

# Fiscal Panorama of Latin America and the Caribbean

2018

Public policy challenges  
in the framework of the  
2030 Agenda



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# Fiscal Panorama of Latin America and the Caribbean

2018

Public policy challenges  
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2030 Agenda



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## Explanatory notes

- Three dots (...) indicate that data are not available or are not separately reported.
- A dash (-) indicates that the amount is nil or negligible.
- A full stop (.) is used to indicate decimals.
- The term "dollars" refers to United States dollars, unless otherwise specified.
- A slash (/) between years (e.g. 2013/2014) indicates a 12-month period falling between the two years.
- Figures and percentages in tables may not necessarily add up to the corresponding totals due to rounding.

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## Foreword

This edition of *Fiscal Panorama of Latin America and the Caribbean* coincides with an important milestone: the thirtieth anniversary of the Regional Seminar on Fiscal Policy organized by the Economic Commission for Latin America and the Caribbean (ECLAC). Over the past 30 years, this seminar has become a key fixture on the agenda of fiscal policy events in the region.

Throughout these three decades, the successive editions of the seminar have served as a forum for national authorities, tax experts and officials from international organizations to discuss the performance, challenges and opportunities of fiscal policy; and it has enhanced policy design and management in the individual countries.

In 2017, the prevailing policy thrust in the region was towards fiscal consolidation, which has been reflected in an improvement in the primary balance, although some countries are still running large deficits. The improvement was most notable among South American countries, where the average primary deficit narrowed from 1.9% of GDP in 2016 to 1.5% in 2017. The northern part of Latin America—consisting of Central America, the Dominican Republic, Haiti and Mexico—attained a primary surplus of 0.1% of GDP, compared to a deficit of 0.2% in 2016. In the Caribbean, on the other hand, the primary surplus remained stable at 1.0% of GDP.

The stronger fiscal position and the upturn of economic activity also slowed the growth of public debt in the region. Latin America's gross public debt to GDP ratio stood at 38.4% in 2017, up by about 0.7 percentage points from 37.6% the previous year. In the Caribbean, central government public debt stood at 70.9% of GDP, down by 1.5 percentage points from its 2016 level (72.5% of GDP).

The region's fiscal consolidation was achieved by containing the growth of public spending and boosting tax revenues. In particular, in 2017 there was a widespread reduction in primary current expenditure throughout the region, from 15.5% of GDP in 2016 to 15.3% of GDP in 2017 in Latin America, and from 21.9% of GDP in 2016 to 21.4% in 2017 in the Caribbean. By contrast, interest payments rose slightly across the region, driven mainly by public borrowing trends.

There was also a worrying decline in capital expenditure in several countries, which resulted in these outlays shrinking in Latin America as a whole (from 3.7% of GDP in 2016 to 3.5% in 2017). The reduction in public investment in recent years will have effects beyond the short term and will further restrict the region's potential growth. This makes it all the more important to take steps to ring-fence investment spending and prevent it from being used as the main adjustment instrument.

In 2017 there were also signs of a revival of tax revenues, especially in South America, where the upturn in economic activity and the new tax measures adopted in 2016 boosted tax collection. Specifically, the real year-on-year variation in revenue obtained from the main taxes in South America turned positive from the third quarter of 2017 onwards, following more than four consecutive quarters of decline.

The trend in the region's public revenues in 2017 was partly supported by the stabilization of revenues from non-renewable natural resources. Revenues from the production and sale of hydrocarbons in the region are expected to stabilize around 3.3% of GDP on average, following substantial declines in 2015 and 2016. Mining revenues in the region also remain stable, albeit low, averaging around 0.4% of GDP.

In addition to analysing the region's current fiscal situation, this edition of *Fiscal Panorama* takes the opportunity offered by the thirtieth anniversary of the ECLAC Regional Seminar on Fiscal Policy to review the evolution of fiscal policy over the past three decades and the future challenges posed by the implementation of the 2030 Agenda for Sustainable Development. Undoubtedly, the Agenda's adoption at the United Nations summit for the adoption of the post-2015 development agenda has required a recasting of the role of fiscal policy in the region, especially in the light of the Sustainable Development Goals.

The issue of financing for sustainable development has taken centre stage and, among the alternative funding sources, the accent has been placed on the mobilization of domestic resources. Among other obstacles encountered, the level of funding is below potential in most countries, not only because of flaws in the design and administration of taxes, but more particularly due to high levels of tax evasion—both domestic and international—and the prevalence of voluminous tax expenditures. Personal income tax, in particular, continues to be the Achilles heel of the region's tax systems, generating revenue equivalent to just 1.8% of GDP in 2015 in Latin American countries, compared to 8.4% of GDP among member countries of the Organization for Economic Cooperation and Development (OECD).

