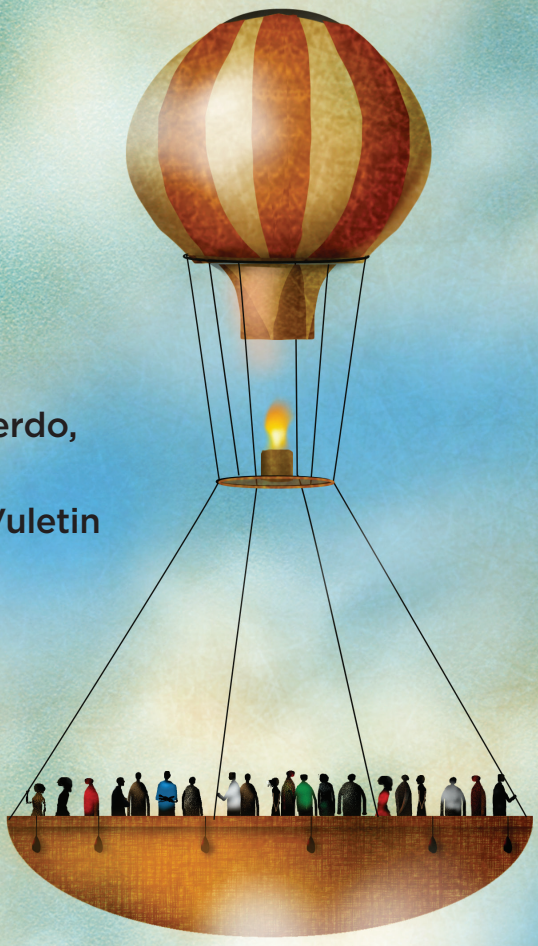
DEVELOPMENT IN THE AMERICAS

Better Spending for Better Lives

How Latin America and the Caribbean Can *Do More with Less*

Chapter 9



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9 Better Institutions: The Key to Better Public Spending

Much of this book has focused on diagnosing the inefficiencies of public spending in Latin America and the Caribbean, both at the macro level and in the myriad of sectors from education and health to infrastructure and public safety that together contribute to the well-being of the region's citizens. Individual chapters have also proposed specific policies and approaches to improve the efficiency of expenditures. This chapter looks at the final piece to this puzzle: the institutions needed to safeguard efficient public spending and execute productive, growth-oriented public policy.

From a macroeconomic point of view, Latin America and the Caribbean has historically struggled to achieve fiscal sustainability and stabilizing (i.e., countercyclical) fiscal policies. Moreover, the region has also continuously biased its spending against public investment, not only in relative terms vis-à-vis current spending, but also in per capita terms. This bias, in turn, may have hurt economic growth (especially given the region's low infrastructure levels). This is, naturally, of particular importance in a region like Latin America and the Caribbean where an important part of economic growth is driven by external factors such as commodity prices and global financial cycles. If the region aims to graduate from this dependency trap and integrate into the global economy in a more strategic manner with higher value added, better and more productive jobs, and sustained, more domestic-driven growth, the region must reverse this bias against public investment. The first part of this chapter focuses on the role that institutions, in particular fiscal institutions like fiscal rules, have had in helping Latin America and the Caribbean (as well as other regions) to cope with fiscal sustainability and stabilizing fiscal policies. The conclusion is that while fiscal rules have, indeed, helped reduce the likelihood of debt crises and procyclicality, they are not without their flaws. In fact, they have tended to exacerbate the bias against public investment. To lessen this bias, the region should turn to so-called second condition fiscal rules, which build upon aggregate fiscal rules to directly or indirectly

"protect" public investment. While de jure (or legal) second condition fiscal rules are relatively new, countries that de facto (or in practice) applied such rules grew more and reduced their economic fluctuations.

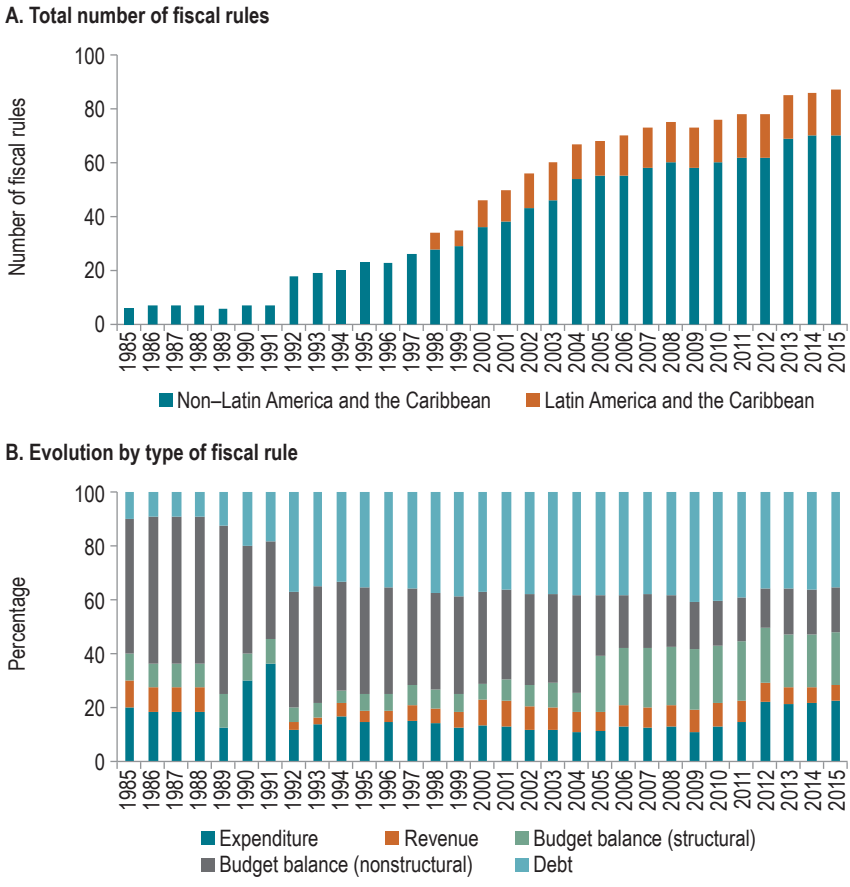
Aggregate Fiscal Rules

In order to avoid well-known fiscal sustainability problems which, in turn, increase the chances of having to rely on procyclical policies (especially in bad times), many countries in the world have increasingly adopted different types of aggregate fiscal rules. These rules impose a long-lasting constraint on fiscal policy through numerical limits on budgetary aggregates. Their aggregate nature aims at correcting distorted incentives and containing pressures to overspend, particularly in good times, so as to ensure fiscal responsibility and debt sustainability. Reducing fiscal sustainability problems is, naturally, a necessary condition to avoid systematic fiscal adjustments in bad times (i.e., procyclicality).

Adopting aggregate fiscal rules has become a usual practice both globally and in Latin America and the Caribbean. The most common fiscal rules impose limits on debt, spending, revenue, and/or the budget balance. The latter comes in two subtypes, depending on whether the limit is imposed on the actual (typically primary) budget balance (as in most U.S. states) or on its structural or cyclically adjusted budget balance (as in European Union countries). The structural fiscal balance is typically calculated as the nominal fiscal balance adjusted by its cyclical component, and net of one-off and temporary measures. The cyclical component of the budget is subtracted from the actual budget balance. The cyclical component is calculated as the product of the output gap (the difference between actual and potential gross domestic product [GDP], as a percentage of potential GDP) and a parameter reflecting the automatic reaction of the government balance to an output gap change. In other words, this cyclically adjusted budget balance corresponds to the budget balance that would prevail if the economy were running at trend levels.

Budget balance rules were at some point the most adopted ones, but since the early 1990s debt rules have also become very popular. Fiscal rules associated with revenue limits have been the least popular and since 2012, spending rules seem to have gained consideration. Figure 9.1 shows the evolution of fiscal rules adoption since the mid-1980s. Panel A shows that the total number of fiscal rules adopted increased substantially between 1985 and 2015. Latin American and Caribbean countries began to adopt them toward the end of the 1990s. Panel B focuses on the evolution of different types of fiscal rules. Those that have gained the greatest

Figure 9.1 Evolution of Fiscal Rules Adoption, 1985–2015



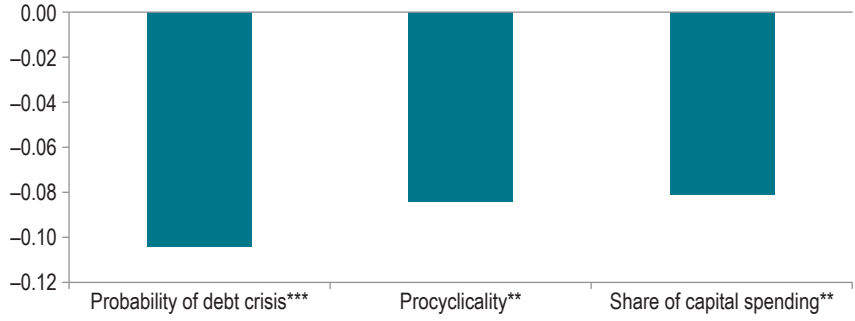
Source: Authors' calculation based on Izquierdo, Puig, et al. (2018b).
Note: Debt rules set an explicit limit or target for public debt as a percent of GDP. Budget balance rules (structural and nonstructural) constrain the variable that primarily influences the debt ratio and are largely under the control of policymakers. Revenue rules set ceilings or floors on revenues and are aimed at boosting revenue collection and/or preventing an excessive tax burden. Expenditure rules set limits on total, primary, or current spending. Fiscal rules, data come from the "IMF Fiscal Rules Dataset, 2016" and Schaechter et al. (2012).

traction are debt rules (which typically impose a debt-to-GDP ceiling) and structural budget rules (which limit measures of the budget balance after excluding the influence of the business cycle).

The Truth about Aggregate Fiscal Rules

While aggregate fiscal rules are not a panacea, as they are sometimes not enforced (or sometimes they are even designed to have a certain degree

Figure 9.2 Fiscal Rules Adoption and the Probability of Debt Crisis, Fiscal Procyclicality, and Public Spending Composition



Source: Authors' elaboration based on Izquierdo, Puig, et al. (2018b).
Note: a) Data for probability of debt crisis come from Reinhart and Rogoff (2011); b) Fiscal rules data come from the "IMF Fiscal Rules Dataset, 2016" and Schaechter et al. (2012); c) Cyclicality is measured by the correlation coefficient between the cyclical component of GDP and cyclical component of total expenditure (both in terms of their trend), calculated with a rolling window of 10 years (WEO-IMF) and d) Bias composition is measured through the ratio between capital spending and primary current spending (WEO-IMF).
Bars represent the associated coefficient between each dependent variable and the fact of having a fiscal rule. All regressions are estimated using panel data with fixed effects and control for heteroscedasticity. Number of countries included in each estimation is 67, 192, and 172 respectively. Statistical significance: *** p<0.01, ** p<0.05, * p<0.1.

of "flexibility" which, in turn, may violate the spirit of the rule itself), they have been useful on average. Rather than dwelling on comparisons among the different types of fiscal rules (see Schaechter et al., 2012; Budina et al., 2012; and Berganza, 2012, for useful reviews), this chapter focuses on their effects on key issues tackled in Chapters 1 and 2. Figure 9.2 shows the effects of fiscal rules adoption (of any kind) on the probability of a debt crisis, fiscal procyclicality, and public spending composition.[1] In particular, as noted by the first and second bars, the adoption of a fiscal rule reduces the likelihood of a debt crisis as well as the degree of procyclicality. Thus far, the news could not be better on the sustainability and procyclicality fronts. Interestingly (and novel in terms of discussions about the implications of fiscal rules), yet not surprisingly, the adoption of fiscal rules increases the bias against public investment. Why? Because as discussed in Ardanaz and Izquierdo (2017) and in Chapter 1, this is the easiest spending component to adjust, especially in bad times. In other words, while aggregate fiscal rules actually work to reduce sustainability and stabilizing concerns, they do so at the expense of increasing the bias against public

[1] All regressions are estimated using a panel of 192 countries and include fixed effects and robust standard errors that control by heteroscedasticity. WEO-IMF is the main data source.

investment. This collateral damage could have harmful consequences for economic growth, especially for a region like Latin America and the Caribbean, which has an important infrastructure gap.

Second Condition (or Composition) Fiscal Rules

Second condition fiscal rules build upon aggregate fiscal rules to directly or indirectly "protect" public investment. For example, in 2018, Peru passed a law limiting not only the growth of overall public spending (which cannot grow by more than 1 percent over the economy's long-run growth rate), but also limiting the growth of current spending (which cannot grow by more than 1 percent below the economy's long-run growth rate). This rule has not only the benefit of limiting the growth of more rigid (especially downward rigid) current spending—such as wages and transfers—but by doing so it also serves as protection for public investment.

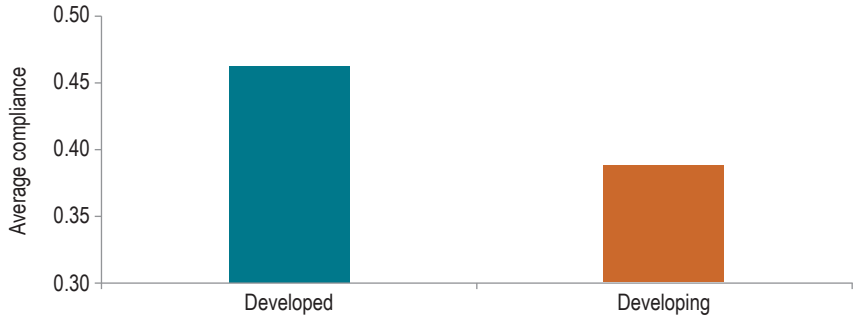
Since de jure (or legal) second condition fiscal rules are relatively new, and in order to assess their implications, the first step is to identify countries that de facto (or in practice) applied such second condition (or composition) fiscal rules and then contrast them with those that did not, in order to evaluate their relative performance in terms of average growth and output volatility. To do so, and following the Peruvian second condition fiscal rule, it is necessary to assess whether a country de facto controls the growth rate of current expenditure (thus protecting capital expenditure). This is done by checking for every country-year observation in the sample whether the growth rate of current expenditures is at least 1 percentage point below the economy's historical long-run growth rate.[2] Figure 9.3 shows average compliance with this implicit rule for both industrial and developing countries. Not surprisingly, such prevalence is larger (and statistically different) in the industrial world than in developing economies.

Moreover, countries with a higher prevalence of these second condition fiscal rules grow more, and tend (weakly) to experience less volatility than those with lesser prevalence (Figure 9.4A and B).[3] These results are consistent with theoretical models like that of Izquierdo and Kawamura (2018), in which, in the context of either political economy frictions (policymakers who run for election and face voters with different preferences

[2] Results strongly hold for variations of the threshold and the identification strategy of the methodology. See Izquierdo et al. (2018) for details.

