EVOLUTION AND RATIONALITY OF BUDGET INSTITUTIONS IN COLOMBIA

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[1]

Introduction

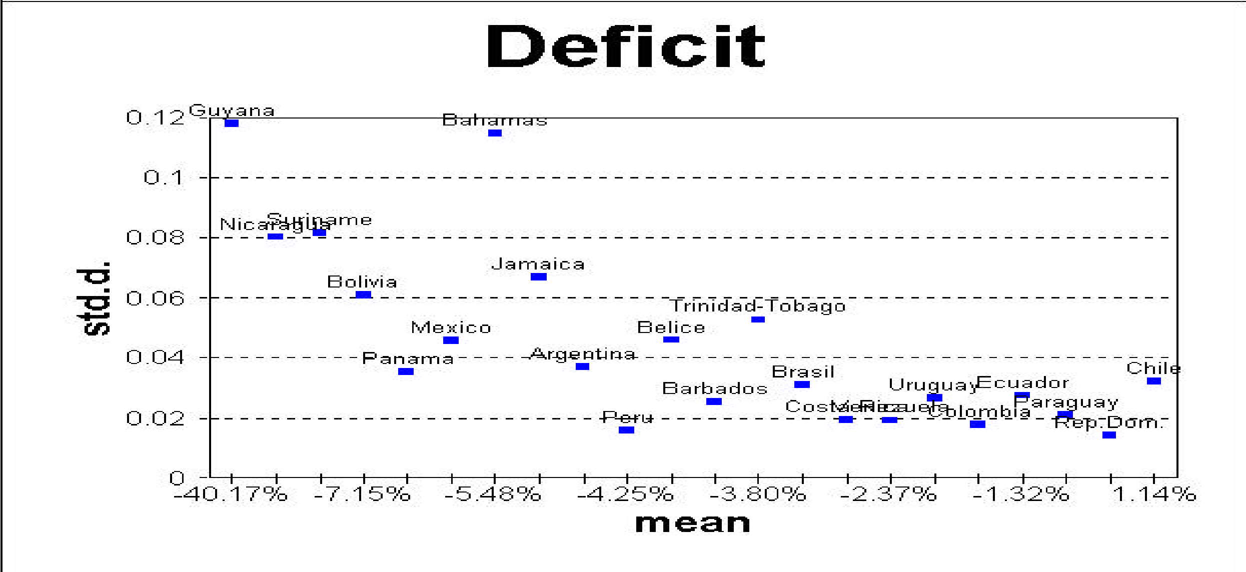
The independence of central banks has an effect on the macroeconomic results of economies and ultimately on inflation [2]. A similar relationship may exist between budget institutions and the fiscal performance of governments. Budget institutions may have a bearing on fiscal results.[3] There is evidence that indicates that budgetary procedures favoring a stronger position of the budget authority vis-a-vis other members of government, or giving more power to the executive lead to greater fiscal discipline.[4] Eichengreen has found that "a number of measures of balanced-budget restrictions are significantly associated with larger surpluses (smaller deficits)" [5] in the state fiscal accounts in the United States. Poterba observed that rules and political factors, such as the control of one party over the state legislature are important in explaining differences in fiscal performance between different states in the United States.[6]

Basically, the premise is that rules and regulations that give the executive more power vis-a-vis parliament will render smaller deficits. Similarly when the budget authorities are given institutional tools to deal with intra-government conflicts during the preparation of the budget and to control the appetite of the spending ministers smaller deficits may ensue. The same applies to strict rules governing the execution of the budget in the sense that when the government is not given a lot of flexibility to change budgetary items or to increase expenditures beyond the original authorization of Congress, presumably the fiscal results will be more conservative when compared with budget regimes in which governments are allowed to move more freely. Budget transparency will support

better results because it fosters accountability; and the universality of the budget --no off-budget items-- will render more fiscal discipline.

In the same line of thought, it is possible that formal fiscal restraints such as balanced-budget rules, when binding, or automatic links with taxation that force Congress to increase taxes when the expected deficit is large, will cause smaller deficits (larger surpluses). Coalition governments are particularly adept at increasing the budget and strong governments are more likely to solve budget deficits than weak or divided governments.[7] Moreover, when the budget is prepared in conjunction with a macroeconomic program and the budget size and composition is subordinated to the achievement of macroeconomic goals, the fiscal outcome may be more conservative. Finally, it should be noticed that when the budget institutions and controls for the state and local governments are weak, the autonomous spending and indebtedness of lower levels of government may contribute to greater deficit spending. [8]

A research project currently conducted by the Office of the Chief Economist at the Inter-American Development Bank has found preliminary but compelling evidence that the budgetary institutions in Latin America have a significant bearing on fiscal results. The researchers have developed an index of budget institutional development which measures the strength of budget institutions, following the lines of thought described in the previous paragraphs. Figure 1 presents the relationship between this index and the primary deficit for twenty Latin American countries. These results suggest that strong institutions have an impact on fiscal performance.



In Colombia, it can be observed that several of these rules and regulations are present and that the system has been gradually developing starting about the middle of the last century, and very intensely since 1985. Possibly, these institutions and the prudent fiscal policy they foster made it possible for Colombia to exhibit a remarkable record of fiscal stability in the continent (Figure 2) which has similar reflections in terms of stable growth and stable predictable inflation[9]. In the next section it will be analyzed how these institutions came into effect in the context of the economic history of the country. But first, it is necessary to spell out the nature of these Colombian institutions and procedures.

First and foremost, the central bank cannot lend to the private sector and can only finance the government when its autonomous board of directors votes unanimously in favor. Since 1991, when the new Constitution established the central bank as an autonomous institution, there has been no central bank financing of the government or the private sector, whereas in the past, the central bank was a frequent source of resources. The Minister of Finance is responsible for presenting the budget to Congress, jointly with the President. This gives Finance more authority than the spending ministers

in all matters concerning the size of the budget. The Director of Planning has considerable authority in the distribution and size of its investment component. The law requires that the budget be consistent with a macroeconomic program approved for the year by the government in coordination with the central bank. This acts as a formal restraint and may be more effective than fixed balanced-budget rules since budget surpluses and small deficits are not always the best fiscal outcome, nor necessarily desirable under all circumstances.

Relative to Congress, the executive is fairly powerful when it comes to the discussion and the legislative approval of the budget. Congress has been given legal deadlines for approving the budget. If the budget is not voted or not approved, the originally presented budget proposal of the government will automatically become the new budget. Congress is required to note first, separately, on the size of the budget and then on its composition. It is not allowed to increase expenditures -- aggregated or line items -- or to reduce revenues without the express authorization of the Minister of Finance.

A budget can be approved when the revenues and expenditures are not in equilibrium, but when there is a deficit, the government should propose a tax increase to Congress to cover the fiscal gap. If the tax increase is not approved, government can unilaterally cut expenditures to achieve equilibrium. Under normal conditions, except in the case of war or "socio-economic emergency", the government is not allowed to increase expenditures beyond the budget originally approved by Congress, without going back to parliament for the approval of such increases. When it invokes a state of emergency, this decision will be reviewed by Congress and by the courts, to prevent misuse of the emergency powers. There is not a lot of flexibility for changing expenditure items but the government can reduce the actual expenditures because it has an iron grip on the cash flow --the

financial plan. This plan is approved by CONFIS - National Council for Federal Policy - in coordination with the central bank.

These institutions and procedures render exceptionally strong budget authority at the Ministry of Finance or and at the Ministry of Planning with the power to overrule other cabinet members at different stages of the budgetary process and also an exceptionally strong executive. In comparison with other Latin American budget regimes, Colombia is only surpassed by Chile and by the newly-issued budget procedures of Peru in which the power of the President and of the finance minister is even greater.

The next section examines the historical development of the budgetary institutions, and the following section attempts to explain why and how the particularly Colombian pattern of fiscal behavior managed to develop.

