BUILDING A CONSENSUS FOR FISCAL REFORM: THE CHILEAN CASE

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1. Introduction

The financial crisis that started in Asia in 1997 brought up a renewed concern over public finances in emerging economies. As most observers failed to detect creeping fiscal disequilibria, large public contingent liabilities, vulnerable asset-liability structures, and time inconsistencies of fiscal policy, international financial institutions committed themselves to promote higher transparency and efficiency in the management of public finances. This has resulted in a stream of transparency codes, guidelines and best practice reports over the last couple of years that intend to prevent such failures in the future.

However, as the world economy enters a new phase of uncertainty and many emerging economies still do not recover from the effects of the crisis, progress towards the new public finance benchmarks is still poor. Fiscal reform appears as the only way to accelerate the pace towards fiscal transparency and efficiency in many emerging economies.

Fiscal reform has indeed been in the agenda of developing countries and international financial institutions for many years, with some success in removing gross distortions, like off-budget deficits from public enterprises or Central Bank lending to governments. Yet many problems remain unsolved while structural changes, like decentralization, have added new pieces to the public finance puzzle.

Fiscal reform, having a medium-term scope, has usually taken a second place to the most acute problems of fiscal adjustment. But the effectiveness of such adjustments to solve long-term problems of public finances might have been limited. Expenditure cuts that concentrate on the discretionary component of budgets, resulting in cuts in salaries, investment programs and social services, may be not only unsustainable but can also put a threat to the effectiveness of public policies. In the case of social programs this may also harm the ability of governments to perform their distributive role.

Modern thinking on public finance is addressing these issues. Macroeconomic theory is paying less attention to the short-term demand effects of fiscal policy than to long-term, portfolio effects. Public sector balance sheets are replacing flow-of-funds charts and medium-term financial sustainability is becoming a central issue in the assessment of fiscal policy measures.

Likewise, budgets are now seen not only as a tool of macroeconomic policy, but also as playing a managerial and political role[1]. To public managers, budgets are a key source of incentives and constraints, as much as markets do so for private companies. In recent years, many governments have been changing financial management rules to enhance accountability and efficiency in public agencies.

Budgets are also a political device: they are prepared by the Executive, as a result of a negotiation between the Ministry of Finance and the spending ministries, and submitted for approval to legislatures and therefore require the support of many actors with different motivations and priorities. Budgets encompass resource allocations for a wide range of activities required for the delivery of public goods and services and usually they result from extensive negotiations and agreements.

The key to successful public finance management is to balance the economic, managerial, and political roles of public finances. It is, therefore, a matter of governance. Fiscal governance is poor when fiscal policy objectives are achieved at the expense of a collapse in public management; fiscal reform has little chance of succeeding when it does not reach the common sense of politicians and the public. Fiscal governance is strong when governments can deliver their fiscal policy in a sustainable way and when public funds do not only comply with macro limits but are also efficiently applied to the provision of public goods and services. Fiscal governance is not reflected in how deep a country can cut into its fiscal deficit, but in how capable it is to prevent it.

This paper describes the initiatives that have been implemented in Chile since the mid-1990s, which amount to a second generation of fiscal reforms aiming at strengthening fiscal governance.

2. Institutional Arrangements and Fiscal Outcomes

Too frequently, external observers appear to rely on a strong and committed authority to sort out a country's fiscal troubles. But political will is not enough. Fiscal governance largely depends on the quality of institutions that shape public finance management.

Countries differ in their budgetary institutions and in their procedures within the three phases of the budget process: the formulation of the budget proposal within the Executive; the presentation and approval of the budget in the legislature; and the implementation of the budget by the bureaucracy. If such differences determine the influence of diverse interests and economic authorities over budgets, then we should perhaps turn to such differences to seek an explanation of why the fiscal performance of some countries is better than others'. A study of the relationships between these practices might help identify "correct" budgetary institutions that are able to ensure solid fiscal performance.

Milesi-Ferretti (1996) divides studies on the influence of budgetary institutions on fiscal policy into two main categories. On one side there are those that concentrate on fiscal

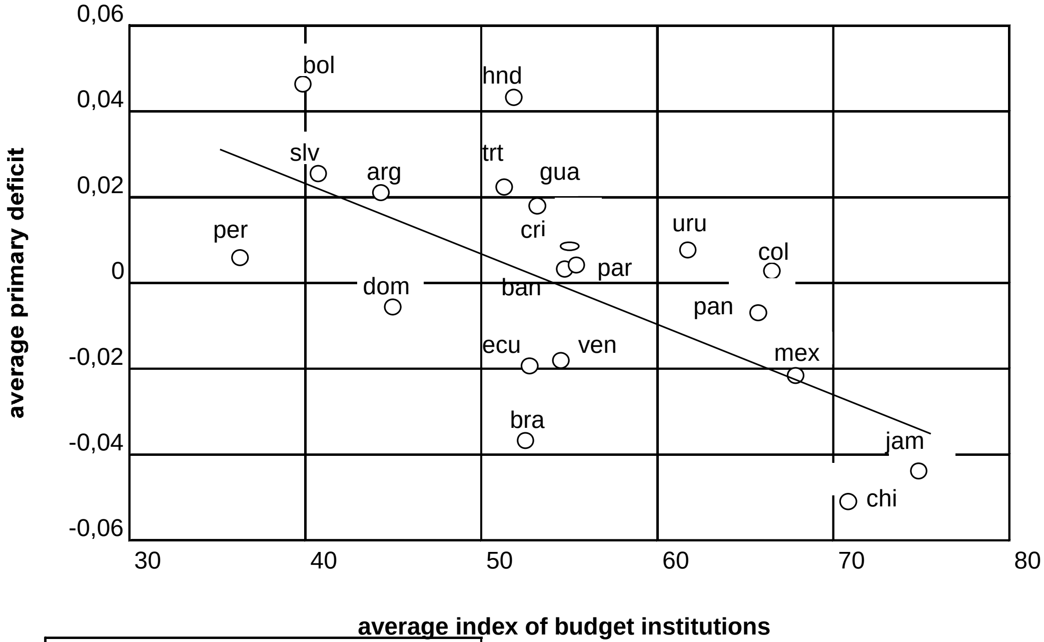
[1] See Marcel (1998) for a description of the different functions of the budget.

