

# The Political Economy of Debt in Argentina, or Why History Repeats Itself<sup>1</sup>

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October 2<sup>nd</sup>, 2006

## Abstract

This paper argues that Argentina's federal fiscal institutions lead to a serious common pool problem that in turn causes a deficit bias. Fiscal rules, which in other countries are used to mitigate deficit biases, have not worked in Argentina. However, the budget process is *de facto* very hierarchical. This means that when the Executive has fiscal resources available to allocate with discretionality – i.e. during good economic times – it can implement its policy agenda with more ease. Since the Executive is likely to value fiscal solvency more than other political actors, fiscal policy in Argentina is especially volatile, with strong improvements during good times and deterioration during recessions. Thus, fiscal policy is an outcome of the interaction of economic shocks and underlying institutions.

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<sup>1</sup> Paper prepared for the World Bank, for the study “Sovereign Debt and Development: Market Access Countries”, under the coordination of Brian Pinto. I wish to thank Manuel Mora y Araujo for providing valuable information, Martín Ardanaz and Joaquín Blaum for superb research assistance and Brian Pinto, Eduardo Ley, Luis Tonelli and participants at seminars at the Universidad de La Plata and FIEL for valuable comments and discussions.

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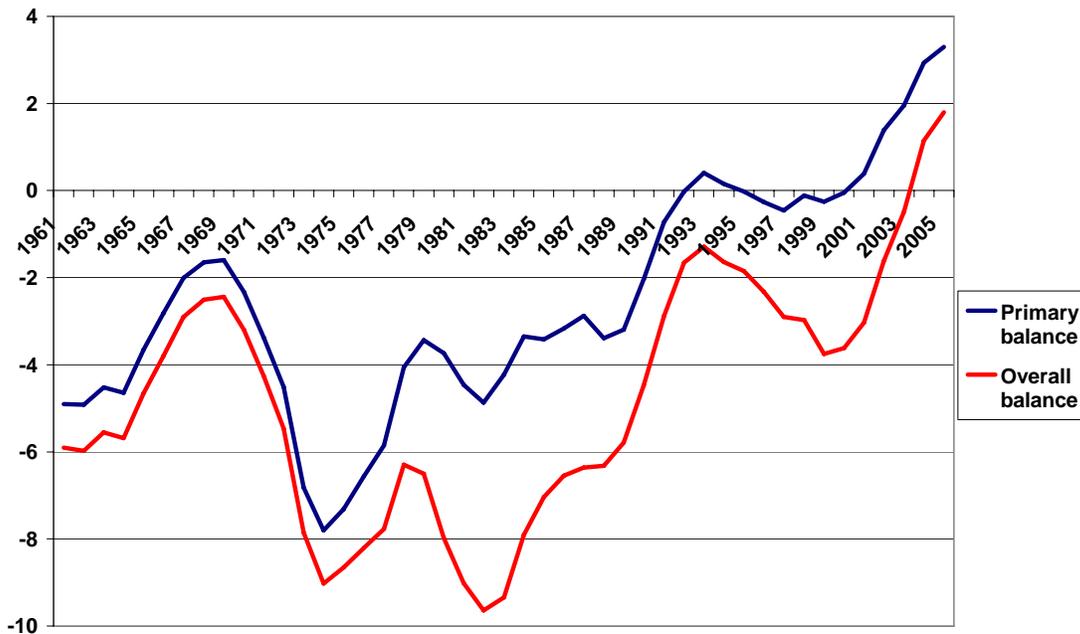
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# 1. Introduction

Argentina's recent economic history is marked by fiscal mismanagement in a context of disappointing growth performance, volatility and deteriorating social conditions. Real GDP per capita in 2005 was only 11% higher than in 1975, whereas poverty, unemployment and income inequality have increased dramatically<sup>3</sup>.

The December 2001 debt default – the largest in the history of defaults – marks the latest in a series of dramatic episodes. In the past 20 years, the country has been ravaged by two debt crises and two bouts of hyperinflation. Until recently, public expenditures were systematically higher than regular fiscal revenues (see Figure 1). As a consequence, successive governments either printed money or issued debt to finance the difference. Public debt was around 10% of GDP in 1975, and reached over 140% of GDP following the 2002 crisis, only to stabilize around 70% of GDP in 2005 after the debt restructuring.

**Figure 1: Argentine general government budget outcomes (5 year moving average, %GDP, 1961-2005)**



Source: Argentine Economics Ministry (MECON)

What went wrong? Is fiscal policy merely an outcome of poor growth performance, or is it part of the problem? And if so, why would rational policymakers persist in fiscal mismanagement?

In this paper we focus on the evolution of public debt in Argentina. We argue that following the rapid growth of debt during the late 1970s, fiscal policy in Argentina has followed a cyclical pattern determined by the interaction of fiscal institutions, which generate a serious deficit bias, and economic cycles. Positive economic cycles provide the Executive with sufficient political power to overcome the deficit bias, and result in favorable debt dynamics. During downturns, however, presidential power dissipates, fiscal policy outcomes worsen, and the debt situation deteriorates. Contrary to what several commentators argue<sup>4</sup>, our claim is that poor fiscal policy in Argentina is more an outcome of the combination of economic volatility and poor institutions than a cause of the problems itself.

The argument in more detail is as follows: fiscal institutions in Argentina set the stage for a serious common pool problem in federal fiscal relations that leads to a systematic deficit bias<sup>5</sup>. In the presence of common pool problems, several countries have adopted numerical fiscal rules that limit expenditures, deficits and debt. However, due to institutional weaknesses, in Argentina numerical fiscal rules lack the credibility necessary to influence actual behavior, and thus have not provided a solution to the deficit bias<sup>6</sup>. This bias is somewhat moderated by the fact that budget institutions are *de facto* very hierarchical<sup>7</sup>, which means that presidents can in some cases negotiate with provincial governors – key players in the Argentine political system due to the control that the electoral system grants them over legislators<sup>8</sup> - and impose their policy agenda,

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<sup>3</sup> See Gasparini (2003) for an overview of social outcomes over the past 30 years.

<sup>4</sup> See, for instance, Mussa (2002).

<sup>5</sup> Much more on this later, but for now let us mention that political and economic power are distributed very asymmetrically in Argentina. 72% of GDP is generated in four provinces, that hold only 17% of the Senate votes and 51% of the lower chamber votes. This level of malapportionment, as it is known in the political science literature, is one of the largest in the world according to Samuels and Synder (2001).

<sup>6</sup> See Braun and Tommasi (2004) and Braun and Gadano (2006) for an analysis of the failure of fiscal rules in Argentina.

<sup>7</sup> See Alesina and Perotti (1996) for an argument that more hierarchical budget procedures contribute to fiscal discipline.

<sup>8</sup> See Spiller and Tommasi (2003) and Jones et al (2002).

including a measure of fiscal solvency<sup>9</sup>. This potential move to solvency happens especially during economic expansions, which provide increases in tax revenues that generate discretionary funds<sup>10</sup> that can be allocated by the Executive to consolidate a governing coalition. Furthermore, during expansions the president becomes more popular, which eases the approval of executive initiatives in Congress<sup>11</sup>. Thus, during expansions, presidents are able to use fiscal resources via the hierarchical budget process and increased popularity to impose their agenda and control the deficit bias

However, during economic downturns, the reverse occurs. Presidents lack the fiscal resources to maintain their governing coalition, they lose popularity, and political agents' planning horizons shorten, leading to incentives to overspend from the common pool. As mentioned in the previous paragraph, numerical rules do not have the binding capacity to limit this behavior. Another alternative solution to this problem would be to strike intertemporal agreements among political agents, but Spiller and Tommasi (2003) convincingly show that the Argentine political environment is far from conducive to this kind of deals, given the short horizons faced by policymakers<sup>12</sup>.

Thus, following the period of rapid growth of public debt during the military government of 1976-1982, since the return of democracy in 1983 Argentina has been oscillating between the vicious and virtuous cycles described above, with international shocks such as the debt crisis of 1982 and the volatility and sudden stops<sup>13</sup> in emerging markets of the late 1990s providing the starting point for vicious cycles. On the other hand, the pro-market reforms of the early 1990s and the post-default favorable international conditions set in motion two virtuous cycles.

During the virtuous cycles, fiscal policy improved its stance, the pace of growth of debt was moderated and in some cases structural fiscal reforms were implemented,

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<sup>9</sup> Since macroeconomic crises are blamed mainly on presidents, it is reasonable to assume, as most of the political economy literature does, that the Executive internalizes the government's intertemporal budget constraint more than other political actors.

<sup>10</sup> The budget in Argentina is very rigid, so increases in tax revenues can have a significant impact on the amount of discretionary funds available for the Executive to allocate (See Abuelafia et al (2005)).

<sup>11</sup> See Calvo (2004)

<sup>12</sup> Spiller and Tommasi argue that the legacy of political and economic instability that Argentina suffered between 1930 and 1983, together with a series of weaknesses in its underlying political institutions, has made it rational for policymakers to develop short planning horizons. The volatility of the period 1983-2005 has confirmed the rationality of this choice.

<sup>13</sup> See Calvo, Izquierdo and Talvi (2002)

such as the Financial Administration Law of 1992, that organized the federal budget process and made it more hierarchical. During the vicious cycles, deficits and debt grew, and economic and political crises ensued.

To an economist of course, it is not surprising that fiscal outcomes improve during good times and viceversa. After all, both Keynesian macroeconomic policy and tax smoothing arguments (see Barro (1979)) prescribe countercyclical fiscal policy. However, in the presence of a dynamic common pool problem, weak institutions and political agents with short horizons, it is not uncommon to observe procyclical fiscal policy due to “voracity effects”<sup>14</sup>. Given Argentine fiscal institutions as we describe in Section 3, absent effective fiscal rules, it would not be surprising to observe an even higher increase in expenditures *vis à vis* revenues during periods of growth, as powerful groups vie to obtain a larger portion of the common fiscal pie. What stops this from happening in Argentina is the *de facto* hierarchical budget process combined with the increased power of presidents during expansions.

Our argument therefore is one that emphasizes the interaction of shocks and institutions<sup>15</sup> in explaining the evolution of public debt in Argentina. Economic shocks determine presidential power, providing discretionary fiscal resources and popularity in good times and taking them away during bad times. This allows the President to control the deficit bias during good times, but the perverse nature of fiscal institutions carries the day during recessions.

