CEPAL REVIEW 90 • DECEMBER 2006

Fiscal policy and social protection

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The inadequacies of social protection in Latin America and the Caribbean reveal a clear need for more active fiscal policies in this area. Although economic growth and decent employment are indispensable preconditions for social progress, the need for financing from public expenditure is ineluctable in the medium term. The present article examines three ways of achieving this objective. The first is to close the tax gap, since the fiscal burden is low in most Latin American and Caribbean countries. The second is to construct budgeting systems capable of removing rigidities and reallocating public spending, thereby helping to improve its quality. The third is to bring social expenditure evaluation mechanisms into general use, with a view to improving the efficiency and effectiveness of public projects and programmes.

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I
Introduction

Although there is still some time to go, it seems safe to say that most of the region's countries will find it very difficult to meet the Millennium Development Goals for 2015 unless special policies are deployed for the purpose. To take just the first goal, halving extreme poverty and hunger, the countries (particularly the lower-income ones) will have to achieve high rates of growth, a task that would be facilitated by better income distribution (ECLAC, 2005). Another pressing issue is that, when it comes to social security and protection, population coverage is severely inadequate everywhere in the region (ECLAC, 2006).

Even in a context of tight borrowing constraints, there seems to be no getting away from the need for a significant rise in public funding to deal with these demands in the medium term. Three concurrent methods may be proposed for attaining this objective: (i) increasing the tax take, (ii) shifting the composition of spending towards social programmes, and (iii) freeing up resources by improving the efficiency and effectiveness of public projects and programmes. There can be no one right answer in such diverse circumstances. In one country or situation it may be necessary to increase the tax burden, either through new taxes or through more efficient collection. In others, it may be more appropriate to aim for a higher quality of expenditure, in terms both of allocation and of efficiency and effectiveness.

These are the issues this essay will address, in the belief that income distribution will not improve significantly in the medium term without active fiscal policies (and these cannot be confined to an effort to improve education, as proponents of a minimalist approach to public policies have suggested) and that higher social spending and the widespread use of "protected" public expenditure categories are no panacea when it comes to reducing poverty and inequality.

☐ Two research assistants from the Budgeting and Public Management Area, María Victoria Espada and Varinia Tromben, assisted the authors with the compilation of information for this article.

In a more constructive spirit, this article will emphasize the unquestionable potential of reforms to tax systems and administrations, of policies that use structural and multi-year planning rules to improve budgetary allocation, and of initiatives to raise the quality of public spending through the systematic use of evaluation programmes.

1. Is there scope for increasing public revenues?

Figure 1 presents government revenues as a percentage of gross domestic product (GDP) and the composition of these revenues in 2005. In a number of countries (Argentina, Brazil, Colombia, Costa Rica, Guatemala, Haiti, Honduras and Uruguay), tax revenues are virtually the only source of current income for central governments. In others (the Bolivarian Republic of Venezuela, Bolivia, Chile, Ecuador, Mexico and Peru), tax revenues are supplemented by other current revenues deriving from natural resources (hydrocarbons and mining). In Nicaragua and, to a much lesser extent, El Salvador and the Dominican Republic, donations provide significant current revenues on top of tax revenues. In Panama and Paraguay, other current revenues from service activities also supplement central government tax revenues.

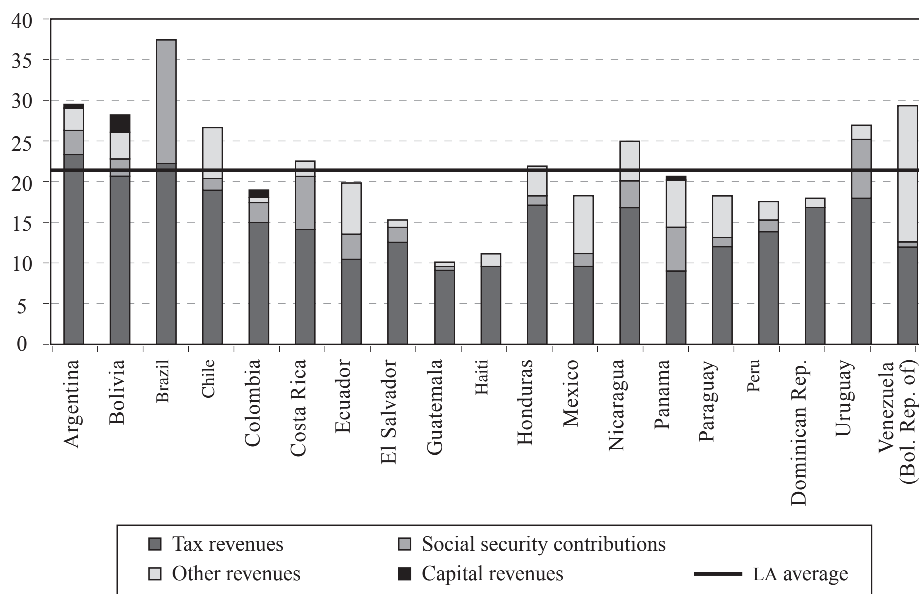
One of the main functions of taxes is to finance government spending on goods and services so that, in the medium term, the level of revenues chosen will set a limit on the level of public-sector expenditure. Apart from the traditional recommendation to avoid types of taxes that distort the allocation of resources, economic theory offers only very limited guidance to the optimum size of the tax burden and the taxation structure employed.

Some studies have found a negative relationship between tax pressure, or public spending, and economic performance. But no firm conclusions can be reached about the subject: there are countries that have grown satisfactorily with a high level of taxes, while many others have combined lacklustre macroeconomic performance with low tax pressure. The causality actually seems to work the other way around: as countries grow, the tax base expands and the system

FIGURE 1

Latin America and the Caribbean: Tax burden, 2005

(Percentages of GDP)



Source: ILPES, ECLAC, on the basis of official figures.

can become more progressive, so that a virtuous circle is set up between growth, public spending, taxation levels and the progressiveness of the system.

One way of telling whether tax levels and structures are "right" is to compare the relationship between taxes and gross domestic product (GDP) for a large number of countries. Simply comparing the situation in Latin America and the Caribbean with that in other regions of the world is very revealing (figure 2). In 2005, the tax burden in the Organisation for Economic Co-operation and Development (OECD) was roughly double that of Latin America and the Caribbean. As for composition, what is striking is the greater weight of direct taxes in the OECD countries, along with the size of social security contributions. In Latin America and the Caribbean, indirect taxation is the backbone of tax systems and it has been argued that, with this being so, the direct tax take is systematically lower there than in other regions with similar rates. Latin America and the Caribbean has a similar level of tax pressure to South-East Asia, although the composition is very different. The Asian countries have a higher burden of direct taxation, while social security contributions are not substantial.

In making the comparison, however, some explanatory variables (per capita income and others) need to be considered. Some authors have used panel regressions to estimate the "tax capacity" of each country[1] before comparing this to the actual rate. Although the present paper does not set out to estimate this capacity, the relationship between the tax take of Latin America and the Caribbean and the per capita income level of the region is shown for the purposes of illustration (figure 3).