regulations such as constitutional balanced budget amendments, international agreements, like the convergence criteria of the Maastricht Treaty in Europe, Macroeconomic Program Requirements and ceilings on government borrowing imposed by the legislature. Such studies emphasize the usefulness of regulations in eliminating systematic bias in efforts to achieve balanced budgets, and in enhancing the need for budget discussions to focus on achieving the desired fiscal policy outcomes.

On the other side there are studies that focus on budget procedures and on how they give greater initiative and control to actors who represent the interests of the community as a whole vis a vis those that advocate particular interests in each of the stages through which a budget must pass. These studies seek to identify at each stage of the process those institutions that assign priority to the economic authority over the various ministries, parliamentarians, pressure groups or government agencies. Comprehensive analysis of these institutions would reveal whether a country's budget system should be characterized as *hierarchical* or *collegial*. Hierarchical institutions are those that attribute strong prerogatives to the Prime Minister to overrule spending ministers within intra governmental negotiations in the formulation and execution of the budget, and those that limit in a variety of ways the capacity of the legislature to amend the budget proposed by the government. Collegiate institutions emphasize the democratic rule in every stage, like the prerogatives of spending ministries within the government, the prerogatives of the legislature vis a vis the government and the rights of minority opposition in the legislature [see Alesina and Perotti (1999)].

In principle, hierarchical systems should result in better macroeconomic fiscal performance, in terms of capacity to enforce fiscal restraint, avoid large and persistent deficits and implement fiscal adjustments more promptly, than collegiate systems. Statistical evidence across countries confirms such hypothesis. Von Hagen and Harden (1994) find support for this hypothesis using several indices to rank fiscal institutions of all of the countries of the European Community from the most hierarchical to the most collegiate. Alesina, Hausmann, Hommes and Stein (1999) follow a similar procedure for a sample of almost all the Latin American countries and arrive to the same conclusion: more hierarchical procedures are associated with lower primary deficits, after controlling for several economic determinants of the government budget. Figure 1 shows the significant negative correlation between the average index of budget institutions and the average primary deficit for the 1980-1992 period.

FIGURE 1: Budget Institutions
and Fiscal Outcomes
(1980 - 1992)



	coef	t-stat
Intercept	0,083	3,33
Index	-0,00151	-3,39

Source: Alessina, Hausmann, Hommes and Stein (1999)

Both political science and empirical studies are leading to the conclusion that an efficient fiscal performance does not only require a competent economic authority with the capacity to analyze and define policies, but also adequate institutions to support its role. These institutions must be capable of ensuring the pre-eminence of the Ministry of Finance and the Executive branch during the budget-making process, or otherwise must be able to impose a priori restrictions on that process. Adequate institutions, particularly in terms of transparency and accountability, are important not only to support the job of competent economic authorities, but also to reduce their incentives to be fiscally irresponsible (see Rogoff (1990)). While reforms that reshape budget institutions are not easy, the effort would be worthwhile since the goal is one of the most valued assets in contemporary economies: powerful and stable means for controlling budget deficits.