We flesh out this argument in the rest of the paper as follows. In Section 2 we present a brief history of public debt in Argentina since 1975, with special emphasis on the post-1983 democratic period, and document the regularity that periods of economic growth are accompanied by improved fiscal results, whereas periods of poor economic outcomes are accompanied by deteriorating fiscal conditions. In Section 3 we discuss the political and institutional environment in Argentina that influences fiscal policy. We describe the common pool problem caused by federal fiscal institutions that leads to a persistent deficit bias, the ineffectiveness of fiscal rules and the *de facto* hierarchical nature of the budget process. In Section 4 we relate the institutional arguments with

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<sup>14</sup> See Tornell and Lane (1999)

<sup>15</sup> See Blanchard and Wolfers (2000)

economic and fiscal outcomes, and show how the interaction of economic outcomes and political institutions leads to successive virtuous and vicious cycles in Argentina. Section 5 concludes.

## **2. A brief history of fiscal policy and debt in Argentina**

In the early 1970s, Argentina's debt to GDP ratio was below 10%. Thirty years later, the country declared the largest debt default in history. What happened in between? In this section we study the evolution of Argentine public debt since the mid 1970s, with special emphasis on the post-1983 democratic era. We argue that since the return of democracy, fiscal policy in Argentina has evolved in tandem with economic performance. In periods of robust growth, there have been improvements in fiscal policy outcomes. On the other hand, during periods of poor or unstable growth, fiscal outcomes have deteriorated.

The birth of Argentina's debt problems occurred during the 1976-1982 military dictatorship. In an international context characterized by the abundance of liquidity following the oil shocks, the government followed a policy of financial liberalization combined with a fixed exchange rate regime, which resulted in a strong real exchange rate appreciation, and a dramatic rise in both public and private sector external debt. Public sector debt reached a level of almost 40% of GDP<sup>16</sup>.

In 1982, following the Mexican default, Argentina became another victim of the international debt crisis, and also defaulted. The democratic government elected in 1983 started its mandate with a serious debt problem and an unfavorable international context. Table 1 divides the evolution of debt in Argentina since the return of democracy into four periods: 1983-1989 and 1995-2001 are generally unfavorable periods, in which external conditions were challenging for the country, growth performance was very poor and fiscal policy, debt and social conditions worsened. On the other hand, 1990-1994 and 2002-2005 were favorable periods with excellent external conditions, robust growth and improvements in fiscal policy, debt and social conditions.

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<sup>16</sup> See, for instance, Calvo (1986) and Rodriguez (1986) for a description of economic policy during the military dictatorship.

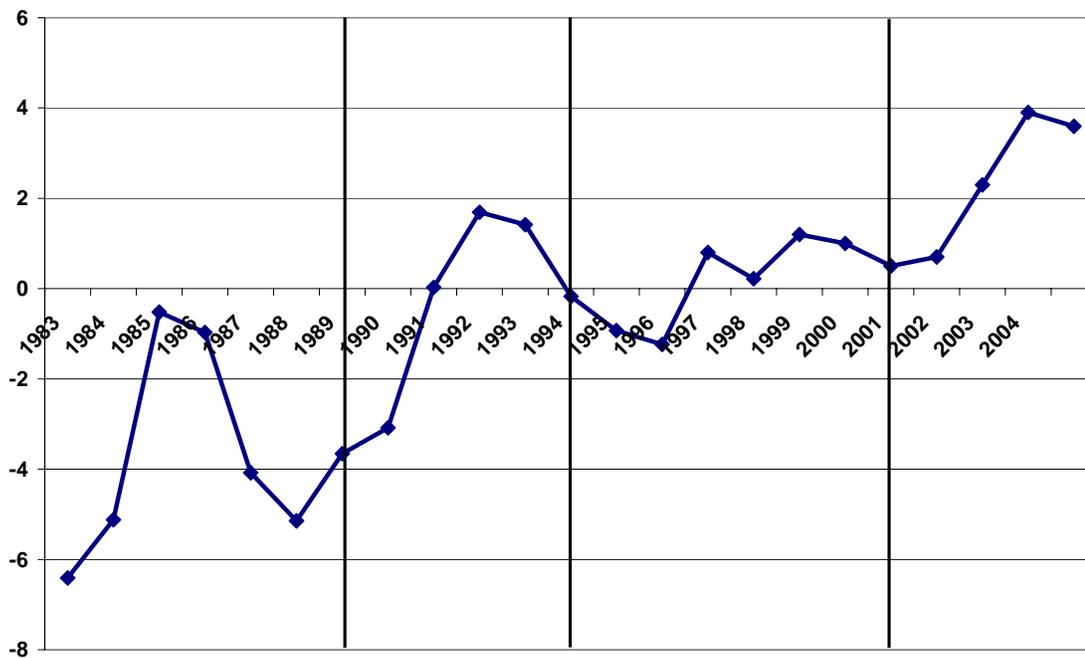
**Table 1: Four periods in recent Argentine economic history**

	1983-1989	1990-1994	1995-2001	2002-2005
<b>External conditions and growth performance</b>	Aftermath of the debt crisis: very limited access to credit  Annualized per capita GDP growth: -1.51%	Very favorable access to capital markets for emerging markets following the Brady plan  Annualized per capita GDP growth: 4.63%	- Volatility following the Mexican peso crisis, Asian crisis, Russian default. - worsened terms of trade  Annualized per capita GDP growth: -0.30%	Favorable conditions: low interest rates, high commodity prices (improved terms of trade)  Annualized per capita GDP growth: 2.57% (7.87% if 2002 is excluded)
<b>Macroeconomic policy and fiscal outcomes</b>	- Volatile monetary and exchange rate policy - financial repression - Large fiscal deficit, eventually hyperinflation	- Currency board - Financial and trade liberalization - Deregulation and privatization - Fiscal consolidation (including pension reform)	- reforms stall in the wake of Menem's second reelection bid - fiscal outcomes worsen due to higher interest rates and the cost of the pension reform	- Default, devaluation, banking crisis - Flexible exchange rate - Twin surpluses
<b>Change in debt</b>	Debt grows due to accumulation of arrears (unpaid interest), and due to fiscal deficits. Some debts are not accounted for (especially pensions)	- debt increases due to recognition of "skeletons in the closet", ie. Previously unaccounted debt, mainly with pensioners	Significant increase in debt. Main causes: - Transition cost of pension system reform - rise in country risk premium due to international volatility	Debt grows in 2002 and 2003 due to cost of resolving the banking crisis and provincial bailout, but falls significantly following the renegotiation in 2005.
<b>Change in poverty rate</b>	From 19,1% to 47,3%.	From 47.3% to 19%	From 19% to 35.4%	NA <sup>17</sup>

In Figure 2 and Figure 3 we show more detailed data for primary fiscal outcomes and debt as a percentage of GDP for the period under study. The vertical lines divide the four periods defined above.

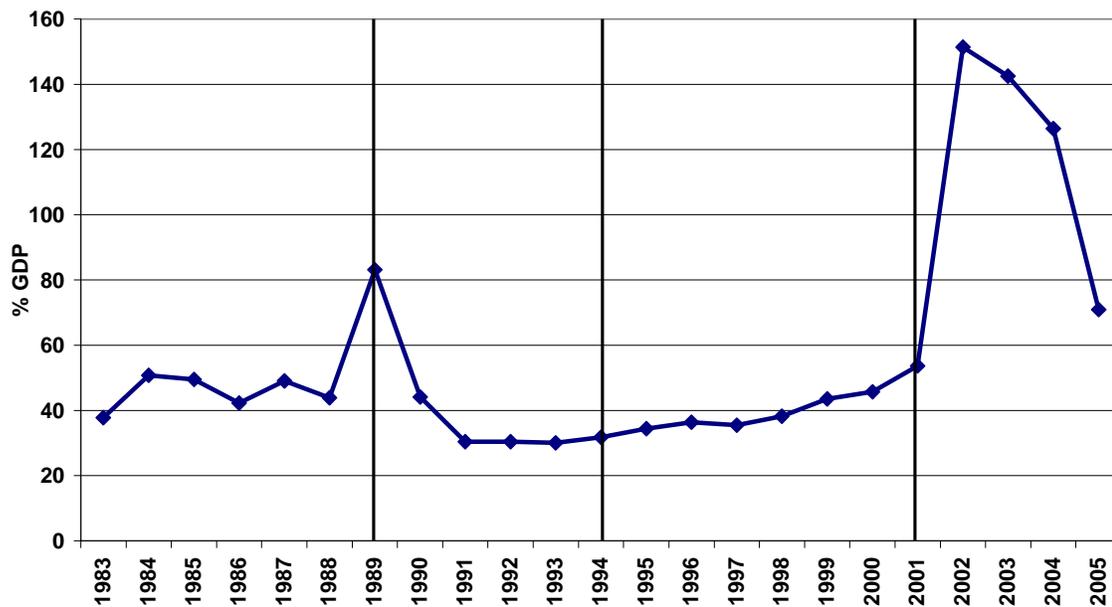
<sup>17</sup> INDEC, the Argentine statistical institute, changed its methodology in 2003. However, the poverty rate increased sharply to over 50% in 2002, and declined in the period 2003-2005 from 47.8% in the second semester of 2003 to 33.8% in the second semester of 2005.

**Figure 2: Primary fiscal result, Argentine general government, 1983-2005 (% of GDP)**



Source: MECON

**Figure 3: Argentine general government gross public debt, 1983-2005 (% of GDP)**



Source: MECON, Central Bank of Argentina, World Bank

During the period 1983-1989, fiscal outcomes were very negative, averaging a deficit of 3.7% of GDP. The debt grew from around \$40bn to almost \$65bn, mainly due to the accumulation of arrears and unpaid interest. Furthermore, the government accumulated unregistered debts with pensioners and other domestic creditors. According to a document commissioned by the Finance Ministry to study this issue, Melconian and Santangelo (1996), these unregistered debts amounted to \$25.7bn. If this amount is added to the registered debt, then the increase in debt in this period is from \$40bn to over \$90bn. Including unregistered debt, the debt to GDP ratio increased from 40% in 1983 to over 60% in 1988. The 1989 hyperinflation and devaluation caused a peak in the debt to GDP ratio of almost 120%.

Between 1990 and 1994, fiscal accounts improved significantly. A primary surplus was achieved in 1992 for the first time in at least 30 years, and the primary result averaged almost zero for the period. The nominal stock of debt increased from \$62bn to \$81bn. However, due to robust growth, the debt to GDP ratio fell from 44% in 1990 to 32% in 1994. It is important to note that if the unregistered debt is accounted for, then the nominal debt actually fell during this period, mainly as a result of the Brady plan.

