

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

**FISCAL POLICY AND MANAGEMENT SECTOR FRAMEWORK DOCUMENT**

**FISCAL AND MUNICIPAL MANAGEMENT DIVISION**

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This document was prepared by the Fiscal and Municipal Management Division (IFD/FMM). The team that prepared the document consisted of: Vicente Fretes Cibils (IFD/FMM), Division Chief; Gustavo García (IFD/FMM), Project Team Leader; Carola Pessino, (IFD/FMM), Alternate Project Team Leader; Carlos Pimenta (IFD/FMM); Luiz Villela (IFD/FMM); Martín Ardanaz (FMM/CNI); Alberto Barreix (IFD/FMM); Axel Radics (IFD/FMM); Edna Armendáriz (IFD/FMM); Ida M. Fernández (IFD/FMM); María Cecilia Deza, Nuria Tolsá Caballero, and Juan Carlos Benitez (consultants, FMM); Luz Ángela García (KNL/KNM); Darinka Vásquez Jordan (KNL/KNM); Micha Van Waesberghey (KNL/KNM); and all other fiscal management specialists at IFD/FMM. The document incorporates comments by Philip Keefer of IFD/IFD; IFD/ICS; SCL/SCL; SCL/LMK; SCL/EDU; SCL/SPH; IFD/IFD; RES/RES; and VPS/VPS.

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## ABBREVIATIONS

|             |                                                            |
|-------------|------------------------------------------------------------|
| BEPS        | Base Erosion and Profit Shifting                           |
| CCTP        | Conditional cash transfer program                          |
| CIAT        | Inter-American Center of Tax Administrations               |
| CoPLAC-MfDR | Latin American and Caribbean Community of Practice on MfDR |
| CPE         | Country Program Evaluation                                 |
| DEM         | Development Effectiveness Matrix                           |
| DSA         | Debt sustainability analysis                               |
| ECLAC       | Economic Commission for Latin America and the Caribbean    |
| ERP         | Enterprise Resource Planning                               |
| ESW         | Economic and Sector Work                                   |
| FTC         | Fiscal Transparency Code                                   |
| FTZ         | Free Trade Zone                                            |
| G20         | Group of Twenty                                            |
| GDP         | Gross domestic product                                     |
| IDRC        | International Development Research Center                  |
| IFMS        | Integrated financial management system                     |
| IMF         | International Monetary Fund                                |
| INTOSAI     | International Organisation of Supreme Audit Institutions   |
| IPSAS       | International Public Sector Accounting Standards           |
| ITD         | International Tax Dialogue                                 |
| MfDR        | Managing for development results                           |
| MTFF        | Medium-term fiscal framework                               |
| NPIS        | National public investment system                          |
| NRR         | Nonrenewable resources                                     |
| OBI         | Open Budget Index                                          |
| OECD        | Organization for Economic Cooperation and Development      |
| OVE         | Office of Evaluation and Oversight                         |
| PBL         | Policy-based loan                                          |
| PEFA        | Public Expenditure and Financial Accountability            |
| PES         | PRODEV Evaluation System                                   |
| PFM         | Public financial management                                |
| PPP         | Public-private partnerships                                |
| R&D         | Research and development                                   |
| RBB         | Results-based budgeting                                    |
| ROSC        | Reports on the Observance of Standards & Codes             |
| SAI         | Supreme Audit Institutions                                 |
| SFD         | Sector Framework Document                                  |
| SMEs        | Small and medium-sized enterprises                         |
| TSA         | Treasury single account                                    |
| VAT         | Value added tax                                            |
| VfM         | Value for Money                                            |

## **I. THE FISCAL POLICY AND MANAGEMENT SECTOR IN THE CONTEXT OF THE BANK'S SECTOR STRATEGIES**

### **A. The Fiscal Policy and Management Sector Framework Document as part of the existing regulations**

- 1.1 This Fiscal Policy and Management Sector Framework Document (SFD) has been prepared in accordance with document GN-2670-1, "Strategies, Policies, Sector Frameworks and Guidelines at the IDB." It aims to guide the Bank's operational, dialogue, and knowledge generation activities with the countries, their governments, and private borrowers.
- 1.2 This is a flexible SFD that will allow the Bank to address the changing contexts and challenges faced by its 26 borrowing member countries, while guiding Bank financing in the fiscal policy and management sector (hereinafter the "Sector") for sovereign-guaranteed and non-sovereign guaranteed operations. In addition, this SFD can be tailored to the individual circumstances and preferences of each country in terms of both the design and the implementation of Sector projects. As provided in paragraph 1.20 of document GN-2670-1, SFDs should be updated every three years, on a rolling basis. Accordingly, the Bank will prepare an updated SFD three years after the approval of this document.

### **B. The Fiscal Policy and Management SFD as part of the Sector Strategy on Institutions for Growth and Social Welfare**

- 1.3 The Fiscal Policy and Management SFD falls within the framework of the Report on the Ninth General Increase in the Resources of the Inter-American Development Bank (document AB-2764) with regard to reducing poverty and inequality and fostering sustainable growth. More specifically, this SFD has been developed as part of the Sector Strategy on Institutions for Growth and Social Welfare (document GN-2587-2) in the areas of institutions for growth, public expenditure management and financing, and improving productivity for growth and social welfare. In particular, this SFD emphasizes improving the provision and utilization of resources for growth and social welfare.
- 1.4 This SFD is also associated with the IDB Infrastructure Strategy: Sustainable Infrastructure for Competitiveness and Inclusive Growth (document GN-2710-5) and the Strategy on Social Policy for Equity and Productivity (document GN-2588-4), in view of the role played by public expenditure and financial management policies through the allocation and management of resources in expenditure budgets, strategic planning, medium-term fiscal frameworks (MTFF), public procurement systems, public investments systems, and fiscal transparency and accountability. This SFD also relates to the IDB Integrated Strategy for Climate Change Adaptation and Mitigation, and Sustainable and Renewable Energy (document GN-2609-1), which identifies the need to have specific fiscal management policies and research, and to the Sector Strategy to Support Competitive Global and Regional Integration (document GN-2565-4), which provides for promoting international fiscal harmonization and regulation of transfer prices.
- 1.5 This SFD recognizes the multisector nature of fiscal policy and management, manifested in part by the various economic and social tasks and responsibilities entrusted to the different national and subnational governments, necessarily

requiring greater resources in order to finance growth and social welfare in conjunction with the private sector. In view of the crosscutting dimension of fiscal management, this SFD relates to the following SFDs: Decentralization and Subnational Governments (document GN-2813-3); Urban Development and Housing (document GN-2732-2); Health and Nutrition (document GN-2735-3); Social Protection and Poverty (document GN-2784-3); Education and Early Childhood Development (document GN-2708-2); Labor (document GN-2741-3); Gender and Diversity (document GN-2800-3); Transportation (document GN-2740-3); Water and Sanitation (document GN-2781-3); Agriculture and Natural Resources Management (document GN-2709-2); Integration and Trade (document GN-2715-2); Citizen Security and Justice (document GN-2771-3); Support to SMEs and Financial Access/Supervision (document GN-2768-3); Innovation, Science, and Technology (document GN-2791-3); and Energy (document GN-2830-3).

- 1.6 This proposed SFD covers the elements that sector framework documents must contain as provided in paragraph 1.19 of document GN-2670-1. In accordance therewith, this SFD consists of five sections. This section describes the relationship between the Sector's SFD and the current regulatory framework. Section II presents a sample of the international empirical evidence available regarding Sector policies and programs. Section III identifies the major challenges facing the Sector in Latin America and the Caribbean. Section IV summarizes the lessons learned from the Bank's experience in the Sector. Lastly, Section V sets out the goals, principles, dimensions of success, lines of action, and specific activities that the Bank will prioritize in its Fiscal Policy and Management Sector work.

## **II. INTERNATIONAL EVIDENCE REGARDING THE EFFECTIVENESS OF PROGRAMS IN THE FISCAL POLICY AND MANAGEMENT SECTOR, AND IMPLICATIONS FOR THE IDB'S WORK**

- 2.1 The second section of this document examines the role of fiscal policy in economic growth in the medium and long terms. This examination is discussed in four subsections. The first addresses the role of fiscal policy in growth by conducting an analysis based on the momentum and revision that has taken place in the relevant literature over the last three or four decades, as well as the fundamental role that fiscal policy plays in achieving sustained growth through the attainment of macroeconomic stability and the sustainability of public debt as a necessary (but insufficient) condition for achieving this objective, including the countercyclical role played by fiscal policy and the institutions and rules that have been established for such purposes. The second subsection analyzes the structural effects of fiscal policy on economic efficiency, savings, and investment, and consequently, on factor productivity and their impact on long-term growth. The third subsection examines the impacts of fiscal policy and management on equity and the relationship thereof with economic efficiency and productivity, and lastly, the fourth subsection discusses the management and transparency of public resources, including tax administration, public sector financial and budgetary management, and fiscal transparency.
- 2.2 The analysis presented in this second section has been undertaken in the broadest possible international context, with particular emphasis on the lessons learned from the 2008-2010 international financial crisis, which impacted most

developed countries, and the global economic recession, which arose as a result of this crisis.

**A. The role of fiscal policy in economic growth and macroeconomic sustainability and stability**

- 2.3 There is a vast and wide-ranging empirical literature on the various paths through which fiscal policy and management can impact growth. Many of these paths have been significantly expanded in light of the theories of endogenous growth (Romer, 1986 and 1990; Lucas, 1990; Aghion and Howitt, 1998; among others),<sup>1</sup> which unlike the neoclassical theories of growth, incorporate changes in human capital, spending on research and development (R&D), technological change, and a rise in savings and investment as determining factors for growth. Taking into account the effects of these changes has broadened the basis for the role of public policies in long-term economic growth, particularly the role of fiscal policy through changes in the incentives available to economic agents in favor of savings, investment, accumulation of high-quality human capital, and innovation (Ter-Minassian, 2015).
- 2.4 In recent decades, this literature has grown considerably to include explanations of the various factors that affect medium- and long-term growth, such as exogenous shocks and macroeconomic volatility, trade liberalization and foreign investment, the role of institutions, and, more recently, the effects of inequity. These lines of research have made it possible to go even further in studying the influence of fiscal policies and management on growth. In this regard, the most extensive literature deals with macroeconomic volatility and the procyclical nature of fiscal policy, public debt and its impacts on growth, the composition and structure of tax systems, the composition, quality, and efficiency of public expenditures (particularly in infrastructure and education), the credibility of fiscal policy and fiscal institutions, and the perceived risk of sovereign debt, with impacts on interest rates. More recently, studies have focused on the tradeoffs between efficiency and equity goals that can result from fiscal policy and the influence of political economy factors that affect the decisions and actions of public policy implementers.<sup>2</sup>
- 2.5 **Sustainability.** One of the most important consequences of the financial crisis of the past decade is the extraordinary increase in public debt in most developed economies and the resulting resurgence of literature on the relation between public debt (measured as a proportion of gross domestic product (GDP)) and growth (Kumar and Woo, 2010; Panizza and Presbitero, 2012). There are various reasons why this relationship tends to be negative once certain levels of debt are reached, including the following: (i) uncertainty as to the sustainability of the debt tends to create pressure for a rise in interest rates as sovereign risk premiums increase. In turn, this rise crowds out private investment and limits the fiscal space available to governments to increase spending as a consequence of higher public debt service; (ii) spending restrictions have a particular impact on public investment programs, which have no immediate social impacts and do not involve a payment commitment on a specific date, thus limiting short- and medium-term growth even

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<sup>1</sup> For a summary and formal presentation of the theories of growth, see Jones and Vollrath (2013). For an expansion of these models and their applications for economic policies for growth, see Aghion and Howitt (1998).

<sup>2</sup> For a review and overview of the literature regarding the theories of growth and the role of fiscal policy, see Ter-Minassian (2015).

further; (iii) economic agents sense that a fiscal adjustment, in the form of an increase in the tax burden and/or a permanent reduction in spending, will ultimately be inevitable in order to avoid government insolvency; this aggravates the perception of uncertainty<sup>3</sup> and the private investment paralysis, deepening the negative impact on growth; and (iv) the reduced fiscal space resulting from the debt limits government capacity to implement countercyclical policies or offset the contractionary effects of exogenous shocks.

- 2.6 There is no single debt threshold for all countries that can indicate at what point governments will become insolvent, since this is not a linear relation. The threshold differs from country to country and depends on several factors,<sup>4</sup> notably including: (i) the level of development and degree of economic diversification of the country, particularly its exports; (ii) the depth and degree of openness of the local financial systems; (iii) the quality of the country's institutions; and (iv) historical precedent in terms of episodes of insolvency or default on public debt.<sup>5</sup> However, there is evidence that debt levels exceeding 100% of GDP for developed economies and 60% of GDP for developing economies constitute critical thresholds pointing to an approaching danger of insolvency (IMF, 2012b). Lastly, the costs of fiscal insolvency or of debt and fiscal sustainability crises have lasting effects on growth<sup>6</sup> in terms of the real income of the population, particularly the lower-income sectors.
- 2.7 The dynamics of debt sustainability depends on a set of economic variables, including economic growth, real interest rates, the primary fiscal balance, and the initial debt levels.<sup>7</sup> More specifically, the stability of the debt/GDP ratio will depend on the structural or cyclically adjusted primary balance, calculated at the rate of potential GDP growth that can ensure a stable ratio given a specific level of initial debt.<sup>8</sup> This definition of a structural primary balance that makes the debt/GDP ratio sustainable also indicates the fiscal space available or the fiscal adjustment required to ensure debt sustainability when compared with the average observed primary balances for a certain number of years (for example, the average for the preceding three to five years). When the observed primary balances are lower on average than the structural primary balance needed to stabilize the debt at the rate of potential GDP growth, a fiscal adjustment is required since the debt/GDP ratio exhibits a growth trend. When the observed primary balances are higher on average than the structural primary balance needed to stabilize the debt/GDP ratio, the country in question has fiscal space.<sup>9</sup> However, this analysis needs to be

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<sup>3</sup> If a perception is created that monetary financing will be used to cover fiscal deficits, inflationary expectations will rise and consequently create upward pressure on interest rates, accentuating the crowding out of private investment and the narrowing of fiscal space due to higher debt service, in addition to the other harmful effects of inflation, particularly on the distribution of income.

<sup>4</sup> Calderón and Fuentes (2013), IMF (2012b).

<sup>5</sup> Reinhart and Rogoff (2013).

<sup>6</sup> Miller and Zhang (2013).

<sup>7</sup> For a review of the literature on the debt sustainability dynamics, see Buitert (1983, 1985, and 1990); van Wijnbergen (1989); Fischer and Easterly (1990); and IMF (2003).

<sup>8</sup> In the case of highly indebted poor countries (HIPC), the high concession of debt means that the interest rate is lower than the economic growth rate, thus violating the condition of invertibility. Consequently, the debt sustainability analysis (DSA) for these countries requires a more specific methodological framework.

<sup>9</sup> Here, the concept of fiscal space denotes a government's capacity to undertake a spending program without needing to increase long-term debt or modify the tax burden (Heller, 2005).



supplemented by a stochastic analysis, since many of the variables that affect the debt dynamics are beyond the control of the government and are subject to exogenous shocks that can alter the trajectory of the public debt. The debt sustainability analyses (DSA) performed on a medium- to long-term debt trajectory, and the primary balance levels at the rate of potential GDP growth needed to stabilize the debt/GDP ratio, point to intertemporal public sector budget constraints (Celasun, Debrun and Ostry, 2006; and European Commission, 2012b and 2014).

- 2.8 Acknowledging the importance of fiscal sustainability for long-term growth, the Bank has developed a tool for performing DSAs for borrowing member countries from various perspectives, including the distribution of potential scenarios as a result of random shocks (fan-charts) (Borensztein et al., 2013 and Arizala et al., 2010). Similarly, there are three other factors that can seriously affect debt sustainability beyond the dynamics of primary deficit, growth, and interest rates. The first of these has to do with the currency (foreign and local) composition of the debt. A larger percentage of foreign-currency debt renders fiscal policy sustainability much more vulnerable to external shocks that can impact the exchange rate and thus raise the ratio of external debt-to-GDP. The second factor is the vulnerability of countries to sudden slowdowns in external capital inflows. These sudden stops (as they are referred to in the literature) can make it difficult to refinance external debt and can lead to debt service default. Despite being willing to meet debt maturities and having the necessary budgetary resources in local currency, authorities are unable to access the external markets (see Calvo et al., 2003; Calvo et al., 2004; and Calvo et al., 2008).<sup>10</sup> Lastly, a third factor that can affect the debt-to-GDP ratio arises from the statistical discrepancies between the primary deficit figures (which constitute flows) and the debt balances (stocks). These discrepancies arise as a result of exchange rate adjustments, changes in the debt balances due to debt restructuring or debt reduction (referred to in the specialized literature as haircuts) agreements, the materialization of contingent liabilities that had not previously been accounted for as part of the public debt, and deficiencies in government accounting. These circumstances in which there is an increase in the ratio of external debt to GDP without a concomitant change in the past or current primary deficits can give rise to significant changes in the public debt balances that must be reconciled with the deficits recorded in the fiscal statistics (IDB, 2007).
- 2.9 DSAs conducted on the basis of gross debt as formally recorded or recognized by the central government may be insufficient for evaluating the long-term sustainability of public finances. Using a broader concept of debt, DSAs should incorporate: (i) consolidated public sector debt, including the secured debt of government enterprises, subnational governments, and public trusts, which are not usually included in the recorded debt; and (ii) contingent liabilities, such as bank deposit guarantees and those of other financial institutions, as well as the explicit guarantees of public-private partnerships (PPPs), legal actions against the State which may give rise to future spending commitments, and other implicit guarantees such as the actuarial deficits of government pension systems (Bloch and Fall, 2015).

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<sup>10</sup> These publications are an important IDB contribution to this issue in general and to the analysis of fiscal sustainability and public debt management in the region in particular.

- 2.10 The aging of the population as a result of higher life expectancy and lower fertility rates will raise the old-age dependency ratio, which on average is expected to double in emerging countries and triple in Latin American and Caribbean countries by 2050. If the replacement rates, benefits of social security systems, and coverage were to remain constant, pension and retirement expenditures as a proportion of GDP would double in advanced economies and triple in Latin American and Caribbean economies. Given that countries are adjusting their systems in response to these pressures (for example, by raising the retirement age and reducing benefits), annual expenditures on old-age pensions in advanced economies are expected to increase by nearly three percentage points of GDP by 2050 (IMF, 2011a). In addition, the pressures on health expenditures due to population aging appear to be much greater now. Consequently, it is critical to complement DSAs with long-term projections of health and pension spending, allowing these effects on fiscal sustainability to be anticipated over the long term.
- 2.11 To ensure the fiscal sustainability of the pension and health systems in the face of an aging population, it is essential to carry out spending and actuarial deficit projections for these systems under various scenarios.<sup>11</sup> The European Commission, together with its member countries, projects expenditures arising from population aging every three years. Starting in 2012, the DSA for each country is being performed employing three levels or pillars of measurement. The first is the conventional DSA, which uses the recorded public debt and incorporates stochastic analyses (fan charts) in the projections. The second consists of incorporating the impact of population aging into the long-term projections of expenditures on health, pensions, and care for individuals above a certain age. The third is a new module added in 2014, which incorporates contingent liabilities, for which the information available to date is limited, and relates exclusively to guarantees furnished to the banking sector, largely in response to the fiscal impacts caused by the international financial crisis (European Commission, 2012b and 2014).<sup>12</sup> In addition to these guarantees, there is evidence that governments provide explicit or implicit guarantees to a variety of public entities, including subnational governments, public enterprises, and PPPs, and that public sector coverage is limited, leading to underestimates or concealment of actual liabilities or implicit contingent liabilities.<sup>13</sup>
- 2.12 Since their inception in the 1990s, PPPs have gained in popularity as a vehicle for mobilizing resources and contributing private-sector expertise to the provision of

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<sup>11</sup> These projections are not a forecast of the event most likely to occur in the future, but they provide a better basis of information and are therefore a useful planning tool for evaluating current policies and making decisions on policy changes.

<sup>12</sup> In the IMF analysis, current DSA projections for countries with access to the financial markets have a five-year horizon. This limits the possibility of including the impact of health and pension spending, which is expected to materialize in the long term. However, the IMF recommends including it when spending pressures materialize quickly. In this case, it recommends that its teams use flexibility in terms of lengthening the horizon of the projections. In other cases, it recommends adding a memorandum item listing the present value of the pension and health costs as a percentage of GDP. It also recommends including the potential risks of materialization of contingent liabilities in its stress tests for debt (IMF, 2013b).

<sup>13</sup> While in the 1980s and 1990s it was the Latin American and Caribbean countries that concealed certain liabilities which became evident following the crisis, the Great Recession of 2008 gave rise to similar situations in some European countries.

public infrastructure.<sup>14</sup> Countries such as Australia, Brazil, Chile, Korea, Mexico, Portugal, Spain, and the United Kingdom have over the past 20 years made intensive use of this model, primarily to finance infrastructure and, to a lesser extent, social services. From an economic standpoint, PPPs should be used when they provide more value for money (VfM) than a traditional investment or public work, in other words, when the private provider is able to deliver the infrastructure at a lower cost and with greater efficiency than the public sector. However, in many cases, investment projects undertaken through PPPs have been used to circumvent spending controls and tax rules involving debt limits by failing to record the investment, the guarantees provided, or the debt incurred in the budget, thereby jeopardizing fiscal transparency and prudence. This lack of a budgetary record transforms committed payments into contingent liabilities which, despite attempts to control them by, for example, estimating risks through sophisticated techniques, are highly correlated to the economic cycle and to government revenues. This occurs both when the government provides a minimum revenue guarantee (explicit contingent liability) and when it does not but instead guarantees delivery of the service as a last resort (implicit contingent liability). In a recession, the projected revenue ends up being overestimated and the investment guarantees materialize.

- 2.13 The materialization of concealed and contingent liabilities in some European countries, such as Spain, Portugal, and Iceland, during the 2008-2010 financial and fiscal crisis shows that these liabilities continue to be insufficiently dealt with both in the DSAs and in the public accounts of countries (in the budget as well as in the debt statistics and national accounting). A recent example of the effect of a failure to record actual or contingent liabilities is the Great Recession in Portugal. Portugal's debt rose from 76% of GDP in 2009 to 130% of GDP in 2014. One half of this increase was attributable to the reclassification of entities that were off the general government accounts—primarily public enterprises, as well as several PPPs—and to interventions aimed at shoring up financial institutions (Cangiano et al., 2014).
- 2.14 Various entities have proposed a series of rules or best practices aimed at promoting the positive aspects of PPPs and minimizing the risks. The Organization of Economic Cooperation and Development (OECD) recommends guidelines that include improving the process of PPP selection by encouraging the use of cost-benefit techniques, strengthening the legal framework, and making spending commitments and contingent liabilities more transparent (OECD, 2012c). Other recommendations include limiting the monetary value of projects to be executed through PPPs by applying specific annual and/or cumulative ceilings, setting quantitative limits on guarantees, and recording assumed commitments as debt, even in the case of pure concessions since, from an accounting standpoint, a

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<sup>14</sup> While there are many definitions of public-private partnership, the most general one is an arrangement that involves a long-term contract between the public and private sectors for the delivery of a public service or public infrastructure. The private contractor agrees to provide the service for which it is responsible, and the government undertakes to pay for the service or allows the private contractor to collect fees or tolls directly from users. There is extensive literature offering alternative definitions (IMF, 2006; OECD, 2008b).

PPP is equivalent to a public debt incurred with the concessionaire<sup>15</sup> (Irwin, 2007; Funke et al., 2012).

- 2.15 With regard to all other contingent liabilities, the financial crisis revealed gaps in many governments' knowledge of their underlying fiscal position and the shocks that could affect it.<sup>16</sup> To identify and mitigate these sources of fiscal risk, it is essential to improve fiscal transparency rules and practices along several dimensions, including: (i) more complete coverage of public-sector institutions and transactions; (ii) presentation of more comprehensive reports on public-sector assets and liabilities; and (iii) presentation of more frequent and timely fiscal reports (Cotarelli, 2012). Several countries, such as Australia, Brazil, Canada, Chile, Colombia, France, New Zealand, and the United Kingdom, identify at least some of the fiscal risks and prepare a report that is submitted together with the annual budget. In general, in these countries, the obligation to report fiscal risks is set forth in fiscal responsibility laws (Cebotari et al., 2009).
- 2.16 **Stability.** Another important role that fiscal policy should perform is to stabilize aggregate domestic demand in order to moderate macroeconomic volatility and thereby contribute to medium-term growth (Fatas and Mihov, 2011; Aghion and Marinescu, 2008). For example, increases in the stabilizing capacity of fiscal policy are associated with reductions of up to 20% in the volatility of output and with increases of 0.3% in the annual growth rate (IMF, 2015a). International evidence indicates that automatic stabilizers<sup>17</sup> are the principal tool for enabling fiscal policy to fulfill its stabilizing function (Debrun and Kapoor, 2010; Baungsgard and Symansky, 2009). Their contribution is particularly significant in developed countries, where automatic stabilizers account for most of the stabilizing capacity of fiscal policy and are strongly correlated with lower levels of macroeconomic volatility (Fatas and Mihov, 2001; Gali, 1994).
- 2.17 Unlike discretionary economic policy interventions, automatic stabilizers are not subject to implementation lags and can quickly and easily be reversed before a change of cycle, ensuring a timely and symmetrical fiscal policy response to shocks (Blanchard et al., 2010). While discretionary fiscal policy can prove necessary under certain conditions,<sup>18</sup> its misuse undermines the impact of

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<sup>15</sup> The correct approach would be to apply the International Public Sector Accounting Standards (IPSAS 32). These standards provide a framework for reducing the bias in favor of PPPs: when control of the asset is in the hands of the grantor (the government), requiring the grantor to record the debt while the asset is being built.

<sup>16</sup> In 10 countries that experienced the largest unforeseen increases in gross public debt as a proportion of GDP between 2007 and 2010, 23% of the increase was attributable to incomplete information on the government's underlying fiscal position. The existence of concealed or implicit obligations with public enterprises and PPPs outside the general government perimeter damaged the public finances when the crisis erupted in Germany, United States, Greece, Iceland, and Portugal. In Spain, Greece, and Portugal, the cash-based budgetary and accounting system and the government reporting system were unable to capture or control spending commitments, leading to an accumulation of past due payments both before and during the crisis.

<sup>17</sup> These include public revenue or expenditure items that are automatically adjusted (without intervention by the authorities) in the opposite direction of the cycle in order to stimulate (moderate) aggregate demand during positive (negative) episodes. The most common examples are income tax and unemployment insurance (Baungsgard and Symansky, 2009).

<sup>18</sup> For example, in the event of significant and unexpected shocks requiring additional action to supplement automatic stabilizers, or in the event of rigid policy frameworks and/or contexts allowing limited leeway for monetary policy.

automatic stabilizers and can contribute to the creation of sustainability problems (IMF, 2015a). For example, asymmetric discretionary policy tends to combine increases in the deficit levels during recessions which are not reversed during periods of expansion, thus limiting the recovery of fiscal space and resulting in an accumulation of debt over time (IMF, 2007).<sup>19</sup> Beyond the problem of sustainability, there is ample evidence documenting the negative effects of sudden changes in discretionary and procyclical fiscal policy on various outcomes, such as growth levels (Fatas and Mihov, 2013; Woo, 2011), macroeconomic stability (Fatas and Mihov, 2003; Ramey and Ramey, 1995), and efforts to protect vulnerable households during recessions (Ravallion, 2002; Hicks and Woodon, 2001; Lustig, 2000).

- 2.18 In this context, international experience indicates the importance of having institutional mechanisms in place aimed at correcting and enhancing incentives for policy designers and implementers to support reducing the procyclical bias of fiscal policy, while also limiting the improper use of discretionary policy, thus contributing to fiscal soundness and stabilization. These mechanisms notably include a role for budgetary institutions acting through a broad spectrum of rules, procedures, and instruments.<sup>20</sup> First, fiscal rules impose numerical limits on key budget aggregates, such as deficit, debt, expenditures, and revenue (Kopits and Symansky, 1998). In addition, the stabilization funds<sup>21</sup> that are common in countries with abundant nonrenewable resources (NRRs) are designed to mitigate the effects of commodity price fluctuations on fiscal accounts. Lastly, medium-term fiscal frameworks (MTFFs) allow governments to commit to fiscal targets beyond the confines of a single fiscal year by incorporating intertemporal budget constraints (World Bank, 2012).
- 2.19 Second, the rules of procedure determine the functions, responsibilities, and prerogatives of the stakeholders who participate in budget negotiations (Alesina and Perotti, 1995). For example, more hierarchical rules that concentrate power in stakeholders with a greater interest in maintaining public finances under control may confer greater budgetary prerogatives on the finance minister relative to the rest of the cabinet, and on the executive branch relative to the legislative branch<sup>22</sup> (Poterba and von Hagen, 1999; Alesina et al., 1999). Lastly, fiscal councils<sup>23</sup> can

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<sup>19</sup> In fact, asymmetrical fiscal policy significantly contributes significantly to the accumulation of debt: in advanced countries, it accounts for one third of the average increase in the debt ratio over the past thirty years (Balassone and Francese, 2004), while in developing countries, estimates suggest that the debt/GDP ratio could be 10 percentage points lower if symmetrical fiscal policies had been in place throughout the cycle (IMF, 2007).

<sup>20</sup> Naturally, fiscal results depend not only on the budgetary institutions but also on the political institutions and more generally on political-partisan context variables (Alesina and Perotti, 1995; Persson and Tabellini, 2003; Frankel et al., 2012).

<sup>21</sup> These funds are comprised of revenues from the development of nonrenewable natural resources, accumulating additional revenues during boom periods and financing necessary expenditures during periods of decline.

<sup>22</sup> These powers include the authority to determine the revenue estimate in the budget and consequently the annual spending and debt limits, while the composition of expenditures and the creation of new taxes remain within the domain of the executive and legislative branches, with the latter having the final say.

<sup>23</sup> A fiscal council is a permanent agency with a legal or executive mandate to evaluate the government's fiscal policies, plans, and performance—publicly and free from partisan influence—against macroeconomic objectives related to long-term sustainability of public finances, short- and medium-term macroeconomic stability, and other government objectives (Debrun et al., 2009).

help improve the quality of fiscal policy through one or more functions designed to reinforce credibility and transparency, such as publishing impartial macroeconomic and budgetary projections, formulating fiscal policy recommendations and/or costing, and supervising or monitoring compliance with fiscal rules (Kopits, 2013; Debrun et al., 2009).