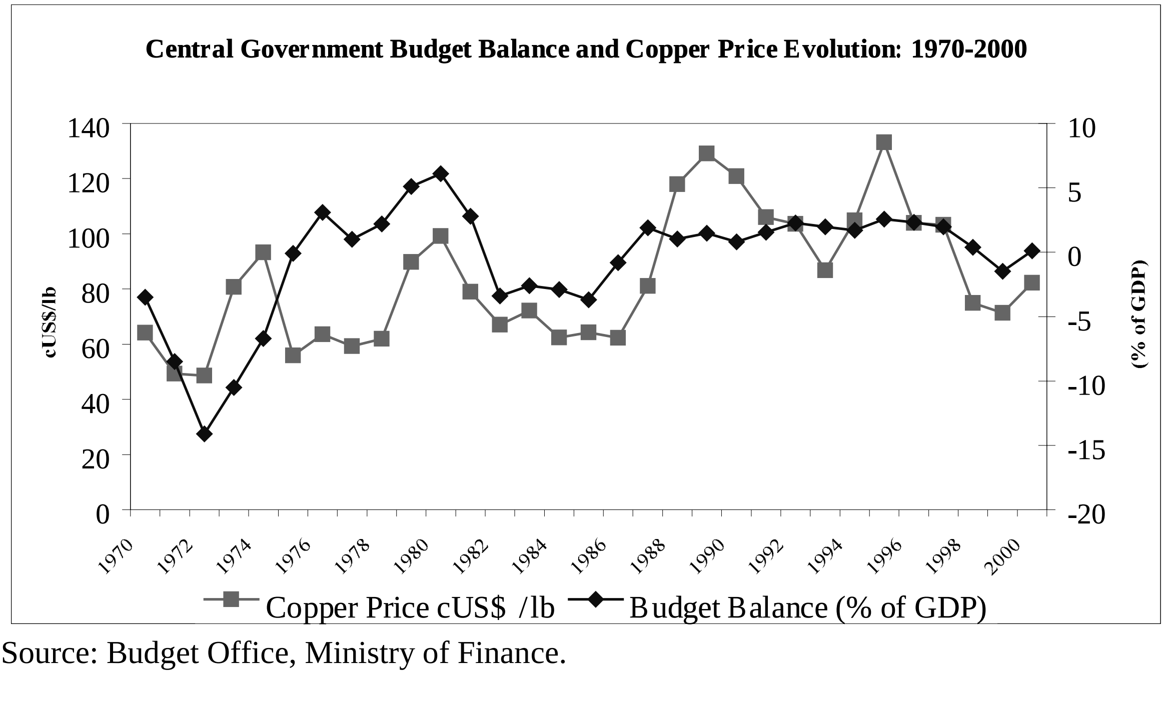
3. Chile’s Budget Institutions

Chile has a first hand experience on the social and economic consequences of fiscal imbalances. These imbalances played a major role in determining economic volatility and sustained inflation that characterized the Chilean economy until the mid-1980s. The large share of fiscal revenues generated by copper sales meant that public finances acted as a multiplier of the terms of trade cycle into the domestic economy. Figure 2 shows the strong correlation between the fiscal balance and the price of copper in the 1970-1987 period. The graph also shows that this correlation was reduced after 1987 through the creation of the Copper Stabilization Fund, a mechanism which isolates most of the effect of copper price volatility on fiscal revenues.

At various times in the republican era, public finances turned into a political battleground. Such confrontations prompted a civil war at the end of the nineteenth century. Presidents elected under the 1925 Constitution, which usually condemned them to be in a minority in Congress, inevitably complained about the opposition's budget blocking tactics. Even the political crisis during the government of Salvador Allende was reflected in serious conflict over the approval of the budget. For this reason, the Chilean system gradually furnished the Executive branch with greater powers over economic matters and public sector financial management.

Current budget institutions in Chile are determined by provisions of the 1980 Constitution and of the State Financial Administration Act of 1975, which establish that the national budget should be comprehensive, covering the various agencies and ministries of the central government, the judiciary and the legislature[2]. The budget is also comprehensive in terms of the transactions covered, including all fiscal revenues and expenditures.

FIGURE 2



Source: Budget Office, Ministry of Finance.

[2] Although municipalities, the lowest level of government in Chile, are not included in the national budget, the effect of this exclusion in fiscal policy is almost null because they are not allowed to: levy taxes on their own, run deficits nor borrow from the Central Government.

The preparation of the Chilean budget is done over a relatively short period of time, with tight deadlines mandated by law. This is accomplished on the basis of a highly centralized financial management system, based in the Ministry of Finance.

Budget discussion in Congress occurs within deadlines mandated by law: the latest date at which the Executive’s budget proposal must be sent to Congress is September 30 and the discussion process must be carried out in no more than sixty days. The budgetary powers of Chile's Congress are highly limited. Congress cannot alter revenue estimates, increase expenditures nor reallocate resources between programs. It can only reduce line item expenditures that are not mandated by permanent legislation.

Only the Executive can propose changes to mandatory spending programs and Congress is not allowed to change the contents of the proposal, however they can reject the government’s proposals. Once mandatory expenditure programs are approved by Congress, it is not required that they are reviewed on a periodic basis. In the budget discussion, Congress appropriates funds for these programs each year. However, if actual expenditure deviates from the original estimates, the resulting differences are automatically funded. In addition to these restrictions, the Constitution establishes that if the discussion in Congress is not over and the budget law is not passed within the sixty days deadline, the Executive’s original budget proposal becomes law.

Budget execution is highly flexible through provisions that allow the Ministry of Finance to adjust item allocations during the year. An important feature of this flexibility is the inclusion in the budget of a central contingency reserve to cover the fiscal costs of legislation passed during the year, as well as contingencies.

The Constitution imposes other constraints on fiscal management: borrowing from the Central Bank and earmarked taxation are strictly forbidden; transfers to state-owned enterprises require specific legal authorization; permanent legislation dealing with taxation, social security, government jobs and financial management can only be considered at the Executive’s initiative.

Given these arrangements, the institutional framework responsible for formulating and executing Chile's budget may be categorized as markedly hierarchical. This is confirmed in the study by Alesina et al. (1999) where Chile is included among the two countries whose budgetary institutions enjoy the most clearly established lines of authority and responsibility in Latin America.

4. Chilean Budget Institutions to the Test

Chile’s hierarchical budget institutions, however, were enacted under military rule and thus can hardly provide a test for consensus building for fiscal reform. The real challenge to their sustainability and effectiveness would come only in a democratic environment, as since 1990.

The memory of past fiscal instability made Chilean politicians quite supportive of fiscal restraint. The combination of a governing center-left coalition firmly convinced that its credibility largely depended on its prudent handling of public finances, and a fiscally conservative opposition, generated a favorable climate to apply, build upon and deepen fiscal responsibility during the 1990s.

