
**EU-LAC Forum on “Fiscal Policies
in Times of Crisis: Volatility, Social Cohesion
and the Political Economy of Reforms”**

**Heliodoro Temprano Arroyo
DG ECFIN, European Commission**

(Montevideo, 19-20 May 2009)



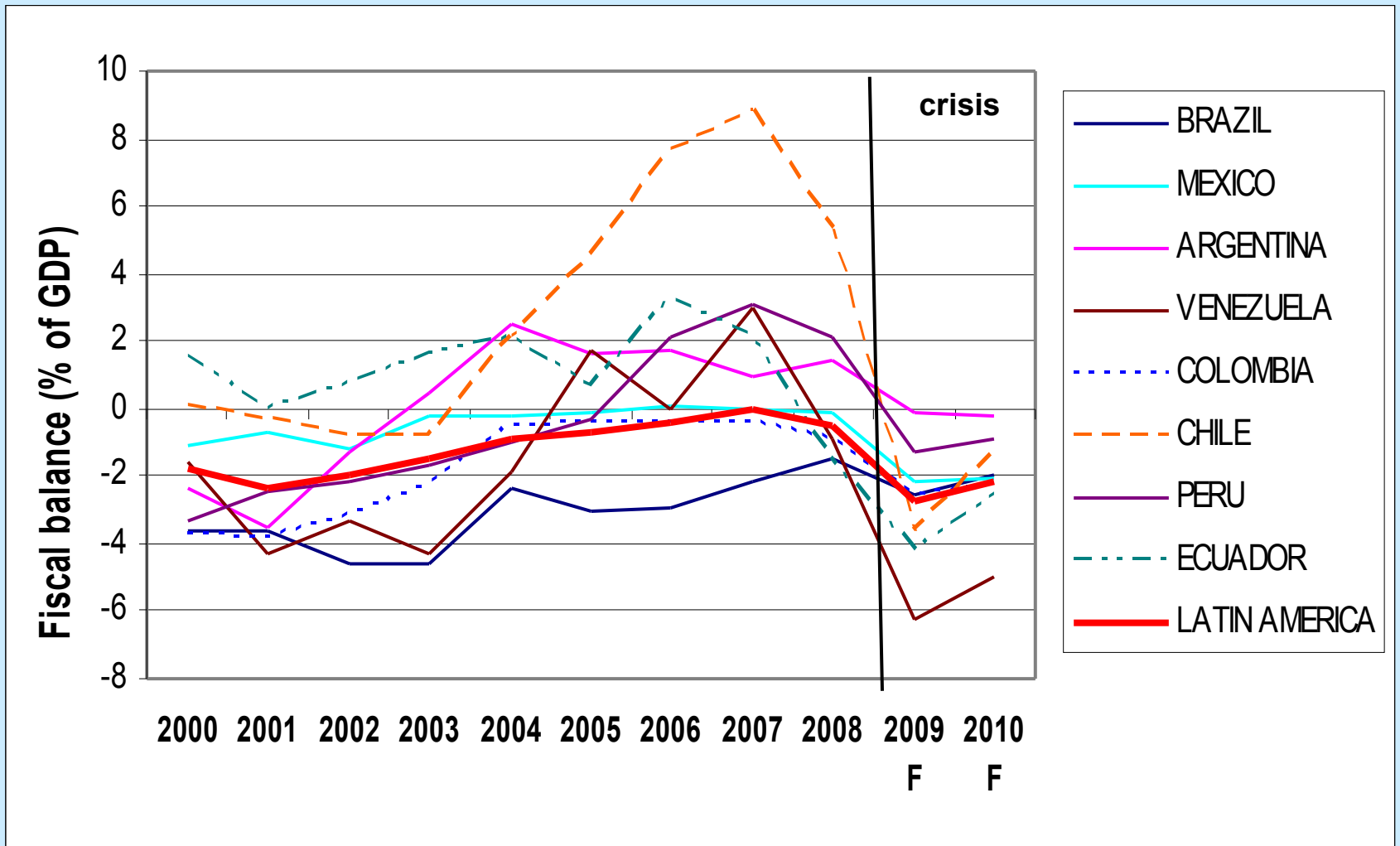
- **Latin American fiscal policies** were characterised for decades by a high-degree of pro-cyclicality, low tax revenues/GDP ratios (even for their per capita income levels), excessive dependence on commodity-related revenues, regressive tax systems, and relatively high deficits and debt ratios (notably external debt ratios, which exposed them to sudden stops in access to foreign finance). Institutional frameworks were also weak.



- However, in the ten years that preceded the global crisis of 2008-09, **substantial progress** had been made:
 - i) Since late-1990s, **institutional fiscal frameworks** were strengthened (adoption of fiscal responsibility laws, Chile's structural surplus rule, commodity stabilisation funds). Also, **privatisation, decentralisation, pension and tax reform** (from trade taxes to VAT)
 - ii) **But many of these structural fiscal reforms had short-term fiscal costs** and then global downturn and South American crises in 2000-02 led to marked deterioration in fiscal balance and debt.
 - iii) From 2003 to 2008, there was substantial **fiscal consolidation**, including reduction in deficit and debt ratios (Figures 1 and 2), even though in some cases the improvement was highly dependent on high commodity prices. There were also improvements in the public debt profile (maturity, sensitivity to interest and exchange rates).
 - iv) And an **increase in tax revenue/GDP ratios** (notably in Brazil), although in some countries largely due to commodity price boom.
 - v) There is also some evidence that the degree of **fiscal pro-cyclicality had declined** in recent years.