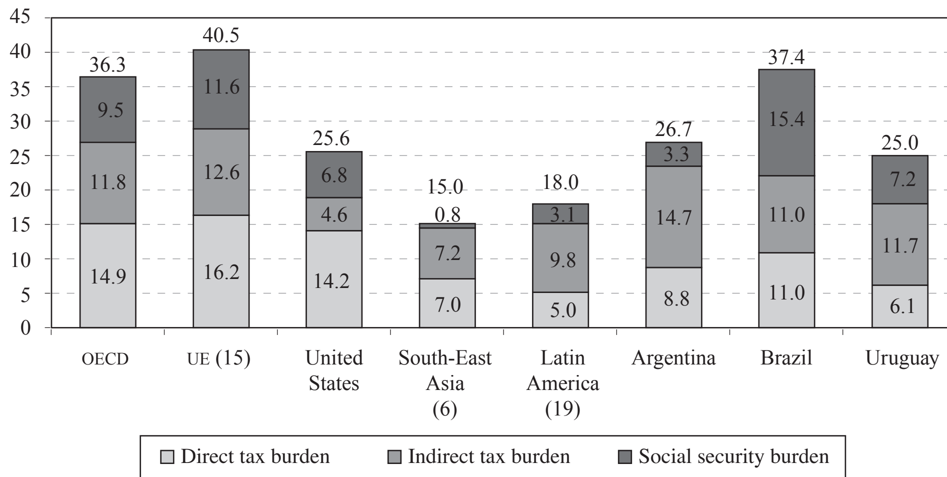
In 2005, the tax pressure in the region was 18% of GDP. It should be stressed, however, that the averages mask large differences between the countries of Latin America and the Caribbean, some of which can be explained by the high dispersion of per capita income in the region. The central government tax burden in Brazil is more than 37% of GDP, a higher level than in the United States. The figures for Argentina and Uruguay are also higher than the average.

Although substantial increases in tax revenues were achieved during the early stage of the reforms in the mid-1980s, two decades later there has been only a slight increase on the levels prior to the debt

[1] See, for example, Agosin, Barreix and Machado (2005) on the countries of Central America.

FIGURE 2

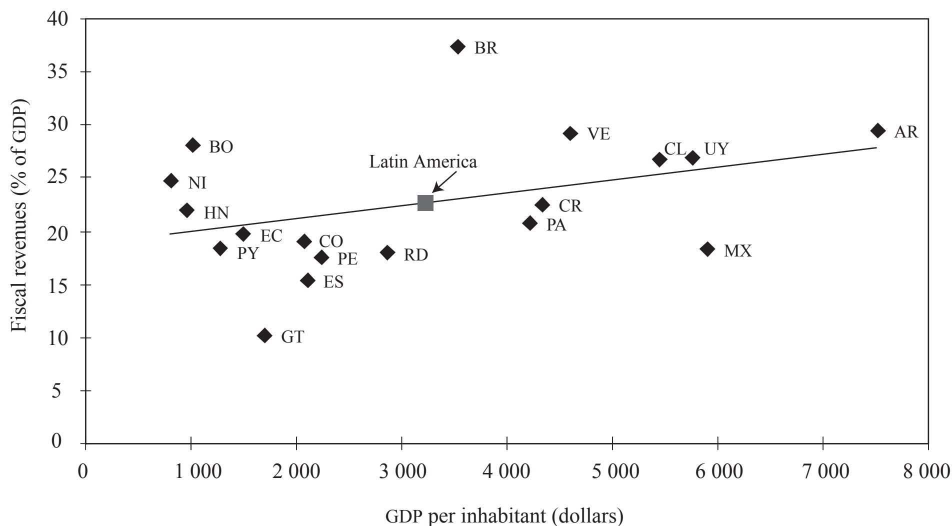
International comparisons: Tax burden



Source: Prepared by the authors on the basis of official figures from each country.

FIGURE 3

Latin America: Fiscal revenues and gross domestic product per inhabitant, 2005



Source: ECLAC.

crisis, with collection being very much centred on consumption taxes while income taxes yield little. Despite the effort to expand the tax base, raise rates and bring in surtaxes, the region is far from collecting as much as it needs.

Efforts have been made to attain the goal of neutrality by making value added tax (VAT) rates more homogeneous and reducing the number of exemptions.[2] In addition, marginal rates have been cut in the highest income tax bands. Protection for some sectors of the economy has likewise lessened as a result of trade

[2] See, for example, ILPES (2004).

liberalization and the resulting consolidation of tariffs at generally lower levels. Internationally, the goal of neutrality has begun to take on greater importance with the proliferation of bilateral free trade treaties and double taxation agreements.

The goals of simplicity, meanwhile, have been furthered by more transparent legislation, improved rules and procedures and stronger administrative systems. In addition, some low-yielding taxes have been abolished. Nonetheless, duplication of functions is still a problem in some federal countries, with differentiated tax structures and collection authorities at various levels of government.

Where the equity of tax systems is concerned, there has been more emphasis on horizontal equity (agents with the same payment capacity should have the same tax burden) than on vertical equity (agents should have a tax burden that matches their ability to pay). There has been little progress with the latter.

The work of designing modern tax systems is still incomplete, in some countries because rates are still too low, in others owing to the survival of exemptions that distort the tax system, and in most because too little attention has been paid to vertical equity in the recent reforms. In cases where VAT is the main tax and is levied at a single rate, the whole system tends to be regressive, since lower-income sectors pay a proportionately larger share of taxes levied on the necessaries of life. Today's tax systems are indeed regressive, making income distribution worse than it would otherwise have been once the effect of taxes is considered.[3]

It has been repeatedly claimed that the most important concept is the "net impact" of fiscal policy, with public spending being assigned the task of achieving progressiveness by targeting the poorest sectors.[4] Studies show, however, that successful redistribution policies do more than just increase public social spending. Furthermore, spending with immediate redistributive characteristics, such as direct transfers, has not increased significantly either, something that stands in contrast to the European experience.

Although VAT has been adopted throughout the region, this tax presents major differences from one country to another in respect of both the size of the tax base and the rates applied in each case (i.e., the number of rates and their level). Concerning the former, some countries tax both goods and services generally, others tax goods and only some services, and a few apply VAT exclusively to goods. As for rates, a first distinction can be established between countries that have applied multiple rates (to differentiate between different types of consumption) and those that have adopted a single rate across the board. Thus, for example, Argentina, Colombia, Costa Rica, Honduras, Mexico, Nicaragua and Panama use a system of multiple rates, while the other countries considered use single uniform rates.

In addition, the rates in force in the region's countries present two basic characteristics (table 1). First, there has been a general upward trend, with the average regional VAT take rising by three percentage points of GDP between 1994 and 2005. Second, the countries differ markedly in the rates they apply. Argentina, Brazil, Chile, Peru and Uruguay apply rates of about 20% or more, while Bolivia, Costa Rica, Ecuador, El Salvador, Guatemala, Haiti, Honduras, Panama and Paraguay have adopted rates of 13% or less, which places them below the 14.7% average.

