006 (*World Economic Outlook*, April 2007: 66)

<sup>4</sup> Chile since the late 1980s is a notable exception to this observation.

<sup>5</sup> “Latin America: Between Populism and Modernity” November 30, 2006 speech by Rodrigo de Rato at the Cato Institute in Washington, DC. See also “Latin America: Structural Reforms and Competitiveness” March 24, 2006 speech by Rodrigo de Rato in Acapulco, Mexico.

<sup>6</sup> Dominican Republic, Venezuela, and Bolivia are the main remaining Latin American countries that have not yet requested a fiscal ROSC; a few countries have either not yet completed the fiscal ROSC or chose not to publish it. The Argentina fiscal ROSC is the oldest in the sample, and since it was done as only a brief desk study, it lacks the depth of later ROSCs.

The layout of this paper is as follows. The following section discusses key benefits of fiscal transparency. Section III identifies weaknesses in fiscal management and governance in Latin America and Section IV analyzes the findings from fiscal transparency ROSCs<sup>7</sup> in the Latin America region that relate to each area of weakness. Since conditions vary widely across countries in the region, in some cases the discussion will distinguish between the experiences of lower income countries (El Salvador, Honduras, Guatemala, Nicaragua, and Paraguay) and emerging market economies (Brazil, Chile, Mexico, Peru, Colombia, and Uruguay). Section V suggests a strategy for improving fiscal transparency as an important element in the effort to avoid future debt crises and sustain economic growth in the region.

## II. WHY FISCAL TRANSPARENCY?

Lack of transparency, including inadequate data, hidden liabilities, and a lack of clarity about government policies, contributed to loss of confidence and fed global instability in the late 1990s. Particularly in Latin America, weaknesses were related to poor monitoring of off-budget fiscal activities that eventually had large fiscal consequences. Not only were these consequences not anticipated, but the lack of transparency may have contributed to the growth of these activities. Fiscal transparency—broadly defined as being open to the public about the structure and functions of government, fiscal policy intentions, public sector accounts, and fiscal projections (Kopits and Craig, 1998)—permits a clear assessment of past fiscal performance, the current fiscal position, fiscal risks, and the future direction of fiscal policy. Most importantly, identification and better monitoring of potential fiscal risks can prevent fiscal surprises in future. More generally, improvements in the quality and timeliness of fiscal data should improve the analysis of fiscal data and the quality of fiscal decisions.

Fiscal transparency is more than improved internal monitoring of fiscal risks, however. Making information available to the public and the legislature provides for greater accountability of government and indirectly should strengthen governance and reduce corruption (Shah and Schacter, 2004). Better information can also enhance public understanding and lead to stronger support for important fiscal reforms needed to reduce public debt and eliminate fiscal vulnerabilities. Donors and civil society also benefit from the availability of better fiscal information which can be used to support their efforts to promote social spending, reduce poverty and promote more equitable outcomes. Greater fiscal transparency—by simplifying tax and business regulations and curbing discretion—can positively impact the business environment and thus attract investment.

Recent empirical studies document the positive impact of fiscal transparency and better governance<sup>8</sup> on investment and economic growth. Using a composite measure of government transparency, Drabek and Payne (2001) find that low levels of transparency have a

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<sup>7</sup> The fiscal transparency ROSCs referred to in this paper can be found on the IMF external website <http://www.imf.org/external/np/rosc/rosc.asp?sort=topic#FiscalTransparency>.

<sup>8</sup> Empirical research shows that measures of governance have a large, statistically significant effect on the level of income and rate of growth as well as a negative effect on growth volatility (IMF, 2003a).

significant negative impact on foreign direct investment (FDI). Since FDI is a relatively more stable capital inflow than other types of capital inflows, countries with more FDI are also less prone to “sudden stops” in capital flows and more able to avoid capital account crises (IMF, 2003a; Reisen and Soto, 2001). Other research finds that emerging market equity funds hold fewer assets in less transparent countries, and that destabilizing herding behavior by international investors is more prevalent in less transparent countries<sup>9</sup> (Gelos and Wei, 2002). Hence, fiscal transparency can promote economic stability by encouraging FDI and reducing herding behavior. In addition, evidence also indicates that sovereign credit ratings improve after publication of key fiscal information including fiscal ROSCs (Glennerster and Shin, 2003; Hameed, 2005). Since sovereign credit ratings determine the lower bound for private borrowing, an improvement in the rating will lower the cost of private investment as well as public investment.

This paper argues that improving fiscal transparency in Latin America will not only benefit the investment environment in the ways noted above, but will also remedy weaknesses in fiscal management practices that have been related to crises in the past. First, fiscal transparency requires an effective medium-term budget framework and forward-looking analysis of fiscal policies that explicitly considers sustainability and medium term policy goals. Second, improving fiscal transparency entails giving much needed attention to analyzing fiscal risks particularly those arising from hidden liabilities and quasi-fiscal activities. Third, improved monitoring of general government activities and the provision of more frequent and more relevant fiscal data to the legislature and the public should reduce surprises in the fiscal sector. Fourth, it will be important to focus on clarifying relationships between levels of government, and for some countries between the branches of government, in order to achieve a hard budget constraint needed to prevent excessive public debt. Fifth, strengthening fiscal transparency by simplifying the tax system, reducing discretion in dealings with the private sector, and fortifying oversight controls will enhance the investment climate.

### III. FISCAL MANAGEMENT WEAKNESSES IN LATIN AMERICA

Improvements in the fiscal stance and a significant decline in debt-to-GDP ratios have been recognized as important factors contributing to the resurgence of economic growth in Latin America in recent years (Singh, 2006). However, public debt remains high relative to the years preceding the crises. In the fiscal sector, Singh and others (2005) identified flaws in the design and administration of the tax system, weak budget institutions, and rigidity in government expenditure as critical areas for reform in order to reduce debt in an enduring way. The *World Economic Outlook* (IMF, 2007) also argues that an even greater premium needs to be placed on fiscal reforms given expected pressures on current account and fiscal balances. Thus, if Latin America is to avoid a repetition of previous economic crises, more fundamental improvements in fiscal management are needed.

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<sup>9</sup> During crises, emerging market funds withdrew more strongly from less transparent countries after controlling for other risk factors.

This section describes key weaknesses related to fiscal management and transparency that have contributed to economic instability in Latin America in the past. This will be followed by a review of the findings from assessments of fiscal transparency that highlights areas where greater transparency could be expected to improve the quality of fiscal policy through better information, greater accountability, and better identification of fiscal risks.

### **Forward-looking fiscal policy**

The susceptibility to debt crises in Latin America points to the need for more explicit analysis of fiscal sustainability, as well as continued successful fiscal consolidation. Although the region has demonstrated fiscal discipline in recent years, fiscal policy in the past has tended to be pro-cyclical (IMF, 2003b; Gavin and Perotti, 1997; Ter-Minassian and Schwartz, 1997) while spending rigidities have made it difficult to reallocate spending to improve efficiency or to shift toward pro-poor expenditures (Chu and others, 2000; Lloyd-Sherlock, 2000). Current expenditures have followed an upward trend and fluctuations in real spending have continued to follow a procyclical pattern (Clements and others, 2007). At the same time, a decline in investment in infrastructure may have inhibited stronger economic growth (Calderon, et al., 2002), and the need to reduce rigidity to target infrastructure and pro-poor spending remains an issue for the region (IMF, 2006). A commitment to avoid these past trends and to maintain more consistent policies is needed. To prevent a repetition of these problems, Latin American countries can improve the credibility of fiscal policy, avoid procyclical spending, and raise pro-poor expenditure by developing a sound medium-term fiscal framework to achieve fiscal policy objectives. This would ideally entail developing a medium term budget framework (MTBF) with rolling three-year budget forecasts, and annually analyzing progress toward attaining medium-term objectives.

### **Identifying fiscal vulnerabilities**

Fiscal crises in Latin America in the past were often rooted in the emergence of “fiscal skeletons” resulting from poor monitoring of contingent liabilities and, in particular, a lack of recognition of the fiscal impact of off-budget fiscal activities related to noncommercial activities of public enterprises or public financial institutions (referred to as quasi-fiscal activities or QFAs). Some of the most costly hidden liabilities in Latin America were related to implicit guarantees in the banking and corporate sector. Quasi-fiscal activities of development banks and public enterprises were often an important source of losses in these sectors. Court mandated expenditures were a second significant source of contingent liabilities in Latin America. In Argentina, court rulings included compensation payments related to social security reforms, refunds of tax credit arrears, and assumption of liabilities of state enterprises prior to privatization (Daseking and others, 2004). In Brazil, further fiscal skeletons arose from the settlement of legal claims asserting inadequate compensation during high inflation, causing debt to rise by 2 ½ percent of GDP from 2000 to 2002 (Singh and others, 2005, p.37). Central government bailouts of over-indebted subnational governments were a third important contingent liability, the best-known examples being Argentina (late 1990s) and Brazil (early-mid 1990s). Fourth, government guarantees associated with poorly designed build-operate-transfer contracts for highways in some Latin American countries



also proved to be costly, especially in Colombia and Mexico in the 1990s (Engel and others, 2003),<sup>10</sup> while government guarantees extended during privatization (such as minimum annual revenue guarantees) were another source of contingent liabilities.

Acknowledgement of these fiscal skeletons caused public debt to grow markedly, even though the primary balance remained close to zero in some countries.<sup>11</sup> In Argentina<sup>12</sup>, for example, fiscal skeletons added 1 ½ percent of GDP to public debt on an annual basis for nearly ten years (1992-2001) (Singh and others, 2005, p.37), yet were overlooked due to a focus on conventional measures of the fiscal balance. These facts highlight the need to identify all possible sources of fiscal risk and improve the overall quality of fiscal risk analysis. “Regular reporting of unfunded and contingent liabilities, reporting of quasi-fiscal activities...and assessments of the fiscal risks they pose are good practices of fiscal transparency that would provide a basis for more realistic debt sustainability analysis (Hemming and Ter-Minassian, 2003: 68).” Ultimately, mechanisms are needed to limit as well as monitor these risks.

