

# **Analysis of the Guatemalan National Budget and the Resources Devoted to Security and Defense**

## **Introduction**

Atlas Economic Research Foundation launched a new initiative to increase the number of intellectual entrepreneurs, organizations, and programs focusing within the field of economics, security, intelligence and defense, from a free society perspective. The National Economics Research Center (CIEN) was invited by Atlas to complete a report that analyzes the Guatemalan national budget and the resources that are devoted to security and defense. The mission of CIEN is to impel the economic development of Guatemala through the technical study of economic and social problems of the country based on the following principles: individual freedom, rule of law, free market economy, a subsidiary state, and solidarity.

Therefore, the objective of this study is to serve as a starting point in the discussion of the Guatemalan national budget and to identify aspects that should be approached in greater depth in later studies. The distinguishing characteristic of this report is that it was made from an economic perspective. The report was elaborated from documents previously drafted by the CIEN but a particular effort was made to compile and integrate the budgetary information of the last three decades in order to count on a perspective that allowed analyzing the cost of the defense and internal security sector since the internal armed conflict. Finally, the CIEN is thankful to the Atlas Economic Research Foundation for the support offered to make the elaboration of this report possible.

## **CONCEPTUAL FRAMEWORK**

People have natural and superior rights to the State. In addition, they are free and is desired that in the exercise of this freedom they obtain their maximum development and fulfillment, reaching their fullness as persons. Therefore, the State must be to the service of the person and in no case in the opposite sense. The aim of the State must be to promote the general well being, defined as the creation of a set of social conditions that allows all and each one of the citizens to reach their total personal fulfillment. The well being demands the State to respect the subsidiary principle.

A subsidiary State is one that limits its participation to foment activities that, in spite of being socially profitable, would not be executed by the individuals, and to disincentive those that are not socially profitable, but privately would be profitable. Article 118 of the Political Constitution of the Republic of Guatemala says: "... When it is necessary, the State will act complementing the private initiative and activity...", that is the expression of the subsidiary principle; that is to say, the principle that regulates the roles and the scopes of the Guatemalan society actors (public and private initiatives). The subsidiary role of the State must be exerted with responsibility, inasmuch as the exigencies of the

well being can be limitless. This means, always to remember, that the public expenditure must be in agreement with the macroeconomics balances.

The affirmation of the subsidiary principle implies the total acceptance of the right to the private property, and freedom in the economic and social fields. In this sense it must be an institutional framework where the power of the State is limited by those human rights, previous to the State, that cannot be waived, like the right to live, to be free, and to have a property.

In synthesis, to move in the path of well being it is necessary to use at their maximum potential the limited productive resources of the country. Therefore, the CIEN suggest for Guatemala a market economy system; that is to say, a system that respects the freedom and the private property rights, that seeks the well being of the citizens, that demands the free manifestation of competition, that is based on a system of prices as the basic system of information, and that on the base of the subsidiary principle defines the role of the State in society.

The State is a suitable candidate to establish the requirements necessary so that the market can appear, and to complement with its intervention his own operation when there are present some of the causes that prevent an efficient result. As part of the minimum scope of action the State, it is incumbent on to him, among other functions<sup>1</sup>, the provision of public goods. For example, the national defense, the police and the administration of justice are typical cases of pure public goods<sup>2</sup>. It seems that the different philosophical currents consider that the national defense is a basic function of the State, since even those that plead for a minimum State consider it as such. In any case, as professor Schenone says: “whichever the intensity that the government takes part in the society, will be always truth that the government will have to collect the resources to carry out such interventions. In last instance, to govern cannot be but to burden to spend”<sup>3</sup>.

### **Macroeconomics surroundings and fiscal analysis**

Guatemala has been characterized by a conservative economic policy that has resulted in a relative monetary and fiscal stability, as well as in a public sector of moderate size. Nevertheless, in the first years of the eighties the fiscal discipline was debilitated significantly. In addition, during the second quinquennium of the eighties although the deficit attributable to the central government was reduced, the total deficit to be financed stayed in a range similar to the one of the first years of that decade due to the losses maintained by the Bank of Guatemala originated by losses with the interest rate and

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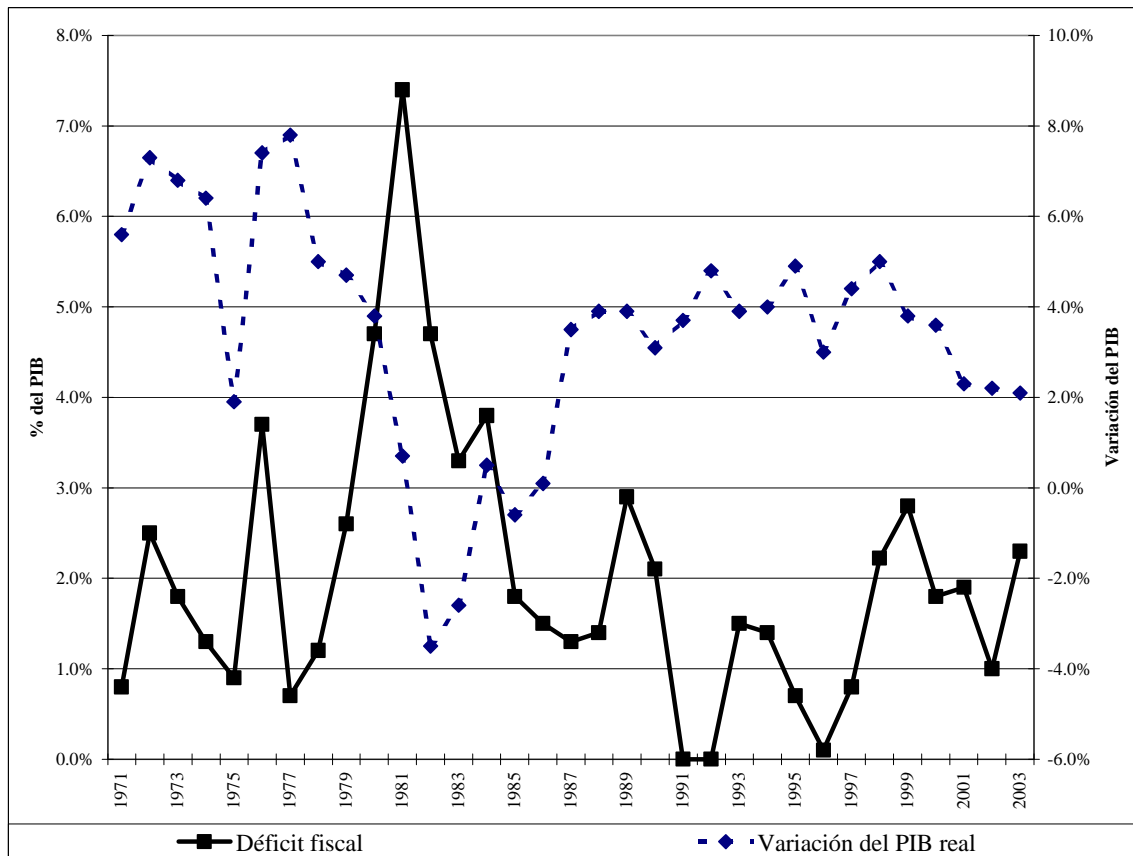
<sup>1</sup> To reinforce the rights of property, the defense of competition, and to correct the failures that prevent an effective operation of the market (for example, externalities).

<sup>2</sup> Those whose consumption is no rival (when the consumption of a certain amount of or on the part of anybody does not reduce the availability of the same one for the other individuals) and the exclusion do not fit (if when the good is also provided for somebody it is available for all the individuals).

<sup>3</sup> Schenone, O. (1993). “Las Tres G: Gobernar es Graver para Gastar”. Cuadernos de Economía, Año 40, N° 119, pp. 111-148 (Abril 2003).

exchange rate losses. This situation gave as result a period of economic stagnation combined with a significant increase of the national indebtedness. Nevertheless, there was a positive result of this situation, it was the introduction of article 133 in the Political Constitution of the Republic that says: “... with the purpose of guaranteeing the monetary, exchange and credit stability of the country, the Monetary Board will not be able to authorize that the Bank of Guatemala grants direct or indirect financing, guarantee or endorsement to the State, its decentralized or autonomous organizations nor to no banking private organizations ...”. It is worth to emphasize that although exists a constitutional prohibition that prevents the Bank of Guatemala to finance the fiscal deficit; an important restriction exists on the monetary policy due to the irregular handling of the deposits of the government<sup>4</sup>.