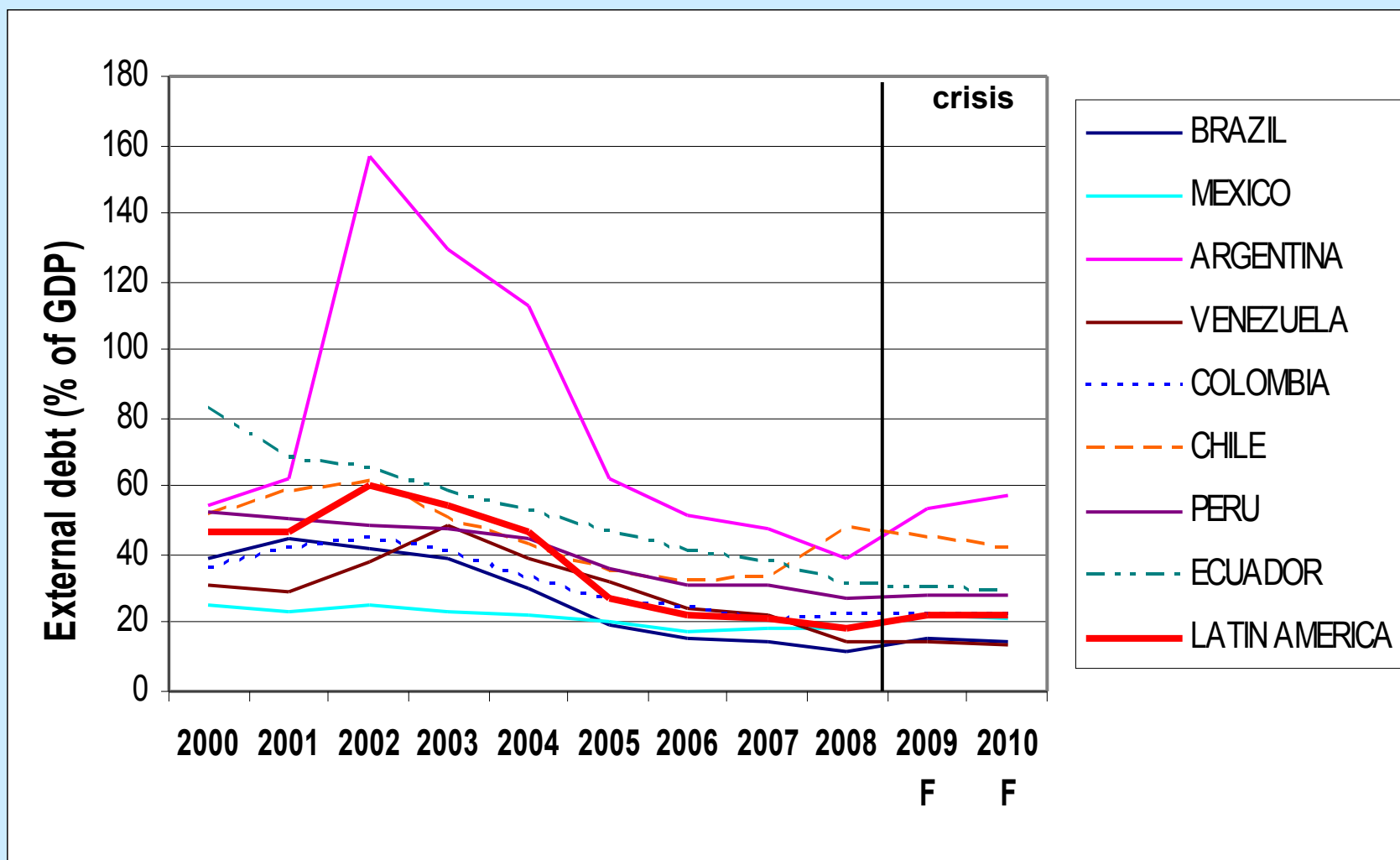


Figure 1: Fiscal balances (% of GDP) in Latin America 2000-2010



Source: Ecowin and Latin Focus

Figure 2: External debt (% GDP) in Latin America 2000-2010

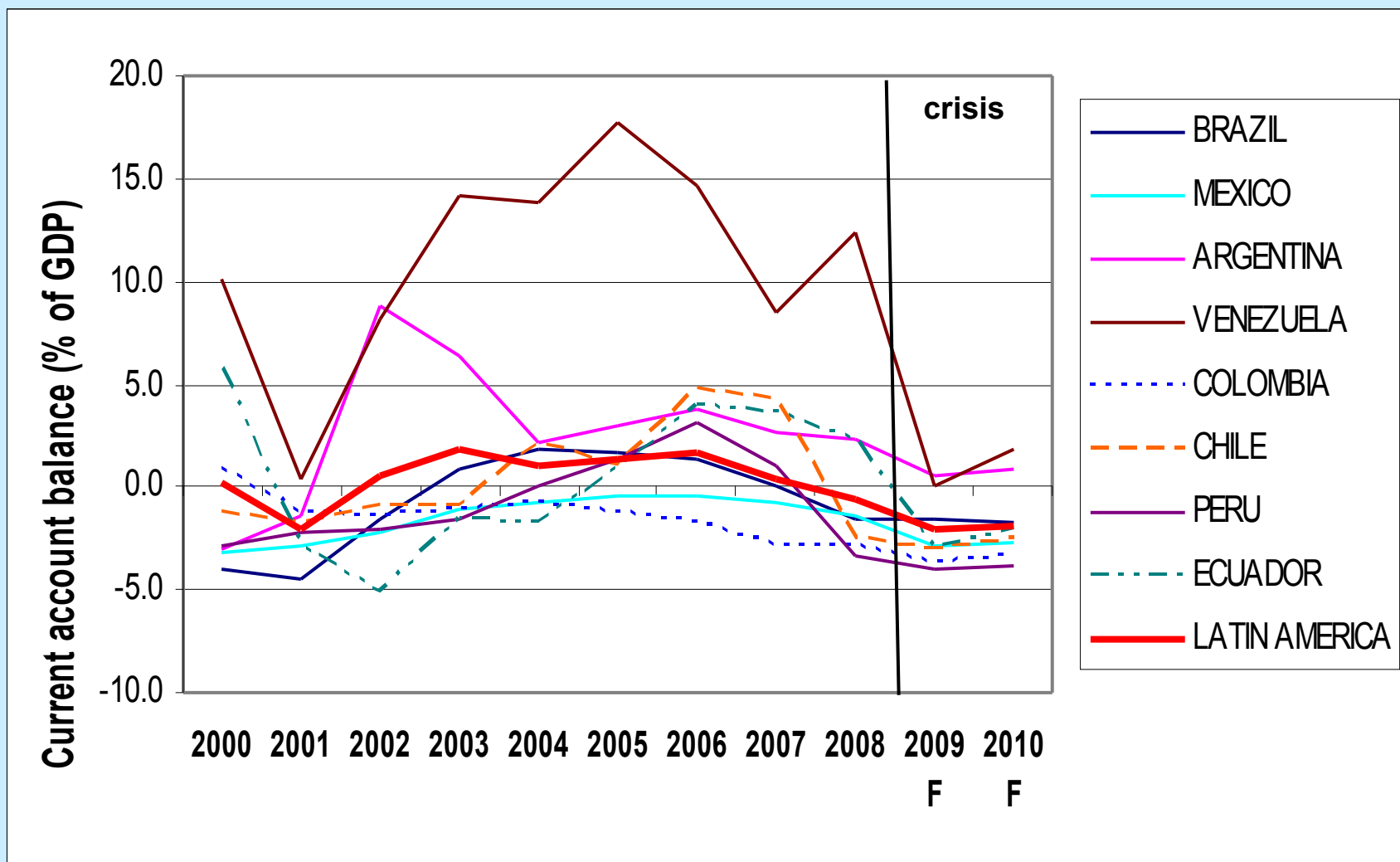


Source: Ecowin and Latin Focus

- This had left Latin American countries in a better position to weather the crisis. In addition to the stronger fiscal fundamentals, there had been a significant improvement in **current accounts and FX reserve levels** (Figures 4 and 5), and **exchange rate exposure of private sector** (partly reflecting declining financial dollarisation rates).
- All this had increased in a number of countries (e.g., Chile, Peru) the **room available for adopting fiscal stimulus** in response to the crisis. In spite of this, however, in most countries the margin was limited (need to maintain credibility, need to accommodate the impact of sharp reduction in commodity prices and other revenues as a result of crisis).

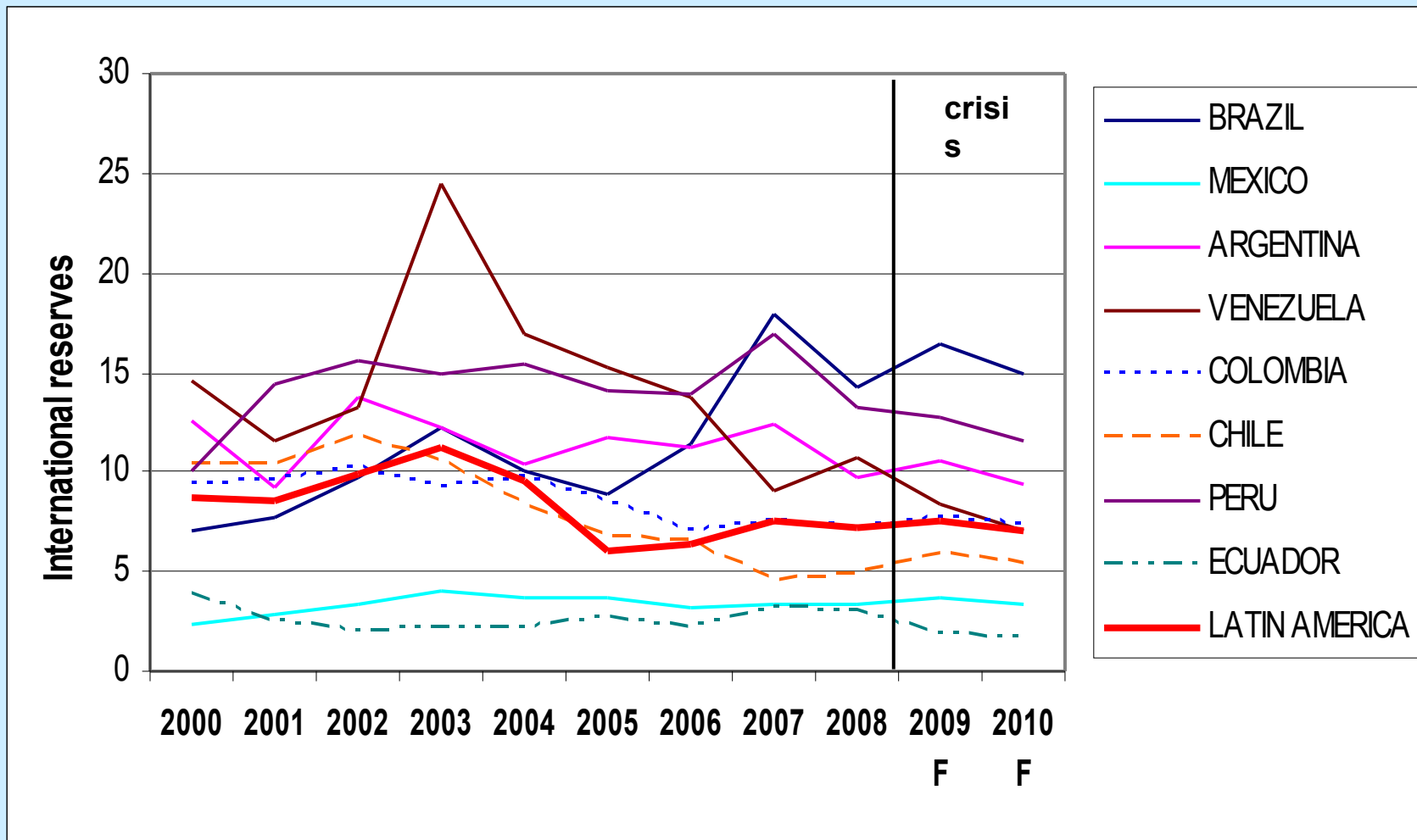


Figure 3: Current account balances (% of GDP) in Latin America 2000-2010



Source: Ecowin and Latin Focus

Figure 4: Foreign exchange reserves (in months of imports) in Latin America, 2000-2009



Source: Latin Focus

- In this context, the **discretionary use of fiscal policy** has been rather diverse but, on average, it has been modest. Chile (over 10 percentage points deterioration in fiscal balance in only 2 years!) has been the main exception.
- In an **international perspective**, the Latin American members of the G-20 (Argentina, Brazil and Mexico) have on average adopted smaller fiscal expansion packages than their G-20 partners.
- As a percentage of GDP, their **discretionary measures** have been smaller than the G20 average, though quite similar to those of the EU countries. But in addition, the magnitude of their **automatic stabilisers** is small (in contrast with their large magnitude in the EU). This results in relatively small overall fiscal expansions.
- From the point of view of fiscal sustainability and credibility, however, this should be welcomed.