## **Monitoring fiscal activities**

### ***Decentralization***

Bailouts of subnational governments weakened the fiscal position of central governments in some Latin American countries during critical periods. This reflected weak monitoring of subnational governments due in part to the impact of decentralization, which in many cases led to incomplete coverage in budgeting and reporting of fiscal activities. In many Latin American countries, some of the responsibilities of the central government were devolved to lower levels of government in order to reap gains in efficiency by exploiting greater knowledge of local conditions and needs while avoiding the bureaucracy of centralized decision making ((Smoke and others, 2007; Montero and Samuels, 2004; Peterson, 1997). However, collection and consolidation of data from subnational government and decentralized entities became a difficult, timely and costly task after decentralization. Furthermore, one form of decentralization seen in Latin America is deconcentration where central government functions are reassigned to entities outside of government. In much of Latin America it is common to find a large “decentralized” sector that includes various

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<sup>10</sup> Contracts included guarantees for traffic volume and/or construction costs. In the case of Mexico, the government spent more than US\$ 8 billion to bail out the highway franchise owners and the banks that lent to them (Engel and others, 2003: 129). Both Mexico and Colombia have subsequently introduced improved accounting and controls of PPPs.

<sup>11</sup> Over a number of years, the costs of a combination of financial and corporate sector liabilities plus unfunded pension liabilities reached 19 percent of GDP in Mexico (1995-97), 14 ½ percent of GDP in Argentina (1999-2002), and 8 ½ percent of GDP in Brazil (1996-2000) (Hemming and Ter-Minassian, 2003: 67).

<sup>12</sup> Build up in debt in Argentina was also related to underestimation of the cost of the 1994 pension reform.

commercial and noncommercial entities. Whatever their legal status, if such entities undertake noncommercial functions, receive a majority of income from earmarked revenues or budget transfers, and/or are controlled by government units, they are classified as nonmarket nonprofit institutions (NPIs) and belong in the government sector according to the GFS Manual (IMF, 2001: 10).

### ***Public availability of information***

In Latin America, much of the information that citizens should have in the course of the budget year to hold governments accountable for their policies is not publicly available. Information should be available on policy intentions, revenue, debt, spending and results. According to the *Open Budget Initiative* (2006), half of the 12 countries in Latin America included in the sample had scant or minimal fiscal information available to the public. The two with the highest scores were Peru (77 percent) and Brazil (73 percent) while the remainder provided only around 50 percent of the fiscal information considered to be essential to hold governments accountable (see also Table 3 in section IV).

### ***Oversight***

Administrators in Latin America appear to have more discretion than commonly found in other regions (Craig and Manoel, 2002: 31) which may be an important factor contributing to corruption and unequal application of rules and regulations. Good practices in expenditure monitoring and audit are especially important to ensure effective government expenditure and prevent misuse of public funds.

### **Enforcing a hard budget constraint**

#### ***Strong budget institutions***

Certain institutional weaknesses may have contributed to lax fiscal policy and growing debt in Latin America. According to the literature on budget institutions, centralization of budget powers is an important ingredient for achieving sound fiscal policies (Alesina and Perotti, 1996; Gleich, 2003; Fabrizio and Mody, 2006). Centralization of budget powers describes a situation in which: (1) the constitution favors the executive over the legislature for reaching fiscal decisions; (2) a strong ministry of finance can effectively hold the demands of the spending ministries in line with overall fiscal constraints; and (3) earmarking of revenue for specific expenditures, which reduces the ability of the ministry of finance to reallocate spending, is limited. In Latin America, weak budget institutions have been associated with pro-cyclical fiscal policy and an absence of control over subnational government debt (Alesina and others, 1999). In addition, the amount of earmarking in Latin America is extensive (Singh, 2005), thus impeding fiscal consolidation efforts. Chile is the one country that has notably stronger budget institutions which may have enabled it to follow sound fiscal policies and to better weather economic volatility (Espinosa-Vega and Phillips, 2004).

### ***Intergovernmental fiscal relations***

Poorly designed intergovernmental arrangements may have created perverse incentives in some countries, undermining effective fiscal management. For instance, central governments did not have as strong an incentive to prevent tax evasion where a large percent of the revenue collected was automatically turned over to lower levels of government through a revenue sharing formula. Furthermore, autonomy to borrow, combined with easy access to debt (especially under automatic receipt of shared revenues), encouraged pro-cyclical expenditure and over-indebtedness at the subnational level (Braun and Tommasi, 2004). These perverse incentives combined with additional political factors partially explain the pattern of repeated fiscal crises in a number of countries in Latin America (see Box 1).

The problem of over indebtedness of subnational governments is usually described as the result of moral hazard: since these governments expect the central government to bail them out, they do not engage in risk averse fiscal policies. Others have described the problem as a “tragedy of the commons” where total public sector debt is the common property shared among various levels of government (Braun and Tommasi, 2004; Jones, et al. 2000). One solution has been for the central government to assume control of total general government debt through instruments such as agreements with other levels of government, setting legal limits on subnational government debt, and careful monitoring of subnational government fiscal activities. Most fiscal responsibility laws (see Box 2) attempt to do this by setting borrowing limits and/or spelling out consequences if subnational governments become over-indebted (Webb, 2004).

### **Strengthening the business environment**

#### ***Regulation and governance***

The lack of a supportive business environment has been an impediment to growth and has diminished the resiliency of Latin American economies in the face of economic crises. “Extensive bureaucracy has led to an excessive and uncertain regulatory environment and, together with weak enforcement of the rule of law and corruption, has discouraged both domestic and foreign private investment” (Singh and others, p.19, 2005). In particular, business start-up costs are much higher in Latin America than in Europe and Asia (Cole and others, 2004). Attracting foreign direct investment continues to be a critical priority for many countries in the region.<sup>13</sup> In many cases this calls for strengthening the rule of law and improving regulatory frameworks governing the business environment (IMF, 2005, p. 39). Indeed, Kaufman (2004) suggests that improving governance has a stronger impact on foreign direct investment (FDI) than other important economic variables. It is therefore

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<sup>13</sup> “Latin America: Between Populism and Modernity” November 30, 2006 speech by Rodrigo de Rato at the Cato Institute in Washington, DC. See also *World Economic Outlook* April 2007.

### **Box 1. Decentralization, Incentives and Fiscal Rules**

Decentralization has often been promoted as a way to benefit from greater efficiency by exploiting better information on local conditions while avoiding the bureaucracy of centralized decision making. From a fiscal transparency point of view, however, decentralization makes the task of recognizing and reporting on all government entities more difficult, and it also makes the task of producing consolidated government data more challenging. Perhaps less recognized are other features often associated with fiscal decentralization that create disincentives for fiscal prudence at the lower levels of government. For instance:

- Due to vertical imbalance in fiscal resources, it is common to find a large portion of total expenditure of subnational governments financed by intergovernmental transfers or shared revenue. Under these circumstances, the lower perceived cost of subnational goods and services may lead to less incentive to spend efficiently, and higher demand than if they were financed fully from local revenues.
- Discretionary intergovernmental transfers motivate subnational governments to lobby for more resources.
- Any history of central government bailouts of subnational governments may further support the inclination to overspend at the subnational level of government.
- Decentralization tends to encourage tax competition which discourages local tax effort.

These features of decentralization have been quite common in Latin America. In some cases political or legal arrangements have further weakened incentives for fiscal prudence at the subnational level of government. For instance:

- Constitutional independence in fiscal policy, including borrowing autonomy by subnational governments, combined with constitutionally assigned revenue sources helps secure access to credit at the subnational levels of government.
- The central government may face a conflict between its need for political support from certain subnational governments and its role as watchdog of subnational governments' fiscal position.

This combination of incentives may partially explain the pattern of debt-led expansion followed by crises that has occurred in a number of the Latin American countries. In order to respond to the lack of fiscal constraint and the need to bailout certain subnational governments, many countries in Latin America have adopted fiscal rules or fiscal responsibility laws. To successfully counteract the perverse incentives identified above, it is important that the central governments be able to effectively monitor compliance, and to impose adequate penalties for noncompliance. Another approach has been to change the incentives faced by subnational governments under decentralization by revising the criteria for distribution of intergovernmental transfers to reward tax effort or fiscal constraint.

### **Box 2. Fiscal Responsibility Laws**

Recently, a number of countries in Latin America have followed the example of Brazil and approved a fiscal responsibility law which aims to overcome institutional weaknesses to improve and stabilize their fiscal position. In some cases the law applies to the central government only while in others it covers the entire public sector. The laws include a combination of numerical rules to limit the deficit or reduce public debt, and procedural requirements to improve transparency and strengthen budget institutions. Sanctions for noncompliance with the law can either apply to the jurisdiction itself (withholding transfers, fines) or to the responsible official (fines, dismissal or prosecution). They also usually include some type of escape clauses to suspend application under unusually difficult circumstances. Fiscal responsibility laws in Latin America include some or all of the following elements:

- Fiscal rules that target debt, primary balance, or expenditures (e.g. personnel expenditures) as a percent of revenue or that forbid financing current expenditure with debt;
- Requirements to reduce pro-cyclicality such as fiscal stabilization funds, escape clauses for low-growth periods, or a rule to require fiscal savings during high-growth periods;
- A commitment to establish the formal use of a medium-term macroeconomic and fiscal framework;
- Standards for reporting government finances, risk assessments, and/or reports on contingent liabilities and tax expenditures;
- Budget requirements (for example, reduced earmarking, limits on the power of the legislature to modify the budget, or restrictions on budget amendments) that strengthen the power of the finance ministry in setting the budget; and
- Limitations on the indebtedness of subnational governments (with sanctions for noncompliance).

Source: Webb, 2004

disappointing that various indicators of governance<sup>14</sup> and the business environment show that most countries in the Latin American region lag behind other important emerging market countries. According to a World Bank database on indicators of good governance, Latin America<sup>15</sup> scores on rule of law and corruption fall below Eastern Europe and East Asia. The

<sup>14</sup> Measures of governance have incorporated such outcomes as political accountability, stability, effectiveness in service delivery, regulatory quality, enforcement of the rule of law, and ability to limit the amount of corruption.

<sup>15</sup> A considerable amount of diversity within Latin America should also be noted with countries such as Chile and Costa Rica scoring close to the OECD average.

business environment index in the *Global Competitiveness Report* (Porter and others, 2004) reports that only four Latin American countries fall within the top 50 countries, while seven are ranked in the ten worst countries in a sample of 80 countries world wide. Even the highest ranked countries in Latin America are surpassed by important emerging market countries in other regions of the world.<sup>16</sup> These domestic competitive barriers in Latin America are one explanation for its slower growth than other emerging market and developing country regions.

### ***Taxation***

A critical issue in many countries in Latin America is the need for tax reform accompanied by stronger tax administration to limit tax evasion and erosion of the tax base. Repeated recourse to tax amnesties has compounded the problem of poor compliance in some countries. In addition, tax systems in much of Latin America are complex, and tax bases are too narrow due to numerous exemptions or special tax regimes. As a result tax collection is relatively low in comparison with other regions of the world (Artana and others, 2003).