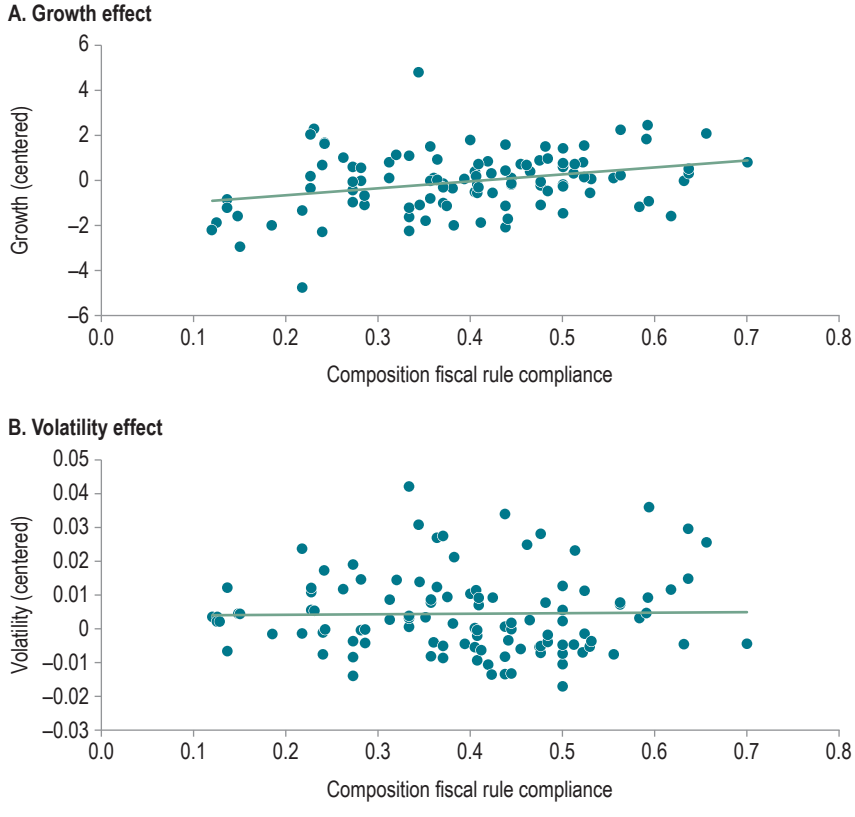
[3] Regressions in Figure 9.4A and B, control for the level of development (industrial countries or developing countries). Figure 9.4A is centered on the sample average growth rate, and Figure 9.4B on average volatility.

Figure 9.3 Incidence of De Facto Second Condition Fiscal Rules



Source: Authors' elaboration based on Izquierdo et al. (2018).

Figure 9.4 Macroeconomic Effects of Second Condition Fiscal Rules



Source: Authors' elaboration based on Izquierdo et al. (2018).

on spending composition), or specific capture technologies (that government bureaucrats may use for current and capital spending), introducing second condition (or composition) fiscal rules indeed generates higher economic growth without significant effects on output volatility.

These results suggest that second condition fiscal rules that protect public investment may be useful in fostering growth. Thus, it could be relevant to couple aggregate fiscal rules—which are good for sustainability and have stabilizing effects—with second condition (or composition) fiscal rules that protect public investment against the natural bias against it, be it because of the negative effects of aggregate fiscal rules themselves, or the political economy effects that lack of trust in government may have on citizens' choices against long-term investments (see Chapter 10).

Institutions for Smart Spending at the Micro Level

Public expenditure accounts for almost 38 percent of the annual wealth created in Latin America and the Caribbean. Managing from 15 to 47 percent of GDP—the range of public spending in the region—in an efficient manner leading to inclusive growth is not a task for an aimless body of public institutions. It demands purpose, planning, and prioritization of best policies, evidence-based decisions on the use of money, and a professional civil service to carry the plan out. The rest of this chapter will show that planning, prioritization, evaluation, and professionalization are common critical factors that Latin America and the Caribbean needs to improve in public spending management.

Latin America and the Caribbean suffers from two interrelated problems: public spending is inefficient and ineffective, both technically and allocatively, and it is inefficient in promoting equity. This problem is reinforced by a weak public expenditure management system—the institutions through which public resources are channeled from taxpayers to prioritized spending programs in the budget and how they are implemented, monitored, and evaluated. Poor management institutions waste resources, erode public trust, hamper growth opportunities, and limit possibilities to reduce poverty and inequality. While institutions are almost universally weak in Latin American and Caribbean countries, they vary widely across the region.

Expenditure institutions and the possibility of reform are severely limited from within and outside government, unless strategies are implemented to deal with them. To begin with, spending entities within government want to see their budget allocation increase, but finance ministries are tasked with keeping overall spending ceilings under control. These tensions increase competition and contention in the spending allocation process and demand effective coordination—one of the critical factors to achieve better results

in spending reforms. Expenditure reforms are also difficult to implement because of the many private special interests that can be affected: unions, firms, and aid beneficiaries, to name a few.

Since the late 1980s, Latin American and Caribbean countries have made great strides putting into operation important expenditure management institutions. Most reforms aimed at fiscal sustainability: quantitative fiscal rules, stabilization funds, medium-term fiscal frameworks, and restrictions to national and subnational debt (Filc and Scartascini, 2007).[4] Several countries lacked budget discipline, but progress was made. The first Integrated Financial Management Information System (IFMIS) to control budget disbursements by automating and streamlining government's financial management processes was implemented after decades of missed, duplicated, and delayed payments. Centralized digital public procurement systems replaced institution-by-institution procurements, which lacked rules, mandatory competitive bidding, or lists of buyers. The civil service system was not organized, and important advances ensued. Reforms emphasized processes instead of an overall restructuring of functions. Despite the advances, however, these reforms lacked an analysis of how and how much to spend across programs and functions, and an appraisal of their effect on growth and equity.

The reforms fell short of achieving long-lasting growth and equity. They were not based on a long-term vision, and when they were, priorities were not clear or too broad. In the mid-1990s, most of the conditional cash transfer (CCT) programs were implemented to alleviate poverty and improve human capital; however, they lacked a clear vision of how to decrease long-term poverty and inequality. Noncontributory pensions and health care also expanded, but without a proper analysis of the effects on informality or their sustainability, particularly in the context of an aging region. Hence, despite the advances in the machinery of budget, procurement, civil service, public financial management (PFM), and even digital institutions, the efficiency, equity, and transparency of public spending continued to be weak and the link with outcomes almost nonexistent.

Some countries that implemented second generation-budgeting and PFM reforms expected to solve most inefficiencies in public spending. But first, a deep, multidisciplinary economic analysis of government spending is needed that sets priorities and a pathway for how to better achieve them. Budget formulation should be aligned and constructed from these

[4] While the first-generation reforms in Latin American and the Caribbean of the early 1990s essentially addressed monetary and fiscal imbalances related to the direct role of government in the economy and aimed at resolving issues in the short term, the second-generation reforms of the 2000s involved institutional changes designed to enhance the efficiency of government regulation and public policy more broadly (Panizza and Philip, 2005).

priorities such that PFM manages the flows of allocated spending more efficiently. But how to change the rigid budget? Anyone who has worked in budgeting knows that old claims on the budget have an advantage over new ones (Schick, 2004). This is what is called incrementalism: budgeting decisions are anchored in the past, usually varying only in small increments from one year to the next. But spending decisions can be inserted in the budget in an incremental yet smart way, making it politically viable to achieve allocative efficiency gradually.

Despite the wave of reforms, the increased spending of the 2000s in most Latin American and Caribbean countries propell an unprecedented growth in the tasks of the public sector. That is why it is most urgent to embark on a new, smart generation of reforms that improve efficiency and equity of spending by reinforcing both first- and second-generation institutions and creating new institutions when necessary. There is a small window of opportunity to enact smart spending reforms—not simple austerity measures—that take a long-term view and acknowledge that public spending is a large proportion of GDP that should be programmed with technical and above all allocative efficiency in order to ensure sustained, inclusive growth.

Smart spending requires operational efficiency, which refers to the provision of public services at a reasonable quality and cost; the relevant question is whether the country is getting the best buy for its money. Allocative efficiency on the other hand refers to the consonance of budgetary allocations with strategic priorities: are budgetary resources being allocated to programs and activities that promote the strategic priorities of the country? Put simply, is the government spending money on the "right allocations," with the highest net present value generated by a social cost-benefit analysis (CBA)? The purpose of doing a CBA is to allow competing policy priorities to be compared in a consistent way[5] and to help policymakers identify the best way to deliver the strategic objectives of government. CBAs should be the every day practice in appraising government spending in all countries in

[5] In a series of studies, the behavioral economist Sunstein (2018) argues that government policy should not be based on public opinion, intuitions, or pressure from interest groups, but on numbers, meaning careful consideration of costs and benefits, even if it seems extremely difficult or impossible to monetize all costs and benefits. The emphasis on CBA for analyzing government spending, taxation, and any regulation was proposed by Dupuit, a French engineer, in 1847 but has become popular since the 1960s. Over the decades, it has been applied in government programs that can be analyzed using data, but mostly in developed countries. In Latin America and the Caribbean, Chile, partly inspired by Harberger (1972), has perhaps the oldest and best-developed system of appraisal operating at all government levels. Critics of CBA argue that reducing all benefits to monetary terms is impossible, and that a quantitative measurement is difficult—and inappropriate—for political decision-making.

the region. However difficult it might seem, the process of doing so is much more informative and can save billions of taxpayers' dollars. From CBAs and rates of return grounded in data, it is possible to understand, for example, more clearly whether and which human capital projects or physical capital projects should be favored, and in what proportions.

In Latin America and the Caribbean, the challenge is to improve the technical and allocative efficiency of public spending. This chapter offers key policy recommendations based on best practices, theory, and empirical evidence provided by more developed countries, which have already implemented several of the reforms, and also from lessons learned from the experience of the IDB and other stakeholders in Latin America and the Caribbean. Most key recommendations are applicable to national, regional, and local governments.[6] Admittedly, there is no one-size-fits-all solution when it comes to better institutions to manage spending. Moreover, no single or new institution is a panacea, especially if implemented without political commitment or with minimum capacities. Most recommendations are set within a unified framework starting from planning, coordination, and coverage challenges, followed by operational and human resource considerations, and considerations related to ex-post evaluation and monitoring and control.

Smart Shopping: Public Procurement Management

Public procurement expenditure amounts to about a third of total public spending in Latin America and the Caribbean (Chapter 3) and its management is recognized as a strategic instrument for public service delivery as well as an activity vulnerable to corruption and inefficiency at the expense of "value-for-money" considerations. In fact, estimated waste in procurement ranges from 10 to 30 percent of total spending. Achieving the best value-for-money involves three principles: economy (acquiring resources in the right quantity and quality), efficiency (minimum cost for the same service), and effectiveness (achievement of intended outcomes) (McKevitt, 2015).

Public procurement reform in the region has come a long way since the early 2000s, when it was a minor part of the second generation of public sector reforms. The region has made more progress than other developed regions, especially in advancing their e-procurement tools (Harper, Calderón Ramírez, and Munóz-Ayala, 2016). But several countries in the region, are still transitioning to procurement systems with better institutions, more agile processes, and

[6] The list of key policy recommendations is not exhaustive and does not pretend to be a full menu of sequencing of reforms or best practices for Latin America.

a heightened capacity to prevent corruption.[7] Clearly, reforms have not been enough to dismantle inefficiencies or eliminate corruption (see Chapter 3).

Implementing an effective public procurement system based on transparency, competition, and integrity, as called for by the United Nations Convention against Corruption (UNCAC), is not simple. A procurement system that lacks transparency and competition is the ideal breeding ground for corrupt behavior. According to the UNODC (2013), reform initiatives need to integrate these goals.[8] A comprehensive and outcome-based procurement index is still needed. A widely used procurement indicator is the Organisation for Economic Co-operation and Development (OECD) Methodology for Assessing Procurement Systems (MAPS), which mostly measures the process against international best practice models, not procurement outputs, outcomes, or systemic performance. Still, it portrays the current state of processes in Latin America and the Caribbean: 14 governments in the region conducted a MAPS self-assessment of their procurement systems between 2008 and 2016[9] ranging from 0 to 3 with 3 meaning full achievement of the standards. For each country, MAPS presents the year implemented and the score. The results, from best to worst, were: Chile (2008, 2.7), Brazil (2011, 2.2); Ecuador (2011, 2.0); Paraguay (2013, 2.0); Peru (2016, 2.0); Colombia (2009, 1.9); Nicaragua (2010, 1.8); the Dominican Republic (2012, 1.5); Costa Rica (2015, 1.5); Honduras (2010, 1.2); El Salvador (2010, 1.2); Barbados (2008, 0.5); Belize (2010, 0.5); and Guyana (2010; 0.5). According to the results, most countries still need to improve procurement processes and evidence points to poor outcomes in several countries.

Table 9.1 provides a list of key recommendations to be adapted to each Latin American and Caribbean country. While professionalization and ex-post evaluation, monitoring, and control of the system are necessary to develop a comprehensive and effective system, there are key critical factors—planning, coverage and coordination, competition, and effective digitalization—that the region's countries need to improve to make the system more efficient and less prone to corruption.

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7 See, for example, Capello and Garcia Oro (2015).

8 In practice, however, too often competition and transparency have been dealt with as issues of procurement reform, while integrity has been addressed separately, as part of anti-corruption initiatives, and this seems the case in the latest reforms in Latin America and the Caribbean.

9 The Methodology for Assessing Procurement Systems (OECD, 2009) assesses countries across four pillars: the existing legal framework that regulates procurement in the country; the institutional architecture of the system; the operation of the system and the competitiveness of the national market; and the integrity of the procurement system. Several countries, such as Colombia, Honduras, and El Salvador, have reformed their system since the last index was published.

Table 9.1 Policy Recommendations to Improve Efficiency in Public Procurement Management

	Key recommendations	Details
Planning/ Prioritization	Develop a comprehensive procurement plan setting a vision, goals, and prioritized methods and tools.	Publishing annual procurement plans increases accountability of contracting authorities, as they need to justify diverging from the plan (European Commission, 2018b).
Coverage/ Coordination	Cover all buying of goods and services by the obligation to comply with procurement laws and regulations and provide for a central regulatory agency.	Include all procurement stages and actors, all levels of government, under a centralized procurement agency that oversees, promotes training, and accountability.
Competition	Use competitive and efficient tendering and limit the use of exceptions and single-source procurement (OECD, 2016c).	Use open tendering as the default method, and modern tools (framework agreements, electronic catalogs, and reverse auctions for standardized products).
Digital technology and efficient tools	Implement electronic procurement via dedicated e-procurement platforms, not only informational but fundamentally transactional, and promote other digital innovations to secure transparency and competition.	Include interoperability of the e-procurement platform with Integrated Financial Management Information System, electronic payroll, and other public electronic platforms and databases. Blockchain can serve for more secure transactions.
Transparency/ Participation	Promote transparency in all the stages of the procurement cycle to guarantee accountability and prevent corruption. Aim for open data in procurement of goods and services and public works.	Allow free access, through an online portal, for all stakeholders, including potential domestic and foreign suppliers, civil society, and the general public, to public procurement information (OECD, 2017e).
Professionalization	Increase the professionalization of the procurement workforce with the capacity to deliver value for money efficiently and effectively.	Promote open and competitive hiring of technical experts and training of procurement officials.
Ex-post evaluation	Evaluate the performance of the procurement system, including evaluating different methods and processes to feed new priorities and planning.	Assess periodically the results of the procurement process. Develop indicators to measure performance of the procurement system (OECD Procurement Toolbox).
Monitoring and control	Provide for a system that operates with integrity, has controls on its implementation in accordance with the legal framework, and can address the potential for corruption.	Central procurement office has responsibility for oversight of procurement management. An independent monitoring entity is essential to avoid conflict of interest.

