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ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

CENTRE DE DEVELOPPEMENT
DEVELOPMENT CENTRE

Making Fiscal Policy Work for Development in Latin America

Introduction

Are Latin American governments making the most of fiscal policy to boost economic growth and combat poverty and inequality? Or could governments be making better use of debt management, tax systems and public spending to foster development?

Most Latin American countries have improved their fiscal performance in recent years. Fiscal deficits, for instance, have fallen significantly, but fiscal performance is still a long way from closing the gap with OECD benchmarks. Between 1990 and 2006 total government revenues averaged only 23% of gross domestic product (GDP) in Latin America, against 42% in OECD countries. Public spending tells a similar story – over the same period it averaged 44% of GDP in OECD countries, but only 25% in Latin America. There are also marked differences in the way public revenues are structured, how decentralized the fiscal system is, and the quantity and quality of the public services citizens receive in exchange for their taxes.

Well-administered fiscal policy can be the basis of a renewed social contract between Latin Americans and their governments. One key element is the need to deliver better and fairer public goods and services, and how success in this area can contribute to democratic consolidation.

This *Policy Brief* looks at the development of fiscal policy in Latin America, the ongoing efforts in the region to advance fiscal performance and the challenges that lie ahead. ■

This Policy Brief is based on the 2009 edition of the Latin American Economic Outlook*, an annual publication by the OECD Development Centre. The Centre conducts comparative analysis and promotes informal policy dialogue on development issues of mutual interest for OECD member and non-member countries. Its objective is to help decision makers find policy solutions to stimulate growth and improve living conditions in developing and emerging economies.*

oecd Observer

How does fiscal policy affect development?

The issue of how fiscal policy affects a country's development is a controversial one. Some experts worry that taxes discourage growth and should be kept to a minimum, while others see fiscal policy as a countercyclical tool to stabilise swings in prices and unemployment. But it is time to acknowledge a third possibility: that fiscal policy can not only foster economic growth, but also contribute to other development goals, such as combating poverty, preventing social exclusion and providing more equal opportunities.

Public expenditure, for instance, should aim to provide high-quality public goods and services for all; if this is achieved, fiscal spending should have a positive impact on reducing poverty, inequality and exclusion, all of which are obstacles to development. The same applies to public revenues: if tax collection systems are fair and broad-based, as well as adapted to the specific nature of the economy, they can raise the funds needed for publicly-provided goods and services sustainably and efficiently.

A look at Latin America's fiscal performance – particularly set alongside the experience of OECD countries – illustrates the magnitude of the work to be done. Public spending is still much lower than in OECD countries, and the quality of vital goods and services such as education is poor. Generation of government revenue is limited and regressive – the rate of tax decreases as income increases, so the poorer taxpayers are proportionally hardest hit. At the same time, although public debt management has improved, deficits remain high, the maturity in domestic bond markets is short, and sovereign-bond markets remain too sensitive to political cycles. Latin American governments are falling short in their use of fiscal policy as a development tool that can boost growth, reduce poverty and inequality, and provide high quality public goods and services. ■

Can debt be decoupled from politics?

The share of public revenues and spending as a percentage of GDP is relatively small in Latin American countries when compared to OECD levels, but the gap between public income and spending has often produced OECD-sized deficits. Although governments in the region have made substantial progress in debt management – partly by being increasingly able to denominate debt-service obligations abroad in their local currency and therefore to reduce their exposure to foreign exchange mismatches – important challenges remain.

One of the main problems is the sensitivity of Latin American sovereign-bond markets to political cycles, which is much greater than in most OECD countries. On average, investment banks start to downgrade sovereign bonds issued by Latin American countries three months ahead of presidential elections. Capital markets where public debt is traded, meanwhile, are particularly sensitive to the effect of Latin American democratic elections on fiscal management. Investors worry that incumbent political parties will be especially prone to expand spending to encourage political support, and they are furthermore uncertain about candidates who espouse populist fiscal rhetoric, a common feature in Latin American political processes.