### ***Governance, inequality and growth***

Reducing bureaucracy, tax reform and stronger enforcement could have a positive impact on equality. When governments succeed in enforcing the rules and limiting corruption, a more level playing field helps to ensure that the benefits to growth are broad-based. This is particularly important for Latin America where, despite recent economic growth, combating persistent poverty and inequality remains a challenge (Saavedra and Arias, 2005). Inequality in Latin America is considered to be among the most severe in the world (Corbacho and Davoodi, 2002) and interferes with reaching poverty reduction goals (Ravallion, 2001). Recent research indicates that greater equality can also extend periods of strong growth (Berg, Ostry, and Zettelmeyer, 2006).

## **IV. ASSESSMENT OF KEY FISCAL TRANSPARENCY PRACTICES<sup>17</sup>**

This section summarizes ROSC observations and recommendations that are directly relevant to improving fiscal management in the areas identified above. Progress in meeting key elements of the Code of Good Practices on Fiscal Transparency (the Code) among the countries in the Latin America region that have undertaken a fiscal ROSC is summarized in

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<sup>16</sup> The highest ranked country in Latin America, Chile, is exceeded by Taiwan, Korea, Malaysia, South Africa, and Estonia; the next highest country, Brazil, is topped by Latvia, Slovenia, Thailand, Tunisia, Jordan, India, Hungary and the Czech Republic.

<sup>17</sup> The discussion in this section is based on observations in the fiscal transparency ROSCs, or a ROSC update in the case of Honduras and Chile. In some cases ROSC observations may be out of date. An attempt has been made to describe developments subsequent to the ROSC, where Fund staff has been able to provide such information, but this is not a comprehensive update for all countries in the sample.

Tables 1-6 and discussed below. However, the group of Latin American countries is diverse and therefore, in some cases their experience and future challenges are discussed separately for emerging market<sup>18</sup> and lower income countries.<sup>19</sup>

### **Forward-looking fiscal policy**

A credible fiscal policy stance depends on developing the ability both to identify future risks to fiscal policy implementation, and to draw on realistic medium-term plans while preparing the annual budget. For emerging markets, a medium-term budget framework (MTBF) can be an important tool to signal policy commitments and to avoid future crises. Lower income countries in Latin America also need to develop medium term planning in order to reach poverty reduction goals. However, none of the Latin American countries had fully developed a MTBF at the time of their fiscal ROSC, though a number of emerging market countries were moving in this direction. While recognizing these efforts, ROSCs recommended taking further steps to develop a MTBF in all these countries. For lower income Latin American countries, ROSCs generally recommend developing a MTBF as a medium-term objective. Box 3 outlines the practices that need to be developed to implement an effective MTBF.

Fiscal transparency practices related to forward-looking budgeting, as observed in fiscal ROSCs, are shown in Table 1 and range from important prerequisites for developing sound medium-term estimates to those practices that are necessary to fully implement a medium-term budget. According to fiscal ROSCs, a number of countries in Latin America lacked the fundamental prerequisites necessary for more accurate forward-looking policy analysis and medium-term planning. First, a requirement for developing reliable medium-term estimates is a realistic budget that is adhered to during the budget year. According to fiscal ROSCs, however, only Chile and Mexico were considered to have a realistic budget, though some others in Latin America, including Colombia and Uruguay, have been improving in this area. Under-spending relative to the budget, especially for investment and foreign financed projects was a common problem. Second, a stable macroeconomic environment and a well-developed multi-year macroeconomic framework are also important requirements for developing sound medium-term estimates. While most countries in Latin America had a macroeconomic framework, only a few countries had incorporated a multi-year perspective, although some countries such as Uruguay and Mexico developed one subsequent to their ROSC. Numerous ROSCs noted that the macroeconomic models and budget assumptions were not explained in the budget documents, nor were they subject to external scrutiny, making it difficult to judge the quality of the forecasts. This lack of transparency may obscure overly optimistic forecasts of economic growth, creating an additional source of vulnerability to fiscal risks.

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<sup>18</sup> Argentina, Brazil, Chile, Colombia, México, Peru, Uruguay

<sup>19</sup> El Salvador, Guatemala, Honduras, Nicaragua, Paraguay

### Box 3. Developing a Medium-term Budget Framework

The development of a medium-term budget framework (MTBF) would enable countries to anticipate future vulnerabilities and to respond accordingly in order to sustain economic growth and meet poverty reduction goals. There are a number of **prerequisites** for a MBTF to be implemented effectively.

- Medium-term estimates will be more reliable if they are based on a **realistic annual budget**. This requires a sound budget formulation process that permits the MOF to enforce ceilings on agency budgets.
- A **multi-year macroeconomic framework** should determine key budget assumptions for the current and future years. The methodology and assumptions used to make medium-term projections should be **open to scrutiny** in order to avoid tendencies toward overly optimistic macroeconomic forecasts.
- The annual budget should contain a **statement on medium term policy objectives**, and these objectives should feed into each year's budget preparation process.

Once these prerequisites have been put in place, the planning process can become more refined. Next steps include:

- Requiring agencies to submit out-year requests for 2-3 years beyond the budget exercise that respect **medium-term fiscal ceilings** and policy goals. These out-year estimates should be examined as part of the annual budget exercise.
- Routinely examining and **explaining deviations in outturn from budgeted** spending and using this information to guide future budget requests.
- As medium-term macroeconomic forecasts improve with accuracy, and forecasts become more dependable, **agency out-year expenditure plans should become a basis for the following year's annual budget exercise**.
- **Costing new policy proposals separately** and comparing them to the medium-term estimates developed under existing policy.
- Paying particular attention to **coordination of recurrent and investment expenditures** to accurately project recurrent expenditures from current investment plans.

Most countries in Latin America have some sort of mechanism for medium-term planning, often in the form of multi-year development plans (DPs) or public investment plans (PIPs) that set out objectives and spending targets for 4 to 5 years. In Uruguay, a five-year investment budget was adopted during the first year an administration took office, which until recently, was not updated until a new administration arrived five years later. This budget represented an upper bound with actual implementation much less than planned. A number of lower income countries have produced Poverty Reduction Strategy Papers which also contained medium-term objectives, macroeconomic forecasts, and fiscal targets. However, according to fiscal ROSCs, neither the development plans nor the PRSPs were connected to the annual budget process in any concrete way. Some fiscal ROSCs noted the absence of a bridging table or other information that could explain how the annual budget figures relate to the development plan or PRSP. Furthermore, neither was revised on an annual basis, so that



Table 1. Forward-Looking Fiscal Policy

ROSC date	Realistic annual budget	Medium-term macroeconomic framework	Budget				New and ongoing policy costs are distinguished in the budget	Analysis of fiscal sustainability/ long term risks
			Budget documents include medium-term objectives	Budget documents include forward year estimates	Medium-term investment plan (PIP), development plan (DP) or PRSP	3.1.1		
Code Practice	4.1.1	3.1.3	3.1.1	2.1.2	--	3.1.4	3.1.1	
Argentina 1999	*	Yes1/	* 1/	Yes1/	*	*	Yes	
Brazil 2001		Yes	Yes	Yes3/	Yes (DP)	4/	Yes	
Chile 2003/05	Yes	Yes	Yes	Yes3/	*	4/	Yes	
Colombia 2003	Yes 5/	Yes 5/	Yes 5/	Yes 5/	Yes (DP)		Yes	
El Salvador 2005	1/ 2/	Yes	Yes	Yes 3/	*		Yes	
Guatemala 2006	1/ 2/			Yes	Yes (4-yr PIP)			
Honduras 2002/05	*			Yes	Yes (PRSP)	*		
Mexico 2002	Yes	1/	1/	1/	Yes (DP)	*		
Nicaragua 2002	1/				Yes (PRSP)			
Paraguay 2006	2/				Yes (PRSP)			
Peru 2004	*	Yes	Yes	Yes 3/	Yes (DP)		/1	
Uruguay 2001	* 1/	Yes 5/	Yes 5/		Yes (5-yr budget)	*		

Source: Fiscal ROSC for the respective countries and IMF staff. Observations are derived from published fiscal transparency ROSCs or updates published on the IMF website.

Yes- indicates that the country observes or largely observes the indicated practice

\* No observation made

1/ improvements underway or recently noted

2/ under expenditure of capital project expenditure

3/ for fiscal aggregates only

4/ some distinction is made in analyzing budget submissions, but not in the budget document

5/ Practice began post-ROSC

by the end of the planning period they might not be a realistic or even desirable guide for the annual budget process. An additional flaw arising from the reliance on development or investment plans is the delinking between investment decisions and recurrent expenditure plans, as noted in some ROSCs (Uruguay, Colombia, Honduras and Nicaragua), though recent improvement has been noted for Uruguay. This disconnect undermines the realism and transparency of medium-term plans.

ROSCs indicated that countries in Latin America could improve the forward-looking content in the budget documentation, and this would also provide a stronger foundation for developing formal medium-term budgeting. First, a clear statement of medium term objectives should guide the annual budget process and be included in the budget presentation. While almost half of the Latin American countries that completed a fiscal ROSC had forward-year estimates for the main fiscal aggregates, only a few countries provided medium term objectives within the budget documents. Second, these objectives should be based, at least in part, on an analysis of fiscal sustainability and longer term fiscal risks to determine the need and pace of fiscal policy adjustment. A few emerging market countries such as Brazil and more recently Chile, Peru and Colombia regularly undertake an analysis of fiscal sustainability. However, some fiscal ROSCs recommended undertaking a more systematic and comprehensive examination of fiscal sustainability. Third, effective medium-term planning requires that multi-year estimates derive from full costing of the current and future impact of new policies. For transparency, the costs of new policy should be distinguished from on-going policy in the budget and in the medium-term estimates. However, at the time the fiscal ROSCs were completed, none provided distinct estimates of new and ongoing policy costs in the budget, though in some cases this occurred during budget preparation.

More recently, some countries in Latin America seem to have responded to ROSC recommendations by developing multi-year rolling estimates and more sophisticated medium term frameworks. For example, Colombia recently began producing a ten year fiscal framework and a four year expenditure framework that are both updated annually. Argentina<sup>20</sup> has also implemented an MTBF which is available to the public, and Honduras and Guatemala have begun to provide more refined medium-term estimates. Uruguay has recently begun to make annual adjustments to the multi-year budget.<sup>21</sup> These countries also now state clear medium term objectives as part of the annual budget process.