Source: Authors' elaboration based on Harper, Calderón Ramírez, and Muñoz-Ayala (2016), OECD (2017e), Volosin (2015), and World Bank (2017).

First, the coverage of the system is far from complete. Procurement rules should apply to the whole "public" procurement system, defined widely to encompass all purchases from the entire public sector. The MAPS sub-index that includes "Scope of application of the legislative and regulatory framework" (from a maximum of 3 to 0) averages 2.3 for 14 Latin American countries, implying full coverage for 5 countries, and almost full for 4 of them.

However, a complete analysis of the scope of application of the law reveals that central governments are covered by the regulations in most countries, but coverage decreases when considering public bodies (about 80 percent covered), subnational governments (SNGs) (about 50 percent fully covered), special funds, public private partnerships (PPPs), and public trusts (only from 10 percent to 40 percent).[10] Hence, while the legal and institutional framework for procurement may conform to best practice, it does so for only a part of the public sector, allowing a portion of procurement expenditure to occur in a "liberated" zone where corruption or inefficiency can creep in. Actually, this is an inherent problem in public procurement in several areas of expenditure that starts with the coverage of public sector institutions.

Second, in public procurement, the digital revolution has been particularly productive. Over the last 10 years, the majority of countries in Latin America and the Caribbean have made progress introducing information and communications technology into their procurement systems; 19 out of 22 surveyed countries have a procurement portal and all of them publicize procurement opportunities through their e-procurement systems.[11] However, by 2016, only seven countries (Brazil, Chile, Ecuador, Jamaica, Mexico, Panama, and Paraguay) had transactional portals, which allow suppliers and procuring entities to interact virtually in order to trade goods and services. Moreover, only a handful of portals incorporate public works (construction, infrastructure) in the procurement system, where the opportunities for overpricing and corruption are higher. Chile did so in 2017. On the positive side, about half of all countries regulate a modern digital procurement procedure and the rest are rapidly introducing them: 1) framework agreements: an overarching agreement for the future supply of goods and services described in broad terms to achieve cost savings by generating economies of scale and reducing the administrative burden of issuing multiple tenders; 2) e-catalogs: a digital version of a supplier's catalogs that functions as an electronic purchasing tool to help increase competition and streamline public purchasing; and 3) electronic reverse auctions, which are useful when price is the key award criterion and where there is a single buyer and many suppliers who progressively bid downward.[12]

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[10] Volosin (2012) and updates of legislation until 2016.

[11] At its simplest, e-procurement is the replacement, throughout the procurement process, of paper-based procedures with communications and processing that are based on information technology (OECD, 2017d).

[12] Brazil is one of the first to use the Electronic Reverse Auction (Pregão Eletrônico) as the procedure for simpler procurements. This accounts for about 16 percent of total procurement.

Third, while the increased use of digital technologies and efficient tools to process procurement contracts has increased savings and reduced corruption,[13] there are still severe problems in using competitive tendering including the excessive use of exceptions and single-source procurement. The type of procurement procedure may have a direct impact on the corruption risk involved in public procurement. For this reason, open tendering is often considered the preferred method (i.e., the default procurement method) and single-source tendering—which poses perhaps the highest risk of corruption and favoritism—is typically allowed only under exceptional circumstances. In fact, only about 60 percent of 26 Latin American and Caribbean countries establish explicit competitive tendering[14] by default, but most establish a long list of exceptions to avoid competition and select direct contracting or single-source procurement.[15] Brazil, Bolivia, and Uruguay allow about 30 exceptions to competitive procurement, compared to an average of about 10.[16] Digital technology alone will not solve the corruption problem in public procurement.[17] Addressing these critical issues by promoting full coverage of procurement methods, ruling out competition exceptions, and using transactional e-procurement is a major step toward greater transparency. By automating services and putting them online, the use of open data by governments

[13] See Pessino, Pinto, et al. (2018) on key findings on the impact of public procurement reforms on efficiency and corruption.

[14] Competitive bidding is used to provide the public with low-priced, high-quality contracts, to fight corruption, and to provide equal opportunities to all firms to enjoy the benefits of a contractual relationship with the government.

[15] Also referred to in some countries as direct contracting or direct award purchasing, purchasing from an economic operator without a requirement for an advertisement or competitive process is often permitted for low-value contracts.

[16] National legislation usually considers special regulations for strategic sectors, such as hydrocarbons (Bolivia, Brazil, Ecuador, Mexico, and Bolivia), mining and energy (Bolivia), environment (Bolivia, Peru), telecommunications (Brazil), health services (Chile, Jamaica), pension funds (Jamaica), essential public services (Honduras), public monopolies (Honduras), or more specific cases, such as the management of the Panama Canal (Panama) (Benavides et al., 2016). These are huge sectors, and not surprisingly some of them were involved in the recent Lavajato-Odebrecht scandal.

[17] While Volosin (2012) studied the amount of exceptions that can trigger corruption in procurement in Latin American and Caribbean countries, some authors are beginning to find a causal mechanism between exceptions and corruption. For example, Auriol, Straub, and Flochel (2016) established that in Paraguay the main channel for corruption in procurement before 2007 was the systematic use of an "exceptional" purchase mechanism, which bypasses legally required minimum standards of transparency and competition and is used much more frequently than what should be expected from international best practice.

leaves corrupt officials less room to make arbitrary decisions (Moreno, 2017). By opening access to their data, governments are enabling citizens to track more closely how their taxes are spent.[18] Uruguay, for example, is close to its goal of enabling citizens to initiate 100 percent of their government transactions online. In Brazil, the Public Expenditure Observatory uses big data analytic tools to detect potential fraud in procurement. In 2015, it scrutinized more than 120,000 contracts, raising red flags in more than 7,500 cases involving $104 million in business. One of its filters, for example, identifies when big contracts are split into smaller deals to avoid more competitive bidding processes (Moreno, 2017).

Better planning, good ex-ante and ex-post evaluation, and enhanced accountability closes most of the remaining gap in procurement systems. The need for integrity and anti-corruption measures to ensure the transparency, good management, accountability, and control of procurement systems is also highly important. Last but not least, professionalization of the procurement workforce—and personnel in all areas of public expenditure management, for that matter—is best practice; capacity is a key pillar to plan and carry out procurement processes.[19]

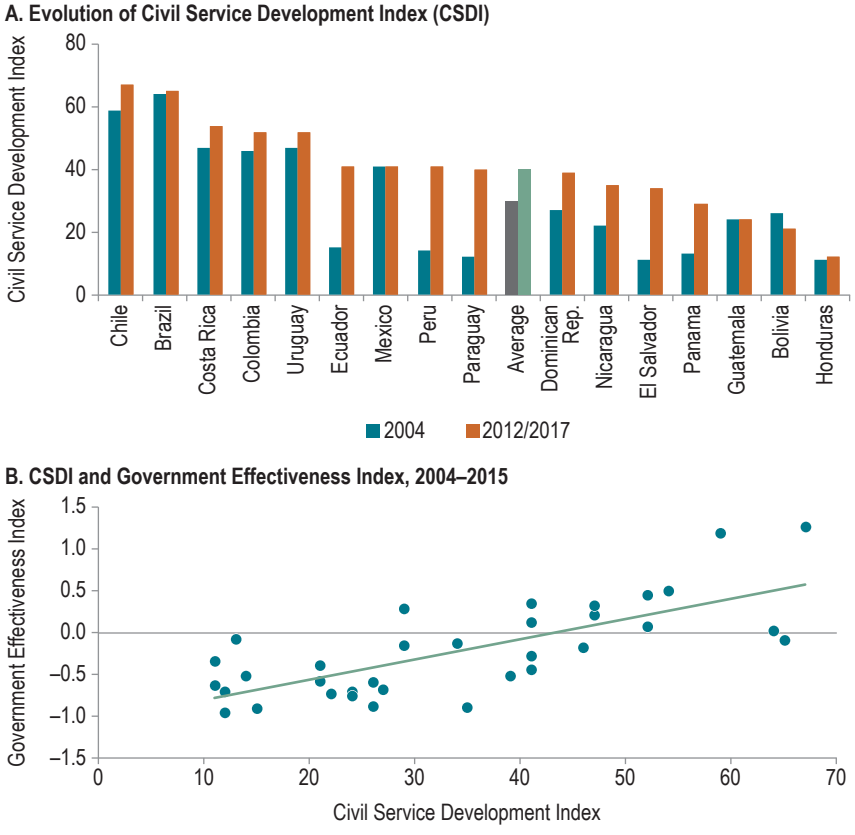
Civil Service Management: The Importance of People

Reforms to government employment and compensation are important elements of public spending reforms. While first- and second-generation reforms have concentrated mostly on controlling rising employment and wages with policies such as wage and payroll freezing, massive layoffs with voluntary retirement processes, and the like, recent reforms have also emphasized the importance of specialized skills needed in the public sector and the professionalization of the civil service. The management of public sector employee compensation is important to attract qualified workers into the public sector and, hence, establish a professional civil service. It is, therefore, one of the key milestones for improving the quality of public expenditures. Several empirical studies draw a link between

[18] The G20/OECD Compendium of Good Practices on the Use of Open Data for Anti-Corruption is a useful resource for countries to assess and improve their open data frameworks (OECD, 2017c). Argentina, Colombia, and Mexico have all announced that they are committing to implementing the Open Contracting Data Standard, a global open data standard for publishing public procurement information. Chile in 2018 with MIT LAB collaboration has set up one of the first Latin American platforms that integrates and visualizes public procurement data: http://datosabiertos.chilecompra.cl/.

[19] See, for example, OECD (2018b) and EBRD (2012).

Figure 9.5 Civil Service Development Efficiency Index and Government Effectiveness



Source: Authors' calculation based on Cortázar , Lafuente and Sanginés (2014) and Lafuente (2015); https://publications.iadb.org/handle/11319/8416#sthash.5GYwKgma.dpuf; Civil Service Development Index (CSDI), IDB; and the Index of Government Effectiveness (World Bank).
Note: The methodology is based in the identification of critical points that feed eight subsystems: a) human resources planning, b) work organization, c) employment management, d) performance management, e) compensation management, f) development management, g) human and social relations management, h) HR function organization; and five indexes: a) efficiency, b) merit, c) structural consistency, d) functional capacity, and e) integrating capacity.

professionalization of the civil service[20] and benefits such as economic growth, less corruption, more trust in government, improved service delivery, and efficient execution of investment. Unfortunately, according to

[20] See Acemoglu, Johnson, and Robinson (2001); Cai et al. (2009); Dahlström, Lapuente, and Teorell (2012); Cortázar, Fuenzalida, and Lafuente (2016); Dollar and Kraay (2003); Evans and Rauch (1999); Henderson et al. (2007); Knack and Keefer (1995); Lira (2012); Mauro (1995); Maxfield and Schneider (1997); Rodrik, Subramanian, and Trebbi (2004); Sacks (2010); and Van de Walle, van Roosbroek, and Bouckaert (2005).

the IDB's Civil Service Development Index,[21] Latin American and Caribbean governments are doing a mediocre job of managing their human resources. Average scores inched up from 30 points (of a possible total of 100) in 2004 to 40 points in 2017, with the best performer achieving 67 points and the worst 12 points (Figure 9.5A). Greater civil service development may have a significant impact on the capacity of the state measured by the Government Effectiveness Index (Figure 9.5B).[22]

Most Latin American countries suffer from a combination of excessive public wages—with a public-private wage gap over 20 percent—and, in some cases, excessive employment—especially at the local level—inflating the wage bill to 30 percent of public spending, which is higher than in developed countries (Chapter 3). Latin America's labor force also lacks professionalism in tasks such as procurement, performance evaluations, and investment management. Hence, following lessons learned, some key policy recommendations based on evidence from the IDB and other theoretical and empirical literature are provided. As with most policy recommendations, there is no one-size-fits-all. The challenge is to improve workforce productivity while balancing costs and the quality of service. Moreover, labor market institutions may be an impediment to comprehensive civil service reform in the region unless they are included as an integral part of the reform. Table 9.2 presents key recommendations to reform civil service.

Whether short-run reforms should focus on wage levels and their dispersion or on employment depends on a country's starting point. Short-term wage measures provide only temporary relief, and thus, it is advisable to concomitantly adopt structural reforms to avoid the recurrence of medium-term wage pressures and avoid demoralizing employees. Short-term measures usually take the form of a temporary wage freeze, an attrition-based employment reduction, or an inflation adjustment to slowly decrease wages as a share of GDP. This process should begin with workers whose wage gap with the private sector is highest, usually less-skilled and middle-level staff who are highly politicized or union protected. While those actions might be effective in the short term, prolonged usage distorts the compensation structure if the public wage falls below the private wage. Eventually, these actions could be reversed retroactively by political forces, again putting

[21] The index follows a methodology that measures the quality of human resource management in the public sector following good practices from the Ibero-American Charter for the Public Service. In 2004, the IDB helped implement a methodology for measuring how the government civil service operates in 18 countries from 2004 to 2017.

[22] Correlation is not causation and the relationship might very well run both ways simultaneously.

Table 9.2 Policy Recommendations to Improve Efficiency in Civil Service Management

	Key recommendations	Details
Short- to medium-term reform	a) Wages: Temporary freezing of nominal wages; b) Employment: recruitment freezes, natural attrition, elimination of job positions in overcrowded areas.	Based on functional review of public sector, including mergers of government units/ministries, process reengineering, subcontracting noncore functions.
Planning/ Prioritization	Develop a comprehensive civil service plan setting a vision and goals while prioritizing methods and tools. Include interactions with labor market institutions.	Develop a strategic long-term vision through forward-looking management (OECD, 2012). Devise possible social dialogue and pacts.
Coverage/ Coordination	Centralize civil service management to track all public-sector workers and control their payroll. Coordination between Civil Service Office and minister of finance is key for short-term sustainability reform.	Include all civil services from low to high skilled in all agencies at all levels of government. Coordinate under a centralized civil service agency that oversees and promotes training and HRM development and accountability.
Competition	Use competitive processes for hiring civil servants. Competitive compensation can be promoted through public and private sector wage comparisons.	Develop a meritocratic service by depoliticizing the civil service. Use oral and written exams and competitive examinations and background checks to recruit civil servants.
Digital technology and efficient tools	Implement a centralized electronic payroll system, as an effective management tool. Make it interoperable with IFMIS and with the overall electronic payroll.	Identify ghost workers, double-dippers, overstaffing, and overpayment through census and payroll analysis in critical sectors.
Transparency and participation	Promote transparent pay systems with equal pay for equal work based on responsibility and performance. Aim for Open Data Contracting.	Develop consistent advertisements for positions. Publish the identification of ghost workers and overstaffing. Curb nepotism.
Professionalization	Strengthen professionalization of the senior workforce to deliver value for money efficiently due to the increasing complexity of spending, and digital technological change.	Promote open and competitive hiring and technical training for senior officials.
Ex-post evaluation	Ensure that performance matters in civil service management. Pay for performance enough to retain more motivated civil servants and improve performance.	Formal performance management systems need to be designed and implemented. If not, they achieve the opposite, and result in more dissatisfied civil servants.
Monitoring and control	Develop payroll audits and institutional assessment of payroll expenditures and management. Hire an external audit firm.	Headcount, transactional audits were applied in Brazil, Honduras, El Salvador, and several African countries, usually with support from multilateral organizations.