This is clearly reflected in Chile's fiscal performance during the 1990s. Table 1 shows that central government budgets recorded an overall surplus in every year, except for 1999. Overall surpluses averaged 1.3% of GDP during the 1990's and public savings grew as a share of GDP during most of the 1990s, to reach nearly 6% of GDP in 1996. This allowed a substantial reduction of total public debt (both domestic and foreign) from 47.2% of GDP in 1990 to 14.8% of GDP in 2000.

TABLE 1: Central Government 1990-2000
(as a % of GDP)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Overall Surplus	0.8	1.5	2.3	2.0	1.7	2.6	2.3	2.0	0.4	-1.5	0.1
Current Surplus	2.5	3.6	5.0	4.9	4.9	5.4	5.8	5.6	4.1	2.5	3.7
Public Debt	47.2	41.1	34.0	31.6	25.6	19.5	16.7	14.5	13.9	15.0	14.8

Source: Budget Office, Ministry of Finance.

Prudent handling of public finances during the 1990s contributed to create a virtuous circle that, as shown in Table 2, benefited public funding in return. The cumulative growth rate of Social Expenditure in the 1990's was 101%, and its importance in total public expenditure increased from 65% in 1990 to 70% in 2000. The sectors which exhibited the highest growth rates were health and education, with cumulative growth of 117% and 141%, respectively, during the 1990's. Government investment, that had remained particularly low during the 1980s, grew 172% in the same period.

TABLE 2: Social Expenditure 1990-2000
(Real Annual Growth Rate)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Health	-4.5	17.8	16.9	12.1	10.2	4.2	8.6	6.0	8.2	3.1	8.4
Education	-4.4	12.3	15.0	8.6	9.1	11.7	12.9	10.2	11.4	6.9	8.4
Social Expenditure	-0.9	9.2	10.4	9.6	6.1	7.3	9.7	5.6	7.6	7.8	6.1

Source: Budget Office, Ministry of Finance.

Additional funding for social services and public investments allowed the government to implement many new programs and projects and to strengthen its distributive function during the 1990s. By the end of the decade, government transfers through social programs increased household incomes in the poorest 20% of the population by nearly 85%, while its net impact on the richest 20% was less than 1%. Government spending not only contributed to increase equity, in fact it was the only source of noticeable improvement in income distribution throughout the decade. It also contributed to reduce the poverty rate from

38.6% in 1990 to 20.6% in 2000 and the indigence rate from 12.9% to 5.7% in the same period.

There is no doubt that fiscal institutions supported this performance. While the government felt particularly accountable for its management of fiscal policy, Congress prioritized its role as an overseer of the Executive's handling of public resources. This kept a systematic pressure on fiscal discipline.

But the experience of the 1990s also revealed some shortcomings of Chile's budget institutions. First, Chile's public finance management, despite all its successes, remained fairly conventional, paying more attention to overall financial performance than to the results of the application of public funds, or the true economic cost incurred to obtain such results. In other words, this is a system that may be highly effective in controlling expenditure, but that does not necessarily facilitate or promote efficient management of public institutions.

Second, the hierarchical structure of the public financial system was not completely accepted by the different actors in the budgetary process. Ever since the country's democratic institutions were fully restored members of Congress complained at the limited role assigned to them in the budget approval process, and sought means to apply greater pressure on the Executive than is permitted under those regulations. For their part, line ministries resented the discretion that the Ministry of Finance enjoyed in drawing up the budget and the controls and authorizations required to execute it.

Third, the discretionary powers given to economic authorities did not guarantee that such powers would be consistently applied in the future. The same powers that helped the authorities to balance the budget might be used to unbalance it. The lack of institutional checks and balances generated uncertainty over the future behavior of authorities and prevented the country from fully reaping the benefits of fiscal discipline. In other words, since hierarchical budget institutions were not accompanied with accountability mechanisms over the authorities' management of public finances, the benefits of such arrangements would remain limited.

These problems became apparent by the mid-1990s and prompted a series of initiatives to strengthen public finance management. By 2001, such measures amount to a second generation of fiscal reforms aiming at strengthening fiscal governance in Chile into the 21st century.

5. Reforming Public Financial Management in Chile: the 1990s

Throughout most of the 1990's, the government and Congress agreed to introduce new regulations and practices into the budget. Most of these measures were formalized as political agreements attached to the budget and, in some cases, written into specific amendments to the Budget Law. These reforms, together with the most recent ones implemented by the government of President Lagos, were designed to address each of the three shortcomings of the Chilean budget institutions identified in the previous section:

- Mechanisms to evaluate performance of programs and institutions were designed and incorporated in decision making procedures to improve the budget allocation decisions and to make them more transparent.
- New management instruments were introduced to improve performance and to promote efficient management of public institutions.
- To limit the discretionality of the Executive over its command over public resources, several rules were established.
- To increase and strengthen the contributions of Congress to the budget discussion process, relevant background information was generated and distributed to congressmen, and commitments resulting from budget discussion were formalized.

In short, the second generation of fiscal reforms being implemented over the last decade aim to improve the Chilean budget institutions and the quality of fiscal policy by increasing transparency and accountability and by limiting discretionality of the Executive over its command over public resources.

5.1 Cash Limits

In the early 1990s, Congress charged that budget flexibility provisions allowed the government to increase spending above authorized appropriations in the budget as long as it had the funding. In response to this claim, the Executive and Congress agreed to limit these powers by introducing a specific provision (Article 4) into the annual Budget Law establishing overall cash limits for current and capital expenditures. According to these regulations, government can enjoy flexibility to reallocate resources among line items, but not to increase the overall amount or to transfer resources from capital to current expenditure.

