

INTRODUCTION

Latin America and the Caribbean are becoming more democratic. Among the borrowing members of the Inter-American Development Bank, only 13 countries had democratic governments in 1980. Today, all 26 countries are not only democracies but also are becoming more decentralized. While only three countries in the region elected their mayors directly in 1980, 17 countries today use this form of local representation, while in six others mayors are appointed by elected municipal councils (see Figure 1).

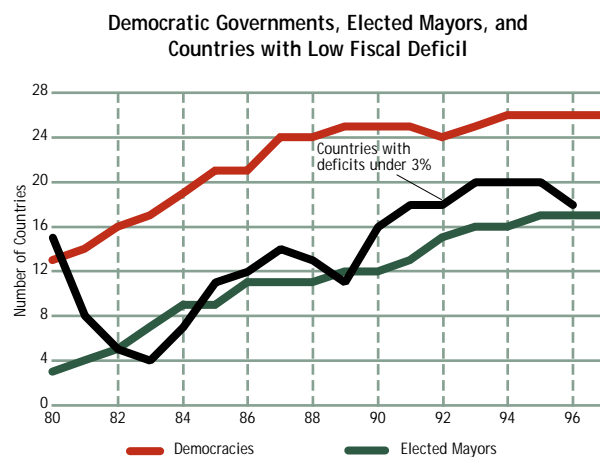
Political decentralization has been accompanied by an increasingly decentralized fiscal structure. The share of state and local governments in total government spending increased from 15.6 percent in 1985 to almost 20 percent a decade later. This process of decentralization has transferred greater responsibilities to subnational governments in providing services such as education, health, housing, roads and water.

The move towards deeper decentralized democracy has coincided with stabilization of the region's economies and the adoption of structural reforms reviewed in Part II of this Report. This is perhaps surprising because much has been written suggesting that stabilization and structural reforms are easier to achieve under authoritarian governments, since these regimes do not need the same degree of social consent required in a democracy. The Latin American experience is in sharp contrast with this view.

Moreover, much economic theory has also suggested that democracy may have an inherent fiscal deficit bias that is aggravated under more federal, decentralized structures. Therefore, it is also important to note that as decentralized democracy has deepened in Latin America, deficits have come down: after reaching 9 percent of GDP in 1982-83, they have averaged 2 percent in the 1990s. In fact, as Figure 1 also shows, the number of countries with deficits under 3 percent of GDP went from five in 1982 to 18 in 1996.

It appears, then, that much can be learned about how Latin America has achieved sound fiscal outcomes while deepening democracy. This section extracts the lessons that can be derived from this broadly positive experience. It focuses on organization of the fiscal decisionmaking process, because the evidence suggests that this process is critical to assure that the advantages of democratic participation in determining social priorities and ensuring government accountability are not wiped out by the perils of collective choice that can cause inefficient social outcomes.

FIGURE 1



One such example is the so-called "commons problem," which is particularly relevant for fiscal systems. To get an intuitive feeling for the nature of the problem, imagine yourself in a restaurant that offers two dishes: chicken for \$10 and lobster for \$50. You prefer chicken because you find the \$40 price difference quite steep. Think now of what happens if you go with nine friends and expect to share the bill. If all the others ask for chicken, then you have the choice of ordering chicken and paying \$10 or asking for lobster and paying only \$14 (that is, $[9 \times \$10 + \$50]/10$). Hence you are tempted to order lobster. But what if all the others plan to order lobster? Not only would lobster then cost you \$50, but the chicken would cost \$46 (that is, $[9 \times \$50 + \$10]/10$). So in this latter scenario as well, you might as well order lobster. Hence, no matter what the others plan to do, you will ask for lobster if you go in a group, even though you would have ordered chicken had you gone on your own.

The problem highlighted in this example is caused by the fact that people choose independently but pay collectively. Such interaction distorts collective choices and makes them inefficient from the point of view of individual participants. The fiscal decisionmaking process is similar in that different constituencies decide on spending initiatives that are paid out of a common pool of tax resources. This coordination problem, if unchecked by the institutional framework, can lead to excessive use of the common resource, i.e., to excessive deficits and debts. The problem is potentially even more serious with decentralization, since it can enable one jurisdiction to shift the tax burden onto other localities.

This example is just one of the perils of collective choice. It gives hints as to how to change the decision-

making process in order to avoid pitfalls. But it is not the only problem. Other problems discussed include:

- Achieving adequate political representation of individual electoral preferences (aggregation problem);
- The incentives of politicians and bureaucrats to follow their own interests and not those of the electors (agency problem);
- The difficulty in making credible commitments about future policies (credibility problem).