Source: Author's elaboration from Lafuente (2018), Meyer-Sahling, Schuster, and Mikkelsen (2018); IMF (2016); OECD (2012, 2017b); Cortázar, Lafuente and Sanginés (2014).

pressure on public spending. The potential adverse effects of this plan can be partially mitigated by targeting overcrowded areas, reengineering government by merging units/ministries, and allowing flexible reassignment of employees across sectors by removing legal barriers to mobility. As in several European countries, "social pacts"—national deals negotiated between governments, trade unions, and/or employer organizations—could be implemented. However, social dialogue to build reform consensus takes time and might be possible only if fiscal space and the menu of reforms allows.[23]

While short-run reforms are necessary for fiscal sustainability, they cannot substitute for structural civil service reforms. Planning serves to match short- and long-term civil service goals. While the region has slowly been improving its workforce planning (this subsystem of the index increased from 31 to 42 points between 2004 and 2015), performance is still weak; most countries do not have a long-term vision of human resources. Centralized personnel databases—important for short-run adjustments and long-term career follow-up—exist in very few countries. The lack of political will to fix this issue has led to huge pockets of inefficiencies.[24] Centralized human resource offices that coordinate with the Ministry of Finance and reliance on an electronic civil service payroll are necessary first steps to improve wage bill spending efficiency. Strengthening these systems is key to track all public-sector workers and control their payroll through information systems.

Another critical factor to improve civil service efficiency is to increase competition in hiring, promotion, and wage setting to establish a truly meritocratic system comparable to the private sector. However, the competitiveness of government compensation can be undermined by politicized hiring, nepotism, and powerful unions, through collective bargaining and strikes that set a wage premium over the private sector where the coverage and strength of unions is usually less.[25] Competitiveness should encourage equal pay for low- and high-skilled workers in the public sector relative to the private sector. However, unions may lead to wage compression,[26] putting senior managers in

[23] For example, the conditions that led to success in Spain in the Moncloa Pacts of the 1970s are not the same as the austerity measures needed after the Great Recession.

[24] A recent study in Central American countries (Dumas and Lafuente, 2016) shows that administrative staff per teacher and per health sector professional have increased in most countries between 2007 and 2013 in an irrational way, raising questions about the efficiency with which the public sector expanded to enhance the delivery of much-needed public services.

[25] A third of the countries conduct wage comparisons on an ad hoc basis, while less than 10 percent conduct a systematic annual or biannual comparison (IMF, 2014).

[26] Wage compression in the public sector in the United States started in the 1970s, and Borjas (2003) claimed that as a result, the public sector found it increasingly more difficult to attract and retain high-skilled workers.

the public sector at a disadvantage in terms of compensation when compared to their private sector peers. Even in countries without powerful unions, 17 out of 18 Latin American and Caribbean countries surveyed include minimum wage provisions in their constitutions, with a minimum wage higher than the median wage in Panama, Costa Rica, Paraguay, Jamaica, Guatemala, Peru, and Honduras (Alaimo et al., 2017). In Brazil, while the minimum wage is lower than the median, it increased 119 percent from 1996 to 2012. This increase put strain on the fiscal situation since raising the minimum wage affects not only the wage bill but pension spending as well. These provisions make civil service reforms and overall public spending reforms more difficult to achieve. Studies document how short-run adjustments in the wage bill were long-lasting when accompanied by payroll audits and structural reforms that improved fiscal consolidation and efficiency. Evidence from performance-related pay in the public sector is generally positive (Meyer-Sahling, Schuster, and Mikkelsen, 2018).

Smart, Integrated Data Systems for Better Targeting

Integrating personal, tax, and property data pertaining to individuals and firms is a difficult task that requires a government to have enough political and legal power to be able to request and integrate data from multiple offices and levels of government that usually refuse to share data. It also requires compliance with secrecy laws protecting privacy of information and digitalizing all databases using common protocols and a unique identifier. Once these hurdles are overcome, digital technologies and "big data" allow the smart automatic crosscheck of data so that government bodies (i.e., tax administration, social security administration, health ministry, etc.) can accurately identify who should pay taxes or fees and the potential beneficiaries of spending transfers. It also allows governments to uncover informality and poverty. All public institutions that feed the system with their data benefit from cross-checks in the system which in turn are set by law. Every office maintains its independence, and continues with its protocols, yet a central system automatically produces economies of scale since datasets useful for several agencies are exchanged with the central unit, which shares with third parties the information, avoiding costly individual exchanges. A system that targets subsidies and social programs based on a static snapshot will likely face serious challenges in providing support to those most in need. Best practices are observed in countries that have achieved a level of online integration between databases such that updates in one immediately result in updates to the integrated system. The foremost example is Argentina's SINTyS, but Chile's SIIS and Brazil's Cadastro

Unico are also breaking ground in this direction.[27] Internationally, Estonia and the Republic of Korea are at the forefront, using and innovating with these smart data exchange systems, or so-called e-service databases. In Estonia, all information is stored in a distributed data system and can be exchanged instantly upon request (X-Roads).[28]

Figure 9.6 shows how most of these systems are set up, which data they integrate, and what are some of the by-products. The integration of administrative public and private data could eventually encompass the employment status of individuals in the labor force and data on income and poverty, assets and properties, finances, consumption of public services, schooling, health services, and so on. Hence, the range of products and savings in government spending could be potentially multiplied. Data sharing can save in leakages (about 1.7 percent of GDP in Latin America), improve coverage of social programs and effectiveness in diminishing inequality and poverty, detect fraud in pensions and other social security payments, detect informality, improve health efficiency by providing comprehensive e-health records, and even facilitate most common services such as obtaining a driver's license or opening up a business. Argentina, a pioneer in creating this type of system in 1997,[29] struggled with the common identifier and set up an algorithm to uncover a unique identity from the civil service, electoral, tax, and health system registries. Subsequent systems with a solid national identity introduced the electronic identity.[30] On the basis of evidence from the region and international experience, Table 9.3 provides a

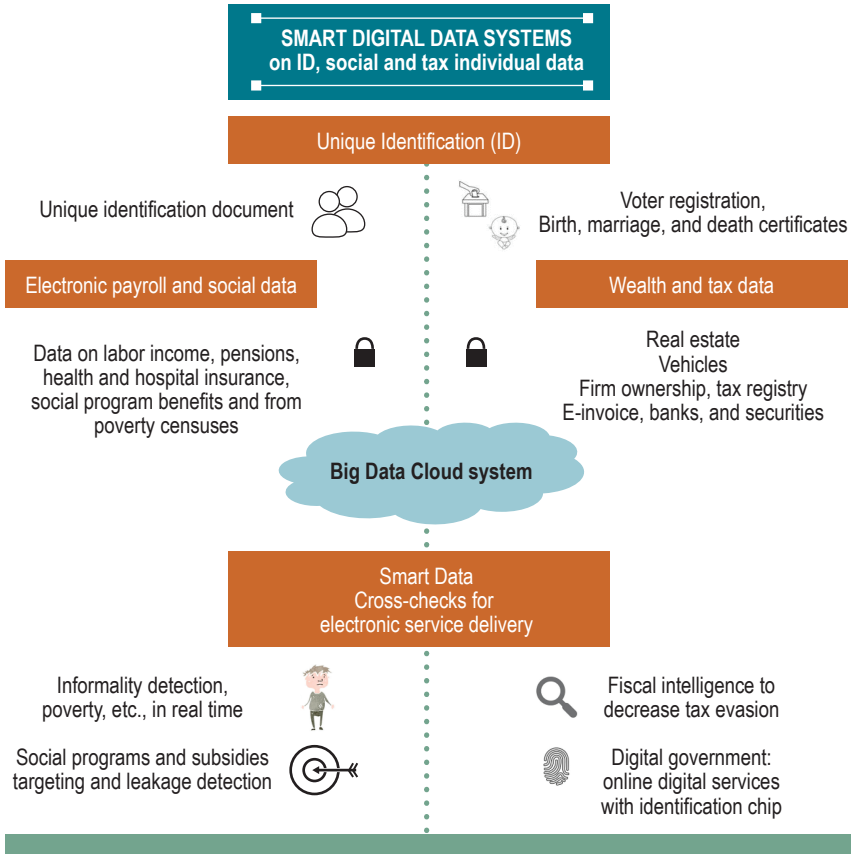
[27] A single registry for all social protection schemes is needed to target programs and achieve efficiency (see Chapter 3). Sharing information between these programs and other databases helps in determining the well-being of individuals, in real time.

[28] Integrated individual data systems evolved from different starting points, ranging from control of leakages and coverage of transfers to detecting fraud in social security payments (Argentina, Belgium, Brazil, and Chile, for example) and reducing tax evasion in Argentina, and providing online digital government services to citizens as in Estonia, or Korea.

[29] SINTyS (Sistema Nacional de Identificación Tributaria y Social) was created in Argentina by decree in 1998. It is unique in the world for integrating data from the expenditure and the tax sides (Barca and Chirchir, 2014). The system involves more than 1,800 databases virtually and performs more than 4,500 data exchanges, 17,000 digital judicial investigations, and about 5 million individual consultations through the Web Service.

[30] In Estonia, the electronic ID is a mandatory national card with a chip that carries embedded files. Using public key encryption, it can function as definitive proof of ID in an electronic environment. Functionally, the ID card provides digital access to all of Estonia's secure e-services, releasing a person from tedious red tape and speeding up daily tasks including banking or business operations, signing documents, or obtaining a digital medical prescription (https://e-estonia.com/). A similar electronic ID is used in the Crossroads for Social Security system (CBSS) in Belgium (https://www.ksz-bcss.fgov.be/en).

Figure 9.6 How Smart Integrated Data Systems Work



Source: Pessino, 2017.

list of key recommendations to be adapted to the data exchange and information technology conditions of each Latin American country.

Political will at the highest level is of utmost importance for information systems since they involve extensive cooperation among government at different levels and offices, some of them very powerful and without clear and direct gains from sharing information. Picking winners at first, by selecting data exchange with the highest expected outcomes, can help overcome the resistance to sharing information by demonstrating the effects of doing so. To avoid breaking the needed trust that this system needs to operate, legal provisions to protect privacy and security of the data together with the most novel technology to prevent information leakages and cyberattacks are indispensable. Ex-post evaluation of products—particularly estimates of impact and outcomes (not inputs) from the working of the system—should

Table 9.3 Policy Recommendations to Improve Efficiency in Digital Integrated Data Systems

	Key recommendations	Details
Pilot (Short to medium term)	a) Set up a pilot within a high-level office with a mandate to coordinate administrative data; b) Set up security and privacy of information; c) Improve, digitalize, and standardize databases beginning with ID data.	Choose two or three databases whose exchange of information could demonstrate the highest benefits of the system (quick wins). Publicize results obtained from the pilot and invite other institutions to join.
Planning/ Prioritization	Develop a vision of electronic service delivery, information management, and privacy security among all stakeholders. Implement a cost-benefit analysis to determine if each data analysis tool has larger expected benefits than costs.	Design the system to coordinate a homogenous framework for databases with administrative data allowing the interchange of information among agencies.
Coverage/ Coordination	Centralize the Coordination unit of the integrated data system at a high level of government for the management of administrative data of multiple offices. Aim to cover all centralized and decentralized databases.	Aim for an autonomous body or independent advisory group to direct the long-term vision. Include social, property, labor, and tax information on citizens and firms.
Regulation	Issue legal norms to include a unique ID number in all databases/transactions; set rules for digitalization with common protocols and algorithms allowed by regulations to cross data-producing outputs for different services.	Only designated agencies can receive outputs of the algorithm and/or data. Protect the right to privacy and habeas data. Provide information security; protect data from privacy invasion and cyberattacks.
Digital technology and efficient tools	Implement a technological model to interconnect databases with a common ID to form not only a master base, but access to algorithm outputs that permit sharing data for specific objectives for and fulfilling the legal mandate of stakeholders.	Encrypt information, protect data security and integrity, and prevent cyberattacks. Evolve continuously to meet new digital, information, and legal challenges.
Transparency and participation	Promote transparency by publishing through different media the information about transfer beneficiaries whose publication is not forbidden by privacy rules.	Allow citizens to review their own data within the system and know which institution accessed the information.
Professionalization	Create a lean, skilled, and motivated interdisciplinary group including information and communication technology specialists who share the vision of obtaining the best services and results for citizens.	Promote motivated and skilled staff for each stakeholder in the system: ministries, registries, state-owned enterprise, social security, tax administration, and subnational government.
Ex-post evaluation	Ensure ex-post evaluation of output and outcomes, not ex-ante control of every input. Measure the performance of the system based on objectives.	Use monitoring indices of the objectives, the percentage of people covered, information and its use for obtaining savings, and better targeting.
Monitoring and control	Develop audits for the detection of consultation patterns correlated with abuse of information. Monitor data integrity and violations of security and privacy.	Use auditing indices of the objectives of the system as the percent of all individuals incorporated in the system and the use of such information.

Source: Authors' elaboration on the basis of Fenochietto and Pessino (2007, 2011); Pessino (2017); Barca and Chirchir (2014); http://www.sintys.gob.ar; https://www.ksz-bcss.fgov.be/en; https://e-estonia.com/.

be constantly updated and publicized. Finally, the explosion of digital technologies and constant challenges require these systems to innovate constantly: Estonia, for example, uses blockchain to protect the integrity of data.[31] Hence, political support and the legal and institutional setting of the system are the pillars that allow its development while smart data mining improves targeting of transfers, increases transparency, and fights corruption. The impact of data mining on savings of money, time and paper, and on lowering corruption is enormous: for example, targeting social transfers and tariffs produced savings of at least $100 million a year in Argentina (computed from only 30 percent of digital exchanges), for a high rate of return to a total investment of $50 million since 1997.

Public Financial Management: Improving Processes

Public financial management (PFM) relates to the way governments manage public resources (both revenue and expenditure). Ideally, PFM deals with both processes and results (short- medium- and long-term implications of financial flows). PFM has a broad and a limited definition.[32] This book focuses on the limited definition: the processes used to manage a treasury, automate public-sector flows of money and resources, and account for these financial movements.[33] Better processes will achieve savings, although rarely estimated.

[31] Blockchain, a novel technology that enables digital information to be distributed in a secure manner, is a way to streamline the sharing of valuable information in a secure way, protect sensitive data from hackers, and give every individual more control over information.

[32] For a broad treatment, see the excellent international handbooks on PFM by Allen, Hemming, and Potter (2013) or Cangiano, Curristine, and Lazzare (2013) and the Latin American and Caribbean compendium of PFM practices by Pimenta and Pessoa (2015).

[33] The backbone of PFM as defined here is a set of "resource management" processes that ensure that after budget formulation, resources are available to those implementing budget policies, making government work. These include treasury single accounts (TSAs), which provide a centralization of financial resources and flows that were previously decentralized. To adopt the TSAs, governments need to have in place an Integrated Financial Management Information System (IFMIS) that enables management, monitoring, control, reconciliation, accounting, and reporting on budget execution and accounting movements including bank account balances. It is a computerized system that tracks government expenditures and payment processing; but constitutes an organizational reform, affecting work processes and institutional arrangements. IFMISs and TSAs require integration, automation, and digitalization of government budgets and financial management. Governments commonly also have "accounting and reporting" processes in place. These allow government to keep records of financial flows, and to structure these records in ways that allow independent scrutiny. Much of this recording is still being done on a cash basis, although a growing number of countries have been moving to an accrual-based accounting system (Andrews et al., 2014; Kaufmann, Sanginés, and García Moreno, 2015).