Starting in 1993, fiscal statistics improved significantly in Argentina, thanks to the implementation of the Financial Administration Law (*Ley de Administración Financiera*). This allows us to carry out a more detailed debt decomposition, to understand the influence of different factors on the evolution of public debt. In particular, the decomposition, whose methodology is described in Budina et al (2005), allows us to distinguish between the impact of three types of effects on the debt to GDP ratio: a) automatic debt dynamics, due to changes in the real exchange rate, the real interest rate and real GDP growth, b) the contribution of the primary deficit or surplus, and c) other identified sources of change in debt, such as privatization receipts, debt renegotiations, debt consolidations due to off-budget government expenditures or resolution of financial crises.

As shown in Table 2 and in Figure 4, in 1993-1994 debt increased by 1.4% of GDP. This is explained by a 5.1 percentage point increase due to off-budget government expenditures (basically, the consolidation of debts described above), and a 1.3 percentage

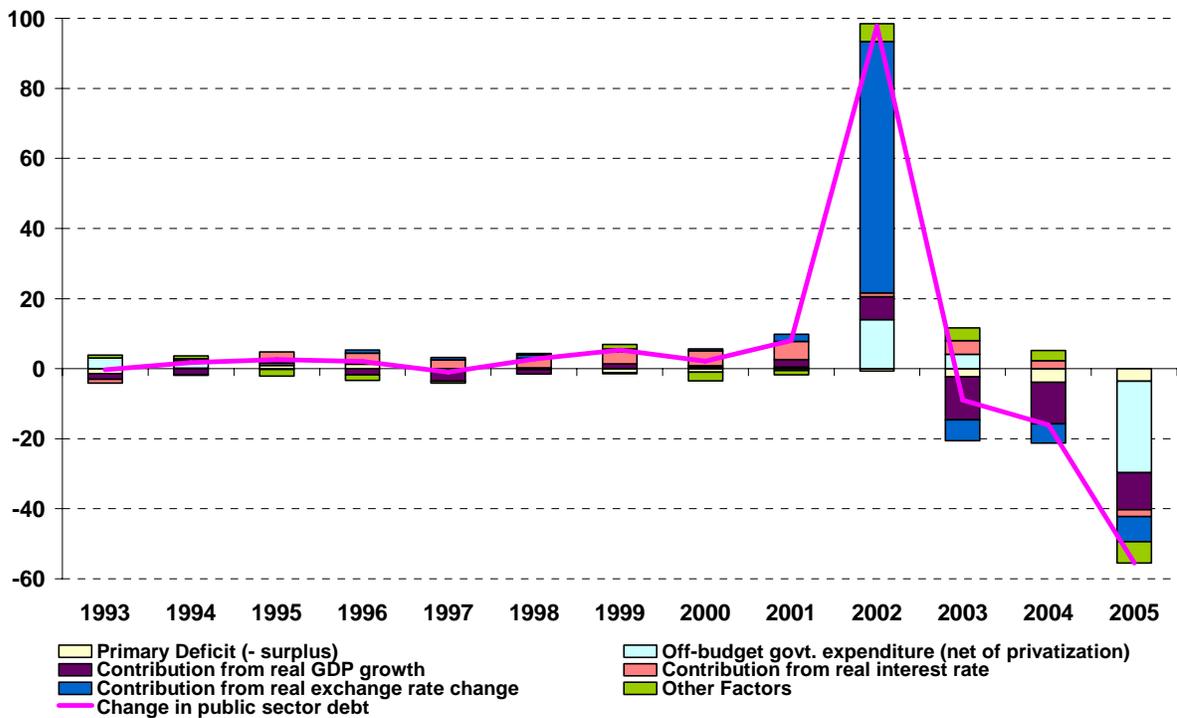
point reduction due to the primary surplus and a 3.3 percentage point reduction due to robust GDP growth.

**Table 2: Debt dynamics decomposition in Argentina, 1993-2005**

Public sector debt	1993-05	1993-94	1995-01	2002	2003-05
Change in public sector debt	40,5	1,4	21,9	97,7	-80,5
Primary Deficit (- surplus)	-13,3	-1,3	-1,6	-0,7	-9,8
Off-budget govt. expenditure (net of privatization)	-1,1	5,1	1,8	14,0	-22,0
Contribution from real GDP growth	-32,6	-3,3	-1,1	6,6	-34,7
Contribution from real interest rate	28,1	-0,5	23,2	1,1	4,3
Contribution from real exchange rate change	58,4	-0,2	5,8	71,7	-18,8
Other Factors	1,0	1,6	-6,2	5,1	0,5

Source: Prepared using the methodology in Budina et al (2005), with data from MECON and World Bank.

**Figure 4: Debt dynamics decomposition for Argentina, 1993-2005**



Source: Prepared using the methodology in Budina et al (2005), with data from MECON and World Bank.

In Table 2 we present the debt dynamics decomposition for our four periods since 1983, with the exception that we separate the year 2002, since as can be seen in Figure 3,

it is a strong outlier mainly due to the effect of the peso devaluation on the debt / GDP ratio.

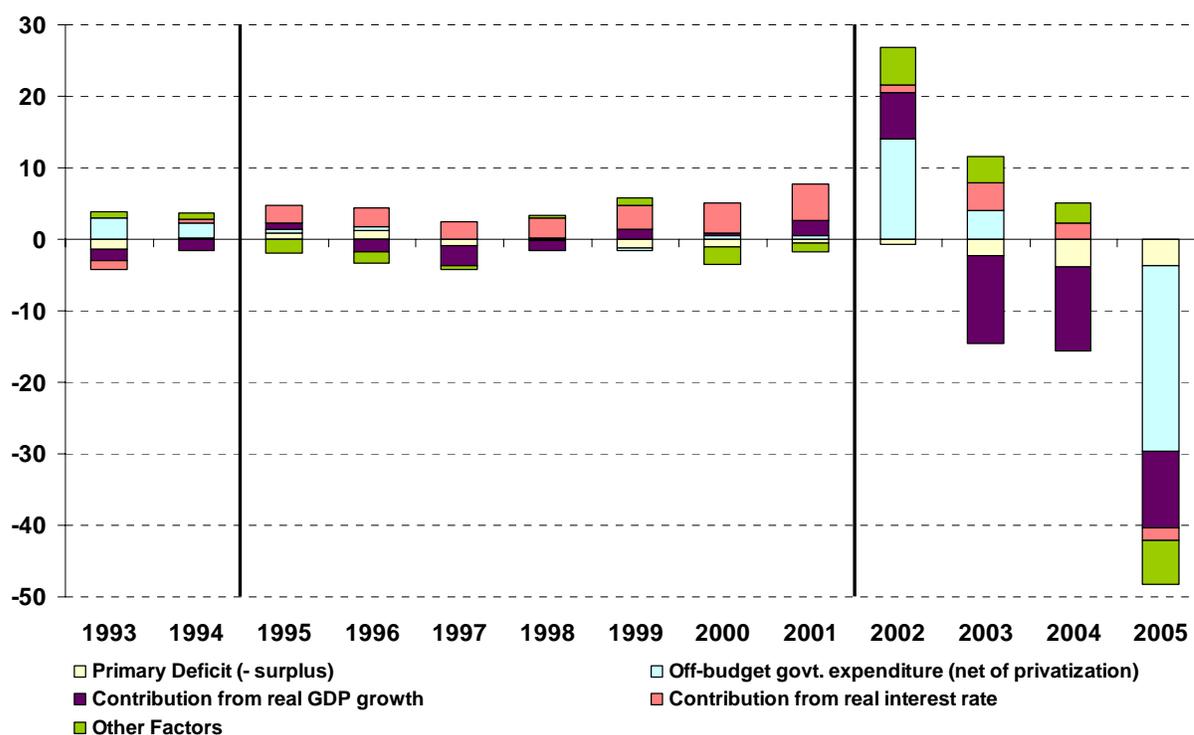
Between 1995 and 2001, the second period of poor fiscal performance, and the period just prior to the 2002 debt default, the primary result first worsened in 1995-1996, but then improved, and was on average a surplus of 0.22% of GDP. However, the debt increased from \$80bn in 1994 to \$144bn in 2001. The debt to GDP ratio increased from 32% in 1994 to 54% in 2001. The decomposition exercise sheds light on the sources of the growth in debt during this period, despite the slight improvement in the primary result. Basically, most of the action is in the contribution of the real interest rate. During this period, the Brady bonds that Argentina had issued in exchange for its bank debts in 1992, and the bonds issued in the early 90s to cancel the unregistered debts of the 1980s had to be rolled over at increasing interest rates. Interest rates of course increased due to the volatility in emerging markets. The Mexican crisis of 1994-95 was followed by the Asian crisis in 1997, the Russian crisis and the devaluation of the Brazilian Real. Markets believed that Argentina's fixed exchange rate was increasingly vulnerable, and thus the risk premium on Argentine bonds increased.

The contribution of interest rates to the change in debt during this period can also be seen clearly in Figure 5, where the effect of the real exchange rate depreciation is omitted so as to clarify exposition. Here we can also see the impact of the recession in 1999-2001, just before the crisis<sup>18</sup>.

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<sup>18</sup> Some commentators – see especially Mussa (2002) – blame fiscal profligacy, particularly in the provinces, for the 2001-2002 crisis. However, Guidotti (2006) argues that precisely in this period, Argentina suffered the short-term transition cost of the pension reform, which arguably can be considered a positive fiscal innovation, to the extent that it eliminates the contingent liability of a future unfunded pension system due to population ageing. He calculates that 48% of the change in debt between 1993 and 2000 can be explained by the deficits generated by the pension reform and its refinancing.

**Figure 5: Debt dynamics decomposition (excluding real exchange rate effect), 1993-2005**



Source: Prepared using the methodology in Budina et al (2005), with data from MECON and World Bank.

Note: The contribution of the real exchange rate effect is excluded. Therefore, the columns do not represent the total change in debt / GDP as in Figure 4.

