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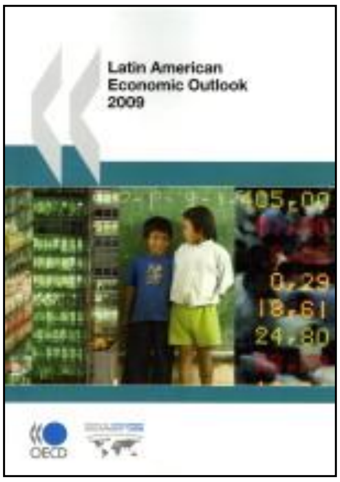


Latin American Economic Outlook 2009

Summary in English

While democratic regimes seem to be firmly rooted in the region, Latin American economies continue to experience sustained economic growth, benefiting from the ongoing process of globalisation.

This *Latin American Economic Outlook*, the first volume in an annual series by the OECD Development Centre, provides original insights and comparative indicators on four key issues affecting Latin America's development: the impact of fiscal performance on democratic legitimacy; the relevance of pension fund reform and governance for national saving and capital markets deepening; the role market-seeking investments by the private sector can have at improving access to telecommunication services; and growing trade with China and India as an incentive to boost the competitiveness of Latin American countries.

Policy recommendations and the identification of best practices in the areas under scrutiny aim to put OECD's expertise and well-known analytical rigour at the service of Latin America's development.

Fiscal policy and development in Latin America: What is the link?

Fiscal policy is not just an instrument for macroeconomic management, but also a tool which can be wielded by Latin American governments in the pursuit of development. Thoughtful and active use of tax policy, public spending and debt management can boost Latin America's development by promoting growth and reducing poverty and inequality.

What is more, the performance of a country's fiscal system provides a snapshot of the social contract that links its government and its citizens. Publicly-provided goods and services of reasonable quantity and quality for the one part, and transparent and progressive tax systems for the other, are signs of a healthy social contract. These two parts go hand in hand: if public goods such as health, education and infrastructure are scarce, low-quality or inequitably provided, the social contract is weakened. The same is true of fragile or regressive tax regimes.

This social contract is especially relevant to Latin America today because the region is in the midst of a democratic consolidation. In this context the performance of a country's fiscal system – and citizens' perceptions of that performance – is closely linked to the legitimacy of democracy itself. Fiscal legitimacy, the belief that the tax and public spending system is fair, is the key mediator in this. High levels of fiscal legitimacy are found where the tax and transfer system is effective in addressing income inequality; high-quality public services are equitably delivered; obligations and entitlements are governed by fair and transparent rules; and there exists a reasonable level of public support for the government's management of the fiscal system.

Fiscal-policy choices do not exist in a vacuum and are always subject to politically-determined constraints. Politics matters because fiscal policy is inextricably interwoven with the nature of the welfare state, the shaping of which is a profoundly political process. In short, political economy matters: a consideration of political constraints needs to be added to the technical design of fiscal systems in order to boost prospects for lasting reform in the region.

Contrary to conventional views of fiscal policy as a threat to growth (via the disincentive effect of taxes on work and investment) or as no more than a macroeconomic stabiliser for inflation and unemployment, this *Outlook* argues that fiscal policy can be a key tool for economic, political and social development in Latin America. Fiscal systems can provide the resources needed to carry out pro-growth investments and structural transformations. Taxes and public spending can directly attack poverty and inequality, twin problems that continue to beset the region.

This potential for good is substantially unrealised in Latin America. While taxes and transfers reduce inequality by 19 Gini points in

Figure 1. Democratic Consolidation in Latin America: Experts' and Citizens' Views

Europe, the difference is less than two Gini points in Latin America. Social-security spending, strongly regressive in the region, is a major culprit in the unfulfilled potential of redistributive fiscal policy. And the quality of basic public goods and services like health or education neither meets the region's development needs nor provides a spur to citizens' engagement with the state. A change of approach is needed if Latin American governments are fully to exploit the potential of fiscal policy as a development tool.

Latin America's fiscal performance: Recent trends

Since 1990 Latin America's fiscal performance has been encouraging. Fiscal deficits in the region, for example, have fallen from 11 per cent of public revenues in the 1970s and 1980s, to only 8 per cent since 2000. Is this change due to good luck or good policies? Evidence for better policies includes increased expenditures, credible macroeconomic management and greater decentralisation. These have been accompanied by creative innovations such as new fiscal responsibility rules, conditional cash transfer schemes and participatory budgeting.