5.2 Budget Execution Reporting

By the early 1990s, the government had no specific obligation to report on budget execution, other than to accountants at the Comptroller's General Office. This meant that both Congress and the public would learn about actual budget execution with a significant delay. The Ministry of Finance has since then agreed and committed to report budget execution on a quarterly basis and to report on the use of the central contingency reserve on a monthly basis. Starting in the year 2000, these reports were made available on-line in the web page of the Budget Office of the Ministry of Finance (www.dipres.cl). The Budget Office also started publishing full provisional financial statements at the end of the year, ahead of the statutory reports of the Comptroller's Office.

5.3 Performance Indicators

Since 1994, the Budget Office has requested ministries and government agencies to provide quantitative and qualitative information on their performance in terms of the delivery of outputs and services. With this information, a system of performance indicators has been developed and they are included in the background information provided to Congress during the discussion of the annual budget. This system currently includes 537 indicators of effectiveness, efficiency, economy and quality in 109 government units. Despite some questionable attempts at using these indicators to support performance-related pay, the Budget Office has been cautious to avoid building a mechanistic connection between indicators and budget decisions. Instead, it has preferred to view the system as a means to strengthen accountability for results to the general public and to provide information to budget negotiations.

5.4 Program Evaluation

In 1996, government and Congress acknowledged that indicators could only provide information on the evolution of performance over time but not on the effectiveness of government programs. For that reason, they agreed to further improve performance assessment in the budget process by developing a system of program evaluation. Since 1997 the Government Program Evaluation System has provided independent, ex-post assessments of more than 120 programs. These evaluations are performed by a panel of experts from outside the public sector that can request information from the executing agency and commission specific studies to support their assessments. These evaluations, which are carried out in a period of five months, follow the logical framework methodology to determine the consistency and capacity of the program to achieve its objectives. Conclusions and recommendations are then submitted to the Ministry of Finance, the Presidency and Congress to feed back into the decision-making process.

Starting in the year 2001, the Government Program Evaluation System has been improved by complementing the five-month-long program evaluations with one-year-long in-depth evaluations of programs. The objective of these in-depth evaluations is to generate an integrated assessment of the programs' results - understood as short, medium and long term benefits of the programs-, the efficiency and economy in the use of resources and features related to the management of internal procedures. The first two in-depth evaluations are currently being performed by the departments of engineering and economics of the *Universidad de Chile*, perhaps the most prestigious university in Chile, and they will be completed in March 2002.

5.5 Management Improvement Programs

Also, in the context of improving the public management in 1998 the government started the implementation of Management Improvement Programs (MIP). MIPs consist in several programs aimed to improve the public management by linking goal attainment to employees' monetary rewards.

After three years of implementation, the MIP system has been reviewed. As a result, during the year 2001, MIPs have been redesigned to focus on the development of key management systems rather than in narrower performance targets, about which MIP can exercise little judgment and/or control. The key management systems have been selected to guarantee a better global performance of the public institutions, mainly in terms of services provided to the citizens, working conditions and valorization of public servants. The management systems translate into a matrix of key management systems and standardizing progress stages. Public agencies identify current and expected progress, and performance is measured in terms of effective progress against these goals.

It is worth mentioning that special attention has been given to the gender perspective. For the year 2002 a new system named Gender Equity has been introduced to the MIP system. Its objective is that public services operate with procedures that promote equal opportunities for men and women in the delivery of outputs.