These obstacles culminate in another major regional shortcoming: the weak redistributive capacity of the tax system, whose structures are dominated by regressive indirect taxes—in a region that remains the most unequal on the planet notwithstanding progress made in this regard during the past decade.

In the light of this evidence, broadening the tax base and improving the design of the tax system, strengthening tax administration and eliminating avenues for tax avoidance and evasion are key tasks for improving financing for sustainable development and inclusive growth in countries across the region.

At the same time, in view of the policies and public spending over the last three decades, and the current status of government action in Latin America and the Caribbean, a degree of dissatisfaction inevitably arises at two simultaneous phenomena: on the one hand, growing State presence in the economy and, on the other, its weakness or outright inadequacy in tackling the serious social and economic problems facing the region's countries. Difficulties in achieving acceptable levels of inclusion, equity and equality in the fulfilment of rights, and in improving the efficiency and effectiveness of public actions, continue to be widespread.

Nonetheless, and although situations vary widely, increasing attention has been paid to making government action more effective. The trajectory of public spending in the region's countries reflects several aims, including improving education and expanding the coverage of social protection, which means improving income distribution and consolidating more equitable public policies.

It is therefore necessary to devise medium-term strategies to pursue a path of progressive reforms that is neither unique nor immutable, but must be capable of adapting to the features of each policy in each place and time. This calls for discussion not only on the end point of the journey, but also on how systems will function during a necessarily lengthy transition period that will demand major redefinitions along the way. Moreover, modernizing and consolidating a dynamic, flexible and efficient State bureaucracy is a permanent challenge facing each and every public expenditure policy.

This edition of *Fiscal Panorama* also offers a regional perspective on the debate that has surrounded fiscal policy challenges since the 2008-2009 crisis. The new approach to the stabilization role of fiscal policy applied in developed countries has brought a breath of fresh air to the fiscal and macroeconomic policy debate. In this regard, Latin America and the Caribbean—a very heterogeneous region in terms of fiscal needs, capacities and spaces—needs to strengthen automatic stabilizers, examine ways to use public borrowing in context of globally low interest rates, and reformulate the role of public spending as a tool to bolster aggregate demand.

**Alicia Bárcena**  
Executive Secretary  
Economic Commission for  
Latin America and the Caribbean (ECLAC)



## CHAPTER

# The fiscal situation: evolution of public finances in Latin America and the Caribbean in 2017

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### Introduction

- A. The thrust of fiscal policy in the region is still towards consolidation, but regaining the fiscal space has been a slow process
- B. Fiscal consolidation and the upturn of economic activity offset the rise in public debt
- C. Fiscal consolidation efforts were evident in the containment of public spending growth
- D. Public spending adjustments also affected the region's socioeconomic targets
- E. Public revenue trends began supporting fiscal consolidation in 2017, especially in South America
- F. The countries maintained a high level of tax activism in 2017
- G. Subnational governments continued to adjust their accounts in response to the new economic context

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## Introduction

This chapter examines fiscal policy developments in Latin America and the Caribbean by analysing the main fiscal indicators and the main measures adopted in 2017. The stylized facts of this analysis are outlined below.

First, the region followed a trend of fiscal consolidation in 2017, as evidenced by improvements in the primary balance, although some countries still have large deficits. South America's situation improved, with the primary deficit falling on average from 1.9% of GDP in 2016 to 1.5% of GDP in 2017. In the north of Latin America—which for the purposes of this analysis includes the countries of Central America, the Dominican Republic, Haiti and Mexico—the primary balance improved from a deficit of 0.2% of GDP in 2016 to a surplus of 0.1% of GDP in 2017. By contrast, the countries of the Caribbean maintained a primary surplus of 1.0% of GDP.

Second, fiscal consolidation and the upturn of economic activity mitigated public debt growth in the region. In 2017, gross public debt in Latin America reached 38.4% of GDP, representing a rise of only 0.7 percentage points of GDP compared to 2016. The favourable differential between real interest rates and real economic growth was enough to offset the increase due to the primary deficit (which was smaller than in 2016). In contrast, central government public debt in the Caribbean reached 70.9% of GDP, a drop of 1.5 percentage points of GDP compared to 2016.

Third, fiscal consolidation was the result of public spending containment and a rebound in fiscal revenues. In 2017, the region witnessed an overall reduction in current primary spending across the board. Fiscal revenues showed signs of recovering, especially in South America, where tax receipts grew on the back of stronger economic activity and tax measures adopted in 2016.

Fourth, tax activism among the region's countries remained high during the year. Both Argentina and Ecuador adopted tax reforms in 2017, and other countries took new measures, such as taxes on energy consumption, international trade and corrective taxes.<sup>1</sup> The region also witnessed certain progress in the development of tax policies relating to the digital economy.