However, fiscal performance is still a long way from closing the gap with OECD benchmarks. Moreover it remains to be seen how resilient positive trends and institutional innovations will be to any change in the good fortune brought to the region by buoyant commodity prices, favourable terms of trade, and cheap and plentiful capital. That test may come soon.

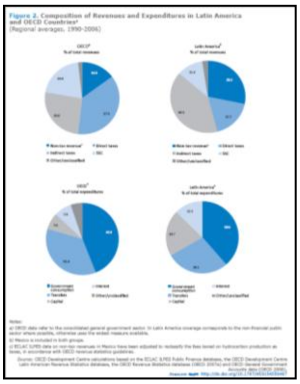
This *Outlook* assesses that performance gap by comparing and contrasting fiscal performance in Latin American and OECD countries. Both public revenues and public expenditures in Latin America are below the OECD average, though there is substantial variation across both groups of countries. Over the period 1990-2006, total government revenues averaged 23 per cent of GDP in Latin America, and 42 per cent in OECD countries. Total expenditures over the same period averaged 25 per cent of GDP in Latin America and 44 per cent in OECD countries. Revenues and expenditures alike have been rising as a share of GDP in Latin America.

Taxation and expenditure also differ substantially in their structure between Latin American and OECD countries. Consider just the revenue side of the ledger. Non-tax revenues are far more important to the public finances in Latin America, averaging fully 8 per cent of GDP. Pure tax revenues only come to 16 per cent of GDP in the region versus 35 per cent in OECD countries. Of these Latin America raises 25 per cent from direct taxes, compared to 42 per cent in OECD countries. Within this, only 4 percentage points is attributable in Latin America to income taxes on individuals, where the OECD comparator is 27 percentage points.

Contrary to the textbook prescription, Latin American fiscal policy is pro-cyclical: governments generally spend more during booms and less during slumps. Moreover, a range of important fiscal variables – including revenues, spending and deficits – are more volatile in Latin America than in OECD countries. This *Outlook* shows, however, that this fiscal volatility has been falling in the region and since 1990 has been closing the gap with the OECD. An index of deficit volatility calculated for this *Outlook* shows a fall of a third from 1990-94 to 2000-06, with Latin America standing just 6 per cent above the level in the OECD in the latter period. Over the same timescale revenue volatility in Latin America fell by a quarter and expenditure volatility by some 40 per cent.

Local governments in Latin America are flexing their fiscal muscles but relative to their counterparts in the OECD remain relatively small and heavily dependent on central-government transfers. While the level of local-government expenditures was around 41 per cent of central-government expenditures in OECD countries during the period 1990-2006, the corresponding figure for Latin America was only 23 per cent. The ratio for revenues was similar. In terms of transfers, the gap is slowly closing but it remains large: inter-governmental transfers as a share of GDP averaged 4.9 per cent in OECD countries and just 2.7 per cent in Latin America.

Figure 2. Composition of Revenues and Expenditures in Latin America and OECD Countries



Despite this positive overall trend in fiscal performance, Latin America still has plenty to do in terms of fiscal reform. Revenue generation should diversify away from its reliance on non-tax sources and indirect taxes. Fiscal volatility, a drag on growth, could fall further. And social transfers do not yet play their proper role. Achievements and innovations in the fiscal realm need to translate into sustained policies and lasting institutional reforms.

The political dimension of fiscal policy making: Public debt, political cycles and capital markets

Compared with the OECD, revenues and expenditures claim a small share of GDP in Latin American countries. But the differences between them have often produced OECD-sized deficits. The legacy of those deficits is public debt, the management of which has long posed problems for governments in the region. Latin America still has high levels of debt, leaving countries in the region vulnerable to adverse shocks. But this fact should not obscure the considerable progress made by Latin American countries in managing the composition of that debt, in particular reducing their exposure to currency mismatches –where government revenues and debt-service obligations are denominated in different currencies.

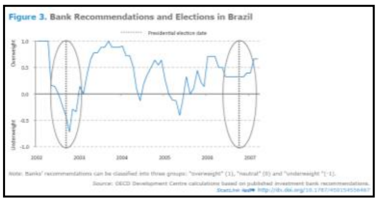
A market for public debt denominated in Latin American currencies is not new; what is new is that Latin American governments have been increasingly able to place local currency debt abroad, aided by the strong economic conditions. But challenges remain. For instance, while available maturities in domestic bond markets have increased over recent years, the overall maturity profile of the region’s debt is short when compared to other emerging markets as well as developed countries.

