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Taxes and Spending in Latin America: First Stability, Now Development

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(Based on the OECD *Latin American Economic Outlook 2009*)

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- More money is needed for Latin American governments to meet the region's development objectives, but how that money is raised and spent matters as much or more.
- Though they have focused on tightening their belts and putting their fiscal houses in order, Latin American governments could do a lot more to use fiscal policy to promote development.

Latin America has not neglected fiscal policy. Since the end of the debt crisis of the 1980s, governments in the region have tightened their belts assiduously. Fiscal deficits have fallen from 11 per cent of public revenues in the 1970s and 1980s, to only 8 per cent since 2000. The year-to-year volatility of taxes, spending and deficits – long a feature of fiscal policy making in the region with harmful effects for economic performance – has likewise fallen: an index of deficit volatility calculated by the OECD *Latin American Economic Outlook 2009* shows a fall of a third from 1990-94 to 2000-06, with Latin America standing just 6 per cent above the volatility levels in OECD countries in the latter period.

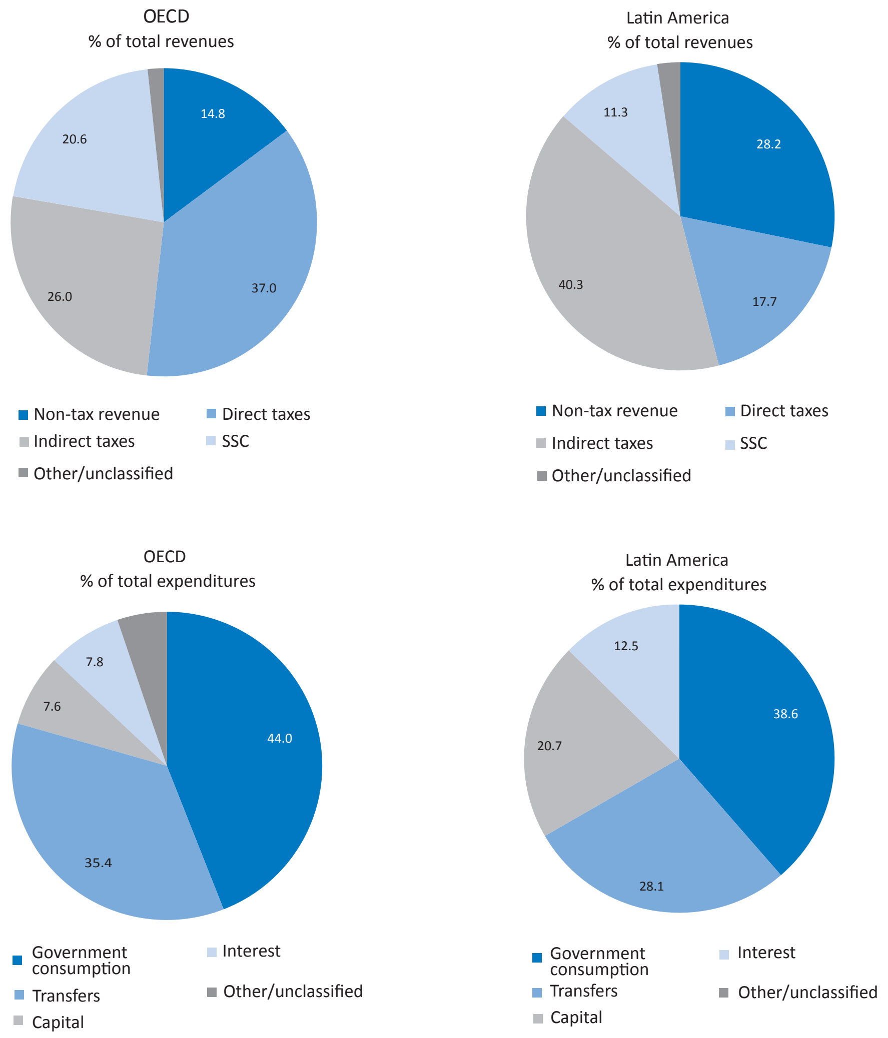
These achievements did not come easy and should be applauded. But macroeconomic stabilisation is not the sole objective of fiscal policy. Fiscal systems can provide the resources needed to carry out pro-growth investments and structural transformations. Taxes and public spending can directly attack poverty and inequality, twin problems that continue to beset the region.

The potential of fiscal policy to do good is substantially unrealised in Latin America. While taxes and transfers reduce inequality by nineteen Gini points in Europe, the difference is less than two Gini points in Latin America (the Gini index is a measure of income inequality that ranges from zero – everyone has the same income – to one hundred – one person has all the income.) Social-security spending, strongly tilted towards higher-income households in Latin America, is a major culprit in the unfulfilled redistributive potential of 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.

Government expenditures averaged 25 per cent of GDP in Latin America versus 44 per cent in OECD countries over the period 1990-2006. Clearly, more money is needed to meet the region's development deficits – nearly 200 million people living in poverty, a number set to increase with recent rises in food and energy prices – but how that money is spent matters as much if not more. The case of education is illustrative: governments in other emerging regions spend about the same amount on primary and secondary schooling per pupil as do countries like Brazil, Chile, Colombia and Mexico, but their students clearly outperform Latin American ones in international standardised tests.

Not only do Latin Americans need high quality government spending, but they also need high quality government revenues, collected fairly and from a broad base. Non-tax revenues – often linked to volatile natural-resource exports – are far more important in Latin America, averaging fully 8 per cent of GDP over 1990-2006. In contrast, tax revenues only represent 16 per cent of GDP in the region versus 35 per cent in OECD countries. Within the share of direct taxes imposed upon individuals and businesses, which represent more than 40 per cent of tax revenues in OECD countries but only a quarter in Latin America, just 4 per cent comes from income taxes, on individuals, versus 27 per cent in the OECD. A reliance on indirect taxes and non tax revenues makes government receipts more volatile and less progressive in Latin America.

Figure 1. **Structure of Government Revenues (top) and Spending (bottom) in OECD and Latin American Countries**



Source: Latin American Economic Outlook 2009, OECD 2008.

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. Citizens' perceptions that taxes and spending are fair and efficient – fiscal legitimacy – are closely linked to the legitimacy of democracy itself.

To promote broad-based economic growth, to reduce poverty while equalising economic opportunities, and finally for the sake of democratic consolidation, governments in Latin America must follow their encouraging work on macroeconomic stabilisation while fully exploiting the potential of fiscal policy as a development tool. In this regard, a change of approach and a focus on strengthening fiscal legitimacy is needed, a task that is as political as it is technical.

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