During the final period, 2002-2005, fiscal results improved dramatically. The fiscal surplus averaged 2.63% of GDP, and reached an unprecedented 3.9% of GDP in 2004. The debt to GDP ratio rose in 2002 basically due to the depreciation of the peso. Of the 97.7 percentage point increase, 71.7 points are explained by the depreciation. If we look at the changes due to other factors, as shown in Figure 5, we observe that in 2002 and 2003, off-budget government expenditure was a significant contributor to the change in debt. In this case, the main culprits are basically two: the resolution of the financial crisis, which cost \$14.4bn, and the bailout of provincial debts, which cost \$12.1bn<sup>19</sup>. Between 2003 and 2005, the annual growth rates of GDP at 9% contributed to a decline in the debt to GDP ratio of 35 percentage points. Furthermore, the 2005 debt restructuring, explained

<sup>19</sup> see Damill, Frenkel and Rapetti (2005) for details.

in more detail in Box 1, implied a reduction of 26 percentage points in the debt to GDP ratio<sup>20</sup>.

**Box 1: The 2005 debt restructuring**

The operation involved 152 different bonds denominated in 6 different currencies and subject to 8 different legislations. The eligible amount of debt to be restructured was \$81,836 million (\$102,566 if past-due interests are included) held by private bondholders around the world. The new debt would be considered as issued on 12/31/2003. In exchange for the old papers in default the Argentine government offered three new bonds<sup>21</sup>:

(i) the Par Bond: has a zero reduction in nominal value; has a maturity of 33 years; has coupon payments with an increasing interest rate (1.33 % during the first 5 years and then it increases until it reaches 5.25 % in the 17th year)

(ii) the Discount Bond: has a 66.3 % reduction in nominal value; has a maturity of 30 years; has coupon payments with an 8.28 % interest rate

(iii) the Quasi-Par Bond: has a 30.1% reduction in nominal value; has a maturity of 42 years; has coupon payments with a 3.31 % interest rate, but these payments capitalize during the first 10 years; furthermore, capital is indexed by CER (similar to inflation).

According to the offer, the bondholders that accepted would obtain: (a) a cash payment for the interests accumulated since the issue date of the new bonds<sup>22</sup>, (b) the chosen new bond, and (c) units linked to GDP growth. These units allow for additional compensation for bondholders in years in which GDP exceeds a certain reference level (extracted from a projected path made by the government).

The results of the operation were as follows. Out of the \$81,836 million of defaulted debt that was eligible for the restructuring, a total of \$62,318 million were presented to the deal, which implies a 76.15 % level of acceptance. After the swap these \$62,318 million were reduced to \$35,261 million. Since the debt not presented to the

<sup>20</sup> This calculation does not consider the “holdouts”, or bondholders who did not enter the renegotiation, as part of the stock of debt.

<sup>21</sup> In the offer there was a maximum amount of new debt to be issued that was equal to \$38.5bn (or \$41.8bn), depending on whether the level of acceptance was less than or greater than 70 %.

restructuring might remain unpaid indefinitely, and was therefore given a value of zero, in terms of principal the deal represented a nominal reduction of 56.9 %. In terms of principal plus past-due interests there was a 65.6% nominal reduction

The change in the composition of the public debt by type of creditor/instrument is summarized in Table 3. Note that the restructuring implied mainly a change in the structure of the Bonds category.

**Table 3: Changes in the composition of public debt, 2004-2005**

	DECEMBER 2004	MARCH 2005
<b>GROSS PUBLIC DEBT</b>	<b>191,296 [100%]</b>	<b>126,567 (100%)</b>
INTERNATIONAL ORGANIZATIONS	16%	22.9%
BILATERAL	3.6%	5.32%
GUARANTEED LOANS	7.66%	12.06%
PROVINCIAL GUARANTEED BOND	5.34%	8.46%
BONDS	64.5 %	46.79%
- BODENES	9.33%	15.31%
- PAR, DISCOUNT, QUASI-PAR (restructured)	0%	29.76%
- BONDS ELEGIBLE FOR RESTRUCTURING	53.6%	0
- OTHERS	1.53%	1.72%
OTHERS	2.94%	4.47%

Source: MECON

### 3. The political economy of fiscal policy and debt in Argentina

We have shown that fiscal policy improved in Argentina in periods with positive economic outcomes and viceversa. In this section we argue that this pattern is driven in part by the interaction of economic outcomes and underlying political institutions. We show first that Argentina has a serious common pool problem caused by the nature of its federal fiscal institutions that in turn generates a deficit bias. Then we argue that numerical fiscal rules, a natural solution to deficit bias problems, do not work in Argentina due to lack of enforceability. We attribute this lack of enforceability to the structure of underlying political institutions. Finally, we show that the federal budget

<sup>22</sup> This is only for Par and Discount Bonds.

process is *de facto* very hierarchical, meaning that the Executive has ample powers to allocate any available discretionary funds.

This institutional setup – common pool problems, lack of enforceability of fiscal rules, and a *de facto* hierarchical budget process – leads to cycles in fiscal policy outcomes caused by economic cycles. When the economy grows, more discretionary funds are available, and the president gains popularity. This increases the likelihood that the president can impose his political agenda on Congress. The opposite occurs during economic downturns.

Since the Executive is more likely to prioritize fiscal solvency as a policy objective than other political actors<sup>23</sup> – macroeconomic crises are blamed on presidents, not on legislators and governors – we should expect to observe better fiscal outcomes when the president is relatively more powerful, i.e. during economic upturns.

Before proceeding with the exposition, it is first necessary to deal with an observation that most economists would make at this stage: it is not surprising that fiscal outcomes improve during good times and worsen during bad times. After all, both Keynesian macroeconomic policy prescriptions and tax-smoothing models á la Barro (1979) promote countercyclical fiscal policy.

There are both empirical and theoretical reasons to doubt a priori that a country like Argentina would have countercyclical fiscal outcomes. The first is that a growing literature has found a positive correlation between government consumption and output in developing countries, i.e. there is evidence that government consumption is procyclical in developing countries in general, and in Latin America in particular<sup>24</sup>. If government spending is procyclical, then even if tax revenues automatically increase during good times, spending might increase even more, worsening fiscal outcomes in good times. Tornell and Lane (1999) argue that an equilibrium in a game with multiple powerful groups with access to a common pool of fiscal resources is for each group to increase its spending following a positive shock, so as to avoid losing its share of the fiscal pie. Since, as we shall show below, Argentina is characterized by a severe common pool problem and institutions are weak, it would not be unreasonable to observe declining

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<sup>23</sup> See Alesina and Perotti (1996)

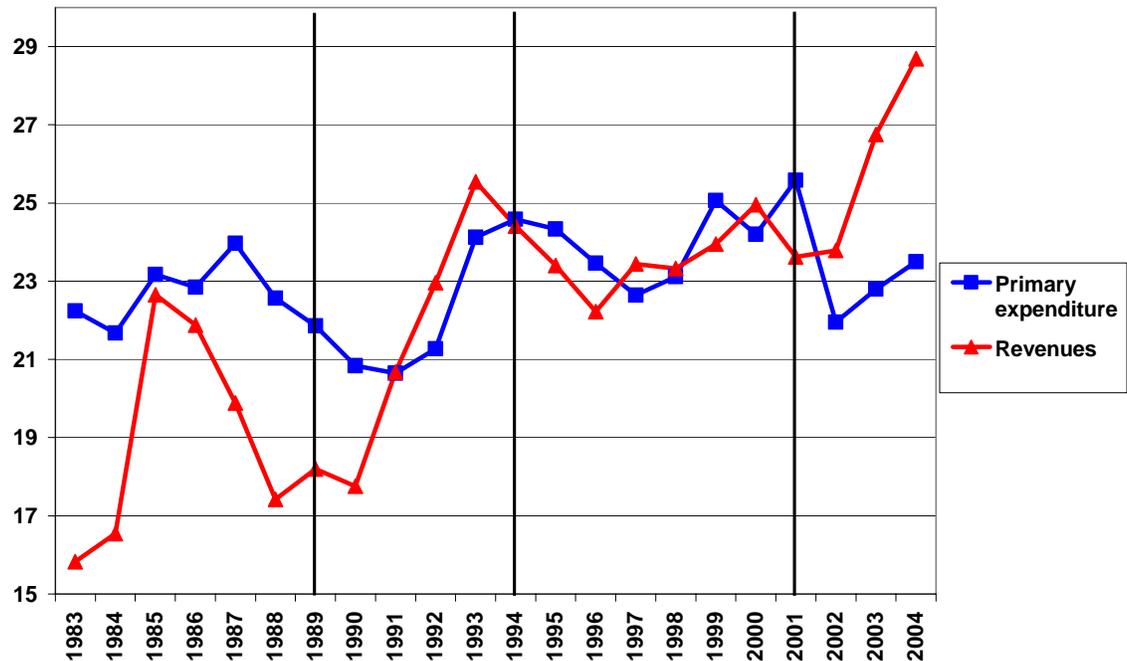
<sup>24</sup> See, for example, Gavin and Perotti (1997) and Talvi and Vegh (2000).

fiscal surpluses during good times and the opposite during bad times. We argue that what avoids this pattern in Argentina, especially during good times, is the combination of a hierarchical budget process and a powerful president – that precisely gains political power during good times.

We also present some suggestive evidence in Figure 6 below. In the two expansive periods, 1990-1994 and 2002-2005, expenditures grow as a percentage of GDP, consistent with the procyclicality hypothesis. However, they grow less than the growth of revenues, meaning that fiscal outcomes improve in good times. This is consistent with our hypothesis that the Executive uses discretionary resources to bargain for his agenda, and that improving fiscal outcomes is part of that agenda.

During bad times, we see that in 1983-1989 there was first an attempt at fiscal consolidation in 1985 (the Austral stabilization plan), but then revenues decline much faster than spending, increasing the fiscal gap. In 1995-2001, revenues first decline faster and then grow slower than spending, once again worsening fiscal outcomes. This is also consistent with our hypothesis that the Executive loses political power, and therefore the ability to impose fiscal discipline, during downturns.

**Figure 6: Primary revenues and expenditures in Argentina, general government, 1983-2004 (% of GDP)**



Source: MECON

Having dealt with this issue, let us return to the building blocks of our argument, and show that Argentina suffers from a common pool problem created by its federal fiscal institutions, that numerical fiscal rules cannot solve this problem, and that the budget process is *de facto* very hierarchical.