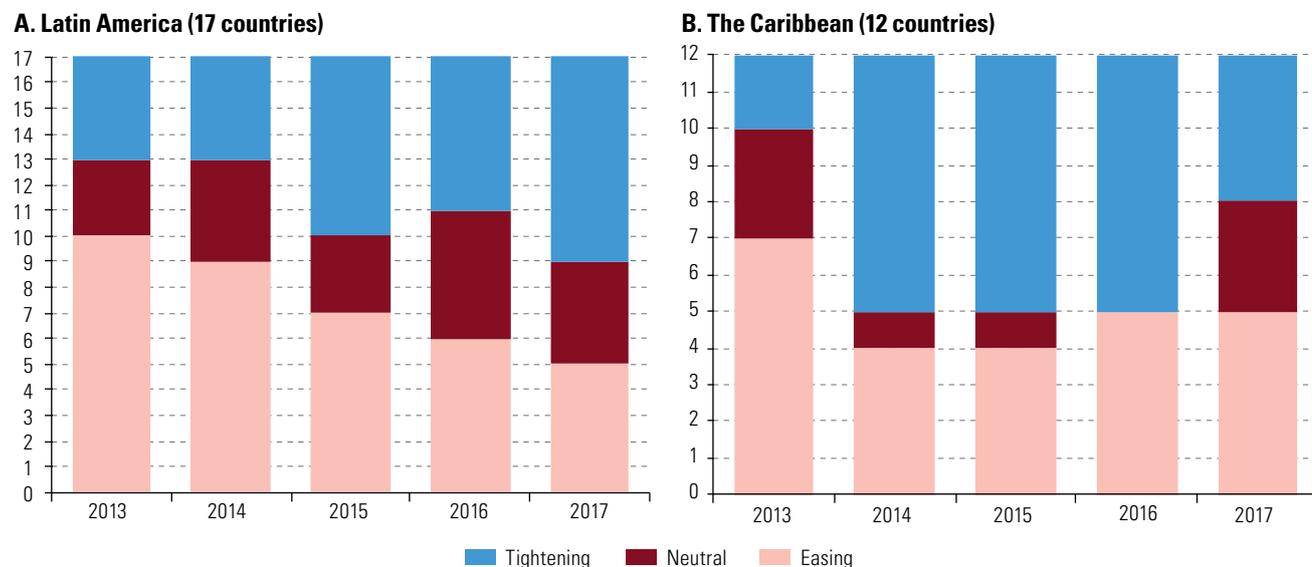
The following pages analyse the evolution of fiscal performance and public debt, as well as trends in public spending, fiscal revenues and subnational fiscal accounts.

### A. The thrust of fiscal policy in the region is still towards consolidation, but regaining fiscal space has been a slow process

As noted in the *Preliminary Overview of the Economies of Latin America and the Caribbean 2017*, fiscal consolidation remained the most salient feature of the region's fiscal policy in 2017. This was evident in the performance of fiscal indicators and in the direction of fiscal policy, as reflected in the annual budgets for the year. Policy guidelines during the year were based on measures aimed at containing public spending growth or increasing tax pressure, in order to regain the fiscal space or at least slow the erosion of the fiscal position. As a result, a growing number of countries in both subregions moved towards a more neutral or indeed a tighter fiscal stance (see figure I.1).

<sup>1</sup> Corrective taxes refer to those levied with the aim of reducing the consumption of certain products or services, such as alcohol, tobacco and gambling.