High volatility in capital markets during electoral cycles could be interpreted as a perceived lack of credibility of governments' and political parties' economic decision making during and after electoral processes. Careful communication by governments can educate banks, investors and other market actors about governments' credibility, and prudent management of economic policies by all political actors will back up these words with deeds. Better information flowing from the rating agencies and the investment banks concerning sovereign bonds would also be crucial to further decoupling fiscal policy from political cycles. Governments can furthermore continue to exploit windows of opportunity to restructure fiscal debt, for example by extending debt maturity or swapping to domestic-denominated debt. ■

How to broaden the tax base?

Given the limited size of public revenues as a share of GDP, one of the most important tests facing Latin American fiscal systems is to improve tax collection mechanisms. Of course, low levels of revenue generation as compared to OECD countries do not necessarily mean that tax revenue in Latin America is "too low" – or indeed "too high". Countries in the two groups start from different historic bases and face different constraints and opportunities. In Latin America itself, tax revenues during the 2000-2006 period ranged from close to 32% of GDP in Brazil, to little more than 13% in El Salvador. But to meet the region's development objectives, more and better public resources will be needed.

The key challenge facing Latin American governments is to broaden the tax base and diversify income sources away from the current over-reliance on non-tax revenues such as fees and royalties from natural resources and

Box 1.

BRAZIL: WHAT A DIFFERENCE FOUR YEARS MAKE

Though still problematic, the impact of political cycles on Latin American capital markets has diminished in recent years. The different reactions in the capital markets to the two elections won by Brazilian president Luiz Inácio Lula da Silva provide a clear example of the role political parties and candidates play in this regard. In 2002 his presidential candidacy was seen as a populist threat to the continuity of credible economic policies, generating negative recommendations by investment banks. The campaign period saw Brazilian spreads soar from 1 100 basis points 100 days before the election to more than 2 000 basis points in the days immediately prior to the vote. For a full year, the Brazilian government was effectively unable to issue public debt in international capital markets.

The contrast with the next presidential elections in 2006 could hardly have been greater. When Lula was re-elected in 2006, against an opponent who also espoused credible policies, the presidential elections caused hardly a ripple in the markets: investment banks maintained bullish recommendations on Brazilian public debt during the campaign period and spreads remained at historically low levels. More concretely, less than a month before polling day the Brazilian government issued a global bond denominated in *reais* with a 2022 maturity – something that would have been unimaginable in 2002.

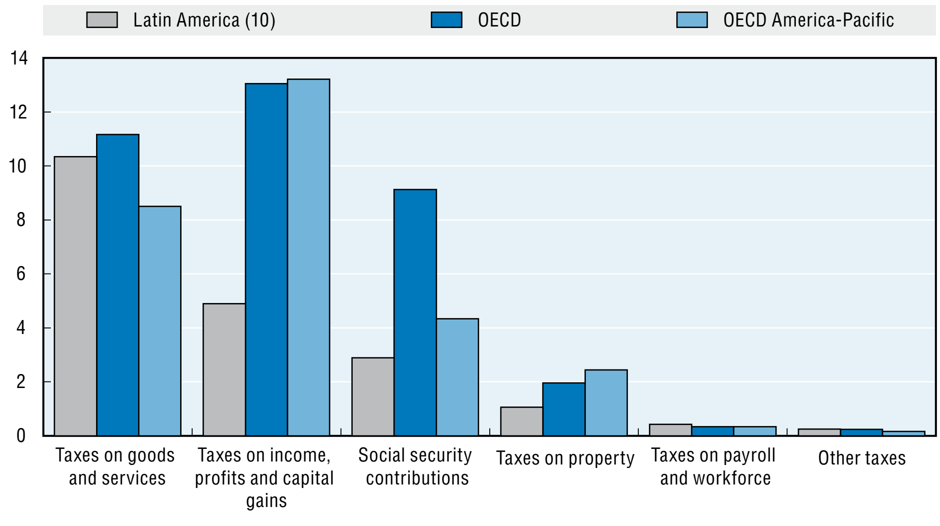
exports. The same applies to the excessive dependence on indirect taxes, which accounted for almost two thirds of tax revenues in Latin America between 1990 and 2006, compared with one third in OECD countries. In contrast, personal income taxes – more easily adapted to progressive taxation than other revenue sources – contribute only 4% of total tax revenues in Latin America, a sharp contrast to the 27% they represent in OECD countries.