A major characteristic of Latin American sovereign-bond markets is that they have been keenly sensitive to political events – for example reacting negatively to the uncertainty that is an inherent feature of democratic elections. Not just economic policies but also the economic policy platforms of electoral candidates have a significant influence on the behaviour of Latin American sovereign-bond markets at these times.

First, investors worry that incumbent political parties will expand spending to encourage political support, with costs for post-election economic performance. This is not unreasonable: evidence of such political business cycles has been observed in rich and poor democratic countries alike. Second, capital markets are unsettled by uncertainty about the economic policies that will be pursued following the election.

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. Perceived as the populist opposition to a fiscally conservative government in 2002, markets reacted with apprehension to Lula’s candidacy as soon as his campaign began to gain momentum and investment-bank recommendations moved sharply negative on Brazil. Yet once in power a communication campaign and a commitment to credible policies reassured the markets and confidence returned. When the same Lula was re-elected in 2006, against an opponent who also espoused credible policies, the presidential elections caused hardly a ripple in the markets.

Figure 3. Bank Recommendations and Elections in Brazil



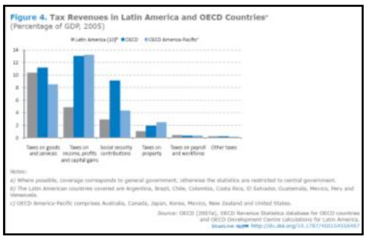
Public revenue generation: Taxation in Latin America

Management of the public debt is one dimension of fiscal policy making; taxes are another. As already noted, tax takes a lower share of GDP in Latin America than in OECD countries. It does not follow, however, 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. This is evident even in the substantial variation between Latin American countries themselves, where tax revenues range from over 30 per cent of GDP in Brazil, to little more than 14 per cent in El Salvador.

These lower levels of fiscal resources are among the factors that explain the poor redistributive performance of the fiscal system in Latin American economies. Latin Americans themselves, however, are as concerned as OECD nationals about inequality and the welfare state. Expressed preferences for or against redistribution are on average the same in the two groups, though opinion is generally more polarised in Latin America than in the OECD.

The tax-collection gap in Latin America does not have a single cause. Personal income taxes, which provide more than a quarter of tax revenues in OECD countries, are a good example. Contrast GDP per head of over USD 30 000 in Finland with Colombia's figure of less than USD 6 000 and it is at once clear that low levels of personal income limit the scope for income taxes. In many countries, the vast majority of working people – approximately 90 per cent in Brazil, Chile, Colombia and Costa Rica, for example – have incomes below the minimum threshold at which personal income taxes must be paid. Also important is the skewed distribution of income in Latin American countries, which means that for a given average income, fewer working people in an economy are in the income brackets where they are liable to pay tax.

Figure 4. Tax Revenues in Latin America and OECD Countries



Reliable cross-country evidence on the extent of tax evasion is scarce. But simple – yet plausible – simulations suggest that even eliminating evasion completely would do little to close the tax-collection gap between OECD and Latin American countries. Indeed, bringing informal workers and employers into the tax net might create a net fiscal loss, since many would be eligible for benefits and incentives of various kinds and administrative costs for tax authorities would rise. Nevertheless, measures to limit evasion – in addition to those legal means of avoiding tax – can play an important role in increasing fiscal legitimacy.

Fiscal policy and Latin America's socioeconomic reality: Accounting for informality

The informal economy is large in Latin America and its existence is intimately related to the fiscal system. Almost by definition, employers and workers in the informal economy do not pay personal or corporate income taxes (either because their incomes are too low, or because they are not registered with tax authorities), nor do their customers generally pay any relevant sales taxes. Against this, the people left out of the social safety net mean that informality is associated with lower public-sector expenditures.

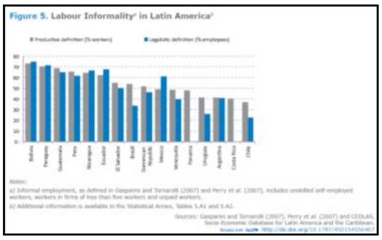
Whether informality is defined in terms of those who do not contribute to tax revenues, or those who are not covered by social security, it is an important indicator of a weak or broken social contract. Some people in the informal economy are there as the result of a deliberate choice not to engage with the state, based on a personal cost-benefit calculation – even if they might not see it that way. Others have been excluded from the formal sector, and for them informal employment is really disguised under-employment stemming from rigidities in labour-market institutions. A comparison with Europe is telling. In Europe informality is largely a matter of tax evasion. In

Latin America informality is much more complex, and firms and workers are rarely either entirely formal or informal. There is evidence in the region of a pick and mix approach to taxes and benefits, with individuals or enterprises accepting some but not all of the engagements the state offers. A survey in Mexico, for example, found that only half of micro-enterprises questioned were fully informal, while one in Bolivia found firms twice as likely to comply with their municipal obligations as be registered for value-added tax.