**Figure I.1**  
Latin America and the Caribbean: changes in fiscal stance, 2013-2017  
(Number of countries)

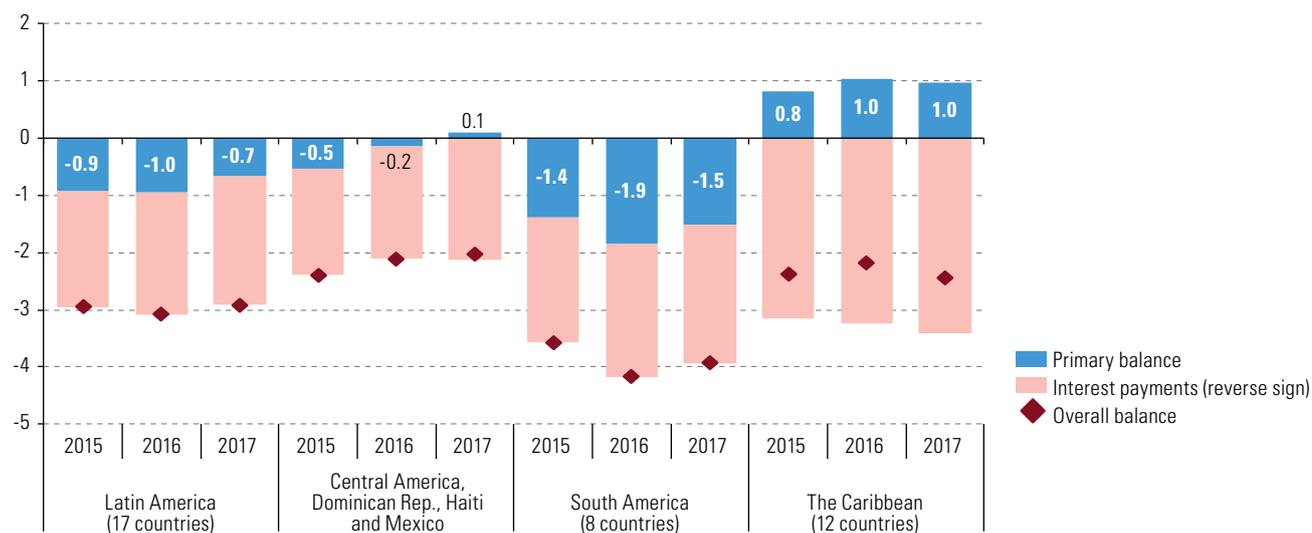


**Source:** Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

**Note:** A tightening of the fiscal stance may be defined as an improvement of at least 0.25 GDP percentage points in the primary balance in one year, while an easing of the fiscal stance may be defined as an erosion of at least 0.25 GDP percentage points in the primary balance in one year.

However, fiscal policy tightening has been a gradual process in Latin America, so that regaining fiscal space has been relatively slow. Furthermore, although a good number of countries have shifted towards what may be described as a neutral fiscal stance—that is, they have stabilized their primary balance—several are still running a large primary deficit. However, in the average figures, the economies of Latin America reduced their primary deficit from 1.0% to 0.7% of GDP in 2017 (see figure I.2). The average overall balance dropped from 3.1% of GDP in 2016 to 2.9% of GDP in 2017.

**Figure I.2**  
Latin America and the Caribbean: overall balance, primary balance and interest payments, 2015-2017  
(Percentages of GDP)

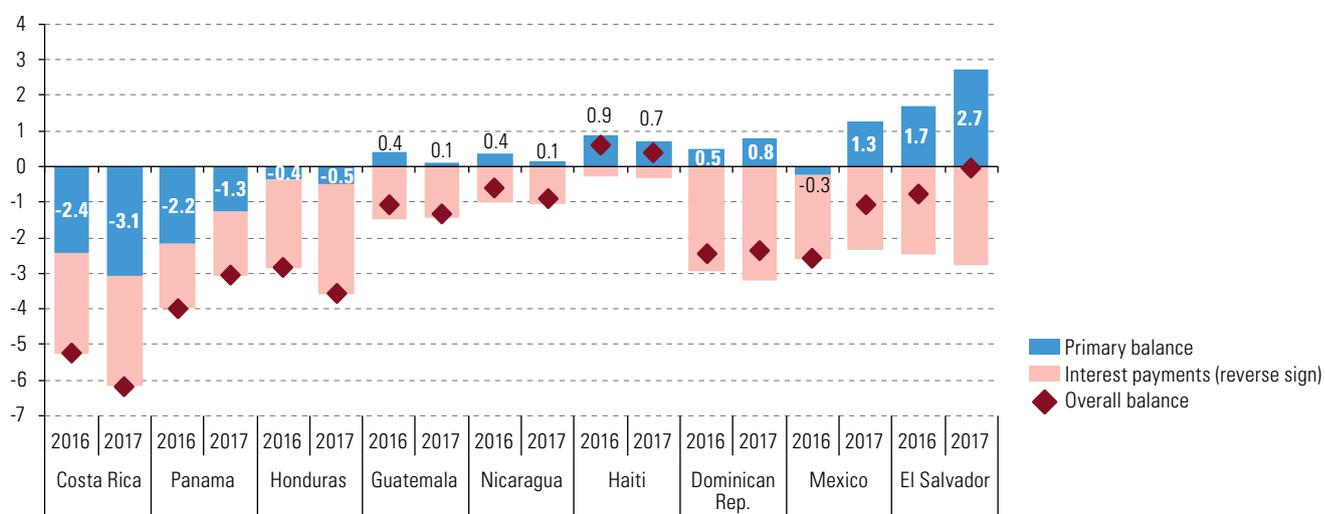


**Source:** Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

There were significant differences in trends between and within the subregions. In the north of Latin America —comprising the countries of Central America, the Dominican Republic, Haiti and Mexico— the average primary balance improved from a deficit of 0.2% of GDP in 2016 to a small surplus in 2017. The overall balance for this group of countries also improved, but to a lesser extent (from 2.1% of GDP in 2016 to 2.0% in 2017) owing to the widespread rise in interest payments, which edged up from 2.0% of GDP in 2016 to 2.1% in 2017. As illustrated in figure I.3, fiscal situations differ among the countries of this subregion. On the one hand, Costa Rica recorded a high primary deficit, up from 2.4% of GDP in 2016 to 3.1% in 2017.