- 2.20 There is ample evidence linking the strength of institutional fiscal frameworks to fiscal performance (Debrun et al., 2008; Fabrizio and Mody, 2006). For example, numerical rules that, among other design features, have a solid legal basis and effective compliance mechanisms are associated with fiscal discipline (Cordes et al., 2015) and episodes of successful fiscal consolidation (Marcel, 2013). In countries with NRRs, fiscal rules help to reduce the levels of procyclicality in fiscal policy (Céspedes and Velasco, 2014).<sup>24</sup> Similarly, stabilization funds can stabilize public spending in countries that generate significant fiscal revenues from NRRs: the volatility of total expenditures is 10% lower than in similar countries that do not employ this type of instrument (Villafuerte et al., 2010; Sugawara, 2014). Lastly, the countries that have adopted MTFs have improved their fiscal position by more than two percentage points of GDP following their implementation, and the more advanced stages of these frameworks (for example, expenditure frameworks with goals at the program level) are associated with lower volatility of social public spending (Vlaicu et al., 2014).
- 2.21 In addition, more hierarchical rules of procedure help to reduce fiscal deficits, facilitate the implementation of fiscal consolidation programs, and can contribute to fiscal sustainability<sup>25</sup> (Hallerberg et al., 2009a). Lastly, countries that have fiscal councils tend to present more accurate and less biased macroeconomic and budgetary projections, while certain characteristics of these councils, such as their degree of independence and of involvement in the budgeting process, help in obtaining better fiscal results and strengthen the credibility of the budgetary processes and institutions (Debrun and Kinda, 2014; Kopits, 2013; Frankel and Schreger, 2012).
- 2.22 Another issue that has become particularly relevant is the effectiveness of fiscal policy in stimulating demand with a view to spurring growth in response to the recessionary impacts of the financial crisis, given the limited effectiveness of monetary policy in this area, in a context of interest rates near zero (or even negative in real terms) in the short term. This discussion has focused on the size of fiscal multipliers to empirically quantify the fiscal policy's effectiveness (Symansky, 2009; Blanchard et al., 2010; Spilimbergo et al., 2009). The size of the fiscal multipliers depends on a series of economic and institutional variables rendering their empirical measurement rather complex and sophisticated, and therefore, there is no single prescription for all countries under any circumstances over time (Ilzetzki et al., 2010). They also depend on: (i) the stage in the economic cycle; (ii) the exchange mechanism in force (fixed or flexible); (iii) the instruments used (tax or spending instruments, with the latter focusing on consumption and/or

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<sup>24</sup> However, the evidence regarding the impact of fiscal rules on the degree of procyclicality of expenditures in developing countries in general is weak (Bova et al., 2014).

<sup>25</sup> Naturally, the benefits associated with fiscal discipline must be weighed against other side effects. For example, increasing the hierarchy could reduce the representativeness of the expenditures or allow these powers to be used strategically to obtain immediate political benefits, for example by creating electoral cycles in the budget.

investment); (iv) the quality and effectiveness of expenditure management; and even more importantly, (v) the perception of economic agents regarding the sustainability of the fiscal and exchange policies. When there is a general perception of a risk of unsustainability of fiscal policy, the multipliers tend toward zero, and in the event of a perception of exchange policy unsustainability, the multipliers may even become negative (Spilimbergo, et al., 2009).

**B. The structure of tax systems and public expenditure and their impact on economic efficiency and productivity**

- 2.23 **Tax systems.** The literature on the impacts of taxes on the economy is very extensive and varied from both a theoretical and an empirical standpoint, since taxes can have negative or positive effects, depending on how they affect the behavior of economic agents and the environment for conducting economic activities. For example, high corporate income taxes can be detrimental to corporate investment or expenditures on research and development (R&D), thus producing a negative effect on productivity and growth. Similarly, personal income taxes can affect savings decisions and consequently impact the cash flows required to finance investment and consumption, thereby also having an adverse effect on growth. Furthermore, payroll or labor taxes can adversely affect the incentive to work and the labor effort of individuals. In some cases, particularly in developing economies, payroll taxes can encourage workers to move to the informal economy as a way of evading the tax burden associated with the formal sector, leading to a decline in productivity and negatively affecting growth. This reaction by individuals is more pronounced if the social security services that are essentially funded through taxes are not perceived as satisfactory in terms of quality and quantity.
- 2.24 Taxes can also produce positive effects by generating the necessary resources to finance public goods and services that favor growth, such as education, public health, R&D, public infrastructure, rule of law, etc. For these reasons, empirical models can run into considerable methodological difficulties in finding an explanation that is statistically significant, robust, and of relatively large magnitude, particularly when working with highly aggregated data. However, significant advances have been made in the literature in recent years with the application of new theoretical models and more sophisticated techniques.
- 2.25 Several studies have analyzed the impact of various types of taxes on growth and its components and, based on the findings, have formulated recommendations for reform (Myles, 2009a, 2009b, 2009c; OECD, 2010c, Martínez-Vázquez et al., 2011; and Mirrless et al., 2011). The most important conclusions of the above-mentioned studies are the following:<sup>26</sup> (i) real property taxes are the least likely to affect growth and distort the allocation of resources to savings and investment; (ii) taxes of the value-added type have no effect on savings-investment decisions; their effects on the allocation of resources between sectors of economic activity are nonexistent if they are designed at a broad-base, standard rate; (iii) selective indirect excise taxes appear not to have any effects on growth, and their final effect on consumption will depend on the type of goods on which they are levied (being corrective if aimed at counteracting negative externalities); (iv) payroll taxes affect the incentive to work and the labor effort; (v) highly progressive personal income

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<sup>26</sup> For more details on these conclusions, see Ter-Minassian (2015).

- taxes (characterized by high marginal rates for high-income groups) can have negative effects on savings rates above a certain level, but the empirical evidence is not entirely conclusive (for this reason, this tax plays an important redistributive role in OECD countries and different rates are in place for labor income and capital income, since the latter can have a significant impact on savings and investment rates); and (vi) corporate income taxes show a greater adverse impact on growth due to the investment sensitivity of businesses, including investment in R&D as well as in fixed assets. This explains the downward trend in corporate income tax rates in most developed countries and in some fast-growing emerging economies of Southeast Asia.
- 2.26 The main recommendations of the report by Mirrless (Mirrless et al., 2011) are consistent with the aforementioned studies, while offering policy recommendations on the characteristics of tax systems as a whole. In this regard, the report indicates, among other things, that every tax system should generate enough resources to finance the spending needs of then countries (sufficiency) and be progressive, neutral, and simple. While not all taxes need to be progressive, the system as a whole should be. Likewise, direct taxes are the best means for achieving progressivity, while other instruments of the tax system should focus on seeking efficiency and sufficiency in terms of generating resources. Thus, there is a relationship between attaining progressivity and minimizing the loss of economic efficiency, which is known as neutrality.
- 2.27 Neutrality is understood to mean that similar economic persons and activities should be given an analogous tax treatment, avoiding discrimination and minimizing the economic distortions that affect resource allocation and factor productivity. Nevertheless, some activities generate negative or positive externalities and warrant differentiated treatment. For example, activities that are harmful to public health or the environment generate negative externalities that can be reduced by means of corrective taxes acting as disincentives. Conversely, investments in R&D, education, and early childhood care generate positive externalities that can be encouraged through a favorable tax treatment. In these cases, the social benefits exceed the private costs of those directly affected by these taxes, generating a net welfare gain.
- 2.28 The search for a greater balance between neutrality and progressivity has led to attempts to modify the personal income tax, which is the most important component in the tax structure of OECD countries (33.5%).<sup>27</sup> Thus, the introduction of the dual income tax system in Scandinavian countries, which taxes labor income and capital income on a separate basis, broke with the synthetic or simplified design systems. In the wake of the Scandinavian countries, many other developed countries have introduced semidual systems, which provide a different treatment for capital income but not for mixed income. The most clear-cut cases are Spain, Germany, and Slovenia, but dual-system features have also been introduced in Austria, Poland, Belgium, Italy, Portugal, Greece, France, and the Netherlands. Evidence indicates that most of these countries have experienced changes in the composition of savings as a result of the increased neutrality brought about by the dual system (Strand, 1999; Picos, 2003).

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<sup>27</sup> Authors' estimates based on OECD (2015e).



- 2.29 **Expenditure policy and management.** The long-term impact of an increase in public spending is difficult to forecast and estimate with accuracy. A positive correlation between expenditure and growth, which would be consistent with the Keynesian view, does not imply causality, since it could be a matter of reverse causality: countries tend to have bigger governments as they develop, and thus the correlation between public spending and growth operates in both directions. Furthermore, increased spending can also be associated with lower GDP growth, since the government can crowd out the private sector by absorbing resources; this relationship is likely to have an inverted U-shaped curve, where the growth rate increases for lower levels of public spending and then slows down as expenditures rise (Tanzi and Zee, 1997). Despite the fact that the initial empirical analysis found no conclusive evidence regarding the impact of the size of expenditures on growth, recent studies using better data and econometric methods (Afonso and Jalles, 2014; Berg and Henrekson, 2011 and 2015) have found that, above a certain level, higher spending is associated with lower growth, particularly in more developed countries.
- 2.30 The impact of increased spending will depend on the composition of the change as well as on the effects of each of the individual categories. In the simplest version of these models, expenditures associated with the production function (productive expenditures) affect the growth rate, while expenditures associated with the utility function (unproductive expenditures) affect growth only if financed through distortionary taxes. Studies that disaggregate spending into its components, usually into consumption and capital expenditures (Barro, 2003) or into further disaggregated levels, find that current spending and government consumption expenditures are less effective or even reduce growth when compared to public investment in infrastructure or in human capital (Acosta-Ormaechea and Morozumi, 2013). For OECD countries, higher spending on health, education, and infrastructure appears to favor long-term growth, while an increase in other types of expenditures appears to have the opposite effect (Gemmell et al., 2009; Barbiero and Cournède 2013).
- 2.31 The international empirical evidence indicates that the effects of fiscal policy on economic growth depend on several factors. With regard to public expenditures, fiscal policy should promote spending on quality human and physical capital. Furthermore, the effectiveness of fiscal policy in terms of growth can be improved through reforms that reinforce one another and are accompanied by other institutional reforms.
- 2.32 Initiatives aimed at enhancing the efficiency and quality of public spending are associated with both fiscal policy and public management considerations. Spending efficiency can be allocative (prioritizing among different expenditures) or operational (improving each spending component).<sup>28</sup> The recent theoretical and empirical literature has focused almost exclusively on operational efficiency, on the assumption that expenditure allocation is already optimal or given or perhaps difficult to address. To measure technical or operational efficiency, the literature

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<sup>28</sup> While allocative efficiency focuses on ensuring that expenditures are optimally distributed among the various functions or sectors, technical or operational efficiency concentrates on achieving efficient results for each spending allocation.

- proposes a number of intermediate outcome, output, and final outcome indicators for different categories of public expenditures.
- 2.33 Analyzing the efficiency of public expenditures also requires indicators of costs, which are directly controlled by the policy implementers. Performance indicators link policy options to outcomes, thereby measuring policy efficiency and effectiveness (for example, linking public spending on education to achievements in knowledge acquisition). The composite indicators developed by Afonso et al. (2005)<sup>29</sup> and CAF (2012) have become a useful tool for comparing and analyzing complex issues between countries (ECLAC, 2013). These indicators and the measurement of technical efficiency are useful for identifying relative inefficiencies but are not capable of explaining the reasons for the differences in inefficiency. The indicators should be treated as one more tool in the toolkit for analyzing public expenditures, and be supplemented by qualitative and sector-specific analyses (Barrios and Schaechter, 2009).
- 2.34 Most of the studies measuring efficiency have focused on three broad sectors: education, health, and infrastructure. For example, in the case of education, expenditures continue to grow, with a current OECD average of 5% of GDP, but this rise has not been validated by improvements in outcomes such as standardized test scores (Bruns, Filmer, and Patrinos, 2011; OECD, 2013c). This lack of correlation also exists when expenditures are compared to outputs (years of education) or outcomes (skills or learning), even when controlling for country or household income. Nonetheless, institutional structure and teacher quality factors account for a significant portion of the enormous differences between countries in terms of student achievement (Hanushek and Woessman, 2011).
- 2.35 The social and economic impact of public investment also depends on its efficiency. Countries that have weak public investment management are incapable of transforming all of the investment into productive capital and growth (Agénor, 2010). A comparison of the value of public capital and measures of infrastructure quality and coverage between countries reveals a level of inefficiency in the investment process of approximately 30%.<sup>30</sup> The economic dividend of closing this efficiency gap is therefore substantial: strengthening the management of public investment can close up to two thirds of the investment efficiency gap (Gupta et al., 2014; Dabla Norris et al., 2011; IMF, 2015c).<sup>31</sup>
- 2.36 The allocative inefficiency of expenditures can be high in certain countries at certain points in their history or even at all times. Allocation should be based on a social cost-benefit analysis of expenditures; in other words, if a particular item of expenditure has a higher rate of return than another item, then the amount of the

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<sup>29</sup> This study on the performance and efficiency of the public sector and its functions used nonparametric methods, primarily FDH (free disposal hull) or DEA (data envelope analysis) techniques. DEA is a nonparametric technique for measuring technical efficiency. It takes a given production unit (in this case, a country) and compares it to the most efficient one in the sample. This leads to an empirical approximation of the production frontier, defined as the maximum possible output per unit of production given a certain quantity of inputs (input-oriented approach) or as the minimum input quantity required to obtain a specific output (output-oriented approach).

<sup>30</sup> Infrastructure is a significant component of public capital, and the public sector continues to be the largest provider.

<sup>31</sup> For an interesting experience in investment expenditure management in partnership with the private sector, see: Infrastructure Ontario, [www.infrastructureontario.ca](http://www.infrastructureontario.ca).

former item should be increased. For example, in China, the ratio of annual investment in physical capital to annual investment in human capital is much higher than in other countries. This imbalance would be justified if the rate of economic return to physical capital were higher than the rate of economic return to human capital (Heckman, 2005). Another example is to analyze how much the government spends on each input for developing skills or human capital. Assuming that human capital is developed only through early childhood, primary, secondary, and tertiary education, the marginal yields on each of these expenditures or investments would have to be equal to transferring resources from one level to another or increasing expenditures on the margin at the level showing the greatest return (Heckman et al., 1999). International experience does not appear to support this rationale; for example, a sample of several countries shows that investment in early childhood education is very low in relation to its high returns (Heckman, 2008).

- 2.37 Recent evidence also points to additional inefficiencies in important public programs in sectors such as energy (see the Social Protection and Poverty SFD, IDB 2014f, and the Energy SFD, in the process of approval). Many countries, particularly those rich in nonrenewable resources (NRRs)—especially oil—established high energy subsidies which, not being targeted to low-income households, have filtered extensively into medium- and high-income households.<sup>32</sup> Despite the fact that these subsidies were reduced when prices fell after the 2008-2010 global crisis and recession, in 2011, worldwide pre-tax subsidies totaled US\$480 billion (0.7% of global GDP or 2% of total government resources).<sup>33</sup> After-tax energy subsidies are higher, roughly 2.5% of global GDP or 8% of total government revenues worldwide (IMF, 2013c).
- 2.38 To improve the efficiency of the various categories of public spending, it is necessary to examine the potential institutional paths that can contribute to this goal. The OECD countries adopted various approaches, such as increasing decentralization and devolution of responsibilities; strengthening competition by transforming workforce structure and size; changing budget practices and procedures; and in particular, introducing results-oriented approaches to budgeting and management (Curristine et al., 2007). Aside from structural changes, which may require new laws or decrees, the most appropriate tool for linking efficiency indicators to execution is results-based budgeting (RBB). The basic idea is that governments should formulate budgets based on actual or expected results (typically referred to as outputs or outcomes) rather than on inputs (personnel, procurement of intermediate inputs, etc.) (Schick, 2006). This requires defining output and/or outcome indicators that are informative regarding the program and the result to be measured, and publishing them on a periodic basis. These indicators could be combined with the MTFF, further strengthening the mechanism and paving the way for improvements in the efficiency, allocation, execution, monitoring, and evaluation of expenditures. While many results-based budgets use outcome indicators only to provide information but without changing budget

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<sup>32</sup> Subsidies can depress economic growth (diminishing resources that could be productive and disincentivizing investment in key sectors) and, if they are not targeted, can be inequitable and benefit the wealthiest segment of the population.

<sup>33</sup> Oil subsidies accounted for 44%, electricity subsidies accounted for 31%, and gas subsidies accounted for practically all of the remainder.

- allocations, those that are used to provide feedback for budget preparation and allocation of resources are the ones that succeed in gradually improving the quality of expenditures. An emblematic example is Korea, where spending on programs with poor results is automatically cut (García López and Bae, 2014).
- 2.39 The evidence on the effectiveness of RBB in improving the quality of expenditures is not conclusive in advanced economies, although it is clear that countries that use this tool as more than a merely information system obtain advantages in quality. While the majority of OECD countries profess to have RBB frameworks (OECD, 2014b), many member countries still use a type of RBB classified by the OECD as presentational or informative for the result, with a weak or indirect connection to performance information and decision-making on budget allocation (OECD, 2007; Hawkesworth and Klepsvik, 2013).<sup>34</sup> Effective RBB uses systematic information on performance (indicators, evaluations, program costs, etc.) for budget allocation decisions. Consequently, the impact of RBB can be perceived in a better prioritization of expenditures and in more effective and/or more efficient services. In order to fulfill their task of generating valid information for decision-making purposes, the indicators must be specific, measurable, attainable, achievable, relevant, and time-bound (SMAART), in other words, significant as a means of indicating the results sought through the expenditure. This results-based management should be accompanied by monitoring and evaluation, so as to establish causality and shed light on unintended results in order to explain how the results were or failed to be achieved, thus creating evidence for improving the policies and indicators (Robinson, 2013b). Three OECD countries (Denmark, Finland, and Korea) would strictly meet this narrower definition of RBB, which emphasizes the nexus between information and decisions, since they report that expenditures are always or usually cut back in the event of poor results. In addition, six countries (Mexico, Australia, Canada, France, Germany, and Korea) would at least come close to meeting this definition, since they monitor programs more intensively when the results are poor<sup>35</sup> (OECD, 2007; 2011b; 2013a). Reforms were recently implemented in New Zealand, Sweden, and Switzerland, leading to very significant advances in the efficiency of RBB, and a comprehensive reform is underway in Austria (OECD, 2013a).
- 2.40 The development of the pillars of management for development results (MfDR) also shows the importance of coordinating planning and budgeting. In the absence of close coordination between these two functions, the long-term vision or MTFF may end up not producing the expected outcomes (García López and García Moreno, 2010). Thus, the RBB tools were of little use during the crisis of 2008 (Diamond, 2003; Robinson and Brumby, 2005; Marcel, 2014; Schick, 2014). In order to achieve impacts, it is essential to continue to expand the stock of

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<sup>34</sup> RBB aims to improve the effectiveness and efficiency of public spending by linking the funding of public sector entities to the results achieved. When those outcomes do not affect the funding or the budgetary allocation, a results-based budget becomes instead an informational budget, incapable of having any impact on efficiency.

<sup>35</sup> Only the relevant part of the OECD's composite index of RBB practices by central governments was used, i.e., the portion that measures the consequences for poor results. The five countries that scored highest under the index are (in scoring order) Korea, Mexico, Canada, Switzerland, and the Netherlands. However, none of these countries, except Korea, reduces the budget in the event of a deficient outcome. The OECD points out that the composite index is not intended to measure the quality of a country's RBB system but rather to provide a description (OECD, 2007; 2011a, 2013a).

evaluations in order to improve the efficiency of expenditures. Given the heterogeneity of experiences with RBB and MTFFs and the problematic fact that allocative and technical efficiency are subject to multiple factors, as well as the resulting scarcity of available data, there is very little quantitative analysis of expenditure efficiency. A specific study of hospitals in the United States and other developed countries that use RBB for casuistic financing finds positive results, even if their measurement of results is not perfect (Robinson and Brumby, 2005). A more recent study using data from 120 countries finds that, in countries with more advanced stages of MTFFs, there is a measurable impact on efficiency in the health sector (Vlaicu et al., 2014).

- 2.41 In addition to the RBB studies, the instruments available to improve the quality and efficiency of expenditures include the periodic reviews of public spending commonly carried out in OECD countries but also being conducted at the World Bank since the 1990s (Pradhan, 1996). Their use is becoming more widespread as a result of the need to generate public savings in the wake of the Great Recession (Robinson, 2013b; Marcel, 2014).<sup>36</sup> These reviews, while differing in degree, coverage, and specific details, typically examine the rationale for a specific expenditure, its efficiency and equity, and its role in fulfilling goals in comparison to other expenditures.<sup>37</sup> Lastly, another instrument<sup>38</sup> is the set of evaluations of specific expenditures or programs, which while desirable due to the depth of their analysis, take longer to complete and tend to result in less specific recommendations than simple indicators. All of these instruments should be published on a regular basis.
- 2.42 In short, international evidence shows that there is room for continuing to research and delve more deeply into expenditure policy and management, and the link between the two, as follows: first, in terms of spending policy, by establishing priorities based on strategic development objectives and channeling them to budget programs in line with each country's economic, social, and growth strategy; second, in terms of managing expenditures, the instruments that can drive improvements in quality must be strengthened, including RBB, economic and impact evaluations of the various programs, and results-based reviews thereof; third, to improve the link between spending policy and management, by defining specific and available indicators and using them for decision-making rather than informational purposes; and fourth, to reinforce the analysis of the economic efficiency of the spending programs, by frequently evaluating the cost of the results obtained (VfM).
- 2.43 Lastly, it is worth emphasizing that a large and increasing part of public expenditures, particularly in the areas of health and education, is executed by subnational governments, which have poor institutional capacity and limited

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<sup>36</sup> Australia, Canada, Denmark, Finland, France, Ireland, Italy, Korea, Mexico, the Netherlands, New Zealand, Russia, Spain, Sweden, Switzerland, and the United Kingdom periodically perform public expenditure reviews (Marcel, 2014).

<sup>37</sup> In the literature, some refer to these instruments as a subcomponent of RBB.

<sup>38</sup> Also quite often classified as a subcomponent of RBB.

incentives to efficiently implement public spending.<sup>39</sup> Nevertheless, as part of their expenditure policy and management, national governments can resort to conditional and equalization transfers (in addition to unrestricted transfers to subnational governments), which can become useful tools for incentivizing improvements in spending efficiency and equity (McLure and Martínez-Vázquez, 2000; Oates, 2006, IDB, 2015c).

**C. The impact of fiscal policy on equity and its relation to economic efficiency and productivity**

- 2.44 The effect of fiscal policy on income distribution and poverty depends on the level and composition of public expenditure, its sources of financing (including distribution of the tax burden), and the distribution of the expenditure's benefits among the population. To reach a growth target with equity, countries can design a fiscal policy that seeks to balance the two objectives, since fiscal actions will on limited occasions lead to simultaneous improvements in growth and equity. To meet the equity objective, beyond ensuring macroeconomic stability (a fundamental requirement for both growth and equity), governments could reduce the most critical poverty and inequality by means of transfers and taxes, and provide equality of opportunity through an improvement of human capital that would enable citizens to access more productive jobs, and therefore better remuneration by delivering quality services in education, health, and water and sanitation. In this regard, governments could use the equity policy itself to balance two objectives that can conflict with one another or that frequently involve significant tradeoffs.
- 2.45 The tax and transfer system performs an important role in reducing poverty and inequality. Essentially, the tax incidence analysis shows the initial effects, that is, before the behavioral responses or the general equilibrium impact are manifested<sup>40</sup> (Musgrave, 1959, Pechman, 1985; Martínez-Vázquez, 2008). The incidence analysis starts by defining the various types of income used: market income, disposable income, discretionary (post-tax) income, and final income.<sup>41</sup>
- 2.46 Some studies use regression analysis on a cross-section or panel of countries to examine the effect of monetary and in-kind transfers and the various types of taxes on income distribution (primarily using the Gini coefficient for disposable income as a dependent variable). Some results indicate that progressive personal income taxes reduce income inequality, while corporate income taxes also have an effect

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<sup>39</sup> While the classical literature underscores closeness to constituents as a positive element for subnational incentives, since this closeness can bring about a better understanding of, and hence an improvement in, the quality of the expenditure, it is also the case that the lack of a fiscal correspondence in terms of own revenue on the part of most subnational governments makes them less responsible for the expenditure.

<sup>40</sup> The exercises involve assumptions regarding the burden and economic distribution of taxes and transfers as well as assumptions regarding tax evasion and benefit coverage. The information used in the tax incidence analysis is obtained by combining microdata from household surveys with administrative information on the amounts and characteristics of the tax system, transfer programs, education, social security, and health systems, and consumer subsidy mechanisms.

<sup>41</sup> Market income is total current income before taxes. Disposable income is equal to market income plus direct government transfers less direct taxes and social security contributions. Discretionary or post-tax income is defined as disposable income plus indirect subsidies less indirect taxes. Final income is defined as discretionary income plus public transfers in kind in the form of free or subsidized services in health and education (Lustig and Higgins, 2013).

- on income inequality which, however, becomes diluted with economic globalization or liberalization. Social security contributions and payroll taxes, as well as indirect taxes, tend to increase income inequality. At the same time, on the expenditure side, higher social, education, health, and public housing transfers have a positive collective and individual impact on income distribution (Martínez-Vázquez et al., 2012).
- 2.47 However, redistributive policies such as progressive taxes or cash transfers can reduce the incentives to work in the formal sector or to save and invest in physical and human capital.<sup>42</sup> Redistribution is likely to increase market income inequality before government action, and therefore aggravate disposable-income or final-income inequality. As a result, a change in taxes or expenditures is likely to have a direct (first-round) distributive effect but, when the behavioral disincentive (second round) is taken into account, the result could be an opposite effect possibly counteracting the initial positive impact.
- 2.48 Expenditure policies are more effective in reducing inequality than progressivity policies in the tax system. In fact, the limited effect of direct taxes on the Gini coefficient for disposable income shows that the impacts on disincentives raise the market income Gini, offsetting their progressive effects on disposable income (Poterba, 2007). These results support the findings of other studies in the literature, which suggest that governments should combat inequality through public spending policies rather than by increasing the progressivity of the tax system. This fact also partly explains the difference in inequality between European countries and the United States: while the latter has one of the world's most progressive income taxes, it exerts little distributive power through expenditures; by contrast, European countries on average rely much more on spending policy to reduce inequality (Doerrenberg and Peichl, 2014).<sup>43</sup>
- 2.49 Investment in quality human capital is the most important medium-term determining factor for reducing poverty and inequality. Fiscal policy should improve quality human capital accumulation in the poorest segments of the population, since the middle and upper classes have means at their disposal for investing properly (Becker, 1964; 1995). In fact, in OECD countries, the best education systems are those that combine high quality and equity.<sup>44</sup> The evidence from the Programme for International Student Assessment (PISA) shows that a student

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<sup>42</sup> This will depend on the elasticities of labor supply and of savings to changes in taxes and transfers, as manifested through wage, income, and interest rate (after-tax) elasticity. The elasticity of labor supply tends to be greater at the lower end of income distribution, especially for single mothers (McClelland and Mok, 2012; Bargain et al., 2014), which means that redistributive measures are sure to affect it. With regard to savings, there is evidence pointing to the negative effects of the interest rate, and particularly of taxes on savings, although in theory the effect is ambiguous (Attanasio and Weber, 2010).

<sup>43</sup> Section III of this document contextualizes this analysis for the countries of Latin America and the Caribbean, since the region needs to make an effort to increase personal income tax revenues, both to improve the equity of the tax system and to increase revenues in most countries, where tax revenues are below potential levels based on the countries' level of development and economic structure. These resources should be channeled toward the types of expenditures discussed in Section III, in order to enhance the potential for growth and equity, as mentioned in the following paragraphs.

<sup>44</sup> OECD countries face various problems in the equity and quality of education combination, including the following: (i) they have a secondary school dropout rate of 20%; (ii) approximately 19% of students 15 years of age lack basic reading skills or are illiterate; and (iii) the students most at risk of failing in school are those whose parents have little education or low socioeconomic status.

from a disadvantaged household is 2.4 times more likely to perform below level 2 in reading than a student from a relatively more affluent household<sup>45</sup> (OECD, 2012a). These shortcomings then become evident at the tertiary education level and in the labor market.<sup>46</sup> To a large extent, the advantage of students whose parents have a better education and higher socioeconomic status is that they are provided with quality early childhood education, both at home and in daycare centers or similar institutions. This early investment is essential for the child's future and tends to be absent in more disadvantaged households. Traditionally, equity and efficiency are seen as competing objectives. What is noteworthy is that policies do exist that are fair, which is to say that they promote equity, and at the same time foster economic efficiency. Investing in the early years of life of disadvantaged children is one of those policies. Each dollar initially invested in early childhood education generates between 7 and 10 cents per year (Heckman, 2000; 2008; 2011). On average, OECD countries invest 0.7% of GDP in early childhood education programs, and the Nordic countries on average invest more than 1% of GDP in this area (1.7% in Iceland, and 1.4% in Denmark and Sweden).

- 2.50 In part, the objective of fiscal policy should be to pursue equality of opportunity, which means ensuring the development of individual capacities so that circumstances such as gender, ethnicity, place of birth, or socioeconomic and family environment, which are beyond a person's control, have no influence on the opportunities available to an individual or the results of his or her efforts. Success should depend on personal choices, effort, and talent rather than on the circumstances surrounding a person's birth (Roemer, 1998).<sup>47</sup> For these reasons, it is important to perform an accurate diagnostic assessment of the causes of inequality and poverty before designing specific policies to mitigate them. Failure to perform such an assessment can in many cases render these policies ineffective or further complicate the situation and possibly transform a temporary phenomenon of poverty into a more permanent one, with concomitant effects on growth. For example, structural increases in the rate of return on education that improve the efficiency of resource allocation within the economy foster equal opportunity, while increases due to temporary problems resulting from financial or fiscal sustainability crises require the use of other instruments on a temporary basis until these exceptional circumstances are overcome. These instruments should not be made permanent.

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<sup>45</sup> In the OECD countries, 15% of the variation in mathematics scores can on average be accounted for by the socioeconomic environment. The percentage is higher in Chile, Hungary, or France, but much lower in Norway, Estonia, Iceland, Finland, or Canada.

<sup>46</sup> Access to tertiary education partly depends on how students performed in primary and secondary school. Thus, socioeconomic status continues to be a good predictor of success in these cases as well. In 2013, more than 50% of students in tertiary education had one parent with at least a similar level of education, while only 10% of students with parents who had not completed secondary school enrolled in tertiary studies. The level of education and socioeconomic status of parents also has a major impact on the employment situation and salaries of their children. In some countries, the increment or premium for having been reared in a better educated family is greater than 20% (OECD, 2015a).

<sup>47</sup> There is a strong correlation between equal opportunity, intergenerational mobility, income inequality, and investment in early childhood education. Income inequality can persist for generations, reflecting differences in economic opportunities resulting, for example, from lack of access to early childhood education and a quality formal education. In turn, this lack of access translates into limits on income. Intergenerational income mobility is low in OECD countries with high inequality levels (Corak, 2013; IMF, 2014b).



