

Fiscal Policy reform in Latin America **Miguel Braun; IDB and CIPPEC**

Introduction

Latin America has historically been a fiscal basket case. Since the 1970s, there have been debt and balance of payments crises and periods of hyperinflation. The public spending and tax systems are still inefficient and regressive and pro-cyclical fiscal policy increases macro-economic volatility still further. Fiscal reforms and higher growth have improved the situation significantly in recent years, but it is not clear that a structural change has yet occurred. An economic downturn could still lead to further fiscal solvency problems.

The challenge

The key fiscal challenge is to consolidate recent gains in fiscal solvency and reduce the pro-cyclical nature of policy. Fiscal profligacy – printing money or borrowing excessively – led to a debt level of more than 75% by 1987 and to periods of hyperinflation in Argentina, Bolivia, Brazil, Nicaragua and Peru.

These factors combined had a pernicious effect on growth, poverty and income distribution. Overall, crises are believed to have cost the region up to 7% in GDP growth per decade since the 1970s. Fortunately, things have improved. Since the mid-1990s, inflation has been kept under control and debt ratios have improved. But crises are still a major risk, often motivated by sudden stops in capital flow. The Argentinean collapse of 2001 illustrates the continuing danger.

Although things have improved, the region's fiscal probity is made to look better than it actually is by the healthy international economic climate. Higher economic growth and resulting increased tax revenues and lower interest rates have reduced debt payments, but it seems that revenue increases are unlikely to be sustained, while expenditure increases are permanent. A reversal of economic fortunes could easily expose the underlying structural deficit.

The continuing, underlying solvency problems are compounded by the dramatically pro-cyclical nature of fiscal policy in the region. Unlike the situation in developed countries, Latin American fiscal policy tends to be expansionary during economic expansions and contractionary during recessions.

Except for Colombia, all countries in the region had a positive correlation between the cyclical component of GDP and real government expenditure; on average more than double the correlation found for OECD countries. The amplitude of the fiscal cycle is also considerably greater: spending varies by almost 7% between good and bad times in Latin America, whereas it actually increased slightly during the downturns amongst OECD members.

Fiscal policy amplifies the already high economic volatility in the region, negatively affecting growth. In the current expansionary cycle, expenditures are rising. This pro-cyclicality remains a significant challenge to Latin America's development.

The determinants of insolvency and pro-cyclicality

There are two types of cause of the problems: economic volatility and politico-institutional factors. Understanding them is the first step towards overcoming the challenge.

Volatility, sudden stops and original sin

In a situation where a country has high levels of foreign currency debt, a sudden stop or deterioration in terms of trade can cause a recession and the crippling of public finances by debt repayments and/or the need to bail out the private sector. Insolvency and pro-cyclical policies result.

A study of the sudden reduction in financial flows to developing markets after the Russian crisis of 1998 showed that Argentina suffered its own crisis, while Chile did not. In Chile's case, debts were tied less to the dollar, the exchange rate was flexible and the fiscal position stronger. More open economies also need a smaller exchange rate adjustment to re-establish a balanced current account.

There appears to be no direct correlation between debt/GDP or debt/revenue ratios and countries' measures of "original sin" (the foreign currency fraction of debt). The potential determinants of both insolvency and pro-cyclicality are therefore economic volatility, dollar-denominated debt in both public and private sectors, a closed economy and a history of debt intolerance and low credibility. These form the starting point for proposals to address the challenge.

Political economy

I now turn to the underlying political causes of the challenge. Poor fiscal behavior falls into two categories: principal-agent and cooperation problems.

Principal-agent problems come in the form of potential abuse in the relationship between citizens (the principal) and their elected representatives (the agent). Power is delegated to public officers, who may pursue their private interests rather than maximize the welfare of the voters. An example directly related to fiscal policy is overspending and stimulation of the economy by government in an election year.

Cooperation problems arise in the game played by multiple political actors with different objectives. A classic example is the common pool problem, which in the fiscal area arises because government programs often concentrate their effects in particular areas, while they are financed from a common pool of resources; use of these is a collective decision involving the president, spending ministers, legislators, bureaucrats, pressure groups etc. The president (or executive branch of government) is more likely to prioritize fiscal solvency than other actors, since they will generally be blamed for crises. Other politicians, however, have narrower constituencies and thus incentives to overspend.

The next section looks in more detail at the role of political institutions in contributing to problems in the fiscal policymaking process (PMP).