The Evolution of Budget Institutions

Budget Institutions During the Nineteenth Century. The leading role of the Minister of Finance in budgetary affairs dates back to 1847. The then Secretary of Finance, Florentino Gonzalez, created the Directorate of Taxes in the Ministry of Finance and issued the first set of rules that would regulate the process of budget preparation and approval (Ley 7, June of 1847). The Ministry of Finance was made responsible for the presentation of the budget to Congress. The approved budget was to be regarded as a maximum level of expenditures which could not be exceeded. Expenditure items were to be specific and not indefinite, and the debt service had priority over any other expense. This initial regulation was refined in 1851 under the stewardship of Secretary Murillo Toro, (Law 14, June of 1951). During the period 1851-1892, the budgeting procedures were contained in the fiscal regulations and although these were subject to numerous reforms, responding to several financial

crisis, the first modern organization of the budgeting process did not appear until 1892[10], in the midst of a crisis provoked by large increases of the monetary base induced by the money financing of the budget.[11] This first "organic budget law" (Ley 33, October of 1892) contained a balanced-budget rule and made the Secretary of the Treasury responsible for suppressing expenditures until they equaled revenues. It also introduced the requirement that all expenditures contained in the budget proposal and in the final budget law approved by Congress must be expressly authorized by a pre-existing law.

Before this law was issued, the new Constitution of 1886 had laid out the general basis for the budget process: (1) No public expenditure could be made without having been approved by Congress or the legislative institutions of the lower levels of government; (2) each ministry could form its own budget proposal and send it to the Ministry of Finance who was responsible for the final project of the national budget and must submit it to the approval of Congress; (3) Congress must approve the expenditure budget and the means to pay for these expenses. This determined that the Ministry of Finance was the budget authority and that Congress and the legislatures of municipalities and departments were responsible for the approval of the budget. However, the Constitution severely limited the power of the legislature in this process because it established that when Congress did not approve the budget for the year, the previously approved budget could be repeated; more importantly, it also established that the government could increase the expenditure budget if it judged that additional spending was absolutely necessary ("unavoidable") during the periods when Congress was not in session. To legalize these extraordinary expenditures, all that was necessary was that the Council of Ministers would authorize the additional expenditures, and that the Council of State would approve this act. When it reconvened, Congress was called to rubber-stamp these decisions.

This, clearly facilitated the increase in expenditures and induced government to wait for the

recesses of Congress to increase the budget. It also gave the judiciary a legislative role that would become a vehicle for clientelistic corruption. This Constitution and its budgetary consequences prevailed, however, until a new constitution was approved in 1991, in which the possibility of executive approval of the budget was prohibited by stating that all expenses must be approved by Congress. This has had and is expected to have a restraining effect on expenditure pressures after the budget is approved because a new negotiation with Congress is a costly proposition. The need to obtain a new Congressional authorization deters demands from the spending ministers and forces more transparency in the initial proposal that government presents to the legislature. Additionally, the need for more transparency in the budget approved by Congress demands new skills of the executive because the Congressional approval, for the first time in over two centuries, has become a relevant event. Before it was a meaningless ritual - lip service to democracy. Naturally, the spending approved by Congress will be escalating as they become aware of their new power.

Many of the reforms of the nineteenth century and some of those conducted during the early twentieth century were not implemented as a response to an imminent crisis or as a result of one. They were introduced by reformist officials. Florentino Gonzalez and Murillo Toro, for example, viewed the budget reform as part of a wider set of economic reforms, seeking to induce dynamism into the export sector of the economy.

The 1886 budget legislature is part of a political counter-reform --the "regeneration" of 1886-- which devolved power to the central government. The counter-reformers had the intention of promoting morality and social discipline and pursuing a greater role for the state.[12] The fiscal, monetary and financial reforms were geared to increase central government control and the efficiency of spending; and to rationalize the use of the very exiguous fiscal resources.

In one instance - the 1892 reforms - budgeting regulations were prompted more by the proximity of crisis and as a reaction to the inflationary pressures created by the monetary policy of the government than by a reformist animus. Most other nineteenth century budgetary reforms were motivated by the severe scarcity of resources and the need to administer what little there was in an efficient manner. The reformers mainly were motivated by good management principles.

Budget Institutions during the Twentieth Century. As part of the efforts geared to stabilize the economy in the years immediately following the civil "war of the thousand days", the budget process was reformed again in 1912 (Ley 110, November of 1912). This law gave the Minister of Finance agenda-setting power in the Council of Ministers for discussions of the budget law proposal and of extraordinary expenditures; and for the first time it required that Congress meet strict deadlines for the approval of the budget, thereby increasing the power of the executive vis-a-vis the legislature. Another law of the period (Ley 3, July of 1916) gave priority to expenditures using earmarked revenues, initiating a budgetary practice that reduces flexibility and tends to increase the size of the deficits. This practice of earmarking became pervasive in the budgetary procedures in Colombia until it was eliminated by the new Constitution of 1991, with the exception of already-existing social expenditure commitments.

Another law (Ley 7, August 1916) tightened even more the deadlines to be met by Congress for budget approval and introduced the notion that budgetary equilibrium consists of expenditures equaling revenues plus new debt, thereby neutralizing the effect that the existing balanced-budget provision could have had as a source of budgetary restraint. This law, however, limited the capacity of Congress to increase expenditures by requiring that any new expenditure must be financed by a new revenue or by other expenditure cuts.

It was not until 1923 that a modern procedural rule was approved for the budgetary processes (Ley 34, July of 1923). This law is the origin of the budgetary practices that are still in operation in Colombia. The motivation behind this law was the need to obtain foreign credit. In 1923, Colombia was one of the most backward countries in the continent. Infrastructure ranged from deficient to non-existing. The total length of the railroad network was only 1481 km., one of the least developed in the region. This prompted the government of Pedro Nel Ospina to seek foreign loans to finance public investment, thereby increasing the leverage of the U.S. indemnity for the take-over of Panama, and taking advantage of the Wall Street boom of the early 1920s. The foreign bankers pressed for reforms such as the creation of a central bank, adherence to the gold standard and adoption of "modern" budget procedures. To accomplish this, the Colombian government engaged the consulting services of a mission led by Princeton economics professor Edwin W. Kemmerer - the Money Doctor of the Andes. The reforms were thus imposed from the outside and were motivated by the scarcity of resources and the desire to obtain foreign financing. [13]

The Kemmerer mission drafted the new law ruling the formation of the budget and its execution and control. After it was approved by Congress, it set most of the basic principles for the management of the budget in Colombia until the present days.

This new law established that Congress cannot increase unilaterally the size of the budget and that any new expenditure to be included in the budget requires the previous approval of the executive. This is an important step to strengthen the executive in the budget negotiations. Furthermore, the new law clearly established that loans could not be assimilated to revenues and required that current expenditures should be less than total government revenues, imposing a soft restraint rule that would foster public savings. It also defined precisely what extraordinary --"unavoidable"-- expenditures

were, limiting the capacity of the executive to increase the budget through the Council of State loophole without congressional approval. Finally, it enabled the government to cut expenditures already approved by law when the current expenditures exceeded total revenues.

Kemmerer was recalled in 1931 to lead another mission to advise the government on financial and monetary affairs, when Colombia was suffering from the effects of the 1929 crash of Wall Street and the world recession. The coffee prices had fallen dramatically and the country was having difficulties servicing the foreign loans obtained by the central government and the local governments during the go-go years.

As a result of this mission, a new organic budget law was drafted that refined the rules created by the previous mission (Ley 64, May 1931). This law limited even more the capacity of Congress to increase expenditures and the size of the budget and strengthened the authority of the Minister of Finance, requiring that any new expenditure must have the previous approval of this official before it could be included in the budget. This law also eliminated the reserve of budget residuals at the end of each year except for items related to debt service, for current expenditures already approved and sanctioned by the Ministry of Finance that had not been paid at the end of the fiscal year and for ongoing contracts, provided that these same amounts would be included in the next-year budget. Unfortunately, these last provisions were considered too restrictive and were reformed by a questionable administrative act of the Contraloría General de la República.[14]

The procedures contained in this law continued virtually intact until 1950, when they were reformed by a "state of siege" decree (Decreto 164, January of 1950). These decree was part of a number of measures taken to control the upsurge of inflation that had remained unchecked during the 1946-50 period and that reached its peak (20.5%) in 1950.[15]

In this decree, a Direction of the Budget was created within the Ministry of Finance, responsible for the preparation of the budget proposal and for the stewardship of the execution and internal control of the budget. This definitely established the predominance of the Ministry of Finance over all other ministries in matters related to the budgetary process, giving the ministry, through the Direction of the Budget, ample powers to cut the budget during the execution process and to monitor the effectiveness of expenditures throughout the government. This decree also eliminated the earmarking of resources to specific expenditures.