The adoption of first-generation PFM reforms in the region took place in the 1990s as part of the overarching modernization of the state. Although good indicators of results are few, better organization of financial flows within the government and faster budget execution are noteworthy. Yet many challenges remain, including improving and updating organizational structures, legal frameworks, methods, strategies, and information systems. One key element is the absence of indicators to measure PFM efficiency (Pimenta and Pessoa, 2015). Results analysis is also missing in first-generation reforms. In fact, Andrews et al. (2014) state that whether a PFM system is good, bad, or indifferent should not rely only on whether the form of the system conforms with "good international practice," but rather on whether it delivers good results. They note that public officials who cannot rely on the PFM system to produce results must rely on other, informal and unofficial means to obtain what they want, opening the doors to inefficiency, waste, and corruption. Theses reforms focused mostly on mechanical and iterative processes from the strategic phase of budget formulation to the end of budget execution, in which governments deliver on the promises and proposals included in the budget. The reforms did not pinpoint the outcome to be delivered, the strategic vision, or the planning of end objectives, much less the outcomes of those objectives.

While PFM progress has been encouraging, it has been uneven, and expectations have not been met in a number of Latin American countries.[34] PFM cannot remedy institutional or organizational weaknesses; that is, it cannot ensure efficient allocations by political decision-makers (Welham, Krause, and Hedger, 2013). Indeed, computerization has the potential to jeopardize genuine reform in PFM. A new generation of PFM reforms must learn from the past and include these key elements: 1) focus on the functioning, not simply the processes, of the PFM system and link it with strategic priorities on expenditure allocation; 2) centralize it under the Ministry of Finance to include all public sector transactions; 3) (re)implement an IFMIS tailored to institutional capacity. More integrated systems (including TSAs, payroll, procurement, budget formulation and execution, investment, etc.) require more capacity, and so it is important to 4) maintain both the IFMIS software and the hardware to keep the system functional and secure. A key risk is that

[34] The Public Expenditure and Financial Accountability (PEFA) framework shows that PFM processes (covering all phases of the budget cycle, comprehensiveness, transparency, and credibility) in Latin America and the Caribbean continue to exhibit weaknesses. Between 2007 and 2016, PEFA assessments were conducted for 15 countries in the region and, under a correlation of grades from D to A to a scale from 1 to 4, the region achieved an average score of 2.7 (67.5% of the highest possible score), showing that there is still ample room for improvement.

once the procurement decision is made in favor of a vendor, the government locks itself in (unless it is willing to reinvest substantially in a different system). Hence, perform a thorough analysis including CBA to decide whether to buy an off-the-shelf or in-house custom-built system. Either way, the decision has major implications for costs and resources (Chêne, 2009). This brings us to two final points: 5) keep, publish, and disseminate consolidated public accounts, including public accounting aligned with the International Public-Sector Accounting Standards (IPSAS); 6) monitor internally and externally the performance and/or compliance of all PFM systems. Finally, as a practical matter, the rollout of IFMIS typically takes at least twice as long and costs twice as much as originally envisaged—even when it ends up working well. That said, effective implementation of a well-designed and appropriate IFMIS can assist the budgetary process more than any other single improvement in the technical infrastructure. Now that the experience is available to all, repetitions of the fallacy of looking for "technical" solutions to political, governance, and institutional problems should no longer be tolerated.[35]

Institutions to Improve Allocative Efficiency

Allocative spending efficiency involves aligning budgetary allocations with strategic priorities. Are budgetary resources being allocated to programs and activities that promote the strategic priorities of the country? Are these priorities based on ex-ante and ex-post sound economic evidence and CBA? Is public expenditure allocated to improve long-term growth perspectives while considering equity?

Several institutions help achieve allocative efficiency. Other key elements include:

- A strategic vision based on evidence that sets out the framework and priorities to be achieved
- Results-based budgeting (RBB)
- Integral or partial spending reviews including CBA to allocate and prioritize public spending to the objectives of growth and equity[36]
- Medium-term Expenditure Frameworks (MTEFs) to gauge performance on a multiannual basis

[35] See also Fritz, Verhoeven, and Avenia (2017); Hashim and Piatti-Fünfkirchen (2018); Schiavo-Campo (2017).

[36] One of the key tools for evidence-based policymaking is CBA and this should be conducted to ensure transparency and objectivity. For a given expenditure proposal CBA compares the total forecast costs to the economy with the total forecast benefits, to see whether the benefits outweigh the costs and by how much.

- Evaluation and recommendations from independent institutions such as domestic fiscal and productivity councils and from international organizations (OECD, IDB, Corporación Andina de Fomento (CAF), the World Bank, and other local or regional banks)

Toward More and Better Results-Based Budgeting

The budget is a tangible manifestation of national priorities: on what will the government spend? How much will go for education, health care, highways, and so on? The objective of RBB is to replace the traditional decision-making process, which is based on expenditure and inputs, with a logic oriented toward results, in terms of the effective provision of goods and services. RBB is not a stand-alone institution; it should be linked with spending reviews, the MTEF, strategic priorities, and evaluation.

Most countries in Latin America and the Caribbean have or are still substituting the traditional line budget into RBB structured by programs that can involve one or more areas. According to the PRODEV index, Chile had advanced the furthest in RBB processes by 2013, followed by Mexico, Brazil, and Peru (Figure 9.7A).[37] The weaknesses associated with lack of allocative efficiency call for a shift from managing state services as a collection of agencies in pursuit of their own objectives toward managing as a system focused on priority outcomes. The performance budget shows what each dollar will accomplish, generally in the way of a measurable result achieved (such as a reduction in crime or improvement in nutrition).[38]

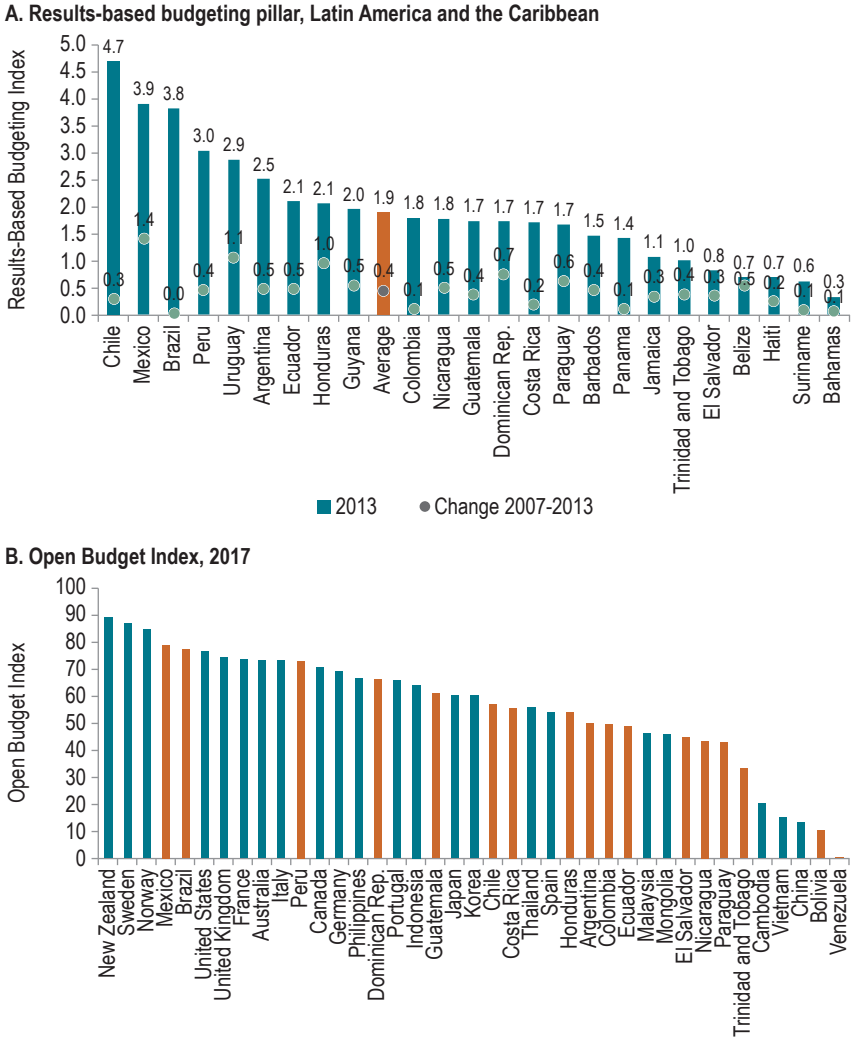
RBB emerged as a driver of budgetary innovation in the United States more than 60 years ago but has had an uneven sometimes disappointing international history (Schick, 2014). Why have RBB reforms been so fragile? The short answer is that RBB is hard work; one year's success doesn't assure the next year's and one year's costly investment in data collection and analysis does not obviate the need for additional investments the next year. The key question is whether RBB can become the process for allocating resources or if its principal aim should be to enrich the supply of information to budget makers. In most countries, performance reports and program evaluations were rarely used to increase or decrease spending, and almost never to eliminate

[37] The PRODEV evaluation system (SEP) points to a slight positive trend between 2007 and 2013 in the RBB pillar: from an average score of 1.5 in 2007 to 1.9 in 2013 on a scale from 0 to 5—38 percent of the highest possible score—suggesting that there is still ample room for improvement (IDB, 2015).

[38] However, every program could (and probably should) be able to show its budget in both formats.

programs.[39] However, performance information can help identify measures to improve the performance of the program. The fact that few governments have a true results-driven RBB speaks to the difficulty of implementing this type of

Figure 9.7 Results-Based Budgeting and Open Budget Index



Source: Authors' calculation based on A) the Results-Based Budgeting Pillar from the PRODEV evaluation tool, Kaufmann, Sanginés, and García Moreno (2015); and B) International Budget Partnership (2018).

[39] Experience shows that it is not appropriate to link strictly reallocations of resources to past results or programs, since in most cases the programs contribute to solving a need or problem in society and it is not appropriate to punish beneficiaries for the inefficient management of authorities responsible for the execution.

budget. The suggestion is to have an allocative RBB with rational incrementalism, that spurs governments to channel spending increases to programs that promise the greatest returns. It should be conceived as a method for allocating incremental resources to achieve incremental changes in results. One may challenge this method claiming it exempts the "base"—the ongoing activities that account for almost all public expenditures from the RBB's purview. To construct a change oriented with marginal increments RBB, prioritized programs must be subjected to performance measurement and be expressed in causal relationships. Then, governments have the capacity to apportion costs among the results produced by spending agencies and can attribute products and outcomes. RBB would become a form of gradual implementation of a zero-base budgeting.[40] Applying RBB to the entire budget would doom the effort to failure for most countries, both because of the conflict it would cause but mostly for the informational burdens it would place on budget makers. Table 9.4 provides broad recommendations, to be adapted to each country's reality, for making an operational RBB achieve outcomes and gradually improve efficiency in public spending.

Chile and more recently Peru provide lessons learned in RBB practices for the whole region. Chile excels in the evaluations of ex-post individual programs and integrates these within the budget, complemented by incentives for management personnel (Darville et al., 2017; Guzmán, 2017; Hawkesworth, Melchor, and Robinson, 2013). The RBB model in Chile, developed gradually but systematically since 1993, uses information to improve allocative efficiency. This is an "informed budget"; it is not a hard-and-fast rule to change resource allocation, but is utilized to inform and improve the budget process. The system requires ample evaluation capacity,[41] enough resources to implement the system; and the institutional commitment of the Directorate of Budget (DIPRES). Peru has excelled in setting key priorities at a high level, developed a causal model, and integrated planning with budgeting (Box 9.1). Peru's few and more manageable priority actions to improve early childhood nutrition and skills follow the more recent evolution of RBB in advanced countries. Finland developed its most recent planning in five key

[40] Recently, the Mexican government implemented a zero-based budgeting (ZBB) approach in the Federation Expenditure Budget (PEF), which included a thorough review of the federal budget. This was done with the aim of stabilizing the public deficit and achieving a sustainable path for public finances (Durán et al., 2018).

[41] During 2006–2017, 358 programs were evaluated, including 49 percent of the total 2017 Chilean budget. In terms of effect on budget, only 7 percent of evaluations conducted between 2000 and 2009 led to the termination or replacement of the program. In 2017, the budget for favorable programs was increased by 17 percent and for underperforming programs it was decreased by about 4 percent.

Table 9.4 Recommendations to Improve Results-Based Budgeting (RBB)

Planning/ Prioritization	Develop a strategic plan setting a long-term vision to prioritize key spending programs. Gradually introducing results-based government spending schemes is preferable to a wide reform. Spending reviews and independent evaluations of programs should provide feedback to guide decisions.	Ideally, set spending priorities whose attainment rests on sound theory and evidence. Select programs with an ex-ante higher return based on CBA to improve growth, equity, or specific objectives. The strategic plan and priorities should be aligned with the budget and the MTEF.
Coverage/ Coordination	Have the budget cover the entire government. Start with a pilot of a few priority programs. Coordinate program objectives and measurement of performance between the Ministry of Finance and the implementing office(s).	Line ministries set performance measures in agreement with the Ministry of Finance or the ministry establishes a coordination unit of each prioritized program to enhance cross-ministry coordination. Ensure adherence to priority policy goals.
Operational model	Choose prioritized programs with a model explaining how development objectives, including causal relationships and underlying assumptions, are to be achieved. These programs should be articulated in the RBB, and performance indicators should be selected based on the model. Link planning and budgeting with an MTEF.	Without a sound model, it is difficult to link inputs to outputs and/or outcomes and hence devise SMAART (specific, measurable, attainable, achievable, relevant, and time-bound) performance indicators. CBA analysis should be the method of choice for ex-ante evaluation.
Digital technology and efficient tools	Develop administrative digital data on individuals and firms (see Table 9.3) to better measure program performance and outcomes for individuals and households. Integrate RBB performance and indicators into existing IFMIS systems to better monitor indicators.	Include or improve interoperability of the IFMIS platforms with RBB indicators and compliance throughout all the line ministries, the Ministry of Finance, and other national and subnational offices.
Transparency/ Participation	Provide taxpayers with a transparent, results-oriented budget; promote assessment of performance indicators by an independent agency (i.e., Statistical Office, Fiscal or Productivity Council).	Provide for an inclusive, participative, and realistic debate on budgetary choices (IBP, 2018; OECD, 2015). Transparency in the budget varies widely among countries and there is room for improvement (Figure 9.7B).
Professionalization	Increase the capacity of the Ministry of Finance, line ministries, and offices to understand, adapt, and develop causal models relating outcomes with inputs and performance indicators. Train budget analysts in program logic, costing, etc. Improve incentives for professional staff.	Gradually develop capacity to implement effective performance information systems. Complement capacity with independent studies and reviews by expert bodies including auditing offices and productivity councils. Incentives should orient personnel to results.
Ex-post evaluation	Evaluate ex-post the results/outcomes of specific programs, choosing every two to three years a new set of programs. Ensure greater use of the strategic spending review to reprioritize programs (OECD, 2018b).	The evaluation of the priority programs should serve to modify the budget "incrementally" if the program has the higher return among alternatives. It can also serve to decrement the budget if it has low or negative returns.
Monitoring and control	Develop and exercise the oversight capability of Congress and independent auditory agencies in relation to RBB. This monitoring and control should be permanent.	Performance data that are not independent should be externally validated to ensure quality. Audit high-risk programs, and consider the reliability of performance data.