Common pool problems: on the consequences of fragmented fiscal PMPs

Fragmentation of policymaking tends to make the fiscal balance worse, but any procedure which forces players to consider the full tax burden should reduce both spending and budget deficits.

It seems clear that the degree of fragmentation – and hence the extent of the common pool problem – is shaped by institutional factors. Electoral rules, government types, party systems, federalism and budget institutions are among the key variables.

Electoral rules, government types and the number of parties

The basic components of any electoral system are the district magnitude (the population, and therefore number of elected representatives, per district) and whether the voting is by plurality (PL or “first past the post”) or proportional representation (PR). Another important factor is whether candidate lists are closed (voters vote for the party, and the order of candidates determines who is elected) or open (in which case votes can be cast for individual candidates). In open list systems, there are incentives to form factions within parties, and personal votes encourage politicians to provide benefits for specific groups of electors.

For 26 Latin American countries in the period 1990-95, large district magnitudes, a large number of effective parties in the legislature and weak support for the governing party in Congress (measures of fragmentation) all tended to be associated with larger fiscal deficits, while plurality systems led to smaller deficits. Other studies show that strong and stable government is a good basis for fiscal stability. Competition between powerful factions has also been shown to foster pro-cyclical fiscal policies: as the number of groups increases, so does overspending at times of increased resource.

Federalism and Decentralization

Decentralization has the potential to aggravate common fiscal problems. This is a problem not just for formally federated nations, but for the region as a whole, where a wave of reform has given regional politicians more powers in fiscal policy areas. Expenditure is typically much more decentralized than revenue generation, and the resulting gap is bridged via transfers from central government.

This, of course, creates incentives for local government to overspend from the common pool, and this problem is exacerbated if local politicians have a large degree of borrowing autonomy. The level of this autonomy, together with the degree of imbalance between local expenditure and local revenues are key indicators of the constraints on sub-national budgets. Tight budgetary constraints from central government, or wide-ranging local taxation powers, tend to lead to good regional fiscal discipline.

Political federalism and the overrepresentation of smaller sub-national units in national government increase the difficulties of achieving fiscal balance. Finally, federal transfers to local government can enhance pro-cyclicality if they are based on a fixed proportion of federal revenues.

Budget institutions

The rules and regulations which determine how budgets are drafted, approved and implemented also influence fiscal discipline. These institutions include fiscal rules (which establish numerical restrictions on fiscal indicators), procedural rules and transparency rules.

In principle, a hierarchical system, in which the finance minister has much more power than the legislature, should promote fiscal discipline by providing a leading role to the Executive branch. In practice, studies confirm that countries with more hierarchical and transparent budget institutions have lower deficits.

Principal Agent problems: the political business cycle

Since governments tend to increase spending and reduce taxes before elections, it is clear that electoral opportunism may be another source of deficit bias. In practice, it appears that such political budget cycles are common in “new democracies” which are in their first few years after moving to democratic systems. This has been put down to a lack of experience of voters with electoral politics, whereas the electorates in more established democracies may be more aware of attempts at fiscal manipulation.

The size of political budget cycles is also much larger in developing than developed countries. This is driven in particular by higher levels of corruption and a smaller proportion of informed voters. The ability of voters to monitor fiscal policy is important in determining responsible political behavior.

The proposed solutions

Three types of solution are proposed here, directly addressing the primary causes of insolvency and pro-cyclicality: improving debt management, consolidating the budget process and improving the efficiency and equity of taxes and expenditures.

Improve debt management

The level of foreign currency debt is a key factor in causing fiscal vulnerability. Of course, there must be a demand for local currency debt if this is to change, and there are a number of proposals as to how a suitable market may be created. Our favored proposal is the use of contingent debt instruments, not linked to emerging market financial instruments.

Such an approach can be likened to insurance, with cost paid upfront and benefits accruing in the future. The size of fiscal adjustment necessary in the event of a crisis would be reduced, as would forced pro-cyclicality.

Consolidate the budget process

Although I have already considered a range of institutional bases for fiscal weakness, it is inappropriate here to propose changes in electoral rules or federal arrangements, the consequences of which would be far wider than the merely fiscal. I therefore concentrate on proposals to improve budget procedures and transparency:

Implement fiscal responsibility laws

Regulating for factors such as independent revenue estimates and limits to the level of deficits, spending and debt is very desirable. Brazil represents the best current example in the region. Such laws limit the common pool that agents can access and also limit the principal-agent problem by increasing transparency and accountability.