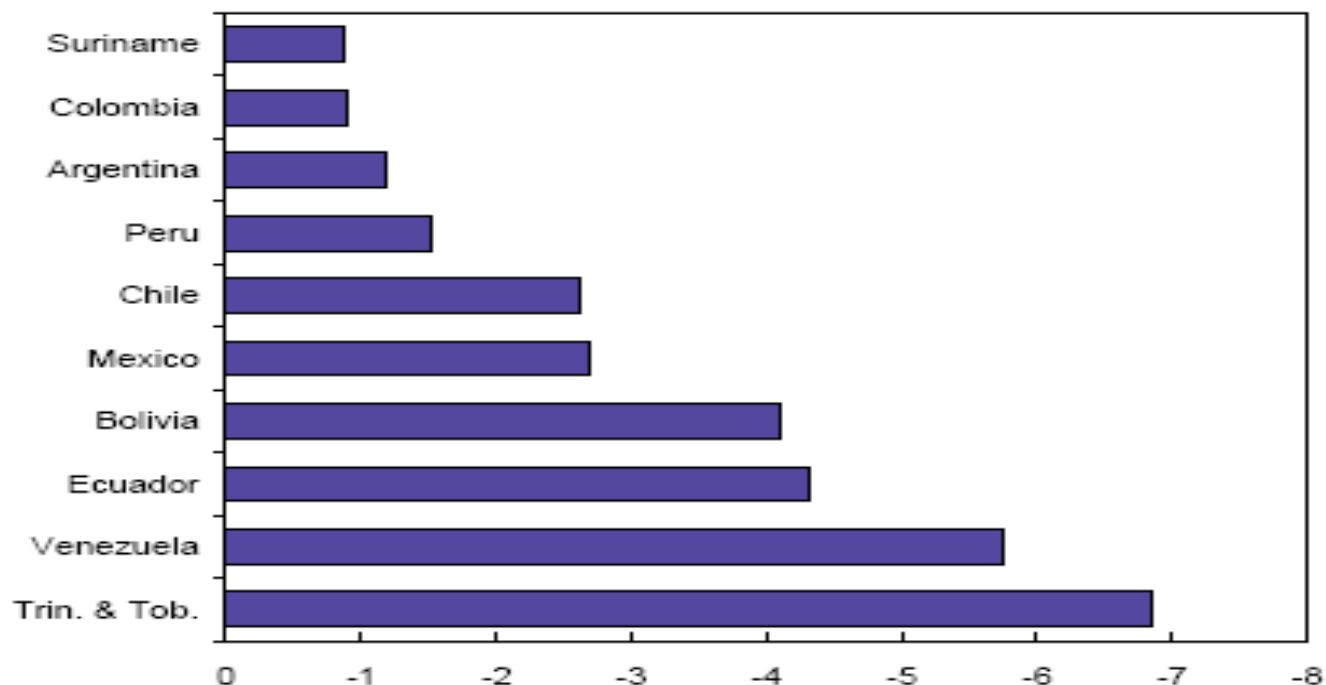


- The high **dependency of Latin American budgets on commodity-related revenues** (Figure 6) also means that the deterioration in deficits considerably overestimates their stimulative effect since it does not add to disposable income or domestic demand.
- On the other hand, discretionary measures have tended to be **concentrated on the expenditure side** (though there have been a significant number of tax measures as well, as CEPAL papers illustrate). This should improve their positive impact on economic activity.
- **Constraints on external financing** caused by the crisis have **made it harder to adopt more ambitious fiscal stimulus measures**. Nonetheless, the current episode implies a break from the traditional pro-cyclical cuts in expenditures Latin American countries often had to make during downturns. Sounder fiscal fundamentals have, therefore, paid off to some extent.



Figure 5: Dependence of Latin American budgets on commodity related revenues

Sensitivity of Fiscal Revenue to Commodity Prices 1/
(In percent of 2008 GDP)



Sources: National authorities; and IMF staff calculations.

1/ Impact on fiscal revenue of a 35 percent decline in commodity prices. Results for the 9 countries with public commodity revenue above 2 percent of GDP.



Table 1: Dependence of Latin American countries on commodity related revenues: by type of commodity

Latin America: % of each country's exports

	% of each country exports			
	Commodities	Oil	Metals	Agriculture & other
Latin America				
Argentina	59.9	12.1	2.7	45.2
Brazil ¹	53.5	8.3	17.7	27.5
Chile	77.3	0.0	54.4	22.9
Colombia	55.7	24.4	17.3	14.0
Ecuador	77.0	59.8	0.0	17.2
Mexico	21.0	16.5	0.8	3.7
Peru	76.9	8.0	62.0	6.9
Venezuela	96.8	93.1	3.7	0.0

Source: Official sources

¹ Brazil imports more oil than it sells abroad



- **In spite of modest discretionary fiscal stimulus** and relatively weak automatic stabilisers (which reflects low T/GDP ratios and low weight of income taxes and unemployment benefits), **a significant fiscal deterioration** is taking place in many Latin American countries due to the impact of weaker economic activity and commodity price declines. This deterioration is estimated by the CEPAL (Jiménez and Gómez Sabaini) at about 3.8 p.p. of GDP for the commodity exporters. Recent IMF estimates for Latin America as a whole are of same order of magnitude (about 3 p.p. of GDP).
- **Compared to the EU**, whose overall fiscal deficit is projected to widen from 0.8% of GDP in 2007 to 6.6% of GDP in 2010, Latin American fiscal balances are estimated to worsen much less (by around 3 p.p. of GDP over the same period). As noted above, this reflects mostly the much stronger operation of the EU's automatic stabilisers but also moderately larger discretionary measures in Europe than in Latin America. Reflecting this, the EU's structural deficit, for its part, is projected to increase from 2.1% in 2007 to 5% in 2010