In comparative terms, the simple average of VAT rates applied in the region in 2005 was almost five percentage points below the simple average for the countries of the European Union (14.7% and 19.6%, respectively). Again, the dispersion of rates between countries was smaller in the European Union than in Latin America and the Caribbean (with a standard deviation of 3.0 in the first case and 4.4 in the second).

Furthermore, the productivity of VAT (calculated by taking VAT revenue as a percentage of GDP and dividing this by the general rate) is comparatively low in the region, standing at 40% in 2005 (by way of illustration, average productivity in the developed countries is over 60%). There are also large differences between countries in this respect, as figure 4 shows. In five countries (the Dominican Republic, Haiti, Mexico, Panama and Peru), collection is less efficient than the regional average. This indicator does not necessarily reflect administrative efficiency, but rather the dispersion of rates around the general rate. In Mexico, for example, dispersion is greater because there are exemptions for food. What the chart illustrates, therefore, is only the shortfall in relation to what could potentially be collected if there were no

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[3] Gómez Sabaini, Santieri and Rossignolo (2002) reached this conclusion after analysing the tax structure of Argentina. The taxes mainly responsible for this are, in order of regressiveness, social security contributions, domestic goods and services taxes, and VAT. The most progressive taxes are those levied on personal and corporate earnings, together with provincial and municipal property taxes. These findings seem readily applicable to the rest of Latin America too.

[4] See, for example, Martin (1997).

TABLE 1

Latin America and the Caribbean: Value added tax (VAT) rates

	1994	2000	2005
Argentina	18	21	21
Bolivia	14.92	14.92	13
Brazil	20.48	20.48	20.48
Chile	18	18	19
Colombia	14	15	16
Costa Rica	8	13	13
Ecuador	10	12	12
El Salvador	10	13	13
Guatemala	7	10	12
Haiti	10	10	10
Honduras	7	12	12
Mexico	10	15	15
Nicaragua	10	15	15
Panama	5	5	5
Paraguay	10	10	10
Peru	18	18	19
Dominican Republic	6	8	16
Uruguay	22	23	23
Venezuela (Bol. Rep. of)	10	15.5	15
Average for Latin America and the Caribbean	11.7	14.2	14.7
Standard deviation for Latin America and the Caribbean	5.1	4.6	4.4

Source: ECLAC, on the basis of official information from each country.

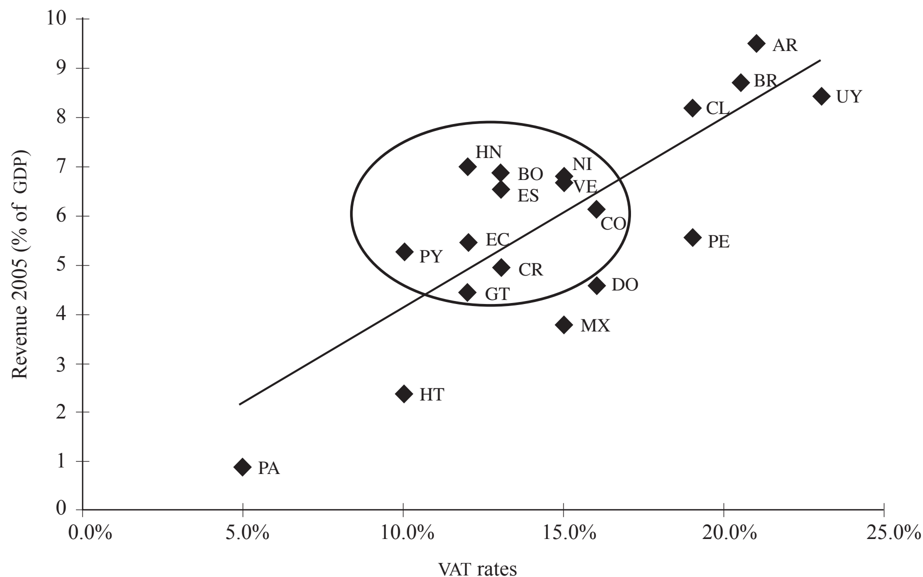
exemptions. In a context where it is becoming ever more difficult to introduce new taxes or higher tax rates, the removal of exemptions and the limitation of tax deductions are emerging as significant sources of future fiscal revenue.

The term “tax expenditure” is widely used to refer to tax exemptions, remissions, credits, deductions, deferments and certain reimbursements. Broadly, tax expenditure can be understood as that portion of tax revenue which is forgone owing to the application of exemptions or special tax regimes whose purpose is to favour or stimulate particular sectors, activities, regions or agents in the economy.

More and more countries in Latin America and the Caribbean are supplying information on tax expenditure. The amounts are very significant in all cases, with the 2003 figures showing a low of 1.6% of GDP in Brazil and a high of 9.2% in Colombia. Of the taxes giving rise to tax expenditure, VAT predominated in Argentina, Ecuador and Peru and income tax in Chile. Concerning the destination of this spending, in Argentina 80% of tax expenditure (2.8% of GDP) went on forms of special treatment provided for in the relevant tax laws and the remainder on benefits provided under the different economic, regional and sectoral promotion regimes. In Chile, tax expenditure (4.4% of GDP) took place mainly in the financial sector (61.3%), the property sector (12.6%) and education (7.4%).

FIGURE 4

Latin America and the Caribbean: Productivity of value added tax (VAT), 2005



Source: ECLAC, on the basis of official figures from each country.

In the 1990s, better economic growth rates led to a recovery in the tax burden. In most cases, the elasticity of tax revenue is higher than one. In the upswings of the cycle, this is because growth expands the formal economy and generates a disproportionate increase in imports and the taxes associated with them. Conversely, in recessive phases the tax take also falls disproportionately because the above mechanisms are reversed and also because evasion increases substantially. The relationship between inflation and tax revenues is also a powerful one. First, because inflation reduces the real value of tax revenues owing to the time lag between the time taxes are generated and the time they are collected. Second, because inflation reduces real incomes, which means families and businesses will try to maintain their real disposable income by paying less tax. Thus, macroeconomic stability, meaning a combination of high growth and low inflation, is the principal requirement for higher tax revenues. When the environment is recessive and inflation on the rise, any tax system will be hard pressed to prevent revenues from declining.

Meanwhile, tax policy implementation requires an institutional framework and specific arrangements appropriate to the functions and objectives being pursued. In particular, the collection of revenue from internal taxes, customs duties and social security contributions requires an administrative mechanism that meets certain minimum conditions of institutional status and internal organization if it is to be able to work properly. The tax administration, therefore, needs to guard against the institutional weaknesses that commonly affect public agencies of various types. In recent years, indeed, recognition of this fact has resulted in the adoption of administrative reforms to raise the institutional status of tax administrations and place them under the leadership of high-ranking officials. Great progress has also been made in strengthening the institutional basis of tax administrations by creating legal structures that provide them with varying degrees of functional, administrative, technical and financial independence.