- 2.51 There are temporary spikes in inequality, such as the one resulting from the fiscal consolidation following the Great Recession of 2008 and the subsequent fiscal stimuli, causing concern to governments. Typically, fiscal consolidation leads to a short-term reduction in GDP and employment, which means lower real salaries. If salaried employees are primarily concentrated in lower-income groups, this situation creates greater market income inequality.<sup>48</sup> However, the consequences of not undertaking fiscal consolidation could be worse. In fiscal or financial crises, real wages tend to fall, poverty tends to increase, and while the evidence for this is not conclusive, inequality may also become greater (Pessino, 1993, 1996; McKenzie, 2004, McIntyre and Pencavel, 2004; Lopez Boo, 2010). The lesson from these experiences is that the short- and long-term effects of fiscal consolidation policies on poverty and inequality should be evaluated in relation to the true counterfactual scenario, which is the possibility of a systematic, aggregated, unresolved, or extended crisis. In this regard, the best fiscal policy option is the one that ensures fiscal sustainability and macroeconomic and financial stability in the medium and long terms, and reduces the economies' vulnerability to external shocks in order to avoid the need for programs of adjustments or fiscal consolidation, unless these shocks are caused by external shocks with exceptional circumstances (such as the recent international financial crisis) or are totally exogenous and significant (such as natural disasters).
- 2.52 If market income inequality is the product of possibly well-intentioned policies that nevertheless distort the allocation of resources while also increasing inequality, these policies should be corrected before any attempts are made to patch them up with another policy or with special regimes that could aggravate and further distort the initial situation and in some cases create fiscal sustainability pressures. This is the case in many countries in Europe and elsewhere where social security programs were established starting in the late nineteenth century and consolidated following World War II, a process that took place throughout Europe and subsequently in Latin America and the Caribbean. These social security programs, which provided health and pension coverage in old age, were implemented only for formal employees (Kaplan and Levy, 2013). The design of social security could create incentives for businesses and workers to continue to operate in the informal sector in low-productivity activities (IDB, 2010; Busso et al., 2012). The lack of social security coverage for workers in the informal sector and the high evasion rates generate inequity and pressure for coverage through special or parallel social security regimes. Therefore, social policies, together with the noncontributory pillars, have promoted increased coverage and social assistance for informal workers, competing with the contributory pillars and becoming de facto informality subsidies (Levy, 2015).
- 2.53 In order to include a larger number of workers in the social security systems, it may be necessary to subsidize contributions, particularly those provided by lower-income individuals (ECLAC, 2012; Bosch et al., 2013), using general resources such as VAT or personal income tax revenues, or completely decouple social security funding from taxes on labor (as has been done in the case of health

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<sup>48</sup> In many cases, this increase in inequality is mitigated by designing adjustment measures accompanied by offsetting measures. In at least two thirds of economies, fiscal action led to a drop or partially counteracted the disposable income inequality caused by an increase in market income inequality (IMF, 2014b).

insurance in some countries; Levy, 2008; Antón and Leal, 2013, IDB, 2013b). In 2008-2009, an average of one in six employees in the European Union held an informal job as his or her main occupation. The informality rate in the European Union is 11% in the Nordic countries, 15% in the east, 16% in the west, and 28% in the south.<sup>49</sup> A descriptive analysis of OECD and eastern European countries reveals that disincentives to formal employment, estimated by means of a measure that includes the labor tax disincentives as well as the disincentive of ceasing to receive subsidies upon initiating informal employment, are especially high for low-wage earners. There is a correlation between this measure and the incidence of informality in six eastern European countries (Bulgaria, Czech Republic, Estonia, Latvia, Poland, and Slovakia) (Koettl and Weber, 2013).

- 2.54 With regard to expenditure management, strategic fiscal policy plans should contemplate the importance of achieving growth with efficiency and equity. This requires considering the various issues involved in achieving equity, and the importance of maintaining fiscal sustainability. Governments should pursue double dividend policies, such as promoting early childhood education programs that include poor families or reducing incentives that favor informal employment. At the same time, policies that create tradeoffs should be examined with greater care, evaluating and if possible quantifying the extent to which one of the objectives is being sacrificed to achieve the other, while taking the institutional, cultural, and social peculiarities of each country into account. One of the appropriate expenditure management instruments for incentivizing not only efficiency but also equity in expenditures is RBB. For example, to improve the quality of investment in human capital, the school performance indicator could be adjusted by household socioeconomic status, the result being a performance differential on standardized school tests based on socioeconomic status (Sutherland et al., 2007). In order to balance the dual objectives of efficiency and equity, the benefits of the additional expenditure aimed at reducing poverty and inequality should be equal at the margin to policies aimed at increasing investment in physical and human capital. And in making this choice between spending on monetary transfers on one hand or on health and education services on the other, countries should also distribute the expenditure by analyzing the rate of return of each investment at the margin rather than try to maximize the short-term political benefits of redistribution.

**D. Efficiency and transparency in the management of public resources and the performance of fiscal institutions**

- 2.55 **Tax administration.** A modern and efficient tax and customs administration should have the following characteristics: (i) sufficient legal authority to perform its mandate autonomously, effectively, and free from political influence; (ii) a well-defined organizational structure; (iii) a clear separation between tax policy planning levels and the local operational level; (iv) a qualified workforce that is properly compensated and benefits from stable professional careers; (v) a sufficient budget to fund operational and capital needs; and (vi) investment in integrated, modern, and secure information management systems (Lemgruber et al., 2015).
- 2.56 The reforms implemented by developed countries in this area have focused on providing their tax administrations with greater autonomy (Hungary, Portugal,

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<sup>49</sup> Among employees, the highest proportion of workers without contracts is in Cyprus (almost half), Greece (one third), and Ireland (more than one quarter) (Hazans, 2011).

Malta, and Slovakia), as well as on merging tax and customs administrations. In addition, the change processes are being aimed at improving the planning, monitoring, and results-based evaluation methods. Improvements in operating efficiency have been brought about through the use of modern computerized services: electronic systems for filing tax returns and making tax payments, progress in automating online tax payments and in pre-filled personal income tax returns (OECD, 2013d), and early electronic submission of import and export cargo manifests.

- 2.57 Efforts undertaken by the OECD, with the support of other multilateral organizations such as the IDB, the World Bank, and the Inter-American Center of Tax Administrations (CIAT), have had a significant impact on international taxation, particularly in fostering fiscal transparency. The first advance was in the area of tax havens, in the form of a set of principles developed by the OECD with the collaboration and sponsorship of several developing countries, notably including several in Latin America. Subsequently, the OECD created the Global Forum, which currently counts more than 125 member jurisdictions committed to fiscal transparency. The Global Forum conducts two-phase reviews of compliance with standards of tax transparency and exchange of information at the request of interested parties. Adding to this initiative is the U.S. Foreign Account Tax Compliance Act (FATCA), which provides for the automatic exchange of financial information with the United States.
- 2.58 More recently, the working group led by the OECD and the Group of Twenty (G20) under the Base Erosion and Profit Shifting (BEPS) project carried out consultations in developing countries, determining that these countries lack the necessary legislation, information, and institutional capacity to implement complex rules for effective control over multinationals. As a whole, these weaknesses give rise to aggressive tax planning resulting in high levels of evasion. In view of this, the OECD and G20 working group proposes a total of 14 lines of action, of which the following are notable due to their impact on Latin America and the Caribbean: limit base erosion via interest deductions and other financial payments (action 4, BEPS Plan); prevent tax treaty abuse and artificial avoidance of permanent establishment status in specific scenarios (actions 6 and 7); improve transfer pricing outcomes and documentation (actions 8, 9, 10, and 13); and seek political support and institutional strengthening to face crosscutting problems identified by the BEPS project, especially for developing countries. Through these measures, the project aims to provide countries with the tools needed to ensure that profits are taxed where the economic activities are performed and where value added is created, thereby improving the mobilization of tax resources. At the same time, the project also aims to give businesses greater certainty and security by reducing disputes over the application of international tax rules and standardizing requirements (OECD, 2014c).

- 2.59 **Public financial management (PFM).**<sup>50</sup> In the past two decades, PFM has become a very significant area of fiscal policy action in virtually all countries. This leading role for PFM includes four basic pillars or areas of action: (i) macroeconomic sustainability and stability, including fiscal risk management; (ii) effectiveness and efficiency in the use of government resources to properly deliver public services; (iii) allocation and evaluation of resources among the various sectors for growth, productivity, and social policy; and (iv) transparency and accountability.
- 2.60 The first pillar includes management of budgetary policy and fiscal rules, strategic planning, and MTFFs. The second pillar includes management of public resources through treasury and public debt management, accounting and recording of financial and budgetary transactions, payroll management, procurement processes, and management of the national public investment systems (SNIP) and integrated financial management systems (IFMS), aimed at improving the decision-making process in the area of resource management and expenditure execution with a view to effective and efficient delivery of public services. The third pillar includes evaluation of the technical allocation of expenditures, monitoring and evaluation of budget execution, and evaluation of the various short-term and medium-term budget programs. The fourth pillar includes aggregating and reporting fiscal and budget information (including fiscal results and public balance sheets), information on the composition and financial structure of public debt and the fiscal risks and contingent liabilities of the public sector, transparency and accountability, and the public expenditure and resource audit and control processes.
- 2.61 International experience is extremely broad with regard to the relation between quality and effectiveness of fiscal policy and the quality of PFM, since a good PFM framework is a required, although not a sufficient, condition for good fiscal policy. For developing countries, several studies attempt to demonstrate that the quality of PFM is associated with economic growth (Andrews, 2010; Andrews et al., 2011; World Bank, 2008; Wescott, 2008; and Dabla-Norris et al., 2011), although PFM quality also depends on income per capita, a country's degree of institutional development, and the size of its population. Evidence also shows that, when PFM is deficient in one or more of its basic pillars, the magnitude and impact of economic shocks, particularly adverse shocks, become significantly greater. This is because various implicit or explicit fiscal risks materialize, and the absence of adequate records for these risks makes it impossible to quantify them and implement mitigation policies in response. (Kopits, 2014; Allen et al., 2013; and Irwin, 2012). Even though the findings of the studies are statistically significant, the

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<sup>50</sup> PFM refers to the set of rules, processes, systems, and institutions through which governments manage public resources in the short and medium term to achieve their public policy goals while producing the information needed to support fiscal policy decisions and providing the necessary tools to implement these decisions (North, 1991; Andrews et al., 2014; and IMF, 2013a). PFM deals with how to manage fiscal policy (how to establish a given budgetary system, how public transactions are recorded, accounted for, and reported, how the various information and public financial management systems are integrated and managed, and how a given expenditure program can be implemented). While fiscal policy is concerned with what to do to achieve certain policy objectives, PFM includes the areas of budget, treasury, accounting, debt management, public investment systems, procurement, government payroll administration and payment, integrated financial management systems (IFMS), audit and control, etc. In recent years, and particularly as a result of the international financial crisis of 2008-2010, the implementation and monitoring of fiscal rules and MTFFs are considered part of PFM.

effects appear to be minor. In any event, they face serious methodological difficulties and significant information limitations.

- 2.62 In recent years, PFM has made considerable strides, particularly in terms of adopting internationally standardized principles, practices, and systems. The institutional capacities of countries and the availability of human resources are determining factors in the speed and gradualness of this process (Andrews, 2014). In addition to having an adequate normative and institutional framework, adopting international standards is essential to achieving high-quality financial, budget, and accounting information that can be compared over time and across countries.
- 2.63 The most commonly used tool for analyzing PFM quality in countries is the [Public Expenditure and Financial Accountability](#) (PEFA) Framework, which currently includes 398 assessments performed in 149 countries and on 136 subnational governments. The 28 PEFA indicators are comprised of the average of the scores of various variables or minimum requirements. Another tool for analyzing and assessing PFM quality is the Open Budget Index (OBI). The OBI makes it possible to monitor the management of public finances through indicators of the quantity and quality of published budget information in terms of: (i) transparency; (ii) participation; and (iii) budget monitoring. The coverage of countries by the OBI has been gradually expanding and the index now reports information for 100 countries, 16 of them in Latin America and the Caribbean.
- 2.64 In addition to PEFA and the OBI, several international organizations have acknowledged the importance of adequate PFM and have consequently developed tools to evaluate certain aspects of these systems and guide the design of the PFM reform programs being implemented in developing countries (OECD-DAC, 2011). For its part, the World Bank has designed the Debt Management Performance Assessment (DeMPA), which operates at the central government level in low-income countries and uses a scoring methodology similar to PEFA. The new Fiscal Transparency Code (FTC) sets international standards for fiscal information disclosure, grouped into four pillars: (i) fiscal reporting; (ii) fiscal forecasting and budgeting; (iii) fiscal risk analysis and management; and (iv) fiscal resource management. The fiscal transparency reports supplement the assessments of the Reports on the Observance of Standards & Codes (ROSC). Among other advances, the new FTC includes a record of fiscal risks and contingent liabilities, in large measure as a lesson learned from the global financial crisis of the preceding decade.
- 2.65 One of the most widely accepted specific set of PFM standards worldwide for public accounting is the International Public Sector Accounting Standards (IPSAS). These standards provide the methodology for recording and valuing financial and accounting transactions in the public sector, as well as public assets and liabilities. Much of this recording is still being done on a cash basis, although a growing number of countries has been moving to an accrual-based accounting system. Naturally, the true financial condition of a country's public sector cannot be fully known without consistent and comprehensive accounting records.
- 2.66 A significant improvement in PFM has been brought about by the adoption of RBB, which is now being used on a regular basis in all OECD countries (OECD, 2007; 2008a; 2013b; and 2015b). RBB is a considerable leap forward from incremental budgeting and program budgeting. RBB goes from an input basis for certain expenditure programs to an outcome or output basis as a function of available

resources, which is very useful for determining the efficiency and effectiveness of expenditures. RBB becomes irrelevant if the indicators used to link resource allocation to use are not objective, relevant, easily measurable, and achievable over the budget period. In the medium term, RBB should be supplemented by an evaluation of specific programs, since results are invariably affected by factors exogenous to the public and budget management process. It should also be supplemented intraregionally and internationally over time to establish more dynamic comparisons and standards of economic effectiveness and efficiency (OECD, 2014b and 2015b).

- 2.67 Expanding and improving the use of RBB has enabled the governments of several OECD countries to make increasing efforts to demonstrate better performance in the management of budget resources. This has also allowed supreme audit institutions (SAIs) to move from a more traditional focus on accounting and financial auditing to looking at aspects of effectiveness, performance, and efficiency in the use of resources (VfM). In this regard, the International Organisation of Supreme Audit Institutions (INTOSAI) posits that performance auditing enriches public accountability and enables SAIs to make practical contributions to improving the efficiency and effectiveness of public administration (INTOSAI, 2010).
- 2.68 SAIs have the potential to contribute to a better design and use of management and budgeting systems linked to performance and improved public accountability. Of the 26 OECD countries, a little more than half conduct performance or value-for-money audits on a regular basis (including Australia, Austria, Japan, Mexico, Norway, and the United Kingdom), while nine countries (Estonia, Finland, France, Hungary, Korea, New Zealand, Slovenia, Sweden, and the Netherlands) do so sporadically and three countries (Chile, Spain, and the Czech Republic) report not having conducted this type of audit to date (OECD, 2015b).
- 2.69 Another important advance in PFM in recent years is the implementation of the Treasury Single Account (TSA). Through the TSA, governments centralize financial resources and flows that were previously managed on a decentralized basis by the various expenditure units or line ministries. The TSA allows for better control and information on the execution of expenditures and the use of resources, and greater coordination and integration between cash management and public debt management. In order to adopt the TSA, governments need to have in place an IFMS that enables management, monitoring, control, reconciliation, accounting, and reporting on budget execution and accounting movements as well as on the management of bank account balances. IFMSs and the TSA require integration and automation of government budget and financial management, thereby fostering the modernization of public management (Andrews et al., 2014).
- 2.70 In the public procurement area, the implemented reforms have been aimed at improving systems and procedures, using open, competitive, and transparent online systems. This has enabled the government procurement area of PFM to fulfill three fundamental principles or objectives: (i) effectiveness, for quick and timely procurement of the necessary works, goods, and services, including specialized services; (ii) efficiency, to obtain the best price-quality or cost-benefit ratio (VfM); and (iii) transparency, for the providers of goods and services through an open and competitive electronic environment that ensures transparency in the

award process, as well as for the budget monitoring and evaluation entities, the supreme audit and control entities, and the general public (Schapper et al., 2006).

- 2.71 Two specific considerations regarding the procurement area are worthy of note. The first is that this expenditure area affects all functional segments of the public sector (for example, education, health, and infrastructure) on a crosscutting basis. As a result, the quality, effectiveness, and efficiency of expenditures in each of these segments are largely determined by the effectiveness and efficiency of the government procurement systems. The second is that a considerable portion of public expenditures takes place through the procurement of goods and services and investment in fixed capital (carried out almost exclusively through bidding processes and contracts). Thus, in 2013, public procurement in OECD countries accounted on average for 29% of total general government expenditures, equivalent to 12% of aggregate GDP. As a result, in addition to effectiveness and efficiency considerations, open, competitive, and transparent online processes produce significant savings in expenditures by reducing not only the price of goods and services but also the incidence of fraud and corruption.
- 2.72 Lastly, the application of advanced information technologies, both in tax administration and in financial management systems, in combination with legal frameworks that are more solid and favor results-based transparency, not only improve the effectiveness and efficiency of fiscal management and public spending, but also help reduce opportunities for corruption and illegal transactions.

### **III. MAIN CHALLENGES FOR THE REGION**

- 3.1 As in the previous section, this section analyzes the role of fiscal policy and management in four subsections: (i) growth, macroeconomic stability, and public debt sustainability; (ii) economic efficiency and factor productivity; (iii) equity and its relationship with economic efficiency and productivity; and (iv) management and transparency of public resources, including tax administration, public sector financial and budget management, and fiscal transparency. Unlike Section II, Section III emphasizes the role of policy and management as instruments for economic and social development in the context of the countries of Latin America and the Caribbean. In this context, the analysis of fiscal policies for Latin American and Caribbean countries is focused on the objective of achieving robust, stable, sustainable, and more equitable growth, while emphasizing the role of fiscal management as an instrument for the mobilization and efficient use of resources for development.
- A. The role of fiscal policy in economic growth and sustainability and macroeconomic stability**
- 3.2 **Fiscal policy and growth.** Latin America and the Caribbean have been experiencing relative long-term stagnation or low growth, due to factors including stagnating productivity of the productive factors despite an increase in the number of workers and the capital stock (IDB, 2014a) (see [Figure 1](#)). Fiscal policy has played an important role in the region's low growth in recent decades. This influence has manifested itself in several dimensions. First, in the debt crisis during the lost decade of the 1980s. Second, in the effects of a procyclical fiscal policy on macroeconomic volatility (Gavin et al., 1996; Gavin and Perotti, 1997; de Ferranti

- et al., 2000; IDB, 2013c).<sup>51</sup> Third, in the impacts of tax policies that introduced distortions into the allocation of resources and were partially responsible for the low productivity levels in recent decades, particularly as reflected in the high levels of informality. Fourth, in the low savings and investment rates in both the public and the private sectors. Fifth, in the shortcomings of public infrastructure, which shows significant gaps in comparison to emerging economies in Southeast Asia and non-Latin American and Caribbean OECD member countries (Perrotti and Sánchez, 2011; ECLAC, 2015a; IDB, 2013). Sixth, in the low levels of public expenditure quality and efficiency, particularly in education (Levy and Shady, 2013).
- 3.3 The procyclical bias of fiscal policy has continued in recent years. It was, however, interrupted from 2009 to 2010, partly due to the boom in commodity prices between 2003 and 2008 and their quick recovery in the second half of 2009, which made resources available to finance expenditure growth in most countries in the region. Moreover, procyclical policies have not been symmetrical but have instead been characterized by cutbacks in investment expenditures during recessionary cycles and an increase in current expenditures, including spending commitments that are difficult to reverse (IDB, 2014b and 2015e; ECLAC, 2009). These circumstances have further narrowed the fiscal space<sup>52</sup> available in the region to implement countercyclical policies, affecting the effectiveness and efficiency of expenditures in public infrastructure investments (IDB, 2015e; ECLAC, 2015a; IMF, 2015c) and limiting the size and effectiveness of the fiscal multipliers associated with investment spending.
- 3.4 Notwithstanding the foregoing, several countries were able during the last decade to improve their fiscal position, achieving significant reductions in their debt levels. In turn, many countries accumulated considerable savings in international reserves, while several countries in the region increased the proportion of their public debt denominated in local currency and reduced the foreign-currency proportion. As a result, macroeconomic and fiscal vulnerability to external shocks and sudden stops significantly diminished: since 2007, the ratio of international reserves to external debt reflects a net creditor position on average for the region, although with significant differences among countries (IDB, 2015e; IDB, 2007).
- 3.5 **Fiscal sustainability.** Despite the improvements in the region's net external creditor position, the loss of fiscal space has in a large number of countries become more acute due to the fall in commodity prices and the rise in permanent expenditures in recent years. These developments jeopardize fiscal sustainability in many countries that have reached high debt levels in relation to GDP and/or recorded primary balances that are not consistent with the stability of the debt-to-GDP ratio. The latter circumstance becomes evident when comparing the average primary balances observed in recent years to the structural primary balance (adjusted for the economic cycle) at the potential GDP growth rate (IDB, 2014b and 2015e). This situation reflects a major challenge for the region in the coming years, since the costs in terms of growth and real income (particularly in the most

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<sup>51</sup> The volatility of fiscal policy accounts for at least 15% of the excess macroeconomic volatility in the region vis-à-vis the OECD between 1975 and 1999 (de Ferranti et al., 2000).

<sup>52</sup> There is no single or generic concept of fiscal space. For purposes of this SFD, we use Heller's definition (2015).



- vulnerable segments of the population) in the face of deteriorating fiscal sustainability are high, even more so should some countries reach levels that bring the public sector close to intertemporal insolvency.
- 3.6 Fiscal pressures will rise in the medium and long term due to population aging. The age dependency ratio (ratio of individuals aged 65 or older to the productive population, i.e., those aged 15-64) is expected to increase three-fold by 2050. As a result, if one considers the demographic factors only and assumes that the system's coverage and benefits remain constant, the cost of pensions will be multiplied by three as a proportion of GDP. This means an increase in pension expenditures equal to 8 percentage points of GDP, from the current 4% of GDP to approximately 12% of GDP by 2050.<sup>53</sup> Adding to the sustainability problems of the contributory systems is the present and future cost of noncontributory pensions. The average noncontributory pension expenditure in Latin America and the Caribbean is close to 0.5% of GDP per year, and this expenditure could also triple in terms of GDP (Bosch et al., 2013). Health expenditures due to population aging are also expected to increase, not only because the proportion of senior adults (whose cost of care is much higher than the average) will be three times greater, but also because health costs tend to rise at a faster pace than GDP for technology reasons.
- 3.7 In Latin America and the Caribbean, an average of 4 of every 10 senior adults currently receives a contributory pension.<sup>54</sup> If one adds noncontributory pensions, the proportion of the senior population receiving a pension rises to 6 of every 10 (Bosch et al., 2013; IDB, 2014f). In the absence of institutional reforms to strengthen the social security systems, between 50% and 60% of the 140 million individuals who will reach retirement age by 2050 will not have generated sufficient savings to have a pension in their old age. This volume of people without pensions constitutes a contingent risk for governments, since it is sure to give rise to a social pension to allow these individuals to receive at least a minimum solidarity pension financed by general budget resources. However, it is worth noting that even in countries that have carried out structural reforms by creating systems based on individual capitalization accounts under the management of private companies, the fiscal costs of a transition to this type of system have proven to be high; for example, in Chile these costs have been equivalent to approximately 4% of GDP each year since the reform was implemented in 1981 (Melguizo et al., 2009).
- 3.8 Fiscal sustainability is also potentially vulnerable to other actual or contingent liabilities that regularly fail to be recorded in the public debt accounts or be included in traditional fiscal risk calculations. As occurred in several European countries in the wake of the financial crisis of 2008-2009 and the subsequent Great Recession, once many of these fiscal risks materialize, public debt levels rise significantly, placing the country in a situation close to fiscal unsustainability. It was as a result

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<sup>53</sup> If the parametric reforms being adopted by some countries in the region are taken into account, the size of the increase becomes smaller (IMF, 2010). In addition, this approximation has not considered that a portion of the pension expenditure is somewhat less than one third of the countries is managed by private pension funds. However, even with these systems in place, governments are taking charge of minimum pensions and have established solidarity pensions for individuals who, for reasons of employment, did not contribute to those systems.

<sup>54</sup> A significant expansion of noncontributory pensions resulted in a reduction in poverty and inequality in many countries (Lustig and Pessino, 2014; IDB, 2014).

of these experiences that the European Commission added two pillars to its analysis of public debt sustainability. The first pillar focuses on fiscal pressures due to an aging population, while the second incorporates other actual and contingent public-sector liabilities. Given that the region is not immune to these scenarios, it would be advisable to begin to estimate and disseminate these additional pillars as indicative complements to the traditional fiscal sustainability analyses, so as to foster an understanding of the fiscal sustainability challenges faced by the region in the medium and long terms.

- 3.9 **Macroeconomic stability and fiscal rules.** There is a twofold limiting factor in achieving greater macroeconomic stability. In the first place, the automatic stabilizers in the region are relatively small and therefore ineffective in moderating output volatility during regular economic cycles (Corbacho, 2013; Suescún, 2008). This is attributable to a tax structure in which income tax, particularly personal income tax, has a small share, to the limited role of unemployment insurance in labor markets with high informality levels, and to the low financial capacity of unemployment insurance funds.
- 3.10 In the second place, the deterioration of the underlying fiscal position is largely due to certain limitations hindering the implementation of discretionary fiscal policy in the region (see [Figure 3](#)). The fiscal stimulus packages introduced in most countries between 2008 and 2010 included significant increases in certain public expenditure categories (wages and transfers), and these increases are difficult to undo when economic conditions improve (see [Figure 2](#)). In turn, there is evidence from several countries indicating that fiscal policy behaves asymmetrically: structural fiscal balances tend to worsen when production is below potential. Consistent with a countercyclical fiscal policy reaction, a 1% expansion of the output gap results in an average deterioration of the structural primary balance of over 0.3% of GDP (IDB, 2014b). However, the underlying fiscal position does not improve significantly in good times (when the output gap is positive). This reduces fiscal space, carries negative implications for debt dynamics, and weakens the capacity of fiscal policy to play a countercyclical role in subsequent stages of the economic cycle. In addition, cyclical behavior is different in the different categories of public expenditure. The procyclical bias is most powerfully evident in capital expenditure (Clements et al., 2007; Akitoby et al., 2006); in-house estimates suggest that, in the average country, a 1% output shock generates a real change of more than 2% in investment expenditure, while the same shock generates an increase of 0.3% in current expenditure.
- 3.11 In the third place, despite advances in the last 20 years in implementing budgetary reforms aimed at reinforcing fiscal sustainability, there is room for improvement in the quality of budget institutions in several respects (Dabla-Norris et al., 2010; IDB, 2006a). With regard to fiscal rules, the number of countries that have implemented rules of one type or another has increased over time. However, fiscal performance in some countries failed to improve following their implementation (Corbacho et al., 2010), and in several cases, targets were not met or were modified under successive reforms, undermining the credibility of the general fiscal framework (Celasun et al., 2015). In addition, many of these rules (such as budget balance rules or rules on spending limits) had a pronounced procyclical bias and were designed without providing for escape clauses in exceptional circumstances. This became evident when the financial crisis of 2008-2009 impacted the region, forcing

some countries to abandon or modify their fiscal rules without reinstating or adjusting them, as the case may be, once circumstances changed starting in 2011.

- 3.12 The lessons learned during the years following the financial crisis demonstrate the need to improve the design and implementation of these instruments. For example, an index that captures the extent to which certain essential elements for achieving proper functioning of the fiscal rules are present shows that there is room for expanding the potential of these instruments in the region's countries (see [Figure 4](#)) (Schaechter et al., 2012b). Among other things, there is an opportunity to expand coverage of the rules, clearly define escape clauses, and set structural or cycle-adjusted goals instead of nominal goals. However, before taking this final leap, it is important to satisfy several preconditions (related to the development of public financial management, transparency, and accountability systems), which, as indicated below, are still not in place in most countries in the region (García 2012; Ter-Minassian, 2010).
- 3.13 Similarly, the experience with the stabilization funds created by the main commodity exporters in the region suggests that these vehicles tend to undergo frequent changes and are not always used as expected, consequently failing to show any connection to fiscal performance (Villafuerte et al., 2010). With regard to MTFs, the coverage, depth, and especially the use of these instruments with compulsory rather than merely indicative budgetary or fiscal goals are still limited.<sup>55</sup> First, the deficient quality of projections tends to reproduce the weaknesses of the annual budgetary processes (Filc and Scartascini, 2010). Second, these frameworks are modified year after year in most countries, and the annual budgets have little in common with them. Thus, the multiyear frameworks continue to fail to provide an effective constraint on the budgetary process (IDB, 2006a).
- 3.14 In terms of procedural rules, despite factual evidence of a movement toward centralizing budget decisions in the countries' finance ministries, there are persistent weaknesses in annual budget processes. These weaknesses include discretionary under- or over-estimates of macroeconomic and/or revenue projections, recurring modifications during the fiscal year that undermine budget credibility, problems of over- or under-execution (Hallerberg et al., 2009a), and low public sector coverage, including extrabudgetary transactions. Lastly, despite the merits and benefits associated with the introduction of institutions such as independent fiscal councils, the region has not contributed to expanding the presence of these institutions in recent years: of 39 countries with independent fiscal councils in 2014, only two (Chile and Mexico) are in Latin America and the Caribbean and, from a comparative standpoint, their fiscal councils have rather limited functions in the budgetary process (Debrun and Kinda, 2014; Kopits, 2013; and Santiso and Varea, 2013).
- 3.15 Since many of the reforms discussed in the preceding paragraphs, primarily to increase the size of the automatic stabilizers in Latin America and the Caribbean, will take a great deal of time, as many of them are the result of the region's economic structure (such as the structure of the labor markets and social security systems), discretionary fiscal policy will continue to play a significant role in most

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<sup>55</sup> For example, while medium-term frameworks have been almost universally adopted in OECD countries (96%), their coverage in Latin America and the Caribbean encompasses less than half of the region's countries (Vlaicu et al., 2014; OECD/IDB, 2014).

countries in Latin America and the Caribbean. Nonetheless, the foregoing discussion based on recent experience in the wake of the financial crisis makes clear the need for substantial improvement in the quality of discretionary fiscal policy for countercyclical purposes in Latin America and the Caribbean.

**B. The structure of the tax and public expenditure systems and their effects on economic efficiency and productivity**

- 3.16 Tax systems have also played an important role in the region's economic growth. The most recent findings for Latin American and Caribbean countries (Martínez-Vázquez et al., 2013) draw conclusions similar to those for other countries (particularly OECD countries) on how specific taxes impact growth, even at smaller sizes or dimensions. This can be explained by the significant weight of fiscal revenues derived from commodities (especially nonrenewable resources) and the limited weight in the region of real property taxes and personal income tax. Nonetheless, the most noteworthy effect is that in the region, tax systems fail to generate a revenue level consistent with the country's development level, while in a few countries the tax burden is too high. The trends exhibited in Latin American and Caribbean countries over the past two decades show that tax revenue<sup>56</sup> rose by more than 36% (approximately 5 percentage points), from an average of 13.8% of GDP in 1990 to an average of 18.6% of GDP in 2013<sup>57</sup> (see [Figure 5](#)).
- 3.17 This growth was driven to a large extent by the VAT (24%), and since 2003 by the corporate income tax, fueled in turn by the rise in commodity prices. In fact, VAT revenue grew steadily during the 1990-2013 period and was exceeded by corporate income tax revenue only starting in 2003. For its part, personal income tax revenue posted the lowest rise of any tax revenue throughout the period under review. Despite this growth trend, the region continues to exhibit shortcomings in terms of the system's adequacy (see [Figure 6](#)).
- 3.18 In addition, the limited fiscal space available in most countries is largely attributable to their incapacity to generate sufficient and stable revenues to finance their development processes. The region's countries exhibit gaps of varying size between potential and actual revenue (Fenochietto and Pessino, 2013 and IDB, 2013c). While the tax burden is high in a few countries, the taxation systems in a broad sample of Latin American and Caribbean countries still fail to generate fiscal revenues consistent with these countries' level of economic development (see [Figure 7](#)). Thus, the empirical evidence shows that, for the vast majority of countries, fiscal revenues continue to be insufficient to cover social public expenditure and investment needs and ensure sustainable growth in the region.
- 3.19 Revenue collection continues to be volatile and highly dependent on commodity price cycles. There are numerous studies documenting the dependence of fiscal revenues on income derived from the exploitation of nonrenewable resources (NRR) and the volatility associated with international commodity prices (see [Figure 8](#)).