### ***3.1 Fiscal Federalism and the common pool problem<sup>25</sup>***

The recent political economy literature identifies common pool problems as one of the key causes of fiscal solvency problems. A classic reference is the paper by Weingast, Shepsle and Johnsen (1981), in which they show how public expenditures can increase due to the common pool problem inherent in the political interaction between regions represented in Congress. Individual congressmen have an incentive to propose spending increases that accrue to their region, because resources are collected from the

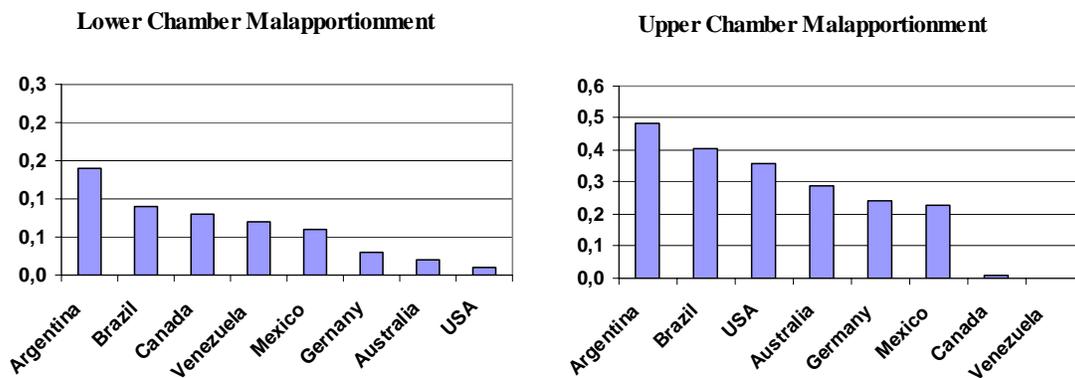
<sup>25</sup> This section draws heavily from Ardanaz (2006), Sanguinetti, Saiegh and Tommasi (2001) and Tommasi (2006).

entire country, and thus the net marginal benefit of an extra dollar of local spending is positive (for that region of course). In a more recent example, Velasco (1999) presents a dynamic game in which different ministers compete to obtain funding from a common pool of resources. He shows that the Nash-Markov equilibrium of the game is that there is persistent overspending, and government assets decline over time.

Federal countries have the common pool problem embedded in their institutional frameworks, since Congressional representatives tend to be elected by province, instead of in a unique national district. Congress determines taxes and approves the budget, and as in the papers cited above, individual congressmen have incentives to lobby for spending directed at their region.

Argentina is arguably one of the federal countries with the most serious common pool problem. First, according to Samuels and Snyder (2001), Argentina is the country with the largest upper chamber malapportionment - the degree to which there is inequality in the number of votes per representative across regions - in the world, and offers a comparatively high degree of lower chamber overrepresentation as well. In Figure 7 below we compare malapportionment across selected federal countries.

**Figure 7: Legislative malapportionment in selected federal countries**



Source: Samuels and Snyder (2001)

This unequal distribution of political power across regions is not random in Argentina. In fact, relatively poor and small provinces are significantly overrepresented in Congress. Argentine federalism is characterized by large regional disparities (Porto

2004). Provinces vary greatly in their size and wealth. In Table 4 below we document population and GDP figures in the 24 Argentine provinces for the year 2002. The four largest provinces, Buenos Aires, Santa Fe, Cordoba and the City of Buenos Aires, account for 63% of the population and 72% of GDP. Furthermore, GDP per capita is on average 76% larger than in the rest of the provinces. However, this concentration of wealth and population contrasts with the distribution of political power in Congress. The four largest districts control barely 17% of the senate and 51% of the lower chamber seats. Thus, a minority of the population and economic output in Argentina has a disproportionate level of political power. Provincial governors from small, poorer provinces use this political power to extract resources from the national common pool of fiscal revenues.

Table 4: Selected Economic and Political Indicators in Argentine provinces (2002)

Province	% Population	% GDP	GDP per capita (pesos)	Number of Senators	Number of Deputies
Buenos Aires	38,1	32,7	6189	3	70
Capital Federal	7,7	22,7	23980	3	25
Cordoba	8,5	8,1	6713	3	18
Santa Fe	8,3	8,1	6537	3	19
<b>Subtotal large provinces</b>	<b>62,6</b>	<b>71,6</b>	<b>10855</b>	<b>16,7</b>	<b>51,4</b>
Mendoza	4,4	3,9	6044	3	10
Tucuman	3,7	1,8	3756	3	9
Entre Rios	3,2	2,1	5014	3	9
Salta	3	1,6	3504	3	7
Misiones	2,7	1,2	3641	3	7
Chaco	2,7	1,2	3279	3	7
Corrientes	2,6	1,2	3115	3	7
Santiago del Estero	2,2	0,9	2866	3	7
Rio Negro	1,5	1,4	6890	3	5
Jujuy	1,7	0,8	3572	3	6
San Juan	1,7	0,8	4040	3	6
Neuquen	1,3	2,9	10548	3	5
Formosa	1,3	0,5	2814	3	5
Chubut	1,1	2,1	8495	3	5
San Luis	1	1	8274	3	5
Catamarca	0,9	1,1	4674	3	5
La Pampa	0,8	1	7416	3	5
La Rioja	0,8	0,5	4623	3	5
Santa Cruz	0,5	1,8	12032	3	5
Tierra del Fuego	0,3	0,7	17158	3	5
<b>Subtotal rest</b>	<b>37,4</b>	<b>28,5</b>	<b>6088</b>	<b>83,3</b>	<b>48,6</b>

Source: CEPAL, INDEC and Argentine Constitution

This common pool problem is enhanced by another combination of characteristics of federal fiscal institutions in Argentina. First, there is a high degree of vertical fiscal imbalance. Subnational governments are responsible for almost 50% of consolidated public spending, but collect only 20% of consolidated revenue. This means that most provinces are highly dependent on transfers from the federal government to cover their expenditures. This implies that it is often easier to improve revenues by bargaining with the federal government in exchange for votes in Congress than to increase provincial tax revenues, which is politically costly. In fact, Argentina is one of the federal countries with the most serious vertical fiscal imbalance (see Ardanaz (2006)).

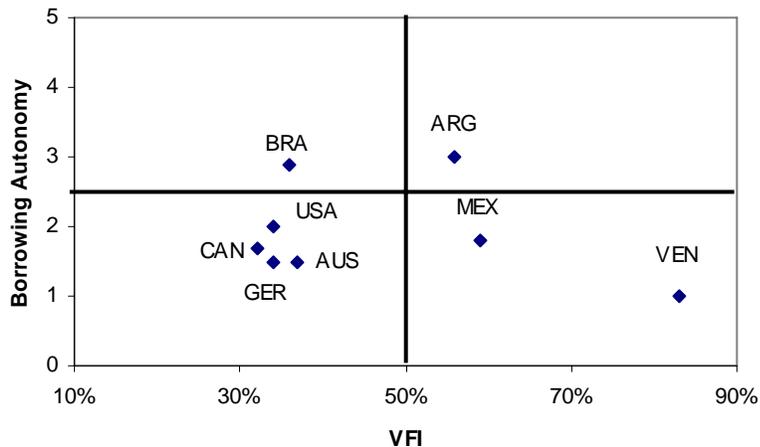
The second characteristic is that subnational governments find it very easy to borrow. In fact, an IDB study found that Argentina had the highest level of sub-national borrowing autonomy in a sample of Latin American countries (IDB 1997). In the 80s and 90s, provinces used state-run provincial banks as sources of funding. Following the Tequila crisis, many provincial banks were privatized. However, provinces continued to borrow from the domestic financial system and from abroad, in many cases using future transfers from the federal government as collateral. Towards the end of the 1990s, many provinces had compromised well over 60% of their coparticipation<sup>26</sup> shares as guarantees (Kopits, Jimenez and Manoel 2000). Some provinces have constitutional limits on the level of debt but these limits are often not binding. As a result, provincial borrowing increased unchecked during the 90s.

The combination of these two factors, a high vertical fiscal imbalance and the ease of subnational borrowing, place Argentina as one of the federal countries with most serious problems of soft budget constraints, according to Rodden (2004). In Figure 8 we show that Argentina is the only federal country that combines a high level of both variables, implying that the budget constraints of subnational governments are particularly soft.

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<sup>26</sup> Coparticipation is the name of the federal transfer scheme that distributes federal government tax collection automatically to provinces.

**Figure 8: Vertical fiscal imbalance and borrowing autonomy in selected federal countries**



Source: IDB (1997) and Rodden (2004)

Note: The degree of vertical fiscal imbalance (VFI) is represented on the horizontal axis, and is the difference between the share of subnational spending and revenues in consolidated spending and revenues. Borrowing autonomy is an index constructed by comparing whether subnational governments need authorization from the federal government to incur in debt, whether there are quantitative restrictions on borrowing or limits on the possible uses of debt, and finally whether subnational governments own banks and other enterprises.

Malapportionment, regional inequality, overrepresentation of small, poor regions and soft budget constraints then are the elements that back up our original claim: Argentina has a serious common pool problem due to its federal fiscal institutions, and arguably one of the most serious in the world.

### 3.2 Fiscal rules<sup>27</sup>

Several authors have argued that numerical fiscal rules can help to solve a deficit bias. Kopits (2001) for instance argues that numerical fiscal rules can impose spending limits that constrain decisionmakers within a moderate deficit. However, a key assumption in this literature is that rules are enforceable. In a context of weak institutions such as the Argentine case, this is not a priori evident.

<sup>27</sup> This section draws heavily from Braun and Tommasi (2004) and Braun and Gadano (2006).

In fact, it is often difficult to find convincing empirical evidence on the effect of fiscal rules on fiscal policy outcomes. Braun and Tommasi (2004) argue that changes in fiscal rules are not common at the national level, and when they occur, they are often accompanied by other reforms (financial liberalization, privatization, etc) that affect fiscal outcomes. This limits the explanatory potential of within-country time-series regressions and of cross-country regressions, because a study that finds a correlation between fiscal rules and prudent fiscal outcomes without controlling for other reforms would be biased. A related limitation on studies on the effectiveness of budget institutions is given by the question of origin of rules. If these rules reflect voters' preference for fiscal rules, and at the same time, voters desire fiscal austerity, then any study finding a correlation between rules and outcomes would be omitting the underlying cause of both phenomena – voter preferences – and would therefore be biased. The academic literature on the effectiveness of fiscal rules has attempted to deal with these complex identification issues, but the results are as yet inconclusive.

In the Argentine case, fiscal rules have not provided an adequate solution to the deficit bias problem. Argentina has experimented in recent years with fiscal rules, following the approval of two fiscal responsibility laws (FRL) in 1999 and 2004.

Faced with a deteriorating budget balance and growing debt payments, the Argentine Congress approved a Fiscal Solvency Law in September 1999. This law aimed at achieving budget balance at the national level of government by 2003. Apart from establishing numeric limits for the central government's fiscal deficit, it also limited the growth of expenditures. Furthermore, the law stipulated the adoption of multiyear budgeting, the creation of a Countercyclical Fiscal Fund, and the implementation of transparency measures to increase the availability of information regarding the state of public finances. Although the law did not include conditions for subnational governments, it invited the provinces to pass similar laws at the subnational level.