**Graph N° 1: Evolution of the fiscal deficit of the central government and the variation of the GDP**



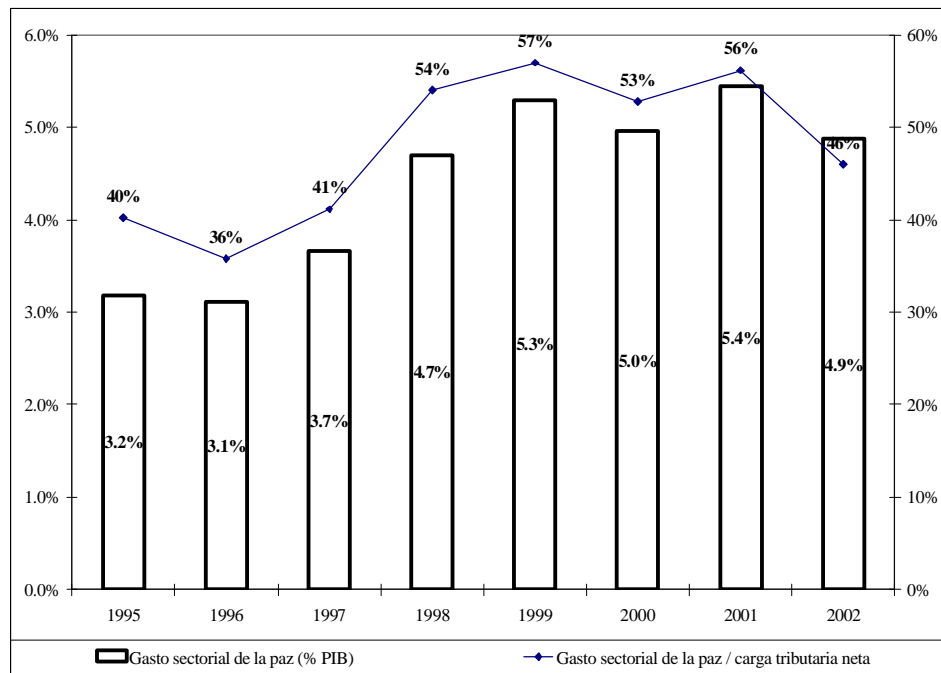
Source: own elaboration from information of the Bank of Guatemala.

During the decade of the nineties the economic growth began to recover but that pattern interrupts itself at the end of that decade. Again one of the factors that affected negatively was the growth of the fiscal deficit from 1997 as a result to fulfill the goals of expenditure

<sup>4</sup> The Bank of Guatemala has had to participate in the money market sterilizing the excesses of liquidity generated by the fiscal imbalances to preserve the stability, even though the bank has not financed them directly.

established as commitments in the Peace Accords, and not to fulfill the goals of growth of the GDP and the tributary income that was agreed in the same accords<sup>5</sup>. In order to conclude this idea, it is presented the executed public expenditure in fulfillment of the goals of the Peace Accords in an added way, as percentage of the net tax burden, in order to have a perspective of the two faces of the coin (see Graph N° 2). It is worth to emphasize that only the basic expenditure to fulfill the quantitative goals of the Peace Accords has meant to dedicate more than 50% of the tax burden, but that same expenditure was equivalent to 40% of the tax burden in the base year. This means that to fulfill the commitments in the Peace Accords (basic expenditure plus the implicit one) and not to incur in a “untenable” fiscal deficit, it will be required to increase the mobilization of internal resources. In Graphs N° 1 and 2 is illustrated what was exposed in the previous paragraphs.

**Graph N° 2: Evolution of the sectorial expenditure executed to fulfill the quantitative goals of the Peace Accords**



Source: own elaboration from information of the Bank of Guatemala and the Public Finance Ministry.

<sup>5</sup> In the Agreement on the chronogram for the implementation, fulfillment and verification in the Peace Accords were settled down the following goals: as minimum the government should have increased, for year 2000, the executed public expenditure in education, health, public security, the Judicial Organism, and the Public Ministry in 50% in relation to the GDP with respect to the expenditure executed in 1995; the government is committed to dedicate to the housing policy the equivalent of not less of the 1.5% of the Budget of Tributary Income, as of 1997, giving priority to subsidy the demand of housing solutions of popular type; to reorient the use and distribution of the budget of the army of Guatemala towards the constitutional functions and the military doctrine that the same agreement makes reference to, optimizing the resources available in order to reach, in 1999, a reduction with respect to the expenditure destined in 1995, of a 33% in relation to the GDP. In addition, to take the actions and to promote the initiatives necessary to obtain, before year 2000, an increase of the tax burden in relation to the GDP of at least a 50% with respect to the tax burden of 1995.

In order to finance the greater fiscal deficit the government retired an important part of his deposits in the Bank of Guatemala. Nevertheless, the deposits alone were not sufficient to finance the increasing deficit and for this reason the government resorted to indebtedness. From the year 2000, the Bank of Guatemala used widely the open market operations (OMAs) as a sterilization instrument. Therefore, without the fiscal support the indebtedness of the Bank of Guatemala will continue to grow. On one hand, to sterilize the retirements of deposits from the government and, on the other, to pay its own debt and its interests every time they are due.

In synthesis, to face the growing deficits during the analyzed period, the government has resorted to actions like retarding the payments to the suppliers; to diminish the investment and operating expenses of infrastructure; to retard the payment to the external creditors; funds of the Guatemalan Institute of Social Security (IGSS) have been used and the governmental contributions to this organization had delayed; to place taxes to the exports; to increase external and internal indebtedness; and to resort to monetary emission.

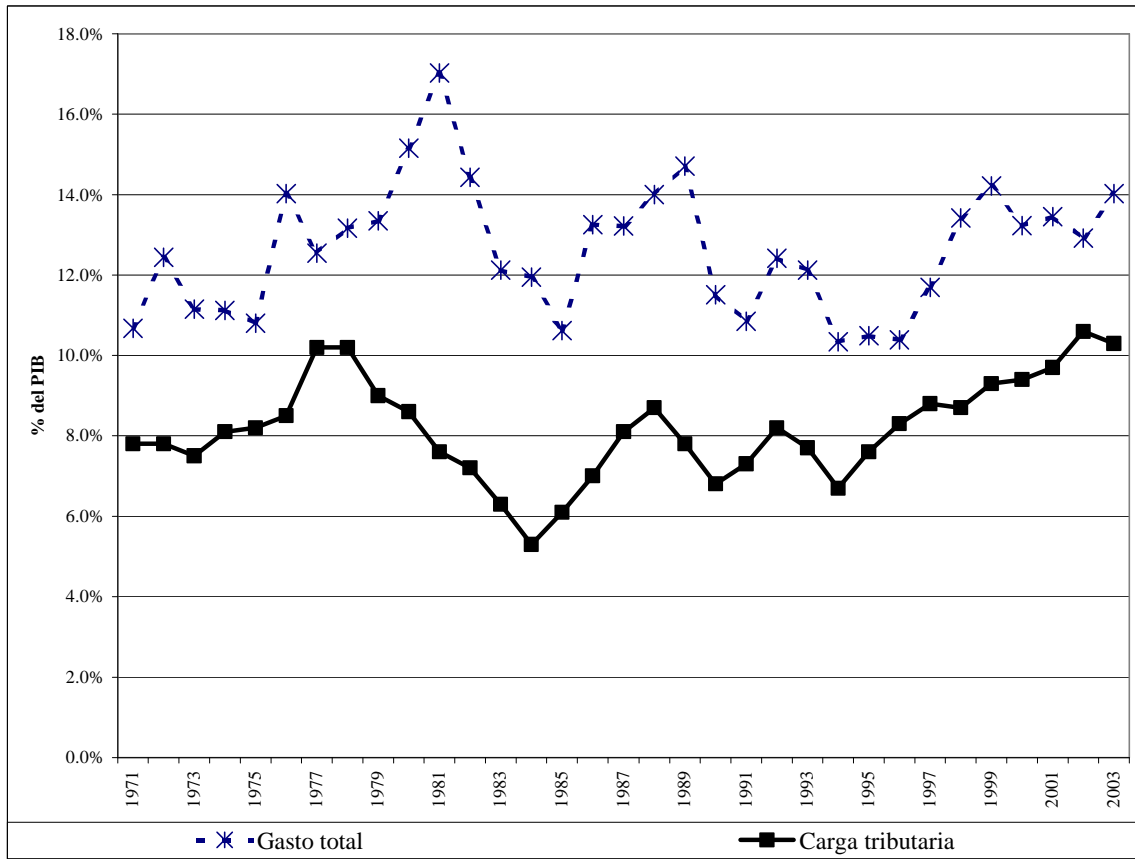
The participation of the central government expenditure in the GDP of Guatemala has been and is one of lowest in Latin America, in average it has been around 13% between 1971 and 2003<sup>6</sup>. According to data obtained from the budgetary executions, the expenses of operation of the central government have stayed in last the three decades around 5.5 - 8.5% of the GDP; the expenses of investment, net of the service of the national debt, fluctuated between 1.5 and 7.2% of the GDP between 1971 and 2003; and the expenses of the national debt represented 2% of the GDP between 1971 and 2003, although between 1986 and 1996 they were superior to that average. Nevertheless, when reviewing the other face of the coin is found that the tax burden has also been one of lowest in the international context, in average it has been around 8% of the GDP between 1971 and 2003. See Graphs N° 3 and 4.