strategic areas, recognizing that its past plans (with 964 strategic priorities for action) were neither strategic nor actionable. The latest OECD Performance Budgeting Survey reveals that a more selective approach to priorities

BOX 9.1 A RESULTS-BASED BUDGET (RBB) PROGRAM FOR NUTRITION AND SKILLS FORMATION IN PERU

Since 2007, the government of Peru implemented policy measures to improve children's outcomes in nutrition, health, and skills. In 2008, the government moved to RBB as the vehicle for investing in children and followed a rigorous approach to allocating spending to achieve results in children's health and development. The implementation of priority programs through RBB in Peru is an example of good practice (Table 9.4):

- **Planning:** Beginning in 2006, consensus building put stunting high on the political agenda to reduce malnutrition in children under the age of 5 by 5 percentage points within five years. It was based on a sound, causal life-cycle model from in utero to five years of age that established the links between inputs (nutrition, vaccinations, etc.) and outcomes (weight, anemia, cognitive achievement, etc.). Priorities were formalized in 2011 in SINAPLAN, a bicentennial plan that set out a vision and strategic planning through 2021. The priorities were aligned to the Budget Law of 2008, creating four programs: the Articulated Nutritional Program (PAN), Neonatal Maternal Health (SMN), Learning Achievements (PELA), and Access to Identity.
- **Coordination:** Primarily led by the Ministry of Finance, which brought health experts on staff and maintained close coordination with the Ministry of Health. The difficulty in coordination was overcome by bringing line ministry officials inside the Ministry of Finance.
- **Operational model:** The government set clear targets in the areas with the highest rates of stunting and doubled spending. Positive outcomes were mostly linked to additional budget allocations.
- **Digital:** Monitoring involves large administrative databases and the cross-checking of data that include the identity of children and their families.
- **Ex-post evaluation:** Indicators were based on the causal model; the National Institute of Statistics, an independent government agency, regularly monitored output and outcome indicators.
- **Professionalization:** A specialized unit on RBB followed the process with highly motivated staff with expertise in areas such as capacity building for regional governments. The World Bank collaborated with the IDB on public expenditure management (including performance-based and participatory budgeting), and with a wide range of agencies, including the United Nations and the European Commission.

Source: For more information, see, among others: https://www.mef.gob.pe/?lang=en; Niño de Guzmán (2016); and Marini et al. (2017).

and performance objectives is being taken today in some countries including Canada, the Netherlands, New Zealand,[42] and the United Kingdom. The Netherlands is removing the use of performance information in areas where the causality between money and results is too weak (Shaw, 2016).

In Latin America and the Caribbean, Peru drew on the Chilean experience, but also incorporated evidence-based causal models, and its articulation with the RBB. At least in the nutrition programs, the RBB application in Peru provides a best practice example to the world. This experience shows that implementing even a handful of programs through RBB well is a lot of work, requires the dedication of specialized resources, but most of all, requires political commitment (the broader the consensus, the better) and solid budget institutions to build performance budget institutions on top. Between 2008 and 2014, expenditure associated with child health grew by 140 percent. The proportion of child malnutrition dropped by 50 percent. Peru reduced extreme malnutrition of children under five years (i.e., stunting rates) from the baseline of 28 percent (which was constant from 2000 to 2008 in spite of economic growth) to 14.5 percent in 2014. This occurred thanks to poverty reduction and sustained implementation of multisectoral interventions (Huicho et al., 2017).[43]

Smart Spending Reviews (SSRs)

In addition to RBB, the instruments available to improve allocative efficiency of expenditures include the periodic reviews of public spending commonly carried out in OECD countries. A previous version of the reviews has been carried out by the World Bank since the 1990s (Pradhan, 1996). Their use has become increasingly popular given the need to generate public savings in the wake of the Great Recession (Robinson, 2013; Marcel, 2014) and as governments search for a "smarter" expenditure allocation across national policy priorities (Vandierendonck, 2014). SSRs can be comprehensive, including most major expenditure programs, or focused on specific programs; rather than identifying what nonpriorities and waste spending to cut, they seek to reallocate resources from nonpriority to priority activities,

[42] The Better Public Services Results approach in New Zealand, introduced in 2012 but put on hold in 2018, chose to commit to achieving results in five areas: reducing long-term welfare dependence; supporting vulnerable children; boosting skills and employment; reducing crime; and increasing interaction with the government. These priorities remained unchanged until 2017, when results were assessed and priorities modified. http://www.ssc.govt.nz/sites/all/files/snapshot-mar17_0.pdf.

[43] It also contributed to improving second-grade literacy and decreasing in maternal and neonatal mortality.

mostly oriented to growth. The pace and depth of spending reviews has been increasing in advanced countries: of the 32 member countries of the OECD, only half used them in 2011 compared to 80 percent in 2018. Of those that implemented them, two-thirds reported the SSR helped them reallocate spending to match government policy priorities (OECD, 2018).

Medium-Term Expenditure Frameworks

An MTEF is a budget institution designed to strengthen the link between policy, planning, and budgeting over a multiyear horizon intended to progressively achieve: 1) fiscal discipline, 2) strategic allocation of resources (allocation efficiency), and 3) good operational management (technical efficiency) (World Bank, 2013). Consistent with the three potential outcomes, the literature distinguishes between three "types," "stages," or "levels of development" of MTEFs: 1) the Medium-Term Fiscal Framework, MTFF, which typically contains a statement of the macrofiscal strategy, a debt sustainability analysis, and medium-term macroeconomic and fiscal targets and forecasts; 2) the Medium-Term Budgetary Framework, MTBF, which broadens the scope of an MTFF to allocate resources based on strategic priorities constrained with the top-down resource envelope; and 3) the Medium-Term Performance Framework (MTPF), which focuses on program objectives, (output- rather than input-based) budgeting, and performance evaluation to enhance efficiency.[44] Latin America has undergone a wave of MTEF adoptions since 2000.[45] However, from the beginning, the intent was not to reform traditional budget institutions and allocative behavior but to promote macrofiscal discipline. There was no integration between the MTEFs and the existing budget process. These reforms were introduced and understood as part of a wider PFM component and as mechanical projection exercises that did not link policies and resource allocation and did

[44] Two studies using Generalized Method of Moments (GMM) on a panel of developed countries found that the more demanding MTPF has positive effects on technical and allocative efficiency (measured by the cost-effectiveness of health expenditure, and health efficiency scores from a stochastic frontier model of health delivery, respectively). Even achieving fiscal balance has stronger effects in countries with more advanced MTEFs (World Bank, 2012; and Vlaicu et al., 2014).

[45] While the World Bank (2013) accounts for 11, Kaufmann, Sanginés, and García Moreno (2015) accounts for 21, and in some cases, countries report that they are in the MTBF or even in the MTPF stage. However, these assessments look at processes (and promises) rather than function, and hence by reviewing official websites, only 10 countries published MTFF documents varying from three pages of fiscal projections to lengthy reports filled with details on various fiscal risks and Debt Sustainability Analysis (DSA) mostly from an initial macroeconomic MTFF stage (Suescún, 2018).

not promote changes in budget behavior toward improving allocative efficiency. Yet, the conclusion is not to ignore the need for an MTEF but to resize and reformulate the approach to the possibilities and capacity of the country, including prioritization of only a handful of programs aligned with the annual RBB through well-specified causal models. In this endeavor, the much-needed capacity to adopt a successful MTEF can be enhanced with professionalization and advice from independent fiscal institutions.

Fiscal Councils (FCs) and Productivity Commissions (PCs)

Fiscal councils are budget institutions designed to provide independent oversight of macrofiscal forecasting, policy, and performance (IMF, 2014). Its role is complementary to MTEFs and can enhance MTFFs by improving countries' understanding of their fiscal position and prospects.[46] However, the main purpose of FCs is to accompany fiscal rules and complement macroeconomic projections of the MTFF rather than evaluate efficiency in spending policy. But modern productivity commissions or councils might play an important role in enhancing capacity building to prioritize spending. Ideally, they are independent advisory or review bodies of capable researchers, some with proven public policy experience, that deal with productivity research in human and physical capital. They can be the first fiscal institutions that are directly concerned with productivity and growth. Internationally, the productivity commissions of Australia (created in 1998) and New Zealand (created in 2011), are examples of independent agencies concerned with productivity issues as well as social and environmental issues. The core function of these commissions is to conduct public inquiries at the request of the government on key policy or regulatory issues that affect their economic performance and community well-being. In addition, the commissions undertake a variety of independent research to support their annual reporting, performance monitoring, and other responsibilities. These institutions flourish more easily and effectively whenever countries develop a culture of evidence-based policy, coupled with arrangements aimed at boosting the transparency and accountability of government (Banks, 2015). These preexisting conditions are fundamental for most public spending enhancement institutions.

Context also matters: there is no one-size-fits-all solution when it comes to pro-productivity institutions (Renda and Dougherty, 2017). The case of

[46] While in the European Union 30 Fiscal Councils were created between 2001 and 2015 (and most after the crisis of 2009), in Latin America and the Caribbean only a few exist in Chile, Colombia, and most recently in Peru and Brazil.

the productivity commission in Chile[47] is an example. Decades of tradition in CBA and project evaluation, added to more recent ex-post evaluation of programs, culminated in 2015 with the creation of Chile's own Productivity Commission, comprised of high-level, well-trained economists who independently inquire and advise government on productivity concerns. These type of review and research commissions, quite appropriate for providing high-quality ex-ante and ex-post evaluation of alternative policies, could be important to make incremental changes in the budget.

In conclusion, it is possible to gradually adjust RBB practices to improve the allocative efficiency of public spending. The key recommendations for countries with less experience in RBB is to select a small number of medium-term priorities from strategic planning; analyze them in a causal model from where inputs, outputs, and outcomes can be identified; and then, integrate them into a narrowly defined RBB. This is not an easy task, and should be accomplished by increasing budgeting and line ministries' capacity. They can be helped in their task by advisory bodies, such as well-staffed and independent productivity commissions, and should be accompanied by periodic strategic or "smart" public spending reviews, and ex-post evaluations, including modern and ever-increasing impact evaluations of programs in the region, that can reengineer public spending gradually, but solidly. The intertemporal link should be provided by redesigned, microoriented MTEFs with priorities and performance evaluation policies.[48]

Institutions to Improve Allocation to Age-Related Spending

Age-related spending for public pensions and health care is the largest item in some Latin American and Caribbean government budgets. While average spending is 10.8 percent of GDP, in some countries, such as Argentina and Brazil, it is 17.8 percent and 16.3 percent, respectively, which is close to 40 percent of total public consolidated spending. The situation

[47] Mexico and Barbados also offer examples of Productivity Councils but with a tripartite representation comprising government, business, and unions. A principal strength of such tripartite bodies is their capacity to build awareness of current policy problems among key stakeholders and the potential gains from change. However, it can also be an obstacle to reaching agreement on robust policy solutions, such as in labor market regulation or industry assistance programs. Also, these tripartite commissions mostly compile existing information, without producing new knowledge through in-house research.

[48] This proposal is close to the much-better-designed and gradually implemented zero-based budgeting of the 1960s, adapted to the political economy reality of budget incrementalism.

will not improve in the following decades; Brazil's projected spending under current parameters on health and pensions will grow to more than 50 percent of GDP and Argentina's to more than 30 percent, shrinking the fiscal space to invest in growth-producing activities even more in the coming decades (see Chapter 3). For some countries (i.e., in Central America) public spending on pensions is much lower as a percentage of GDP or total spending, but pension coverage is low and limited to the well-off. Consequently, governments are increasing noncontributory pensions everywhere in the region. These policies are not only difficult to sustain but impose a tax on formality and a subsidy to informality, thereby increasing the need for further unfunded spending since formal coverage will not increase (nor will revenues from contributions to social security) and the incidence of social policy on poverty will diminish (Alaimo, Garganta, and Pessino, 2018). The problem is how to address old-age inequities in a fiscally sustainable manner without imposing more distortions (i.e., unintended effects on informality).

Current budget-making procedures fail to resolve one of the most important tensions in budgeting: how to protect the financial security of the elderly without unduly burdening younger generations to pay for these commitments.

The OECD suggests that the rationale for governments to prepare and publish long-term fiscal projections is to raise the profile of fiscal sustainability, provide a framework to discuss the fiscal sustainability of current policies and the possible fiscal impact of reforms, and centralize responsibility for long-term policy analysis. In fact, it is critical to complement debt sustainability analysis (DSA) with long-term projections of health and pension spending, factoring in these effects on fiscal sustainability over the long term. However, in many Latin American and Caribbean countries, even current social security spending is not considered part of consolidated public spending, although the IMF GFS manual explicitly considers it as part of total spending.[49] Much less consideration is given to liabilities, even when they arise from government employees. Most countries do not have actuarial projections of pensions, health spending, and deficits (Glassman and Zoloa, 2015) and when they do, they are not disseminated. For this reason, almost no country incorporates periodic projections of actuarial deficits into fiscal accounts, MTEFs, or DSAs. Chile, Peru, and Colombia have achieved some progress in this area. However, a full analysis

[49] According to the IMF, fiscal transparency demands working with a broad definition of public spending that covers at a minimum the central government, aggregate state and local governments, and social security expenditures within any separate fund.

of contingent and long-term liabilities from public employees and special pension regimes either in central government, state-owned enterprises (SOEs), or SNGs has yet to be done (see Box 9.2).

From a longer-term budgetary perspective, Latin America and the Caribbean needs to focus on two key areas. The first is to improve the forecasting of longer-term expenditure and revenue trends, including the fiscal impact of demographic trends. The second is to link fiscal policy to long-term sustainability considerations. Fiscal councils could take the lead in the second area. The current imbalance between taxes and spending, which has led to an unsustainable level of debt, did not occur overnight. In practice, however, the budget process is focused too much on short-term effects and not enough on longer-term impacts. It is necessary to analyze all the pension entitlements that the region's countries are implicitly or explicitly committed to pay that might or might not be in the short- or medium-term budget but are in the "real" budget that countries should consider when planning future expenditures and taxes. Moreover, it is necessary to project age-related spending on a regular basis and contemplate the effects of future higher spending on pensions, for instance, by lowering spending on other transfers and investment.