**Figure I.3**

Central America (6 countries), Dominican Republic, Haiti and Mexico: overall balance, primary balance and interest payments, 2015-2017  
(Percentages of GDP)



**Source:** Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

On the other hand, the Dominican Republic, El Salvador, Mexico and Panama recorded improvements in their primary balances. Mexico improved notably, from a primary deficit of 0.3% of GDP in 2016 to a surplus of 1.3% of GDP in 2017, thanks to government efforts to contain public spending and to the record operating surplus transferred by the Bank of Mexico to the federal government (1.5% of GDP). Improvements in the primary balances of the Dominican Republic —from 0.5% of GDP in 2016 to 0.8% in 2017— and El Salvador —from 1.7% of GDP in 2016 to 2.7% in 2017— offset the increase in their public debt servicing costs, leaving the overall balance for both countries relatively stable.

In South America, efforts to contain the public spending expansion reduced the average primary deficit, which narrowed from 1.9% of GDP in 2016 to 1.5% in 2017 (see figure I.2). As in the northern part of Latin America, interest payments on public debt increased, from 2.3% of GDP in 2016 to 2.4% in 2017. This rise mitigated the effect of the narrowed primary deficit on the overall deficit, which nevertheless improved for the first time since 2011, from -4.2% of GDP in 2016 to -3.9% in 2017.

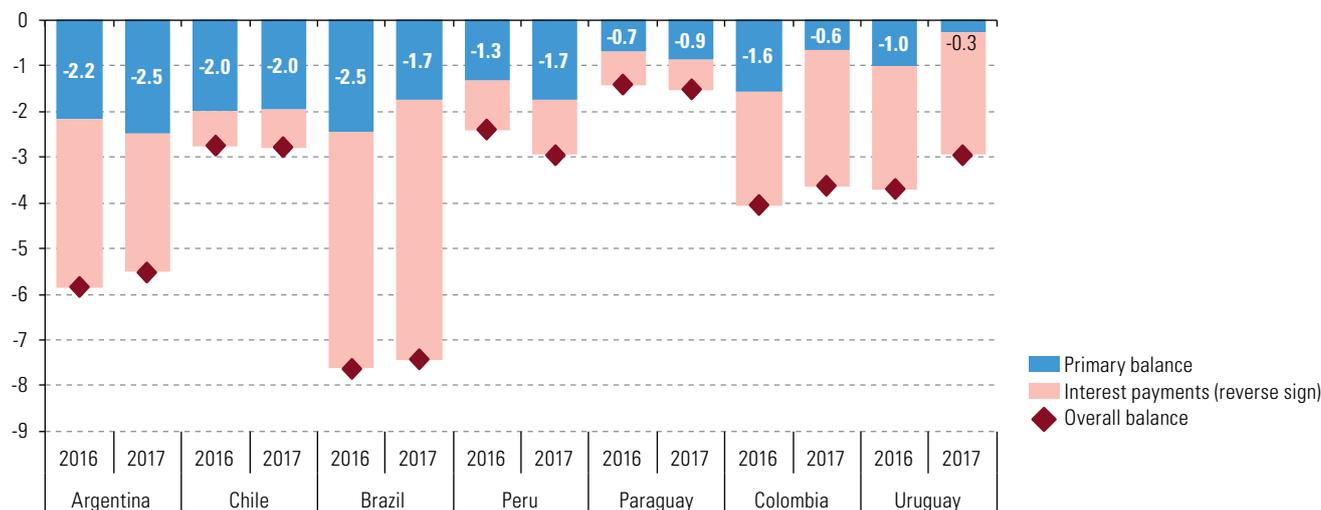
As illustrated in figure I.4, consolidation measures led to an important reduction in the primary deficits of Colombia (from 1.6% of GDP in 2016 to 0.6% of GDP in 2017) and Uruguay (from 1.0% of GDP in 2016 to 0.3% of GDP in 2017). Colombia's performance was attributable to the measures adopted under the government's intelligent austerity

strategy, which aimed to spread out the burden of the adjustment between the available instruments (revenues, expenditures, debt) (Ministry of Finance and Public Credit of Colombia, 2017). For its part, after two years of primary deficit expansion, Uruguay adopted a series of consolidation measures (on the revenue and expenditure sides) with a view to balancing public accounts.