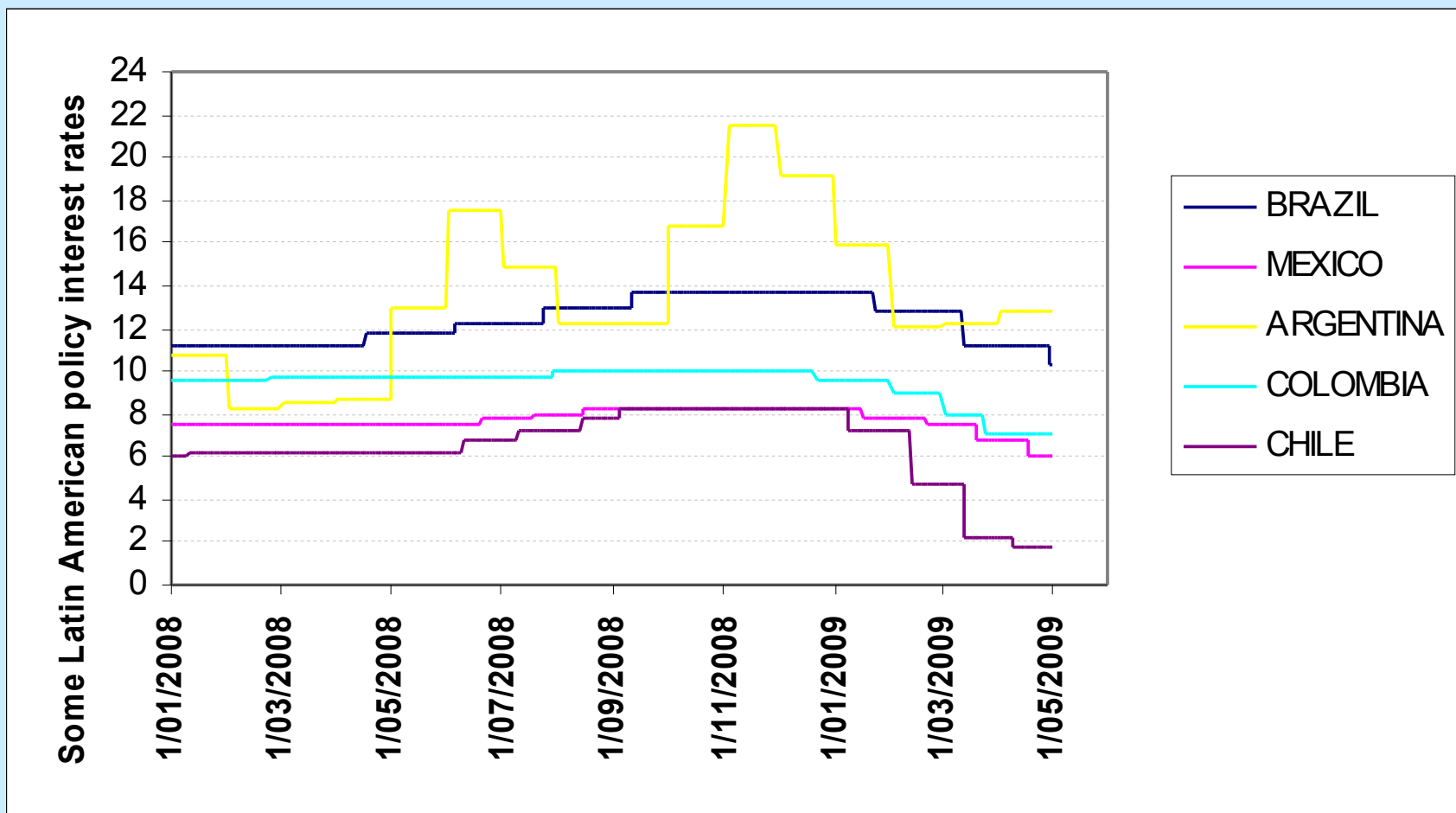
- **A significant deterioration in EU debt/GDP ratios** is also projected (from about 59% in 2007 to about 77% in 2010).
- A majority of EU countries already exceeded last year or will exceed in 2009-10 the 3% of GDP limit established by the Maastricht Treaty, in some cases (notably Ireland, Latvia, Spain and the UK) by wide margins. As a result, **quite a few EU countries will be subjected to the Excessive Deficit Procedure.**
- While **the revised Stability and Growth Pact adopted in 2005 provides increased flexibility** (e.g., through the possibility to invoke the exceptional circumstances created by the recession and by prolonging somewhat the time allowed to correct the excess of the deficit over the limit), it is clear that the crisis will imply significant challenges for the Stability and Growth Pact.
- There is, however, **a strong consensus among EU Member States on the need to protect the Pact** as a guarantee of medium-term fiscal sustainability and a key ingredient of our monetary union, and most are already announcing plans and measures to correct the fiscal situation, particularly after the recovery is firmly in place.
- In sum, **the fiscal challenges posed by the crisis on the EU are not smaller than those it is posing for Latin America.**



- Refocusing our attention on Latin America, it should be noted that not only fiscal policy has been less expansionary but also **monetary policy was cautious**: easing was delayed (Figure 6) to avoid losing hard-won credibility, make sure inflation expectations were brought under control following the relatively strong impact of commodity price increase in 2007 and H1 2008. This means that, since the crisis began, the overall countercyclical effect of macroeconomic policy on domestic demand has been weaker in LA than in the advanced regions. On the other hand, sharp currency depreciations helped many countries, though not all (e.g., Ecuador, Venezuela, El Salvador), to stimulate exports.
- With the benefit of hindsight (the gravity of the downturn could not be anticipated), earlier easing might have been warranted in some countries. However, with the information available at the time, it was the right thing to do. Moreover, many Latin American central banks have subsequently compensated their delayed response through quick reductions in interest rates (Chile, Brazil, Mexico, Peru...).