Regarding the limits on budget deficits, the Law established that fiscal balance had to be reached no later than 2003, and it set nominal ceilings for the non-financial public sector deficit between 1999 and 2002. The Fiscal Solvency Law was modified by the 2001 Budgetary Law, which relaxed the deficit ceilings, and extended the date at which budget balance should be achieved until 2005. Contrary to the optimism expressed

by some analysts of the Argentine case, the rule was broken in the first three years of its application (1999-2002).

At the sub-national level, several governments followed the national example and passed fiscal solvency rules. These rules differ across provinces in some of their characteristics, as well as in the degree to which they have been adhered to. These rules include several of the properties favored by the recent literature on fiscal institutions, such as clear limits on government debt and requirements regarding the timely and accurate publication of fiscal information. However, Braun and Tommasi (2004) show that compliance with these laws in terms of debt and deficit performance has been uneven. For example, only 5 out of 11 provinces that imposed a hard budget constraint actually fulfilled their commitment in 2000. Out of the five that complied with the law, two of these, Córdoba and Tucumán, had been achieving the objective stated in the law for several years, so the law appears more like a reflection of pre-existing underlying political agreements. With respect to limits on expenditure, three out of eight provinces that imposed limits did not comply with them in the year 2000. In 2001, none of the provinces complied with FRLs. However, with the economy recovering in 2003-2004, provincial governments are having a much easier time fulfilling them.

The tradition of not respecting rules goes beyond these recent cases. Several provincial constitutions contain limits on public debt. In fact, 16 of 24 provinces have constitutional limits regarding the ratio between debt service (principal and interest) and total revenue. These limits vary between 20% and 25% of the total revenue. However, during most of the 90s and early 2000s, several provincial governments have not respected these limits (Sanguinetti 2002). For example, only 10 of the 16 provinces complied with those limits in 2000, with results for 2001 being of course much worse due to the crisis (Braun and Tommasi 2004).

In 2001, the FRLs stopped working because of the extreme mismatch between the national government's fiscal and monetary policies in the context of a fixed exchange rate. Although the federal government's FRL lacked enforcement power, the more fundamental problem was the government's many legally inflexible spending obligations, most notably debt service and provincial transfers. Federal-provincial agreements in 2000 had set nominal peso floors on transfers to the provinces that would last several years

during a transition to a long-term arrangement of moving-average calculations that were more favorable to the federal government. Unfortunately the recessions of 2001 and thereafter reduced revenues to the point that the federal government could not make the promised transfers and defaulted on those and other obligations, paying them with debt that circulated as money (Gonzalez, Rosenblatt and Webb 2003). Even with stronger enforcement procedures on paper, the FRL could not have solved the problem (Webb 2004).

#### *The FRL of 2004*

During and after the 2001 crisis, scant public attention was given to the almost zero degree of fulfilment of the 1999 FRL. Even though it remained in force, several of its prescriptions (such as the integration of a Countercyclical Fiscal Fund) were temporarily suspended by successive annual budgetary laws. Yet, fiscal rules regained the spotlight during 2004 when Congress approved a new FRL.

The new law included several measures already treated in the previous FRL, such as fiscal transparency, and the adoption of pluriannual budgeting. The most important elements were the numerical limits set on the growth of expenditures and measures regarding subnational borrowing. The Law tied the expansion of primary expenditures to GDP growth and prescribed fiscal balance at both national and subnational levels, after excluding certain types of expenditures.<sup>28</sup> With respect to provincial borrowing, the ratio between debt service and total revenue was limited to 15 % of current revenues (net of transfers to municipalities). Additionally, a new institution was created, the Federal Council of Fiscal Responsibility (*Consejo Federal de Responsabilidad Fiscal*), charged with the application and monitoring of the FRL. The Council includes representatives (e.g. finance ministers) from each of the adhering provinces and the federal government, and has the power to enforce sanctions on deviations from the Law. These sanctions vary from the publication of deviations to limits on federal government budgetary transfers to the provinces (excluding *Coparticipation*). Finally, in an attempt to institutionalize the transitory provincial financing agreements of 2002/2003, the federal government was empowered to initiate financing programs (known as *Programas de Asistencia*

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<sup>28</sup> Such as expenditures financed by international organizations, and expenditure in basic social infrastructure.

*Financiera*) with those provinces adhering to the law. As of this writing, 21 out of 24 provincial legislatures have already adhered to the new FRL.

Even though it is still too early to evaluate the performance of the new FRL, preliminary outcomes are not very encouraging. For example, in the first fiscal year of the law's application (2005), primary expenditures grew at a faster rate than GDP. Overall, fiscal rules in Argentina seem not to constrain national and provincial fiscal behavior.

### **3.3 Federal budget institutions<sup>29</sup>**

Alesina and Perotti (1996) argue that another solution to the deficit bias problem is to reform procedural budget rules to make them more hierarchical, in the sense of giving more decision power to the Finance Minister vis a vis spending ministers, and to the Executive vis a vis the Legislative. The argument is that if actors who incorporate the aggregate government budget constraint have more power over fiscal policy decisions than those who do not (provincial governors, spending ministers, etc), then fiscal policy will be more prudent. Alesina et al (1999) and Filc and Scartascini (2004) find that Latin American countries that have more hierarchical budget institutions tend to have better fiscal policy results. In the index of hierarchical budget procedures constructed by Filc and Scartascini (2004), Argentina ranks sixth in a group of 11 Latin American countries, and is above the average for a sample of 43 countries.

In this subsection we describe the federal budget process in Argentina, and argue that above and beyond its formal degree of hierarchy, it is *de facto* very hierarchical. This would imply that we might expect fiscal outcomes to be in general good. However, an important caveat is in order: the federal budget process accounts for only a fraction of overall public resources. Argentina is a federal country, with a highly decentralized allocation of spending responsibilities. The result is that of the total public resources spent in Argentina by the Federal Government the provinces and the municipalities, the federal budget process only accounts for 48%. Therefore, to turn this power over the federal budget process into fiscal discipline, the Executive needs to bargain with subnational governments.

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<sup>29</sup> This section draws heavily from Abuelafia et al (2005).

### *The formal budget process*

The budgetary process contains four key stages. The first stage is the formulation of the Executive power's budget proposal, the second is the discussion and approval of the proposed budget in Congress, the third is its execution (implementation) and finally, the subsequent congressional audit of this execution. The budget process is formally guided by the *Ley de Administracion Financiera*, approved in 1992. The main actors contemplated by these rules are the Executive branch – especially the President, the Chief of Cabinet and the Ministry of Economy - and Congress. Let us now analyze their formal roles in the different stages of the process.

*Formulation.* At this stage, the Ministry of Economy sets the budget priorities and defines the investment programs, prepares macroeconomic forecasts, and provides support in the definition of expenditure ceiling setting. The National Budget Office, the ruling authority of the process, evaluates the preliminary budget proposals prepared by the agencies and puts together the aggregate proposal. The Executive then decides the aggregate budgetary policy and distributes the expenditure ceilings among the agencies. Congress only receives information about the general guidelines of the budget proposal.

*Approval.* The Executive submits the proposal to Congress and replies to enquiries formulated by Budget Committees of both chambers. Congress is empowered to approve or reject the budget proposal, to introduce modifications and to remove articles. After Congress approves the budget, the Executive can introduce line item vetoes to the budget. If the Executive uses its veto power, Congress can overrule the vetoes with a 2/3 majority.

*Execution.* The Executive distributes the expenditure authorizations among agencies, and introduces modifications to the project. It cannot introduce modifications that alter the total expenditure and the debt level. The agencies' heads distribute the quotas among the programs and they are responsible of keeping a record of the physical execution. The Chief of Cabinet is responsible for providing information regarding budget execution to Congress. At this stage, Congress is the only institution that can modify total expenditure, the debt level and the purpose and objective of expenditures.

*Control.* The Executive coordinates the internal auditing activities and procedures, and the internal auditing units (that depend on the line ministries) perform the internal

audits. Congress, through the National Audit Office (*Auditoría General de la Nación*) performs ex-post controls regarding budget implementation. Additionally, it has to evaluate and approve the *Cuenta de Inversión* (the annual budget execution report prepared by the Executive).

***Incentives and practices: the actual workings of the budget process***

In practice, the Executive has significantly more power *vis à vis* Congress in the allocation of public resources relative to the letter of the law. Below we discuss some actual practices throughout the budget process that reflect this.

*Formulation.* As noted above, the formulation stage of the budget is conducted within the Executive. This stage includes the development of macroeconomic and revenue forecasts. These are theoretically designed to act as a limit on spending, and to contribute to fiscal sustainability. In practice, however, there has been a systematic strategic use of macroeconomic forecasts. The strategic underestimation and over estimation of revenue forecasts on behalf of the Executive has important implications for the role of Congress at the subsequent stage. At the approval stage, Congress receives a budget proposal with income and spending levels quite different from the real levels that will be later on executed by the Executive. During the 1990s, tax revenues were systematically overestimated, to ease the approval of the budget in Congress, and to send optimistic signals regarding growth to the market. When actual revenues were below estimates, adjustments were made either via underexecution of discretionary budget items or via increases in public debt. Following the 2001 crisis, the Executive has tended to underestimate tax revenues, leaving it with discretionary funds to allocate throughout the year.

*Approval.* Regarding Congress' role in approving the budget, Abuelafia et.al. (2005) analyze the relative magnitude of changes in spending composition introduced by Congress. They find a rather limited role in all but the exceptional years of 1997 and 2002.

*Execution.* Theoretically, at this stage the Executive should simply implement the budget approved by Congress. If any significant change has to be made to the size or allocation of the budget, Congress should approve it. However, the Executive has clearly

exerted its political power at this stage, and increasingly put Congress in the back seat of the budget process.

There are three main ways in which the Executive changes the budget at this stage. The first is by the proactive use of presidential powers. The most common recent practice has been changing the approved budget by issuing decrees (*Decretos de Necesidad y Urgencia*). In this case the Executive uses – or rather, abuses - the power granted by budget institutions to increase the total amount of the budget in case of an emergency. In theory, these decrees are subject to Congressional revision. Whenever the Executive promulgates this kind of decree it has to submit them, jointly with a justification, to Congress. A bi-cameral committee is empowered to overrule these decrees. However, in practice the committee has not been constituted yet and therefore the Executive can modify the budget unchecked<sup>30</sup>.