During the years of the Colombian National Front (1958 - 1974), Congress did not intervene directly in the setting of new budgetary procedures, but it gave the government blanket authorizations to reform procedures and institutions. This gave government the upper hand, but these authorizations were not always used in a way that would promote smaller deficits. For example, in 1963 (Law 21, August of 1963), a Monetary Board was created, independent of the central bank, that would become the monetary, credit and exchange authority of the country until the new Constitution of 1991. The members of this board were the Minister of Finance, the Director of Planning and two spending ministers -- Agriculture and Industry -- in addition to the governor of the central bank, the Superintendent of Banks, the Director of the Institute of International Trade (INCOMEX) and two technical advisers that would set the agenda and participate in the discussions but could not vote. The composition of this board and the financing practices that were introduced in the same law (the use of bank reserves to finance government expenditures and the establishment of a monetary budget to finance the government and private sector activity) were the seeds of a long-lived inflationary bias during the period 1963 to 1991.[16] This formally introduced the practice of quasi-fiscal financing for

the private sector that survived until 1991. The budget was left for the executive and the politicians to divide, and the quasi-fiscal expenditure for the private sector through subsidies and bail-outs. The law also gave the government authorization to reform the rules for the budgetary process (Decreto 1675, June of 1964). This decree introduced the concept that the budget should reflect the targets and objectives of the development plan and of the government investment plans. This created a link between the short-term and the long-term management of the economy and provided the basis for a posterior coordination between the macroeconomic policy and the budgetary process. It introduced the Department of Planning as a new budget authority, in charge of the investment budget, but still subordinated to the Ministry of Finance in the final decisions of the budget preparation and execution. The decree restated that earmarking was not permitted and reinforced the power of the Director of the Budget.

It also increased the power of the executive vis-a-vis the legislature, because it determined that when the budget is not approved by Congress, the previous year's budget would apply plus all the additions decreed by the government during congressional recesses. However, this new regime consecrated the "budget reserves" consisting of keeping alive expenditure authorizations of the previous year, overlapping the new authorizations for the current year. This creates a backlog of authorizations that press for greater expenditures and blur the transparency of the budgetary process and its macroeconomic consequences.

Using a blanket authorization of Congress, the government enacted a new budgetary regime in 1973 (Decreto 294, February of 1973). This regime integrated the budgets of independent public institutions into the national budget, limiting the off-budget component of the public sector expenditures. It gave a coordinating role to CONPES (Council of Economic and Social Policy) that

would eventually evolve into the formulation of a macroeconomic program that would become a source of restraint for the government budget. It gave the Department of Planning a new role in the allocation of resources for investment, but subject to the resource limitations imposed by the Ministry of Finance. This role of the Planning Department continues today and creates a dichotomy of functions that fosters tensions between Finance and Planning that are healthy in terms of development but also may pressure for greater budgets - Planning, although co-responsible for the macroeconomic performance of the economy is ever pressing for greater investment expenditures. This, in a well managed economy, would result in greater public savings, a higher level of public investment and faster growth. But, when politics intervene, it results in greater budgets and presumably higher inflation - through monetary financing - depending on the strength of the Ministry of Finance and the support it receives from the President.

Independently of the formal power granted to the Finance Ministry and the budgetary authorities, the President plays a key role in fiscal restrain because all these authorities are appointed officials that can be dismissed and replaced without hesitation in the event of a disagreement between the President and his Minister.

In 1981, the government regulated the budget process of lower levels of government along similar lines to those existing for the central government and its institutions (Decreto 2407, September 1981). It should be noticed, that the authorizations for public indebtedness of all levels of government were always centralized in the Ministry of Finance, until 1994 when the new law of public contracting gave more flexibility to departments and municipalities despite the opposition of the Ministry of Finance.

After a severe economic and financial crisis in the beginning of the 1980s, the government

convened a group of economists and other experts in 1985 to evaluate the fiscal and budgetary problems of the public sector, under the coordination of Luis Fernando Alarcón, who would later become Minister of Finance and was then Director of the Budget. This group and the adjustment initiated by Finance Minister Roberto Junguito in 1984 signaled the beginning of a process of institutional building that is still under way and that has deeply reformed budgetary mores in Colombia.

Starting in the last years of the Betancur administration and during the Barco and Gaviria administrations, the government sharpened its technical skills for budget management and public sector macroeconomic and financial programming and coordination. For the first time, during those years, the government was capable of routinely producing evaluations of macroeconomic consistency, to follow up the fiscal and macroeconomic variables and to program coherently the fiscal, monetary, foreign exchange and credit policies. These skills were a by-product of the fiscal crisis of 1982-89. The repeated visits of the IMF monitoring missions under the Article IV of the Fund agreement made it necessary for the government to train and maintain technical staff capable of producing and understanding the data required by the IMF missions on a regular basis, using the format and methodology of the Fund. Initially, the central bank had the technology, but after several missions, these technical skills were diffused to Finance and Planning.

It was in this environment of higher programming skills that, a thorough reform of the budget regime was enacted (Ley 38, April of 1989, decreto 3077, December of 1989, decreto 411, April 1989 and decreto 2162, September of 1989). The government was given more power to limit the budget of the legislature and the judiciary, it was also given authority to set financial targets for the parastatals and to follow up on their financial performance. This extended the control of the fiscal

authorities to the whole non-financial public sector.

The new law formally introduced an instrument of macroeconomic coordination of the budget --the financial plan-- which covered the programming of effective operations for the whole of the public sector and called for consistency with an annual macroeconomic program. It required that this financial plan be compatible with an annual cash budget and with the targets of the monetary and exchange policies. In these new regulations, the budget was also en element of coordination with the medium and long-range planning of the government. These are all legal requirements but the end result of economic importance is that programming and budgeting have been integrated into the macroeconomic management as essential functions that have to be coordinated into an overall policy with those of other institutions. Curiously, in the past, budgeting had been a purely bureaucratic or accounting activity that formally complied with the legal provisions of the budget law and supervised the compliance of other public institutions with it. This is no longer so. The institutions have changed to become active participants of policy and decision-making. However, they are still very poorly equipped to deal with the problems of efficiency of public expenditures. Also, budgeting still is not considered an activity for economists but rather something akin to accounting.

An important feature of the new regime and a break with the tradition of concentrating the budget authority in the Ministry of Finance was the establishment of the Council for Fiscal Policy (CONFIS) which was responsible to submit to CONPES the financial plan of the public sector for approval --the formal procedure that guaranteed macroeconomic coordination-- and to approve the annual effective operations and budget execution programs, key fine-tuning mechanisms that had previously been under the domain of the Director of the Budget. This was a step backwards for the authority of the Ministry of Finance because attributions that previously had been exclusively of the

ministry such as programming the cash flow, budget execution, follow-up of the financial and budgetary performance and monitoring the budget execution of the public sector were now given to the council which had two spending ministers in its midst. Why was this done? Probably what happened is that politicians and other public officials had suffered from the excessive rigor of the Finance Ministry rule during the adjustment period of 1984 - 1986. Public sector salaries had been slashed in real terms during those years and public investment had suffered. These changes were part of a reaction within government and in Congress against the concentration of fiscal power in one place.

To increase the effectiveness of public spending, this law required that all investment projects had to be evaluated and incorporated in a "project bank" as a necessary condition for their inclusion in the investment plan. This is a very important new feature because all other procedures and institutions are geared to control the quantity of fiscal expenditures and this is the first attempt to address the problem of quality of public investment in a technical context. Cost-effectiveness is a concept alien to the fiscal and budgetary management in Colombia and in most of Latin America. In Colombia, the absence of quality controls and the consequent lack of economic effectiveness of public investment are vividly highlighted by the fact that cuts in public investment during the adjustment periods do not appear to have significant effects over economic growth (see the section on Rationality of Fiscal Procedures and Institutions).

The government was also authorized to reduce expenditures when revenues are expected to fall below the amount approved in the budget. For the executive this is a useful tool that allows flexibility in the case of negative revenue shocks. The law also restructured the Direction of the Treasury and limited the congressional authorization to utilize central bank financing to the level of

eight percent of the current revenues of the government in the previous year. Although this limitation is still very lax considering that the average Colombian deficit is of the same order of magnitude, it represented a step in the right direction. Additionally, the new regime subjected all public indebtedness to the previous authorization of the central government. This is particularly important to avoid excessive municipal indebtedness and that of parastatals.