Publishing these projections regularly could help lead to a structural reform that increases incentives for formal work, reduces the budgetary cost of aging, and increases intergenerational equity. Basic parameters include the retirement age, the replacement rate, and the contribution rate. Gradually raising the retirement age in consonance with life expectancy while protecting the vulnerable is the preferred option (Bosch, Melguizo, and Pagés, 2013). For public health-care systems, evidence suggests that most countries have room to improve efficiency (see Chapter 8), which would help contain the growth of health spending while expanding coverage. When possible, structural reform should be gradually implemented to build a universal pension system paying entitlements from the same source of revenue. The aim is to provide all workers with protection against basic risks (and avoid old-age poverty), stop increasing fiscal vulnerability, and align the incentives of workers and firms to increase productivity and efficiency.[50] Consensus building, combined with the transparent release of

[50] The reform could be two-pronged: i) An anti-poverty, noncontributory pension for all citizens; and ii) mechanisms to promote formal employment (i.e., subsidies offered to reduce contributions for wage and nonwage earners and that require all workers to contribute, irrespective of their occupational category). See Levy (2008); Antón, Hernández, and Levy (2012); and Bosch, Melguizo, and Pagés (2017) for further details and options.

information on pension and health systems, might help in the difficult process of reform.

Latin American and Caribbean countries will need to make significant additional policy changes and investments to cope with rapidly aging populations. In particular, they must develop policies to help older, still-productive citizens find full-time employment or more flexible work arrangements so as to increase their labor supply, productivity, and ultimately, their well-being. Japan, Singapore, and Korea have already made major investments in automation and robotics to make up for lost productivity in their aging workforces (Scott, 2018).

Public Investment Management

Public investment is critical to current and future growth as it expands a country's productive capacity (Chapters 3 and 5). However, it is not only how much is invested that matters but how well investments are managed, that is, how decisions are made as to where, why, and how investments are funded and delivered to attain the best possible social outcomes.[51] Public investment efficiency levels, in turn, are a function of the quality of institutions, and the relative strength of public investment management institutions. The quality of procedures varies greatly across countries and determines how well investments are planned, whether allocations are made to priority activities for economic development, and whether the implementation avoids waste and delays (Rajaram et al., 2014; Dabla-Norris et al., 2012).

In Latin America and the Caribbean, public investment is low, averaging 4.5 percent of GDP in 2016, whereas Asian developing regions are investing an average of 6.3 percent of GDP. Furthermore, investment expenditures are highly volatile as they tend to decline sharply in periods of fiscal consolidation, economic downturns, or whenever public finances come under stress (Ardanaz and Izquierdo, 2017). In addition, while an important share of public investment is executed by SNGs (between 60 and 70 percent of consolidated spending in Argentina, Bolivia, Guatemala, Mexico,[52] Peru, and Brazil, followed by Colombia with about 41 percent), in-depth knowledge about their management capacities is limited.

At the regional level, an analysis of public investment management efficiency revealed that the areas showing the weakest performance were

[51] Delivery models include traditional public investment (TPI), PPPs, or investments through SOEs.

[52] Mexico's share of subnational investment is smaller when investment by SOEs is included in consolidated spending.

strategic alignment and project appraisal, ex-post evaluation and audit, scrutiny, and public access to information over the investment cycle. The lack of systematic ex-post appraisal and data collection on performance undermines evidence-based decision-making (Contreras et al., 2016). Investment projects that are larger than a small fixed amount should always be appraised through a CBA to ensure projects are prioritized according to the highest internal rate of return.[53,54] Additionally, digital tools are not being exploited to their fullest in the region to save time and provide more accurate, integrated, and timely information on investment procedures and outcomes.

There is an urgent need for more efficient public investment spending given the short window of opportunity that ends in 2040. International evidence and lessons learned pinpoint critical factors for the reform of public investment management systems (PIMSs), presented in Table 9.5. The IDB has supported institutional reforms aimed at strengthening PIMSs in several Latin American and Caribbean countries over the last 15 years, empowering national and subnational governments. A key lesson emerged—that of taking a comprehensive approach as follows.

Importantly, to avoid unrecorded expenditures in the budget or off-budget, PPP and SOE investments should be integrated into modern public investment management and general budget procedures (Box 9.2).

Subnational Expenditure Assignment and Management

Growing decentralization of spending can support efficiency in public spending if several preconditions are met (Chapter 3), among them: 1) a fairly matching level of tax decentralization; 2) a well-defined, nonconcurrent, and transparent distribution of spending responsibilities; and 3) institutions at the local levels with enough capacity and quality to manage higher spending effectively. For horizontal equity, it is also important to improve the design of intergovernmental transfers[55] so that they

[53] However, the coverage of ex-ante evaluations in most Latin American and Caribbean countries is small, receiving only 2 out a maximum of 5 in the PRODEV evaluation tool. Chile, Colombia, Mexico, and Peru were consistent leaders across different surveys (Kaufmann, Sanginés, and García Moreno, 2015).

[54] When a project has large positive but unmeasurable externalities, a cost-effectiveness analysis will have to suffice (Fontaine, 2006). Other less data-demanding methods such as multicriteria decisions should be considered only second best.

[55] Revenue sharing is the most commonly used instrument to fill vertical imbalances, whereas equalization transfers aim to reduce horizontal imbalances, and special purpose transfers seek to finance subnational spending in priority sectors and programs.

Table 9.5 Recommendations to Improve Public Investment Management

	Key recommendations	Details
Planning/ Prioritization	Develop a medium-term public investment strategic plan. Link to a multiyear budget and to national plans. Cost-benefit analysis (CBA) should be the first method of choice to prioritize projects.	A comprehensive long-term approach considers all sectors in a single plan, ensures coherency, and avoids overlapping spending.
Coverage/ Coordination	Establish unified coordination between planning entities, the Ministry of Finance, and subnational governments for the entire investment cycle. Cover all financing entities including public-private partnerships (PPPs), trusts, and state-owned enterprises (SOEs)	Coordination avoids duplications and ensures coherence in national, sectoral, and regional prioritization (IMF, 2015). It is advisable to have a high-level interinstitutional entity.
Operational	Align the ex-ante CBA to a national development strategy; consider maintenance costs; distributional effects; complementarities and transversal appraisals of projects affecting many sectors to avoid wide political discretion.	Prioritize investment projects with relevant economic trade-offs (Laursen and Myers, 2009). Use sector-specific methodologies for CBA and standardized social prices. Have clear criteria to choose delivery model: traditional public investment (TPI), PPPs, or SOEs (Box.9.2).
Digital technology and efficient tools	Design a digital platform for the entire investment lifecycle and integrate it with the Integrated Financial Management Information System (IFMIS) to interoperate with other modules such as budgeting, procurement, and treasury.	Big data analytics, algorithm, and machine learning will benefit efficiency and transparency of public investment management systems (PIMSs) such as Geographic Information Systems (GIS) and visualization techniques.
Transparency/ Participation	Make budgetary information pertaining to investment projects available to the public, disclosing costs and contingent liabilities for PPPs (OECD, 2018b).	Combat corruption by improving transparency and accountability mechanisms; provide detailed and accurate information to oversee competitive procurement process for projects.
Professionalization	Skills of civil service need to be attracted, enhanced, and retained across project planning, management and appraisal, procurement, and policy analysis.	Developing skills to manage investment is critical. Outsource training to national and local universities across the country with a rigorous curriculum (OECD, 2014c).
Ex-post evaluation	Mandate ex-post evaluations on all public investment projects and use ex-post evaluation findings to improve the ex-ante appraisal process.	The lack of feedback on the quality and performance of large projects impedes improvements to future investments such as infrastructure and entails a clear risk with high costs.
Monitoring and control	Develop a set of relevant and standardized indicators throughout the investment cycle that feeds into a monitoring system. They are an important check on cost and time overruns.	Monitor the implementation progress of projects through inputs, activities, and outputs; intermediate and final outcomes should be aligned with strategic goals. Monitoring indicators need to be tracked years after the investment is made.

Source: Based on assistance to various countries in the region as well as international evidence. See Contreras et al. (2017); Eguino et al. (forthcoming); IMF (2015); OECD (2014c); and Rajaram et al. (2014).

BOX 9.2 FISCAL RISKS FROM PUBLIC-PRIVATE PARTNERSHIPS (PPPs), STATE OWNED ENTERPRISES (SOEs), AND PUBLIC TRUSTS

PPPs are long-term contracts whereby the private sector supplies infrastructure assets and services traditionally provided by the government, which funds them directly or through user fees and tolls, in this case called concessions. In recent decades, an increasing proportion of infrastructure services has been delivered through PPPs in Latin America. When compared with traditional public investment (TPI), the benefits of PPPs mainly arise through bundling, which allows the costs of building and maintaining the assets to be internalized, since the same agent undertakes them, engaging in life-cycle costing and reducing operational and maintenance costs. Hence, from an economic standpoint, PPPs should be used when they provide more value for money (VfM) than TPI, that is, when the private provider is able to deliver the infrastructure at a lower cost and with greater efficiency than the public sector. However, in many cases, investment projects undertaken through PPPs have been used not for efficiency reasons but to circumvent spending controls, delay the recording of costs or not record the investment, the guarantees provided, or the debt incurred in the budget, thereby jeopardizing fiscal transparency (Engel, Fischer, and Galetovic, 2013). PPPs allow governments to increase investment without immediately adding to government borrowing. This is tempting, particularly for cash-strapped governments trying to meet fiscal targets; while they liberate fiscal space in the short run, they lose it in the long run. This lack of a budgetary record transforms committed payments into contingent liabilities, which, despite attempts to control them by, for example, estimating risks through sophisticated techniques, are highly correlated to the economic cycle. The materialization of concealed and contingent liabilities in some European countries, such as Spain, Portugal, and Iceland,[a] during the 2008–2010 financial crisis shows that these liabilities continue to be insufficiently dealt with in the public accounts of countries. Even when private partners bear the majority of explicit risks, the government continues to be the real residual claimant of the project, guaranteeing service provision. This problem largely explains the renegotiation of contracts with high cost overruns in some Latin American and Caribbean countries. The great majority of road concessions in Chile, Colombia, and Peru before 2010 were renegotiated, leading to cost increases of between 20 and 100 percent (Bitran, Nieto-Parra, and Robledo, 2013). This situation has led to low-quality and fiscally costly investments. Governments should limit overall fiscal risks from PPPs by i) choosing the right project through CBA first, then evaluating whether to procure with a PPP or TPI, and ensuring good governance along the project cycle to avoid corruption and inefficiencies; and (ii) implementing good budget reporting and registering in the budget and on balance sheets direct liabilities as the asset is constructed. Annually, all exposure, debt, and guarantees that generate contingent liabilities and fiscal risks should be disclosed.[b] Meanwhile, as reforms are implemented, limit the use of PPPs (Honduras limits the use of PPP projects up to 5 percent of GDP, Peru 12 percent of GDP and Mexico 10 percent of revenue).

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BOX 9.2 FISCAL RISKS FROM PUBLIC-PRIVATE PARTNERSHIPS (PPPs), STATE OWNED ENTERPRISES (SOEs), AND PUBLIC TRUSTS *(continued)*

State-owned enterprises (SOEs) are major but overlooked contributors to public investment in the region, accounting for a large share of total public-sector investment (Mussachio, Pineda Ayerbe, and García 2015). In Argentina, Mexico, and Uruguay, SOEs' account for more than 40 percent of total public-sector investment, particularly in key sectors such as electricity, water, and sanitation. SOEs face several challenges since most of them provide socially sensitive public goods and services that can undermine the soundness of their investment appraisal processes. For instance, SOEs are sometimes required to undertake very risky or suboptimal investments due to political meddling (Reyes-Tagle and Garbacik, 2016). In other cases, SOEs on their own might incur higher levels of risk as they expect central governments to bail them out in cases of crisis (Ter-Minassian, 2017). Given their public nature and the fiscal risks SOEs can entail, governments should i) require them to submit projects through a tailored procedure using CBA within the public investment-cycle; ii) strengthen control and monitoring systems of SOEs including investment decisions; iii) record their transactions in statistics and budgeting, considering them a part of the overall public sector; and iv) limit the scope for politically motivated intervention in the day-to-day operations of SOEs.

Transitory Public Firms—**Trust Funds** ("Fideicomisos")—are another vehicle to carefully manage investment in Latin America and the Caribbean. These extra-budgetary funds (EBFs) have been set up for a variety of reasons, including to avoid the constraints of the budget process and a detailed and transparent CBA, thereby protecting funds from political scrutiny. On the other hand, well-designed EBFs provide a mechanism for linking earmarked taxes and levies to the services delivered (e.g., social benefits and road maintenance). If left outside the budget, the funds must be subjected to a robust and transparent system of control, reporting, and external audit (IMF, 2018). Several PPPs in the region are financed through these EBFs, which allows them to remain off-budget during the entire cycle and avoid being subjected to the same provisions of the project cycle as other investments. This practice not only leads to fiscal risks but raises the probability of corruption unless well monitored or, even better, if registered in the budget.

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[a] A recent example of the effect of a failure to record actual or contingent liabilities is the Great Recession in Portugal. Portugal's debt rose from 76 percent of GDP in 2009 to 130 percent of GDP in 2014. One half of this increase was attributable to the reclassification of entities that were off the general government accounts—primarily public enterprises, as well as several PPPs—and to interventions aimed at shoring up financial institutions (Cangiano, Curristine, and Lazare, 2013). See additional case studies for the region in Reyes Tagle (2018).

[b] With regard to other contingent liabilities, the financial crisis revealed gaps in many governments' knowledge of their underlying fiscal position. To identify and mitigate all sources of fiscal risk, it is essential to improve fiscal transparency rules and practices along several dimensions, including: i) more complete coverage of public-sector institutions and transactions; ii) presentation of more comprehensive reports on public-sector assets and liabilities; and iii) presentation of more frequent and timely fiscal risks reports (Cottarelli, 2012). In Latin America and the Caribbean, there is little identification, quantification, and management of fiscal risks ranging from liabilities related to old-age expenditures, to explicit or implicit guarantees for the financial sector, to loan guarantees for enterprises, subnational governments, PPPs, and certain public trusts. Many of these liabilities are off-budget and should be quantified and recorded, particularly those that represent explicit public-sector commitments.

are equalizing,[56] that is, to allow SNGs to provide reasonably comparable levels of public services for citizens at reasonably comparable tax rates even if resources differ across areas.[57]

In Latin America and the Caribbean, these institutional and administrative constraints hinder achieving efficient, effective, and transparent spending at the subnational level. The reform of decentralized fiscal arrangements is one of the more complex areas of public finance, since it spans several policy and institution-building issues, and is strongly influenced by historical, political, social, and economic factors. Accordingly, there is no single right model; thus, advice must be tailored to each country's specific circumstances (IMF, 2009). A set of nonexhaustive recommendations to overcome the main problems SNGs face when engaging in fiscal decentralization is presented in Table 9.6. Lack of transparency and capacity at the local level are key constraints to improve spending efficiency in SNGs. Moreover, and in particular for large federations, many reforms such as increasing SNGs' tax base and improving intergovernmental transfers to make them more efficient and equalizing, require changes with a two-thirds majority in Congress, even changes in the Constitution in some cases, such as Brazil, or the approval of all provinces as in the case of Argentina. Hence, these reforms require ample consensus building and negotiations. Some countries, such as Mexico and Argentina, have benefited from fiscal agreements or pacts to achieve desired outcomes. In the past, many of those agreements were highly political, without much data or evidence to make the sharing of revenues or responsibilities more efficient or equitable. Once they are based on evidence, with good analysis and diagnostics of tax bases, expenditure needs, and costs, the political consensus is expected to be enhanced. As in most spending institutions, planning and prioritization with careful diagnostics and evidence are key to improve the institution of fiscal federalism. Other institutions, such as for intergovernmental fiscal coordination can also help in the diagnostic, evidence, and consensus-building processes. Building equalization transfers may also improve the construction of a federation with common ends.