The main problems of the Guatemalan tributary system have to do with the high number of fiscal exemptions, deductions, incentives and privileges, the institutional weakness of the Tributary Administration Supervision (SAT), the complexity and lack of clarity of the tributary norms, and the little persecution and sanction of the great evasions. Of that account, the greater problem of the present tributary system is not of rates, but of breach of the tributary obligations and a tax structure that causes economic distortions (for example, the Income Tax - IRS -). The IRS and Mercantile and Land-and-Cattle Companies Tax (IEMA), as of 1998, are two of the taxes that have generated more distortions in the efficient allocation of the resources of the country.

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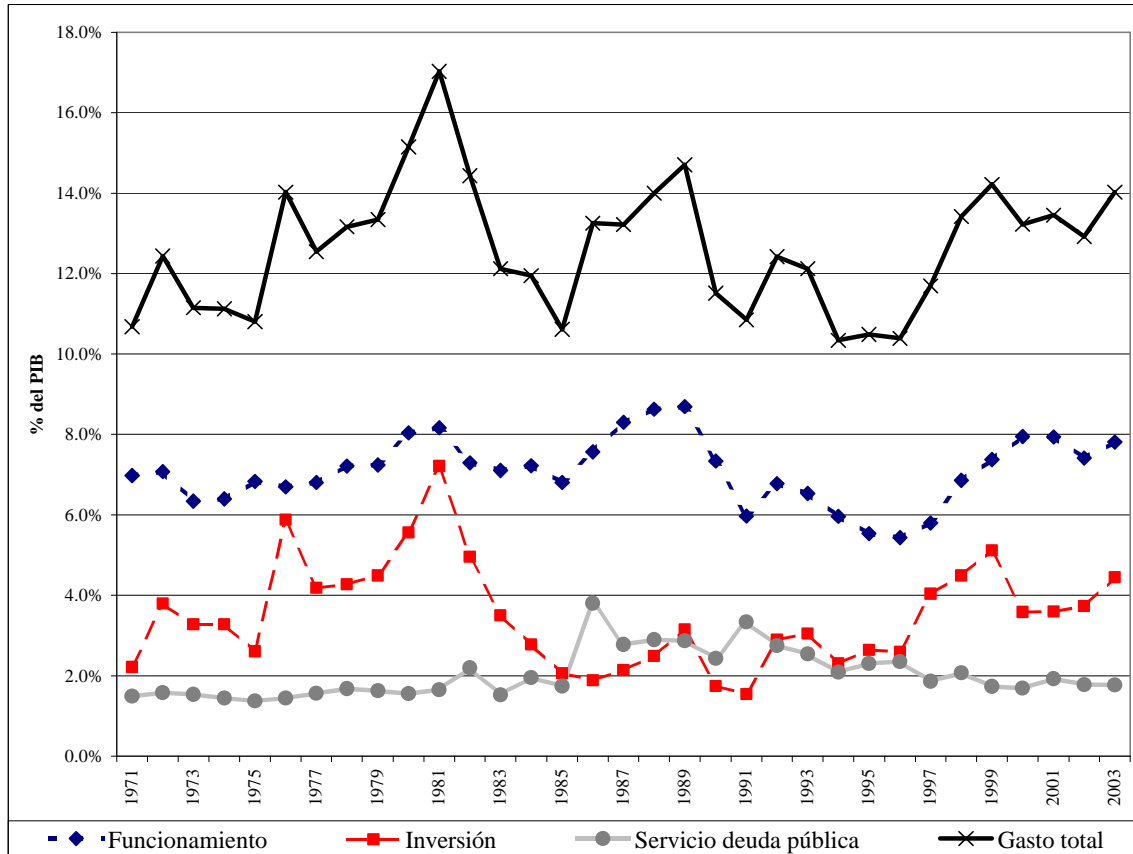
<sup>6</sup> The amounts of expenditure presented in this report only include the central government operations. Besides this level of government, there should be included the operations from the municipal governments, the non financial organizations and the public enterprises in order to work with the non financial public sector. Lamentably this information is not available.

**Graph N° 3: Evolution of the central government expenditure and the tax burden**



Source: own elaboration from information of the Bank of Guatemala and the Public Finance Ministry.

**Graph N° 4: Evolution of the composition of the central government expenditure**



Source: own elaboration from information of the Bank of Guatemala and the Public Finance Ministry.

When analyzing the structure of the public expenditure it is found that most of it has been dedicated to remunerations and capital expenses. Between 1980 and 1991 the participation of these items of the expenditure was reduced of near 68% to 40% of the total expenditure. Nevertheless, from then it has oscillated between 50% and 55%. In order to analyze the remuneration's item is advisable to compare it with the evolution of the number of public employees in technical and administrative positions. Lamentably this information is not available but from information on the number of permanent positions from 1995 to 2003 it is possible to conclude that in average there was an increase in real terms of the remunerations by position in around 4% per year. Nevertheless, the practice to grant generalized wage increases has stayed without taking into account the merit from the public servants and therefore it has not been promoted to accompany the improvements in remunerations with the workers productivity.

In the capital expenditures the transfers to the municipalities, to the social funds and the development boards have a significant participation. In addition, the Political Constitution of the Republic establishes that resources to the municipalities must be transferred according to the following criteria: 1) 25% in equal parts between all the municipalities of the country, 2) 25% in a proportional way according to the number of inhabitants of each municipality, 3) 25% in a proportional way to the taxes collected by

inhabitant of each municipal jurisdiction, 4) 15% in a proportional way to the number of villages and small settlements of each municipality, and 5) 10% in a proportional way to the inverse of the taxes collected by inhabitant of each municipal jurisdiction.