The second way in which the Executive changes the budget allocation is by the discretionary administration of the quota system. In theory, the quota system is the administrative tool by which the budget is implemented. In practice, it was used in years of overestimation of resources as a *de facto* way for the Executive to decide on budget allocations. By choosing which agencies and ministries received their full quota and which received less, the Executive could decide the actual allocation of the budget. This allocation often differed substantially from the allocation approved by Congress.

Finally, the Executive changes the budget thanks to congressional delegation. The rules governing the budget process establish that Congress is the only branch of government entitled to modify total expenditures and the total authorized debt level. Additionally, only Congress can modify the economic classification of expenditures and its objectives and functions. In practice, these restrictions were almost never fulfilled. Congress (in the budget law or in a particular law) authorized the Executive to modify the budget. In 2000, 2001 and 2004 the authorizations were conceded in the Budget Law. In 1998, 1999, 2002 and 2003 the authorizations were established by decrees. In 2002 and 2003, the decrees were based on the Economic Emergency Law. Finally, in July 2006

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<sup>30</sup> At this writing, Congress is discussing the regulation of decrees, but the proposals being discussed do not significantly limit the Executive's power.

Congress reformed the *Ley de Administración Financiera* and gave the Executive permanent power to change budget allocations during the implementation phase.

In summary, Congress clearly has a weak role during the implementation stage as well. The modifications introduced by Congress are almost minimal. It delegates (in the budget law itself in some cases) or the Executive entitled itself the powers that budgetary rules stipulate for Congress to modify the budget law.

*Control.* As shown by Berensztein, Lerena and Peña (2000), oversight by congressional audit and control institutions is also weak. The *Auditoria General de la Nación* (AGN) is the public entity subordinated to Congress charged by budgetary rules with oversight and control responsibilities in the budget process. One of the main problems affecting the way control mechanisms work relates to their being highly politicized; that is, they are subject to political manipulation by powerful actors who are able to limit and/or distort the functioning of the agencies and personnel involved in the process.

Overall, compared with the attributes granted by the Constitution and budgetary rules, Congress appears to play a marginal role in determining both the total size and allocation of the federal budget.

This discussion suggests that a president that governs over a period of robust economic growth, and therefore growing tax revenues, should be able to use his budgetary power to consolidate a strong governing coalition. Growing revenues could be used as a bargaining chip with provincial governors, who in turn would provide congressional support for the president's agenda. Bambaci, Saront and Tommasi (2002) and Tommasi (2006) describe how the Menem administration strategically used resources to "buy" legislative support for reform from the marginally cheapest governors<sup>31</sup>.

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<sup>31</sup> The reverse of the coin is that when a recession or crisis occurs and revenues fall, the common-pool nature of federal fiscal arrangements makes it difficult to adjust spending and distribute costs. The president's coalition weakens, and this can result in a political crisis, as occurred in 1989 with the early resignation of the Alfonsín government and in 2001 with the resignation of the De la Rúa government.

#### 4. Putting it all together: virtuous and vicious cycles in Argentina, 1983-2005

In the previous section, we argued that Argentina's federal fiscal institutions cause a severe common pool problem, and numerical fiscal rules do not appear to be a solution to the resulting deficit bias due to their weak enforceability. The deficit bias is somewhat mitigated by the *de facto* very hierarchical federal budget process, which gives the Executive ample discretion in the allocation of funds.

Given this institutional configuration, it is not surprising that Argentina has had a poor fiscal behavior since the return of democracy in 1983. In this section we bring together the evidence and arguments presented in sections 2 and 3, and argue that it is not surprising that fiscal problems have become especially strong during economic downturns. Planning horizons shorten and incentives to “pass the buck”<sup>32</sup> along to other political actors and future governments increase. Furthermore, since tax revenues fall during recessions and a high percentage of spending is rigid, the amount of discretionary funds available to the Executive decline sharply. At the same time, presidential popularity declines during recessions (see Figure 10). Less discretionary funds and less presidential popularity mean that the Executive has less power to implement its agenda. To the extent that the Executive is more interested in fiscal solvency than other political actors, this will imply *ceteris paribus*, worse fiscal outcomes during recessions.

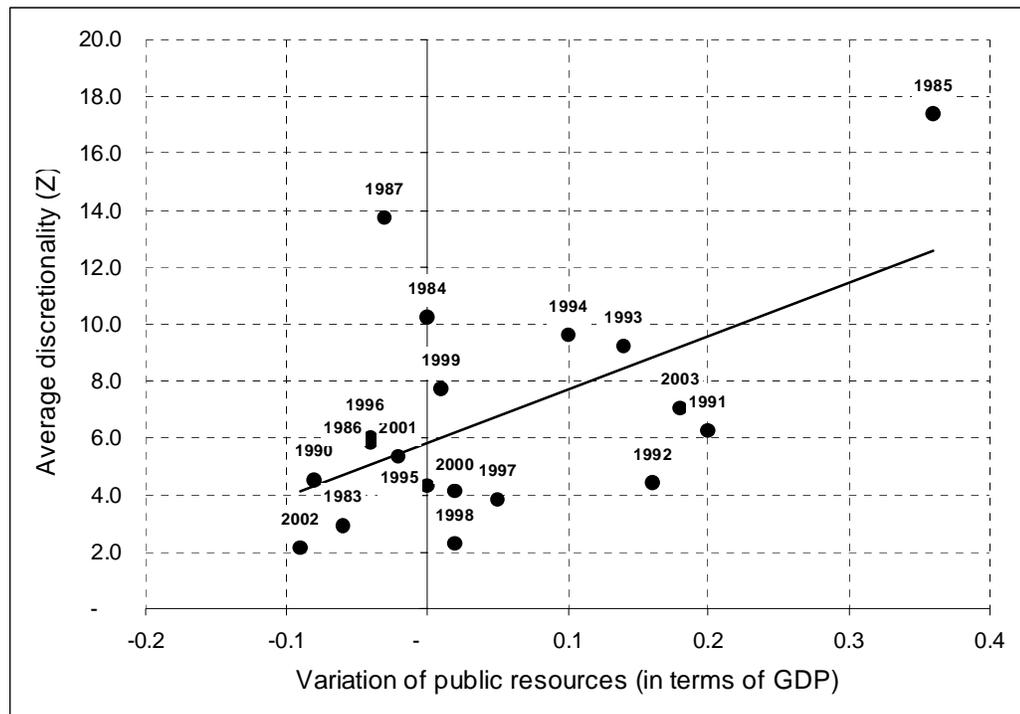
In Figure 9 we show that when tax revenues increase, the amount of discretionary funds available for the Executive to reallocate increases<sup>33</sup>.

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<sup>32</sup> This expression is used by Della Paolera et al (2003) to describe the fiscal behavior of Argentine governments in the period 1853-1999.

<sup>33</sup> Discretionality is measured by an index constructed by Abuelafia et al (2005). The index measures the average residuals from regressions of different categories of public spending on a set of controls.

**Figure 9: Growth of revenues and spending discretionality (1984-2003)**



Source: Abuelafia et al (2005)

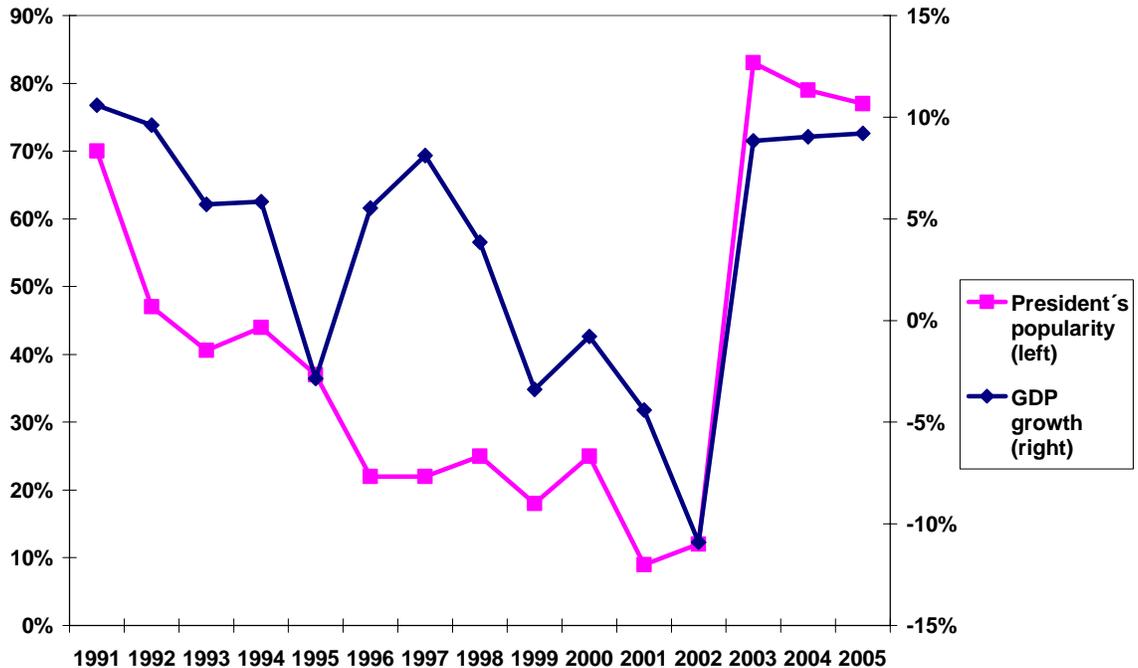
On the other hand, presidents that are lucky enough to govern during periods of robust economic growth have both discretionary funds and popularity. This gives them power to influence policy outcomes and implement their agenda, leading to better fiscal outcomes during good times. Given the Executive's high relative power in the budget process, discretionary funds can be used to consolidate a stable governing coalition by exchanging fiscal resources for congressional support with governors<sup>34</sup>. In addition, as shown in Figure 10, during good economic times the president tends to be more popular. Calvo (2004) shows that popularity is translated into higher responsiveness in Congress to the president's agenda<sup>35</sup>. These two factors – fiscal resources and presidential popularity – make it easier for the president to implement his policy agenda during good times, which *vis à vis* other political agents, tends to include fiscal solvency as an objective, because the president internalizes the government budget constraint more than

<sup>34</sup> Bambaci, Saront and Tommasi (2002) describe this process during the Menem administration, which was successful in building a lasting coalition and implementing wide-ranging reforms.