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<sup>56</sup> Tax burden is defined as the revenue collected by a country in the form of taxes at all levels of government; fiscal burden additionally includes social security contributions; and Equivalent Fiscal Pressure (EFP) includes all of the above plus contributions to all mandatory social security systems (pension and healthcare) and freely disposable net income transferred to the government by companies that exploit natural resources (IDB/CIAT/ECLAC/OECD, 2015).

<sup>57</sup> Estimated data based on IDB/CIAT/ECLAC/OECD (2015).

- 3.20 For countries that produce NRR, the average percentage of fiscal revenue derived from such resources rose from 18.7% of the total in 1994-1998 to 28.1% of the total in 2005-2010. Over the same period, their share of revenue available to the central government also increased, along with the vulnerability of total revenue collection to price declines in the global markets (IDB, 2013c). Moreover, the volatility of oil and mineral revenues is associated with higher public expenditures or a discretionary reduction in general taxes during export boom periods (Perry and Bustos, 2012). In addition, estimated fiscal revenues arising from NRR in Latin America and the Caribbean are four times more volatile than revenues derived from general taxes, and the availability of natural resources has a displacement effect of 20% on tax revenues not derived from NRR (Ossowski and Gonzáles, 2012).
- 3.21 The dependence of tax revenue collection on commodity prices becomes a weakness for the tax system when income derived from both renewable and nonrenewable natural resources effectively displaces the countries' tax effort. Furthermore, revenue volatility adversely affects the public expenditure and investment cycle. Consequently, reducing the dependency associated with the commodity price cycle and cushioning the volatility of tax revenues constitute a significant challenge for the region.
- 3.22 The tax environment has been no exception when it comes to major changes, which have occurred in various fiscal policy areas. Thus, countries in the region have implemented numerous reforms of varying magnitude in two distinct areas: tax policy and tax administration. The tax policy reforms, of which 345 were carried out between 1990 and 2004, had several distinguishing features. First, faced with a greater need to open up the economy and encourage international trade, governments acted to lower barriers to trade by replacing tariffs with VAT and excise taxes. Second, governments sought to encourage investment through fiscal incentives, creating negative repercussions on the neutrality of the tax system (Tanzi et al., 2008). Third, in the second half of the 2000s, following the failure of the classical formulas in the search for progressivity in personal income taxes (expanding personal exemptions and minimum exemption levels and reducing maximum rates), Latin American countries started a trend toward separating labor income from capital income<sup>58</sup> in an attempt to increase the tax base without harming investment by taxing savings at lower rates. Lastly, under the reforms, the VAT became the principal instrument for revenue collection, although to a lesser extent in the Caribbean countries, as well as the most important of the three pillars of modern taxation.<sup>59</sup>
- 3.23 In summary, the common denominator and main focus of the tax reforms implemented in the past two decades has been to improve revenue collection, setting aside issues such as the impact on economic growth and efficiency (particularly the creation of savings and labor incentives) and the redistributive capacity of the fiscal system as a whole (Focanti et al., 2013). In fact, the region still faces the challenge of a distortionary tax burden that limits growth and is

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<sup>58</sup> Uruguay introduced a personal income tax that taxes labor income and capital income (interest, dividend, profits, rent, and capital gains) separately from one another. In the wake of Uruguay's initiative, countries such as Peru, Nicaragua, Honduras, Panama, El Salvador, and Guatemala have implemented personal income taxes with dual, or so-called semi-dual, features (IDB, 2013c).

<sup>59</sup> The two others being income tax and social security contributions.

- characterized by: (i) direct tax structures biased against the labor factor; (ii) tax structures heavily dependent on indirect taxation; and (iii) non-evaluated or managed, and often redundant, fiscal incentives and preferential treatments for certain types of taxpayers and sectors, and low-quality taxes (special regimes and treatment for small and medium-sized enterprises (SMEs), free trade zones (FTZs) and fiscal incentives for multinational companies, different VAT rates); (iv) low utilization of taxes to correct negative externalities; and (v) limited development of real estate (property) taxes.
- 3.24 In fact, given the limited revenue derived from the personal income tax, the main element affecting allocation of the factors of production and raising the costs of the labor factor is the social security contributions levied on workers' wages (Bosch et al., 2013). IDB/CIAT/ECLAC/OECD (2015) provides evidence that these social contributions make formal employment more expensive. The report shows that, for a married couple with two children earning an average wage,<sup>60</sup> the tax wedge, defined as the portion of a worker's salary that is not received by the worker, amounts on average to 22.9% of the total labor cost. Of this portion, 92% is accounted for by the social security contributions provided by employees and employers (21% of the total labor cost). Given their high cost, which in effect is borne exclusively by salaried workers, social security contributions constitute the largest labor market distortion, as demonstrated by Antón et al. (2012) in the case of Mexico.
- 3.25 The tax structure in the region is biased in favor of indirect taxation. One of the distinctive features of the tax reforms undertaken over the past two decades was the consolidation of VAT as the most important tax in the region. In fact, VAT revenue levels in Latin America and the Caribbean reached an average of 6.5% of GDP in 2013, matching even the revenue levels in the OECD (6.7% of GDP for the same year). The generalized adoption of the VAT in the region is not fortuitous but rather a result of the legacy of inflation, the extent of informal employment, and the many advantages of the VAT in terms of sufficiency, neutrality, and ease of management (Tanzi, 2000).
- 3.26 The advances made with regard to this tax have essentially consisted of expanding the tax base and gradually raising the general rates, from 11.3% in the 1990s to 14.8% in 2012 (Gómez-Sabañi and Moran, 2013). However, given the significant volume of current revenue and the equity implications of raising VAT rates, many countries in the region could instead focus on improving specific aspects that undermine the purpose of the tax and thereby transform the VAT into a tax that provides greater revenue and is more neutral and easier to collect. On average, the region's governments forgo 21% of the potential VAT revenue by providing exemptions and reduced rates. In addition, 26% of the potential revenue is lost due to evasion, fraud, and management inefficiencies (IDB, 2013c). Therefore, efforts should concentrate on improving compliance and eliminating preferential treatment and multiple rates, moving toward a uniform rate for a generalized tax base and offsetting the effects of these measures through well-targeted transfers to the lower-income deciles. This would reduce part of the tax's regressivity while increasing revenue collection and neutrality and fostering ease of management (Barreix, Bès, and Roca, 2009 and 2012).

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<sup>60</sup> According to surveys of household income.

- 3.27 The region's tax structures are also characterized by an abundance of fiscal incentives and preferential treatments for certain types of taxpayers, sectors, and low-quality taxes. In Latin America and the Caribbean, fiscal incentives have been used extensively for purposes of attracting foreign investment in order to foster economic development or correct a market failure.<sup>61</sup> At present, 88% of the countries in the region provide some sort of tax exemption, while 32% offer reduced rates, 52% offer deductions on investments in capital goods or on interest payments,<sup>62</sup> and 12% offer deductions on research and development investments (James, 2013). While the effectiveness of these measures has not been demonstrated, their costs in terms of efficiency and revenue losses have been documented. Thus, Cubeddu et al. (2008) quantify the tax expenditures arising from tax incentives in the Caribbean at 5.5% of GDP. Moreover, forgone tax revenues in Latin American and Caribbean countries range from 0.5% to 6% of GDP (Villela et al., 2009). In addition, incentives distort allocation and location decision-making by economic agents, erode the tax base, create horizontal inequities in the system, and in some cases can lead the government to forgo taxing domestic residents so as to avoid preferential and distortionary treatment of foreign companies. Furthermore, incentives complicate the tax administration function and their opacity often creates fertile ground for corruption (IMF, 2011c). Similarly, many incentives tend to produce periodic benefits, thereby creating interest groups that exert pressure to make these benefits permanent or extend them over time (IDB, 2014f).
- 3.28 FTZs, another tax incentive instrument, have been used extensively in the region. They provide large benefits to their beneficiary businesses, their effectiveness is modest, and they target large companies (Artana and Templado, 2012; IDB, 2015g) (see [Figure 9](#)). Recently, Artana and Templado (2015) have conducted a study for three Central American countries in which they examined the tax incentives provided in the framework of FTZs. The authors found evidence to assert that: (i) corporate income tax exemptions may favor projects that, due to their high profitability, would have been undertaken even in the absence of these incentives; (ii) the projects undertaken by the beneficiary companies are readjusted for the sole purpose of extending the tax incentives over time; (iii) highly mobile industries are disproportionately favored; and (iv) these arrangements facilitate tax evasion through the use of transfer pricing, which in turn is detrimental to fiscal transparency efforts.
- 3.29 In addition, the high level of informality in the region's economies has led most of the countries to implement tax measures aimed at alleviating the situation. In this regard, countries have elected to implement income tax substitute systems and special treatment for small taxpayers. With respect to the former, income tax substitutes make it possible to increase revenue by expanding the tax base and the number of taxpayers, thus reducing tax evasion (Bulutoglu, 1995). However,

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<sup>61</sup> For a broader discussion of public policies aimed at correcting market failures that affect productive development, see IDB (2014a).

<sup>62</sup> As a result of the financial crisis of 2008-2009, there has been a careful review of excessive interest deductions in corporate income taxes (de Mooij, 2011; Slemrod, 2009; IMF, 2009). In practice, these deductions have created an excessive bias in favor of corporate debt as opposed to capital contributions as a means of financing investment, thus becoming a de facto savings disincentive. In addition, many multinational companies use intracorporate financing arrangements with their subsidiaries (particularly those located in developed countries) to transfer part of their profits, thus eroding the income tax base.



- the application of a minimum tax covers up the problems of tax administrations and the legal flaws in the definition of income tax. Thus, the objective of revenue collection is ultimately eroded due to the diminished fiscal effort that can result from this measure (Baer, 2006). Furthermore, when the minimum tax is greater than the tax calculated on income, it discourages productive investment since inventories, machinery, and other fixed assets are being taxed. This can result in disinvestment in companies, regardless of the tax mechanism (lump sum, percentage of assets, gross income, etc.). In fact, when levied above net income, it becomes a tax on capital (IDB, 2013c).
- 3.30 With respect to the latter, simplified tax regimes are widely used in the region. In fact, with few exceptions (El Salvador, Panama, and Venezuela), all of the region's countries have implemented a differential treatment system. These systems have resulted in low tax collection levels and negative incentives for efficiency. The evidence (IDB, 2013c and Cetrángolo et al., 2013) shows that this type of system leads companies to artificially disaggregate economic units to capitalize on the tax advantages of the preferential treatment (fiscal dwarfism). In addition, it elevates the risk that activities taxed under the normal or personal income tax system will be passed off as activities subject to the substitute regime. Similarly, simplified taxes pose the obvious risk of giving rise to false invoices since they are disconnected from the general system or are levied in the form of a lump sum or an amount not dependent on the volume of income. This encourages both VAT and income tax evasion. Lastly, their collection levels are low and they involve a large number of taxpayers, thereby discouraging tax administrations from allocating resources to control them, which in turn reinforces the above-indicated negative effects.
- 3.31 With respect to low-quality taxes, the need to mobilize domestic resources in the region has led to a search for and implementation of taxes that can generate quick revenue, without any attention being paid to the major distortions they produce. The tax on financial transactions and the tax on exports are paradigmatic examples of this trend. In the case of the former, seven countries currently include it among their permanent taxes, collecting an average of 0.8% of GDP. The evidence (Kirilenko and Summers, 2003; Arbeláez et al., 2005; Kirilenko and Perry, 2004) indicates that the performance of this tax falls off in the medium term, since it lacks the capacity to become an efficient source of revenues. Moreover, the financial disintermediation created in the long term is irreversible, even if the tax is abolished. For its part, the tax on exports is levied on domestically produced goods when they are being exported, creating a gap between the international and the domestic price of the taxed goods. The use of this type of taxes has been declining with the opening of trade and is currently concentrated in certain countries that develop natural resources and/or in cases of pronounced distortions in the exchange rate. The main advantage of this tax lies in its relative ease of management and low cost of collection. However, an economic analysis of export taxes should not underestimate their dissuasive effect on the supply of affected goods in the medium and long term.
- 3.32 The region's tax systems make little use of taxes to correct negative externalities. The mobilization of resources to foster the development and efficiency of the tax systems by correcting negative externalities (such as those produced by fossil fuels, use of vehicles and traffic congestion in large cities, carbon emissions created by some industries, overexploitation of NRR, and consumption of high-calorie foods and other products harmful to human health) is limited in Latin



America and the Caribbean. The taxes most frequently used in the region to address these problems are excise taxes on fuel, alcoholic beverages, tobacco, and, most recently, fast foods and motor vehicles (IDB, 2013c). Yet these taxes, which were originally conceived as a means to obtain revenue rather than correct externalities, are far from optimal for forcing economic agents to incorporate the costs of the resulting externalities (congestion, pollution, accidents, diseases, etc.) as well as the maintenance costs. Therefore, the challenge consists in improving the design of these taxes with a view to minimizing efficiency losses and promoting their inclusion in the tax structures of a larger number of countries.

- 3.33 Lastly, real estate (property) taxes are not well developed in the region. While the literature shows that property taxes can be efficient and equitable, the Latin American and Caribbean region has failed to make full use of them. Their principal strength is that they are applied on a relatively immobile base and their progressivity is assured by the strong correlation between property ownership and income level (IMF, 2011c). While revenues from real estate property taxes in the OECD have in the last decade risen from 0.94% of GDP to 1.15% of GDP, property tax revenues in Latin America have remained practically unchanged over the same period at roughly 0.28% of GDP. This shows the significant potential of real estate taxes in the context of subnational governments (IDB, 2014e). In short, the region needs to make greater efforts to increase direct non-distortionary taxation, by taking advantage of the opportunity presented by the low levels of revenue from the personal income tax and real estate tax in order to mobilize more resources for growth and at the same time enhance the equity of the tax system.
- 3.34 **Public expenditure policies** in Latin America and the Caribbean face significant medium- and long-term challenges that, unless resolved, could jeopardize the search for fiscal consolidation, economic growth, and equity. More specifically, the fiscal challenge for countries in the region in terms of fostering economic growth includes improving the quality of public investment in physical capital (infrastructure) and human capital. Latin America and the Caribbean have room to enhance the efficiency of public expenditures, particularly spending on infrastructure and education and health, and to generate savings in energy and transportation subsidies. In the short/medium term, the region can enhance fiscal consolidation through savings on spurious expenditures, leaks, and other inefficiencies, including in procurement and human resource systems. In the medium term, strategic planning should allocate expenditure composition and quality so as to: (i) maximize growth without neglecting poverty and inequality; or (ii) minimize inequality without neglecting growth or impacting productivity. The optimal combination will depend on each country's circumstances and strategic priorities.
- 3.35 The public sector in Latin America and the Caribbean invests very little and the quality of public investment is low<sup>63</sup> (ECLAC, 2011).<sup>64</sup> Despite the acknowledged

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<sup>63</sup> One of the factors influencing the low level of public infrastructure investment as a percentage of total public expenditures is the high budgetary rigidity in the form of permanent expenditures on wages and salaries, public transfers (especially to subnational governments), private transfers, subsidies, and interest payments to service public debt.

<sup>64</sup> This ECLAC publication provides a detailed study of the evolution of public infrastructure investment in the region. In addition, it defines and measures the infrastructure gaps by sector and the financing needs and alternatives for covering these gaps.

strategic role of infrastructure in growth, public investment in this area only started to increase in the last decade, following three decades of decline (IMF, 2015c).<sup>65</sup> Between 2011 and 2013, public investment in Latin America and the Caribbean averaged 5% of GDP, higher than in the OECD (3.2% of GDP) but was still lower than in ASEAN member countries<sup>66</sup> (in excess of 6% of GDP on average). In addition, the region has one of the world's lowest stocks of real public capital per capita (see [Figure 10](#)). As a result, Latin America and the Caribbean lost ground in terms of competitiveness in relation to its peers and competitors. While public investment is relatively low, the inefficiency gap is even more pronounced: the current efficiency level is lower than the average levels in countries with similar income and in more developed economies. In the 1996-2011 period, relative efficiency in the use of available physical and human capital in Latin America and the Caribbean was 45%, compared to 65% in the OECD. The difference is primarily due to shortcomings in public management (Giménez et al., 2015).<sup>67</sup>

- 3.36 The quality of human capital expenditures in Latin America and the Caribbean is also very poor, in part because skill development management is in the hands of various government agencies (secretariats or ministries of health, education, labor, economy, housing, etc.) that most of the time fail to coordinate with one another. In addition, the countries in the region lack programmatic budgetary structures that prioritize investment in human capital or skill development on an integrated and coordinated basis throughout the life cycle. They also, and even more so, lack structures that can use information on the outcomes of such investment to review these programs for subsequent budgetary reallocation aimed at improving quality. Furthermore, these decisions are not framed in the countries' MTFFs.
- 3.37 Starting in the 1980s, many countries in the region decentralized a significant portion of their expenditures to subnational governments. Subnational public expenditures in Argentina, Brazil, and Mexico account for more than 40% of total expenditures. Consequently, the way responsibilities are allocated and the degree of fiscal correspondence in terms of taxation powers are major determinants of the incentives to provide basic services with minimum levels of quality (such as health, education, and infrastructure). There are opportunities for introducing fiscal savings by streamlining the system of transfers between different levels of government and performing better monitoring and control of expenditures and their results. Conditional intergovernmental transfers and equalization transfers can be improved by aligning them with a given country's strategic objectives. Reforms in the mobilization of subnational resources in Latin America and the Caribbean are essential for driving development at the local level (IDB, 2015b). The Decentralization and Subnational Governments SFD is a reference source for information on the diagnostic assessment, challenges, and policies regarding these issues in Latin America and the Caribbean (IDB, 2015c).

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<sup>65</sup> In 2000-2005, Latin America invested 3.2% of GDP. The figure increased to 4.4% of GDP and 5.8% of GDP, respectively, between 2006-2011 and 2012-2014. Source: IDB.

<sup>66</sup> Association of Southeast Asian Nations. The figure is for Philippines, Malaysia, and Thailand. Source: OECD.

<sup>67</sup> Institutional flaws are the main obstacle for the execution of public investment. The greatest shortcomings in less developed and emerging countries are in the preinvestment, cost-benefit analysis, and project implementation phases (Dabla-Norris et al., 2011; Gupta et al., 2011; IMF, 2014).

- 3.38 In the majority of the region's countries, there is no medium- or long-term strategic vision for expenditure allocation based either on economic and social development priorities or on an allocative efficiency analysis and thus resulting in a budget that reflects agreed-upon public policies derived from government plans (Martner et al., 2008). In some countries, incremental annual budgets prevail over government plans or MTFFs. In others, the reason is that ministries of finance have little influence over long- and medium-term strategic decisions (Schick, 2006). Several countries, such as Colombia, Mexico, and Uruguay, have planning experience associated with the MTFFs. At the other end of the spectrum, Chile is an example of low planning institutionalization combined with highly developed budget management, including an advanced RBB system.
- 3.39 One of the main challenges in implementing RBB is coordinating medium-term planning with the annual budget.<sup>68</sup> In Latin America and the Caribbean, the results-based planning pillar of the evaluation system for the Program to Implement the External Pillar of the Medium-term Action Plan for Development Effectiveness (PRODEV) (SEP) is the pillar that showed the largest gain in recent years, rising an average of 0.5 points from 2.3 in 2007 to 2.8 in 2013, although the latter level continues to be relatively low.<sup>69</sup> The countries with the highest scores are Brazil, Mexico, and Colombia, holding a considerable lead over the rest of the region (IDB, 2015a) (see [Figure 11](#)).
- 3.40 At the same time, several countries have made good progress in results-based planning, including the Dominican Republic, Belize, Paraguay, Nicaragua, Peru, Ecuador, Panama, and Mexico. One of the components of this pillar is long-term vision, for which the average score is 2.0, the lowest in the category (despite the existence of institutional arrangements that facilitate the continuity of State policies).

**C. The impact of fiscal policy on equity and its relation to economic efficiency and productivity**

- 3.41 The distributive effects of tax policies in Latin America and the Caribbean have been extensively evaluated. The first studies for the region (Barreix et al., 2006 and 2009 and IDB, EuroSocial and IEF, 2010) assessed the net impact of tax policy and the public expenditure it finances. These studies found that income tax is very progressive and is paid by very few taxpayers. In addition, they showed that the VAT can be either progressive or regressive depending on the method used to estimate it. Thus, it is regressive when estimated on the basis of declared income, but its regressivity disappears when the estimate is based on the relative consumption of the various income brackets and when the combined revenue-expenditure effect is examined. More recently, Lustig et al. (2013) found that direct taxes and cash transfers reduce inequality and poverty in Argentina, Brazil, and Uruguay, to a lesser extent in Mexico, and to a relatively limited extent in Bolivia

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<sup>68</sup> There is evidence regarding the distance between formal regulations and reality in the budgetary process in Latin American countries. These differences are particularly significant concerning the relative power of the executive branch and congress with respect to the budget, given the presumptive superiority of hierarchical institutions in generating good fiscal results (Hallerberg et al., 2009a).

<sup>69</sup> The components evaluated in results-based planning are: strategic planning capacity; planning operations (integration of plan-programs-budget and short- and medium-term coordination); and participation in planning (participation by the legislative branch and by civil society).

and Peru. They also found that direct taxes are progressive, but that their redistributive impact is insignificant since direct tax collection as a percentage of GDP is very low.

- 3.42 Tax systems in Latin America and the Caribbean are affected by high tax expenditure. Tax expenditure is defined as the revenue forgone by the State when it grants incentives or benefits that reduce the tax burden for certain taxpayers (Villela, Lemgruber, and Jorrat, 2009 and Pecho, 2014). In the five-year period of 2008-2012, tax revenue forgone for this reason in Latin American countries averaged 4.3% of GDP (see [Table 1](#)). For a region that on average collects 18.6% of GDP, the tax expenditure is high (23% of regional average tax collection), particularly considering extreme cases such as Guatemala, where forgone taxes total more than 50% of tax revenues. Worse yet are the effects of many of the tax expenditures on the tax system's equity. Tax incentives for businesses create horizontal inequities among taxpayers, depending on the sector in which the business activities are carried out.
- 3.43 Furthermore, it is worth noting that, in Latin American and Caribbean countries, personal income tax deductions (approximately 1.6% of GDP) on mortgage interest payments, private education expenses for children of a certain age, medical expenses, and other expenses that only benefit higher-income population groups create repercussions on equity and are therefore a highly regressive form of tax expenditure. Similarly, tax exemptions in the form of reduced or differential VAT rates aimed at enhancing the progressivity of this tax end up creating a regressive tax expenditure as a result of targeting or inclusion errors (Barreix et al., 2009).
- 3.44 The distributive impact of the expenditure's size and composition is crucial, especially for the impact of social spending. There is a great deal of heterogeneity in the region. Some countries have great redistribution potential, similar to the levels found in OECD countries, while the potential in other countries is lower. In 12 selected Latin American and Caribbean countries (Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Ecuador, El Salvador, Guatemala, Mexico, Peru, and Uruguay),<sup>70</sup> social spending averages 15% of GDP. This is equivalent to 60% of social spending in OECD countries, but with a potential for redistribution (Lustig et al., 2013; Lustig, 2015a) (see [Figure 12](#)).
- 3.45 In the aforementioned 12 Latin American and Caribbean countries, taxes and direct transfers reduce inequality on average by only 5%, while in a sample of OECD and European Union countries they are shown to reduce it by 40% (see [Figure 13](#)). There are several reasons for this difference (see Social Protection and Poverty SFD; IDB, 2014f). First, the Latin American and Caribbean countries that reduce inequality the most (between 9% and 14%) are, in descending order, Uruguay, Argentina, and Brazil. These countries lead the region in social spending. However, even when compared to these countries, advanced nations reduce inequality four times more. The low weight of some direct taxes, such as the

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<sup>70</sup> The analysis is based on the following studies of 12 LAC countries selected as part of the Commitment to Equity (CEQ) project: Argentina (Pessino), Bolivia (Paz Arauco et al.), Brazil (Higgins and Pereira), Chile (Ruiz-Tagle and Contreras), Colombia (Lustig and Meléndez), Costa Rica (Sauma and Trejos), Ecuador (Llerena et al.), El Salvador (Beneke, Lustig, and Oliva), Guatemala (Cabrera, Lustig, and Morán), Mexico (Scott), Peru (Jaramillo), and Uruguay (Bucheli et al.).

personal income tax and real estate tax in most Latin American and Caribbean countries, largely explains these results. Second, the redistributive effect of pension expenditures is minimal. In terms of contributory pensions, the average expenditure for the 12 countries is 4.1% of GDP, compared to 8.7% for the OECD<sup>71</sup> (see [Figure 14](#)). Despite the fact that some Latin American and Caribbean countries spend a figure close to the OECD average on pensions as a percentage of GDP, the difference between the Gini coefficient with, and without, pensions is minimal in these countries and much greater in the OECD.<sup>72</sup> Third, direct transfers in Latin American and Caribbean countries have targeting problems, with leakage toward the nonpoor. On average, approximately 40% of conditional transfer beneficiaries and 50% of noncontributory pension beneficiaries in Latin America and the Caribbean are not poor (Robles et al., 2015).

- 3.46 One of the main reasons for the spending leakages is the high informality level throughout the region, affecting the entire welfare and redistribution system in terms of both actual tax collection and redistribution of resources.<sup>73</sup> Informality, which is used by some taxpayers to avoid certain taxes (particularly, payroll or labor factor taxes) and benefit from certain social transfers, hinders the functioning and effectiveness of the welfare system and limits effective revenue collection and the redistributive capacity thereof (Birdsall, et al., 2010). Obviously, the ideal solution is to create economic incentives to reduce the problem of informality and, along with it, the subsidies used to counteract its undesirable effects. At the same time, the targeting systems can and should be improved. Several countries in the region use means-tested or geographical targeting systems, which provide an estimate of per-capita income or consumption based on demographic characteristics and ownership of assets, but account for only 50% to 60% of the observed variability in living standards (Robles et al., 2015). The integrated information systems implemented in Argentina in 1997 and in Brazil in 2001 could be used as initial models to improve targeting in the region's countries (Pessino and Fenochietto, 2007; Azevedo et al., 2011).
- 3.47 In summary, the difference in fiscal policy effectiveness in reducing poverty and (static) inequality in the region, in comparison to more advanced countries, is to a large extent due to spending policy rather than to the progressivity of the tax systems, largely because of the low weight of the personal income and real estate taxes in direct taxation, and the higher weight of taxes or contributions on the labor factor. In addition, the inefficiencies in social spending management, including social protection expenditures and high informality levels, dampen the impact of fiscal policy on redistribution.

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<sup>71</sup> For the OECD, this figure includes both contributory and noncontributory pensions. This is not the case for the Latin American and Caribbean countries.

<sup>72</sup> With the addition of pensions, the Gini coefficient for market income only drops from 0.523 to 0.516 in Latin America and the Caribbean, while dropping from 0.482 to 0.366 in the OECD; in other words, their equalizer effect is slightly higher than 1% in Latin America and the Caribbean, compared to almost 25% in the OECD (Lustig and Pessino, 2014; Lustig, 2015a). This is due to the low coverage of the contributory pension systems in most Latin American and Caribbean countries (an average of 41%), since these systems include only formal employees and do not extend to informal workers, who for the most part are low-income individuals (Bosch et. al, 2013).

<sup>73</sup> In order to be effective, the welfare state needs to know the first and last name, identification number, and address of the beneficiaries, as well as their transactions, assets, and market income.

- 3.48 Most of the studies addressing the impact of public spending on inequality and poverty fail to account for the regressive effect of energy subsidies, which are economically inefficient, poorly targeted, and thus referred to as pro-rich subsidies.<sup>74</sup> In several countries, propane gas, diesel, and electricity subsidies benefit the higher-income population segments, with decile 10 receiving one quarter of all the benefits while the poorest decile receives only 5%; in other words, in these countries, the high-income population receives 5 times more subsidies than the poor (Llerena et al., 2015; Paz-Arauco et al., 2014). These subsidies are distortionary, since they are extended to the entire population through the final sales price of the subsidized products, regardless of the consumers' income level. Thus, price-based subsidies generate a high fiscal cost and result in a loss of economic efficiency. Reversing this double loss requires substantially modifying this type of subsidy so as to produce targeted transfers that compensate only the low-income population for loss of income, reducing the subsidy's fiscal costs while also enhancing its impact on equity. There are countries in Latin America and the Caribbean that spend 5 to 10 times more on regressive subsidies of this type than on conditional cash transfers, which are mostly progressive. This means that it is possible to transfer part of the savings on subsidies to other, more progressive social programs and even generate savings (Arze del Granado, et al., 2012; IDB, 2014f; and Energy SFD).
- 3.49 A composition analysis of social spending in Latin America and the Caribbean indicates that education spending accounts on average for 4.4% of GDP (5.4% in the OECD) and health spending is 4.2% of GDP (6.5% in the OECD), with significant differences among the various countries in the region (see [Figure 14](#)). These transfers, valued at cost in the fiscal policy incidence analysis, are on average highly progressive, reducing inequality to an even greater extent than do direct transfers (see [Figure 13](#)). The results are encouraging from an equity standpoint, but the concern for Latin America and the Caribbean is that the progressivity of health and education spending is being seriously undermined by the expenditures' inefficiencies and low quality. Thus, the middle-income and wealthy sectors of the population choose to use private, better-quality health and education services, while the low-income sectors receive lower-quality services. This limits the medium- and long-term distributive effects of social spending, particularly in human capital formation and skill development among the poorest sectors (Ferreira et al., 2013). Moreover, while spending on primary and secondary education, regardless of its perverse effects stemming from the quality of service, is aimed at or benefits the poorest sectors, spending in tertiary education does not similarly target these sectors since it is aimed at or benefits primarily the middle- and high-income population (a similar result is observed in the OECD)<sup>75</sup> (see Education and Early Childhood Development SFD; IDB, 2013f).
- 3.50 A major fiscal policy challenge for reducing inequality and poverty is appropriately selecting the tax instruments and expenditures that can help to improve human

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<sup>74</sup> If the subsidy's concentration or quasi-Gini coefficient is positive, the subsidy benefits the higher-income population.