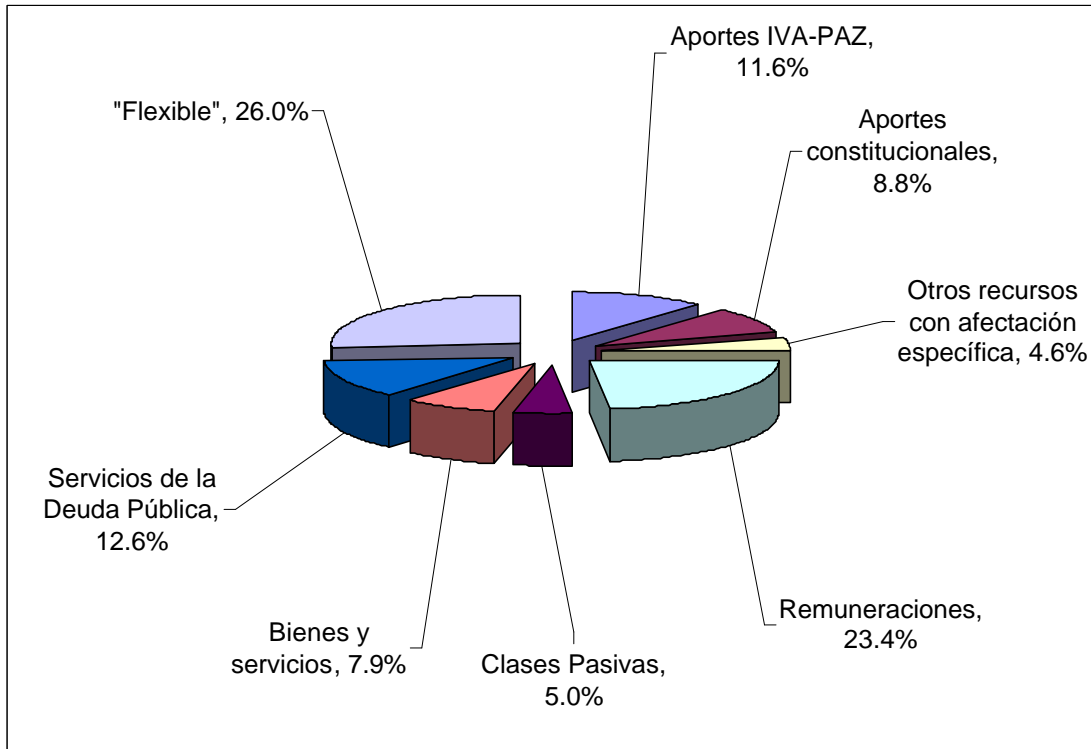
CIEN made an analysis of the formula used to distribute the constitutional contribution and concluded that: “there are serious deficiencies in the used formula to distribute the transference’s, reason why is suggested to replace it by a new one. The main problems that it presents come from the coexistence of two opposed criteria, related to the tax collected in the municipalities. One of the criteria favors the collection of income in the municipality, while the other seeks to compensate the municipalities that collect the lesser income. These criteria, apparently logical, actually are incoherent and give rise to the fact that in some municipalities an increase in its own income can end not only in a reduction of the amount of the transference’s, but to even mean a diminution of their total income”.

It is important to emphasize the fact that part of the public expenditure is bundle by legal mandates which limits the capacity of the Government to allocate resources to other programs and projects. In other words, the legal allocations do not take into account efficiency criteria to assign the resources but rather they are based on the collected income. In addition, the execution of the budget of the social funds and the municipalities is not known but rather the transference’s that are registered in the Public Finance Ministry is what is known. Therefore, the transparency in the use of these resources is limited.

An explanation of why the composition of the public expenditure does not change in a significant way throughout the time is that in fact there is not much margin to assign the resources. Part of the income collected has a specific destiny by constitutional mandate and specific laws, and therefore, so there is no possibility of making a decision regarding what to do with these resources. In other words, part of the public expenditure already is tied by legal mandates in each fiscal year and even subject to a smaller control. These resources are allocated independently of the performance of the organizations that benefit with these allocations. Obviously, since the resources are limited, these allocations are necessarily resources that are not assign to other programs or projects, although this other programs or projects have a greater social yield. Next a graph appears to illustrate that, being very conservative; it would be around a 25% of possibilities for assigning the public expenditure. Nevertheless, in this scenario the inertia of external loans for which the government must make a counterpart is not being taken in consideration to establish the budget inflexibility. Therefore, the true maneuver margin in the short term could be around 10-15% (see Graphs N° 5 and 6).

**Graph N° 5: Composition of the executed expenditure in fiscal year 2003**

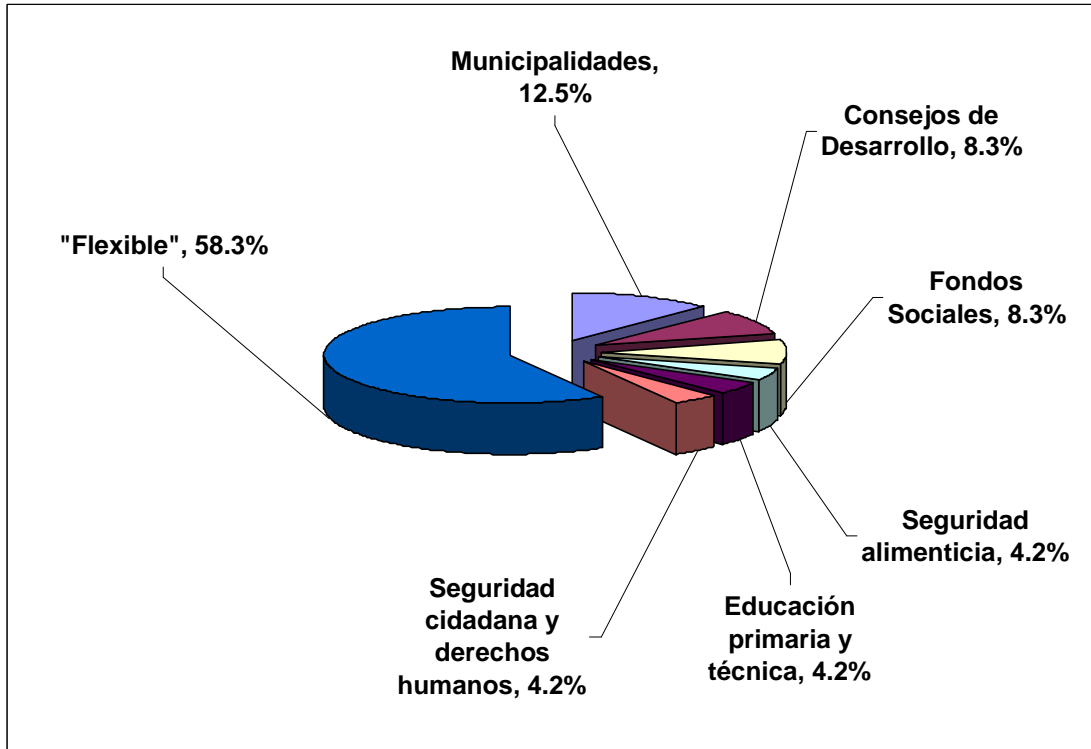
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Source: own elaboration from information from the Public Finance Ministry.

**Graph N° 6: Distribution of the VAT by legal mandate**

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Source: own elaboration from information of the VAT Law (Decree 27-92 y its reforms).

In order to have the more profitable options of investment, in the last years the government had been carrying out the process of implementation of the Public Investment National System (SNIP). One of the deficiencies of the actual system is that it is not mandatory that all the public investment projects should fulfill an evaluation process, and also that the Congress usually approves investment projects that are in the stage of an idea, without the proper technical evaluation. According to the Technical Budget Direction of the Public Finance Ministry, in the 2002 budget near 70% of the investment projects were replaced by which the presented by the congressmen, without going through the evaluation process of the SNIP. In addition, the criteria that in the previous years the SNIP has used to approve the investment projects correspond mostly to considerations other than the social yield of the project.

### **The national budget**

The national budget is the instrument that makes the true priorities of the politicians explicit. In this occasion we will briefly explain the legal framework that serves as base to formulate the national budget of Guatemala, and then we made an analysis of the resources assigned for defense and the internal security in last the three decades.