Figure 6: Monetary policy: interest rates of reference 2008-2009



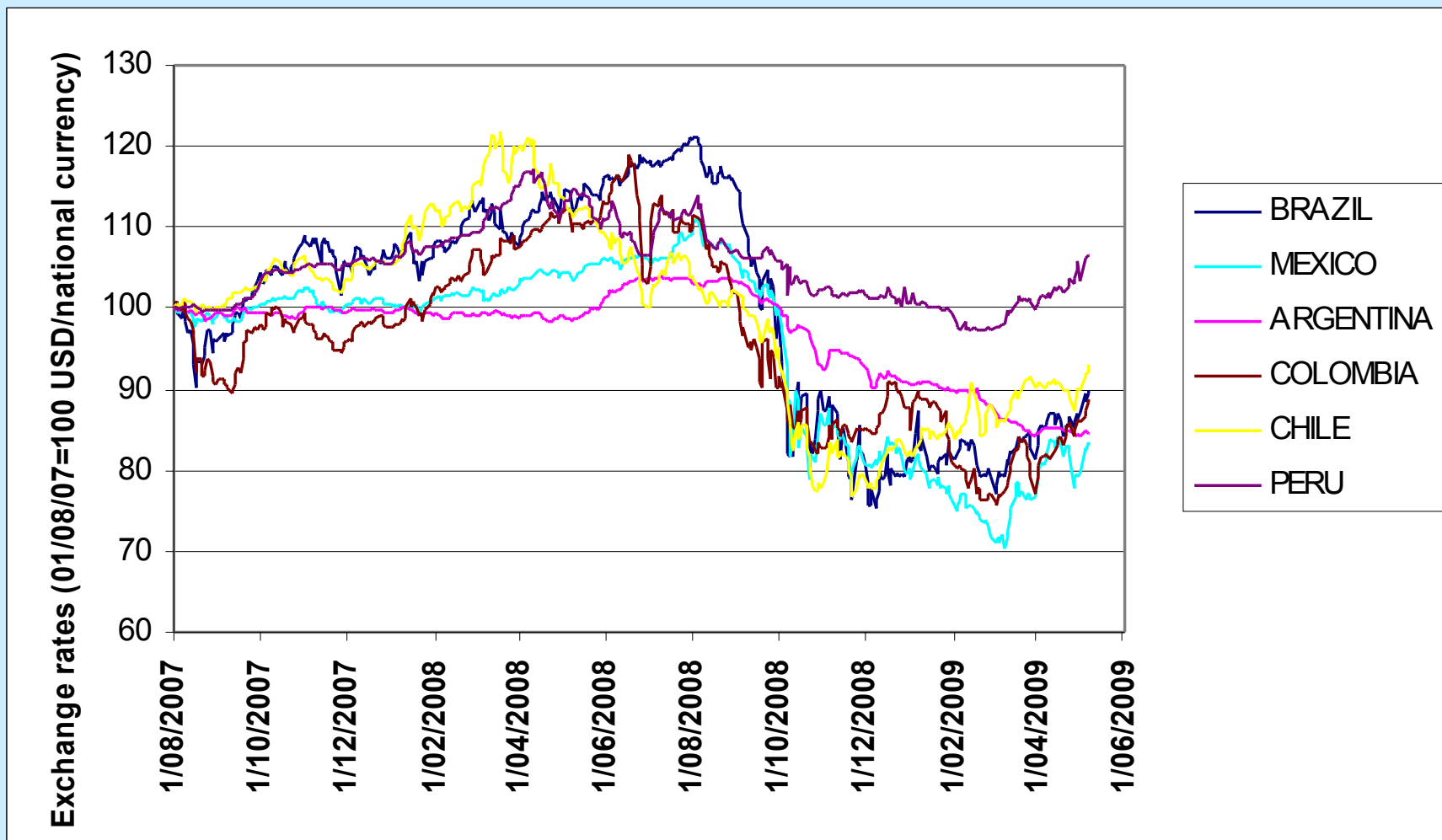
Source: National Central Banks



- This prudent monetary policy has contributed to maintain monetary credibility and to limit **exchange rate depreciation pressures**, which had been very important in the final months of last year (Figure 7).
- More recently, Latin American currencies have recovered part of the ground lost, which together with weak domestic demand and lower commodity prices, has clearly put **inflation on a downward trend**.



Figure 7: Exchange rates of main Latin American currencies



Source: Ecwin



Policy recommendations



Macroeconomic stability, social cohesion and growth: three inter-related objectives for fiscal policy

Dealing with the crisis (stability objective)

- Overall message: **prudence to maintain the credibility of macroeconomic policies**. Otherwise, exchange rates will weaken and monetary will have to be tighter than we would like it to be. Fiscal policy is ultimately the guarantor of Latin American macroeconomic stability and credibility. It must **create the conditions to allow monetary policy to play a counter-cyclical role**.
- Second: there is a **diversity of situations**: in countries with room (Chile, Peru), the more proactive use of fiscal policy to stimulate demand seemed warranted. In countries with less solid fiscal positions, at most automatic stabilisers should be allowed to work. In countries with unsustainable fiscal/debt dynamics, even tightening may be warranted, as noted by IMF.
- **Financing from IFIs** and other donors, as well as regional financing schemes, can help increase recipient countries' fiscal space. In this respect, the reinforcement of IMF resources and new facilities and the front-loading of assistance by MDBs should be welcomed.



Policy recommendations

- Stimulus measures should be **Timely, well Targeted and Temporary**, and **should aim both at stimulating demand and at protecting the vulnerable (social cohesion)**: in Latin America, the crisis risks undoing recent progress in poverty and inequality reduction. Targeting on vulnerable also increases likelihood that transfers will be spent. For the same reason, it is better to increase expenditure than to cut taxes. Public investment ensures increase in demand but long lags and difficulty to ensure appropriate evaluation of projects (Italy's strategy to frontload projects in pipeline can solve this problem). Temporary also means **need for exit strategy**.
- As emphasised by the EU during the G-20 debate on the use of fiscal stimulus, it is essential to **preserve medium-term fiscal sustainability for several reasons**: first to **ensure creditworthiness of states**, which is key for re-establishing confidence in the financial system given the role states are play as ultimate bank guarantors. Second, to make stimulus measures more effective (limit Ricardian reactions by private sector, interest rate increases and crowding out). Third, to **accommodate medium term pressures from ageing** and lower potential growth.
- **Structural reforms to raise the potential rate of growth** will also strengthen long-term fiscal sustainability.