**Figure I.4**

South America (7 countries): overall balance, primary balance and interest payments, 2015-2017

(Percentages of GDP)



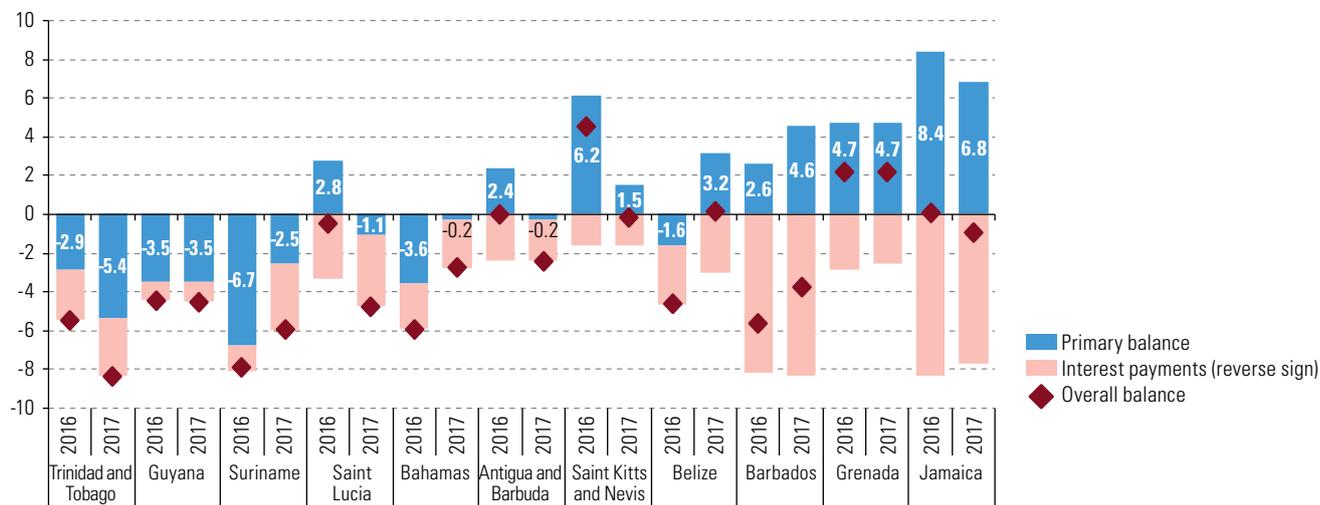
**Source:** Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

Despite these consolidation efforts, primary deficits remain large in South America. In 2017, primary deficits above 1% were recorded in Peru (1.7% of GDP), Brazil (1.7% of GDP), Chile (2.0% of GDP) and Argentina (2.5% of GDP). By contrast, in the north of Latin America, only two countries, Costa Rica and Panama, recorded primary deficits of this magnitude. The size and persistence of these deficits limit the policy space in these countries, given the need to safeguard the medium-term public debt sustainability.

In the Caribbean, the average primary surplus remained stable at 1.0% of GDP in 2017 (excluding Dominica) (see figure I.5). The overall balance rose to 2.5% of GDP, owing to the rise in interest payments (from 3.2% of GDP in 2016 to 3.4% in 2017). These countries' need to continually generate large primary surpluses—in order to service their heavy public debt—greatly limits the space for fiscal policy to boost economic growth. Figure I.5 shows that Jamaica (6.8% of GDP), Grenada (4.7% of GDP), Barbados (4.6%) and Belize (3.2% of GDP) all run hefty fiscal surpluses. By contrast, Trinidad and Tobago's primary deficit deteriorated from 2.9% of GDP in 2016 to 5.4% of GDP in 2017.

**Figure I.5**

The Caribbean (11 countries): overall balance, primary balance and interest payments, 2015-2017  
(Percentages of GDP)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

## B. Fiscal consolidation and the upturn of economic activity offset the rise in public debt

In 2017, gross public debt in Latin America reached 38.4% of GDP, a rise of only 0.7 percentage points of GDP over 2016 levels. Debt levels rose in fewer countries than in 2016, and 11 of the 18 reporting economies saw a drop in their level of indebtedness. However, most of the region's countries increased their sovereign bond issuance during 2017, with 17 out of 18 reporting countries issuing bonds (Haiti being the exception), which stands in stark contrast with 2008 when only 6 countries managed to place sovereign bonds.