In any event, the countries of Latin America and the Caribbean still have a long way to go in terms of the efficiency and effectiveness of their tax administrations, especially when compared to more developed countries. The fact is that, although tax administrations in the region operate with fewer budgetary and human resources, their collection costs are higher than those of their counterparts in more developed countries.

This rapid review of the public revenue situation does provide some answers to the first question. Yes, it is possible to detect scope for increasing tax revenues, especially in the current environment of strong economic growth. Rates are comparatively low in some countries, especially for VAT and specific taxes. There are also exemptions that can be reviewed.

In this analysis, two peculiarities of the region's tax systems are of particular importance. The first is the VAT treatment of food. Exemptions for this reduce the tax take by up to two points in some countries, as they do not discriminate between a basket of staples and other foods. It has been argued that replacing these measures with targeted spending policies would be beneficial in net terms. However, it remains to be shown whether, in terms of redistribution, such policies are better than direct exemptions for a basket of staple foodstuffs, in countries where this basket represents a significant proportion of family consumption for many people. The second peculiarity is the growing importance of tax incentives in free trade zones, especially those granted to maquila companies in the countries of Central America.[5] Although their positive impact on employment is undeniable, consolidation of this production regime goes against the principle of horizontal tax equity and, when these activities have few backward linkages, reduces the income-elasticity of tax systems.

In addition to these restrictions, there is the impact of free trade agreements and regional integration on tax revenues. The consequent reduction of taxes on external trade can exceed one point of GDP in some cases. Just replacing these taxes may involve complex political battles, leaving little room for net increases in tax revenue.

Lastly, it is possible to affirm that the institutional strength of tax administrations has now increased to a point where, in the short term, any further gains yield decreasing returns in terms of tax collection. The fact is that high levels of evasion and avoidance are closely related to the degree of informality in the region's economies, which in turn is strongly correlated with growth and income levels. Reducing evasion is therefore a structural task inherent in the development process, and not just a matter of administration or short-term management improvements. Relying on a rapid decrease in evasion as a mechanism for financing social policies, or on economic growth alone, would have very risky implications for the stability of the public finances.

[5] See Agosin, Barreix and Machado (2005) for an extensive analysis of tax systems in these countries.

II

Public spending and social protection

Expanded coverage for social protection programmes will not be achieved solely through better tax collection. If the aim is to redirect resources to the social area, then a hard but urgent task is to improve the productivity and quality of public spending.

1. The public spending dynamic

Public spending as a percentage of GDP is commonly used as an indicator to measure the State's share of the economy, although it does not take account of the regulatory activity conducted by governments. As figure 5 shows, the "incrementalism" that characterized the budgetary process in the OECD countries and laid the basis for the welfare State has been progressively replaced by a "decrementalism" characterized by the setting of macrofiscal rules and multi-year targets for deficit reduction and public spending restraint. Public spending also has a clearly countercyclical character, so that spending constraints in periods of expansion alternate with a larger role for the State when the level of activity slows.

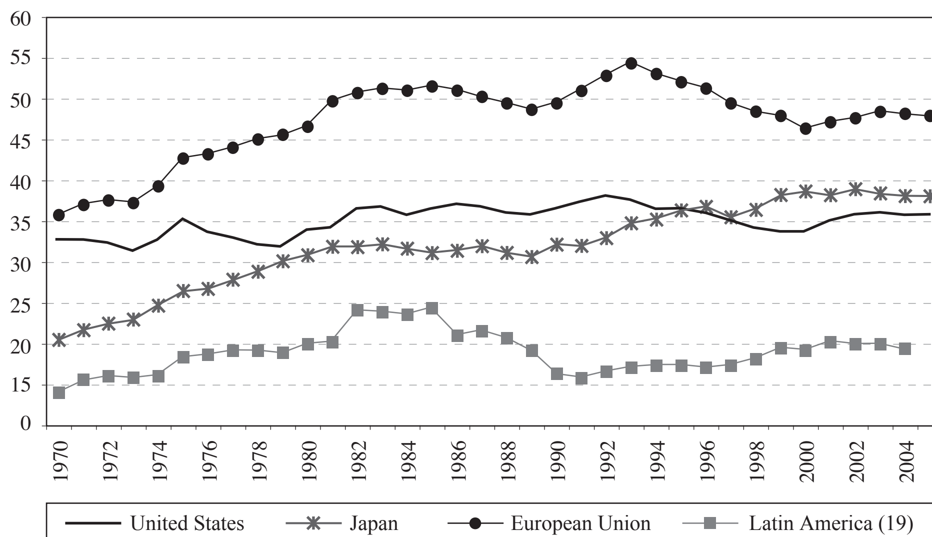
In Europe, the large rise in public spending in the 1970s was basically due to the establishment of the welfare State, which more recently has taken the form of monetary transfers including pensions, unemployment benefits, education and health care. Transfers increased by 5.7 points of GDP on average in the 1970-2004 period, and have stabilized at around 18 points of GDP. In the aggregate, the composition of public spending has shifted from the categories of general services (including interest payments) and economic affairs towards health and social protection. The data do not show any major reduction in the size of the welfare State in recent years.

Although the level of spending is much lower in the United States, it has followed a path very much like the one described, with a stage of growth during the 1980s and one of reduction during the 1990s. Over the coming decades, however, public spending on health and pensions is expected to grow strongly (by some 10 points of GDP) as a result of population aging. Again, the size of the State in Japan has grown strongly to reach over 35 points of GDP.

FIGURE 5

International comparisons: Public spending, 1970-2004

(Percentages of GDP)



Source: OECD (2004) for OECD countries (general government); International Monetary Fund (IMF) and ECLAC for Latin America (central government).

To obtain a fuller picture of the changing size of the State in Latin America and the Caribbean, measured by public spending as a proportion of GDP, it is worth examining other definitions of government (table 2), particularly general government and the non-financial public sector. The first concept (general government) is particularly important in certain federally organized countries, such as Argentina and Brazil, where a substantial part of public spending takes place at the provincial and state level, respectively. The concept of the non-financial public sector, meanwhile, is a more useful one when it comes to grasping the variety of organizational and financial structures that emerged from the structural reforms of the 1990s.

To take a simple average, public spending as a proportion of GDP was 19.5% in 2005, having increased by almost four percentage points of GDP between 1990 and 2003 for the central government category (19 countries); between 2003 and 2005, public spending fell by 0.8 percentage points of GDP. For the general government category (nine countries), public spending was 24.2% of GDP in 2005 and grew by almost two percentage points of GDP in the 1990-2003 period. As regards the non-financial public sector category (14 countries), public spending was 28.5% of GDP in 2005 and rose by 2.4 percentage points of GDP in the 1990-2005 period. The largest drops were in Chile, Mexico and Peru, for the definitions of government available.