One way to solve this problem would be to better adapt fiscal regimes to the specific nature of the economy and labour markets. Due to low income levels, only one out of three Latin Americans is subject to income tax. The skewed distribution of income in the region is also an important factor. In economies with income distribution as unequal as those in Latin America, there are fewer working people in income brackets where they are liable to pay taxes compared with economies where income is more equally distributed, even if average income is the same.

Fiscal policy makers in Latin America should also take into account the scale of the informal or underground sector in the economy, which has consequences for government revenues and expenditures. Understanding that many workers and companies opt out of taxes and benefits by choice, governments should adopt simplified fiscal regimes that better align the costs and benefits of compliance. Providing universal social protection for formal and informal workers on an equal footing might encourage informal employment, but it would also protect vulnerable workers and could improve national productivity by promoting inter-sector and inter-regional labour mobility. Combating tax evasion and encouraging voluntary compliance could also play an important role in boosting fiscal legitimacy. ■

Figure 1.

TAX REVENUE IN LATIN AMERICA AND THE OECD



Note: Where possible, coverage corresponds to general government, otherwise the statistics are restricted to central government.

Source: OECD Development Centre (2008); based on OECD Revenue Statistics database for OECD countries (2007) and OECD Development Centre calculations for Latin America.

How to make public spending more efficient?

Another building block of fiscal policy where Latin American governments can do more and better is public spending. The challenge for the region is to improve the progressivity of public spending so that the poor get the larger share, and to raise both the quantity and quality of public goods and services.

Unfortunately, Latin American states perform badly in both respects. The redistributive potential of taxes and transfers is largely underutilized, and fiscal policy does far less to reduce income inequality in the region than in OECD countries. At the same time, the quality of basic public goods and services that are key for combating poverty and inequality, such as health or education, is poor.

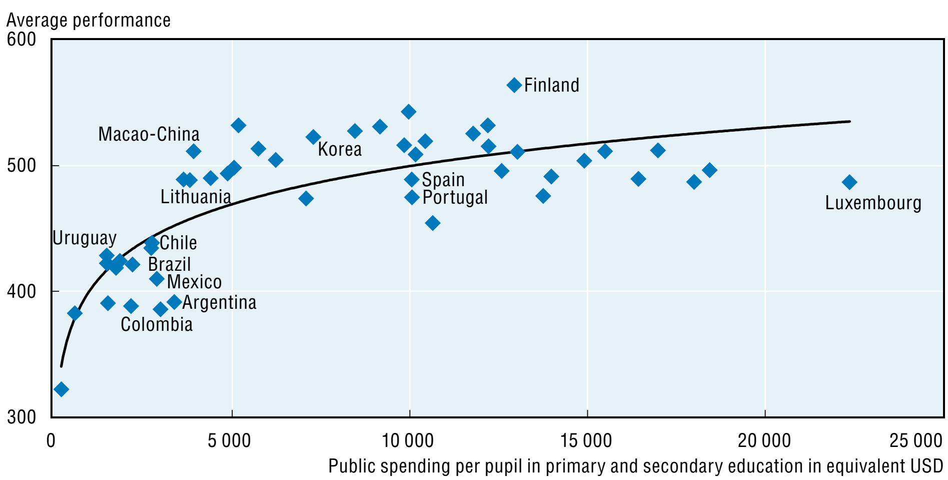
A close look at education in Latin America provides some light on how to improve the efficiency of public spending in order to maximize its potential as a tool to boost human development. In matters of education policy, quantity and quality are both critical. Spending on education as a share of total public expenditure has grown significantly in Latin America, dramatically reducing the percentage of the population with no schooling. However, spending per pupil is still five times lower in Latin America than in OECD countries, and this translates into poor performance. The performance gap between Latin American pupils participating in the OECD Programme for International Student Assessment (PISA) tests and their OECD peers is equivalent to three years' worth of schooling.