In this light, Latin America's fiscal achievements are so much more impressive. They show that democracies can be made to work well. Nevertheless, these positive trends occur in the context of old and new unsolved problems, as discussed in Chapter 1. First, the region still has a bias towards deficits that has not been contained with equal success in all countries. Second, fiscal accounts remain vulnerable to the volatility that characterizes Latin American economies, which implies that the political system must deliver more wrenching adjustments in a shorter span of time than industrial democracies.

Third, fiscal policies have not played the stabilizing, anticyclical role that economic theory suggests they should and that characterizes the experience of most industrial democracies. Instead, fiscal policy has tended to react to the large shocks it must absorb mainly in a procyclical manner, i.e., it has been expansionary in booms and especially contractionary in downturns, thus aggravating rather than cushioning the underlying volatility.

There is also evidence that many Latin American governments suffer from electoral budget cycles. Budget deficits tend to grow in the run-up to the election, forcing costly adjustments in the following year.

Some of these features, like the bias towards deficits, may reflect the same political distortions that have been well documented for the industrial democracies, with similar negative effects on their fiscal outcomes. Others reflect specific interactions between these political distortions and the characteristics of the Latin American economic context, especially greater economic volatility and a weaker tax base. In particular, Chapter 1 argues that countries in the region may be trapped in a vicious circle: their initially higher volatility creates the need for larger and more frequent fiscal adjustments. Doubts about the ability of the political system to deliver those adjustments may cause access to financial markets to disappear in bad times. Lack of financial resources enforces a procyclical fiscal reaction just when a more stabilizing response would have been most valuable. The procyclical response then accentuates the underlying macroeconomic volatility.

Fiscal performance is affected by interaction between problems in the decisionmaking process and an economic environment that is less forgiving. Chapter 1 analyzes the economic environment and fiscal performance, then looks at the decisionmaking process. Chapter 2 focuses on the way the fiscal decisionmaking process is organized at the national level, while Chapter 3 studies fiscal decentralization.

Chapter 2 looks specifically at electoral systems and budget institutions. The former are important because they affect how individual preferences of voters are aggregated into social choices and political majorities. The chapter finds evidence that systems that rely more on proportional representation, as opposed to first-past-the-post systems, tend to generate a greater number of effective political parties, less congressional support for the government, and greater difficulty in addressing issues of deficit bias and procyclicalities. They also tend to lead to larger governments, which may be explained as a consequence of the fact that proportional representation systems must include the preferences of a larger share of voters.

Chapter 2 also discusses budgetary institutions, i.e., the set of rules whereby budgets are drafted, approved and carried out. These rules are important because they may affect the way in which coordination, credibility and agency problems are dealt with. For example, spending ministers, the executive branch's budget authority, legislators, state enterprises and the public at large must interact with one another in the budget process. If the process is not well structured, as in the chicken and lobster problem, it may lead to excessive spending, deficits and debts, and inadequate management of both good times and bad, as the political process may not react appropriately to changing circumstances. Countries with transparent budget institutions that put explicit limits on the deficit and provide hierarchical or agenda-setting powers in the budget process for the finance minister and the executive vis-à-vis congress can put an effective check on the bias towards deficits and debts. This shows that strong budget institutions can overcome the fiscal consequences of proportional representation, indicating that countries need not renounce this type of electoral system in order to achieve fiscal control.

However, existing institutions have yet to deal effectively with the problems of procyclicalities and electoral budget cycles. The chapter ends with a set of ideas on the types of reform that could be effective on these fronts.

Chapter 3 looks at the challenges of decentralization. It reviews the way subnational government officials

are elected and studies the distribution of the power to tax, spend and borrow in the different countries, together with the vertical financial relations and imbalances between the different levels of government. It studies the potential benefits that political decentralization can provide in terms of a better match between citizens' preferences and public priorities, and the effect that elections may have in disciplining public officials. It also explores the risk of coordination failures emerging from the incentives that one jurisdiction has to shift the burden onto taxpayers from other jurisdictions. These incentives tend to be created when subnational governments face soft budget constraints that arise when they can force the federal government to bail them out of financial troubles.

Budget constraints can be ameliorated by:

- Limiting vertical imbalances by assigning to subnational governments those taxes that can be efficiently imposed and collected at that level;
- Reducing the discretionality and instability of government transfers;
- Setting mandatory constraints on borrowing.

Chapter 3 also includes a discussion on how to implement these strategies.

Latin America has opted for democratic participation and macroeconomic stability. The challenge is to learn about the institutional arrangements that can best deliver on both fronts.