## **Legal grounds**

The Constitution of the Republic establishes that the General Budget of Income and Expenses of the State approved for each fiscal year should include an estimation of all the income to be collected and the detail of the expenses and investments to make. In addition it establishes that the Statutory law of the Budget will regulate: 1) the formulation, execution and liquidation of the General Budget of Income and Expenses of the State and the norms which according to the Constitution should guide his discussion and approval; 2) the cases where funds within the total assigned to each organism, dependency, decentralized or independent organization can be transferred; 3) the use of economies and the possible investment of any surplus and incidental income; 4) the norms and regulations that all aspect relative to the national debt is subject to; 5) the form and amount of the remuneration of all the civil and public employees; 6) the form to verify the public expenses; and 7) the forms of collection of the public income. The Congress of the Republic must approve, modify or disapprove no later than thirty days before the next budget starts in effect; and the Executive should send the budget project to the Congress with 120 days of anticipation to the date in which the following fiscal year starts. If at the time of beginning the fiscal year the budget has not been approved by the Congress, then it will again rule the budget used in the previous exercise, but could be modified by the Congress.

The Statutory law of the Budget in force was approved in 1997 by means of Decree 101-97 of the Congress of the Republic. In this disposition its settle down that the public budgets are the annual expression of the plans of the State, that should be elaborated within the framework of the economic and social development strategy, and that the Executive Branch by interval of the Public Finance Ministry will consolidate the institutional budgets and will elaborate the budget and the added accounts of the public sector.

By means of Governmental Agreement 240-98 the Regulation of the Statutory law of the Budget was approved. For the formulation of the budget its settle down that the Planning and Programming Secretariat of the Presidency (SEGEPLAN) must present a report evaluating the execution of the general policy from the Government no later than the 28 of February of every year. This evaluation must serve as base so that the Public Finance Ministry, in coordination with the SEGEPLAN, proposes the budgetary policies and the general lineaments for the formulation of the project of budget for each fiscal year. The first drafts of the budget of each organization must be delivered to the Public Finance Ministry no later than the 15 of June of each year.

In synthesis, the Executive Branch formulates the budget project in four phases: 1) preparation of the global framework, 2) formulation of the first draft of the budget of each organization, 3) analysis and integration of the budget first drafts, 4) validation of the budget project. Then the Commission of Finances of the Congress of the Republic issues a dictum of the budget project and the budget project is put under the consideration of the plenary session of the Congress.

## Resources for security and defense

### Antecedent

According to article 244 of the Political Constitution of the Republic, the Army of Guatemala is the responsible institution to maintain independence, the sovereignty and the honor of Guatemala, the integrity of the territory, peace, and the inner and outer security of the country. Nevertheless, in the Agreement on the Fortification of the Civil Power and Function of the Army in a Democratic Society, a proposal was formulated to modify this article to limit the function of the army to maintain the sovereignty of the State and the integrity of the territory. This proposal of reform was not ratified in the popular consultation that was celebrated to introduce reforms to the Constitution of the Republic, and for this reason its original writing stills in effect.

Nevertheless, in this agreement was settled down that the size and the resources of the Army should agree with the necessities of the fulfillment of his functions of defense of the sovereignty and the integrity of the territory, and with the economic possibilities of the country. In addition it was established that the use and the distribution of the army budget should be reoriented towards his constitutional functions and the military doctrine<sup>7</sup> referenced in the same agreement, optimizing the resources available in order to reach, in 1999, a reduction with respect to the expenditure of 1995, of 33% in relation to the GDP.

The quotient (defense expenditure/GDP) allows to measure the weight that, in terms of goods and services, the Armed Forces in the national economy have<sup>8</sup>. The cost of the resources used by the Armed Forces can be seen like its opportunity cost in other sectors. This quotient is the one that commonly is used to make international comparisons. During period 1972-1990, the military expenditure was, in average, 5.10% of the GDP of 124 countries<sup>9</sup>. In the industrial countries it was 3.90% and whereas in the developing countries it was 5.20%. In Guatemala in the same period it was in average 1.4% of the GDP. Next we do a synthesis on the relation between the defense expenditures and the development of the countries<sup>10</sup>.

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<sup>7</sup> Oriented towards the Political Constitution of the Republic, to the human rights, to the international instruments ratify by Guatemala regarding military aspects, to the defense of the sovereignty and national independence, to the integrity of the country, and the spirit of the Peace Accords.

<sup>8</sup> Although it is considered that the activities of the arm forces contribute to the GDP, they actually represent the resources devoted to avoid the risks of the national security.

<sup>9</sup> Knight, M., Loayza, N. y Villanueva, D. (1996). "The Peace Dividend: Military Spending Cuts and Economic Growth", Policy Research Working Paper 1577, The World Bank.

<sup>10</sup> The synthesis was taken from Scheetz, T. (1998). "Gastos Militares en Guatemala: su impacto fiscal y macroeconómico: 1969-1995", Dialogo Centroamericano; and from Giha, Y., Riveros, H. and Soto, A. (1999). "El gasto militar en Colombia: aspectos macroeconómicos y microeconómicos", Revista de la CEPAL 69.

Nobody questions the fact that the military expenses, the security and the economic development variables are interrelated. Nevertheless, the empirical nature of that relation, in particular the impact of the military expenditure in the economic development of the underdeveloped countries, was object of an ample academic debate during the decades of 1970 and 1980. Some maintain that this expenditure is unproductive, arguing that any outlay in this field generates negative effects on the economy and limits the public resources available to invest in areas of greater social benefit. Others, however, think that the military expenditure favors the economic growth as it contributes in a significant way to increase the national productive capacity.

Those who argue that there is a negative relation between the military expenditure and the indicators of economic and social development affirm that, although this expenditure constitutes a necessary strategy for the capitalist system, has an adverse impact in the rate of growth because causes less investment levels. In other words, although in some circumstances the military institution could contribute to the development, in the immense majority of the underdeveloped countries it was considered that the net effect of the military expenditure was to slow down the development. This because the military expenditure does not have a rate of return related to its budgetary execution. Thus, in as much a tractor, for example, it contributes to produce grains or a teacher helps to increase the human capital of a country, a military tank, however, does not contribute anything to the growth of the economy (except for its function of "insurance policy"). On the contrary, the tank is like ballast that the economy must support. Although in the developed world the defense industries could contribute to the economic growth, in the developing countries the same import of arms made in the developed countries would be a negative weight in the external sector of the economy, and still more when those arms are acquired with indebtedness. That way, instead of facilitating the development of the nation the military expenditure would produce exactly the opposite effect.

On the other hand, the authors who have come sustaining the thesis from which to greater military expenditure, greater economic growth, believe that this expenditure can be economically productive if takes to a situation of national security and allows to exert with more effectiveness the rights of property, stimulating therefore the private investment and, therefore, the growth. They have indicated in addition that the military capital expenditure can have productive uses: some developing countries still benefit from the transport and the communications constructed for military objectives. On one side it was maintained that the military expenditure worked as a stimulus to the economic growth, just as any other fiscal expenditure (a typically Keynesian argument). In addition, it was affirmed that the military expenditure benefited the economy in other ways, for example by means of the training of recruits for their future insertion in the labor market and providing an important impulse to the modernization of the economy. This last one, was said, by means of the appearance of defense industries that were technologically outpost, the road construction and other infrastructure, as well as by means of fomenting the spirit of enterprise and effective leadership of the military, presumably scarce between the civil elites.

Thus, it has been emphasized that the military expenditure is able to provide feeding, housing, medical services and training to a number of people who, otherwise, would be maintained by the civil sector; that, it can advance a great range of public services that also benefit the civil economy, and commit themselves in scientific and technical specialties that, otherwise, would fall to the civil personnel of the society (Benoit, 1973; Thompson, 1974; Frederiksen and Looney, 1982).

Recent studies have scrutinized the macroeconomic effects from the military expenditure in the less developed countries. It has been verified that it adversely affects the growth, the balance of payments in current account, the saving and the investment. In addition, has been observed a significant difference between the level of expenditure made by military dictatorships and the carried out by civil governments. These studies conclude that if the security of a nation depends on the economic growth, then the expenditure in their troopers seems to be buying as much insecurity as underdevelopment (Smith, 1977; Deger, 1986; Nabe, 1983; Ball, 1983; Leontief and Duchin, 1983; Pivetti, 1992).

It is worth to emphasize that the individual studies about the effects of the military expenditure in the economic growth apparently throw contradictory results. Nevertheless, Todd Sandler and Keith Hartley conclude that the models based on the influence of the demand generally postulate that the military expenses crowd out the investment and therefore they have negative effects, whereas the studies that tend to center in the supply generally find positive or neutral effects, whatever the samples, the analyzed periods or the econometric methods that are used.