In one group of countries (Bolivia, Colombia, Ecuador, Paraguay), there was a significant increase in public spending at the central government level between 1990 and 2005. This dynamic could be characterized as upward convergence, since in 1990 public spending as a proportion of GDP was well below the regional average. In general, the causes of this expansion in public spending as a proportion of GDP are to be sought in a movement towards decentralization and increases in social security benefits and coverage. In some cases, decentralization has increased the weight of central government (Colombia) because the financing of subnational bodies has depended heavily on transfers, or has led to significant growth in general

TABLE 2

Latin America and the Caribbean: Change in the size of the State, by definition of government, 1990-2005
(Percentages of GDP)

	Public spending, 2005			Change from 1990 (points of GDP)		
	Central government	General government	Non-financial public sector	Central government	General government	Non-financial public sector
Argentina	16.6	24.7	25.2	4.8	-1.6	2.7
Bolivia	29.0	28.9	30.0	11.5	6.5	-5.1
Brazil	24.6			5.9		
Chile	19.8	21.8	33.9	-1.8	-1.3	-3.1
Colombia	21.0		35.2	11.7		14.6
Costa Rica	15.9	23.4	25.5	1.0	1.8	2.7
Ecuador	17.2		24.5	2.8		-1.9
El Salvador	14.6		17.5	1.0	1.6	1.5
Guatemala	11.7			1.4	3.8	
Haiti	11.5			-0.1		
Honduras	23.0		34.1	0.2		8.3
Mexico	19.7		23.3	-0.9		-4.2
Nicaragua	23.0	27.3	30.3	1.5	4.9	6.8
Panama	19.0		24.8	1.0		1.0
Paraguay	17.5		33.3	7.4		12.0
Peru	16.7	19.2		-2.4	-1.7	
Dominican Republic	19.3			6.8		
Uruguay	23.2		29.6	7.2		1.3
Venezuela (Bol. Rep. of)	26.9		32.2	1.1		-3.6
Latin America and the Caribbean	19.5	24.2	28.5	3.2	1.8	2.4

Source: ECLAC, on the basis of official data.

government, as in Costa Rica and Nicaragua. Where the non-financial public sector is concerned, Colombia recorded an increase of 18 percentage points of GDP in the 1990-2003 period and Paraguay one of 12 percentage points up to 2005. The non-financial public sector shrank in five of the 14 countries for which information is available.

2. The quality of public spending

Of course, the productive effects of public spending do not so much depend on the amount of resources used as on the impact achieved. In recent years, emphasis has been placed on poverty reduction as a priority goal. International agencies have made tremendous efforts to promote "pro-poor" budgets. The Heavily Indebted Poor Countries (HIPC) Debt Initiative was a unique opportunity in this respect, as it meant that the interest savings resulting from the reduction of external debt could be channelled into social spending instead. There is growing concern, however, about this excessive reliance on social spending to reduce poverty.

Most programmes focus on the composition of public spending, especially in social areas, placing less emphasis on other aspects of a broader strategy to stimulate growth with poverty reduction. Although these experiences mainly involve lower-income countries, the conclusions from them hold good for the great majority of the countries in the region: it is not such a small matter to associate the composition of public spending with poverty reduction, income distribution and economic growth.

The analysis becomes more complex when this last goal is included. The member States of the European Union, for example, agreed as part of the Lisbon strategy to *strengthen the contribution of the public finances to growth by redirecting public expenditures towards physical, human and knowledge capital*; in the case of the European Union, spending on research and development, education and infrastructure investment is more productive than other types of spending (European Commission, 2004). In any event, these brief notes show how hard it is to set priorities, even when explicit poverty reduction targets are set. It is enough to glance at the functional classification of public spending (table 3) to realize how enormously difficult it is to rank spending priorities without considering the specific characteristics of each country and situation. Although it is clearly important to allocate resources to the different social protection categories, it seems very hard to do this at the expense of other categories that are no less crucial to economic and social development.

TABLE 3

Functional classification of public spending

General classifiers	Social protection
1. General public services	1. Sickness and incapacity
2. Defence	2. Third age
3. Public order and security	3. Survivors
4. Economic affairs	4. Families and children
5. Environmental protection	5. Unemployment
6. Housing and community services	6. Social housing
7. Health	7. Social exclusion
8. Recreation, culture and religion	8. Others
9. Education	
10. Social protection	

Source: United Nations.

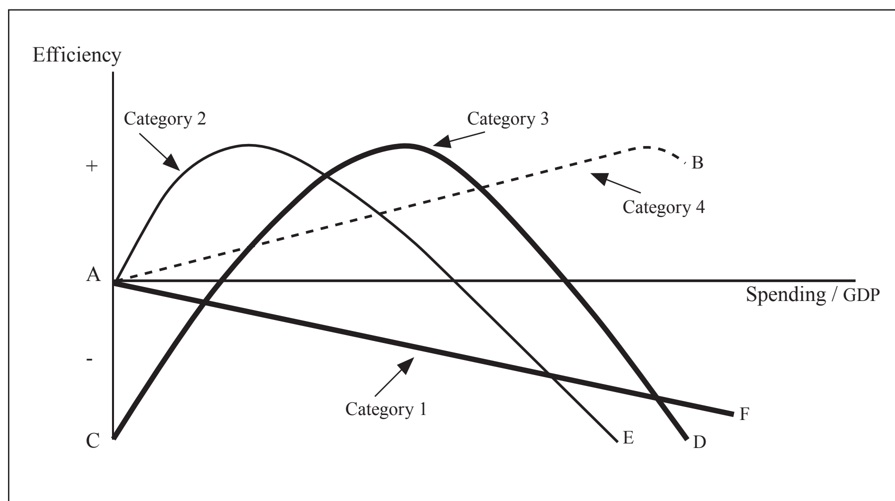
When considering the quality of public spending in macroeconomic terms, it is possible to distinguish four categories, which combine the functional and economic classifications. Expenditures are defined as "efficient" when they have positive effects on economic growth and employment. The empirical evidence delivers a mixed message: the effects of public spending vary depending on its composition, are positive within moderate ranges, and can rapidly turn negative if certain limits are exceeded.[6]

This non-linear relationship between public spending and growth varies by the type of expenditure, giving rise to the four categories referred to (figure 6). Category 1 is interest payments, represented in the chart by line AF; this spending has a negative effect on growth and employment, since any increase in it forces other public spending down. Category 2 includes spending such as public consumption and pensions, including survivors' pensions, represented by line AE. Studies generally argue that while such spending is efficient up to a point, increasing it can have negative effects on saving, investment and growth. Category 3, represented by line CD, illustrates the effects of expenditure such as unemployment insurance, or spending on social exclusion. Keeping spending below a certain level reduces macroeconomic efficiency, making it harder for the excluded to enter the labour market and holding down their participation rates.

[6] See European Commission (2002) for a detailed analysis of this typology.

FIGURE 6

Quality and efficiency of public spending



Source: European Commission (2002).