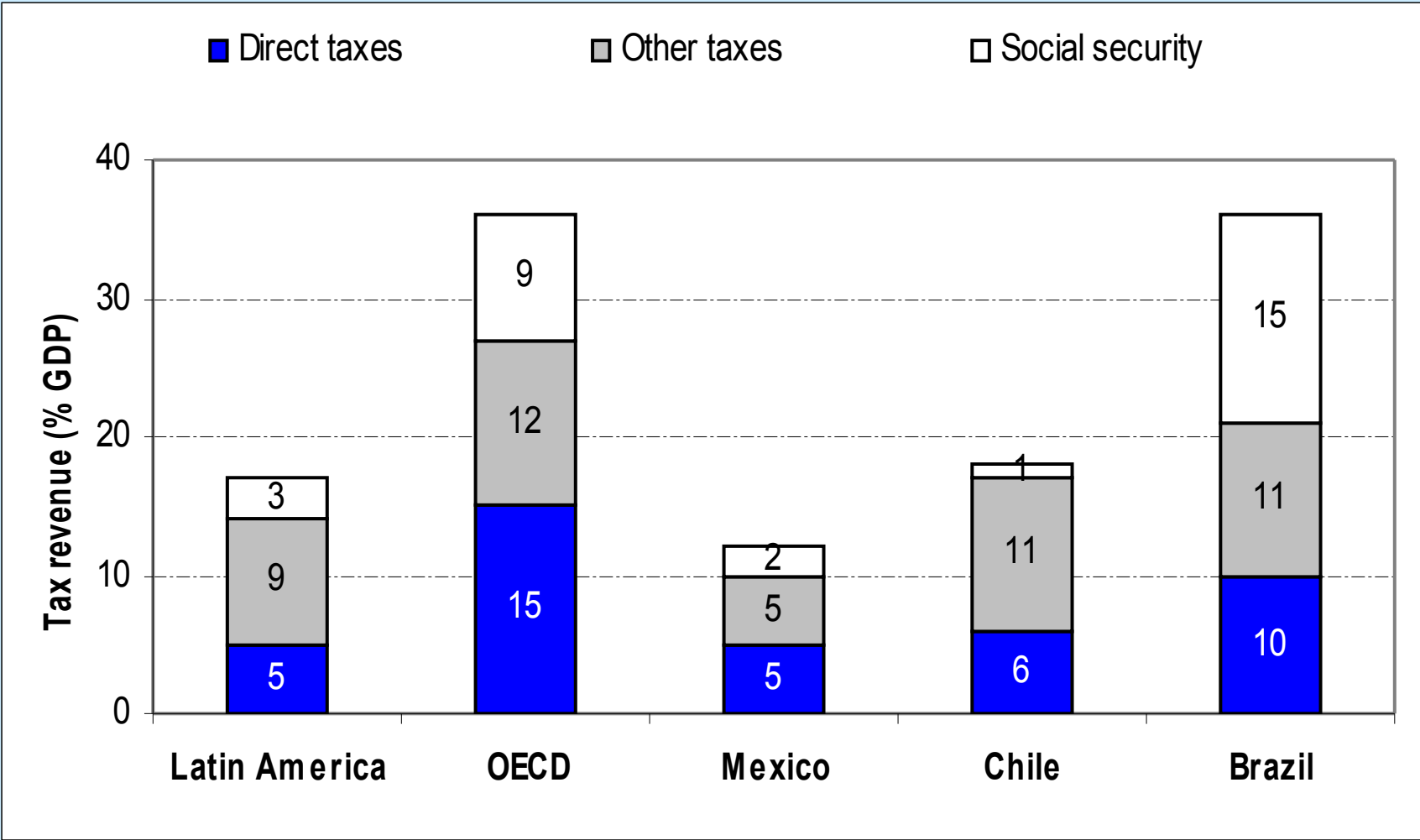
Policy recommendations

Limiting fiscal pro-cyclicality and volatility (stability objective)

- **Eliminating the traditional pro-cyclical bias of fiscal policy** is essential to reduce LA's overall macroeconomic volatility (one of the highest in the world). Less pronounced cyclical fluctuations, in turn, tend to increase long-term growth and, since crises affect disproportionately the poor, help reduce economic inequality/poverty.
- **Increase the weight of income taxation** (which remains very low; see Figure 8) and reduce the reliance on fiscal revenues from natural resources and trade taxes, which tend to be more volatile. **Increase the coverage of unemployment subsidy schemes**, which should strengthen the size of automatic fiscal stabilizers while promoting social cohesion.
- Save surplus income (notably from commodity revenues) during the booms to be in a better position to pursue an expansionary fiscal policy during downturns. This can be done through the **adoption of counter-cyclical fiscal rules** such as the Chilean one and the creation of commodity stabilisation funds. Fiscal rules must be realistic and flexible and take into account not only of impact of the cycle (output gap) but also gyrations in commodity prices.



Figure 8: Structure of tax systems in Latin America and OECD countries, 2004



Source: OECD Latin American Economic Outlook 2008



- More generally, establish **stronger fiscal institutions**, clear and prudent fiscal arrangements with local governments, and appropriate budgetary and public management procedures
- Continue to **improve debt management** and **develop domestic capital markets** so as to reduce weight of short-term and exchange-rate linked debt and the dependency on foreign finance. This will also reduce need to cut deficit during downturns because of a sudden stop in foreign financing.

Promoting social cohesion

- In Latin America, in addition, it is essential to create fiscal space for pursuing a **more ambitious redistributive policy** (consistent with social cohesion objective of EU-LA partnership) and investing in infrastructure (**medium-term growth objective**).
- This in turn requires in most countries **increasing or maintaining tax/GDP revenue ratios**, which remain on average very low (see Tables 2 and 3). (Brazil is, as noted, an exception, and this has created some controversy).
- Higher tax/GDP ratios and a higher weight of income taxation should also strengthen the operation of automatic stabilisers, improving the counter-cyclical properties of fiscal policy (**stability objective**).



Table 2: Tax revenue in percent of GDP in Latin America (2004)

Tax revenue (%GDP)	Total
Argentina	26.4
Bolivia*	15.9
Brazil	35.9
Chile	18.5
Colombia	20.4
Costa Rica	20.1
Dominican Republic	15.4
Ecuador	13.4
El Salvador	12.9
Guatemala	10.1
Honduras	17.7
Mexico	12.1
Nicaragua	17.4
Panama	12.9
Paraguay	12.7
Peru	15.4
Uruguay*	25.0
Venezuela	12.1
Latin American average	17.5

* Data available for 2003

Source: OECD Latin American Economic Outlook 2008



Table 3: Tax revenue in percent of GDP in advanced OECD countries (2004)

Tax revenue (%GDP)	Total
Sweden	50.3
Denmark	48.3
Belgium	44.6
Finland	44.1
Norway	44.0
France	43.3
Italy	41.0
Ireland	13.4
Italy	12.9
Iceland	38.7
Luxembourg	37.8
The Netherlands	37.2
United Kingdom	35.8
New Zealand	35.6
Spain	34.6
Canada	33.5
Japan	26.4
United States	25.5
OECD average	35.8