[56] See Muñoz, Pineda, and Radics (2017) on the design of equalization transfers for Latin America and the Caribbean.

[57] Revenue equalization aims at reducing differences in a jurisdiction's per capita revenue-raising capacity. Since it focuses on tax capacity, it does not provide disincentives to raise revenues. On the other hand, cost-equalization aims at reducing differences in the per capita cost of providing a standard set of public services. Most OECD countries use a mixture of those, while Canada uses revenue equalization. Besides compensating for tax capacity, Australia also includes compensation for expenditure costs.

Table 9.6 Key Recommendations to Improve Fiscal Decentralization for Better Spending Efficiency

	Key recommendations	Details
Planning/ Prioritization	Strengthen strategic planning at subnational levels and integrate with central planning. Assess human, physical, and tax capacities, how potential decentralization of taxation could be developed, how different transfers affect equity and efficiency, and how to diagnose concurrencies of spending.	Planning should be based on evidence-building knowledge and consensus for future reforms. Improve planning, management for results, and transparency. Strong planning capacity at the local level is required to reduce waste and misuse of decentralized resources.
Coverage/ Coordination	Develop vertical intergovernmental fiscal coordination (IFC) for effective management of concurrent spending responsibilities[a] (Ter-Minassian and de Mello, 2016). Specify in high-level legislation which level of government can override decisions in concurrent responsibilities (Ter-Minassian, 2016). Develop horizontal IFC to improve cooperation with the central government on financial management in education, health, etc.	Horizontal cooperation can help minimize adverse spillovers, especially neighboring ones, and exploit potential economies of scale. Vertical cooperation can help avoid cost shifting when higher-level governments establish inappropriate standards and regulations for lower-level counterparts. For fiscal sustainability, limit current spending at the expense of capital and align fiscal rules with the federal level.
Own-source revenue mobilization and transfer schemes	Assign gradually sufficient tax autonomy to SNGs in line with spending responsibilities (allowing them to set rates on own taxes and impose surcharges on national taxes; IMF, 2009). Improve the design of intergovernmental transfers to increase equalization and efficiency. Special-purpose grants could be used for specific objectives.	Tax decentralization improves spending efficiency when it matches spending decentralization. Introduce equalization transfers, which can gradually accommodate further tax decentralization and smooth the transition (Fenochietto and Pessino, 2000). Capital transfers could be used to close infrastructure gaps and foster more equilibrated growth.
Digital technology and efficient tools	Use digital tools to i) manage a central cadaster and update market valuations; ii) integrate individual ID, tax, and social data to digital integrated systems; and iii) coordinate reform of integrated financial management information systems (IFMISs), e-procurement, and e-payroll with federal systems.	Digital tools are a core component of modern government and a strategic asset for improved service delivery. Such tools can also build administrative capacity and improve citizens' perception of public services (OECD/ CAF/ECLAC, 2018).
Transparency/ Participation	Improve the publication of timely and accurate fiscal accounts. Disclose all information, including financial interactions between levels of government, and formulas to distribute transfers to SNGs.	SNGs should disclose public accounts and fiscal risks, and consolidate all information with the central government to build better decision-making processes and trust.
Professionalization	Invest in local capacity building, including development of digital skills. Develop a lean professional civil service workforce to shield against political turnover and nepotism.	Human resource systems in SNGs should promote incentives, together with meritocratic competitive hiring to improve the technical capacity of civil servants. Integrate SNG civil servants in a centrally managed payroll system.

(continued on next page)

Table 9.6 Key Recommendations to Improve Fiscal Decentralization for Better Spending Efficiency *(continued)*

	Key recommendations	Details
Ex-post evaluation	Develop reliable information on the cost-effectiveness of spending programs at the subnational level and integrate in national budgeting for a results framework.	A continuous appraisal of the results and outcomes of spending programs is required to permanently assess whether spending is achieving value for money.
Monitoring and control	Build SNG capacity in internal and external audit systems to provide assurance of the integrity of financial statements, thereby improving accounting standards and the regularity of financial management procedures (IDB/World Bank, 2011).	Improve monitoring and control tools at the subnational level to identify wasteful practices and prevent opportunities for corruption.

[a] Since 2012, Colombia has introduced the Contratos Plan in some of its departments to coordinate public investment policies, with a view to promoting more balanced regional development. The Chilean central government also uses Contratos-Region to agree on investment plans with its regions.

The evidence is scarce, but has been increasing in the past 20 years (Chapter 3; Pessino, Pinto et al., 2018).

The Future Is Now: Social Investment Management and Policy

Achieving equity in society is usually considered an objective within each institution that deals with public expenditure, but equity cannot be achieved in fragments even though most countries approach it this way through a myriad of line ministries (social development, social security, health, education, labor, public works, and finance). Each minister is empowered to deal with specific aspects of social policy and programs. To increase equity effectively and efficiently, an integrated vision and system is needed to develop social investments. Quality human capital investments are as important as physical capital in most countries in the region to increase growth; thus, social investments to achieve growth should be treated on a par with public investment management.

The building blocks of an ideally integrated social policy should include at least the following elements.

- **Planning and prioritization based on strong evidence, ex-ante CBA of all major social programs, and feedback from an ex-post evaluation of programs.** Social planning and prioritization should prevent governments from manipulating spending in democratic contests for political power. Often, governments lean toward higher spending on poorly targeted transfers in the interest of

faster growth, but at the expense of long-term fiscal sustainability (sometimes labeled populism).[58]

- **A long-term vision that takes an integrated approach to social investment.** Latin America and the Caribbean should take a comprehensive approach and formulate policies that clearly recognize what capabilities and skills matter, how they are produced, and how to prioritize public policy for producing skills. This method avoids a fragmented and often ineffective approach to public policy that misses the importance of each element in shaping life outcomes. Current policy discussions often focus on one social problem at a time with policies designed to address that one problem, often by some remediation strategy. Examples of fragmented solutions are spending more on police agents to solve crime, building more schools, hiring better teachers, and raising test scores to promote skills. None of these policies is necessarily wrong. However, they miss opportunities for policy synergies and effective targeting. Current research on skills formation suggests a unified approach based on a strategy of human development to reduce inequality by promoting capabilities at all stages of the life cycle. Effective policies supplement the family and its resources, engaging caregivers to enrich the early life of the child and support the child in school. Policies that enhance the skills of parents to be parents are similarly effective. For example, high-quality early interventions reduce inequality by promoting schooling, reducing crime, and reducing teenage pregnancy. They promote health and healthy behaviors; they also foster workforce productivity. These interventions have high benefit-cost ratios and rates of return, passing efficiency criteria that any social program should be asked to pass. Early interventions have much higher economic returns than later remediation and prevention programs, such as public job training, convict rehabilitation programs, adult literacy programs, tuition subsidies, or expenditures on police to reduce crime (Heckman, 2016).
- **An integrated vision of social investment should be reflected in an integrated social investment management strategy.** A central unit should coordinate public investments (PIMSs as analyzed earlier in this chapter) effectively and efficiently and one unit should be dedicated to following social investments (social investment management systems, SIMSs) through the full cycle from analysis, formulation,

[58] As Minister of the Interior of Argentina, Rogelio Frigerio mentioned in a TV program, referring to populist governments: "...they give as a gift well-being and in exchange they sacrifice the future...".

and implementation, to ex-post evaluation and monitoring. This process should in turn be integrated with the budget in a programmatic stance and gradually lead to results-based budgeting. Heckman, Lochner, and Pessino (1999) envisioned a system like that for Argentina, resembling a PIMS, with a broad, analytical, integrated vision with a life-cycle model of skills building from birth onward as the major building block and targeting disadvantaged families. Although schools and schooling are important, effective social policy targets and strengthens the family since inequality in families—far more than inequality in the resources applied to schools—produces inequality in schooling outcomes. It is important to examine integrated policies and break down barriers across cabinet agencies.[59]

- **The social investment system should incorporate the specific characteristics, institutions, culture, and legal framework of Latin American and Caribbean countries.** To improve the efficiency of fiscal policy in reducing poverty and inequality, it is necessary to follow household and public financial data and analyze how equity can be improved by different social programs and policy. Benefit incidence analysis (Chapter 4), following the modern Commitment to Equity (CEQ), allows for a transparent and independent assessment of which programs perform best to reduce poverty and inequality. Informality should also be addressed particularly in the context of escalating payroll taxation and noncontributory social programs that incentivize informality, lower productivity, hinder growth (Levy and Schady, 2013), and decrease the effectiveness of social programs on equity (Alaimo, Garganta, and Pessino, 2018). A comprehensive social investment program should gradually eliminate the tax on formality and the subsidy to informality and provide all workers with the same social insurance programs. After ensuring that CCTs reach their entire target population and operate effectively, additional efforts to help the poor need to focus on raising their productivity by helping them land a higher-productivity formal job. Tackling this challenge requires revising regulations in the region's labor markets, and the methods of financing social insurance programs. Put more bluntly, it demands tax and labor market reform. These issues, long unaddressed, are as difficult as they are urgent (Levy, 2015).

[59] New Zealand provides recent lessons in building social investment, including the launch of a cost-benefit evaluation tool, CBAx, and a new Social Investment Unit, charged with setting evaluation standards, developing methods for estimating return on social investment, and building an information exchange to enable the safe sharing of data to support better decision-making (English, 2016).

The Challenges Ahead

This chapter offers a novel, integrated approach to expenditure policy and management from a comprehensive institutional perspective. It provides key recommendations to improve the governance of most spending institutions and national and international evidence of the impact of those policies. First, a common framework of analysis includes recommendations and evidence for those institutions most capable of improving technical efficiency: public procurement, civil service, smart integrated data, and core PFM processes. Second, a similar framework is used for institutions that foster allocative efficiency: RBB, smart spending reviews, MTEF, productivity councils, institutions to deal with aging and other fiscal risks, public investment management, decentralization institutions, and finally a new proposed institution to deal with both equity and growth— that is, one dedicated to social investment policy and management.

Although most institutions require major improvements, those dealing with allocative efficiency are less developed than those dealing with technical efficiency. This uneven development reflects two facts: 1) the emphasis of first- and second-generation reforms was to achieve fiscal sustainability either by increasing taxes or improving tax administration, and 2) the belief was that spending size and composition did not affect productivity and growth, and that inequality and poverty could be effectively and easily reduced through transfers (without affecting productivity). The assumption was that PFM reforms, including approving the budget on time, setting fiscal rules, and a mechanical MTFF would "automatically" deliver efficiency to public spending. Those beliefs are challenged in this book, which advocates rethinking and reengineering allocative spending institutions to deliver better outcomes in productivity, growth, and overall efficiency. In fact, government today is a large and sometimes selfish partner of the private sector that gives privileges to a few in contracts, hiring, etc., rather than choosing the best growth options based on CBA, growth analysis, transparency, and fair competition practices.

Considering all institutions within a unified framework, six systematic challenges for the governance of public spending hinder the achievement of the best possible outcomes:

- **Challenges in strategic vision and planning.** Most countries lack a strategic vision with priorities based on theory and evidence in overall public spending. There is no national planning and when there is, it is mostly a wish list, without specifying a plan based on a causal model on how to best achieve the intended outcomes.

The lack of planning and prioritization is echoed in each spending institution: procurement, civil service, public or social investment, etc. Key priorities should be kept simple and should not start covering all programs and much less the entire budget to keep them within manageable and measurable SMAART indicators.

- **Coordination and coverage challenges.** Overall spending lacks coordination, in part because the constellation of actors involved in public spending is large and their interests are not aligned and are difficult to reconcile. This lack of coordination permeates most individual spending institutions. Cross-sector, cross-jurisdictional, and intergovernmental coordination are necessary, but difficult in practice. Specific organizations, units, or even periodic fiscal or social pacts to coordinate overall spending and each specific institution should be created or strengthened. Coverage of overall spending in budget, procurement, and civil service systems; public investment systems; medium- and long-term frameworks; and budgeting is consistently limited and low in most countries. This insufficient coverage hinders transparency and jeopardizes most institutions, allowing many to slip through the cracks of the system and leaving many without governance. This opens up each institution to all sorts of inefficiencies, including waste and, more importantly, corruption.
- **Competition and transparency challenges.** While the claim is that competition is the default in procurement, the civil service, and public investment, the exception is the rule in many countries, opening the door to direct contracts, nepotism, and again increasing waste and corruption. While digital systems help improve processes they are no guarantee that coverage and competition will be complete; this must come from enforced regulations. Open data in contracts, procurement, social transfers, and budget, while sometimes problematic with sensitive information, can help expose the loopholes if monitored adequately.
- **Performance measurement and evaluation challenges.** Performance measurement indicates what a program is accomplishing and whether results are being achieved. It helps by providing information on how resources and efforts should be allocated to ensure effectiveness. It keeps programs focused on key goals. This should be coupled with evaluation and analysis to increase understanding of why results occur and what value a specific spending item adds or wastes. Finally, based on performance data and evaluations, reprioritization should gradually occur to keep spending at the most efficient levels.

- **Capacity challenges.** Where the capacity to design and implement spending strategies is weak, policies may fail to achieve their objectives. Evidence suggests that public spending management and growth outcomes are correlated with the quality of government, and this depends critically on the quality of civil service. Most spending institutions require a highly professional staff that can plan, analyze, be willing to change, and is motivated. Current civil service and other labor market institutions prevent this adequate professionalization.
- **Monitoring and control challenges.** Independent auditing should follow procurement, wage setting, data mining, and performance indicators.

Finally, improving spending efficiency requires hard work to build capacity within government and consensus and coordination outside. Most Latin American and Caribbean countries allowed public spending to grow faster than taxes, governance, and capacity. Cash transfers were increased without adequate targeting or without analyzing the trade-off between efficiency and growth. Inequality declined little and countries failed to achieve high rates of growth even as they risked fiscal sustainability. Nonpoor beneficiaries of transfers and subsidies do not want to lose them. Hence, expenditure reforms are more likely to be successful and long-lasting if supported by high-level political compromise coupled with extensive political consensus building and a broad communications strategy, particularly during times of political uncertainty and rising social pressure. Social dialogue and public support for reform allow policymakers to introduce more fundamental reforms; reforms with little social dialogue may well unravel after a few years. For some reforms, switching spending causes some people to lose benefits; it is best to compensate losers if they are poor (as in the case of energy subsidies transformed into social tariffs) or execute the reform gradually so that potential losers are not yet beneficiaries (as in the case of tying increases in the retirement age to life expectancy increases). As usual, most successful reforms build on better basic institutions, such as the presence of property rights, enforcement mechanisms, and basic budget institutions. And of course, no size fits all, and the challenges and recommendations must adapt to the circumstances of each country.

It is time that Latin America and the Caribbean achieves sustained growth without relying on external windfalls of any type. Technical change coming from the digital revolution is both an opportunity to use advanced digital innovations such as big and smart data and a challenge

for governments to develop the capacity to administer digitalization. For that, the region must begin to implement deep, comprehensive reforms in public spending policy and management as soon as possible. Again, paraphrasing Heckman, these reforms are not for indicating where to cut, but where to invest and how much. Reallocating public monies toward the most socially beneficial or cost-effective interventions would improve lives, equity, and overall growth.