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<sup>20</sup> Argentina's MTBF goes to the congress, and is available to the public at <http://www.mecon.gov.ar/onp/html/index.html>.

<sup>21</sup> The *rendicion de cuentas* in the context of the 2005-09 budget has provided an enhanced assessment of the budget execution, an update of the macroeconomic framework, and a revision of budget appropriations for the remainder of the budget period beyond increasing previous appropriations by inflation.

## Identifying fiscal vulnerabilities

Table 2 provides a summary of fiscal ROSC observations on good practices related to assessing fiscal vulnerabilities. Important fiscal risks stem from various off-budget activities such as contingent liabilities and quasi-fiscal activities (QFAs) when these activities are not well-monitored. Fiscal risks may also arise from poorly monitored extrabudgetary entities. These types of activities, which are decided outside the realm of the usual budget process, are common in much of Latin America. Information on such activities is important to secure a complete picture of government activities. Only a few emerging market countries in the region regularly analyzed fiscal risk related to these activities or the impact of changes in budget assumptions.<sup>22</sup>

### *Contingent liabilities*

The fiscal ROSCs for Mexico, Colombia, El Salvador, Guatemala and Paraguay indicate that contingent liabilities were significant, but unfortunately, many ROSCs for Latin American countries did not provide information on the amount or magnitude of contingent liabilities. Among those countries for which information was available, only Brazil and Chile provided complete details on contingent liabilities while Colombia and El Salvador published partial data on contingent liabilities. Following the ROSC assessments, both Peru and Colombia have begun to disclose detailed information on contingent liabilities including those related to public-private partnerships. Colombia also provided a detailed description of the methodology used to calculate contingent liabilities in the medium-term fiscal framework. In addition to projected pension shortfalls, calculations of the net present value of contingent liabilities related to infrastructure contracts, public credit, and judicial rulings are now provided under different scenarios. In Mexico, some information on contingent liabilities was available at the time of the ROSC, but the budget did not provide any statistics or analysis of federal government contingent liabilities. These included government guarantees covering all debts of the Bank Savings Protection Institute, which carried a capital deficit equivalent to 11 percent of GDP in September 2001. Also, future obligations of public-private partnership<sup>23</sup> projects were reported as contingent liabilities, when in fact they were not contingent. Recently, both Colombia and Mexico have been improving the control and accounting of public private partnerships and their associated contingent liabilities.

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<sup>22</sup> The fiscal ROSC update for Chile notes that the 2005 budget documents contained a thorough analysis of fiscal risks applying internationally accepted methodologies.

<sup>23</sup> PIDIREGAS projects are capital investment projects undertaken by the private sector on behalf of the public sector. Only financing amounts payable during the current fiscal year and the following fiscal year were considered as liabilities, the remaining financing was considered as contingent liability.

Table 2. Identifying Fiscal Vulnerabilities

Code practice	ROSC Date	Contingent liabilities are reported	Limited Contingent Liabilities	Data on QFAs published	PFI	Limited QFAs	NFPEs	Few or no EBFs; small extrabudgetary expenditure	Analysis of fiscal risks
		2.1.3	2.1.3	2.1.3	1.1.4	1.1.4	1.1.4	1.1.3	3.1.5
Argentina	1999		*		Yes	Yes	Yes		
Brazil	2001	Yes	*	*	Yes	Yes	Yes	Yes	Yes6/
Chile	2003/5	Yes	*	*	1/	Yes	Yes	Yes 3/ 5/	Yes
Colombia	2003	Yes 2/	1/	1/					Yes6/
El Salvador	2005	Yes				Yes	Yes	3/ 4/ 5/	
Guatemala	2006							4/	
Honduras	2002/05		*			Yes	Yes	5/	*
Mexico	2002				1/			4/	1/
Nicaragua	2002		*		*				*
Paraguay	2006				1/			Yes 5/	
Peru	2004	Yes 7/	*						
Uruguay	2001		*		1/	1/			

Source: Fiscal ROSC for the respective countries and IMF staff. All observations are derived from published fiscal transparency ROSCs or updates published on the IMF website.

Yes- indicates that the country observes or largely observes the indicated practice

\* No observation made

1/ Improvements in progress

2/ Only partial information was provided but full reporting subsequent to the fiscal ROSC

3/ Some military expenditure excluded from the budget

4/ Some extrabudgetary transactions

5/ Decentralized entities or some entities have separate budgets

6/ Analysis need to be more comprehensive and systematic.

7/ Practice began post-ROSC in 2005

### ***Quasi-fiscal activities***

In many Latin American countries the identification, measurement and reduction of quasi fiscal activities (QFAs) is important not only to reduce fiscal vulnerability, but also to promote the overall health of the economy. Numerous fiscal ROSCs noted that the widespread use of QFAs in public financial institutions (PFIs) weakened the financial sector and interfered with its ability to mobilize and efficiently allocate savings to productive investment, undermining any contribution from the financial system to economic growth and stability. Similarly, ROSCs reported that QFAs in the nonfinancial public enterprises (NFPEs) weakened the private sector by requiring inefficient production (e.g., through input requirements) or reducing competition in certain sectors. However, without a requirement to make an inventory and analysis of QFAs, neither policy makers nor the public are fully aware of the costs of QFAs or their impact on broader economic activity.

As described in Box 4, QFAs have been prevalent in most Latin American countries, though in some cases steps have been taken to reduce or eliminate these activities. Significant QFAs were carried out by both NFPEs including some decentralized entities, and by PFIs. Despite their relative abundance, according to the fiscal ROSCs, no Latin American country was publishing data on quasi-fiscal activities, and only Colombia was making an attempt to quantify the costs of subsidized prices.

The last series of crises in Latin America may have been a catalyst for improvements with respect to QFAs, but fiscal ROSCs may also have played a role by calling attention to this issue. Colombia now includes data on some QFAs in the medium term fiscal framework which is presented to Congress and published. Mexico has also begun reporting an “augmented balance” that includes important QFAs and off-budget items. In Chile, Honduras and Brazil some QFAs have been replaced with explicit budget transfers for certain noncommercial activities conducted by public enterprises. Paraguay and Mexico have ceased directed lending by PFIs, and Uruguay has also reduced subsidized lending and eliminating differentials in the taxation of public and private enterprises.

### ***Extrabudgetary expenditures***

In addition to QFAs and contingent liabilities, other types of extrabudgetary expenditure can introduce fiscal vulnerabilities, particularly if not properly monitored. According to the ROSCs, extrabudgetary spending was relatively common in Latin America. In Chile earmarked revenue for the purchase of military equipment was held off-budget, while Uruguay held several social security funds off-budget. In Honduras, 45 percent of investment expenditure was made by an extrabudgetary fund, the Social Investment Fund. In Peru significant extrabudgetary activities were undertaken by regulatory and supervisory agencies and by social development funds. Finally, about half of the Latin American countries with ROSCs had a number of NPIs that perform noncommercial activities that were not included in the budget (see below and Table 3 on monitoring fiscal activities).

#### **Box 4. Quasi Fiscal Activities in Latin America Recorded in Fiscal ROSCs**

##### ***QFAs conducted by public financial institutions:***

- Maintaining unprofitable branches in small or rural areas (Chile)
- Granting insurance to low-income or risky sectors of the economy (Chile)
- Directed lending to certain sectors of the economy—usually agriculture, certain industries and small businesses—leading to a large share of nonperforming loans (Mexico, Brazil, Peru, Paraguay, Honduras)
- Granting loans at below-market rates to certain groups or sectors of the economy, the government and public sector entities, public sector employees, or pensioners (Mexico, Peru, Uruguay, Paraguay, El Salvador)
- Debt forgiveness (at the direction of the government)
- Refinancing nonperforming loans in key sectors of the economy—usually agriculture and small businesses (Uruguay)
- Forced merger with failing banks (Guatemala)
- Public sector deposits are not remunerated which are usually captive resources (Peru); Captive deposits are remunerated at below market rates (Brazil)
- Charging government above-market rates for services and for overdrafts (Peru)
- Offering generous mortgages or personal lines of credit to employees (Paraguay)
- Promoting foreign trade (Mexico)

##### ***The central bank is often involved in QFAs such as:***

- Zero or symbolic interest rate paid on government deposits (Uruguay, Paraguay, El Salvador, Honduras, Guatemala)
- Services as fiscal agent of the government are not remunerated or not fully remunerated (Chile, El Salvador, Honduras)
- Paying interest on debt related to financial sector restructuring (Uruguay)
- Absorbing losses on nonperforming public sector loans, and losses related to intervention in the banking sector (Paraguay, Nicaragua, Guatemala)
- Granting guaranteed loans to PFIs or NFPEs (Paraguay) or lending at below market (subsidized) interest rates (El Salvador)

##### ***QFAs conducted by nonfinancial public enterprises include:***

- Subsidized prices (frequently below average cost) (Mexico, El Salvador, Guatemala, Honduras, Paraguay,)
- Cross-subsidization of different users for social purposes (Colombia, Honduras, Nicaragua, Peru, Uruguay)
- Implicit subsidies for services given via low collection rates (Mexico)
- Provision of free services (water, electricity, telephone or mail) for certain groups or regions (Nicaragua)
- Directed investment, particularly in rural areas for transportation, telephone, electricity and water (Guatemala, Paraguay, Uruguay)
- Over-employment or directed employment policies (Uruguay)
- Requirements to purchase insurance or other inputs from other PFIs or NFPEs (Uruguay) or from private companies at above-market prices (Guatemala)
- Some public enterprises paid taxes not levied on other private enterprises while others paid lower rates or were exempt from normal business taxes such as the VAT (Uruguay)

Source: Fiscal Transparency ROSCs

Reducing fiscal vulnerability related to the various types of off-budget activities requires improved monitoring as well as publication of reports on these activities. Although some progress is noted, the absence of reporting and analysis of contingent liabilities and QFAs remains a serious weakness in much of Latin America that has already had negative repercussions for some important emerging market countries. Improved reporting on extrabudgetary activities, especially nonmarket NPIs is also important; however, placing QFAs and other extrabudgetary expenditures on budget is the preferred solution since their inclusion in the budget would also subject them to the regular budgetary oversight and procedures and help prevent any misuse of public resources. Ultimately, the large amount of earmarked resources assigned to these activities should be reconsidered in light of the need for greater budget flexibility.