The Constitution of 1991. A major change in the budgetary process was introduced by the new Constitution of 1991. First of all, the central bank was granted autonomy. It was to be ruled by a seven-member board of directors --five autonomous members, the governor of the bank and the Minister of Finance. The governor is elected by the board. The Finance Minister has no veto power except when the budget of the bank is approved, and the President of Colombia can only appoint two members during his term. The Bank is the independent authority in monetary, credit and exchange matters. The government is responsible for providing the Bank with sufficient resources to independently intervene in the financial markets with its open market operations and to monitor the exchange rate. The Bank is responsible for bringing down inflation every year. The Constitution also prohibited Central Bank credit for the public sector, except to provide liquidity to the financial sector and when the bank is a bank of last reserve.

Additionally, the Constitution established the all-inclusiveness --universality-- of the budget, prohibiting off-budget expenditures and subjecting all taxes and contributions to congressional approval. The new Constitution added to the transparency of the process by requiring that the budget submitted to Congress and the budget law that it would eventually approve should include all the expenditures and revenues. It did not foresee a balanced budget but called on government to obtain the additional revenues required in a separate project to balance the budget. If this is not achieved,

the Constitution entitled the government to cut expenditures until the budget is balanced. This way, the government is fully responsible for the fiscal outcome, and the approval issued by Congress can only be regarded as a maximum authorization. This enables the government to conduct a coherent fiscal policy that is consistent with macroeconomic objectives.

The new Constitution increased the power of the executive by establishing a deadline for the approval of the budget by Congress and allowing the government to adopt its own budget proposal in the case that Congress does not approve the budget law by the time of this deadline. It also stated that Congress could not increase expenditures or add expenditure items, nor cut existing revenues without the express authorization of the Minister of Finance. Additionally it suppressed the figure of parliamentary grants --"auxilios parlamentarios"-- that had been created by Abdón Espinosa, Minister of Finance in the Carlos Lleras administration. Through this figure, all Congressmen obtained budgetary resources for their political non-profit foundations, presumably for good deeds and public works of local importance. However, these funds increasingly had been used to finance their political campaigns and to foster a corrupt patronage system that gave excessive political advantages to the incumbents. Originally, the idea had been that Congressmen would become interested only in the amount allotted for these grants and that this would give the government a free hand during the approval of the rest of the budget once the size of the grants was settled. This proved to be correct, but the cost was that the budget approval process was contaminated by personal interest and that Congress abdicated one of its main responsibilities in a democracy --the discussion and approval of the budget-- in exchange for these grants.

However, outlawing the congressional grants did not calm the apetite for Apork-barrell@funds of politicians and the willingness of executive officials to accomodate them. As it stands, the budget

approval process is an open season for Apork@. Politicians seek regional projects and find ways to divert resources to policital targets. As a result, there are economists in Colombia who think that the formal prohibitions to allot small grants to congressmen will render larger deficits in the future and that having given up that mechanism to satisfy the clientelistic drive of Congress will be costly in terms of governance and fiscal stability. In fact, the system that operated before 1981 had a well defined division of labor and of resources. Urrutia (1991) claims that industrialists, politicians and labor unions were quite distinct from each other and that they had separate realms of exerting influence. According to him, the budget did not favor the private sector but rather, it was spent in a fairly progressive way in programs that had some distributive consequences.[17] The portion of the budget taken by politicians for their own clientelistic programs was small, and the private sector carved the quasi-fiscal deficit of the central bank through its directed credit programs, but not the budget.. With the creation of an autonomous central bank that cannot lend to the private sector, pressures are mounting to obtain subsidies from the budget. Similarly, politicians are demanding Apork@ now that they do not have access to grants. Altogether, the system is progressing to a more participatory democracy, but it may become more costly until new rules are developed to deal with the new mounting pressures for greater expenditure.

Another important contribution of the new constitution was the deletion of the procedures for increasing the budget during legislative recesses which, in fact, gave the government and the Council of State legislative powers that did not contribute to fiscal restraint or to the independence of the judiciary.

It also eliminated all earmarking, except pre-existing earmarking for social expenditures, but required that the social expenditure would have priority over any other expenditure (previously, this

priority was given to debt service) and that the social investment budget should always be a non-decreasing proportion of the total budget. These two rules should contribute to increase the budget size over time. So far, their effect has been negligible because of the creativeness of the staff of the Budget Director, but eventually they will become effective pressures on expenditure. Regarding the distribution of social expenditures it called for rules of distribution that would take into consideration the relative needs and levels of destitution and also the fiscal performance and administrative effectiveness of the regions.

The Constitution took a very important step towards the financial decentralization of government and, consequently, of the budget. It required that every year, an increasing proportion of the budget would be allocated to finance the supply of services that would be the responsibility of departmental and municipal governments. Furthermore, it also ruled that the municipal governments should obtain a proportion of the current revenues of the government to finance social investment at the local level. This proportion was determined to be fourteen percent in 1993 and to increase to twenty-two percent of current revenues in 2002.

The law established that the proportion of the current revenues of the central government to be shared by lower level governments should ascend from thirty-four percent in 1993 to forty-two percent in the year 2002. The services that should be taken over by the lower levels of government are essentially education, basic health, water and sewage, police, local public works, environmental protection and recreation.

If local governments seriously take over these responsibilities and use the transferred resources to pay for them, the effect on the budget size should be negligible. But, it has been observed that the central government and the politicians do not want to surrender these functions because the

whole structure of political clientelism controlled from the top was built on them. The basis for the old-order governance mechanisms was the provision of these functions by the central government. This way, congressmen influenced the allocation of services, and government rewarded or punished local governments channelling more or less services to them. As a consequence, the central government is re-assuming the financing of some of these services in a way that smacks of recentralization and also creates an undue pressure on the budget because most expenditures have to be financed twice: once through revenue-sharing and then, a second time, through ad-hoc transfers to departments and municipalities to obtain political support.[18] Furthermore, the decentralization process may have adverse fiscal consequences because in the early stages of the transition from centralized to decentralized forms of government, it is unlikely that strong budget institutions develop at the local level pari-passu with decentralization.

At the end of 1994, Congress passed a law that set the new rules for the budget process under the Constitution of 1991. This law contains several innovative features that must be singled out: it introduces as basic principles of the budgetary process both the macroeconomic consistency of the budget and the need for the process to be self-regulating in the sense that when revenues increase above normal levels, due to a positive revenue shock such as a temporary boom, the excess revenues should not be immediately incorporated as current revenues but, rather, saved and gradually absorbed in later years. This gives government the possibility to save the proceeds of the new increase in oil production and to distribute this portion of current revenues to lower-level governments only when the revenues are gradually incorporated in the budgets of future years. In the first semester of 1995, another law was approved that makes this saving in an oil stabilization fund mandatory for revenues of the new oil fields.

The new budget law of 1994 also gave back CONFIS to the Ministry of Finance, restoring the budgetary authority of this institution. It created the formal link between the budget process and the monetary, credit and exchange policies by requiring that the central bank advise Congress on the macroeconomic effects of the budget proposed by the government, that the budget be consistent with the macroeconomic program approved by CONPES for the year, and that the government and the central bank coordinate the contents of the financial plan to which the budget must be subordinated.

It also authorized the government to delete all budget items that have not been spent at the end of each year (they have to be incorporated in the new budget if the government and Congress so decide) and to create a stabilization fund -- the Fund of Surplus Resources -- when revenues are earned that could cause a macroeconomic disequilibrium.

The law created a new budget approval feature: the budget commission must first approve the rise of the budget and then vote on its contents. It was hoped that this procedure would help control the appetite of Congress during the budget discussion by settling the size rapidly at the beginning of the process of approval. However, it does not appear to be an effective rule because when the size is being decided, the members of the budget commisssion are already making sure that their projects and those of their collegues obtain financing.