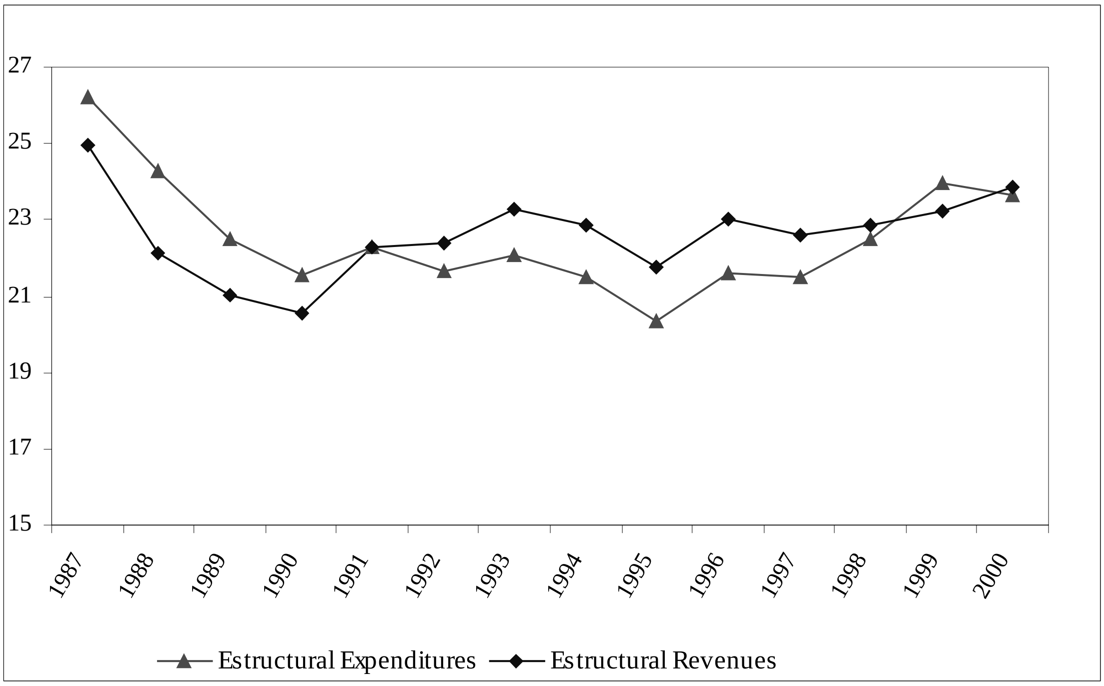
6. Recent Developments

The reforms of the 1990s, built upon the inherited hierarchical budget institutions, already provided Chile one of the strongest fiscal systems among emerging countries. Yet, by the end of the decade, it became evident that this might be insufficient to sustain fiscal discipline and effectiveness in a more turbulent environment.

In 1997-99, fiscal balances deteriorated by nearly 4% of GDP, moving from a surplus of 2.5% of GDP in 1996 to a 1.5% deficit in 1999. Public saving fell even more sharply, from 5.8% to 2.5% of GDP in the same period. This was mainly a result of the international financial crisis that halted fast growth in Chile and forced a recession in 1999, but it also reflected a more expansionary fiscal stance. Figure 3 shows how structural expenditure has been growing as a percentage of GDP since 1995 at a faster rate than structural revenues which have remained relatively stable. The structural reduction in the central government's surplus and a build-up of medium term financial commitments meant that fiscal aggregates would not necessarily return to their pre-crisis levels in the upswing stage of the cycle.
The political climate also threatened to become less supportive of fiscal discipline. A string of elections stretching from 1999 to 2001 would be more closely contested between the Concertacion coalition and its right-wing counterpart and would make consensus building and co-operation on economic matters less likely than in the past.

The Lagos Administration therefore attached great priority to deepening fiscal reform. During the years 2000 and 2001 this has translated into a bold set of new initiatives to improve medium-term fiscal programming, raise allocative efficiency, improve follow-up of budget discussions, and increase transparency and accountability. The results of which can already be observed in the improvement of the fiscal accounts in the year 2000. Indeed, the Central government's overall deficit of 1.5% of GDP in 1999 was reverted to an overall surplus of 0.1% of GDP in 2000, and the current surplus was raised from 2.5% of GDP in 1999 to 3.7% of GDP in 2000. Figures 3 and 4 show that these improvements are due mainly to the improvement of the central government's structural accounts and not to an upturn of the economic cycle.

FIGURE 3: Structural Revenues and Expenditures 1987-2000
(as a % of GDP)



Source: Marcel, Tokman, Valdés and Benavides (2001a).

6.1 Improving Fiscal Policy Formulation and Medium-Term Fiscal Planning

6.1.1 A Fiscal Policy Rule

After 14 years of continuing budget surpluses in Chile, by the end of the 1990s nothing granted that such performance would continue in the future. As many observers criticized the conduct of fiscal policy in the late 1990s, the behavior of the new government in exercising its broad discretionary powers over public finances was a major source of uncertainty among economic agents.

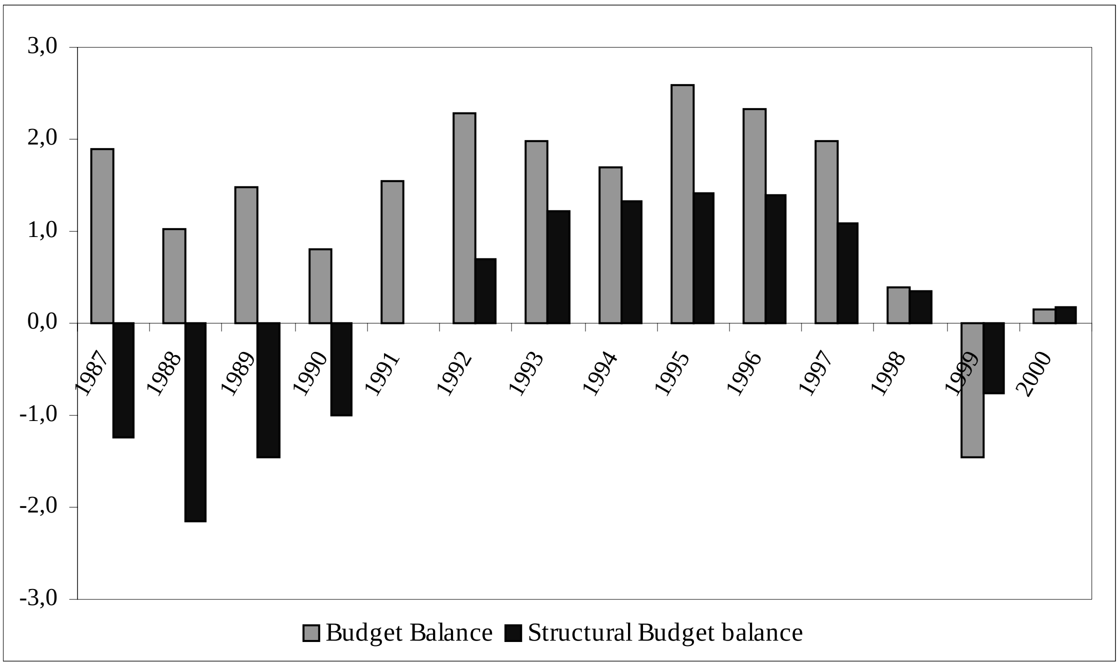
The Lagos Administration faced this challenge by committing itself to pursue a strict fiscal policy rule: starting 2001 the government would generate a structural budget surplus equivalent to 1% of GDP (see Marcel, Tokman, Valdés and Benavides (2001b)).