<sup>75</sup> This is a global phenomenon, since only those who have developed greater skills reach the tertiary education level, an achievement which is associated with the prior acquisition of skills. Attaining this level of education is very difficult for students from poor backgrounds who attend low-quality schools and carry skill shortcomings since childhood.



capital in the poorest population sectors. This requires carefully designing interventions that avoid disincentives to formal employment, investment, and savings. Just as the international evidence shows the collateral effects of fiscal policies, there are also studies in the region that suggest modifying the incentives for beneficiaries to obtain formal jobs (Amarante et al., 2011 for Uruguay, Bosch et al., 2013 for Ecuador; and Antón and Leal, 2013 and Antón et al., 2012 for Mexico). There is also evidence that programs such as unemployment insurance can have collateral effects in the search for employment and can incentivize long-term dependency on social transfers, disincentivizing the search for formal employment (see Labor SFD, IDB, 2013b).

- 3.51 Beginning in the 1990s, most of the countries, starting with Mexico, Venezuela, and then Brazil, developed conditional cash transfer programs (CCTPs). To ensure that these transfers do not become a permanent need, they should be directly contingent on investment by the beneficiary households in human capital, particularly health, nutrition, and education, especially for children (Levy, 2015). In turn, the amounts should be limited and should not be permanent in order to avoid creating a disincentive for development and work. The main idea behind these programs is for the children in these households to build their human capital in order to enhance their entry into the labor market in more productive jobs and, consequently, break the circle of poverty that is usually transferred from one generation to the next.
- 3.52 CCTPs also present significant leakages to nonpoor sectors, although their targeting has improved in many countries over the last two decades through the cross-referencing of household data, as mentioned above. In addition to continuing efforts to target these programs, efforts should be made to strengthen their use for improving early childhood education in order to build human capital. There is evidence that CCTPs have played an important role in reducing poverty and inequality in the region,<sup>76</sup> and therefore represent a crucial instrument for social progress originally conceived and designed in Latin America and the Caribbean and replicated in other regions around the world. Nonetheless, after achieving complete coverage of those in need, the greatest triumph of CCTPs in Latin America and the Caribbean would be a gradual reduction of such programs over time until they are no longer necessary, as extreme poverty is progressively eradicated and the region benefits from macroeconomic stability, sustained growth, and a healthier, educated, and productive workforce.
- 3.53 The high levels of informality and the low productivity in the region constitute threats to the aforementioned objectives. The excessive tax burden on formal employment, with a social security system that discriminates in favor of formal workers, prevents more of the expected benefits of CCTPs from being captured. In fact, this circumstance has forced the region to create parallel noncontributory social security programs, for both health and pensions, which are poor in comparison to the benefits of the social security systems for formal workers. There is no unemployment insurance or workplace accident or disability coverage in the informal sector. Moreover, given the low proportion of productive capital in the informal sector and the limited size of informal enterprises or firms, largely to avoid labor or other taxes, productivity is extremely low in most of these economic

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<sup>76</sup> See the Social Protection and Poverty Sector Framework Document (document GN-2784-3).

activities.<sup>77,78</sup> Consequently, the region has reached a point where it levies various fiscal charges (labor-related and otherwise) on formality and subsidizes informality in a number of ways. These circumstances not only limit the growth of the productivity and real income of informal workers, but also unfairly discriminate in terms of social security coverage and quality, prevent breaking the vicious circle of informality and poverty for which CCTPs were designed, and put significant pressure on fiscal sustainability (Levy, 2015). The dynamics among poverty, equity, efficiency, and fiscal sustainability may constitute one of the most important challenges for the region's economic development.

- 3.54 In summary, to fulfill the goal of achieving faster and more equitable growth, the Latin American and Caribbean region needs to ensure that its social programs do not discourage labor formality or promote tax evasion and at the same time are fiscally sustainable over the long term (Levy and Schady, 2013 and Levy, 2015). The management of fiscal policy, as well as social and labor policies, should focus on: (i) speeding up productivity growth; (ii) increasing the savings rate in order to achieve greater investment efforts; (iii) enhancing the efficiency of the public infrastructure investment process; and (iv) improving the quality of health and education services for the more disadvantaged sectors, creating a true equality of opportunity.
- 3.55 Lastly, an essential aspect of the relationship between equity on one hand and fiscal policy and management on the other, regarding which the theoretical and empirical evidence is still limited, is the impact of fiscal policy and management on gender equity (Grown and Valodia, 2010). This impact can be assessed by focusing on three significant elements of fiscal policy and management: tax policy, budgeting, and public procurement. In general, the tax systems in Latin America and the Caribbean are implicitly biased against women-led households, despite the absence of any bias in the tax codes. This systemic bias is particularly true in the case of direct taxes, while in the case of indirect taxes it depends on how wellbeing is measured (IDB, 2015i). With regard to the budget, Latin American and Caribbean countries continue to exert only limited efforts to examine the impact of budget allocations on the gender gap. Lastly, despite significant strides in some Latin American and Caribbean countries (for example, Chile and Dominican Republic), there is a need for greater strengthening of and participation by women-led enterprises in public procurement, with a view to achieving greater social inclusion.

**D. Efficiency and transparency in public resource management and the performance of fiscal institutions**

- 3.56 **Tax administration.** Most of the tax administrations in the region have limited institutional capacity for effectively establishing information exchange arrangements and maintaining bank secrecy and bearer share confidentiality. The limited development of international taxation units and the lags in creating and maintaining an up-to-date and accurate registry record impede the exchange of

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<sup>77</sup> See the Labor Sector Framework Document (document GN-2741-3).

<sup>78</sup> In late 2012, Colombia approved a tax reform (Law 1607), which reduced the tax burden on the labor factor, or payroll taxes, in order to stimulate formal employment and enhance productivity. The loss in revenues resulting from these measures was neutralized with an adjustment to the corporate income tax and a simplification of VAT rates. The reform increased formal employment and reduced the unemployment rate, while increasing revenues as a result of enhanced growth. The effects of this reform have been analyzed in Steiner, 2014; Antón, 2014; and Bernal et al., 2015.



- information between countries. Nevertheless, under the sponsorship of the OECD Global Forum on Transparency and Exchange of Information for Tax Purposes, advances have been made in Latin America and the Caribbean on lifting bank secrecy for tax purposes, on putting an end to bearer shares, and generally on complying with the new international standards provided by the aforementioned forum and, to a lesser extent, by the Financial Action Task Force (FATF).
- 3.57 There is very limited measurement of tax expenditure, particularly in terms of analyzing and monitoring incentives, and subsequent disclosure of the results. Progress on quantifying and publishing tax expenditures in the region has been slow, and there are still a significant number of countries that fail to perform these measurements on a systematic and regular basis. At present, 12 countries in the region prepare some tax expenditure estimates, although not all of these countries make them available to the public (Pecho, 2014). Greater advances in this regard would make fiscal policy more transparent. Furthermore, having more and better tax expenditure information available, whether grouped by type of tax, activity sector, targeted region, or income deciles, would make it possible to identify the beneficiaries of tax policy and its potential economic, regional, and distributive effects. In addition to enhancing transparency, this would provide the inputs needed to assess the effectiveness of incentives, subsidies, and other tax exemptions in achieving tax policy objectives and would facilitate tax administration. In this regard, it is important that the tax expenditure reports be included among the documents annually submitted to Congress along with the budget, so that they may be compared with the direct expenditure reports and subjected to the same evaluation, review, and control process.
- 3.58 There is a necessary institutional network supporting the tax collection functions (penalty systems, tax courts, ethics and administrative committees). The institutions tasked with supporting the tax administrations in certain collection functions require more general or overall strengthening processes. In this regard, the development of the Tax Code Model (IDB/GIZ/CIAT, 2015) is an important step forward designed to create greater stability by regulating the relations between tax administrations and taxpayers. The institutions that support the collection and regulatory functions of the tax administrations (tax policy units in the ministries of finance, tax courts, ethics committees, courts of justice) should be developed, modernized, and strengthened at the same time as the tax administrations in order to coordinate, facilitate, and streamline the processes initiated by the latter.

### The cost of paying taxes, use of information technologies, and persuasion in revenue collection

The administrative cost of paying taxes can represent a significant transaction cost for corporate taxpayers, given the wide range of taxes and fees to which they are subject. The transaction cost is represented by the number of hours and processes per year that taxpayers must devote to fulfill all their tax obligations for a wide range of taxes, including payroll taxes and other contributions, at both the national and subnational levels. In fact, the World Bank and PwC calculate an index on the ease of doing business in a sample of 189 countries and 22 cities worldwide, including an indicator on the effective payment of taxes and the administrative burden associated therewith (see Figure 16). The ease of tax payment index is the simple average of three subindexes: (i) tax payments (number); (ii) time to prepare and pay taxes (hours); and (iii) total tax rate (% of commercial profits); calculated for a wide range of taxes. The subindexes are measured as a country's distance from the range defined by the thresholds of worst and best performance ("distance to frontier"). The thresholds are determined on an ex ante basis. For further details on the methodology, see: <http://doingbusiness.org/methodology/paying-taxes>.

A very high transaction cost to pay taxes could be a disincentive for small and even medium-sized enterprises, which may opt for informal activity in order to evade taxes and reduce the transaction costs of their operation. One effective way to reduce both effects is through the use of information technologies. Using the internet to file and pay taxes online reduces these transaction costs significantly, which can facilitate taxpayers' willingness to fulfill their formal tax obligations, while also reducing the levels of tax evasion and transaction costs for the tax administration itself.

The use of cutting-edge information technologies is also one of the most important advances in reducing tax evasion (see Figure 17). These technologies are available on the market and are widely used by financial institutions and telecommunications service enterprises worldwide, as well as in other industries, to undertake and monitor in real time a gigantic universe of transactions, and can be placed in the service of tax administrations. A recent study by the OECD (2015f) shows that these services can be used for such purposes. Most countries in Latin America and the Caribbean lag significantly behind in this area. In recent years, these technologies have been used to build large databases, including information from tax administrations and third parties (utilities companies, banks and financial institutions, property registries, and other public sector databases, etc.), in order to build integrated fiscal information systems for cross-referencing data. This information allows tax evasion and other instances of tax fraud to be detected (such as overestimating VAT tax credits) and builds risk profiles for taxpayers for more selective and effective oversight and audits. The use of electronic invoices represents a fundamental element for the use, monitoring, and cross-referencing of information with these systems. Likewise, the use of electronic forms for monitoring labor income and the payment of contributions, including social security, as well as single windows for the payment of all taxes, and the use of consolidated tax accounts for taxpayers, represent important steps in this direction.

An effective tax and customs administration requires the following five fundamental pillars: (i) a legal framework that gives broad powers to the tax administration to obtain the information it needs from taxpayers and third parties in a broad and effective manner; (ii) highly skilled, well compensated human resources, with a stable, long-term career outlook; (iii) sufficient budgetary resources to procure, maintain, and renew cutting-edge technology and information systems; (iv) a depoliticized technical management, to the extent possible, with a long-term strategic vision based on obtaining results and serving clients (taxpayers); (v) a results-based organizational culture; and (vi) high levels of demand for results-based accountability by the respective hierarchical superiors in the public sector. Lastly, the realization of these pillars to achieve effective tax revenue collection, based on a firm political will by governments and other public authorities, such as parliaments, to give tax and customs administrations the legal powers and budgetary resources needed to meet their objectives.

There is evidence that the use of the electronic invoice helps reduce informality (McKinsey & Company, 2014) and more importantly, that taxpayers respond positively when fulfillment of tax obligations is broadly facilitated and transaction costs are reduced. There is also evidence that taxpayers react positively to persuasive messages that are constructive, and not only messages related to enforcement for fulfillment of obligations (Castro and Scartascini, 2013; Scartascini and Ortega, 2015). This evidence shows that messages that inform and explain to taxpayers how public resources are used, the impacts of fiscal policy on equity, compliance by most taxpayers, etc., contribute to positive and proactive behavior by taxpayers in the payment of taxes. In conclusion, the use of information technology for these purposes helps produce a win-win situation for governments and taxpayers.

**3.59 Management of expenditures and fiscal risks.** In Latin America and the Caribbean, there is very little fiscal risk identification, quantification, and management in the broad sense of fiscal risks, which include liabilities related to old-age expenditures, mostly pension and health; contingent liabilities associated with explicit or implicit guarantees for the financial sector; loan guarantees for

enterprises (public or private); for subnational governments, PPPs, and certain public trusts. Many of these liabilities are off-budget and should be quantified and recorded, particularly those that represent explicit public sector commitments.<sup>79</sup> Many of the contingencies are neither recorded nor budgeted, nor are they properly captured in a traditional fiscal analysis. While fiscal transparency in various Latin American and Caribbean countries was improved after the Asian crisis in the late 1990s revealed shortcomings in public financial reporting, there is still a great deal of room for further improvement (Cotarelli, 2012; Irwin, 2012) (see [Figure 15](#)).

- 3.60 Despite the region's rapidly aging population, few Latin American and Caribbean countries are performing periodic projections of pension expenditure and even fewer are projecting their actuarial deficits. Essentially, there are no projections of health expenditure or actuarial deficits, or of other expenditures associated with the elderly (Glassman and Zoloa, 2014). This is the reason why none of the region's countries periodically includes projections or actuarial deficits in its public accounts, MTFs, or debt sustainability analyses (DSAs).
- 3.61 With regard to the fiscal risk associated with PPPs in Latin America and the Caribbean, the information available on these entities is deficient, particularly when they take the form of a public enterprise, a temporary vehicle such as a trust, or a concession (or self-sustaining entity, as concessions are known in many countries). In some cases, there is information on the initial investment and part of the future spending streams, but these entities are never formally reported on the public accounts and only partially in fiscal risk reports.<sup>80</sup>
- 3.62 Most of the countries that publish fiscal risk reports fail to analyze how different risks can interact in a systemic financial or fiscal sustainability crisis. This is problematic, since different fiscal risks have in the past materialized at the same time and reinforced one another (Gray and Malone, 2008). It is common for countries that have fiscal risk units to calculate risks using option prices with contingency simulation techniques (Peru, Chile, and Colombia). However, these methods generally fail to properly capture aggregate risks in the event of a systemic crisis in which these risks would tend to materialize simultaneously. In view of this, the initiatives of Latin American and Caribbean countries in recent years to improve the governance of PPPs, notably including limiting both the flow and the stock<sup>81</sup> of PPP investment amounts, appear to be the correct path to take until these entities begin to become more transparent and their transactions and debts begin to be recorded.
- 3.63 Other fiscal risks in Latin American and Caribbean countries are related to government banks and public credit transactions; implicit guarantees extended to government enterprises; contingent liabilities arising from legal action against the government; and natural disasters (Celasun et al., 2006). Greater transparency,

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<sup>79</sup> These usually also include the contingent liabilities that can materialize in the event that, under certain circumstances (such as when essential public services are being provided by private companies), bank crises and/or private sector debt require a government bailout.

<sup>80</sup> Mexico, as well as Chile and Colombia, reports on fiscal risks, including PPPs that have used central government budget resources but not including concessions and subnational PPPs.

<sup>81</sup> Brazil, Colombia, Mexico, El Salvador, Honduras, and Peru set a limit to the investment flow in some cases and to the annual investment balance in others.

- while not eliminating these risks, would help in responding to them. For example, implementing international accounting and statistics standards, alternative projections of fiscal variables, and audit publication in accordance with international standards could help mitigate these risks. In addition, the monitoring and control of all contingent liabilities should be centralized at the ministries of finance or equivalent bodies, even if these liabilities are periodically evaluated and monitored by other government units (Cebotari, 2008).
- 3.64 PFM in Latin America and the Caribbean continues to exhibit significant weaknesses. Between 2007 and 2012, PEFA assessments were published for 14 countries in the region and, under a correlation of grades from D to A to a scale from 1 to 4, the region achieved an average score of 2.7 (67.5% of the highest possible score), showing that there is still ample room for improvement (see [Table 2](#)). Advances in management for development results (MfDR), measured through the PROVED evaluation system (SEP), point to a positive trend between 2007 and 2013 in the five pillars of central government in 24 Latin American and Caribbean countries.<sup>82</sup> However, the average overall score for Latin America and the Caribbean in 2013 was 2.3 on a scale from 0 to 5—46% of the highest possible score—suggesting that there is still room for improvement. More specifically, the region's average score in the PFM pillar was 2.9, 58% of the highest possible score (IDB, 2015a).
- 3.65 Cash and treasury management in Latin America and the Caribbean is not fully integrated. Efficient treasury management requires the existence of a treasury single account (TSA) system to make all government financial resources available on a consolidated basis and facilitate their management and control. Establishment of a TSA system does away with the treasury's role as a mere payor, creating instead a modern PFM structure with proactive cash management (Fainboim and Pattanayak, 2011). A TSA system generates savings by reducing the need to issue short-term debt while maximizing the returns of temporary cash surpluses. The consolidation of a TSA system in Latin America and the Caribbean, albeit with limited public sector coverage, has been made possible by the significant spread of integrated financial management systems (IFMSs) in the region (IDB, 2015f).
- 3.66 The cash management and debt management functions in Latin America and the Caribbean are performed properly in certain respects despite the use of different structures or organizational arrangements. The historical tradition of having two separate units has been predominant in the region, even if the potential advantages of integration are recognized. The three national treasuries in which these two functions are merged (Brazil, Colombia, and Peru) have reported that this integration has facilitated: (i) coordination; (ii) adoption of a more comprehensive financial policy; and (iii) consolidation of financial operations.
- 3.67 The IFMSs and public resource management systems need to be modernized. Latin America and the Caribbean, where every country has an IFMS, is one of the world's regions with the most widespread use of this type of system. Nevertheless, IFMSs in Latin America and the Caribbean face four challenges: (i) technological modernization through the use of web platforms and systems that have lower

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<sup>82</sup> The SEP is a tool that analyzes five pillars of the public policy management cycle: (i) planning; (ii) budget; (iii) public financial management; (iv) program and project management; and (v) monitoring and evaluation.

- maintenance costs and greater flexibility for specific adjustments; (ii) alignment with the public accounting modernization processes in several countries in the region toward convergence with international standards; (iii) contributing to the processes of integrating financial information with performance indicators in the context of RBB and cost accounting initiatives; and (iv) extending the use of IFMSs to subnational governments (IDB, 2015f). To complement the IFMSs, links to payroll (personnel payments), procurement, and planning systems are valuable for purposes of improving public resource management. Enterprise resource planning (ERP) systems, commonly used in the private sector, are an example of information systems that include the above-listed functions. ERPs adapted for public sector use as a public resource management system are new to the region and are starting to be used by some countries (for example, Nicaragua and Panama).
- 3.68 The use of procurement systems has also made inroads in the region. Procurement is a significant component of public expenditure in Latin America and the Caribbean, accounting for 5% to 10% of the region's GDP (depending on whether or not all levels of government and public enterprises are included). Many countries have created national procurement agencies to develop policies and systems. Combined with the advances in information technologies, the institutional and financial autonomy of these agencies has made it easier to promote significant reforms in the sector, including electronic procurement. For example, using Brazil's procurement system as an initial benchmark, Paraguay adopted the use of reverse electronic auctions for public procurement in 2008. In addition to providing transparency, reverse electronic auctions gave rise to significant savings. For example, in 2011, auctions reduced final prices by almost 20% with respect to the initial bids and by 12% with respect to the amounts initially estimated in the invitations to bid.
- 3.69 E-procurement systems in Latin America and the Caribbean have expanded and on average offer more extensive services than in OECD member countries. Of the 12 services most commonly offered by e-procurement systems in Latin American and Caribbean countries, 10 provide better coverage than in OECD member countries. On average, Latin American and Caribbean countries disclose a larger proportion of information on bidding processes at the central government level. For example, more than 70% of the surveyed Latin American countries disclose plans for early procurement, compared to 50% of OECD member countries; close to 90% of the surveyed Latin American countries provide general information to potential bidders, compared to 75% of OECD member countries; and more than 70% of the surveyed Latin American countries provide information on procurement expenditures, compared to approximately 20% of OECD member countries (OECD/IDB, 2014).
- 3.70 One of the main PFM issues related to fiscal transparency is the publication and dissemination of public accounts, including public accounting aligned with the International Public Sector Accounting Standards (IPSAS). Proper measurement of fiscal results, the real and actual debt level, and the government's net worth requires an accrual-based rather than a cash-based accounting system and correct valuation of the assets and liabilities in the entire public sector. Proper and effective accountability cannot be achieved without a good accounting system.

- 3.71 To date, no Latin American or Caribbean country has fully applied IPSAS or other wholly accrual-based accounting practices, although significant progress has been made. Most of the region's countries are implementing a mixed system that combines accounting regularization for certain elements and cash-based accounting for others. In some cases, the national legislation is consistent with the IPSAS, placing several countries in a better position for completing the reforms. For example, Mexico approved an IPSAS-based government accounting law with coverage throughout the public sector and reinforced it in 2012 through a reform that linked it to RBB; Ecuador enacted a law in 2010 that singles out accrual as the accounting principle that the nonfinancial public sector entities are required to follow; El Salvador, Guatemala, Nicaragua, and Panama are in the midst of an IPSAS-based accounting reform; Guatemala started the process of applying IPSAS in 2005 as part of a financial systems project; Colombia, the Dominican Republic, and Honduras have prepared a strategy for transition or announced their transition to IPSAS; and Brazil, Chile, Costa Rica, and Peru have approved a plan including legal authority to converge with IPSAS or wholly accrual-based accounting.
- 3.72 Transparency issues are aggravated in some countries in the region by the failure to disseminate and publish economic, financial, and budget data in a timely manner. This shortcoming prevents the population from knowing how public resources are used and how they perform, and limits evaluation of social and economic impacts, policy effectiveness, and fiscal management. This problem is particularly severe in the Caribbean nations, but it also impacts other countries that do not face the institutional capacity limitations affecting a number of countries in the Caribbean.

#### **IV. LESSONS LEARNED FROM THE BANK'S EXPERIENCE IN THE SECTOR**

##### **A. Reports by the Office of Evaluation and Oversight (OVE)**

- 4.1 This section is based on the OVE analysis as reflected in: (i) an evaluation of the Bank's role in the fiscal sector (IDB, 2006b); (ii) the most recent Country Program Evaluations (CPE), as regards the Sector's relevance in the country strategy evaluated; and (iii) the Annual Report 2013-2014 (IDB, 2015h). The most relevant conclusions and recommendations made by those studies are as follows:<sup>83</sup>
- 4.2 **Evaluation of the Bank's role in the fiscal sector, 1990-2004.** The report recognizes that in the absence of an explicit Bank strategy in the Sector, the implicit intent in the Bank's interventions should be inferred. Thus, the report defines a fiscal framework against which to verify: (i) the relevance of the intervention model used by the Bank in the Sector; and (ii) the effectiveness of the attribution embodying this intent. With regard to the former, the evaluation found that the Bank's work was relevant in responding to the fiscal problems in the region. However, it identified weaknesses in terms of the evaluability of Bank operations, evidenced by a weak link between objectives, components, and policy conditions. With regard to the latter, the report recognized the Bank's contribution,

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<sup>83</sup> The included OVE recommendations have been extracted from: IDB (2006b), Evaluation of the IDB's role in the fiscal sector; and CPEs for Jamaica (2009-2014), Dominican Republic (2009-2013), Mexico (2007-2011), Uruguay (2005-2009), Bolivia (2008-2010), Honduras (2011-2014), Panama (2010-2014), and IDB (2015h).

particularly in improving tax administration, financial management transparency, and quality of government control. Nonetheless, it indicated that the objectives of the Bank's interventions in the Sector failed to take sufficiently into account the relationship between fiscal sustainability and wellbeing, particularly in terms of poverty reduction and equity enhancement.

- 4.3 The document also indicates that the Bank faced a pronounced shift in priorities during this period, from concerns related to high inflation and the debt crisis to the challenges of fiscal sustainability associated with maintaining economic stability, with a focus on poverty reduction. The Bank actively participated in the financing of policy reforms and fiscal efficiency improvements, with noteworthy growth in sector loans. The main OVE recommendations include the following: (i) fiscal matters should be identified as a specific and key work area within the Bank; (ii) the Bank should produce an analysis of the country-specific fiscal concerns, including the Sector in the country strategies; and (iii) operations' results frameworks should be improved. The Bank implemented these recommendations following the evaluation.
- 4.4 With regard to the country program evaluations, insofar as the Sector is concerned, OVE underscores the Bank's leadership in supporting fiscal policy and tax administration in various countries in the region (including Honduras, Jamaica, and the Dominican Republic), thus contributing to fiscal consolidation. More specifically, the Bank played a leading role in supporting tax reform in Jamaica. The Bank's support helped to reduce the budgetary burden, reinforce fiscal responsibility, and strengthen the expenditure management and debt management processes, giving rise to a more favorable trend in the debt/GDP ratio. In the case of countries such as Mexico and Uruguay, OVE emphasizes the Bank's importance as a strategic partner in technical discussions of fiscal reforms. Similarly, in the case of countries such as Bolivia and Nicaragua, OVE points out the Bank's importance in maintaining a strategic presence in the area of fiscal sustainability and public management by means of policy-based loans (PBLs) as well as investment loans relevant to the countries' needs. Lastly, in the case of Panama, OVE indicates that the Bank was very effective in supporting sustainable fiscal policies; however, the results of the Bank's intervention were mixed, with more advances in revenue reinforcement, fiscal risk management, and financial supervision and fewer advances in public financial management.
- 4.5 Lastly, the IDB (2015h) underscores the role of PBLs as one of the major tools for supporting fiscal sustainability and achieving structural reforms in the region. As the document indicates, recent CPEs emphasize that the Bank should balance short-term fiscal needs with long-term support for significant fiscal, institutional, and regulatory reforms. In this regard, some of the reforms supported by the Bank had a medium to low degree of structural depth, particularly those financed with the initial loans of a programmatic series. In addition, subsequent operations within a PBL series were frequently canceled, and some of the reforms failed to achieve their final objective. OVE's recommendations arising from these recent evaluations emphasize the importance of supporting reforms that have depth, continuing the policy dialogue, and completing programmatic PBL series whenever possible.

## **B. Results of the Development Effectiveness Matrix**

- 4.6 The DEM classification for Sector projects has improved significantly since 2009. In addition, since 2011, all Sector projects have been classified as evaluable or



highly evaluable. The average DEM score for the Sector for 2014 (8.6) was similar to the Bank's average (8.8) (see [Table 3](#)).

- 4.7 Within the dimensions of the DEM, all categories have improved in the period considered, with the most significant improvement taking place in the economic analysis dimension, where the Sector score in 2014 was higher than the Bank's average. The improvement in the program's logic dimension (8.9 in 2014) is also noteworthy.

**C. Lessons learned from experience with Bank operations<sup>84</sup>**

- 4.8 KNL and FMM conducted a study on a sample of 22 sovereign-guaranteed operations from the Sector's portfolio in 14 countries. This study was based on the documents associated with the selected projects, as well as on interviews with the projects' team leaders. The main lessons learned, as extracted from the aforementioned study, are set out below.

- 4.9 **Combination of the financial instrument with technical assistance and advisory support.** Programs in support of fiscal sustainability consolidation acquire greater importance when countries are in a difficult fiscal position and need to make fast institutional changes and policy reforms. Therefore, this type of operation should be implemented in the form of loans that are flexible, fast-disbursing, and adaptable to changing circumstances during the period of execution and approval of the reforms, in addition to being supported by high-level technical assistance and advisory support. Thus, policy-based loans (PBL),<sup>85</sup> and even performance-driven loans (PDL),<sup>86</sup> have been effective in strengthening public finances and consolidating fiscal policy by virtue of being supported by high-level technical advisory support from the Bank.<sup>87</sup> This support, provided from the outset of the reform discussions, has allowed the programs to be backed by investment loans and technical cooperation operations aimed at maintaining a dialogue with the government and building institutional capacity, ensuring that the reforms are implemented.

- 4.10 **Consolidation of fiscal transparency accompanied by the implementation of results-based budgeting.** Support for fiscal sustainability programs should be accompanied by actions aimed at improving public finance transparency and accountability so as to consolidate a results-based budgeting (RBB) culture. The analyzed operations show the need to advance toward a second generation of

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<sup>84</sup> The analyzed documents include loan proposals and contracts, results matrix, risk matrix, Institutional Capacity Assessment System (ICAS) reports, Operating Regulations, project execution plans (PEP) and annual work plans (AWP), technical cooperation projects in support of loans, project monitoring reports (PMR), midterm and final evaluation reports, project completion reports (PCR), and OVE evaluations. The analyzed operations for the respective countries included the following: 2710/OC-ES; 2032/BL-HO; 2359/OC-JA; 2502/OC-JA; 3148/OC-JA; 2658/OC-JA; 2378/OC-ME; 3201/OC-ME; 2146/OC-PR; 2727/OC-PR; 1902/OC-DR; 3110/OC-DR; 1788/OC-UR; 1772/OC-UR; 2133/OC-UR; 1743/SF-BO; 1743/SF-BO; 2862/OC-SU; 2841/OC-BR; and 3139/OC-BR.

<sup>85</sup> 2359/OC-JA; 2502/OC-JA; 2378/OC-ME; 3201/OC-ME; 2146/OC-PR; 2727/OC-PR; 1902/OC-DR; 3110/OC-DR; 1788/OC-UR; 1772/OC-UR; 2666/OC-SU; and 2862/OC-SU.

<sup>86</sup> 1743/SF-BO.

<sup>87</sup> This type of program makes it possible to support policy and institutional reforms not only through technical assistance but also through investment programs that strengthen the impacts of the reforms. Examples of the latter include tax reforms that require strengthening of the tax administrations or PFM reforms that require establishing a TSA or implementing an IFMS.



fiscal transparency that goes beyond information on funds allocation to reporting on efficiency in the use of resources. In operations similar to the Bank's loan in Mexico,<sup>88</sup> other countries<sup>89</sup> have made strides in creating and consolidating a reliable and transparent public accounting system that has helped measure quality, efficiency, and effectiveness in the use of their public resources. However, institutional capacity limitations, especially in a number of Caribbean countries, have represented a significant constraint limiting the sector's progress in this area, while in other countries in Latin America and the Caribbean that do not face such institutional limitations, progress in transparency and disclosure of economic and social statistics and information on the purpose, use, and effectiveness of fiscal policies in general and budgetary policies in particular, continue to be a challenge for the sector.

- 4.11 **Relationship between fiscal sustainability strengthening programs and pension system reforms.** The IDB's Fiscal and Municipal Management Division and Labor Markets Unit have coordinated various actions in research activities, technical assistance, and operations in these two areas, given the impacts of pension and social security systems in general on fiscal sustainability. Specifically, the Bank approved the programmatic series for Jamaica, Fiscal Structural Programme for Economic Growth I and II (3148/OC-JA and 3511/OC-JA),<sup>90</sup> and recently, the policy-based loan (PBL) for Honduras, Fiscal Consolidation Support Program (3590/BL-HO).
- 4.12 **Inclusion of the private sector as a participant in the tax reform dialogue.** In order for tax reforms to achieve their objective of reducing market distortions and fostering economic development, the private sector and other stakeholders must be included and take part in the discussions from the outset. This facilitates an understanding of the long-term benefits and makes it possible to arrive at a proposal more likely to obtain political backing and be sustainable. After a failed attempt and with the Bank's support and technical leadership, Jamaica approved a tax reform aimed at expanding the tax base and reducing and limiting tax and discretionary exemptions.<sup>91</sup> This was achieved by creating a working group on incentives that included representatives of the relevant government agencies and the private sector, with the Bank participating in a leadership role. This working group obtained the support of various sectors of Jamaican society for moving forward on measures such as streamlining corporate tax incentives, reducing the income tax rate, and simplifying tariffs.<sup>92</sup> In contrast, tax reform in Guatemala was not approved, due to the resistance of important sectors, especially corporate sectors, to a tax increase in view of the country's poor economic performance as a result of the crisis, as well as to lack of confidence in the measures and an absence of knowledge of the benefits. However, seminars and a dialogue conducted with the private sector, unions, and civil society under a technical

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<sup>88</sup> 2378/OC-ME.