Furthermore, a certain level of unemployment transfers helps make the labour market more flexible and tends to reduce excessive labour protection. The relationship is not linear, however; a point comes where spending of this type starts to have a negative impact on growth. Category 4 includes education, health care, research and development, and gross fixed capital formation, represented by line AB. This spending is positive for growth and has a much higher expenditure limit than the other categories, although a turning point is eventually reached here as well.

Like any typology, this breakdown is rather arbitrary and has numerous limitations. It is useful for three purposes, however. The first is to emphasize the non-linear character of the macroeconomic effects of public spending. Thus, it would be as wrong to reject growth in such spending for reasons of efficiency as it would be to rely on it as the sole engine of development. It is clear that, for the vast majority of countries in the region, the slope of categories 2 and 3 is positive; public spending is below its optimum level. This does not mean, of course, that its productivity might not be improved.

The second purpose served by the typology is to provide a more illustrative differentiation than the economic and functional classifications. Just distinguishing between current and capital expenditure, important though this is, is not enough when it comes to attaining social and economic policy goals. Regarding the functional classification, the tendency to prioritize social spending can also be a limitation when, as analysed earlier, it is recognized that growth and job creation play an important role in poverty reduction.

The third purpose of this classification is to provide the basis of a medium-term sequence for improving the quality of public spending, primarily by reducing the burden of interest payments, which in some cases are as much as 50% of the approved budget. When these levels are reached, the priority is to return public debt to a sustainable path, both by generating primary surpluses and by working to improve internal and external financing conditions (ECLAC, 2004a). In the last five years, fortunately, the share of resources going to the social sectors has increased in relation to both total public spending and GDP. Indeed, ECLAC (2004a) notes that public social spending has been reoriented towards human capital investment (education and health), which has more pronounced redistribution and growth effects than other categories. Lastly, as ECLAC (2004c) pointed out recently, there is an urgent need to stimulate spending on infrastructure and on research and development, given the alarming decline in such expenditure during the recent cutbacks.

To summarize, it can be said that the task of improving the quality of public spending in Latin America and the Caribbean must involve sustained investment in physical, human and knowledge capital. Although progress has been made recently, major

challenges still remain: continuing the effort to reduce the interest burden and thus free up resources, maintaining human capital investment, and accelerating spending on fixed and knowledge investment.

In a context of severe institutional rigidities, reorienting public spending is no easy matter. Use of a medium-term public spending framework can facilitate the necessary reallocations between categories (Shick, 2002). In the OECD countries, indeed, this instrument has been used to prioritize targets for investing in education and raising overall productivity (Blondal, 2005). A multi-year framework is a financial planning instrument whereby annual budgetary decisions are taken in a context of global or sectoral spending constraints over periods of from three to five years.

The key to success in implementing a multi-year framework is that the institutional mechanisms used should allow decision-makers to balance the aggregate resources available with the country's priorities. This balance is struck using a top-down sectoral/ministerial resource allocation approach. Properly used, this instrument should overcome budgetary inertia and change the prevailing mindset from a sectoral "needs" approach to an "available budget" approach.

The instrument described can be useful for reducing budgetary rigidity insofar as it allows sectoral shifts to take place over time, with fewer particular pressures and upheavals. Although it is early days to rate these experiences, they are clearly a necessary but not sufficient condition for proper supervision and reallocation of public spending, as they have to be accompanied by macrofiscal rules that confer a reasonable degree of certainty upon medium-term projections and avoid procyclical bias in public spending.

3. The procyclical nature of public spending

Ideally, public spending ought to be "acyclical" (i.e., more or less neutral in respect of macroeconomic cycles) or countercyclical, with specific policies to pay down public debt at times of plenty, the better to cope with periods of scarcity. Spending decisions should follow an intertemporal approach, with programmes and projects financed over a multi-year goal horizon.

Unfortunately, this rather technocratic approach is by no means the one applied, owing to the extreme vulnerability of the region's public finances to changes in the macroeconomic environment. If interest rates rise or public revenues fall, the authorities are obliged to restrain primary expenditure growth, with capital spending usually suffering more than current spending. During the six years from 1998 to 2003, in fact, cumulative GDP growth in Latin America and the Caribbean was 6%, while public investment by central government experienced a cumulative 14% decline (Martner and Tromben, 2005).

There is ample empirical evidence to show that fiscal policies in the region have been procyclical in the recent past.[7] Thus, it is vitally important to bring in countercyclical fiscal rules to set public spending on a stable path. There is a crucial need to take advantage of the current phase of growth to establish or strengthen mechanisms that can give public spending consistency over time. The fiscal responsibility laws of the early 2000s have served to moderate the dynamic of rising public debt in some countries.

In only a few instances, however, has the explicit objective of macroeconomic rules been countercyclical. Funds designed to stabilize revenues from tax (Argentina, Peru) or raw materials (Chile, the Bolivarian Republic of Venezuela, Ecuador, Mexico) are indeed explicit countercyclical policies, but their mere existence is not a sufficient guarantee. Meanwhile, legally mandated limits on public spending growth (3.5% a year in real terms in Ecuador and Peru, for instance) actually tend to drive spending down over time as a proportion of GDP if trend growth in the economies concerned is higher, and thus cannot be described as neutral over time.

Chile is an exception. The 1% structural surplus rule means that, in practice, public spending growth is pegged to trend GDP and also to the long-term copper price, which is a key variable in determining structural revenues (Dirección de Presupuestos de Chile, 2005), irrespective of short-term fluctuations in actual GDP and thus revenues. In theory, this ensure a stable and neutral spending path, reducing the likelihood of sharp adjustments and conferring a degree of certainty in practice on the multi-year implementation of public projects and programmes. This experience shows that policies not involving preallocation of spending are not necessarily detrimental to social expenditure in the long term.

4. Priority for social spending?

The vulnerability of social spending is also disturbing. While the procyclical bias of primary spending as a whole has already been mentioned, there is

[7] See Martner and Tromben (2003) for a recent analysis.

even stronger cause for concern when it comes to social spending. Since this is priority expenditure, it is important for its hard core to be given explicit protection if cutbacks are unavoidable.

Column A of table 4 gives estimates for the GDP-elasticity of social spending. The results are striking: as a simple average, the elasticity of social spending is 1.87, indicating that it is procyclical to a high degree. This characteristic is not common to all the countries, however. The value seems to depend on the starting point; elasticity is greater in countries where social spending was lower in the early 1990s (Bolivia, Colombia, Guatemala, Mexico, Paraguay, Peru), in a context of rising expenditure across the board. This could also explain the lower elasticities of Argentina, Brazil and Chile, countries that had higher social spending to begin with.

One thing that is crucial is to differentiate these elasticities from those of spending generally. Column B of table 4 shows the GDP-elasticity of total public spending, and column A/B calculates the ratio between the two elasticities. The countries whose total public spending has been most sensitive to GDP fluctuations are Bolivia, Colombia, the Dominican Republic, El Salvador, Mexico, Paraguay and Uruguay. Conversely, this elasticity is close to or less than one in Argentina, Brazil, Chile, Guatemala, Honduras and Peru. In these countries, public spending has fluctuated much in line with economic growth.