Source: OECD Latin American Economic Outlook 2008

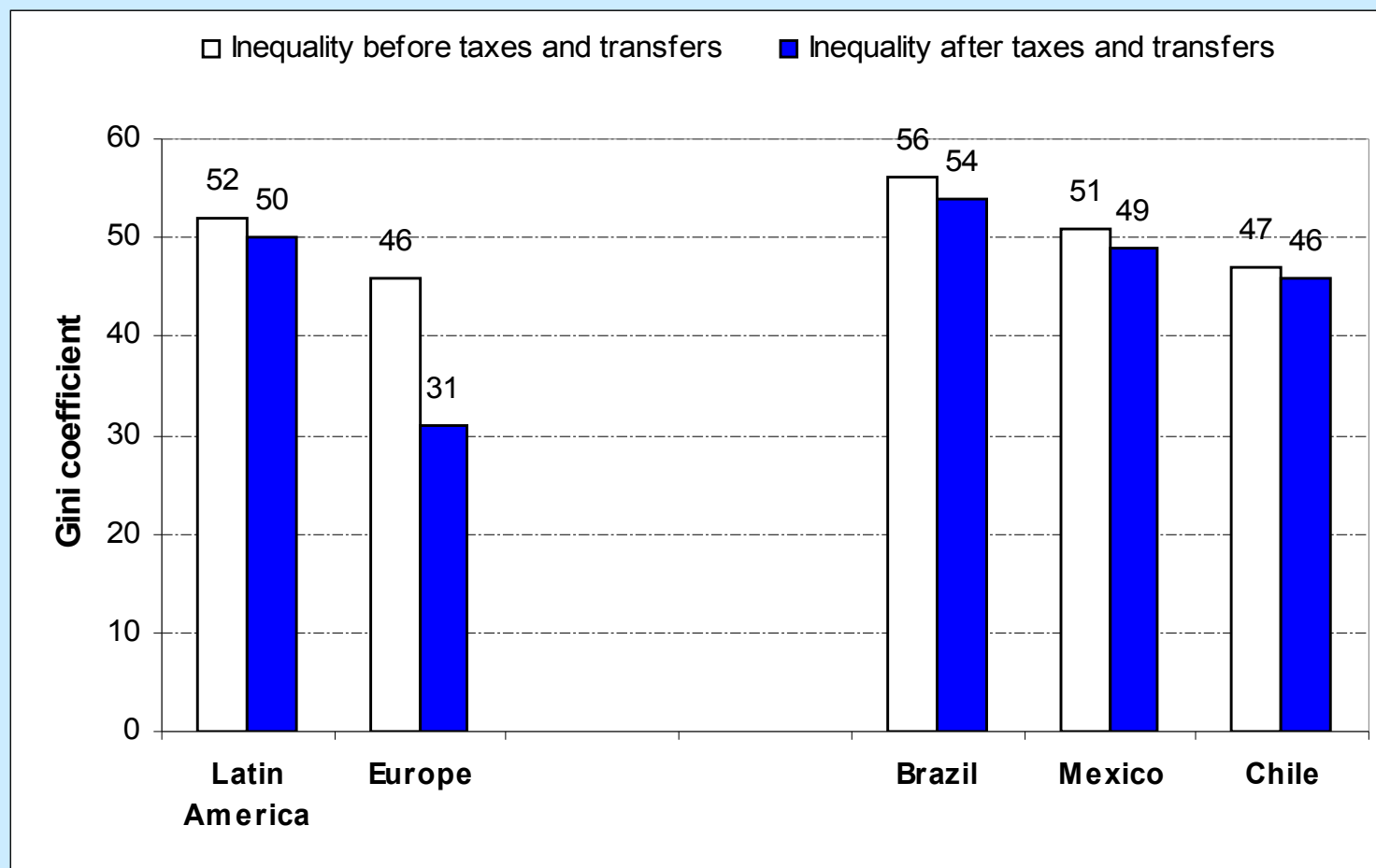


Policy recommendations

- It is also important to **increase the progressivity of the tax and expenditure system**, including through a more ambitious and better targeted social expenditure policy. Latin American states continue to have a limited distributional effect. This, rather than before tax/transfer inequality, is the main reason why inequality levels in LA are higher (Figure 9). Also, Gómez Sabaini 2006 (CEPAL) shows that all tax categories in LA are regressive.
- **Social assistance programmes must not only be better targeted but also promote investment in human capital (growth objective)**. In this respect, the experience with conditional transfer programmes in some countries (Chile, Brazil, Mexico) has been very positive. More generally, it is also important to give priority to expenditure on education and health to the detriment of social expenditures with little progressivity and human capital/growth enhancing effects, such as pensions.



Figure 9: Redistribution of wealth through taxes and transfers in Latin America and Europe, selected countries



Source: OECD Latin American Economic Outlook 2008



Policy recommendations

Fostering long-term growth

- Tax revenue/GDP ratios can and should be increased without making the tax system more distortionary. One way to do so is by **reducing the size of the informal sector**, which remains too important in many LA countries.
- Also, **growth-enhancing tax reforms** should continue to be pursued. This should include the elimination of distortionary financial transaction taxes and high reserve requirements that tend to increase financial intermediation costs and interest rates.
- Governments should devote **a significant share of public expenditure to public investment** and, as noted, human capital formation. Recent evidence suggests that investment in infrastructure, by improving access by the rural poor to basic services such as water, electricity health and education and facilitating the marketing of their production, can also have a positive effect on poverty



Concluding remarks

- In sum, while **Latin America** had made substantial progress on fiscal front before the crisis, significant challenges remain.
- The region must not let the crisis deviate fiscal policy from the prudent path many countries had been pursuing.
- Fiscal policy must do three things at the same time: ensure **macroeconomic stability**, **enhance growth** (short-term and long-term) and **increase social cohesion**. These are mostly mutually-reinforcing objectives.
- Unfortunately, while the crisis has increased the **demands** on fiscal policy, it has also reduced, as usual, the **available fiscal space**. A balance must therefore be sought between replying to those demands and ensuring fiscal sustainability/credibility.
- In **Europe** too, a balance must also be respected between the need to stimulate domestic demand and fiscal sustainability and respect of the Stability and Growth Pact framework, which requires adopting now measures to reverse the ongoing fiscal deterioration over the medium-term.



Thank you for your attention