Today, at the academic level, and judging that expenditure from a world-wide approach (that is to say, not with a regional or national perspective), the question almost has been solved. The accepted conclusion among the economists is that, without denying some beneficial economic effects, the military expenditure has generally had a negative net effect on the developing countries.

This debate was made almost exclusively at empirical level using econometric models. A model is an attempt to formulate the most varied economic interrelations found in a country through simultaneous equations. It must notice that, despite the utility of this tool, all the econometric results, mainly in underdeveloped countries, must be taken with certain precaution. Even though with results that mathematically seem to be precise, these must be interpreted as indicators of general tendencies and not as exactitudes.

In the Guatemalan case professor Scheetz affirmed that, although there is a lack of greater econometric work on the model, the obtained conclusions are robust. The military expenses in Guatemala have had a negative effect on imports, exports and growth of the GDP during last the 27 years (1968-1994). The theory that sub lies the negative effect on the imports suggests that military expenses, by its use of the scarce foreign exchange, reduce capacity of import of capital or consumer goods for the other sectors of the economy. All this without discarding other indirect relations through the negative effect of the military expenses on investments. The negative effect of the military expenditure

on exports is probably due to its effect, jointly to the one of the internal war, in the flow of the investments towards other latitudes, affecting therefore the creation of competitive national industries, with capacity to sell at world-wide level. Of similar way, the negative effect on the Gross Domestic Product seems to be the direct result of the discouragement towards the national investment caused by the war and the levels of military expenditure. The investment provides the fixed capital that along with the labor produces the GDP. If it is not reinvested, among other things importing machines (capital assets), it is not possible to have economic growth and there will not be jobs for the population. In all the equations professor Scheetz has quantified these strongly negative effects.

In addition, professor Scheetz presented the following reflection. Although the civil war, without a doubt, had very injurious effects on the economy, it is also conceivable that the presence and power of the Army have created an atmosphere of confidence for many investors. There are cases of other countries in which the presence of military governments stimulated the investment (v.g., Argentina and Chile in the decade of 1970). Nevertheless, if we even take into account this possibility, it is possible to affirm that the Guatemalan military expenses had a injurious net effect during period 1968-1994. This happened because the military cleared limited resources of productive sectors of the economy without compensating with a positive contribution (v.g., creating a climate of security for other investors) sufficient to offset their high economic costs.

We consider that the previous results do not have to be interpreted as a justification to don't have any military expenditure. At the end the military expenditure would really be an inefficient way to promote the economic growth in comparison with the private investment. The justification of the military expenditure has to do with the search of the national security that is a mean to have well being.

#### *The determination of the defense expenses in Guatemala*

The first step is that the different dependencies from the National Defense Ministry send to the Department of Finance of the same ministry their first drafts of budget that respond to the lineaments that they receive from the “Estado Mayor de la Defensa (EMD)”. The second step<sup>11</sup> is the analysis made of each first budget draft by the Department of Finance comparing them with the parameters established by the EMD. In these analyses aspects like the personnel, the vehicles and the extension of land that each dependency must cover are taken in consideration. Depending on the result of the analyses there are corrections to some of the first budget drafts. The following step consists of unifying the first budget drafts of all the dependencies by budgetary line and structuring the budget by group<sup>12</sup> of expenditure. Besides to add the financial necessities of the dependencies the

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<sup>11</sup> This is done in April of every year. Before initiating the analyses they consult to the Technical Budget Direction of the Public Finance Ministry if there are modifications in the structure of the budget.

<sup>12</sup> These groups correspond to the filing cabinet by object expenditure from the Budgetary Classifications Manual for the Public Sector of Guatemala and they are: personal services (group 0), no personal services (group 1), materials and provisions (group 2), property, plant, equipment and intangible (group 3), current transferences (group 4), capital transferences (group 5), financial assets (group 6), services of the national

physical goals are added and sent together as part of the programming. In June of every year the first budget draft of the National Defense Ministry is given to the Technical Budget Direction of the Public Finance Ministry<sup>13</sup>. Between June and August of every year the Technical Budget Direction informs to the Department of Finance of the National Defense Ministry their budgetary ceiling. Then the National Defense Ministry elaborates a new budget draft according to the budgetary restriction and delivers it to the Technical Budget Direction of the Public Finance Ministry so that it elaborates the General Budget of Income and Expenditure of the State Project for the following fiscal year. In September the budget project is given to the Congress of the Republic in order to be known and sanctioned. In this instance is initially settled down the budget for the National Defense Ministry. This new budgetary ceiling is distributed internally based on the mission of each commando or military dependency. Throughout each fiscal year the budget undergoes modifications in order to answer to specific and unexpected necessities.

In order to illustrate the changes previously described, the budgetary allocations of the National Defense Ministry in the different stages are presented in Table N° 1 for the budget of fiscal years 2001-2003.

**Table N° 1: Budgetary allocations to the National Defense Ministry (2001-2003)**

	Fiscal Year 2001			Fiscal Year 2002				Fiscal Year 2003			
	Budget Project	Approved by Congress	Executed	First budget draft	Budget Project	Approved by Congress	Executed	First budget draft	Budget Project	Approved by Congress	Executed
US\$ millions of 2003	125.3	119.1	220.0	209.0	156.5	131.8	163.2	212.7	124.7	118.5	177.0
% GDP	0.53%	0.51%	0.94%	0.87%	0.65%	0.55%	0.68%	0.87%	0.51%	0.48%	0.72%

Source: own elaboration from information of the Bank of Guatemala and the Public Finance Ministry.

In fiscal year 2001 the difference between the budget approved by the Congress of the Republic and the budgetary execution was almost superior to 85%. Most of the difference (96%) is explained in two programs: Central activities (01), and Independence, Sovereignty and Integrity of the Territory (11). In fiscal years 2002 and 2003 a significant difference between the amounts asked for by the National Defense Ministry in its first budget draft and the budgetary ceiling assigned by the Public Finance Ministry can be observed. In the three fiscal years the Congress of the Republic made a last

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debt and amortization of other liabilities (group 7), other global expenses (group 8), and global allocations (group 9).

<sup>13</sup> The goal of military expenditure of the Peace Accords is used as a reference but the National defense Ministry asks for financial resources that surpass the goal. This is so because they know beforehand that its request will undergo a budgetary cut.

budgetary cut and the executed amount significantly surpassed the one approved by the Congress of the Republic.

According to the Agreement on the Fortification of the Civil Power and Function of the Army of Guatemala, in 1999, the military expenditure had to be 0,66% of the GDP; that is to say, the expenditure of the National defense Ministry should be reduced in 33% in relation to the executed military expenditure as percentage of the GDP in 1995 (that was 0,99% of the GDP). In Table N° 2 is presented the evolution of the expenditure executed by the National Defense Ministry between 1995 and 2003.