### **Monitoring fiscal activities**

The ability to fully evaluate the impact of fiscal policy on the economy requires, first, identifying all government activities so that government is clearly defined, second, routinely consolidating data to produce regular reports on the consolidated operations of general government, and third, ensuring that the accounting system produces timely, accurate data including on arrears. According to Table 3, fiscal ROSC observations indicate that few countries in Latin America met this requirement, but many have implemented information systems that permit them to monitor arrears and to regularly reconcile accounting data with other sources.

### ***Definition of government***

Latin America fiscal ROSCs reported that only Brazil and Chile were in full compliance with the GFS definition of government, with Honduras making good progress towards it. One of the main obstacles to a clearer definition of government is the existence of a complex “decentralized sector.” The definition of the decentralized sector varies (see Box 5), but it generally includes a mixed bag of entities that perform commercial and/or noncommercial activities. As a result, the distinction between what is in the government sector and what lies in the rest of public sector is unclear.<sup>24</sup>

Decentralized entities that primarily engage in commercial activities for which they collect a fee should be classified outside the government sector, as PFIs or NFPEs, even if they conduct quasi-fiscal activities. Other decentralized entities fit the definition of non-market nonprofit institutions (NPIs) in that they mainly perform noncommercial activities which are directed by or mainly financed by government sources of income—either direct transfers or earmarked revenues. These entities should be included in the definition of general

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<sup>24</sup> El Salvador is another country where there is a fairly clear distinction between decentralized public institutions performing noncommercial functions, which are included in the budget and government finance statistics, and those performing commercial functions, which are only included in statistics on the public sector. However, some extrabudgetary expenditures are excluded.

Table 3. Monitoring Fiscal Activities

ROSC Date	Full compliance with GFS definition of government	Report on Consolidated General Government	Report on Comprehensive Central Government	Has a Financial Management Information System (FMIS)	Accounting system can monitor arrears	Legal obligation to publish fiscal data	Public Availability of Information Subscribes to SDDS	OBI** Score (percent)
Code practice								
Argentina 1999	1/	1/	Yes	Yes	1/	*	Yes	39
Brazil 2001	Yes	Yes 6/	Yes	Yes	Yes	Yes	Yes	73
Chile 2003/05	Yes	Yes 6/	Yes 1/	Yes 1/		Yes	Yes	*
Colombia 2003	2/3/ 5/	7/	Yes 1/	Yes	Yes	Yes	Yes	57
El Salvador 2005	5/	Yes 7/	1/ 8/	Yes	Yes	Yes	Yes	27
Guatemala 2006	3/	7/	1/4/	Yes	9/		Yes	46
Honduras 2002/05	Yes 1/	3/7/	1/4/	Yes 1/	9/			38
Mexico 2002	2/	7/6/	1/	1/			Yes	50
Nicaragua 2002	2/3/	7/	1/8/	Yes 1/	Yes			20
Paraguay 2006	2/		4/	Yes 1/	9/ 1/			*
Peru 2004	2/3/ 5/	Yes	Yes	Yes 1/	9/	Yes	Yes	77
Uruguay 2001	2/3/	Yes 6/	*	Yes 1/	9/	*	Yes	*

Source: Fiscal ROSC for the respective countries and IMF staff. All observations are derived from published fiscal transparency ROSCs or updates published on the IMF website.

Yes- indicates that the country observes or largely observes the indicated practice

\* No observation was made

\*\* *Open Budget Index 2006* evaluates the quantity of information provided to citizens in 7 key budget documents

1/ Improvements in progress

2/ Some NFPEs and PFIs included in government;

3/ some nonmarket NPIs excluded (or just transfers shown in budget)

4/ No consolidated central government budget (decentralized agencies have separate budgets submitted to Parliament)

5/ Different reporting institutions use different definitions for government

6/ Data not timely

7/ No data on local/subnational government fiscal activity; or difficulties in data consolidation

8/ Central government outturn is monitored, but not available to the public

9/ System can record stages of expenditure, but not done correctly in practice



### **Box 5. The Decentralized Sector in Latin American Countries**

- Decentralized entities have functional and financial autonomy.
- Their creation and function is based on national legislation.
- They may or may not be supervised by the (central) government.
- They may be financed by a combination of charges for services, transfers from government, or earmarked revenues. Some also have special tax exemptions.
- Some perform mainly noncommercial activities.
- Some perform mainly commercial activities and respond to market incentives, but they may also undertake significant QFAs.
- Their budgets are not usually monitored by the Ministry of Finance or Congress, though in a few cases their budgets are approved by Congress.
- They are not usually included in the state budget, or in official statistics on government operations.
- In some countries (Nicaragua, Guatemala, Honduras, Mexico) there is a distinction between decentralized and deconcentrated entities. Deconcentrated entities have less autonomy, report to a ministry, and may be included in the central government budget and statistics.
- Subnational governments may also have their own decentralized sector.

government, but evidence from the fiscal ROSCs indicates that only a few countries in Latin America follow this practice in budgeting and reporting on government activities.

In Uruguay, some decentralized agencies performed commercial activities while others performed mainly noncommercial activities. Certain entities were created by law to pursue public policy goals. They operated under private sector law with autonomy to decide their own budgets, but they were financed by a combination of government transfers, earmarked revenues, and tax exemptions. At the time of ROSC completion none of these entities were included in the government budget or fiscal reports even though the noncommercial activities of these entities accounted for a large portion of central government activities. In Colombia, the decentralized sector consists of “special administrative units with legal status (public establishments), non-financial public enterprises (NFPEs) and mixed-capital societies; and other administrative entities with legal status.” In Honduras the initial fiscal ROSC noted that noncommercial decentralized agencies were excluded from central government. A fiscal ROSC update (2005) reported that the New Organic Budget Law (2004) mandated definitions of government and the public sector in accordance with GFSM (2001), but the budget and fiscal reports are not yet compliant with GFSM (2001).

In Honduras and Paraguay, the decentralized entities had their own budget, separate from the central government budget that was also approved by the legislature. In many countries, however, ROSCs indicate that only transfers to these entities are recorded in the central government budget and there is no central information on the budgets of this sector. In Peru and Colombia, the lack of a clear definition of government led to a situation where various agencies published different statistics on government finances because they covered a different mix of institutions and activities, making information difficult to interpret.

### ***Monitoring consolidated general government operations***

Reporting on fiscal activities in Latin America seems to be broad because they often claim to report on the public sector, but according to fiscal ROSCs, some parts of the government sector—either decentralized NPIs or subnational governments—were not included. Some did not regularly report on consolidated general government or even consolidated central government fiscal operations making it difficult to assess the true size and reach of the government sector. Even though decentralization is important for a range of countries in Latin America, fiscal ROSCs indicate that a number of countries did not collect or consolidate subnational government fiscal data because they either did not have data on local government fiscal activities, or because an inconsistent classification made a meaningful consolidation impossible.

Most of the emerging market economies indicate that, even though they report on general government, they did not have access to timely data on subnational government fiscal activities. In Uruguay local governments had no legal obligation to provide fiscal data to the central government, and in Paraguay reporting obligations of subnational governments were not enforced. Nevertheless, a number of countries are working on expanding the coverage of their information management systems to include lower levels of government. In Argentina, measures have been developed to improve comparability of provincial budget data and the 2004 FRL requires provinces to implement financial management information systems that are consistent with the federal government classification system. As a result there is timely reporting on a broad definition of general government.

Even when fiscal reporting indicates that subnational government finances are healthy, it needs to be recognized that they can also engage in the same off-budget and quasi-fiscal activities as described earlier for central government, and these can hide important fiscal vulnerabilities. Subnational government can have extrabudgetary funds or they might support nonmarket NPIs. In Colombia, the subnational governments are described as having a decentralized sector similar to that found at the national level of government. Even where subnational governments have restricted access to credit, they may use arrears to finance expenditure overruns. Some ROSCs specifically mentioned the problem of spending arrears at the local level of government. Therefore, it is not only important to improve reporting from subnational governments, but a complete assessment of fiscal vulnerabilities requires examining all off-budget activities as well as budget arrears at the subnational level of government.

### ***Timeliness and public availability of information***

The emerging market economies have a strong commitment to publish fiscal data, and all subscribe to SDDS. Mexico publishes a large amount of fiscal data on a monthly and quarterly basis on an internet website; and a draft law on transparency and access to information would make it a legal obligation to publish additional fiscal data. In Chile, monthly, quarterly and annual budget execution data are published on the budget website. In Uruguay fairly comprehensive fiscal data is published monthly (excluding local government finances). In Peru publication of detailed fiscal information within specific time limits is a legal requirement. In Brazil detailed data on central government finances are posted monthly on a government website with a one-month lag. In Colombia, several public entities regularly disclose a large volume of data on public finances (though coverage varies) with a lag of one to two months.

The use of financial management information systems (FMISs) for monitoring fiscal activities is an important strength in Latin America. Nearly all countries in Latin America that have undertaken a ROSC have a FMIS in place or under development, and as a result, many of the developing nations in Latin America are better placed to produce higher quality data than their counterparts elsewhere in the world (IMF, 2003c). Some countries have made progress in broadening the coverage of these systems, which was consistent with ROSC recommendations. Other recommendations included better monitoring of arrears, stronger reconciliation practices, and improved timeliness and publication of reports.

Given the existence of the FMISs in lower income Latin American countries, budget execution reports could be done on a frequent and timely basis. It is therefore disappointing that some of these countries lacked a legal requirement to publish data on budget execution. In Nicaragua, the annual report and quarterly reports on budget implementation were submitted to the legislature in a timely manner, but neither was published at the time of the ROSC mission. The central bank published monthly data on budget implementation, but its coverage was incomplete. In El Salvador, some fiscal data were available monthly on the central bank website, but additional monthly and annual reports produced by the ministry of finance were not published. However, recent improvements in the availability of information on fiscal policy, budget outturn and public debt data via the ministry of finance website were noted in Guatemala and Paraguay. In Honduras the 2005 ROSC update indicated some improvements in public availability of data including publication of quarterly reports on budget execution and half-yearly reports on public debt on the website of the finance ministry.