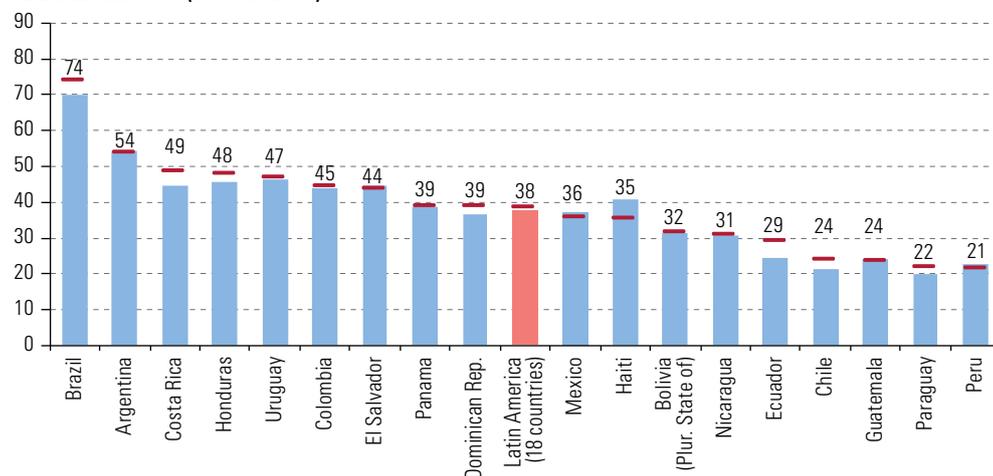
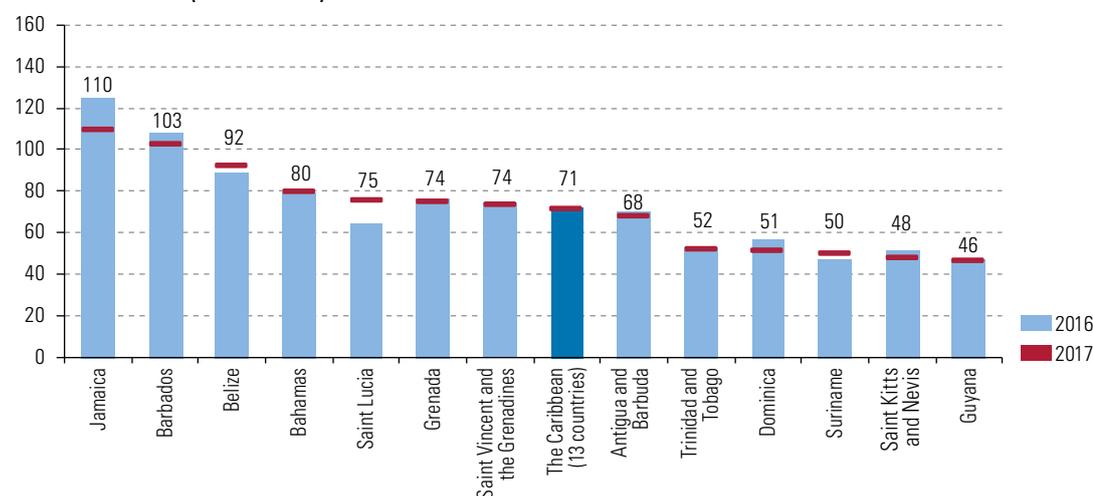
In Latin America, Brazil continues to hold the highest public debt levels (74.0% of GDP), followed by Argentina (53.7%) and Costa Rica (48.8%). On the other extreme, Peru has the region's lowest level of debt (21.5% of GDP), followed by Paraguay (21.9%) and Guatemala (23.5%) (see figure I.6).

At the subregional level, gross public debt in South America increased by 1.4 percentage points of GDP, reaching an average of 38.6% of GDP. Ecuador, Brazil, Chile and Paraguay recorded the largest increases, at 4.4, 4.0, 2.5 and 2.0 percentage points of GDP, respectively. In Central America, indebtedness levels remained flat compared to the previous year, at 38% of GDP on average, with increases in Costa Rica (4.1 points), Honduras (2.3 points) and the Dominican Republic (2.2 points). This highlights the extent to which South America's public debt levels have risen since 2015, as they exceeded those of Central America in 2017.

Figure I.6

Latin America and the Caribbean: central government gross public debt, 2016-2017<sup>a b c</sup>

(Percentages of GDP)

**A. Latin America (18 countries)****B. The Caribbean (13 countries)**

Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

<sup>a</sup> Preliminary figures for 2017.

<sup>b</sup> Coverage refers to general government for Brazil.

<sup>c</sup> Public sector figures for Guyana and Jamaica.