The law gave new powers to the Ministry of Finance authorizing it to cut expenditures when revenues fall, when Congress does not approve an increase in taxes that would balance the budget or when "macroeconomic coherence" calls for such cuts. This, coupled with the definition of the budget approved by Congress as a maximum, gives the government a variety of tools to exercise budgetary restraint. This is a far cry from the situation described by Eduardo Wiesner who as outgoing Minister of Finance in 1982 publicly doubted that any government would have the political

backing to detain the process of fiscal deterioration that had reached a critical level under his stewardship.[19] There are signs, however that prevent the taking of an overly-optimistic approach: The absence of grants to quench the thirst of politicians, the detachment of politicians from the monetary base and the democratic reforms that prevent the executive from approving budget additions without congressional approval will require additional skills, both political and managerial from the Ministry of Finance. It is also possible that new rules and regulations - additional institutions - will be necessary.

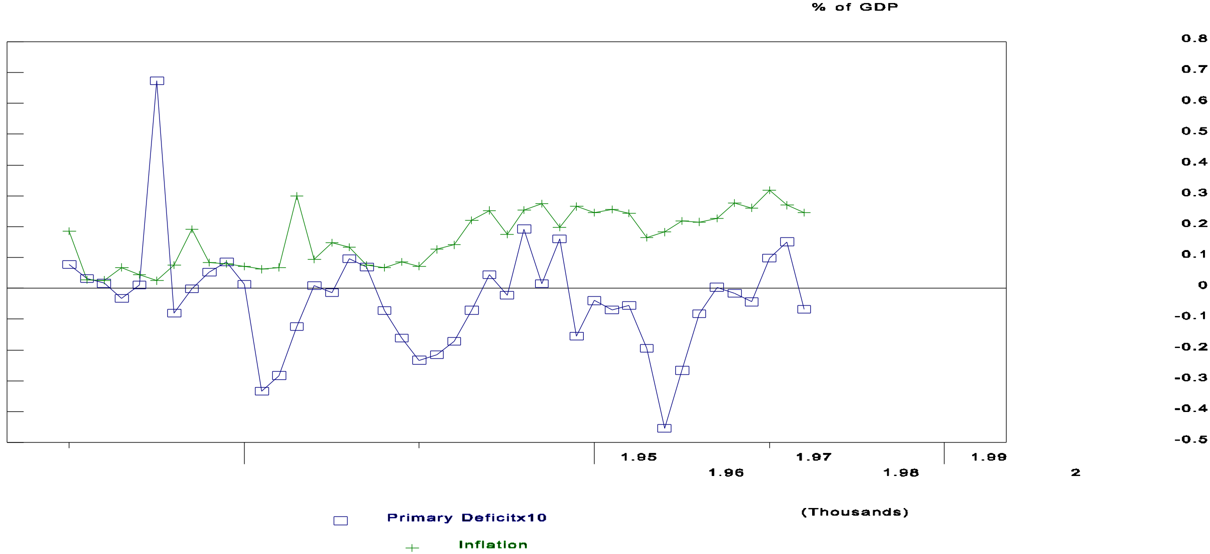
However, a lot of progress can be shown after a ten-year period of institutional building that started in the second semester of 1984, and culminated with this budget law, at the end of 1994. The budgetary procedures that have developed in Colombia have empowered the executive to exert greater control over fiscal outcomes. Consequently, government can be held totally accountable for the fiscal results. Centering the responsibility on the government and moving it away from Congress, where it could be diluted, does not ensure good fiscal management but it increases the probability of careful fiscal administration.

The Rationality of Fiscal Procedures and Institutions

Why Do Public Deficits Matter? The evolution of the budget institutions suggests that the Colombian polity has traditionally supported orthodox financial policies and has empowered the government to perform accordingly. "In Colombia the management of fiscal deficits and their financing has been generally sound. Episodes of loose fiscal policy have been minor in comparison with other Latin American countries. The near-crisis of the early 1980s was addressed in a timely way through a sharp fiscal adjustment." (Easterly. 1994.p.262)

Where does the political backing come from? Why is there political support for lower deficits

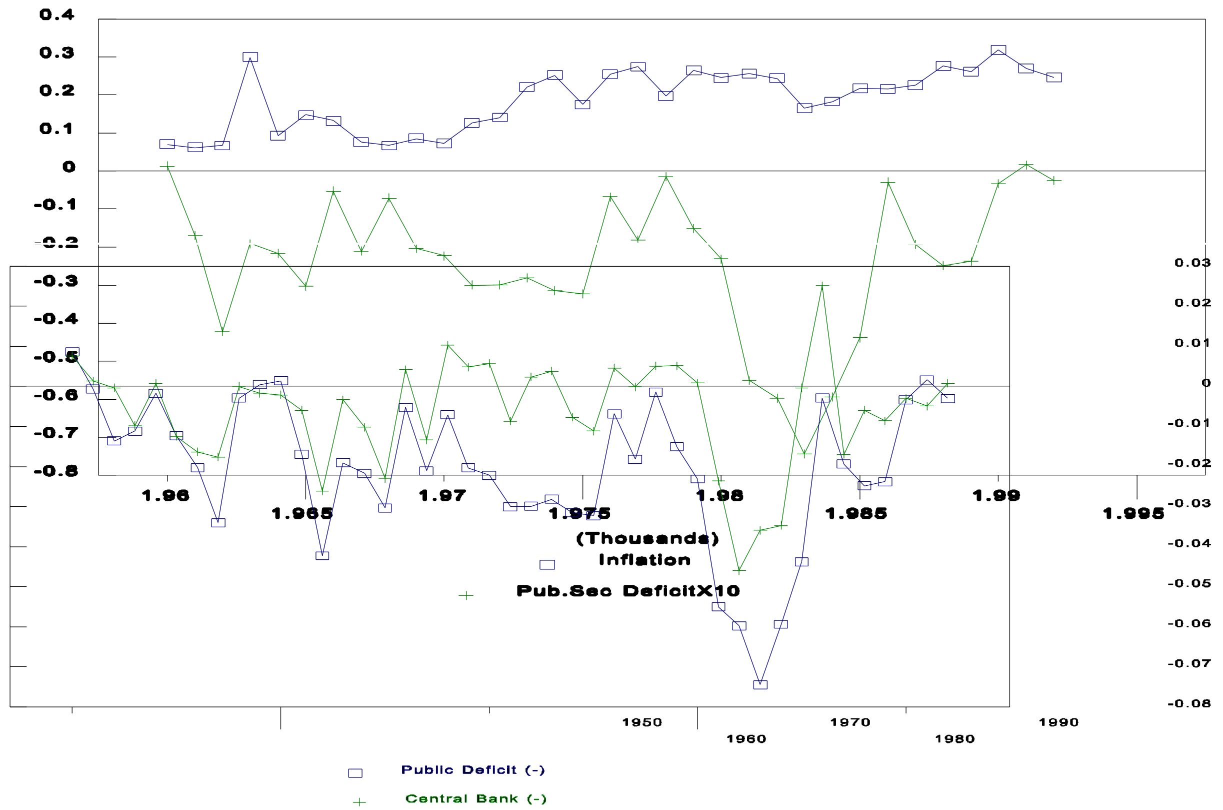
in a country ridden by unsatisfied basic needs and deficient infrastructure? Why is it that Colombian ministers of finance are expected to be ruthless in their pursuit of lower deficits and are publicly



condemned when they fail to do so or even when they find the means to augment public expenditures without increasing the deficits? In trying to answer these questions, the starting point and perhaps one of the most crucial elements to understand is to what extent are fiscal deficits good indicators of macroeconomic health and how they affect macroeconomic performance in Colombia?