<sup>89</sup> 1902/OC-DR; 3110/OC-DR; 2359/OC-JA; 2502/OC-JA.

<sup>90</sup> See paragraph 4.12 and footnote 91.

<sup>91</sup> 2359/OC-JA; 2502/OC-JA; and 3148/OC-JA.

<sup>92</sup> Country Program Evaluation: Jamaica 2009-2014, OVE.

cooperation project aimed at supporting the fiscal covenant resulted in intersector agreements to support a potential reform.<sup>93</sup>

- 4.13 **Modernization of the public-sector financial management systems.** Process upgrading programs aimed at improving financial management should be accompanied by assistance programs designed to identify technical and functional shortcomings that impede the development and implementation of information systems.<sup>94</sup> For example, in the case of Colombia, integrating information for public management purposes through a services portal and through the design and implementation of a government procurement system required high technical capacity in the four entities involved. Execution delays occurred because the entities displayed different learning curves in implementing the new information systems and procurement processes, depending on the availability and expertise of the respective technical teams and, in some cases, on the priority given to the project by each entity.<sup>95</sup>
- 4.14 **Coordination with other multilateral organizations.** Fluid dialogue between the Bank and other institutions (such as CAF, the IMF, and the World Bank) has enabled a division of labor and timely and significant technical and credit assistance to improve the fiscal position of Latin American and Caribbean countries. In fact, aside from its financial support, the Bank's presence in the region, institutional knowledge, and ongoing dialogue with national authorities, combined with its technical capacity, have made it the partner of choice for countries designing and implementing fiscal reforms and have engendered trust in embarking on this type of process, which tends to be politically and institutionally complex.
- 4.15 **Importance of preinvestment in the national public investment systems (SNIP).** One alternative for efficiently using limited fiscal space to undertake public investment consistent with fiscal goals is to improve the quality and efficiency of public investment projects by strengthening the institutions responsible for the preinvestment stage. In several countries, including Ecuador, projects finance the performance of specific engineering, environmental impact, final design, and complementary studies with a view to assembling a portfolio of investment projects that can obtain financing and be ready for immediate execution. However, these projects cannot ensure the sustainability and financial capacity of the borrowing institution, creating risks in terms of the efficiency and effectiveness in absorbing the demand for preinvestment studies once the projects' execution is completed.<sup>96</sup>
- 4.16 **Institutional capacity of the executing agency.** Operations of this type, which seek to create large-scale institutional and policy reforms, require a detailed diagnostic assessment of the initial institutional capacities that includes not only an analysis of budgetary, material, human, and technological resources but also an evaluation of the organizational culture, attitude to change, and capacity to engage in political negotiations with other entities.<sup>97</sup> In the case of Jamaica, the Ministry of

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<sup>93</sup> 2008/OC-GU.

<sup>94</sup> 2032/BL-HO; 2146/OC-PR; 2727/OC-PR; 2666/OC-SU; 2862/OC-SU.

<sup>95</sup> 1561/OC-CO.

<sup>96</sup> 2359/OC-HA; 2502/OC-JA; 2378/OC-ME.

<sup>97</sup> 1743/SF-BO; 1561/OC-CO; 3110/OC-DR; 2032/BL-HO.

Finance failed to appoint a project coordinator exclusively devoted to implementing the PBL. This function was undertaken by the Office of the Financial Secretary on an ad-hoc basis, jeopardizing the program's implementation.<sup>98</sup> In the case of Guatemala, despite the technical capacity of the Ministry of Finance staff, difficulties arose regarding the political management and the ability to negotiate and move forward on the planned reforms.<sup>99</sup>

#### **D. The Bank's comparative advantages in the Fiscal Sector**

- 4.17 The Bank has secured a privileged position in supporting the Sector in the region, particularly by deepening the fiscal reforms over the last three decades. The continuous support and fluid dialogue with the authorities, the broad coverage of countries, the track record of good practices and innovation, and the high technical capacity in the Sector are all part of this achievement.
- 4.18 Between 1990 and 2014, the Bank financed 292 loans in the Sector for approximately US\$25.5 billion, with operations in all borrowing countries.<sup>100</sup> More recently, between 2006 and 2014, Sector loans accounted for roughly 12% of the Bank's portfolio of sovereign loan approvals. Through these projects, the Bank has supported the main fiscal management reforms and improvements in the region. The evolution of the Bank's work in the Sector shows peaks in terms of approval amounts in years of macrofiscal crisis (for example, in 1998, 2001, and 2010), but it also shows substantial growth in the number and amount of operations from 2006 to 2014 (see [Table 4](#)). In 2007, partly as a result of this demand, the Fiscal and Municipal Management Division was created in the Bank, giving fiscal matters an institutional focus and relevance.<sup>101</sup> Between 1990 and 2014, Argentina, Brazil, and Mexico were the countries with the highest approval amounts. In the more recent period (2006 to 2014), the fiscal operations with Brazilian states were particularly noteworthy.<sup>102</sup>
- 4.19 An analysis of the evolution of the Bank's areas of intervention over the past 25 years<sup>103</sup> shows, on the side of fiscal revenue, a remarkable growth in the last decade in operations involving support for tax reforms. Projects aimed at strengthening tax administration also grew, although this has been a traditional work area for the Bank. Support for customs administration remained strong and stable after a peak in operations early in the 1990s in a context of support for trade liberalization in many countries. With regard to improving financial management and expenditure efficiency and quality, the Bank has in the last decade increased its support for IFMS modernization, financing new phases in numerous countries. The Bank has also expanded its contribution to improving other administrative systems as well as contributing to innovations in fiscal management. The former notably include the Bank's growing support for modernizing the national public

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<sup>98</sup> 2359/OC-JA; 2502/OC-JA.

<sup>99</sup> 2008/OC-GU.

<sup>100</sup> Source: IDB (2006b) for the 1990-2005 period and OPS for 2006-2014.

<sup>101</sup> In this regard, the Bank has complied with the first recommendation of the evaluation of the IDB's role in the fiscal sector (IDB, 2006b), namely, to identify fiscal matters as a specific work area within the Bank.

<sup>102</sup> Analyzed in the Decentralization and Subnational Governments SFD.

<sup>103</sup> Source: IDB (2006b) for the 1990-2005 period and an analysis by the authors based on project information for the 2006-2014 period. Subnational fiscal operations are not included, having already been considered in the Decentralization and Subnational Governments SFD.

investment systems, procurement systems, public credit offices, payroll systems (public sector), and asset management systems. Fiscal management innovations include substantial growth in support of establishing MTFFs and modernizing budget processes; RBB strategies, and evaluation and improvement of public expenditure quality; and creating and developing the institutional framework for analyzing contingent liabilities and PPPs.

- 4.20 In addition, following the 1998 Asian crisis, the Bank has been approving operations in support of establishing numerical fiscal rules. With respect to the 1990s, there was a substantial decline in the number of operations addressing issues with a fiscal impact, such as the reform of public enterprises or pension systems. The Bank continued to lend strong support to better social expenditure targeting, as it has been doing for more than 15 years. Administrative reform issues were in constant demand during this period, with a shift in emphasis from civil service reform and administrative streamlining until the mid-2000s to more recent support for improving the quality of services and modernizing public entities.
- 4.21 In this context, the evolution of the Bank's work in the Sector suggests that, in the last decade, the Bank took on a leading role in terms of technical and financial support for fiscal policy and management reforms in Latin America and the Caribbean. This is evidenced by the notable growth in Bank operations involving support for issues such as tax reform and the establishment of MTFFs. In addition, the Bank has in recent years developed closer technical ties to other institutions, including the OECD and the IMF, centered on evaluation, advisory, and dissemination activities regarding fiscal matters in the region's countries. This has allowed the Bank to enhance the quality of its dialogue with counterparts and the technical quality of fiscal programs.<sup>104</sup> In fact, the combination of the various financial instruments available to the Bank, including both PBLs and investment loans, with the technical cooperation operations for ongoing support to the countries, has given the Bank's work in the sector a privileged position in Latin America and the Caribbean. PBLs open up dialogue to develop the institutional and policy reforms needed to improve the outlook for growth, strengthen fiscal sustainability, and improve the mobilization of resources for economic development, while investment loans enable countries, under favorable conditions, to finance the spending needed to implement these reforms, with ongoing technical assistance by the Bank. A large proportion of the structural and institutional reforms mentioned in this SFD have been possible thanks to the opening of spaces for dialogue and assistance channeled through PBLs and their implementation with investment loans.
- 4.22 PBLs have also made it possible to combine programs devoted to policies to strengthen fiscal sustainability with other sectors crucial for the region's economic growth, such as the Comprehensive Fiscal Sustainability and Climate Change Adaptation Program for El Salvador (2710/OC-ES); the Fiscal Stability Consolidation Program for the Development of the State of Rio Grande do Sul II (3138/OC-BR); the Program for Fiscal Balance Consolidation to Improve Public Service Delivery in the State of Amazonas (3139/OC-BR); Fiscal Stability Consolidation Program for the Economic and Social Development of the State of Alagoas (3061/OC-BR); and the Fiscal Strengthening Program to enhance the

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<sup>104</sup> For example, improvement of tax administration in Peru (3214/OC-PE).

efficiency of the electricity sector in the Dominican Republic (2213/OC-DR). In addition to the PBLs, Brazil's PROFISCO operations have also contributed to a substantial improvement in the management of tax administrations, expenditure, and finance in all the states in Brazil. All of these sector programs include governments at the national and subnational levels.<sup>105</sup>

**4.23 Technical cooperation operations.** Technical cooperation operations are an important support instrument in the Sector, whose volume grew substantially over the last decade in the wake of PRODEV. This program represented close to 50% of the volume of nonreimbursable resources in the Sector between 2006 and 2014. Partly on the basis of this program, the annual average of nonreimbursable Bank resources in the Sector increased from approximately US\$10 million between 1990 and 2005 to US\$15 million between 2006 and 2014. PRODEV contributed 88 technical cooperation operations for some US\$64 million through 2013, benefiting ministries of economy and finance, subnational governments, and sectors in 24 of the region's 26 borrowing member countries, seeking to make public sector management more efficient and effective through a better design, execution, monitoring, and evaluation of policies, strategies, programs, and projects. The Special Program for Institutional Development (SPID) continues to support the managing for results agenda in the region through efforts to strengthen public institutions and make them more effective, efficient, open, and citizen-centric. Moreover, since 2006 the Bank has approved an additional 190 technical cooperation operations in the Sector for US\$68 million, aimed at strengthening public entities responsible for fiscal matters by performing national and regional studies in the Sector; financing the development of Sector-specific databases; supporting the preparation of operations; fostering regional exchanges of good practices; and supporting the Bank's strategic knowledge and dissemination initiatives (see following paragraphs).<sup>106</sup> Currently, under the leadership of the Fiscal and Municipal Management Division, three IDB departments (IFD, RES, and SCL) are moving forward with an analysis of the quality and efficiency of public spending, including aspects such as the quantification and analysis of the sustainability of pension systems' actuarial liabilities in Latin American and Caribbean countries, as well as the impacts on fiscal sustainability, over the long term, of an aging population, particularly in the health sectors and pension systems.

**4.24 The Sector's knowledge products.** The Bank stands out with a broad range of knowledge products in the Sector. Some of the publications include: (i) with respect to tax administration and policy, the report *Development in the Americas 2013, More than Revenue* (IDB, 2013c); *Taxation and Latin American Integration* (IDB, 2008); and *Revenue Statistics in Latin America and the Caribbean, 1990-2013* (IDB/CIAT/ECLAC/OECD, 2015); (ii) with respect to PFM, *Gestión Financiera Pública en ALC* [Public financial management in Latin America and the Caribbean] (IDB, 2015f) and *Government at a Glance: Latin America and the Caribbean 2014: Towards Innovative Public Financial Management*, which provides comparative

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<sup>105</sup> The programs in subnational governments were exhaustively addressed in the Decentralization and Subnational Governments Sector Framework Document (document GN-2813-3).

<sup>106</sup> Several technical cooperation operations mentioned in this section have been financed thanks to the contributions of the Public Capacity Building Korea Fund, the Fund for Institutional Capacity Building; the Special Program for Institutional Development, and the Transparency Fund.

indicators between Latin American and Caribbean countries and the OECD in public finance, PFM, employment, and public procurement (OECD/IDB, 2014); (iii) various working documents on the Sector, many of them financed with resources from economic and sector work (ESW); and (iv) in the context of executing technical cooperation operations and preparing country strategies, the Bank has prepared diagnostic assessments, surveys of information, and proposals aimed at addressing the Sector's challenges in the region's countries; examples include ATN/SF-12586-RG (2010), Fiscal Policy for a More Sustainable and Equitable Growth; ATN/KR-13791-RG (2013), a structural fiscal balance database covering the last decade for 20 countries in the region; and ATN/AA-14695-RG (2014), regional studies evaluating the quality and efficiency of public expenditure. In addition, in the past two years the Bank has spearheaded significant knowledge and dissemination activities aimed at underscoring the importance of incorporating impact on gender equity into fiscal policy decisions (paragraph 3.55), in the form of: (i) seminars and workshops with the participation of experts on a gender approach to fiscal policy;<sup>107</sup> and (ii) preparing an ESW that empirically evaluates the impact of tax systems on gender equity in six Latin American and Caribbean countries (IDB, 2015i).

- 4.25 **The Sector's dissemination work.** The Bank has also worked intensively to promote the exchange of Sector knowledge between the region's countries and generate learning opportunities in the preparation and execution of its programs through regional workshops, field visits, and the organization of and participation in international seminars. Noteworthy achievements include the Bank's ongoing participation in the International Tax Dialogue (ITD), which seeks to facilitate discussions on tax matters among national public officials, international agencies, and other Sector stakeholders;<sup>108</sup> cosponsorship of the Regional Seminar on Fiscal Policy, organized every year by the Executive Secretary of ECLAC through the Latin American and Caribbean Institute for Economic and Social Planning (ILPES),<sup>109</sup> with the regular participation of Bank staff; cosponsorship of the Regional Policy Dialogue on Public Financial Management, Treasury and Public Accounting, together with the Latin American Treasury Forum (FOTEGAL);<sup>110</sup> cosponsorship, along with the Organization of American States (OAS) and the International Development Research Center (IDRC)<sup>111</sup> composed of the highest-level directors responsible for public procurement in the member countries; and cosponsorship of the Latin American and Caribbean Public-Private Partnership Network, together with the IMF and the OECD. In addition, through the PRODEV program, the Bank supports the region's countries in managing several networks

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<sup>107</sup> Brown Bag Lunch (2013): The Gender Focus within Fiscal Matters (Caren Grown, speaker); Seminar (2015): Discussing gender budgeting (Lekha Chakraborty and Janet Stotsky, speakers); and Seminar (2015): Promoviendo el desarrollo inclusivo: *Incrementando la participación de las mujeres en la contratación pública* [Promoting inclusive development: Increasing women's participation in public procurement].

<sup>108</sup> ITD ([website](#)) is a joint initiative of the European Commission, the Bank, the IMF, the OECD, the World Bank Group, and CIAT.

<sup>109</sup> In addition to the Bank, cosponsors of this event include the IMF, the World Bank, the OECD under the auspices of the Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ), and the Chilean Ministry of Finance.

<sup>110</sup> See [FOTEGAL](#).

<sup>111</sup> See [Inter-American Network on Government Procurement](#).

of the Latin American and Caribbean Community of Practice on Management for Development Results (COPLAC-MfDR). These networks, which include those responsible for budget, planning, and national public investment systems (SNIP) (among others), help foster efficient, effective, transparent, and modern public management.<sup>112</sup>

- 4.26 In short, the Bank shows the following comparative advantages in the Sector:
- a. **Corps of quality specialists, with broad coverage on the ground.** This is a key factor that has contributed to making the Bank the region's preferred multilateral institution in the Sector on a full range of fiscal policy matters, including tax policy and administration, financial management and expenditure policy and management, public asset and liability management, budgetary frameworks, fiscal rules, and fiscal transparency.
  - b. **Diversity of instruments.** Both the availability of technical cooperation resources and the PRODEV program, together with resources for knowledge products, improve the flexibility, timeliness, and relevance of the Bank's response to the countries' demands, helping to identify needs that have been translated into innovative projects.
  - c. **Adaptation to the heterogeneity among and within the countries.** The Bank has succeeded in tailoring its intervention modalities in the Sector to the region's heterogeneity.
- 4.27 Given the foregoing, the Bank will continue to devote priority to its work on fiscal policy and tax administration, public financial management and expenditure policy and management, public asset and liability management, budgetary frameworks, fiscal rules, and fiscal transparency. In the context of the Sector, this implies relegating areas in which the Bank has fewer comparative advantages, such as economic advisory offices for parliaments or fiscal councils, to a second tier.

## **V. GOAL, PRINCIPLES, DIMENSIONS OF SUCCESS, AND LINES OF ACTION GUIDING THE BANK'S OPERATIONAL AND RESEARCH ACTIVITIES IN THE SECTOR**

### **A. Goal and principles underlying work in the Sector**

- 5.1 The Bank's main goal in the Sector is to promote fiscal policy management that fosters robust, stable, sustainable, and equitable growth. To achieve this goal, the proposed lines of action and operational activities respond to the diagnostic assessment in Section III, and to the Bank's comparative advantages identified in Section IV. The SFD also presents knowledge and dissemination activities, which are the foundation for the generation of future innovations in the Sector. The Bank will design interventions on the basis of the specific conditions prevailing in each country, in accordance with the principles for work in the Sector. These principles, arising from the analysis of international evidence (Section II) and from the lessons learned (Section IV), include:

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<sup>112</sup> The eight COPLAC-MfDR networks are: RBB, national public investment systems, planning (REDEPLAN), subnational governments, public enterprises, monitoring and evaluation, parliamentary forum on MfDR, and private sector.

- a. **Institutional capacity-building in the public sector.** The Sector's emphasis is on developing the public sector's institutional capacities to improve fiscal policy design and management, so as to promote higher and more stable and sustainable economic growth. In particular, the Sector will promote the development of public sector capacity for more effective and efficient fiscal management with a view to raising productivity and economic efficiency, including efficiency and transparency in public resource management, and enhancing the impacts on equity.
- b. **Consideration of the multidimensional nature of fiscal policy.** Fiscal policy and management action has macroeconomic and microeconomic impacts, creating incentives that affect the behavior of the economic agents, which in turn produces effects on the allocation of resources, economic efficiency, and equity. For these reasons, policy and fiscal management objectives and decisions often give rise to tradeoffs in the short, medium, and long terms. Consequently, decisions should aim at general rather than only partial equilibrium, and be informed by a dynamic and intertemporal vision as required to evaluate the entire range of impacts and design the appropriate mitigation measures in the event of unexpected or undesirable effects.
- c. **Recognition of the political economy constraints and dynamics imposed on Sector decisions.** Given their multiple and crosscutting effects on the interests and motivations of various stakeholders (parliaments, executive levels of government, trade unions, communications media, and civil society in general) and factors (labor unions, business associations, professional associations, trade partners, etc.), fiscal policy and management decisions are significantly conditioned by political economy constraints. This often creates a contrast, and sometimes a contradiction, between the optimal public policies and those that are socially viable or feasible. Nonetheless, the lessons learned from the Bank's work in the sector lead to the conclusion that these political economy constraints can be mitigated or reduced by: (i) engaging other political and social sectors in the dialogue to further the reforms, such as the private sector, parliaments, and through public consultations by governments; (ii) to the extent that it increases the transparency and accountability accompanying the reforms, reducing the resistance to many measures that are necessary but have unfavorable impacts on certain sectors; (iii) accompanying tax measures or spending restrictions with offsetting measures targeting low-income sectors of the population; and (iv) identifying and engaging the sectors favored by the reforms in the short and medium terms in the dialogue leading to the reform. In the end, fiscal policy design and structural reforms in the sector are the result of social compacts involving crucial decisions such as the size of the State or the total tax burden, the distribution of that burden among various sectors and/or factors, and the allocation of spending across different sectors of society. These social compacts or agreements are complex and difficult to achieve, and therefore determine decision-making in the sector.
- d. **Adaptation of fiscal policy management recommendations to the heterogeneity of countries.** Despite many similarities of various kinds, the region is highly diverse in terms of economic development, institutional strength, and availability of resources. The recommendations for the Sector



will be adapted to these circumstances so as to lead to the best possible feasible outcomes.

**B. Dimensions of success, lines of action, and activities<sup>113</sup>**

**5.2 Dimension 1. Fiscal policies will seek to reinforce sustained growth in a context of fiscal sustainability and macroeconomic stability.** The interventions in the Sector will seek to reinforce long-term growth policies by building fiscal sustainability, public savings, and macroeconomic stability, reducing the procyclical behavior of fiscal policy. The interventions will aim to promote the use of rules of procedure with quantitative targets that ensure a commitment to medium- and long-term fiscal sustainability and annual targets for cycle-adjusted primary balances. Similarly, the Sector will promote measures that improve the effectiveness and quality of countercyclical policies. Particular attention will be devoted to the quality of discretionary countercyclical policy decisions to protect infrastructure investment expenditure and reduce the use of instruments that create permanent expenditure commitments and discourage labor effort. To achieve these objectives, the following lines of action are proposed:

**5.3 Lines of action:** (i) consolidate fiscal policy sustainability by means of rules that contain a clear definition of the intertemporal budgetary restriction, including three pillars: contingent liabilities, actuarial cost of pension systems, and fiscal pressures from population aging; (ii) improve the fiscal risk management instruments, including contingent liabilities arising from PPPs; (iii) reinforce macroeconomic stability by strengthening countercyclical fiscal policy instruments, with a special emphasis on the composition of discretionary policy measures to protect investment in physical infrastructure and avoid creating permanent expenditure commitments; and (iv) enhance the credibility of fiscal policy to facilitate access to and the cost of long-term financing with a view to promoting greater public and private investment. To fulfill these lines of action, it is proposed that financing be provided for the following operational and knowledge and dissemination activities:

**a. Operational activities:** (i) support the processes of introduction and reform of fiscal and procedural rules to ensure the fiscal sustainability of the consolidated public sector, using cycle-adjusted quantitative targets whenever possible; (ii) promote the introduction and use of stabilization funds and intergenerational savings funds in countries with abundant nonrenewable resources (NRR); (iii) improve the management of fiscal risks and contingent liabilities to build fiscal sustainability; (iv) improve MTFs with a clear and explicit definition of the intertemporal budgetary restriction, consistent with fiscal sustainability; (v) strengthen the effectiveness of automatic stabilizers and fiscal multipliers; and (vi) support the establishment of independent fiscal councils.

**b. Knowledge and dissemination activities:** (i) generate and disseminate knowledge on the measurement of fiscal sustainability under the abovementioned three pillars and of structural or cycle-adjusted fiscal balances and their determinants; (ii) seek greater depth in studies on fiscal risks and contingent liabilities and on the implementation of fiscal risk

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<sup>113</sup> The lines of action and activities to be financed by the Bank must follow the guidelines contained in this SFD and any other SFDs that are applicable to specific interventions.

management models; (iii) develop more detailed knowledge regarding the determinants and measurement of the effectiveness of automatic stabilizers and fiscal multipliers; (iv) develop more detailed knowledge regarding the asymmetrical cyclical behavior of various public expenditure components; (v) develop more detailed knowledge regarding the implementation and management of MTFFs; and (vi) develop more detailed knowledge regarding the determinants of public savings and their inclusion in the MTFFs as desirable objectives.

- 5.4 **Dimension 2. Governments build the public sector's institutional capacities to design and implement fiscal policies that improve efficient mobilization and allocation of resources.** The interventions in the Sector will promote the design of tax and public expenditure management policies aimed at incentivizing savings, investment, and labor in order to boost growth and productivity. A focus of attention will be the efficient mobilization and use of public resources for development, particularly investment expenditure in public infrastructure and human capital, without affecting labor and savings incentives. To achieve these objectives, the following lines of action are proposed:

- 5.5 **Lines of action:** (i) improve the structural design of tax systems, placing particular emphasis on their neutrality, adequacy, simplicity, and progressivity; (ii) enhance the quality, effectiveness, and efficiency of public expenditure;<sup>114</sup> (iii) improve coordination in the allocation and demarcation of functions among the various levels of government regarding taxation powers and expenditure responsibilities, with a view to making the use of public resources more efficient and effective.<sup>115</sup> To fulfill these lines of action, it is proposed that financing be provided for the following operational and knowledge and dissemination activities:
- a. **Operational activities:** (i) support improvements in resource mobilization and allocation through a more efficient design of tax policies; (ii) support actions to reduce highly distortionary taxes and fiscal incentives that undermine the productivity of the economic structure and have a deleterious effect on growth; (iii) support reforms to diminish the bias against the labor factor;<sup>116</sup> (iv) promote the use of environmental taxes that reduce the use of fossil fuels and carbon emissions; (v) support improvements in the quality, effectiveness, and efficiency of expenditures, particularly in public infrastructure and human capital investments; (vi) support institutional strengthening for the design and management of public investment projects; and (vii) support improvements in the targeting of expenditures and subsidies in general.
  - b. **Knowledge and dissemination activities:** (i) generate and disseminate knowledge regarding the impacts of the tax system on private savings and investment; (ii) quantify and evaluate the impacts of the tax burden on the incentive to work and be formally employed; (iii) promote policy options to enhance efficient mobilization of fiscal resources, eliminating tax expenditures that erode revenues; (iv) promote studies aimed at identifying the factors that limit the quality and efficiency of public spending, with a

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<sup>114</sup> These actions will be coordinated with the actions provided in the SFDs indicated in paragraph 1.4.

<sup>115</sup> This dimension will be designed and implemented in coordination with the guidelines set out in Dimension 1 of the Decentralization and Subnational Governments SFD.

<sup>116</sup> This activity will be coordinated with the actions provided in the Labor SFD.

particular emphasis on social spending and investment in public infrastructure; (v) develop SMAART (specific, measurable, achievable, action-oriented, relevant, and time-bound) indicators to measure the quality and efficiency of public expenditure; and (vi) support measuring the efficiency of public investment and the development of maintenance cost instruments and preinvestment methodologies for project formulation, and promote the exchange of knowledge and learning between countries.

**5.6 Dimension 3. Governments promote fiscal policies that improve equity and social inclusion.** The interventions in the Sector will seek to strengthen spending programs that have a greater impact on equity through improvements in quality, effectiveness, and targeting aimed at the lower-income population. Special emphasis will be placed on reviewing programs that do not distort incentives to work and are perceived as a temporary, rather than a permanent, means of helping beneficiary households and/or individual beneficiaries to overcome poverty.<sup>117</sup> Particular attention will be devoted to initiatives aimed at enhancing gender equity and social inclusion. To achieve these objectives, the following lines of action are proposed:

**5.7 Lines of action:** (i) enhance the quality and effectiveness of the expenditure programs that have a greater impact on equity, reducing the social and human capital gaps; (ii) improve the effectiveness and targeting of the general subsidies that leak into nonpoor population sectors; (iii) evaluate the subsidies and transfers that may create disincentives to work and to formalization for workers or small businesses; and (iv) promote expenditure programs that enhance gender equity and social inclusion. To fulfill these lines of action, it is proposed that financing be provided for the following operational and knowledge and dissemination activities:

- a. **Operational activities:** (i) promote comprehensive reviews of public expenditure, including efficiency as well as equity considerations; (ii) promote operations to incorporate indicators derived from studies on the impact of fiscal policy on equity; (iii) support comprehensive reforms to improve fiscal correspondence and a clear allocation of specific expenditure responsibilities to the subnational and national governments; and (iv) support medium- and long-term reforms aimed at reducing the distortions fostered by fiscal policies that diminish efficiency without contributing to greater equity.
- b. **Knowledge and dissemination activities:** (i) design periodic studies regarding the impact of fiscal policy on poverty, inequality, and gender equity; (ii) create a model questionnaire and template for periodic public expenditure reviews that integrate efficiency, equity, and fiscal stability considerations, contributing to fiscal consolidation and gradual improvement of results-based budgeting by enhancing the allocative efficiency of spending; and (iii) promote studies and dissemination plans regarding spending programs that create disincentives to formal employment or labor effort and perpetuate poverty.

**5.8 Dimension 4. Governments promote strengthening the efficiency of tax administrations and of financial management and use of public resources.** The interventions in the Sector will promote strengthening tax administrations and

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<sup>117</sup> This activity will be coordinated with the actions provided in the Social Protection and Poverty SFD and with the EDU, SPH, and LMK Divisions of the SCL Department.

PFM with a view to boosting effectiveness and efficiency in revenue collection and the use of public resources by adopting, improving, and modernizing generally applicable practices and instruments, such as: (i) electronic invoices, tax inbox, payroll and employment contribution spreadsheets, mass data cross-referencing with public service enterprises and institutions and property registries to detect tax evasion, and use of evasion-risk management models and systems; and (ii) TSAs, IFMSs, accounting standards (IPSAS), and e-procurement portals for procurement of public goods and services. In addition, interventions will promote adopting RBB and MfDR as policy instruments and practices designed to enhance the quality, effectiveness, and efficiency of public expenditure. Special emphasis will be placed on encouraging greater results-based public transparency, efficient use of resources, compilation and dissemination of economic, social, and fiscal statistics, and public accounting (revenues, public spending, results-based budgeting, concealed and contingent liabilities, with greater potential coverage of the public sector). To achieve these objectives, the following lines of action are proposed:

- 5.9 **Lines of action:** (i) institutionally and technologically modernize the tax administrations; (ii) build institutional capacity in international taxation matters; (iii) promote the use of technologies for administration and cross-referencing of mass data; (iv) promote the adoption of RBB and MfDR; (v) modernize and upgrade the IFMSs; (vi) expand TSA coverage; (vii) promote the adoption of IPSAS; (viii) promote the adoption of e-procurement portals and price catalogues for generic goods and services; and (ix) promote initiatives aimed at enhancing the compilation and dissemination of fiscal and public accounting statistics in the broadest possible sense. To fulfill these lines of action, it is proposed that financing be provided for the following operational and knowledge and dissemination activities:
- a. **Operational activities: tax administration:** (i) promote the mandatory use of comprehensive electronic invoices to record the purchase of goods and services, and of payroll spreadsheets on the part of enterprises, including information on wage and salary payments, professional fee payments, personal income tax withholdings (when applicable), and payment of all payroll taxes or contributions, broken down into worker and corporate contributions; (ii) promote mass use of information technologies (electronic tax mailbox) to cross-reference taxpayer information and reduce administration costs; (iii) promote digitization of the property registries with the assistance of the tax administrations at the national level for purposes of cross-referencing information; (iv) promote the use of mass databases to cross-reference information from the property registries and the financial system (banks and credit card issuers); (v) promote the practice of sending import shipment manifests to customs in electronic format on an early basis for early approval; (vi) build the capacity of tax administrations to perform oversight and collection enforcement functions in coordination with the prosecutors' offices and courts; (vii) promote the use of risk identification models and systems by the tax administrations for early detection of tax evasion; and (viii) strengthen the international taxation and information exchange units within the tax administrations.
  - b. **Operational activities: public financial management:** (i) promote the adoption of RBB and MfDR; (ii) support PFM modernization by technologically and functionally strengthening the IFMSs, integrating the

budget, treasury, public debt management, procurement, and accounting functions; (iii) reinforce expanded coverage of the TSAs, including coordination between cash management and public debt management; (iv) support public-sector adoption, harmonization, and coverage of the IPSAS; (v) support the implementation, reinforcement, and coverage of the government procurement systems under principles of transparency, effectiveness, and efficiency through the use of instruments such as reverse auctions, price catalogues for generic goods procurement, and e-procurement portals; and (vi) strengthen results-based public-sector transparency and efficiency in the use of resources.