Fiscal policy makers in Latin America, in addition to taking into account the scale of the informal sector in their economies, need to respond to the multiple ways the phenomenon expresses itself and its diverse causes.

Policy must also balance the attractions of special regimes for firms and individuals in the informal economy against universal tax and benefits for all; each of these policy packages can create unintended incentives that are counterproductive. Typically, governments (not only in Latin America) craft special tax regimes to formalise particular parts of the economy. But these regimes can become barriers to expansion by small firms. And where from a quarter to more than half of workers hold informal jobs then piecemeal extensions to tax and spending regimes are likely to be inadequate, particularly as eligibility for the expenditure side (social protection and all the state's benefits) is often linked to formal-sector employment. Universal social protection, meanwhile, could encourage informal employment since it decouples formal work from eligibility. On the other hand it protects vulnerable workers and may improve national productivity by promoting inter-sectoral and inter-regional labour mobility.

Figure 5. Labour Informality in Latin America



Innovative policy experiments in Latin America and beyond show that tax compliance can be facilitated by better aligning the costs of formality for an individual with its benefits, adopting simplified regimes for all tax payers, and offering formal and informal workers social services on an equal footing.

Improving the quality of public spending: The case of education

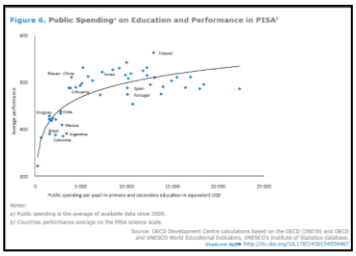
Taxes and transfers have a powerful potential to redistribute income; but social spending on human development – in particular, health and education – can play an enormous role in equalising opportunities for all. With this in mind, this *Outlook* takes a close look at education spending and performance in Latin America. What emerges is that the main challenge the region faces is to improve the quality of education, as measured by student learning and cognitive abilities. At the same time, quantity must also be improved, as Latin American countries must increase rates of participation and completion beyond universal primary education.

Public expenditure on education in Latin America is substantial and rising. Spending on education as a share of total public expenditure has been growing in Latin America; as a share of GDP education expenditure now stands at around 4 per cent, a level similar to that observed in OECD countries. But spending per pupil is still five times lower in Latin America, as the school-age population accounts for between a quarter and a third of the total, compared to less than a fifth in the OECD.

Latin American countries spend proportionally more on primary education than OECD countries, and less on tertiary and secondary. The gap is particularly evident in secondary education, where Latin American countries spend on average 13 per cent of GDP per head, while OECD countries spend over 24 per cent of GDP per head. Partly as a result of this allocation of spending, gross secondary-school enrolment rates in Latin America average under 77 per cent while the OECD average is over 100 per cent.

To assess quality of education-expenditure outcomes, this *Outlook* focuses on performance (measured by the average and distribution of test scores in the OECD Programme for International Student Assessment [PISA] study) and equity (measured by the degree to which a student's socio-economic background determines his or her test scores). On both counts, Latin America's PISA results give cause for concern.

Figure 6. Public Spending on Education and Performance in PISA



PISA test scores in Argentina, Brazil, Chile, Colombia, Mexico and Uruguay – the six Latin American countries that participated in the study – are poor compared to the OECD. The performance gap between Latin American pupils and their OECD peers is equivalent to three years' worth of schooling, while the gap for other emerging countries in the study is only about half as large. The good news is that between the 2003 and 2006 PISA rounds scores for Latin American countries generally improved.

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. In the OECD, school and educational policies such as the time students spend in regular lessons, better accountability and merit-based admission policies could have a powerful effect on student learning. The PISA study furthermore shows that there is not necessarily a trade off between performance and equity. Policy makers in Latin American countries can benefit from studies like PISA, as they grapple with the political economy of educational reform.

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 practice 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.

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 on both dimensions.

The full report can be accessed on www.oecd.org/dev/publications/leo2009

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