### ***Data reliability***

Table 4 provides a summary of ROSC observations on data reconciliation and on internal and external audit practices. The data produced by accounting systems should be verified against independent sources of information to ensure the accuracy of the data. With a well-functioning FMIS there should be routine reconciliation of accounts with the budget appropriation, as well as routine reconciliation of accounts against bank statements. While reconciliation practices in Latin America appear to be fairly good, a number of fiscal ROSCs

Table 4. Data Reliability and Oversight

ROSC Date	Routine reconciliation against budget	Routine reconciliation against bank statements	Effective internal audit and oversight	Independent comprehensive external audit	Annual accounts are audited regularly	Effective follow-up mechanisms for external audit
Code practice	4.1.3	4.1.3	3.3.3	4.2.1	3.4.2	4.2.1
Argentina 1999	*	*	*	Yes	*	*
Brazil 2001	Yes	Yes	Yes 1/ 4/	Yes	Yes	
Chile 2003/05	*		1/	Yes	Yes	*
Colombia 2003	Yes	Yes	1/	Yes 3/	Yes	Yes
El Salvador 2005	Yes	Yes	Yes	Yes	Yes	Yes
Guatemala 2006	Yes	Yes	3/	Yes	Yes	
Honduras 2002/05	*		1/ 4/	Yes 5/	1/	*
Mexico 2002	Yes 2/		Yes	Yes	Yes	
Nicaragua 2002		Yes	3/ 4/	Yes 5/		
Paraguay 2006	Yes			Yes 3/ 5/	Yes	
Peru 2004	Yes	Yes	1/ 4/	Yes	Yes	Yes
Uruguay 2001	Yes 2/	Yes	Yes 3/	Yes	Yes	

Source: Fiscal ROSC for the respective countries and IMF staff. All observations are derived from published fiscal transparency ROSCs or updates published on the IMF website.

Yes- indicates that the country observes or largely observes the indicated practice

\* No observation made in the ROSC

1/ improvements in progress

2/ on an annual basis only

3/ weak capacity

4/ roles of internal and external audit need clarification

5/ coverage incomplete (central government only, some exempt institutions) or not comprehensive in practice

noted that reconciliation against banking statements was not yet routinely established. Reconciliation against the budget appropriation in some cases was only done on an annual basis (Mexico, Uruguay) or not at all (Nicaragua, Chile<sup>25</sup>).

Although arrears were not identified as a significant problem for most countries in Latin America, when under fiscal pressures, governments often find relief by postponing payments. A financial management system that can monitor arrears makes it more apparent when such a practice is followed. The use of state-of-the-art FMISs in most of the Latin American countries means that some accrual data is generally available, and in some emerging market and low-income countries payment arrears are monitored effectively (see Table 3). The ability to monitor arrears in El Salvador, Nicaragua and to some extent in Honduras puts them well ahead of most other developing countries (IMF, 2003c). However, ROSCs note some other countries in the region that had not implemented sound practices for recording the stages of expenditures, and as a result they could not monitor arrears even after investing in a costly FMIS. Improper recording at the commitment stage was a common problem. For example, in Mexico commitments were not recorded and accrued obligations were recorded at the same time as the payment order. In Guatemala, the commitment and accrued obligation were also generally recorded simultaneously—a practice that contradicts their accounting regulations. In Paraguay the commitment may not have been entered into the system at all, thus giving rise to arrears without the awareness of the treasury—although this practice has improved with regard to public contracts. In Peru commitments were registered on the basis of monthly advances and not on the actual amount of contracts and orders placed. Arrears have recently increased in Honduras and have not been fully captured in the government's accounts.

### *Oversight*

Minimizing corruption or the misuse use of public resources requires developing strong internal control and internal and external audit functions. Most emerging market countries in Latin America have sound internal control and audit systems and some (Peru and Colombia) have made recent improvements in this area. However, fiscal ROSCs noted serious problems in the lower income countries where internal control and internal audit systems were still very weak—reflecting inadequate staffing of control units and a lack of technical capacity. In both Paraguay and Guatemala, the institutional capacity of the internal audit offices varied widely depending on the willingness of the agency head to assign appropriate human and material resources to them. In other cases the assignment of responsibilities for internal and external audit required clarification. In these cases the external audit office was overly involved in internal audit decisions<sup>26</sup> (approving or dismissing heads of internal audit units,

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<sup>25</sup> The 2005 fiscal ROSC update for Chile notes that a new FMIS has been implemented with a goal of full deployment by 2006. While the update does not mention reconciliation practices, these have likely improved with the new system.

<sup>26</sup> The fiscal ROSC update for Honduras notes improvements in this area based on the recommendation in the original fiscal ROSC.

or approving audit plans) as well as being responsible for examining and assessing the internal control system—thereby at risk of becoming both judge and defendant of the internal control system.

An independent, high quality external audit office is another essential ingredient for assuring the integrity of the financial management system. Fiscal ROSCs indicated that most external audit offices in Latin America were considered to be independent. The audit function in most emerging market countries were also considered to be effective, and many of them were developing systems to monitor results. However, lower income countries had some serious weaknesses related to constraints on staff and expertise, and most of them neither published audit reports nor monitored recommendations. Audit reports in Honduras, Nicaragua, and Paraguay were considered weak, lacking in substantive comments, coverage and accuracy. A serious problem in Nicaragua was the absence of an audit of the final (annual) accounts of the government. In Honduras the final accounts were audited for the first time in 2004.

### **Enforcing a hard budget constraint**

Table 5 summarizes practices related to the ability to impose a hard budget constraint as discussed in the literature. Some of these practices, such as power of the executive branch, degree of earmarking, and limits on subnational borrowing, are not included in the Code of Good Practices on Fiscal Transparency, but nevertheless many ROSCs covered these issues. Other good practices in this area are the use of fiscal rules, clear mechanisms for intergovernmental transfers, and clear assignment of responsibilities to provide greater accountability.

### ***Strong budget institutions***

According to the literature on budget institutions, better fiscal outcomes are associated with limited earmarking and a stronger executive role in the budget process. However in many Latin American economies, the legislature had considerable power to amend the executive's budget proposal, and most have a high degree of earmarking. Evidence from fiscal ROSCs indicates this often resulted in upward revisions of revenue estimates (sometimes with little foundation) to fund additional expenditure. For example, in Honduras and Guatemala there were no restrictions on the ability of the legislature to amend the budget submitted by the executive branch, and this power was used extensively. In Guatemala the president could veto the budget approved by the legislature, but in Honduras the legislature's broad authority to amend the budget was not balanced by executive power to veto the budget. According to the ROSC for Paraguay (footnote 21) congress could expand "the budget envelope through unrealistic upward revisions of revenue projections, and accountability is limited by the lack of disclosure of the budget discussions in congress." In Brazil a constitutional provision requires amendments for additional expenditure to be matched by canceling other expenditures and/or by additional revenue. According to the Brazil fiscal ROSC (paragraph 36) "...overoptimistic upward revisions by congress of the revenue estimates included in the government's budget proposals, and commensurate increases in expenditures, have generally required an under execution of the approved budget in recent years."

Table 5. Enforcing a Hard Budget Constraint

ROSC Date	Clear assignment of roles to branches of government	Strong executive branch	Minimal degree of earmarking	Clear assignment of responsibilities to subnational government	Clear transfer/revenue sharing mechanisms	Limits or controls on	
						local government debt and borrowing	Use of fiscal rules
Code practice	1.1.2	1.1.2	1.1.2	1.1.2	1.1.2	1.1.2	3.1.2
Argentina 1999	*	*	*	Yes	*	Yes 1/	Yes 1/
Brazil 2001	Yes	2/			*	Yes 5/	Yes 5/
Chile 2003/05	Yes	Yes	Yes	Yes	Yes	Yes 5/	Yes 5/
Colombia 2003	Yes	Yes		1/	Yes	Yes 1/ 5/	Yes 1/ 5/
El Salvador 2005	Yes	Yes		Yes			
Guatemala 2006	Yes	2/		Yes		4/ 5/	4/ 5/
Honduras 2002/05			*	Yes		*	*
Mexico 2002	Yes	Yes	*	Yes	3/	*	*
Nicaragua 2002	Yes	Yes		Yes		*	*
Paraguay 2006		2/				4/	4/
Peru 2004		2/	*	1/	1/	Yes 1/ 5/	Yes 1/ 5/
Uruguay 2001	Yes	Yes		Yes	Yes	Yes 1/	Yes 1/

Source: Fiscal ROSC for the respective countries and IMF staff. All observations are derived from published fiscal transparency ROSCs or updates published on the IMF website.

Yes- indicates that the country observes or largely observes the indicated practice

\* No observation made in the ROSC

1/ Improvements in progress

2/ Congress has no constraints or can circumvent them to alter the executive budget

3/ Revenue assignment and transfers are clear to state governments, but not to local

4/ The use of credit to finance current expenditure is prohibited.

5/ Fiscal Transparency Law (or had a law in draft at the time of ROSC mission)

In addition to amending the budget before passage, some fiscal ROSCs noted that the legislature could easily pass supplemental expenditures during the fiscal year. In Honduras, any new spending during the year required a specific source of revenue for financing the expenditure, but in practice new appropriations were approved without the required financing. The legislature could also find other ways to circumvent restrictions on altering the budget. In Peru, for example, congress circumvented a constitutional provision against creating or increasing public expenditure by passing various kinds of legislation granting tax exemptions for favored activities. Any presidential veto could be overridden by a simple majority in the congress.

In order to cope with implementation of these unconstrained budgets, the executive has to resort to a variety of strategies including across the board cuts, and limits on commitments and payments in order to avoid fiscal imbalance. However, while such strategies make it possible to contain the deficit, they also can have important negative repercussions. Spending agencies may not be able to plan expenditures effectively since the budget overstates permissible spending; and if the system lacks commitment controls, budget arrears are likely to emerge.

While fiscal ROSC data seems to support the notion that a weak executive branch can lead to unrealistic budgets and fiscal pressures, a few fiscal ROSCs revealed instances where a strong executive branch was responsible for proposing unrealistic budgets or heavy reliance on supplementary budgets. Hence, it is not assured that a strong executive will be fiscally prudent. In fact, the evidence from ROSCs suggests that clear lines of accountability to the public are critical to promoting fiscal prudence. In a number of lower income countries in Latin America lack of information on proposed and final budgets obscured responsibility for fiscal policy making. Fiscal ROSCs for Honduras, Paraguay, and Guatemala noted that the absence of a legal obligation to publish the draft budget submitted to congress or a lack of disclosure of budget discussions in congress prevented the public from understanding the relative roles of the executive and legislature in determining the final budget. Hence, neither branch was held fully accountable for overall fiscal policy as specified in the final budget.