- c. **Knowledge and dissemination activities:** (i) promote the advantages and benefits of fully adopting RBB and MfDR at all stages of the budget cycle; (ii) promote events for the dissemination and exchange of information and best international practices on the use of electronic invoices; (iii) conduct seminars and international exchanges of experiences on the use of mass data cross-referencing technologies; (iv) promote events for exchanges of experiences on international taxation matters; (v) disseminate the IPSAS; (vi) promote and disseminate the various instruments used in the government procurement processes, with a particular emphasis on e-procurement portals, reverse auctions, and price catalogues for generic goods procurement; (vii) promote and disseminate instruments and indicators to enhance the transparency of the public sector; and (viii) promote the compilation and dissemination of fiscal and public accounting statistics in the broadest sense and with the broadest possible coverage of the public sector.

5.10 The four dimensions of success that will guide the Sector's operational and analytical activities will enable the Bank to respond to the demands of both public and private sector stakeholders in its 26 borrowing member countries. Under the working principles for the Sector presented in this SFD, the Bank will coordinate the lines of action through the country strategies, and will orient them toward the specific needs of each country to which it provides support. The sum of the policies, programs, and studies presented herein has the primary aim of moving toward a region where fiscal policy and management contribute to improving the quality of life of all citizens. The priorities for the Bank's work in the sector will depend on the demands and circumstances of each country in particular. However, in general terms, in the short and medium terms, efforts will be aimed at strengthening fiscal sustainability and macroeconomic stability, given the current circumstances affecting the region, particularly the slowdown in growth and the drop in commodity prices. In parallel, with a medium- and long-term perspective, the sector's basic priority will be the mobilization of resources for economic development and the enhancement of the efficiency and quality of spending and management, and transparency in the use of resources.<sup>118</sup>

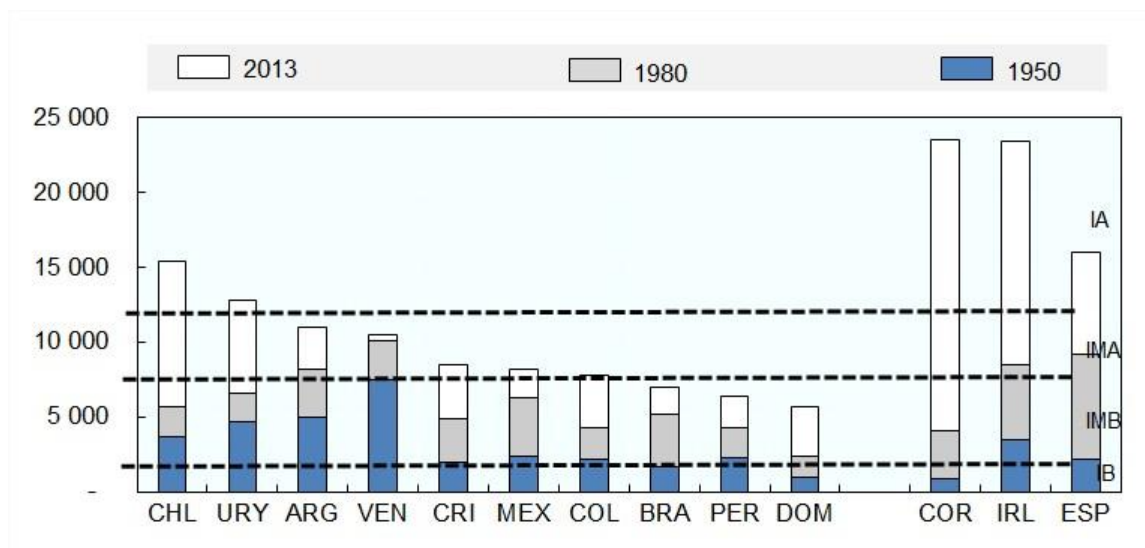
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<sup>118</sup> These priorities are also consistent with the Finance for Development initiative, made up of regional development banks and other multinational agencies of which the IDB is a part, in order to coordinate development objectives and policies. See: <http://www.fin4dev.org>.



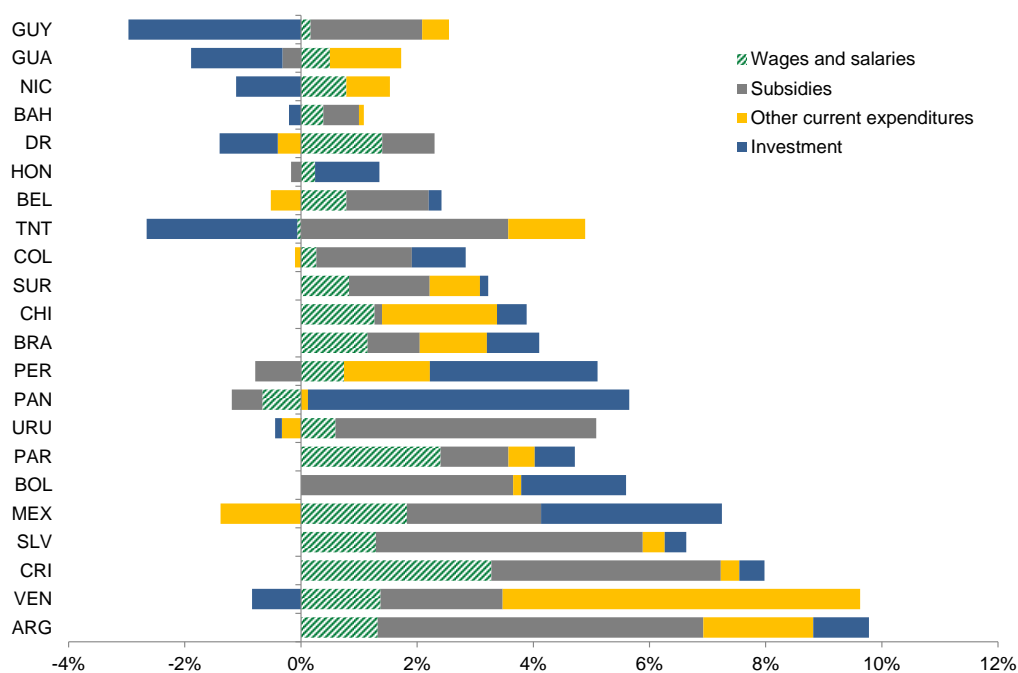
## FIGURES AND TABLES

**Figure 1. Latin America and the Caribbean vs. selected economies, GDP per capita (1990 US\$)**



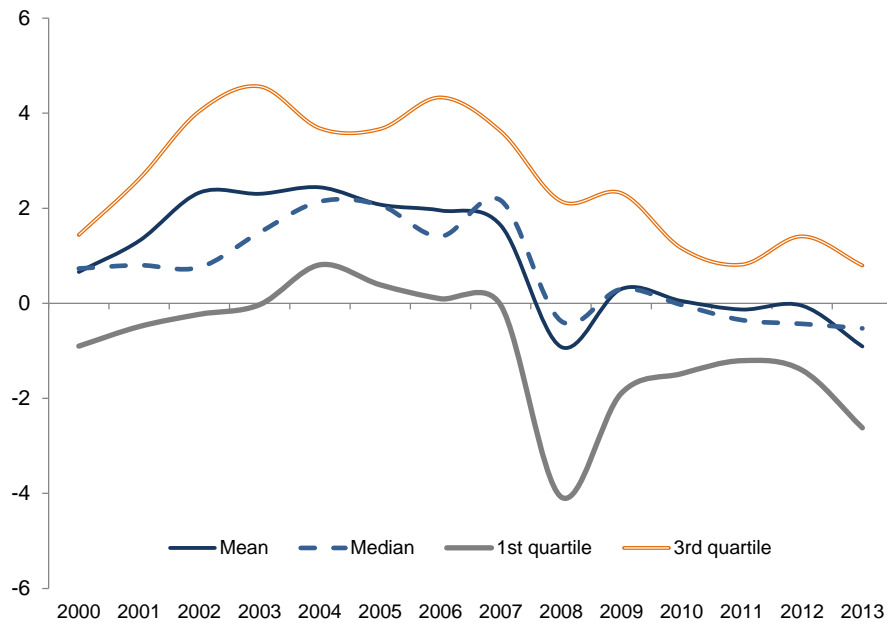
Source: OECD (2015g).

**Figure 2. Changes in primary public expenditures 2007-2014 (% of GDP)**



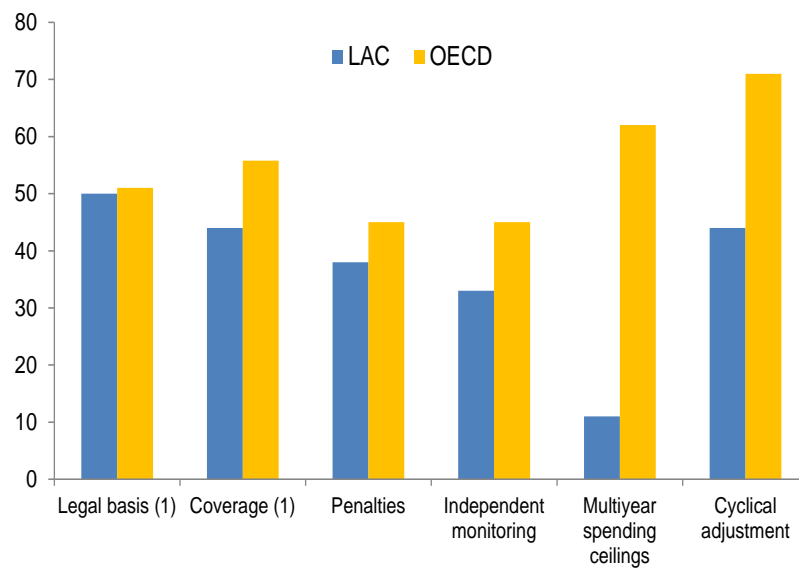
Source: IDB (2015e).

**Figure 3. Evolution of structural fiscal balances in Latin America and the Caribbean 2000-2013 (% of GDP)**



Source: Prepared by the authors based on Ardanaz et al. (2015).

**Figure 4. Characteristics of fiscal rules (2014), Latin America and the Caribbean vs. OECD (% of countries)**

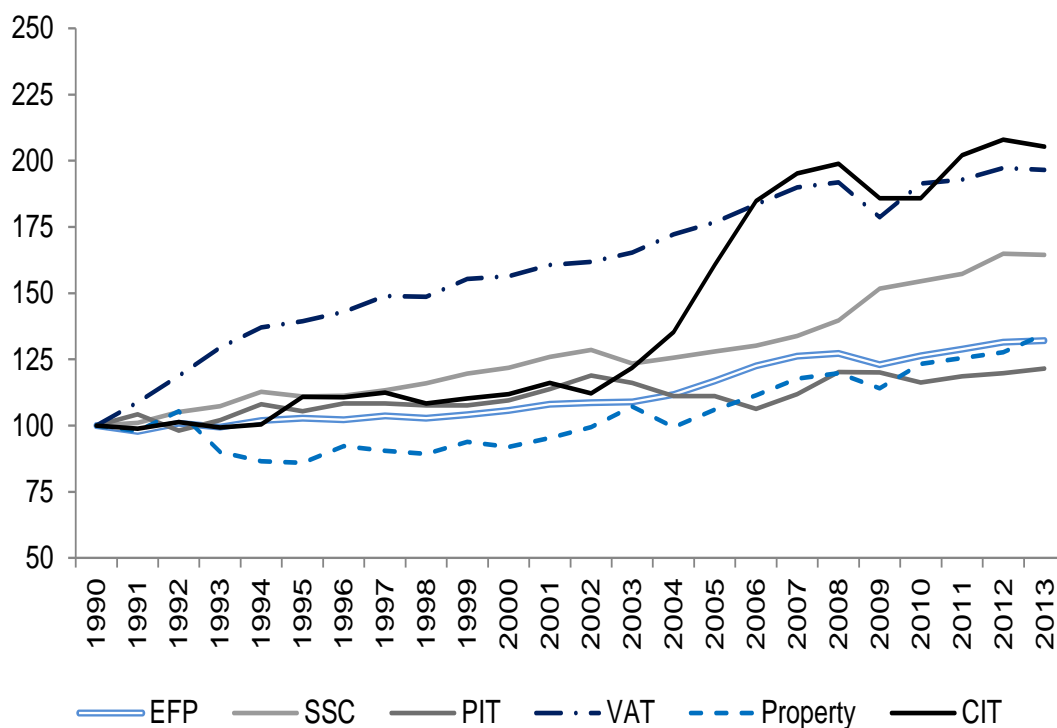


Source: Prepared by the authors based on IMF (2015d).

Note: (1): Index from 0 to 1 that captures the strength of the legal basis and coverage of the fiscal rule (higher values denote greater strength).

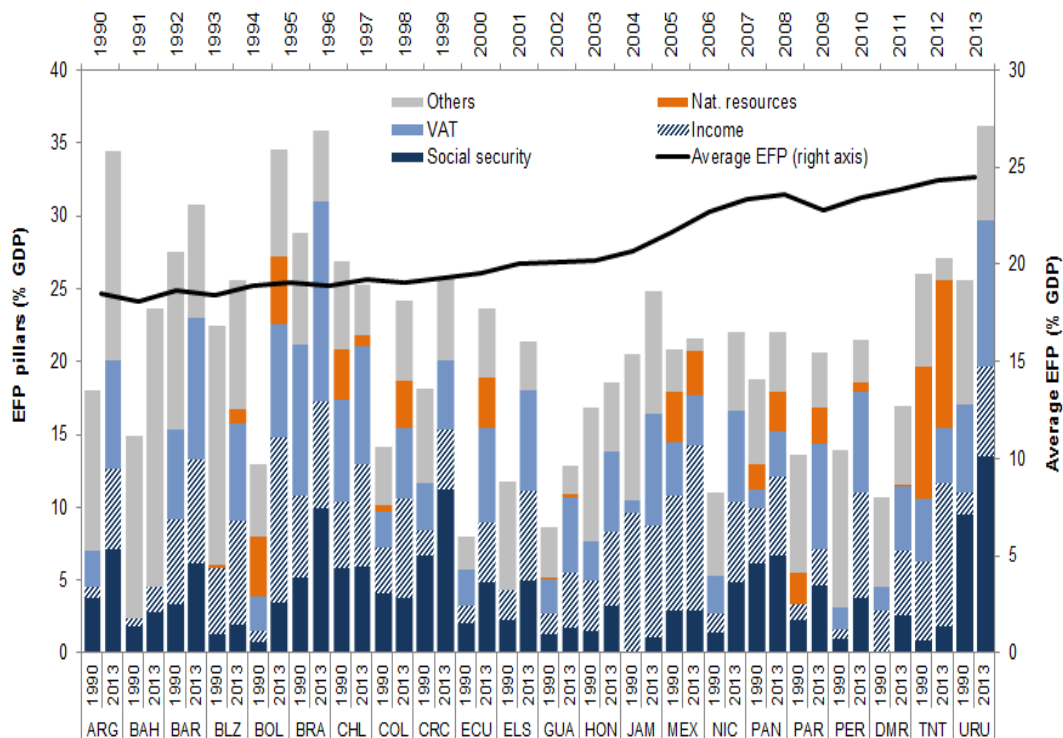


**Figure 5. Index of Equivalent Fiscal Pressure (EFP) and selected taxes  
in Latin America and the Caribbean  
(1990 – 2013, 1990 index = 100)**



Source: Prepared by the authors based on IDB/CIAT/ECLAC/OECD (2015). Index built on the basis of the ratios as a % of GDP. EFP: Equivalent Fiscal Pressure = central government tax revenues + mandatory contributions to the social security systems + nontax revenues derived from the development of renewable and nonrenewable resources. SSC: social security contributions; PIT: personal income tax; CIT: corporate income tax; VAT: value added tax.

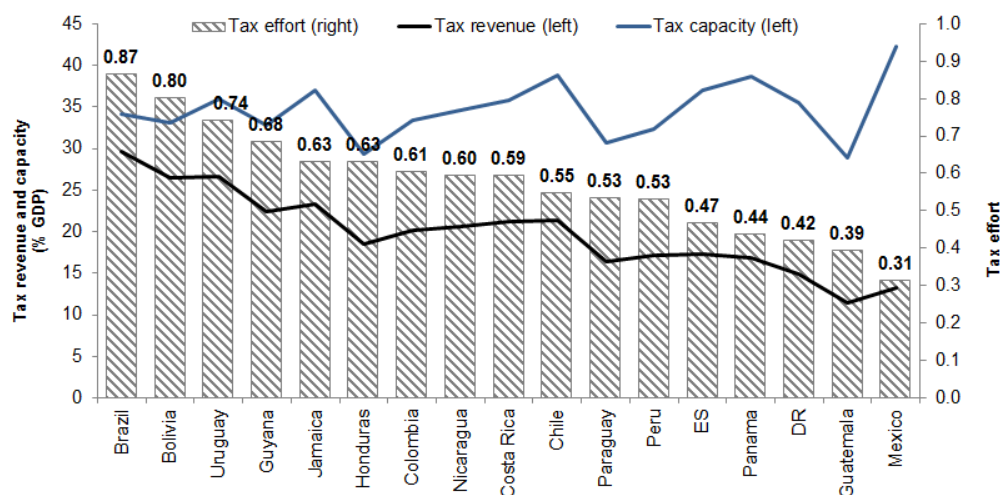
**Figure 6. Comparison of fiscal pillars 1990 and 2013 (% of GDP)**



Source: Prepared by the authors based on IDB/CIAT/ECLAC/OECD (2015).

Note: Equivalent Fiscal Pressure (EFP) = central government tax revenues + mandatory contributions to the social security systems + nontax revenues derived from the development of renewable and nonrenewable resources.

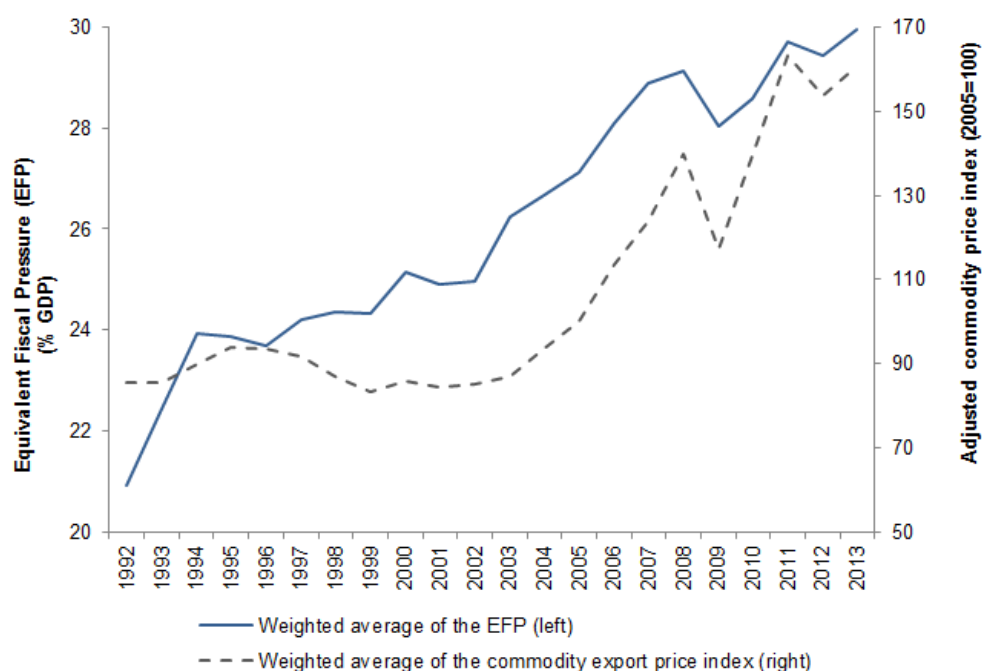
**Figure 7. Tax effort**



Source: Fenochietto and Pessino (2013).

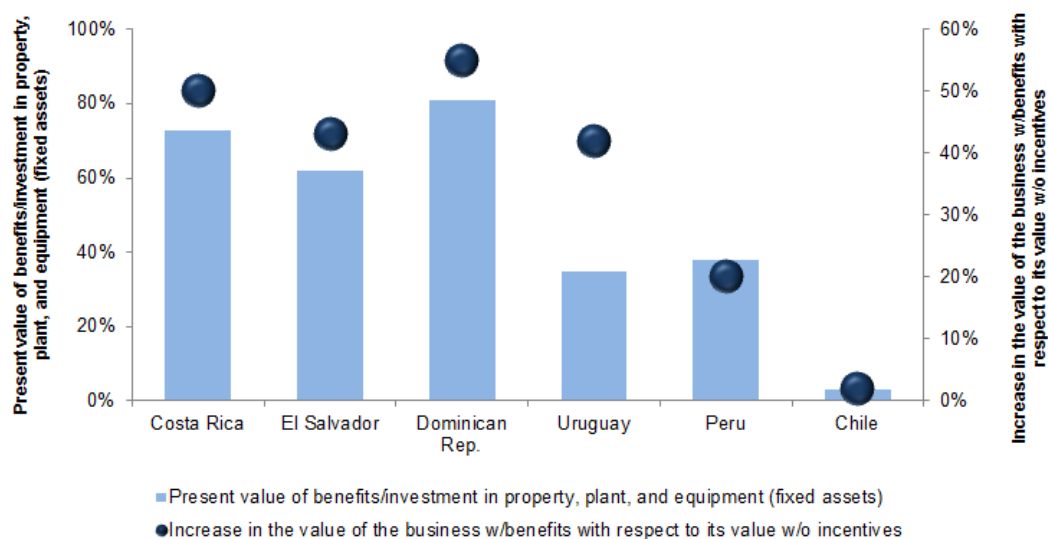
Note: Considers tax revenues and social security contributions. Does not include tax revenue from NRR if it constitutes more than 25% of total tax revenue.

**Figure 8. Relationship between tax revenue and international commodity prices**



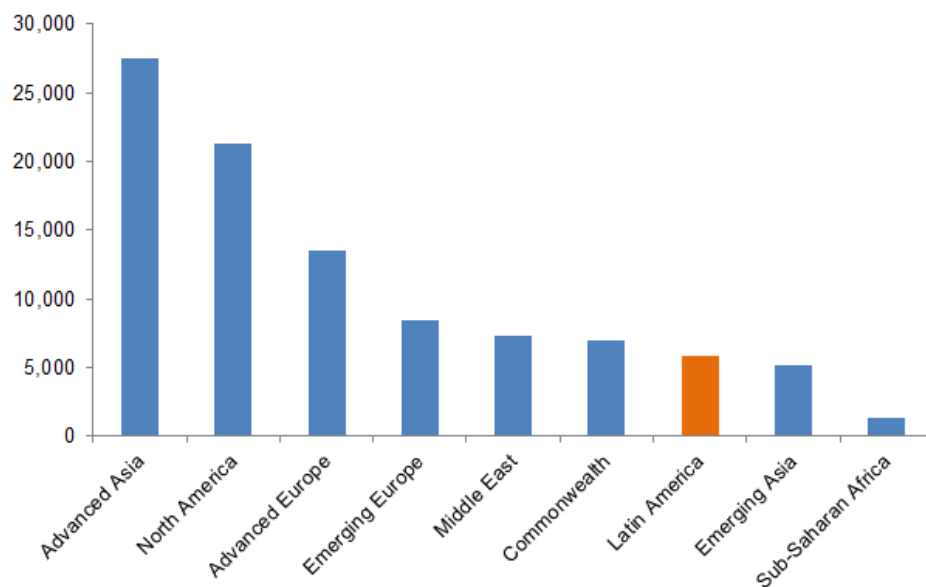
Source: Prepared by the authors based on IDB/CIAT/ECLAC/OECD (2015).

**Figure 9. Generosity of fiscal incentives**



Source: Artana and Templado (2012 y 2015).

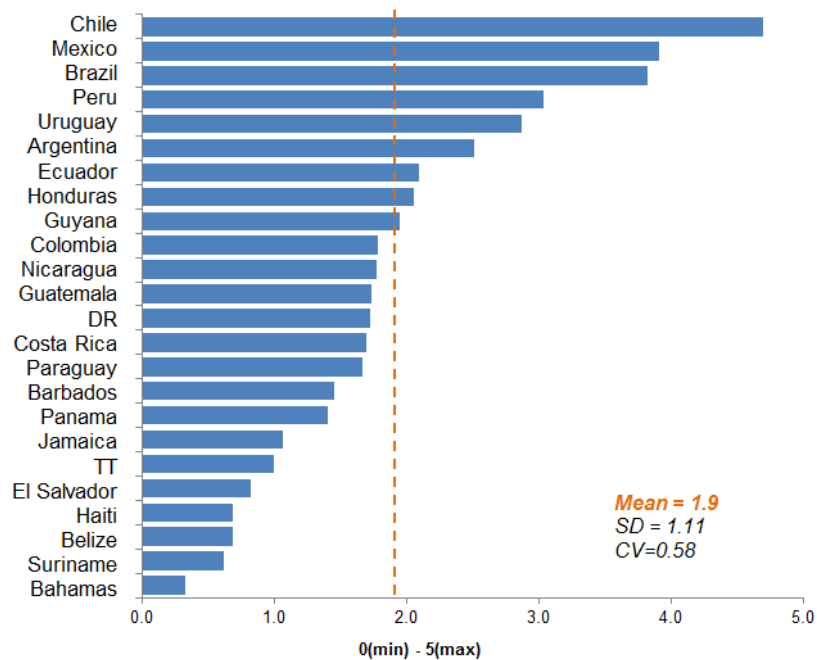
**Figure 10. Real public capital stock per capita  
(US\$ PPP 2005, per capita)**



Source: IMF (2014c and 2014f).

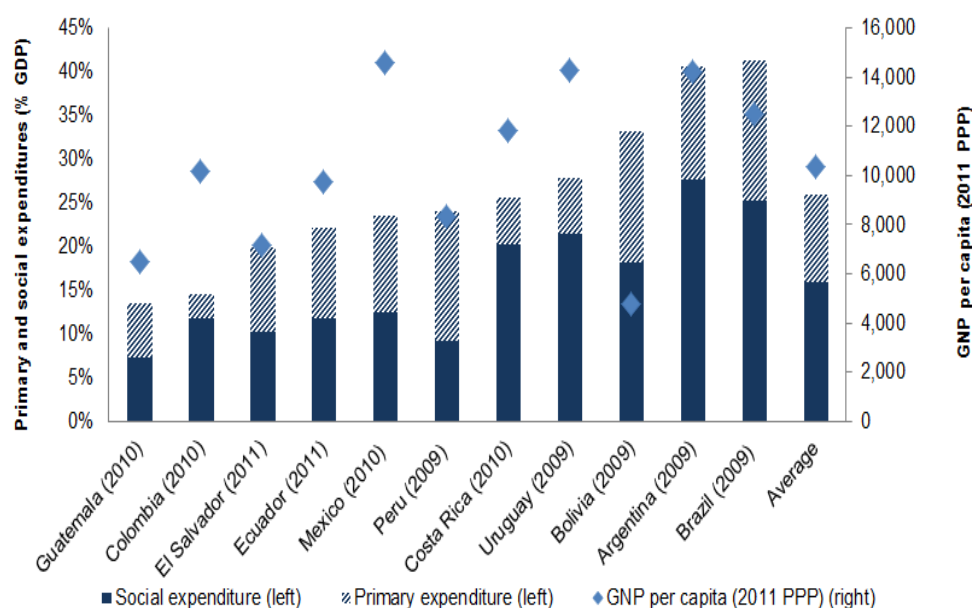
Note: Built by accumulating investment expenditures assuming an initial value for capital stock and depreciation rates.

**Figure 11. PRODEV evaluation system 2013–Pillar 2: Results-based budgeting  
(scale from 0 to 5)**



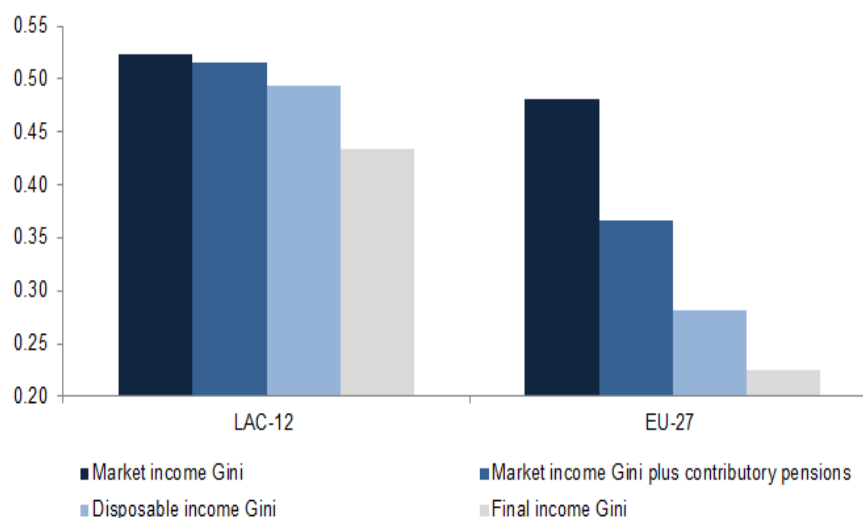
Source: IDB (2015a).