The structural balance measure closely follows a well-established methodology developed by the IMF and the OECD. It aims at assessing the stance of fiscal policy by separating the cyclical variations from the more permanent components of the budget. Such separation does not only provide more transparency into the conduct of fiscal policy, but also provides a sound basis to design and implement it. The fiscal policy rule base on a fixed target for the structural balance allows automatic stabilizers to operate in the short run while keeping a medium-term focus in steering public finances. Indeed, the structural balanced budget rule is an effective instrument to face the politically induced deficit bias (see Alesina and Perotti (1995)) without the limitations of the standard balance budget laws in terms of the countercyclical role of fiscal policy and the dynamic optimal taxation theory (see Barro (1979)).

The structural budget balance of the public sector (SBPS), as applied in Chile, reflects the level that revenues and fiscal spending would reach if GDP were at its potential level and if the price of copper were at its medium-term level. Therefore, it excludes the cyclical and random effects of the two most important exogenous factors: economic activity and the price of copper. The SBPS is estimated by (a) making accounting adjustments so that the budget balance becomes a correct proxy of net worth change; (b) estimating potential GDP and the medium-term copper price[3], and (c) re-estimating fiscal revenues on the basis of GDP elasticities.

Applying this methodology to the 1987-2000 period shows that the structural budget balance followed a more consistent path than conventional balances (Figure 4). After a large drop in 1988, it gradually increased until the mid-1990s, when it stabilized around 1.4% of GDP. Between 1997 and 1999 it fell to a minimum of - 0.8% of GDP in 1999, to recover to 0.1% of GDP in 2000. The estimate for 2001 is a structural balance of 0.9% of GDP and the budget for the year 2002 has been structured to achieve the 1% surplus target.

FIGURE 4: Structural Budget Balance 1987-2000
(as a % of GDP)



Source: Budget Office (2001).

[3] To assure transparency and non-discretionality, the medium term price of copper is obtained by consulting a group of experts from the mining, the academic and the financial sectors.

The 1% SBPS surplus stands out as one of the most strict fiscal policy rules under application in the world. This does not only reflect the commitment of the authorities to strict fiscal discipline, but also some distinct features of the Chilean economy. These features include: (a) the operational deficit of the Central Bank, originating in the bailing out of financial institutions in the mid-1980s; (b) substantial contingent liabilities, stemming from guarantees provided under the roads concessions program and state-guaranteed minimum pensions to affiliates of the private capitalization system; (c) the need for the government to contribute to raise domestic saving to fund investment needs without generating large current account imbalances; and (d) the symbolic nature of fiscal policy as a benchmark to macroeconomic policy in Chile and a cushion against external volatility.

The implementation of the fiscal policy rule is expected to have three major beneficial effects. First, it will reduce uncertainty of economic agents over the conduct of macroeconomic policy and the risk of restrictive monetary policy, reducing long-term interest rates and sovereign spreads in foreign markets. This will stimulate private investment. Second, fiscal policy will play an effective counter-cyclical role by allowing full operation of the automatic stabilizers. And third, it will broaden the programming horizon of public institutions by avoiding the inefficient contraction of spending in recessive periods as well as over-expansions financed under temporary fiscal surpluses (see Ministry of Finance (2001)).

6.1.2 Medium-Term Financial Programming

Building upon a methodology developed in the late 1990s, the Budget Office has started releasing medium-term financial forecasts (MTFF), covering a three-year period. Such estimates are mandatory under the 1975 State Financial Administration Act but they had never been developed or published up until now.

MTFF for the central government are prepared by the Budget Office as a financial projection of existing policies and regulations and therefore do not involve either negotiations or commitments to line ministries and programs. They are therefore presented in aggregate terms as part of the background information to the annual budget.

MTFF has proven to be extremely useful in recent discussions, particularly those related to the Law Against Tax Evasion and the 2001 and 2002 budget discussions. Indeed, MTFF showed that a tax evasion law was required to finance and implement all the proposals contained in President Lagos' government program. These forecasts have also revealed that even after a full recovery of the 1999 crisis, there would be a shortfall of public revenues due to a drastic reduction in transfers from public enterprises, given by the privatization program of the late 1990s. Reverting this phenomenon will require paying special attention at the use of privatization proceeds, increasing pressure on state owned enterprises profitability, widening user charging for public services and raising the profitability of public financial assets, including cash holdings.

6.2 Raising Allocative Efficiency

In order to break away from incrementalistic budgeting, the Ministry of Finance introduced new practices in the preparation of the 2001 and 2002 budgets. Inertial funding was strictly limited and ministries were required to reallocate at least 2% of their inertial expenditures.

Budgetary bids for new or expanded programs are required to compete for a central fund of resources, which is allocated according to the quality of the submitted proposals and their consistency with the government's priorities. Prioritization is based on a logical framework presentation of competing initiatives. This new presentation format emphasizes and encourages a more detailed analysis of the program itself by requiring the statement of the program's general goal as well as the enumeration of specific purpose, components and activities related to the implementation of this program.