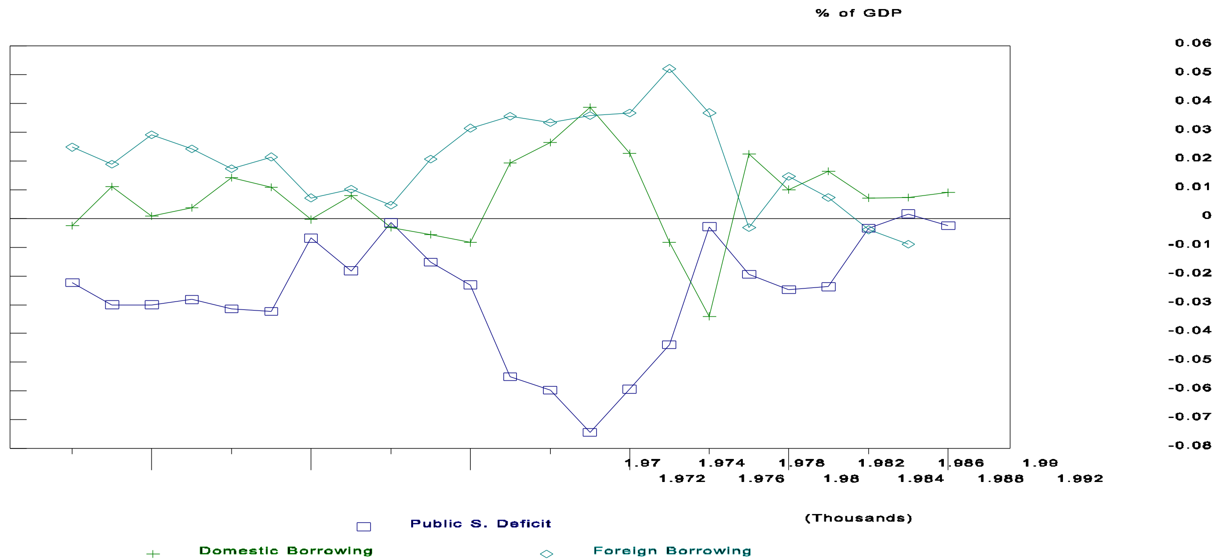
The first factor to consider is the relationship between deficits and inflation.. In Colombia public expenditures or deficits do not exhibit by themselves a demonstrable statistical relationship with inflation. Figure 3 shows the behavior of inflation and the primary deficit of the central government between 1950 and 1992; Figure 4 shows that of inflation and the non-financial public sector deficit from 1960 to 1992. No clear relationship between the public deficits and inflation can be discerned.[1] This is confirmed by other studies that have recently been published and does not

[1] The correlation for the period 1970-92 between the primary deficit of the government and the annual rate of inflation is 0.28 (t=1.31 with 21 d.f.).



appear to be a typical Colombian trait but rather a fairly general finding.[20] "Inflation and deficits show no simple correlation. But there is a long-run association between inflation and one means of deficit financing --money creation."[21] There is also evidence that the volatility of public deficits shows an association with the volatility of inflation, when the deficits are large in comparison to the size of the domestic financial markets.[2]

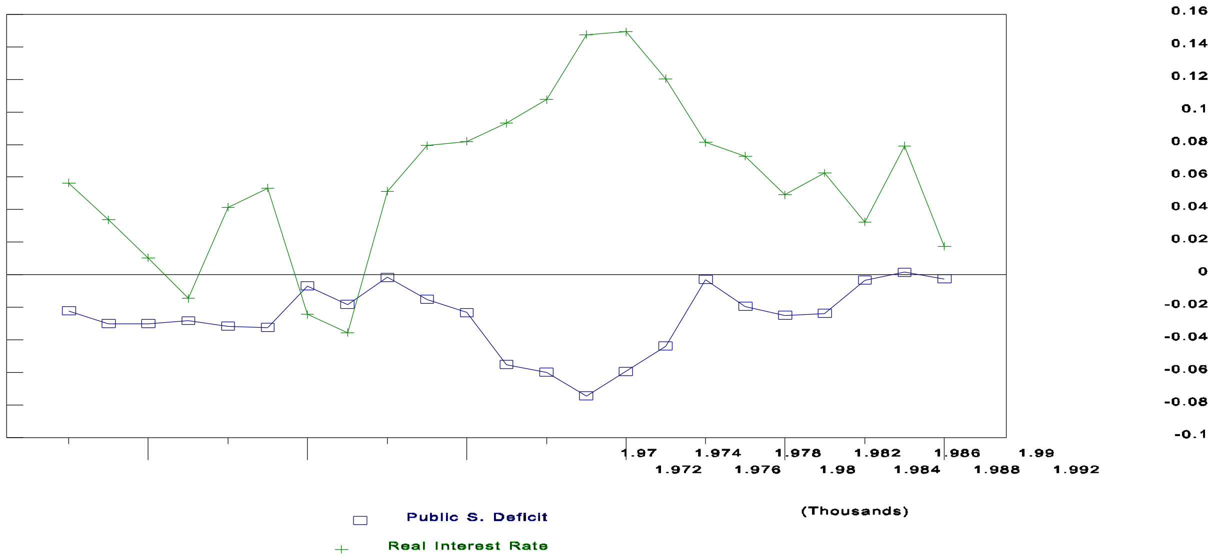
[2]Ongoing research conducted by the Office of the Chief Economist at the Inter-American Development Bank indicates that the effects of fiscal deficits on inflation are not first-but second-moment effects: The volatility of inflation shows a significant relationship with the volatility of fiscal deficits relative to the size of the financial markets.



The money financing of deficits can be linked to higher inflation rates.[22] When the public sector deficit --or the private deficit-- is financed through money creation, it contributes to increase inflation. Figure 5 traces the relationship between central bank financing and public sector deficits since 1950, indicating that the central bank financing of the deficit had been substantial before 1984[3], except during the Lleras Restrepo (1966 - 1970) and Lopez Michelsen (1974 - 1978) administrations. After 1994, this source of financing was sharply reduced and the practice was virtually abolished in 1991 with the new Constitution, eliminating a source of inflationary pressure. However, it was not entirely removed, because the central bank continued to use seniorage as a financing source for its own activities of money-market and exchange rate intervention.

[3]The correlation between the public sector deficit and central bank credit to the government for the 1950-90 period is 0.77 (t=7.49 with 39 d.f).

There is public awareness in Colombia that when deficits grow beyond a relatively small threshold, the sources of financing required --central bank finance, external and domestic credit-- generate other side effects that have negative macroeconomic consequences. As shown in figure 6, when the deficit grows above normal historical levels its domestic financing becomes unusually large. And Figure 7 indicates that attempts to finance the public deficit with domestic credit will induce sharp increases in the domestic interest rate. There is also a private sector fear that public expenditure will inhibit private investment because the country has lived more frequently under



conditions of credit rationing that cause public spending to displace private investment than under conditions of capital abundance. "Public capital has had a negative effect on private investment (...) and the contribution of public investment to growth is highly uncertain" (Easterly. 1994. p.262) In other words, delaying or halting public investment has not had demonstrable negative consequences on growth. This is probably caused by the poor effectiveness of public spending, at any rate it has made the trade-off between adjustment and growth less relevant in the past history of Colombia.

There is a perceived strong relationship between the current account balance and the public deficit (Figure 8). Also, there are strong links between the creation of public deficits and the appreciation of the real exchange rate. This is not only caused by the fact that government traditionally has imposed strict controls on private sector indebtedness and has monopolized the use of foreign credit but also because the deficit was partially financed through money creation and the demand expansion spills over to the external sector.

There is also a strong relationship between the size of the deficit and the flows of external credit (Figure 6) and the trade balance. These two factors --fiscal deficit and foreign financing-- contribute to the trade deficit in the same direction: An increase in the public sector surplus contributes to higher trade surpluses and a decrease in the foreign financing of the deficit has a similar effect (Easterly. 1994. pp.257-259). Moreover, an increase in the trade surplus contributes to the depreciation of the real exchange rate (RER), whereas a decrease acts in favor of an appreciation. In this manner, greater fiscal deficits will indirectly cause an appreciation of the currency. Government spending in Colombia, on the other hand, has shown a positive relationship with the real exchange rate in the past --greater government spending as a percentage of GDP is associated with depreciation of the exchange rate (Easterly. 1994. p. 256). [4]

In view of the behavior of domestic interest rates, considering the foreign financial constraint, and the low impact of public spending on growth, permanently seeking near fiscal equilibrium has been a rational approach: The government has responded to political pressures to increase

[4] The correlation between the RER and the trade balance for the period 1975-92 is 0.8 (t=5.33 and 16 d.f.). The correlation between the RER and government expenditures in t-1 for the same period is .64 (t=3.36 and 16 d.f.). The correlation between trade balance and public sector deficit for the period 1970-92 is .81 (t=6.44 with 21 d.f.).