<sup>35</sup> Calvo finds a high and significant correlation between presidential popularity and the percentage of bills presented by the executive to Congress that are approved for the period 1983-2001.

other political actors – especially if he sees a chance for reelection which lengthens his horizon.

**Figure 10: President’s popularity and GDP growth in Argentina (1991-2005)**



Source: MECON and IPSOS-Mora y Araujo

The flip side of the coin is of course that a vicious cycle can ensue. If growth is low, then a president will lose popularity and at the same time, will lack additional fiscal resources to muster a solid coalition. This will make it harder for the president to implement his policy agenda, and will signal to other political actors – especially provincial governors – that now is the time to make a grab for the dwindling common pool of resources. An extreme case of this is the deal between provincial governors and interim president Eduardo Duhalde in 2002 – in the midst of the political and economic crisis that ensued following the default and devaluation – by which the federal government bailed out provincial debts.

Of course, if it were possible to implement credible fiscal rules to punish irresponsible fiscal behavior, then this vicious cycle could be limited, or at least its negative fiscal consequences could be limited. However, as discussed above, recent fiscal

rules in Argentina have not been binding, and therefore lack credibility and the ability to control fiscal deficits.

Another possible solution would be for political actors to agree on intertemporal arrangements to limit opportunistic fiscal behavior. However, the environment described by Spiller and Tommasi (2003), in which political actors face short horizons and therefore have low incentives to strike intertemporal bargains makes this an unlikely option.

How has this institutional environment interacted with economic outcomes in the recent history of Argentina to generate the fiscal problems mentioned in the introduction and the evolution of public debt described in Section 2? Our interpretation is that following the initial increase in debt during the late 1970s, successive economic administrations have been struggling to take steps towards debt sustainability, hindered by the institutional framework described above and by a succession of unfavorable external shocks.

Following the period of rapid growth of debt in the late 70s and early 80s under the last military dictatorship, the 1980s saw the return of democracy to Argentina, implying the return in full force of the political and institutional problems described above. The Alfonsín government lacked the incentives to arrange the external debt that had been in an irregular situation following the Mexican default of 1982, because fixing the debt problem would have meant paying huge amounts to creditors, without the possibility of rolling over the debt or obtaining access to fresh funds via the capital markets, since these markets were basically closed for developing countries.

Furthermore, the economy was stagnant in this period. This led to limited fiscal resources with which to consolidate a governing coalition, which was necessary since the Alfonsín government suffered from a divided Congress, with the Senate controlled by the Peronist opposition. Once the initial popularity of the government was eroded due to poor economic results, this translated into losing the lower house and most governorships in the 1987 elections. With this, the administration's ability to control fiscal policy became even lower. Until the late 1980s, the government had financed part of its deficit by printing money, leading to high inflation. In 1989, this situation exploded, ending in

hyperinflation and an early resignation by the government. This period fits the description of a vicious cycle presented above.

The early 1990s saw better economic performance, which ushered in a virtuous cycle. The international environment favoring emerging markets provided more incentives to arrange the debt problem, the wave of privatization, liberalization and deregulation sweeping through Latin America and the depth of the hyperinflation crisis combined to promote deep reforms by the entering Menem administration. Argentina subscribed to the Brady plan, exchanging its bank debt for bonds and reentering international capital markets, which were now avid to invest in “emerging markets”. The government repeated the formula of a fixed exchange rate and financial liberalization, but this time the regime was much more credible, since it was accompanied by deeper fiscal reforms. Probably a combination of the incentives provided by the market and some “learning”<sup>36</sup> by society and policymakers can help explain the difference with the previous bout of liberalization, in particular, why fiscal consolidation was a cornerstone of the president’s agenda.

The reforms led to an initial jump in real GDP growth, which provided the government with sufficient popularity and fiscal resources to generate a solid coalition – in fact, solid enough to reform the Constitution and be reelected – which allowed the Menem government to consolidate reforms. In the fiscal arena, these reforms included:

- the implementation of the Financial Administration Law in 1992 (*Ley de Administración Financiera*), that aimed at unifying the federal budget process, giving more control to the Executive over the allocation of funds, and limiting the ability of discretionarily increasing spending
- privatization, that apart from providing fresh funds, eliminated structural sources of deficits and corruption
- the reform of social security from a pay as you go system to a system of individual accounts: although in the short run this reform increased the deficit by eroding an important source of revenue for the government, it was seen as

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<sup>36</sup> See Tommasi and Velasco (1996) for a survey on the political economy of reform that mentions learning following crises as a possible cause for reform.

solving a long-term fiscal problem as Argentina closely followed developed countries in the ageing of its population

- decentralization of spending: which was supposed to increase efficiency of public spending by closing the gap between providers and beneficiaries of public goods, especially health and education.
- A tax reform that increased the VAT rate and improved tax collection, which combined with economic growth, provided the government with fresh funds.
- The hardening of budget constraints implicit in the Convertibility Law, which prohibited the issue of pesos to finance the government. This in turn meant that the Central Bank could no longer finance provincial banks, that during the 1980s had been a channel to finance provincial fiscal imbalances.

These reforms achieved a drastic reduction in fiscal deficits in the 1990-1994 period, as shown in Figure 2, and contributed to the credibility and sustainability of the Convertibility regime.

However, following the Mexican peso crisis in 1995, doubts emerged regarding the sustainability of the regime. As shown above, the debt started to grow again mainly due to the cost of rolling over the stock of Brady bonds and bonds issued to recognize previous unrecognized debts. In fact, Guidotti (2006) shows that the growth in debt during the 90s can be accounted for basically by the consequences of “skeletons in the closet” – mainly debt with pensioners that accrued during the 1980s and was only recognized and made explicit by issuing bonds in the 1990s -, the high transition cost of the pension system reform, and the increasing cost of rolling over the debt, due to the increase in country risk generated by the sudden stop of capital to Argentina following the turbulence in international financial markets in the second half of the 1990s.

The “skeletons” part of the debt increase should clearly not be blamed on the Menem government, and rather should be accounted as debt increase that accrued during the 1980s. This adjustment makes the debt data more consistent with the interpretation we put forward in this paper, since the real growth of the debt during the 1980s would be higher and that during the 90s lower than shown by the official debt figures. Melconían and Santángelo (1996) calculate that over \$25bn, amounting to around 85% of the growth of debt between 1991 and 1995 can be explained by these “skeletons”.

Regarding the reform of the pension system, it can be understood as a gamble taken in a favorable external context, that generated a short-run fiscal cost in exchange for long-term fiscal sustainability<sup>37</sup>, but turned out being an ex-post mistake once international capital markets turned sour on Argentina. It could be argued that a more prudent government would have adjusted spending, but it is unlikely that this would have been feasible given the institutional limitations described above.

The new government that came to power in 1999 was met by an unfavorable international context and a recession that had started in 1998 following the sudden stop. Furthermore, the government was weak, since it lacked a congressional majority and support in the provinces. This made it politically infeasible to engineer the level of fiscal adjustment that would have been necessary to avoid the crisis. Once again, the vicious cycle in action.

Following the crisis, default and debt renegotiation, Argentina has an opportunity to set itself on track to achieve debt sustainability and tolerance. We are once again in a virtuous cycle, and in addition, with many of the positive fiscal reforms of the 1990s having survived the crisis. The economy is growing rapidly, the debt renegotiation left the country with a manageable payment schedule, and the current government is running an unprecedented primary surplus of 3-4% of GDP. The question that remains is that since there have been no significant changes in the underlying institutional context described in this paper, what will happen when the political and external conditions change? Can Argentina turn this new virtuous circle into lasting and credible institutions and fiscal rules that will avert the risk of the next recession heralding another vicious cycle, or will history once again repeat itself? The jury is still out.

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<sup>37</sup> The debt with pensioners and suppliers could have continued unrecognized, but this would have generated an uncertain contingent liability that eventually would have generated a cost for the government when the justice system ruled in favor of creditors. The reform of the pension system from a pay as you go system to an individual accounts system generated a short-term cost as current pensioners kept receiving benefits, whereas current workers started contributing to their individual accounts.

## 5. Conclusions

We will not repeat our main argument here, rather, we will apply the analysis presented above to a particular policy reform approved very recently in Argentina, and to the discussion over debt intolerance in emerging market economies.

In the weeks prior to this writing (July and August 2006), President Kirchner has sent a proposal to Congress to reform the *Ley de Administración Financiera*, that was approved by the government's majority. This reform grants ample powers to the Chief of Cabinet to change the allocation of resources across budget items during the fiscal year, in practice making the Congressional approval of the budget a mere formality. Therefore, the budget process has become even more hierarchical.

In light of the analysis presented in this paper, the reform is not surprising. President Kirchner has enjoyed three years of GDP growth between of between 8 and 9%, together with record levels of presidential popularity well above 70%. His government is running an unprecedented fiscal surplus above 3% of GDP, and the popular press consistently reports that he is "buying" the support of provincial governors via the discretionary allocation of infrastructure projects and other federal funds. In fact, the four provincial governors that nominally belong to the opposition Radical party have publicly manifested their support for the president. In this favorable context, reelection in 2007 is highly likely. Since it is possible for the country to suffer a recession over the next five years, the president may be preparing his government for a rainy day. By using his current majority in Congress to impose a reform that provides more budget powers to the Executive, he is arming himself with the tools necessary to face a possible vicious cycle that could occur before the end of his second term.

We have argued that Argentina's fiscal problems have a strong cyclical component. This however is true of most countries, since tax revenues improve and in general, so does the government's popularity. What makes Argentina's fiscal problems special is that they are compounded by its particular institutional arrangements. When things go well, the *de facto* hierarchical budget institutions allow the president to use part of the additional revenues to strike political bargains to overcome the underlying

common pool problem. But when the economy enters a recession, this is no longer feasible, since there are no excess resources, and the president loses popularity.

This mechanism that interacts economic shocks with political institutions can also shed some light on the debate regarding the relevance of “debt intolerance”<sup>38</sup> in emerging market debt problems. The debt intolerance argument links past default behavior with current problems with debt management in emerging markets. The problem is that, as argued by Eichengreen, Hausmann and Panizza (2003), it is not clear what the causal mechanism linking the past with the present is. The mechanism we discuss is a possible candidate. To the extent that fiscal institutions are a relatively permanent feature of emerging markets, then it is not surprising that history repeats itself. This paper of course is not a test of this hypothesis, but at least it provides suggestive analysis of a particular case.

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<sup>38</sup> Reinhart, Rogoff and Savastano (2003)

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