A number of emerging market countries in Latin America have adopted Fiscal Responsibility Laws (FRLs) or fiscal rules to try to overcome institutional weaknesses and achieve sounder fiscal outcomes. Others have also taken interest in this type of legislation more recently. Peru began to implement a law on public indebtedness in 2005, and Uruguay adopted a public sector debt law in 2006 that restricts the growth of net debt. In addition, Paraguay adopted a “golden rule” (current expenditures cannot be financed by credit), which has constrained the fiscal deficit but allows current spending to grow in periods of high revenue growth. Another important element of the FRLs is to place constraints on subnational government debt as discussed below. While FRLs have contributed to the transparency of policy intentions, the transparency of budget decisions could be furthered by publishing the executive budget proposal along with the budget passed by the legislature as well as any budget amendments.



### *Intergovernmental relations*

To encourage overall fiscal responsibility and enforce a hard budget constraint on lower levels of government, clear roles and responsibilities for each layer of government, and mechanisms to contain over-reliance on public debt at the subnational level are needed. Perhaps because decentralization is a fairly recent strategy, fiscal ROSCs reveal a number of countries in Latin America lacked a clear assignment of responsibilities to lower levels of government, usually resulting in overlapping areas of expenditure responsibilities between levels of government. This duplication of effort and lack of coordination reduces the expected efficiency gains from decentralization.

Subnational governments in Latin America tend to rely on a large amount of financing from shared revenues and intergovernmental transfers, but ad hoc, complex or discretionary transfer mechanisms are a common problem. In Honduras, the law provided objective criteria for distribution of shared revenues, but in practice, the rules were not applied in full, and distribution of a significant portion was largely determined by discretion. In Paraguay and Nicaragua the distribution of some transfers was negotiated annually. In Peru<sup>27</sup> the ROSC reported that distribution of transfers was based on indicators and weights which were annually determined by the Ministry of Finance and Economy. In Colombia and El Salvador, discretionary elements in the distribution of resources were related to the choice of investment projects to be financed by the transfers.

Discretionary transfers encourage bargaining, corruption and political favors which ultimately soften the budget constraint faced by the recipient governments. In addition, discretionary decisions may create instability for subnational government finances that ultimately can contribute to indebtedness at the subnational level. Simplifying transfer mechanisms and developing stable, objective principles for their distribution would set a clear, reliable resource envelop and contribute toward improved fiscal management of subnational governments in Latin America.

A number of countries in Latin America have reacted to the possible threat of over-indebted subnational governments by passing fiscal responsibility laws or other requirements that limit the ability of subnational governments to borrow. At the time of their fiscal ROSCs:

- In Chile, municipalities were legally prohibited from contracting debt.
- In Uruguay, issuing public debt at the local level required authorization from both the local assembly and Congress by majority vote; but borrowing from a bank only required authorization from the local assembly.
- In Brazil, the fiscal responsibility law prohibited credit or rescheduling operations between different levels of government to avoid the risk of intragovernmental

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<sup>27</sup> The Fiscal Decentralization Law, and in 2005 the issuance of its implementing regulations, now clarify fiscal responsibilities of subnational governments in Peru.

- bailouts. The fiscal responsibility law (as well as debt rescheduling agreements) set specific debt limits (relative to real net revenues) beyond which new debt is banned.
- In Peru, the amendment to the fiscal responsibility law introduced rules limiting the deficit and borrowing of subnational governments.
  - In Colombia, two laws sought to avoid the creation of a new and unsustainable deterioration of subnational public finances and debt as had occurred prior to the fiscal ROSC mission.<sup>28</sup> The Territorial Fiscal Restructuring Law established that the operating expenses of the territorial entities may not exceed a certain percentage of freely disposable revenues.<sup>29</sup> In turn, there were rules on the ratios of debt interest to operational savings, and debt to current income.

Caution is needed when the central government aspires to control the indebtedness of lower levels of government as passing a law or adopting a rule is not sufficient to achieve desired fiscal outcomes. Especially in the lower income countries, it can be difficult or impossible to monitor compliance with debt restrictions. Furthermore, subnational governments can respond to debt limits in ways that can do more harm than good. As noted above, one way is to “borrow” from suppliers, pension recipients, or others by accumulating unpaid obligations (arrears) which can also be very difficult to monitor. The discovery of these arrears can amount to another fiscal skeleton for central governments. Another way for subnational governments to avoid constraints is to engage in various types of off-budget activity to hide their true indebtedness. Therefore, comprehensive monitoring of decentralized fiscal activities is required to capture all fiscal risks. Unfortunately, in many cases subnational accounting and reporting systems are not yet sufficiently advanced to meet this challenge.

### **The business environment**

Attracting investment, sustaining economic growth, and ensuring a broader distribution of its benefits will require significant improvement in the business environment in Latin America. As noted above, countries in Latin America are behind other important emerging markets according to key indicators of governance and the business environment. In particular, tax reform and improvements in the quality of the regulatory environment along with strengthened capacity of oversight mechanisms are needed as part of overall efforts to reduce corruption. Table 6 summarizes fiscal ROSC observations on those practices related to government relations with the business sector. According to the ROSCs, Chile was the only

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<sup>28</sup> The Department of Valle and the Municipality of Cali are mentioned as examples of unsustainable debt at the subnational level.

<sup>29</sup> For example, Law 617 established the following sanctions for entities that exceeded the limits: 1) they must submit a fiscal adjustment program to the MHCP, 2) in the event of failure to comply with the adjustment program, the entity may be reclassified under a lower category or merged with another territorial entity, 3) the National Government will not guarantee the debt of territorial entities that do not comply with the law.

Table 6. The Business Environment

ROSC Date	Clear tax law/ limited discretion	Tax expenditures are limited	Data on tax expenditures is published.	Clear, nondiscretionary regulation of private sector	Clear, well supervised privatization procedures	Clear procurement legislation is followed in practice.	Clear employment legislation is implemented in practice
Code practice	1.2.2	1.2.2	2.1.3	1.1.5	1.1.5	3.3.2	3.3.2
Argentina 1999	2/4/	*		Yes	*	6/	6/
Brazil 2001	Yes 2/	*	Yes	Yes 2/	Yes	Yes 7/	*
Chile 2003/05	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Colombia 2003	1/2/				*	Yes 7/	6/
El Salvador 2005	Yes 1/	Yes 1/		Yes	Yes	Yes	3/
Guatemala 2006	2/5/		Yes	2/		Yes 7/ 1/	3/
Honduras 2002/05	2/			1/	*	Yes 1/	1/
Mexico 2002	2/5/		Yes	1/	*	Yes	1/3/
Nicaragua 2002	4/			Yes	*	Yes 1/	
Paraguay 2006	Yes 1/	Yes 1/		*		Yes 7/1/	1/3/
Peru 2004	2/		Yes	Yes		6/	
Uruguay 2001	* 1/4/	*		1/	*	1/	3/

Source: Fiscal ROSC for the respective countries and IMF staff. All observations are derived from published fiscal transparency ROSCs or updates published on the IMF website. In several cases, particularly when no recent updates have been done, significant reforms may have occurred.

Yes- indicates that the country observes or largely observes the indicated practice

\* No observation was made

1/ Improvements in progress

2/ Complexity reduces transparency

3/ Discretionary practices are a problem

4/ Poor compliance, weak administration are a problem

5/ Insecurity created by frequent changes

6/ Legislation is clear, but not followed in practice

7/ Important exceptions noted

country in Latin America that observed good practices in fiscal transparency in all these areas, and this may be an important factor contributing to its resilient economy.

### ***Taxation and regulation of businesses***

The quality of tax law and tax administration are critical elements of the business environment. The tax systems in Latin America were commonly described as complex, and ROSCs noted that this impeded the transparent application of the law, and provided opportunities for abuse. Chile, El Salvador and Paraguay were the only countries for which the fiscal ROSC described tax laws as relatively clear and simple and Colombia has subsequently proposed measures to simplify their tax systems. Despite the prevalence of various tax exemptions, data on tax expenditures were only published in four countries, all of them emerging market economies (Brazil, Chile, Mexico and Peru). Tax expenditures introduce incentives that may encourage inefficient decisions in the private sector, and their effectiveness in attracting businesses and promoting growth is dubious.

Excessive tax expenditures and weak tax administration seemed more severe in lower income countries. In Honduras, for example, the ROSC noted that an excessive number of tax exemptions, exonerations, and instances of differential treatment led to low revenue collections, tax evasion and corruption. This situation had led to the dismissal of roughly 30 percent of the tax administration officials for corrupt practices. In Nicaragua, tax exemption rules were given by various laws designed for a wide range of purposes. Without an assessment of their impact on tax collections, it was difficult to predict revenues or assess compliance with tax obligations. The situation was compounded by noted weaknesses in administrative capacity. In Guatemala the tax system was complicated by numerous exemption schemes. The high turnover of superintendents of the tax administration also highlighted the need to protect the tax administration from political interference and to establish clear grounds for removal from the office.

According to the fiscal ROSCs, some important emerging market countries could also improve the transparency of their tax system. A number of these countries had numerous tax exemptions that were determined through complex procedures. Not only were there a large number of exemptions in Colombia and Mexico, but the wording of the laws and regulations was not always clear. In Peru, frequent recourse to tax amnesties and deferred payment plans posed a threat to transparency and credibility of the tax administration. Some countries still needed to clarify taxpayer rights and ensure an unbiased appeals process. At the time the ROSC was completed in Colombia, the courts were not seen as independent and the average time to appeal a tax decision was 3 years. In Chile, efforts were underway to make first-round tax appeals independent of the tax agencies by end 2004. Subsequent to the fiscal ROSCs Pure has strengthened tax administration, and Colombia has taken steps toward reforming its tax system that are expected to address these problems.

Fiscal ROSCs also noted that regulation of the private sector lacked transparency in several emerging market and low-income countries in Latin America. In Brazil, government regulation of the nonbank private sector was complex with a number of legal stipulations. In Colombia, the ROSC noted that over-regulation in the business sector, bureaucratic red tape,

and irregular payments had a negative impact on the development of the private sector. In Guatemala, regulation of the private sector was not carried out through simple rules nor were regulations determined in an open manner. In some cases, frequent changes to regulations resulted in a high level of uncertainty in the private sector. In Honduras, the original ROSC described excessively bureaucratic procedures and broad discretion in interpreting regulatory standards. However, according to the ROSC update (2005) procedures for creating a new enterprise have been simplified and a timeline set for completing administrative procedures.