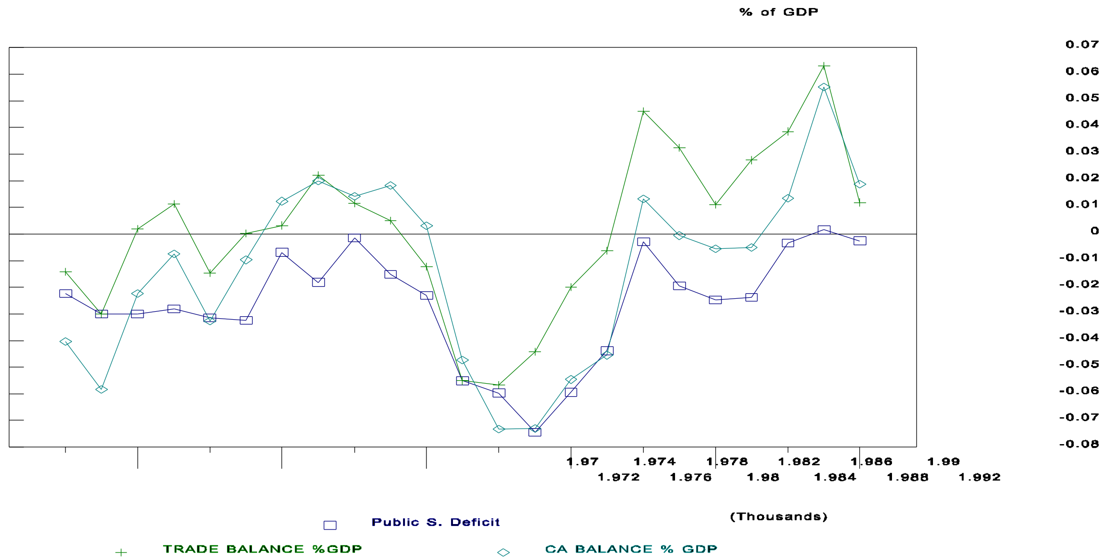
expenditures by seeking to maintain the deficit at comparatively low levels, pushing up revenues each time that expenditures grow. When this rule is frequently adhered to, as has been the case of Colombia, the process becomes almost self-regulated because there is a limit to the increase of revenues through taxes, which puts a cap on the growth of expenditures.

This also acts as a powerful deterrent of deficit creation when the central bank is independent and if the availability of foreign credit is constrained from abroad. The government cannot overly depend on domestic credit, given the very strong relationship between public sector deficits and domestic interest and the negative consequences of high interest rates over stability and growth. Private opinion makers react negatively to increases in the real domestic interest rate because they cause a drop in the ratio of private investment to GDP and ultimately affect growth.[23] The relationship between the real exchange rate and the public deficit is another powerful deterrent to deficit creation in Colombia, because of the existence of a very strong exporter lobby and due to the traditional overwhelming influence of the coffee producers and other exporters that are forever seeking higher domestic prices for their products and abhor the real appreciation of the currency.

Accordingly, in balancing the short-term political objectives with the long-run demands of economic management, the advantages of a conservative financial policy are clear to anyone willing to do the analysis because large deficits affect negatively all the variables that are the key elements of macroeconomic stability and economic progress --growth, private sector investment, inflation, real exchange rates and the trade balance. What still remains unclear is why the government has sought a policy that is sound and very rational in the long run without yielding to the short-term attractiveness of deficit spending. To answer this it is necessary to delve in the dominion of political economy. The preference shown for budget institutions and for economic rationality in the long run

has to be a reflection of who really holds power in Colombia.

One aspect that must be understood is that the constituency of Finance ministers in Colombia are not the political parties, nor the public at large, but the relatively powerful and very vocal business associations. Another aspect that must be highlighted is that traditionally, the most powerful pressure group in Colombia has been the Federation of Coffee Growers, a combined business conglomerate and lobby that had the virtual monopoly of foreign exchange during many years and represented the interests of the principal producers of exported goods of the country. The other business associations are conformed either by exporters or by producers of export substitutes. There is no strong organization of consumers, and fortunately for Colombia, there is no powerful importer lobby,[24] nor or a well organized populist party. The left has been a confused focus of opposition to the traditional parties and has not ever had significant popular backing or influence over public opinion.



In economic matters, the opinion makers are predominantly the economic pressure groups, independent think tanks like FEDESARROLLO and individual economists. There is also a small economic technocracy that can apply peer-group pressure on the government. Given this mix of public opinion sources, there must be and there is a definite bias in favor of policies that do not cause large deficits. There also is strong public opinion pressure to avoid policies that may cause the real exchange rate to appreciate. This was not always so, but since 1967 it has been the rule. Furthermore, the private sector nearly always favors lower interest rates; and given the scarcity of foreign financing, there must be a strong preference for smaller public sector deficits and for positive trade balances.

Since those groups that would pressure for more populist policies do not have permanent political and public opinion representation, the policy mix that is rewarded in Colombia is macroeconomic prudence. Politically it has made sense for governments to have given so much weight to the creation and maintenance of strong budget institutions that prevent expenditure excesses by Congress and control executive indebtedness because the principal constituencies of

economic policy gain from stable and prudent fiscal policies. The new Constitutional charter of an independent central bank put an end to its previous excesses as a source of finance of the public and members of the private sectors and has the same political constituency of strong fiscal institutions.

This political organization may be criticized for being unduly oligarchical in nature or for not letting other mechanisms of democratic participation flourish, but in purely fiscal terms it has been a blessing. It has facilitated Colombia's slow but steady transition from being one of the poorest countries in the continent to the middle-income status it enjoys since the seventies.

It is particularly interesting how the government and the organized business guilds have worked together to imprint a real exchange rate objective on fiscal policy. For example, in the past, the adjustment to positive shocks in the international coffee prices has been achieved more through fiscal means than through changes in the real exchange rate. Similarly, when coffee prices fall, domestic prices of coffee are sustained using fiscal resources of the National Coffee Fund. This helps explain why during long periods of time, the real exchange rate has moved independently of the international coffee prices. [25] Producers of export goods different from coffee and of import substitution goods have been shielded from the full appreciating effects of the international booms on the real exchange rate and have been able to grow and develop with relative independence of the variations in prices of the main export commodity. In the long run, this has made the country more resilient vis-a-vis external shocks through export diversification.

With all its merits, the government-business consensus that ruled in Colombia during the 1967 - 1991 period, also had some costs, mostly in terms of inflation and growth. This is closely related to fiscal policy and merits some analysis: Although Colombia has had a stable fiscal policy, it has not been overly restrictive. As a rule, the government has chosen to generate moderate and stable deficits,

producing surpluses only when extremely favorable external conditions would require so; and even in these circumstances, the surpluses also have been moderate. The rate of inflation also has been stable but moderately high. These policy results seem to reflect a national preference for the middle of the ground. A favorite Colombian aphorism says: "don't place the candle so far from the saint that it cannot be seen; nor so close that it will burn it." In economic policy, this has been the rule.

From the late sixties to the early nineties, Colombia had a nominal exchange rate policy that attempted to favor exporters: Through a crawling-peg mechanism, the nominal exchange rate was confined to a path determined by the expected domestic and foreign inflations. The rates of inflation were carefully monitored and forecasted on a monthly basis and the rate of devaluation was determined by this expectation. Forecasts and macroeconomic programming were based on a stable inflation assumption.

Additionally, the central bank financed the private sector through development credit schemes or by granting direct credit to firms in sectors that were depressed or in distress. These activities were wholly or partly financed through monetary expansion. The money base was carved and distributed by a Monetary Board that treated it as a budget to be allocated and disbursed; the growth of the base and M1 were carefully programmed so that the nominal exchange rate and the credit to the private sector and to government could be accommodated. The implicit programming rule was that M1 would grow at the same rate of the expected growth of nominal GDP, assuming stable inflation. The nominal exchange rate devaluation would be programmed accordingly targeting a stable real exchange rate. This made inflation and devaluation easily predictable and it became a self-fulfilling rule. The accommodation with higher inflation was started in the early seventies and continued until 1991. The Pastrana government narrowly had won the presidential election of 1970 and sought to

gain public support through expanded public expenditures and higher quasi-fiscal credit subsidies. With time, the government and the public came to a tacit agreement: If inflation was kept around twenty-four percent per year in a band that would not exceed thirty percent, the public would not seek to reduce their monetary assets. The government also tolerated the indexation of nominal contracts and eventually accepted a form of indexation of wages, by yearly adjusting the minimum wage to the past inflation. [26]

Given these mores of monetary management and in view of the strong pressure to keep the exchange rate from appreciating, it is a small wonder that Colombia has one of the most remarkable records --stable moderate inflation. Even in a closed economy, keeping money and exchange rate under control is an improbable mission, but it explains why fiscal restraint is essential: There are just not enough degrees of freedom when most other variables are already pre-determined. Still, the government obtained the financing it required for a number of projects it favored and for its statist development programs, including its export-promotion strategy, at the cost of a higher inflation.