The third column compares the elasticities estimated. A value higher than one for this indicator shows that social spending has been more procyclical than other spending.[8] This is what is obtained for all the countries except El Salvador, although the indicator is significant in only a few cases (Bolivia, Brazil, Guatemala, Honduras, Peru). In these countries, social spending has increased by substantially more than aggregate spending at times of expansion and has fallen by substantially more than aggregate spending during phases of recession.

[8] Strictly speaking, this form of calculation does not actually indicate procyclicality, since the comparison should be made with the GDP gap and not with actual GDP. The results would probably not differ much.

TABLE 4

Latin America and the Caribbean (14 countries): Elasticity of social spending in relation to gross domestic product[a]

	Elasticity of social spending (A)	Elasticity of total spending (B)	Ratio (A/B)	Number of observations
Argentina	0.91	0.82	1.11	15
Bolivia	2.95	1.90	1.55[b]	15
Brazil	1.56	1.16	1.34[b]	15
Chile	0.93	0.73	1.27	25
Colombia	2.12	2.02	1.05	22
El Salvador	1.57	1.99	0.79	9
Guatemala	1.84	0.99	1.86[b]	25
Honduras	1.56	0.97	1.61[b]	21
Mexico	1.78	1.58	1.13	15
Paraguay	3.31	3.17	1.05	25
Peru	2.41	1.02	2.36[b]	15
Dominican Republic	1.60	1.46	1.10	25
Uruguay	1.82	1.64	1.11	15
Venezuela (Bol. Rep. of)	-	-	-	25
Latin America and the Caribbean	1.87	1.50	1.38	

Source: Aldunate and Martner (2006), on the basis of social spending data from the ECLAC Social Development Division.

[a] The estimates were produced using the following equation: $Log\ S_i = \alpha\ Log\ S_{i-1} + \beta\ Log\ GDP_i + \gamma$, where S is total spending or social spending and GDP is the gross domestic product of each country i, both variables measured in constant terms. Long-term elasticities $\beta/(1-\alpha)$ are shown.

[b] Cases in which both elasticities are significantly different from 5%.

The question, then, is whether social spending should be given priority in the public budget. In many countries, the answer has been yes. A first option is to raise this priority to the very highest level. In Colombia, for example, article 350 of the 1990 Constitution provides that "public social spending will take priority over any other allocation". Furthermore, another article provides that social spending must increase from year to year. The final clause of the first section of the definition laid down by Law 179 of 1994 includes not only specific activities but also "(…) those tending to the general welfare and a higher quality of life for the population". The problem is that by laying down such an unrestricted principle, the article accommodates all categories that can be characterized as tending to the general welfare and a higher quality of life for the population.

A second option is to "earmark" some social spending, which involves preallocating a certain amount of resources from the public budget. In many countries of Latin America there are, for example, constitutionally mandated lower limits on health or education spending, generally expressed as a percentage of GDP. For all the good intentions of legislators, mechanisms of this type do not remove the procyclical bias of public spending, since they allow social spending to fall if the same thing happens to GDP. In too many cases, furthermore, these limits are not respected because the resources are simply not available and the budgets passed are not implemented. Earmarking public spending does not solve the problem, because it does not go to its root: the chronic inadequacy of public resources at times of crisis.

A third option is to "shield" some public social spending, which is salutary because it assumes that the authorities are capable of setting and applying resource allocation priorities despite the many pressures that arise in this process. A number of recent experiences show that it is possible to identify a hard core of social spending which, incidentally, contributes to governance throughout the system. There are still classification problems to complicate the task, however.

Naturally, each situation merits a different response. It does seem clear, though, that medium-term strategies need to aim at the development of explicit mechanisms for the protection of public spending generally so that it becomes possible to meet the tremendous needs arising in periods of recession, which unfortunately are more frequent than might be wished.

III

Evaluating social policies and programmes

1. The need for evaluation

In the previous section, it was pointed out that the effects of public spending did not depend so much on the amount of resources employed as on the impact achieved. This is a key factor to be borne in mind when designing social security and protection policies, programmes and projects. There is no point in increasing investment and spending in social sectors if the benefits generated for the country with these resources are lower than the costs.

If a country channels more resources into social security and protection, these must necessarily be diverted from other uses, whether in the public or the private sector. When resources come from reallocations within the public budget, it will have been necessary to cut allocations to some agencies to increase the budget of others, implying a quantitative or qualitative drop in the provision of certain public services. For example, if an increase in the budget allocated to the Ministry of Health is funded by reducing the budget of the Ministry of Mines, the latter might have to reduce support for small-scale mining or for exploration, with all the resultant costs for the country in terms of lower production in the present or future, less employment and greater poverty.

If resources come from higher tax rates or lower tax avoidance, on the other hand, then they will have been diverted from alternative uses in the private sector. If these resources would otherwise have gone into productive activities, forgoing these will entail an opportunity cost to the country equal to the value set by society on the goods or services that could have been produced. If the additional resources collected were going to be used for private consumption, there will also be a cost in the form of lower consumer satisfaction and lower aggregate demand for goods and services. There is room for debate about the costs

and benefits of such cutbacks in consumption, but it is important to recognize that lower consumption will almost always have a cost for society.

The cost is even starker if the additional resources come from borrowing, as there will be interest and commissions to pay. Furthermore, higher borrowing by the country will increase lending rates in general, affecting the productive sector. Fewer projects will be started, and the contribution made by new productive jobs to poverty reduction will consequently be less.

It is clear, then, that irrespective of the origin of the resources used to increase investment and spending on social security and protection, there will be a cost for society. Accordingly, the benefits generated by programmes and projects will have to be at least equivalent to the costs incurred if the country and its inhabitants are not to end up poorer than before.

This explains the concern discussed earlier about the possible constraints arising from the tendency to prioritize social spending, once the important poverty reduction role played by growth and job creation is recognized. Draining resources from activities that generate productive jobs will only be justified if the benefits created by allocating them to social security and protection programmes or projects are greater than those that would have accrued from the productive activities forgone.

Another concern is how resources should be allocated to maximize their impact. As was pointed out in the previous section, the effects of public spending vary according to its composition, are positive within moderate ranges, and can turn negative if certain limits are exceeded. There is a need, then, to work out how far spending can usefully be raised in each of the sectors associated with social security and protection, so that resources are allocated only up to the point where higher spending leads to lower efficiency. In situations of limited resources, furthermore, intersectoral allocation should aim to stop short of the zone in which efficiency is still positive but declining.

To avoid overallocating resources to a particular sector, it is necessary to know what effect marginal programmes and projects will have on key development indicators such as life expectancy, the educational level of the population, sickness rates and per capita income (and its distribution). Estimating these effects is not easy, and it is harder still to know when diminishing or negative efficiency levels have been reached.