### ***Corruption***

While fiscal ROSCs are not designed to uncover or evaluate the level of corruption, the issue of corruption frequently surfaces in discussions about privatization, procurement and employment practices. Although problems were most often noted in the lower income countries, they were also a significant weakness in some emerging market countries in Latin America. Fiscal ROSCs noted irregularities in the privatization process in Paraguay, which was halted in 2002 when the privatization law was repealed following social unrest. They also described the privatization process in Guatemala and Peru as lacking transparency and oversight. In Peru, the executive branch abused its authority by offering special incentives (tax and debt relief) in the privatization process. Nearly all the countries in Latin America were found to have nontransparent practices with respect to hiring and salary decisions (Chile was one exception). In particular, multiple personnel systems led to unequal pay/benefits for those doing similar work. Discretionary practices in hiring and firing and salary determination were found in some lower income countries and a few emerging markets in Latin America, where ROSCs indicated the need to end the use of government employment policy for purposes of political favoritism.

Reform of the procurement and contracting system would help to reduce costs as well as combat corruption. A serious problem noted in a number of fiscal ROSCs for Latin American countries was the use of special exemptions to circumvent procurement regulations. For example, according to the fiscal ROSC, "...in Brazil there are still risks of fraud because of exemptions in specific tenders, which may call for certain technical requirements and may indirectly determine the choice of a particular supplier..." In Peru, the procurement law was frequently violated, and waivers were used without strong justification to circumvent normal public contracting procedures. Emergencies were declared without cause to take advantage of exemptions from bidding and competitive processes under these conditions, and legal provisions for additions to contracts were abused. In addition, there were important exceptions for specific institutions that were without justification. Despite improvements in procurement regulation in Colombia and Nicaragua, ROSCs noted a large number of exceptions remained. In Nicaragua, for example, exceptions covered public enterprises in transportation and infrastructure and army and police procurement.

## **V. IMPROVING TRANSPARENCY AND FISCAL MANAGEMENT**

Latin America has emerged from the recent region-wide recession to achieve its highest growth rate since 1997. Maintaining growth and avoiding future crises will depend on putting sustainable public finances in place. A key challenge is the need to tackle high levels of public debt, as noted in late 2006 by the IMF Managing Director: "Public debt in the region

has fallen... But the debt level is still as high as it was in 1999-2000—the years immediately preceding the crises in Latin America.”<sup>30</sup> Fiscal reforms to raise revenue, restrain spending and shift it toward pro-poor programs are needed to promote stability and reduce inequality. Assessments against the Code of Good Practices on Fiscal Transparency in Latin America suggest important weaknesses in fiscal institutions that limit accountability, and obscure fiscal risks. Fiscal reforms that strengthen fiscal transparency practices should be a key element in the effort to improve fiscal management, achieve debt sustainability, and enhance fiscal policy credibility in Latin America. Roughly in order of priority for the region, these reforms include: promoting a transparent business environment, reporting on fiscal risks, promoting public access to fiscal information, strengthening oversight mechanisms, extending the coverage of fiscal information, developing medium-term budget frameworks, and promoting transparent intergovernmental relations. Of course, priorities will vary for individual countries.

### **Promote a transparent business environment**

In order to develop a stronger, more resilient economy, tax and regulatory reform should be a top priority for many countries in Latin America. These are areas where the region clearly falls behind other regions of the world. Simplified tax regimes would not only be more transparent, but would raise revenue collection while reducing the costs of collection. A number of countries are now taking steps in this direction. Publication of statements on tax expenditures would highlight the costs of excessive tax exemptions and promote interest in their reduction. Also, regulations affecting business operations need to be streamlined as much as possible to promote easy entry and exit of firms and to minimize restrictions that can be misused. More stable and transparent regulatory and tax systems will reduce uncertainty, promote fairness, and strengthen the business environment in much of Latin America.

### **Report on fiscal risks**

Fiscal sustainability and economic stability require that all types of fiscal risks be identified and monitored, and measures taken to minimize exposure to such risks. In addition to external shocks and forecasting error, fiscal vulnerabilities derive from various off-budget activities such as contingent liabilities, QFAs, and other types of extrabudgetary operations. Contingent liabilities in Latin America go beyond the usual list of government guaranteed loans to include the possible costs of court rulings, bank recapitalization, bailouts of state-owned enterprises, contingencies in public-private partnership contracts, bailouts of subnational governments, and costs related to public pension system reforms. Although a few countries in Latin America have improved the management of contingent liabilities and produce comprehensive reports on them, this practice needs to be adopted throughout the region. Similarly, as QFAs are particularly extensive in Latin America, regular reports on their extent and costs should be published. Presently only Colombia produces a report summarizing the costs of some of these activities. Countries in the region should give high

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<sup>30</sup> “Latin America: Between Populism and Modernity” speech by Rodrigo de Rato at the International Foundation for Liberty Conference, Cato Institute, Washington, DC, November 30, 2006.

priority to collecting data on all types of off-budget commitments that will impact the current and future budgets, and question the rationale for such activities. One useful consequence of publishing cost estimates of these activities is that it may help influence popular support toward eliminating them. Alternatively, if it is decided these activities are fully justified, they should be incorporated into the budget and be subject to the same scrutiny and regulations as budgeted expenditures.

### **Keep the public informed**

Although the emerging market countries in Latin America subscribe to SDDS and make good use of the internet to publish data, some lower income countries could strengthen their commitment to publish regular fiscal reports. By investing in FMISs the countries in Latin America have put themselves in a good position to produce meaningful and reliable fiscal data on a timely basis. These countries could be setting the standards for fiscal data quality for emerging market and developing countries in other regions; however, they fall short of this potential. Internal reports produced for fiscal management should be made available to the public—at a minimum by publication on a government website. This would be a simple and cost effective way to inform markets and enhance the ability of civil society to monitor and evaluate fiscal policies. This should also provide an extra incentive to improve the quality of data, for example by improving and regularizing reconciliation practices. A number of countries could focus on firmer enforcement of accounting practices to enable them to effectively monitor arrears. Efforts also should be made to expand the content of published fiscal reports, particularly analyses of fiscal risks and sustainability.

Greater transparency in the budget formulation process may help to harden the budget constraint and make both the executive and legislature more accountable to the public. This would require the timely publication of the draft executive budget sent to the legislature, open legislative debate, and publication of the final approved budget and any supplemental appropriations during the year. Timely publication of budget outturn compared to budget estimates, an explanation of deviations from the budget, as well as a requirement for a mid-year review of the budget will not only reveal unrealistic revenue estimates, but also improve accountability and the credibility of fiscal policy decisions.

### **Strengthen oversight of fiscal activities**

A well-functioning government might be considered part of the wider business environment especially given the evidence of a positive relationship between foreign investment and governance. However, the evidence indicates that most of the region is behind other emerging market countries on critical measures of governance. Some countries in Latin America could strengthen governance by extending coverage of institutions subject to regular audits, and by publishing both internal and external audit reports to promote accountability to the public. Many countries could also develop more effective follow-up mechanisms to ensure the recommendations of these reports are implemented. This would aid in preventing or detecting corruption, and promote a more effective government in general. More specifically, large transactions between the government and the private sector, as occur in procurement and privatization, need to receive stronger scrutiny. Special exemptions with

regard to procurement regulations should also be examined with the aim of eliminating them as far as possible.

### **Extend the coverage of the budget and fiscal reports**

Improving coverage and diminishing budget rigidity by reducing extrabudgetary activities is important for many countries in Latin American, while extending coverage to general government is an important priority for the more decentralized countries in the region. Routine reports on the whole of general government activities are necessary for understanding the full size and reach of government, and reducing fiscal vulnerability introduced by the independent actions of subnational governments. However, this is challenging for two reasons. First, the existence of numerous decentralized entities that carry out a mixture of commercial and noncommercial activities make it difficult to identify all institutions that should be part of government. Second, accounting and reporting by subnational governments is weak, and due to nonstandard classification of expenditure, they often cannot be meaningfully consolidated. Tackling these issues will require taking an inventory of all those institutions that meet the GFS definition of government, and subjecting these institutions to strict reporting standards that will permit the ministry of finance to produce timely reports on the consolidated general government operations. One option, though costly, is the expansion of FMISs to include all government institutions.

### **Develop a medium-term budget framework**

In order to develop fiscal policy credibility, an important priority for some countries in Latin America is the need to abandon static development or investment plans made in isolation of the annual budget process. In exchange, capital spending plans should be integrated into realistic medium term framework with rolling estimates that feed into the annual budget preparation. Since medium term plans need to be built on a realistic annual budget, improving the quality of budget estimates is an important first step for some countries in Latin American. Budget outturn should be analyzed with respect to the original budget, and this information used to develop more accurate budget estimates. Other requirements are the specification of a multi-year macroeconomic framework that is open to public scrutiny and explained in the budget document, and better linkages between current expenditure plans and capital projects underway or near completion.

A number of both emerging market and low-income countries have recently made considerable progress in implementing MTBFs and others can learn from their experiences. As countries begin to develop a MTBF, they will need to involve their spending ministries in developing detailed medium-term estimates, which should then be reviewed as part of the annual budget process and included in the budget document. As the quality of forward estimates improves, they can serve as the basis for the following years' annual budget to deepen the connection between forward-year plans and the annual budget preparation process. The medium term budget will then become a credible statement of fiscal policy intentions and a means to avoid pro-cyclical fiscal policy. The MTBF should also be recognized as a valuable tool for planning reallocation of expenditure toward pro-poor programs.



**Promote transparent intergovernmental relations**

Countries that have pursued decentralization need to give relatively high priority to promoting fiscal transparency in intergovernmental relations. Decentralization has made subnational governments important players in the provision of government services, but they have also been a source of fiscal imbalance in some countries. A disconnect between those who pay for local services (central government transfers and sometimes bailouts) and those who benefit from them weaken the incentives for subnational governments to spend wisely or to control their indebtedness. Without strong local oversight to hold officials accountable, such a set up can be an open invitation to inefficiency and/or corruption at the subnational level of government. Promoting fiscal transparency at the local level through higher quality fiscal reporting including on QFAs, off-budget transactions and arrears can inform local constituents as well as permit the central government to better monitor the fiscal activities of subnational governments. This is particularly important where the subnational governments are subject to legal debt limits, since off-budget activities or arrears may hide their true indebtedness.

Well designed decentralization policies include a clear, and usually exclusive, assignment of responsibilities, and transfers based on stable and transparent criteria. Predictable sources of financing will enable subnational governments to be more effective in carrying out their assigned responsibilities. The central government can also, through the design of transfer mechanisms, limit the potential for subnational government to circumvent hard budget constraints. For example, transfers can be made contingent on meeting reporting requirements or earmarked for debt reduction or debt servicing when legal debt limits have been exceeded.

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