Jorge Garcia Garcia has expressed how this policy mix succeeded in keeping a consensus alive Amostly on false premises@ with some costs but yielding very stable macroeconomic results:

> (Nominal) devaluation did not prevent a real appreciation of the peso ....; nor did it favor exporters or protect those sectors that compete with imports. However, it produced an illusion that something had been done in favor of domestic producers. It also contributed to keep inflation high. The public believed that establishing real targets motivated more exports and never questioned whether a relationship existed or not between a trade liberalization and export promotion; and the country maintained (for many years) a very restrictive foreign trade regime. Colombia had a stable economy but a repressed economy.[27]

<u>Do Legal Changes Really Matter?</u> Colombia has shown remarkable stability in terms of inflation and public deficits, unparalleled in the continent and with few rivals abroad . A similar record may be claimed in terms of economic growth.[28] As we have seen, budget institutions have

played a role in this picture of stability and moderate growth. Still, a question remains: How important have been institutional and legal changes for the fiscal performance. To get an impression about this, a simple test was devised, comparing the size of primary deficits as a proportion of GDP for the three years immediately preceding every mayor twentieth century budget reform from 1931 to 1989 with the size of those in the three years immediately following the year of the reform. This yielded two samples of fifteen observations. The average primary deficit of the years preceding the reforms were on average 1.35 percent of GDP larger than those for the years following the reforms[5]. A casual observation of Figure 3 shows that the deficits are getting smaller but that there is a cyclical pattern. Governments allow the situation to deteriorate and then they correct it. This may be concluded also from the before and after reform comparison: It appears that periodic reforms are required to build up a morale for deficit slashing, and that this zest will disappear with time, making it necessary for another set of reforms to arouse the orthodox spirit once again. In conclusion, it appears that institutions really matter, but also that governments and the public opinion must keep on working at it because the effectiveness of the rules appears to wane with time.

Conclusions

The development of budget institutions in Colombia has spanned a period that starts a few decades after Independence and continues at the present time. It has been a gradual development and,

[5] Reforms took place in 1931, 1950, 1963, 1973 and 1980. The average primary deficit for the 15 years preceding the reforms was 1.11% of GDP and the average primary surplus of the 18 years following the reforms was 0.24% of GDP. The difference of 1.35% of GDP is significant (t=3.61, p=0.0005).

except for the decentralization of government induced by the new Constitution of 1991, which opened a parallel path for local-government institutional development now in its infancy, the process has pointed almost continuously in one direction. The thrust of the institutional building inertia has been to give the central government the power to autonomously determine the outcome of fiscal policy in a democratic setting. The Constitution of 1991 gave new democratic meaning to the budget approval process, and it gave Congress more power than it had in budgetary matters. Nevertheless at present time, the Colombian government has the institutions and mechanisms that ensure that it controls the fiscal outcome and may be held responsible for them, despite the political pressures involved in the budget approval and fiscal policy formation processes. With the budget rules that now exist and given the authority of the central government in budgetary affairs, coupled with central bank independence, no modern-day Minister of Finance can come out -- as others have done in the past -- and blame Congress, the judiciary, the decentralized system of government or revenue-sharing, for the expansion of public spending or for the budget outcome of a given year. On the contrary, public opinion can and will hold the government totally responsible for the fiscal results because it has empowered it with the tools necessary for good fiscal management.

These are mainly derived from the legal rules and institutions that govern the budget formation, approval and execution process in which the government has been given the upper hand. The principal feature of this legal framework is the independence of the central bank because this assures that government cannot appropriate an inflation tax to finance deficits or to subsidize the private sector. Then, there is the required concordance of the budget size and distribution with a macroeconomic program in the design of which the central bank has played a key role in coordination

with government. This provides the fiscal restraint that is often sought when "balanced-budget rules" are imposed without the hindrances derived from those rules. Additionally, if the President is fiscally responsible, the Ministry of Finance in Colombia has greater power than the spending ministries in the budget formation process because it can impose its authority in the final count when the budget is taken to Congress for approval and because the budget formation process is biased to give more power to this Ministry and the Planning Department in setting targets and in ultimately allocating expenditures. Moreover, Congress, although empowered with the authority to approve the budget, cannot increase expenditures without the express authorization of the Minister of Finance, nor can it threaten the government refusing to approve the budget because in this event, the government can impose by decree the budget proposal it took to Congress. After the budget is approved, the Minister of Finance can ask Congress for new taxes to balance the fiscal result. If these taxes are not approved, the Ministry of Finance is entitled to cut the expenditures until equilibrium is achieved. During the execution of the budget, no major changes between items can be effected and budget increases are prohibited without congressional authorization, except in the cases when a state of emergency can be legitimately invoked. The maximum authority that sets the monthly targets for spending and determines the cash flow is CONFIS --a Ministry of Finance dependency. The management of the cash flow is essentially the most important fiscal management tool because it is what in the end determines the budget execution, and it is dominated by Finance. In short, this Ministry is equipped with all the mechanisms that insure the fiscal results against negative shocks derived from congressional and political actions inside and outside the executive, with the sole exception of those coming from the Presidency. It also has the tools to react to adverse shocks derived from international markets or acts of nature. Additionally, the government also has tools to deal with

positive shocks. The new budget organic law introduced two new principles to the process of budget formation: macroeconomic coherence and homeostasis. According to the first, the government is entitled to cut expenditures when the macroeconomic environment requires it to do so; the second principle of self-regulation gives the government the possibility of creating stabilization funds when the revenues exceed the absorption capacity of the economy in instances like the forthcoming boom of oil resources. Many of these "nice features" of the budget process have been the work of the Barco and Gaviria administrations. The Samper government has also improved the system by promoting a law that has been approved and will allow the government to create and operate an oil stabilization fund.

Perhaps the most interesting aspect of the process is that there are sound economic reasons behind the political backing that orthodox fiscal policy has received in Colombia. The maintenance of a small public sector deficit has helped Colombia to maintain a stable and competitive real exchange rate, it has contributed to avoid large swings in the current account balance and to maintain it within sustainable levels and has been a key factor to avoid substantial increases in foreign indebtedness, which would have brought down the trade balance and added to the appreciation of the currency. Furthermore, the political economy of fiscal management in Colombia can be enriched if it is taken into consideration that public investment is not a complement of private investment, but rather an undesirable substitute; and that in Colombia growth does not suffer considerably when the government has to reduce its investment to accommodate fiscal adjustment programs. This is particularly critical because it may be an indication that despite all the procedures that act in favor of reduced deficits, there are no institutions that would control the quality and effectiveness of public spending.

The analysis of the political economy of fiscal and macroeconomic policy since 1967 yields several interesting conclusions. First, it provides a political framework to explain why Colombians prefer to control public expenditures than to let them run amok. A careful management of public deficits yields a more stable macroeconomic performance, which tends to benefit the private sector and gets its support. Since there are no active competing constituencies with oppositing objectives, this policy has been more easily maintained than in countries where populism was organized as a political party or where political factions had stronger claims on the budget. Inflation was kept at its moderately high levels during many years, without any serious attempts to reduce it on a permanent basis, because there was a monetary financing of the --mostly-- moderate deficits; and the private sector tolerated the predictable level of moderately high inflation in exchange for cheaper credit and a stable real exchange rate. The policies were successful to the extent that they yielded stability and moderate growth. Time will tell if economic management in the more open economy that was started in 1991 will be able to yield better results. So far, it is already noticeable that in an open economy the government has to apply even tighter fiscal restraint if it is expected to continue providing price and real exchange rate stability.

1. The author is a consultant for the Office of the Chief Economist of the Inter-American Bank. This paper is part of a research project about the effect of budget institutions on the fiscal performance of Latin American countries conducted for this office by Alberto Alesina, Ricardo Hausmann, Ernesto Stein and the author.

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