The right policies can help. Economies such as Lithuania and Macao-China spend similar amounts per pupil to Latin America yet do better on both performance and equity. Money matters, but how it is spent matters just as much, if not more. Some of the education policies that have the greatest

Figure 2.

PUBLIC SPENDING IN EDUCATION AND PERFORMANCE IN PISA

As country average on PISA science scale and average public spending in primary and secondary education



Note: Public spending is calculated as average of available data throughout the 2000s.

Source: OECD Development Centre (2008); based on OECD (2007), PISA 2006 Science Competences for Tomorrow's World and UNESCO Institute for *Statistics database*, accessed 12 June 2008.

impact on student learning are under-emphasized in Latin America. The single most important example is the time students spend in regular lessons, but better accountability and merit-based admission policies could also have a powerful effect. The PISA study also shows that there is no necessary trade off between performance and equity – but there is a precondition: schools must mirror society at large. Where a system's schools are inclusive in the sense that the distribution of their students' backgrounds resembles the socio-economic distribution of families nationwide, they achieve more in terms of both equity and performance.

Education spending is but one example of how fiscal policy can foster development, not just economic growth, in Latin America. The challenge is to channel public spending towards policies that encourage demonstrated best practices and secure the social support needed to leverage the state's own actions. Certainly there is a need for more expenditure on the key areas of physical and human capital formation, but the real priority for the region is to improve the quality of that expenditure by making it more efficient and better targeted. ■

How to build trust in fiscal systems?

The final test for fiscal policy as a development tool will be its ability to deliver results. The agenda for action in this regard is clear: successful efforts to reduce fiscal volatility should be maintained, revenue generation should diversify away from non-tax and indirect tax sources, and public spending should focus on efficiency, quality and equity. Governments in the region should also fully incorporate and consolidate into their systems ongoing fiscal innovations, such as new fiscal responsibility rules, conditional cash transfer programs and participatory budgeting mechanisms.

Achievement in these areas will help build the public trust needed to strengthen fiscal systems, which in turn is closely linked to the legitimacy of democracy itself. High levels of fiscal legitimacy – the belief that the tax and public spending system works and is fair – help consolidate public confidence in democratic institutions, something of particular importance to Latin America. Indeed, a country's fiscal system provides a snapshot of the social contract that links its government and its citizens: if the fiscal system delivers, citizens are more willing to comply, which in turn contributes to strengthening the system and its institutions. An unequal society where publicly provided goods are scarce and low-quality, and where a significant fraction of working people opt out of the formal fiscal system, is one in which the social contract is broken.

Finally, fiscal policy making can never be a purely technical matter: it is as political as it is technical. Fiscal policy is inextricably interwoven with the nature of the welfare state, the shaping of which is a profoundly political process. As a result of this, political economy considerations are fundamental when designing and addressing fiscal issues. Fiscal policy-making is always subject to politically-determined constraints, which need to be factored-in when designing fiscal systems or introducing reforms. For all these reasons, good fiscal reforms in Latin America stand greater chances of success if governments there have cultivated high levels of fiscal legitimacy. Reforms will benefit from larger public support if decision makers can explain how new measures contribute to exploit the potential of fiscal policy to foster development and improve living conditions. ■

For further information

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For further reading

OECD (2008), **Latin American Economic Outlook 2009**, OECD Development Centre, Paris, ISBN: 978-92-64-03917-9, € 20, $ 30, 230 pages.

OECD (2007), **Latin American Economic Outlook 2008**, OECD Development Centre, Paris, ISNB: 978-92-64-03826-4, € 50, $ 65, 188 pages.

OECD (2007), **Revenue Statistics 1965-2006**, OECD, Paris, ISBN: 978-92-64-03834-9, € 120, $ 156, 344 pages.

OECD (2007), **OECD Economic Surveys: Chile**, OECD, Paris, ISBN: 978-92-64-04006-9, € 49, $ 66, 183 pages.

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OECD (2006), **OECD Economic Surveys: Brazil**, OECD, Paris, ISBN: 978-92-6402999-6, € 45, $ 52, 152 pages.

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