**Table N° 2: Evolution of the expenditure executed by the National Defense Ministry (1995-2003)**

	1995	1996	1997	1998	1999	2000	2001	2002	2003
US\$ Millions of 2003	186.9	159.5	150.7	153.6	149.4	187.6	220.0	163.2	177.0
% of total expenditure	9.4%	7.9%	6.4%	5.4%	4.7%	6.2%	7.0%	5.3%	5.2%
% of GDP	0.99%	0.82%	0.74%	0.72%	0.68%	0.82%	0.94%	0.68%	0.72%
Peace Accord Goal as % of GDP			0.88%	0.77%	0.66%				

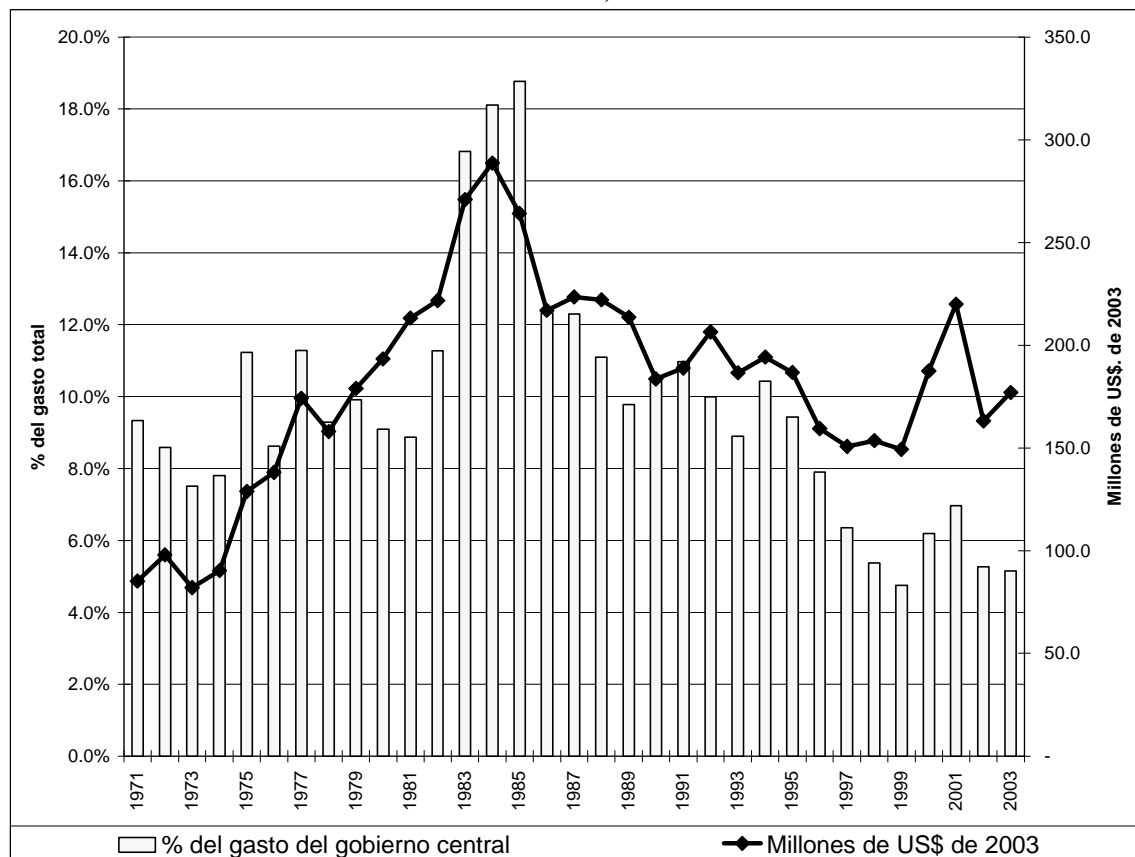
Source: own elaboration from information of the liquidations of the State budget, the Bank of Guatemala and the Agreement on the Fortification of the Civil Power and Function of the Army in a Democratic Society.

Between 1997 and 1999 it can be said that the commitment of the goal to limit to a percentage of the GDP the military expenditure was fulfilled. Nevertheless, in fiscal years 2000 and 2001 more resources are executed in real terms than in 1995 even though that as percentage of the total expenditure its participation in the total budget is reduced.

In the Report of the Mission of Verification of the United Nations in Guatemala (MINUGUA) titled "Situation of the commitments relative to the Army in the Peace Accords" its affirmed that during the years the 2000 and 2001 the expenditure executed by the Army reached relative numbers similar to those of the period of the armed conflict and it is recommended to maintain the stipulated goals of expenditure of the Peace Accords. This recommendation has implicit that a 0.66% of the GDP is the amount of resources that are needed by the Armed Forces to fulfill their mission in the different scenes from threats from the national security, and therefore they bet that the conflicts could be solved through negotiation using the created multinational mechanisms for this case.

In order to have a more ample vision the amount executed by the National Defense Ministry and the approved budget by the Congress of the Republic was compared for the period 1971-2003. It was found that in average the ministry executed an amount 29% greater than the budget originally approved by the Congress. Nevertheless, when repeating the same exercise with the total expenditure and the expenditure of the Ministry of Interior (the one in charge of the internal security) it was found that in average a 4% and 1% lesser than the total amount approved by the Congress were executed, respectively. In addition, we founded that in average the National Defense Ministry executed US\$181 million of 2003 during the same period although at the most agilest time of the armed conflict it got to execute US\$289 million of 2003. In the same period the participation of the expenditure of the National Defense Ministry was near 10% whereas at the time of the armed conflict it reached 19%. These findings show that we must be cautious of affirmations like the one of the MINUGUA with respect to which during the years 2000 and 2001 total expenditures executed by the Army reached relative numbers similar to those of the period of the armed conflict (see Graph N° 7).

**Graph N° 7: Evolution of the expenditure executed by the National Defense Ministry (1971-2003)**

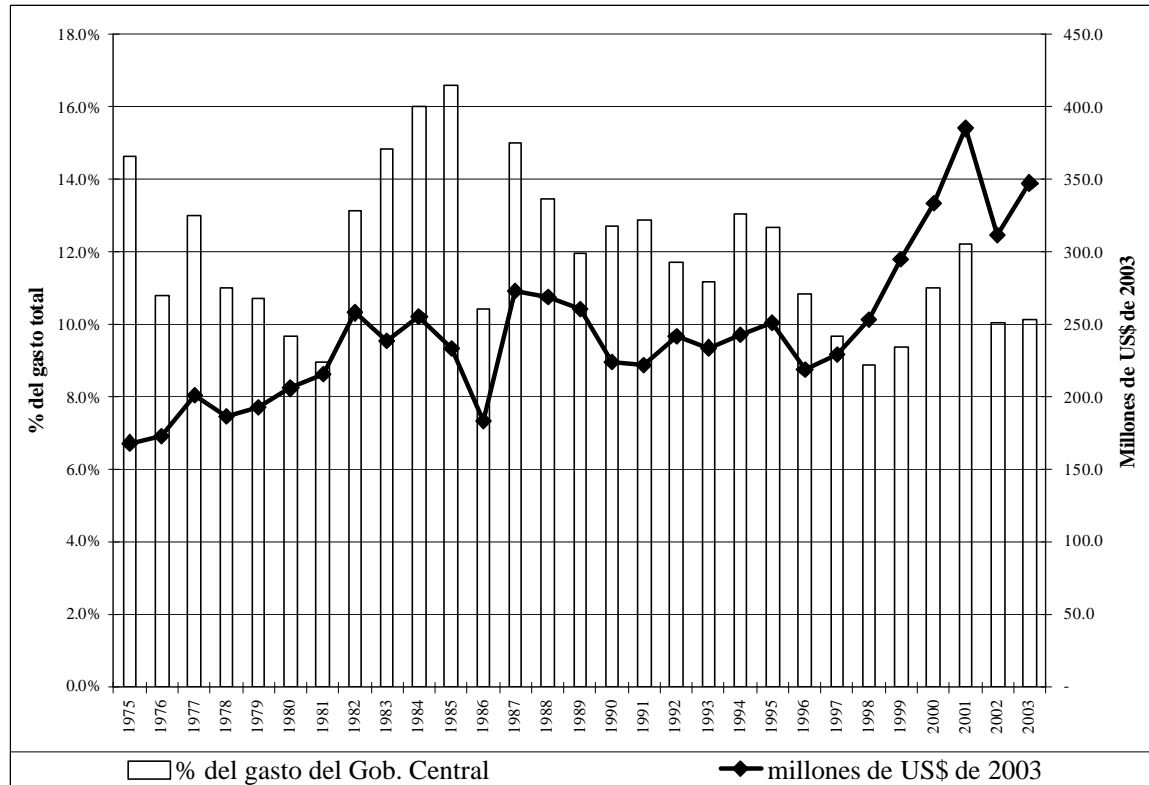


Source: own elaboration from information of the Bank of Guatemala and the Public Finance Ministry.

From 1975 it is possible to construct a sectarian classification of the expenditure of the central government that allowed us to analyze the evolution of the expenditure executed in defense and internal security. In average, between 1975 and 2003, the expenditure

executed in defense and internal security has been equivalent to a 12% of the total expenditure of the central government. After the signing of the Peace Accords in 1996 this sector represented 10% of the total expenditure of the central government but in real terms it meant more financial resources (see Graph N° 8).