The information on the main objectives and goals of public programs provided under the logical framework presentation does not only allow for a better and more efficient allocation of the resources in the budget; it will also feed back into program evaluations in the future.

During the first two years of operation of this fund, US$ 520 millions have been allocated to finance 330 selected proposals. This mechanism has proven to be a transparent and efficient procedure to allocate the budgeted increases in spending.

6.3 Raising Accountability: Closing the Budget Cycle

Political agreements attached to the approval of the annual budget proved to be an extremely useful tool to foster consensus building for fiscal reform in the 1990s. But such agreements do not only provide a sound political backing to break away from conventional practices and strengthen fiscal discipline; they have also a rationale in themselves.

If the political role of public budgets is due to a large extent to the network of negotiations and commitments that lie beneath them, strengthening and formalizing these commitments may improve the quality of the budget process. Budgeting is indeed a repetitive game, and its outcomes may be improved by feeding back from one fiscal cycle to the next. This can be achieved through formal agreements that address issues that emerged during the discussion of the budget but have no direct effect on the annual appropriations.

On the basis of this rationale, the Lagos Administration paid special attention to the budget agreement that accompanied the approval of its first budget, the 2001 budget. In addition to the agreements covering traditional issues like transparency and evaluation, the government supported two main innovations. First, the budget agreement 2001 included, for the first time, the commitment to develop specific studies on high-profile financial issues, like contingent liabilities, minimum pension guarantees and state owned enterprises profitability. The results of these studies, that were either conducted directly by the Budget Office or prepared by private consultants, were presented to Congress at the beginning of the 2002 budget discussion. Second, it created a new stage in the budget cycle: prior to the discussion of the 2002 budget, the government submitted to Congress the information concerning budget execution, performance indicators, program evaluations and specific studies which allowed Congress to review the government's performance in 2000.

6.4 Improving Transparency and Accountability: The Public Finance Reform Program

To strengthen the transparency and efficiency in public management, the Budget Office has designed a program to modernize the financial management of the public sector. This program can be summarized in the following three main elements.

6.4.1 Improving the Public Sector Accounting System

This includes the development of accounting systems that allow measuring, in a more accurate way, the real economic cost of the activities carried out in the public institutions. Moreover, these accounting systems would allow a more effective control of the financial obligations acquired by the public sector. Although currently public sector accounting system is accruals-based, budget formulation and execution operates on a modified cash basis. Transition towards a modified accruals basis will include the development of a commitments control system and capital costs measurement.

6.4.2 Integrated Financial Management System

In mid 1999 the National Budget Office along with the General Comptroller's Office started a study to produce the Integrated Financial Management System (IFMS). The IFMS would create a single, complete, and uniform information system that would support a more effective and transparent management of the public institutions. Moreover, IFMS would not only facilitate the generation of aggregate information but it also would allow the design of output and performance indicators that will permit a better evaluation of the results. At this moment IFMS is at a design stage and it is being tested, as a pilot scheme in five public institutions. Full implementation of the system is expected for 2004.

6.4.3 Financial Assets Management

Cash management currently operates in a highly decentralized way. On the basis of an annual cash program, the Treasury transfers monthly cash allotments to ministries and agencies that are then spent according to the existing budget appropriations. Liquid funds, both for the Treasury and government agencies are deposited in non-interest bearing accounts in the Central Bank and the State Development Bank. This system facilitates agencies' management but has a very high opportunity cost. The public finance reform program will device cash management and transfer of funds systems in order to minimize this opportunity cost without compromising financial decentralization.

7. Final Remarks

Regardless of the specific merit of any of the initiatives included in the budget reform program in Chile a valid question remains: Why should such initiatives enhance fiscal governance if the Minister of Finance is already a powerful figure?

The answer rests mostly on political economy grounds. The concentration of power over public finances in the hands of a single authority does not guarantee fiscal governance if: (a) such authority is not accountable for its application of such powers, and (b) if its concerns and priorities are not shared by other influential actors, be them politicians, business or social leaders, or the media. This is particularly true for a coalition government like Chile's.

The limited experience of the Lagos Administration supports this view. The introduction of a fiscal policy rule based on achieving a structural budget surplus of 1% of GDP has already changed the focus of the fiscal policy debate and has been welcomed by both sides of the political spectrum. While fiscal conservatives have seen it as a constraint over public expenditure in the future, spending-prone politicians have valued its capacity to generate a more stable and predictable environment for public policy programming. To the government, the SBPS has shifted attention away from expenditure/GDP ratios and short-term fine-tuning to a medium-term scope in fiscal policy monitoring.

This framework has facilitated the discussions of the 2001 and the 2002 budgets in Congress. Contrasting with recent past experience and with the pessimistic prospects founded on its coincidence with municipal elections in 2000 and with parliamentary elections in 2001, the budget discussions have been quite uneventful and they have been dispatched by Congress weeks before the constitutional deadline. Moreover, political consensus over the budget agreements were easily attained.

Of course, most of the initiatives in the budget reform agenda are yet to be implemented and tested. As it is well documented in the literature, fiscal rules may be easy to draw but more difficult to implement, and their actual effectiveness ultimately depends on their credibility, which is built over long periods of time.

Fortunately, fiscal reform in Chile can rely on the strong basis of the country's past record. As a matter of fact, fiscal reform in Chile now has a good chance of succeeding because it is not a device to overcome a fiscal crisis but to continue preventing it in the future.

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