Structural deficit rules

Chile enforces a structural budget surplus of 1% of GDP, which allows current account deficits during recessions, but demands higher surpluses during good

times. Such an approach can limit overall deficits and encourage counter-cyclical fiscal policy.

Create a Congressional Budget Office

An independent office, avoiding capture by political factions, would increase the ability of the legislature to analyze budgets and evaluate their impact.

Finally, we should note the importance of all fiscal rules being properly enforceable. If not, the rules themselves become worthless and contribute to a further reduction in political credibility.

Improve efficiency and equity of spending and taxes

Although not directly related to fiscal deficits and pro-cyclicality, improved fiscal policy can reduce the negative effects on growth of poor fiscal institutions.

Spending

Create an independent agency to provide rigorous and systematic evaluations and cost-benefit and distributive impact analysis for government programs

Given the limited capacity in some countries, such an agency should initially be regional. By building up a database of impacts, benefit-cost analyses etc, this should influence national governments to prioritize more effective programs.

Increase the proportion of automatic stabilizers in the budget

Developed countries, with a much lower degree of cyclicality, also have a greater preference for transfers in their budgets, many of which act as automatic stabilizers. For example, unemployment insurance programs automatically pay out more during recessions and build up surpluses when more jobs are created. However, if underlying problems are not resolved, such adjustments can cause deeper fiscal problems in other areas, and I do not consider this approach as appropriate yet in Latin America.

Tax reform

Eliminate excessively distortionary taxes

While the neutrality of tax systems has improved significantly since the early 1990s, there are still a number of excessively distortionary taxes, including financial transaction taxes. This not only has the negative impacts of any turnover tax, but also encourages growth of the informal economy in the region. Their removal should be encouraged, but must be done gradually to avoid upsetting the fiscal balance.

Modify the income tax by a) reducing corporate taxation and offsetting lost revenue by including dividends and capital gains in the personal income tax base, and b) replacing complex personal income taxes with a constant marginal rate

Given the mobility of capital, the present structure places most burdens on workers, and limits incentives for profits to be re-invested. Exempting reinvested profits from corporate income tax and including dividends in personal income tax would incentivize investment and encourage growth. Simplifying the tax system removes the disincentive for productive employees to work, and can be done in such a way that the overall system remains progressive.

The impact of the proposed solutions

I focus here on the impact of the proposals on economic growth. Extending this to the impact on individual incomes would be highly complex while adding little to the conclusions. Even for the broader economy, there is no consensus in the literature on the degree of impact. For some recent policies, there has simply been too little time for proper evaluation. Precise costs and benefits are very difficult to define.

Individual proposals are considered below but, in summary, the potential impacts are: 0.7-0.8% of GDP per year for contingent debt instruments, 0.3-0.6% for fiscal rules and 0.47-1.82% for tax reform. No estimates of the benefits of a policy evaluation agency are available. In principle, up to 3% of additional annual growth seems achievable by combining all the initiatives.

Improve debt management

Reducing debt levels is good for growth up to a point, but studies show a variable level below which further reductions in debt actually lower growth. Countries with better institutions actually need a higher level of debt to improve growth rates. Hedging the possibility of a suffering sudden stop seems to be equivalent to a reduction of 10% in the level of external debt. Different studies suggest an annual growth benefit of 0.7 to 0.8%. However, this estimate is built on very shaky foundations.

Consolidate the budget process

Fiscal rules have an impact on budget outcomes. A index combining the degree of hierarchy and transparency of the process and the existence of numerical limits on budget variables found that countries in the top quartile had a fiscal balance 2.3% of GDP better than those in the bottom quartile. Combining this rather speculative result with figures for the effect of fiscal balance on growth suggest that growth could be boosted by 0.3 to 0.6% by moving countries from the lowest to the highest quartile.

Improve efficiency and equity of spending and taxes

Spending Although both theory and practice suggest that more efficient spending can increase growth, it is not feasible to derive any meaningful quantitative figures.

Tax reform Corporate taxes and progressive personal income tax have been shown to reduce risk-taking and innovation; a relatively low level of corporate tax encourages it. Calculations suggest that a 10% reduction in the tax rate – probably the greatest which is politically feasible – leads to an increase in the annual growth rate of between 0.47 and 1.82%.

Conclusions

Despite recent improvements, there remain underlying structural problems in the region in terms of fiscal solvency and pro-cyclicality. Addressing the root causes – volatility, debt structure and political economy issues – has the potential to give a total boost of 3% to annual growth rates, although the exact figures are extremely tentative.