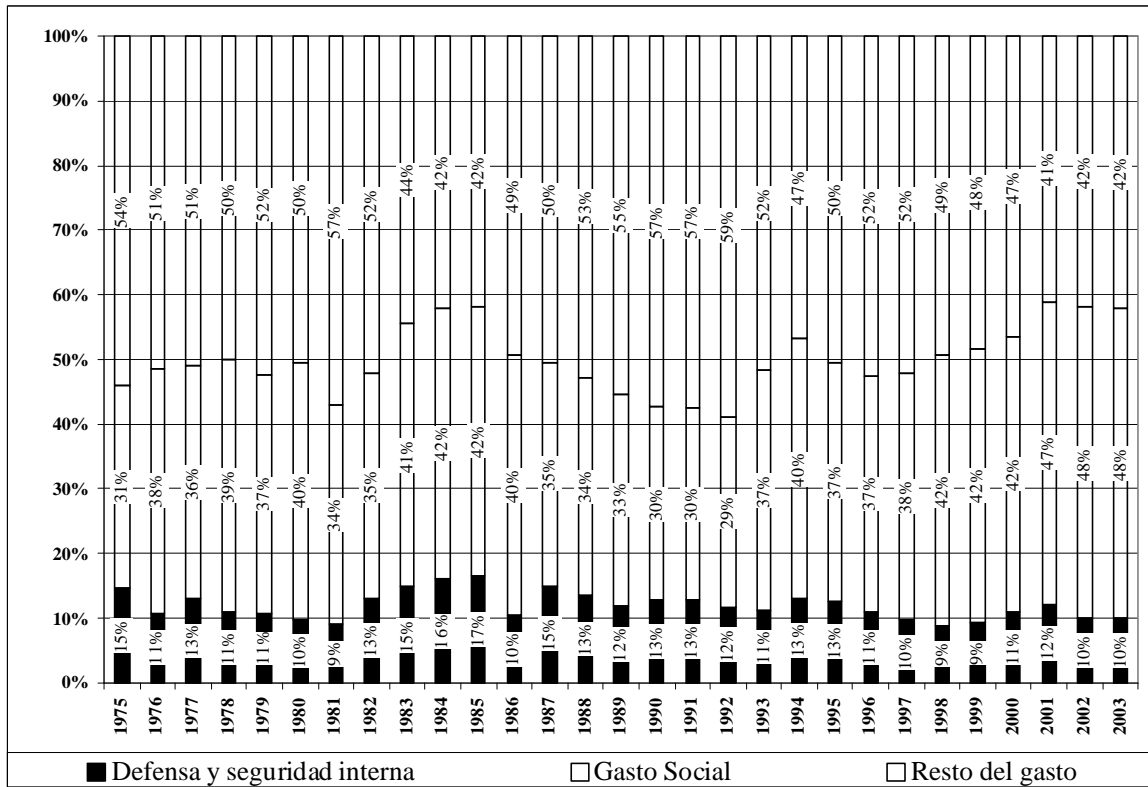
**Graph N° 8: Evolution of the expenditure executed in defense and internal security (1975-2003)**



Source: own elaboration from information of the Bank of Guatemala and the Public Finance Ministry.

As of 1998 it was possible to determine that more than 98% of the expenditure executed in the defense and internal security sector was through the National Defense Ministry and the Ministry of Interior. In addition, it was found that near 95% of the expenditure executed by the Ministry of Interior was in activities classified as internal security; whereas around 88% of the expenditure executed by the National Defense Ministry was in defense classified activities. In any case the best way to identify priorities is analyzing the distribution of the total expenditure. In Graph N° 9 we present the evolution of the distribution of the total expenditure in defense and internal security, social expenditure, and rest of the expenditure. It is worth noticing that when the participation of the expenditure executed in defense and internal security was greater, did not take place a reduction of the participation of the social expenditure and it was even increased. Finally it is worth to indicate that most of the expenditure executed in both ministries is for the remuneration of its personnel.

**Graph N° 9: Evolution of the participation of the sectarian expenditure (1975-2003)**



Source: own elaboration from information of the Public Finance Ministry.

## Conclusions and recommendations

The bad handling of the fiscal policy reflected in recurrent fiscal deficits has had a negative impact in the economic performance of Guatemala. Therefore, the deficit must be approached from both faces of the coin: the income and the expenses. The contribution that the tax collecting action and the expenses of the public sector does to the economic growth and the social development of the country, depends on the effectiveness whereupon it collects his income and of the efficiency whereupon it spends those resources. In principle the decision of closing the gap between the public income and expenses by means of a reduction of the expenditure or an increase of the income had to be based on an estimation of the costs and the benefits of taking the actions to do so. In any case, it will be beneficial to reduce the superfluous expenditure, and to increase efficiently the collection of resources to finance the public expenses that are advisable to keep doing.

We consider that in the discussions on the fiscal policy the two faces of the coin should never be separate. Traditionally in Guatemala the attention has been centered in one face of the coin: the tributary side. Nevertheless, both faces are closely related although the way that the resources are given back to the society, through the public expenditure, is what legitimizes the tributary collection. The departure point should be to attain agreements of long term national objectives; that is to say, objectives that serve to orient several governments. The second step should be to identify and to quantify the resources

necessary to achieve the long term objectives. As a result of the previous exercise there should be an estimation of the tax burden necessary to finance the public expenditure associate to the long term objectives.

In the income side we suggest two lines of action: 1) to improve the administration and the fiscal achievement by fortifying the Tributary Administration Supervision (SAT).and 2) to modify the tributary system to increase the collection but reducing its distortions in the economy. For example, in the first line of action it is recommended to establish the positive administrative silence in fiscal matters. This means that if the period that establishes the legislation for the resolution of the interposed resources ended and the governmental authority does not respond, it will be understand that the resolution is favorable to the person that interposed the resource. This is crucial mainly in processes where it is required that the contributor has legal certainty on the procedures of the tributary authority, as in the case of the processes to give back some taxes.

In the second line of action, in the short term it is suggested to replace the present tax on the individual income by means of a tax of unique rate on the gross income. In addition, we consider that there is not an economic justification for the present tax on the enterprise profits. A progressive tax for enterprises takes to an artificial division of the companies automatically. The fragmentation is carried out exclusively to reach tax savings. Therefore, we suggested that in the short term should be adopted a unique tax rate but that in a reasonable longer term it should disappear. As far as the VAT, it is recommended to eliminate most of the existing exemptions and the regime of the small contributor. Regarding the devolution of the VAT to the exporter, it is imperative that agile and simple mechanisms get implemented to avoid abuses on the part of the SAT. Any improvement of the VAT must be to move as quickly as it is possible to a uniform rate of tax in order that it becomes the main source of income. Finally it is recommended to eliminate other specific taxes that generally have high administrative costs and don't contribute much in the total collection of income.

By the expenditure side, it is recommended to optimize the use of the fiscal resources. For example, it is suggested to reduce the number of organizations to the minimum in order not to duplicate functions. Therefore, it is important to review all the institutions of the State to determine if there are duplications in some organizations or if some must be suppressed being inconsistent with the role of the State, which should facilitate and norm, in opposite to being a direct provider of services. In order to assign efficient and effectively the resources it is necessary to count on information on what it is being attained with the financial resources that are assigned to each program and project. In addition, it is suggested to extend the horizon of budgetary programming to at least five years. It is fundamental that the total amount of the expenditure is defined from macroeconomic projections so that there is congruency between the fiscal, monetary and the exchange policies.

In synthesis, we suggest that the expenditure should be assigned from an economic analysis in order to be sure that it has a positive yield for the country. This implicitly

means that the allocations by law must be eliminated and that a system of performance indicators must be implemented in order to verify that the assigned resources fulfill the predicted goals. Therefore, the resources assigned for defense and internal security must compete with the other sectors, and will be defined from the long term objectives of their sector as well as from the macroeconomic situation of the country.