Lastly, a third concern is to be able to identify, in any given sector, the programmes or projects that are most efficient in terms of achieving the maximum impact with limited resources. Needs usually far exceed the potential for satisfying them, and large sections of the population are left with unmet basic needs (in health care, education, housing and so on). In these circumstances, it is important to be able to prioritize the programmes and projects proposed, so that those with the best cost-benefit ratios can be implemented first. This will ensure the greatest impact for the limited resources available.

Evaluation is the tool available for attempting a response to concerns about the amount of resources to be spent on social security and protection, their allocation between sectors, and the projects and programmes to be undertaken. Policies, programmes or projects are evaluated in an effort to assess their value, meaning the difference between the total benefits and total costs of the initiative. And here, a question immediately arises: their value for whom?

Depending on the answer, there are two types of evaluation: private and social. Private evaluation seeks to ascertain the value of the project or programme for a person, a company or an institution. Social evaluation, on the other hand, seeks to determine the value of the initiative for the country, i.e., for society as a whole.

To determine the value of an initiative it is necessary to identify, quantify and value all the "relevant" costs and benefits associated with it over its life cycle. By relevant costs we mean those that are incurred if the programme or project is executed, but that would not have to be incurred if it were not. Similarly, relevant benefits will be those that can only be obtained by executing the programme or project.

It is also necessary to distinguish between *ex ante*, mid-term, final and *ex post* evaluations. The purpose of *ex ante* evaluation is to determine whether or not it is advisable to undertake the initiative. Mid-term evaluation is to find out whether the initiative is worth continuing with and, if so, in what respects it can be improved. Final evaluation is to provide information about the fulfilment of objectives and to benefit from lessons learned during execution. Lastly, learning is the main purpose of *ex post* evaluation, which covers everything that happened with the initiative from its conception to the evaluation date.

The multiplicity of evaluation approaches and techniques, the existence of different types of evaluation, the differences that arise when initiatives in different sectors are evaluated and the difficulties inherent in any evaluation all make the task of ascertaining and comparing the value of different government initiatives a complex one. It is therefore indispensable to have

qualified staff and methodologies to facilitate and standardize the work of the assessors. Furthermore, given the number and diversity of initiatives proposed or being implemented in any budgetary period, the work of evaluating all programmes and projects takes resources and a good level of organization. National systems of public investment, which now exist or are being developed in almost all the region's countries, are a reflection of this. These are described and analysed in the following section.

2. Evaluation in the social sectors

The theory and practice of private and social project evaluation were originally developed to ascertain the value of industrial or agricultural-type projects. Consequently, there is a large body of experience and literature dealing with the evaluation of projects such as power stations, industries and irrigation systems. Transport is another field in which evaluation has long been widely applied.

Evaluation has a long track record in the health sector, but with the focus on the effectiveness of different types of treatments or drugs. Only recently has the economic variable been incorporated into the analysis. In the education sector, too, there is a century and more of experience with the evaluation of learning outcomes, but the evaluation of programmes or projects from a socio-economic perspective is also a recent development. In both health and education, this is due to the great difficulty of setting a monetary value on the benefits that programmes and projects generate.

In other sectors, such as justice and citizen security, there is very little evaluation experience and socio-economic evaluation criteria are hardly ever applied. On the whole, the sectors concerned with social assistance and protection are very badly served when it comes to evaluation methodologies and capabilities. This puts them at a disadvantage when they have to defend budgetary allocations, since it is hard for them to demonstrate what benefits will be generated from the resources allocated to them.

Among the factors accounting for this slowness to adopt evaluation as a decision-making instrument in the social sectors are a lack of trained personnel, the absence of specific methodologies and, to some degree, the lower priority traditionally given to these sectors.

Evaluating social assistance and protection initiatives in socio-economic terms is not straightforward. The costs of programmes or projects can almost always be determined fairly accurately. Most of the benefits are very difficult to value in monetary terms, however. A variety of methodological approaches have been adopted to get around this difficulty.

The most common and straightforward is to accept how difficult it is to set a monetary value on the benefits generated by social programmes or projects and seek lowest-cost solutions. The problem with this approach is that it is only useful for choosing between alternatives that generate identical benefits and does not provide any indication as to whether the value of the initiative is positive, since only the costs are known. The benefits can be identified and perhaps quantified, but they are not valued, so to assume that their value exceeds the costs requires an act of faith.

Another methodological alternative, known as cost-effectiveness, seeks to determine the cost of producing a certain impact on some relevant variable. In other words, the aim is to calculate a cost per unit of benefit, such as cost per health-care service provided, or cost for each percentage point reduction in the incidence of a certain disease.

The above two approaches are the ones most widely used in the region's countries. Bolivia, Chile and Peru, for example, all regularly apply methodologies based upon them.

Yet another methodological alternative is contingent valuation. This method aims to ascertain people's willingness to pay for the benefits generated by the programme or project concerned by conducting surveys among a sample of potential beneficiaries. This methodology has been used mainly in research work, owing to the cost of executing surveys and the difficulty of designing them in a way that avoids bias in the opinions expressed.

One problem with applying this methodological approach in the social assistance and protection field is that the willingness of poor people to pay for certain services may be very low. For example, a family that barely manages to subsist on the combined income of all its members is unlikely to be willing to pay for education. Consequently, if the value set on a good or service by a group of poor beneficiaries is determined, it is very likely to be low. Then, if the benefits of the project are assessed by the value set upon them by the poor beneficiary group, the conclusion is very likely to be that it is unprofitable for the country.

This goes against the general perception that projects providing social assistance and protection to very disadvantaged sections of the population are highly beneficial to a country. The apparent contradiction was

addressed by professor Arnold Harberger, who proposed the basic needs approach as a way of understanding it. The reasoning behind this approach is that there is a positive externality for society when poor groups are able to consume goods or services deemed essential for a decent life. In other words, certain groups in society are willing to pay for a programme or project, without themselves being beneficiaries of it, so that this can provide essential goods or services to the most vulnerable groups. This approach, then, recognizes and seeks to set a monetary value on the altruism which many people share.

Unfortunately, this methodological approach is also difficult to apply in practice owing to lack of information. The willingness of the poor to pay for basic goods or services is not known, much less the value that non-poor population groups set on the consumption of the poor. The theoretical soundness of this method, however, and its great potential for application, mean that it is one whose use should be promoted in social assistance and protection sectors, with investment to create the necessary databases.

To increase the efficiency and effectiveness of social security and protection spending, it is vital for evaluation to be institutionalized as a key management instrument in these sectors. Most of the region's countries have recognized the importance of evaluation and created national systems of public investment. Almost invariably, however, evaluation activities are seen as just another formality that has to be complied with to obtain resource allocations. Valuation has not yet been positioned as an integral part of the public management process.

Within the public sectors of most of the countries, there is a need to re-engineer evaluation systems and procedures so that evaluation is positioned as part of a process of learning and continuously improving efficiency and effectiveness. Evaluation needs to be one of the standard administrative and management procedures of public institutions. These should be evaluating their programmes and projects and their management because they really believe that they will achieve better results and impacts in this way, and not just because funding bodies demand it.

(Original: Spanish)

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