**Figure 12. Social and primary expenditures (% of GDP) in selected Latin American and Caribbean countries**



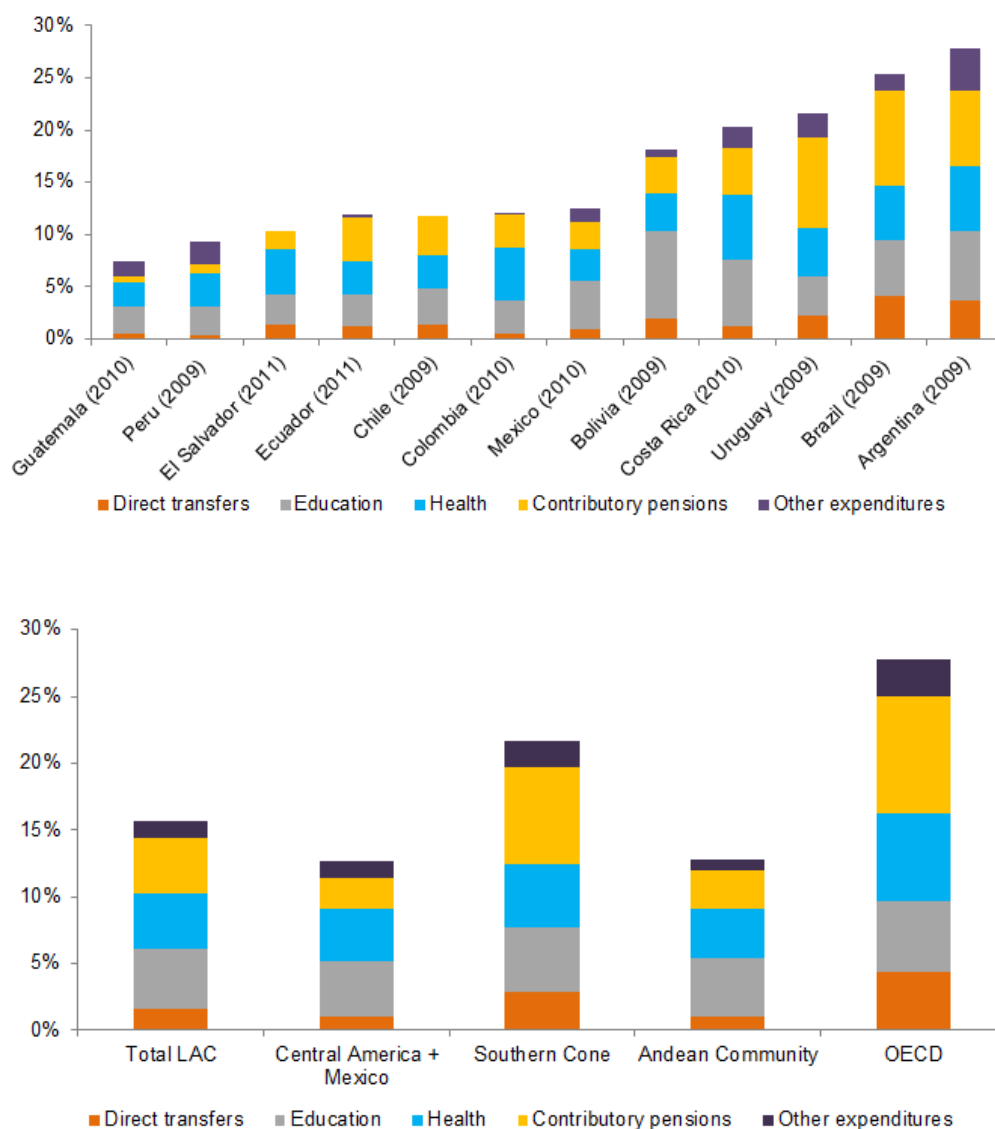
Source: Prepared by the authors based on: Argentina: Lustig and Pessino (2014); Bolivia: Paz-Arauco et al. (2014); Brazil: Higgins and Pereira (2014); Chile: Ruiz Tagle and Contreras (2014); Colombia: Meléndez (2014); Costa Rica: Sauma and Trejos (2014); Ecuador: Llerena et al. (2015); El Salvador: Beneke et al. (2014); Guatemala: Cabrera et al. (2014); Mexico: Scott (2014); Peru: Jaramillo (2014); Uruguay: Bucheli et al. (2014) and Lustig (2015a).

**Figure 13. Effect of fiscal policy on average income distribution (GINI coefficient) in selected Latin American and Caribbean countries and the European Union average (circa 2010, simple average)**



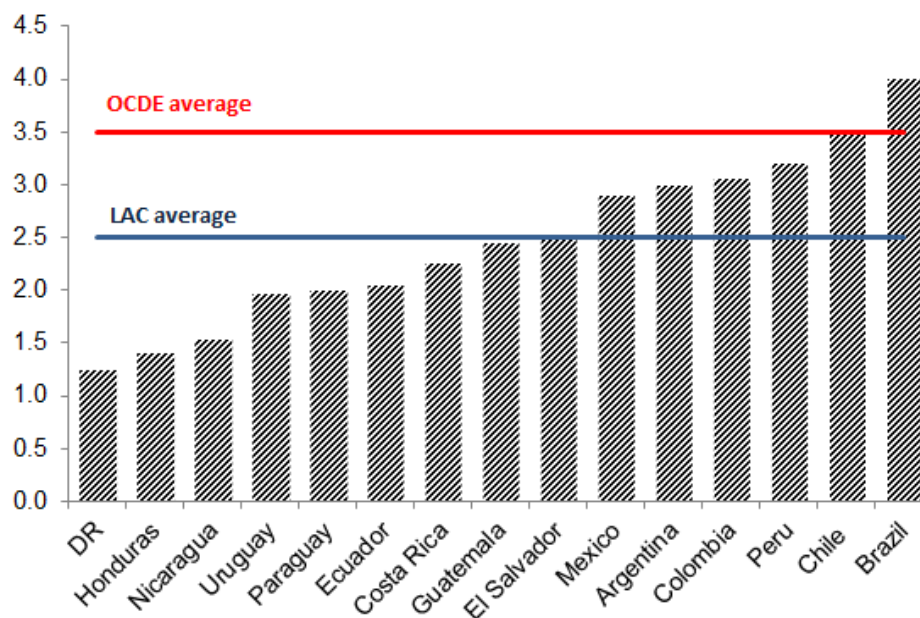
Source: Prepared by the authors based on Lustig and Pessino (2014); Lustig (2015a); EUROMOD version No. G2.0; and OECD, Income Distribution Database.

**Figure 14. Composition of social expenditure in selected Latin American and Caribbean countries and OECD average (% of GDP, simple average)**  
(Arranged by social expenditure/GDP)



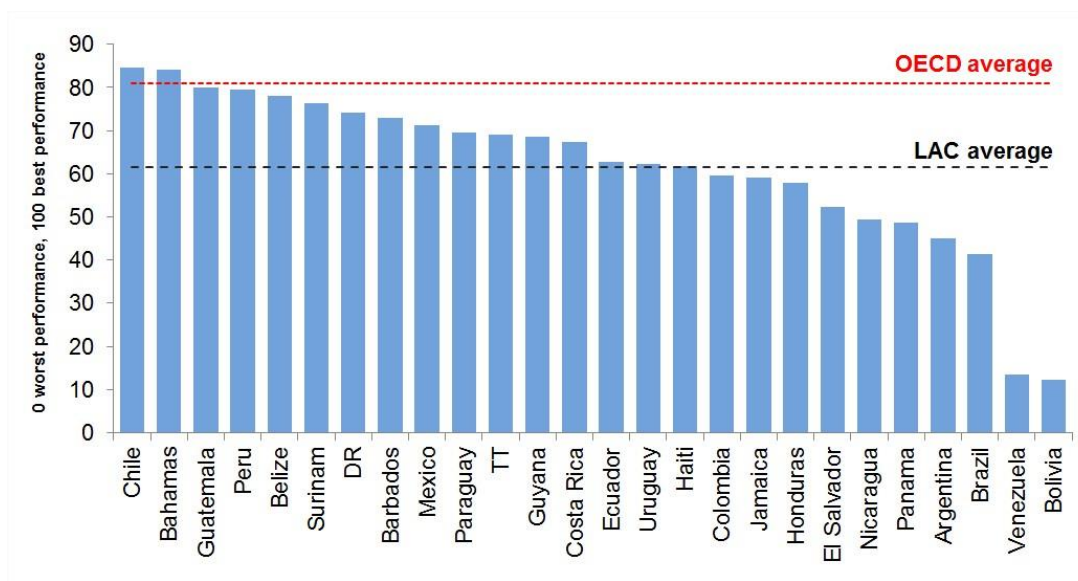
Source: Prepared by the authors based on: Argentina: Lustig and Pessino (2014); Bolivia: Paz-Arauco et al. (2014); Brazil: Higgins and Pereira (2014); Chile: Ruiz Tagle y Contreras (2014); Colombia: Meléndez (2014); Costa Rica: Sauma and Trejos (2014); Ecuador: Llerena et al. (2015); El Salvador: Beneke et al. (2014); Guatemala: Cabrera et al. (2014); Mexico: Scott (2014); Peru: Jaramillo (2014); Uruguay: Bucheli et al. (2014), Lustig (2015a), and OECD Stat. Social Expenditure and Education at a Glance.

Figure 15. Fiscal transparency index, 2011



Source: IMF.

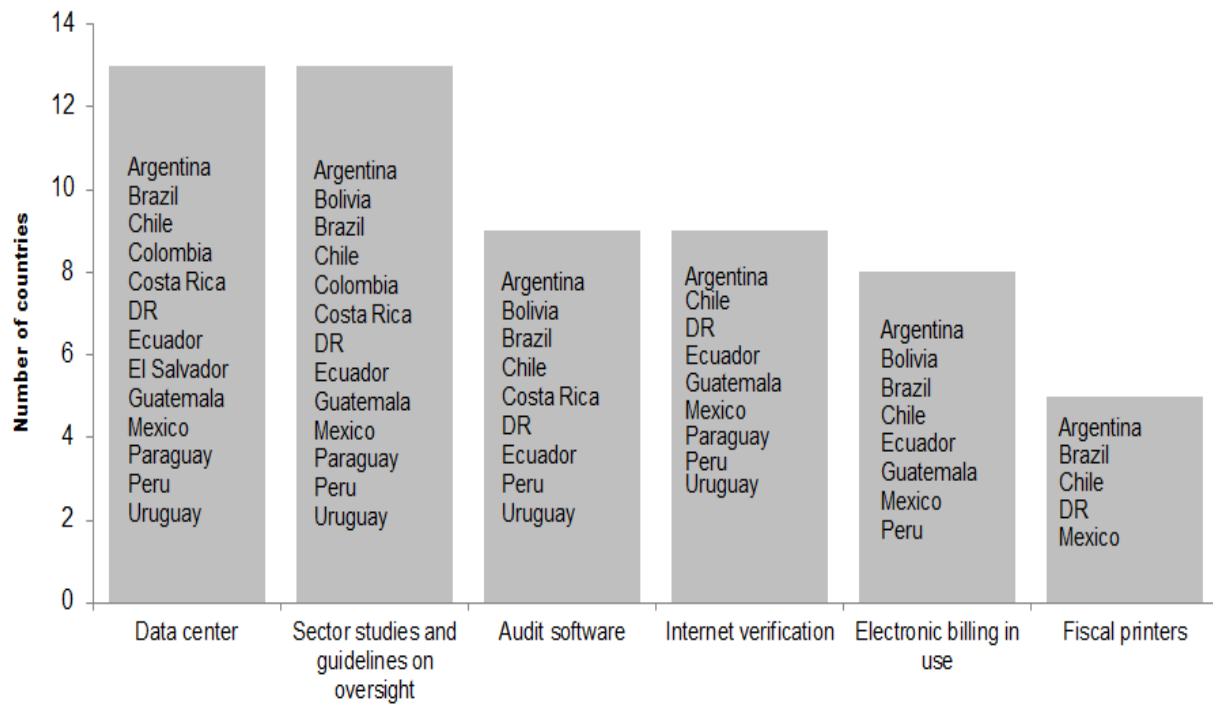
Figure 16: Ease of tax payment index, 2015



Source: World Bank, Ease of doing business index database (Doing Business).

Note: The ease of tax payment index is the simple average of three subindexes: (i) tax payments (number), (ii) time to prepare and pay taxes (hours), and (iii) total tax rate (% of commercial profits); calculated for a wide range of taxes. The subindexes are measured as a country's distance from the range defined by the thresholds of worst and best performance ("distance to frontier"). The thresholds are determined on an ex ante basis. For further details on the methodology, see: <http://doingbusiness.org/methodology/paying-taxes>.

**Figure 17: Technological support for the tax administration (number of countries)**



Source: Update based on IDB (2013c).



**Table 1. Tax expenditures in Latin America<sup>1</sup> (% of GDP)**

|                        | 2008        | 2009        | 2010        | 2011        | 2012        |
|------------------------|-------------|-------------|-------------|-------------|-------------|
| Argentina <sup>2</sup> | 2.11        | 1.98        | 2.33        | 2.46        | 2.59        |
| Bolivia                | -           | -           | -           | -           | -           |
| Brazil <sup>3</sup>    | 2.51        | 3.15        | 3.02        | 2.80        | 3.32        |
| Chile <sup>4</sup>     | 5.00        | 4.83        | 4.69        | 5.04        | 4.46        |
| Colombia               | 3.12        | 3.20        | 3.25        | n.a.        | n.a.        |
| Costa Rica             | -           | -           | 5.54        | 5.52        | 5.62        |
| Ecuador                | n.a.        | 4.22        | 4.17        | 4.67        | 4.86        |
| El Salvador            | -           | n.a.        | 3.40        | n.a.        | n.a.        |
| Guatemala              | 8.01        | 7.87        | 7.81        | 7.54        | 8.39        |
| Honduras               | -           | -           | -           | 6.18        | 6.45        |
| Mexico <sup>5</sup>    | 4.71        | 3.80        | 3.60        | 3.87        | 3.82        |
| Nicaragua              | n.a.        | n.a.        | n.a.        | n.a.        | n.a.        |
| Panama <sup>6</sup>    | -           | -           | -           | -           | 2.27        |
| Paraguay               | 1.94        | 1.82        | 1.90        | n.a.        | n.a.        |
| Peru                   | 1.96        | 1.95        | 2.08        | 1.84        | 1.91        |
| Dominican Republic     | 6.41        | 6.24        | 5.50        | 5.11        | 5.13        |
| Uruguay                | 5.67        | 5.74        | 6.31        | 6.31        | 6.40        |
| Venezuela              | -           | -           | -           | -           | -           |
| <b>Simple average</b>  | <b>4.14</b> | <b>4.07</b> | <b>4.12</b> | <b>4.67</b> | <b>4.60</b> |

Source: Pecho (2014).

Notes:

<sup>1</sup> Projected, estimated, or executed figures, according to available information.

<sup>2</sup> Includes the cost of the benefits and incentives that form a part of economic promotion regimes.

<sup>3</sup> Only considers tax expenditures at the federal level. Thus, it includes the Programa de Integração Social - Programa de Formação de Patrimônio do Servidor Público [Social Integration Program – Public Service Employee Savings Program] (PIS-PASEP) and the Contribuição para o Financiamento da Seguridade Social [contribution for social security financing] (COFINS) but not the Imposto sobre Operações relativas à Circulação de Mercadorias e Prestação de Serviços de Transporte Interestadual e Intermunicipal e de Comunicação [tax on the movement of goods, interstate and intercity transportation services, and communications services] (ICMS). Includes the Contribuição Social sobre o Lucro Líquido [social contribution on net profits] (CSLL).

<sup>4</sup> Starting in 2011, an alternate measurement is being published, using NPV to estimate personal income tax-related tax expenditures. This measurement has not been considered.

<sup>5</sup> The negative tax expenditure arising from collection of the repealed Impuesto Empresarial a Tasa Única [flat rate business tax] (IETU) has not been added. The tax expenditure associated with the Impuesto Especial sobre Producción y Servicios [special tax on production and services] (IEPS) is not considered due to its volatility. Includes employment subsidy.

<sup>6</sup> Only includes the Impuesto sobre la Transferencia de Bienes Corporales Muebles y la Prestación de Servicios [tax on the transfer of goods and services] (ITBMS).

**Table 2. PEFA in Latin America and the Caribbean**

| Dimensions                                                                           | BE<br>2009 | BO<br>2009 | BR<br>2009 | CO<br>2009 | CR<br>2010 | DR<br>2012 | ES<br>2009 | GU<br>2010 | HA<br>2012 | HO<br>2009 | JA<br>2007 | PE<br>2009 | PR<br>2008 | TT<br>2008 | Average    |
|--------------------------------------------------------------------------------------|------------|------------|------------|------------|------------|------------|------------|------------|------------|------------|------------|------------|------------|------------|------------|
| <b>1. Budget credibility</b>                                                         | <b>2.8</b> | <b>3.3</b> | <b>3.8</b> | <b>2.9</b> | <b>3.6</b> | <b>2.6</b> | <b>2.8</b> | <b>2.6</b> | <b>1.9</b> | <b>3.5</b> | <b>3.3</b> | <b>2.9</b> | <b>3.1</b> | <b>2.9</b> | <b>3.0</b> |
| Aggregate expenditure results in comparison to the originally approved budget        | 3.0        | 3.0        | 3.0        | 4.0        | 3.0        | 1.0        | 2.0        | 4.0        | 3.0        | 4.0        | 3.0        | 3.0        | 2.0        | 3.0        | 2.8        |
| Budget expenditure deviations from the originally approved budget                    | 4.0        | 2.0        | 4.0        | 3.0        | 4.0        | 2.5        | 3.0        | 2.0        | 2.5        | 3.0        | 2.0        | 2.0        | 3.0        | 2.0        | 2.7        |
| Total revenue deviations from the originally approved budget                         | 4.0        | 4.0        | 4.0        | 4.0        | 4.0        | 3.0        | 4.0        | 4.0        | 1.0        | 4.0        | 4.0        | 4.0        | 4.0        | 4.0        | 3.8        |
| Balance and monitoring of delays in expenditure payments                             | 1.0        | -          | 4.0        | 1.5        | 3.0        | 3.5        | 3.0        | 1.0        | 1.0        | 2.5        | -          | 2.5        | 3.5        | 3.5        | 2.7        |
| Budget classification                                                                | 2.0        | 4.0        | 4.0        | 2.0        | 4.0        | 3.0        | 2.0        | 2.0        | 2.0        | 4.0        | 4.0        | 3.0        | 3.0        | 2.0        | 3.0        |
| <b>2. Itemization and transparency</b>                                               | <b>1.5</b> | <b>2.7</b> | <b>3.7</b> | <b>3.5</b> | <b>3.7</b> | <b>2.4</b> | <b>3.4</b> | <b>3.0</b> | <b>1.5</b> | <b>1.8</b> | <b>2.7</b> | <b>3.9</b> | <b>2.6</b> | <b>3.5</b> | <b>2.9</b> |
| Sufficiency of the information included in the budget documents                      | 2.0        | 2.0        | 4.0        | 4.0        | 4.0        | 3.0        | 4.0        | 4.0        | 2.0        | 2.0        | 2.0        | 4.0        | 2.0        | 3.0        | 2.8        |
| Size of the governmental transactions included in budget reports                     | 1.5        | 4.0        | 4.0        | 4.0        | 4.0        | 2.5        | 4.0        | 3.0        | 1.0        | 1.5        | 2.0        | 4.0        | 1.5        | 4.0        | 3.0        |
| Transparency of intergovernmental fiscal relations                                   | 1.0        | 2.5        | 4.0        | 3.0        | 3.3        | 2.0        | 3.5        | 2.0        | 2.3        | 2.0        | 2.5        | 4.0        | 3.5        | 3.5        | 3.0        |
| Oversight of aggregate fiscal risk created by other public sector entities           | 1.0        | 2.0        | 2.5        | 3.5        | 4.0        | 1.5        | 2.5        | 2.0        | 1.0        | 1.5        | 4.0        | 3.5        | 2.0        | 4.0        | 2.5        |
| Public access to key fiscal information                                              | 2.0        | 3.0        | 4.0        | 3.0        | 3.0        | 3.0        | 3.0        | 4.0        | 1.0        | 2.0        | 3.0        | 4.0        | 4.0        | 3.0        | 3.0        |
| <b>3. Policy-based budget</b>                                                        | <b>2.3</b> | <b>1.8</b> | <b>3.3</b> | <b>3.3</b> | <b>3.1</b> | <b>2.9</b> | <b>2.8</b> | <b>2.9</b> | <b>1.3</b> | <b>3.3</b> | <b>2.8</b> | <b>3.5</b> | <b>2.8</b> | <b>2.5</b> | <b>2.6</b> |
| Orderliness and participation in the annual budget process                           | 3.0        | 1.5        | 4.0        | 3.0        | 4.0        | 3.3        | 3.0        | 3.0        | 1.0        | 4.0        | 3.0        | 4.0        | 4.0        | 2.5        | 3.0        |
| Multiyear perspective in terms of fiscal planning, expenditure policy, and budgeting | 1.5        | 2.0        | 2.5        | 3.5        | 2.3        | 2.5        | 2.5        | 2.8        | 1.5        | 2.5        | 2.5        | 3.0        | 1.5        | 2.5        | 2.2        |
| <b>4. Predictability and control in budget execution</b>                             | <b>1.9</b> | <b>3.4</b> | <b>3.5</b> | <b>3.0</b> | <b>3.3</b> | <b>3.1</b> | <b>3.2</b> | <b>3.4</b> | <b>1.7</b> | <b>2.7</b> | <b>2.4</b> | <b>3.2</b> | <b>2.4</b> | <b>3.2</b> | <b>2.8</b> |
| Transparency of taxpayer obligations and liabilities                                 | 2.5        | 3.5        | 4.0        | 3.0        | 2.7        | 3.7        | 3.0        | 3.7        | 2.3        | 3.0        | 3.0        | 3.5        | 2.5        | 3.5        | 3.1        |
| Effectiveness of taxpayer registration and tax base estimation measures              | 2.0        | 3.5        | 3.5        | 3.0        | 2.7        | 3.3        | 3.0        | 3.3        | 1.7        | 3.0        | 2.5        | 4.0        | 2.0        | 3.5        | 2.9        |
| Effectiveness of tax collection                                                      | 1.5        | 3.5        | 3.5        | 1.5        | 3.7        | 3.0        | 3.5        | 3.5        | 1.3        | 1.5        | 1.5        | 1.5        | 1.5        | 1.5        | 2.3        |
| Certainty as to the availability of funds for expenditure commitment purposes        | 1.0        | 2.5        | 2.5        | 4.0        | 4.0        | 2.7        | 3.5        | 3.0        | 1.7        | 2.5        | 1.5        | 3.5        | 2.5        | 3.5        | 2.5        |
| Recording and management of cash balances, debt, and guarantees                      | 2.5        | 4.0        | 4.0        | 3.5        | 3.7        | 3.0        | 3.0        | 3.3        | 1.3        | 3.5        | 3.5        | 3.5        | 3.5        | 4.0        | 3.3        |
| <b>5. Payroll, procurement, and internal controls</b>                                | <b>1.3</b> | <b>2.0</b> | <b>3.8</b> | <b>2.6</b> | <b>2.6</b> | <b>2.1</b> | <b>3.4</b> | <b>1.8</b> | <b>1.3</b> | <b>2.5</b> | <b>1.6</b> | <b>3.3</b> | <b>2.0</b> | <b>2.1</b> | <b>2.3</b> |
| Effectiveness of payroll controls                                                    | 1.5        | 1.5        | 3.5        | 2.5        | 3.3        | 2.8        | 4.0        | 2.0        | 1.5        | 2.5        | 1.5        | 3.5        | 1.5        | 2.5        | 2.3        |
| Competition, reasonable prices, and controls in procurement                          | 1.0        | 3.0        | 3.5        | 3.0        | 1.3        | 1.5        | 3.5        | 1.7        | 1.5        | 3.0        | 2.0        | 3.5        | 3.5        | 1.5        | 2.6        |
| Effectiveness of internal controls of nonwage expenditures                           | 1.5        | 1.5        | 4.0        | 3.0        | 2.7        | 2.3        | 3.5        | 1.7        | 1.3        | 2.5        | 1.5        | 3.5        | 1.5        | 2.5        | 2.4        |
| Effectiveness of internal audits                                                     | 1.0        | 2.0        | 4.0        | 2.0        | 3.0        | 2.0        | 2.5        | 1.7        | 1.0        | 2.0        | 1.5        | 2.5        | 1.5        | 2.0        | 1.9        |
| <b>6. Accounting, records, and reports</b>                                           | <b>1.5</b> | <b>2.0</b> | <b>3.6</b> | <b>3.2</b> | <b>3.3</b> | <b>3.0</b> | <b>3.5</b> | <b>2.5</b> | <b>1.3</b> | <b>3.0</b> | <b>1.9</b> | <b>2.8</b> | <b>2.4</b> | <b>2.6</b> | <b>2.5</b> |
| Timeliness and frequency of account reconciliation                                   | 2.0        | 3.0        | 4.0        | -          | 4.0        | 3.5        | 3.5        | 3.5        | 1.0        | 4.0        | 1.5        | 3.5        | 2.5        | 3.0        | 2.8        |
| Availability of information on funds received by the service units                   | 1.0        | 1.0        | 4.0        | 3.0        | 3.0        | 3.0        | 3.0        | 2.0        | 1.0        | 1.0        | 2.0        | 1.0        | 2.0        | 1.0        | 1.9        |
| Quality and timeliness of budget reports for the current year                        | 1.5        | 2.5        | 4.0        | 2.5        | 3.7        | 3.0        | 3.5        | 2.0        | 1.0        | 3.5        | 2.5        | 2.5        | 2.5        | 4.0        | 2.7        |
| Quality and timeliness of annual financial statements                                | 1.5        | 1.5        | 2.5        | 4.0        | 2.7        | 2.7        | 4.0        | 2.3        | 2.0        | 3.5        | 1.5        | 4.0        | 2.5        | 2.5        | 2.5        |
| <b>7. External scrutiny and audits</b>                                               | <b>1.3</b> | <b>1.3</b> | <b>2.5</b> | <b>2.3</b> | <b>3.4</b> | <b>1.9</b> | <b>2.0</b> | <b>2.4</b> | <b>1.7</b> | <b>2.2</b> | <b>2.8</b> | <b>3.2</b> | <b>2.5</b> | <b>2.0</b> | <b>2.1</b> |
| Scope, nature, and monitoring of external audits                                     | 1.0        | 1.5        | 2.5        | 3.0        | 3.7        | 2.7        | 2.5        | 3.0        | 1.0        | 2.5        | 2.5        | 3.5        | 2.5        | 3.0        | 2.3        |
| Legislative scrutiny of the annual budget law                                        | 1.5        | 1.5        | 4.0        | 2.5        | 3.8        | 2.0        | 2.5        | 2.8        | 3.0        | 2.5        | 3.5        | 3.5        | 3.5        | 1.5        | 2.5        |
| Legislative scrutiny of the external auditor reports                                 | 1.5        | 1.0        | 1.0        | 1.5        | 2.7        | 1.0        | 1.0        | 1.3        | 1.0        | 1.5        | 2.5        | 2.5        | 1.5        | 1.5        | 1.5        |
| <b>Average</b>                                                                       | <b>1.8</b> | <b>2.3</b> | <b>3.4</b> | <b>3.0</b> | <b>3.3</b> | <b>2.6</b> | <b>3.0</b> | <b>2.7</b> | <b>1.5</b> | <b>2.7</b> | <b>2.5</b> | <b>3.2</b> | <b>2.5</b> | <b>2.7</b> | <b>2.6</b> |

Source: PEFA Assessment Portal Data and FMM.

**Table 3. Summary of DEM results for the sector**

| Year | Number of operations | Section       |                           |                     |                 | Average annual DEM |
|------|----------------------|---------------|---------------------------|---------------------|-----------------|--------------------|
|      |                      | Program logic | Monitoring and evaluation | Economic assessment | Risk management |                    |
| 2009 | 14                   | 7.6           | 5.2                       | 0.7                 | 7.7             | 6.0                |
| 2010 | 25                   | 7.2           | 5.0                       | 5.7                 | 7.4             | 6.3                |
| 2011 | 15                   | 7.3           | 5.9                       | 8.2                 | 9.3             | 7.7                |
| 2012 | 17                   | 7.4           | 6.6                       | 8.7                 | 9.7             | 8.1                |
| 2013 | 20                   | 8.1           | 7.8                       | 9.4                 |                 | 8.4                |
| 2014 | 19                   | 8.9           | 7.4                       | 9.5                 |                 | 8.6                |

Source: Prepared by the authors based on information from OPS, IDB.

**Table 4. Evolution of the Bank's work in the sector, 1990-2014**  
(Number of projects by country and amounts in US\$ millions)

| Country             | 1990-1997          |              | 1998-2005          |              | 2006-2014          |               | 1990-2014          |               |
|---------------------|--------------------|--------------|--------------------|--------------|--------------------|---------------|--------------------|---------------|
|                     | Number of projects | Total amount | Number of projects | Total amount | Number of projects | Total amount  | Number of projects | Total amount  |
| Argentina           | 6                  | 701          | 4                  | 2,918        | 5                  | 641           | 15                 | 4,260         |
| Bahamas             | 0                  | 0            | 0                  | 0            | 1                  | 33            | 1                  | 33            |
| Barbados            | 2                  | 15           | 1                  | 4            | 1                  | 5             | 4                  | 24            |
| Belize              | 0                  | 0            | 0                  | 0            | 2                  | 40            | 2                  | 40            |
| Bolivia             | 4                  | 13           | 9                  | 190          | 6                  | 285           | 19                 | 488           |
| Brazil              | 2                  | 524          | 3                  | 344          | 43                 | 3,370         | 48                 | 4,237         |
| Chile               | 1                  | 10           | 4                  | 318          | 1                  | 48            | 6                  | 376           |
| Colombia            | 5                  | 241          | 4                  | 983          | 7                  | 838           | 16                 | 2,062         |
| Costa Rica          | 2                  | 92           | 1                  | 65           | 0                  | 0             | 3                  | 157           |
| Ecuador             | 4                  | 48           | 1                  | 5            | 4                  | 590           | 9                  | 642           |
| El Salvador         | 2                  | 89           | 0                  | 0            | 3                  | 405           | 5                  | 494           |
| Guatemala           | 1                  | 1            | 1                  | 20           | 5                  | 694           | 7                  | 715           |
| Guyana              | 1                  | 30           | 3                  | 48           | 0                  | 0             | 4                  | 78            |
| Haiti               | 0                  | 0            | 3                  | 55           | 5                  | 110           | 8                  | 165           |
| Honduras            | 4                  | 74           | 4                  | 45           | 5                  | 172           | 13                 | 291           |
| Jamaica             | 2                  | 125          | 1                  | 16           | 8                  | 739           | 11                 | 880           |
| Mexico              | 2                  | 450          | 4                  | 1,700        | 4                  | 2,045         | 10                 | 4,195         |
| Nicaragua           | 3                  | 36           | 5                  | 105          | 6                  | 203           | 14                 | 344           |
| Panama              | 4                  | 90           | 2                  | 18           | 5                  | 750           | 11                 | 858           |
| Paraguay            | 3                  | 95           | 3                  | 20           | 4                  | 219           | 10                 | 334           |
| Peru                | 7                  | 461          | 11                 | 1,019        | 10                 | 435           | 28                 | 1,914         |
| Dominican Republic  | 0                  | 0            | 2                  | 33           | 5                  | 1,032         | 7                  | 1,064         |
| Surinam             | 0                  | 0            | 3                  | 40           | 4                  | 74            | 7                  | 113           |
| Trinidad and Tobago | 3                  | 105          | 0                  | 0            | 2                  | 160           | 5                  | 265           |
| Uruguay             | 6                  | 197          | 5                  | 466          | 11                 | 456           | 22                 | 1,118         |
| Venezuela           | 5                  | 115          | 2                  | 218          | 0                  | 0             | 7                  | 333           |
| <b>Total</b>        | <b>69</b>          | <b>3,513</b> | <b>76</b>          | <b>8,629</b> | <b>147</b>         | <b>13,342</b> | <b>292</b>         | <b>25,484</b> |

Source: IDB (2006b) and analysis by the authors based on OPS data.

Note: Includes all projects with components and conditions related to at least one of the issues identified as challenges for the region.

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