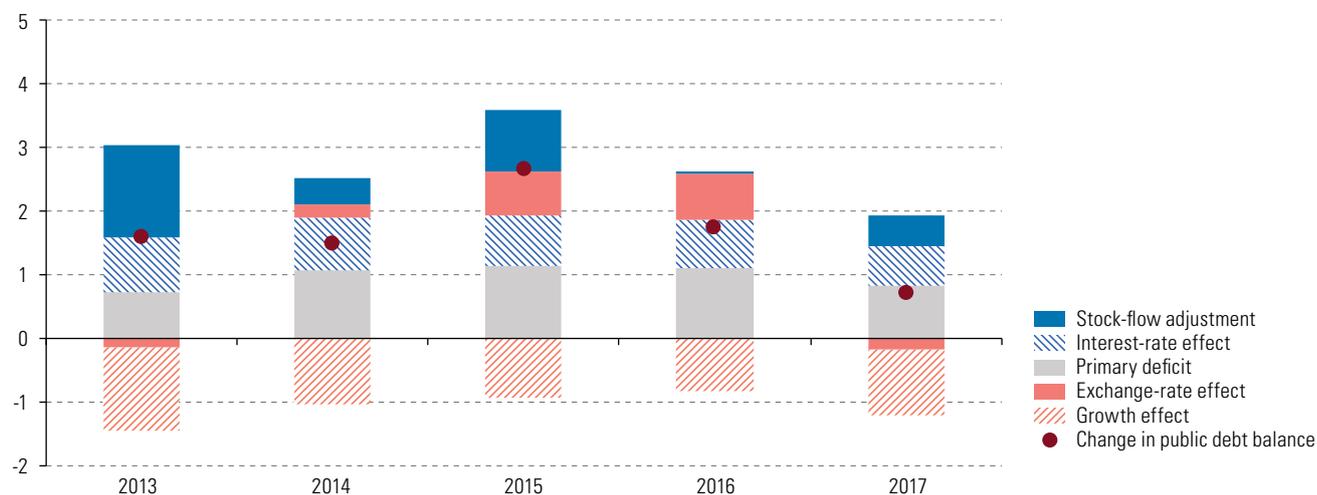
Central government public debt in the Caribbean reached 70.9% of GDP in 2017, a drop of 1.5 percentage points of GDP compared to 2016. The downward trend of recent years continues, with only 4 of the 13 reporting countries posting a rise in debt levels. Jamaica remains the largest debtor (109.5% of GDP), followed by Barbados (102.7%), although these two countries also saw the largest decline in indebtedness, together with Dominica and Saint Kitts and Nevis (see figure I.6).

The fact that public debt has grown less than expected in Latin America, considering its levels of primary deficit, warrants a deeper examination of the region's public debt dynamics.<sup>2</sup> As illustrated in figure I.7, between 2013 and 2016 public debt increased by

<sup>2</sup> See box IV.1.

over one GDP point annually, owing mainly to the contribution of the primary deficit, the effect of real exchange rates (especially in 2015 and 2016) and the impact of real interest rates. In turn, the negative contribution of real growth declined substantially because of the sharp slowdown in the region during the period. However, in 2017 these trends all showed some signs of reversal, which slowed the growth of public debt. In particular, the region's economic recovery and the fall in real interest rates more than offset the public debt expansion originating in the primary deficit.

**Figure I.7**  
Latin America: explanatory factors of public debt dynamics, 2013-2017  
(Percentages of GDP)



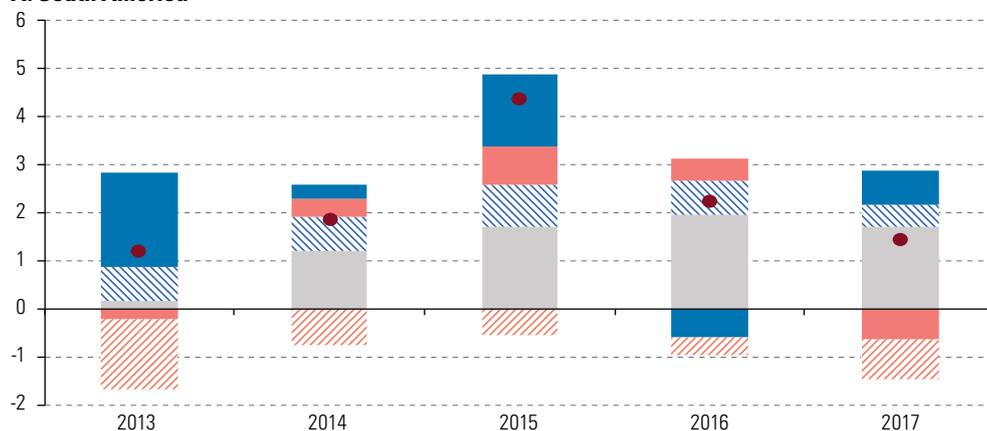
**Source:** Economic Commission for Latin America and the Caribbean (ECLAC).

At the subregional level, although the South American countries' public debt increased in 2017, all the main variables improved over 2016 levels. The increase in public debt was chiefly attributable to the primary deficit, which was offset by the negative rate differential, the improvement in financial conditions (lower interest rates) and the impact of the economic recovery (see figure I.8). In Central America, the variation in public debt was virtually nil, owing mainly to the negative differential between interest rates and economic growth rates—as the subregion has continued growing at a rate close to 4%—and to the steady improvement in the primary deficit.

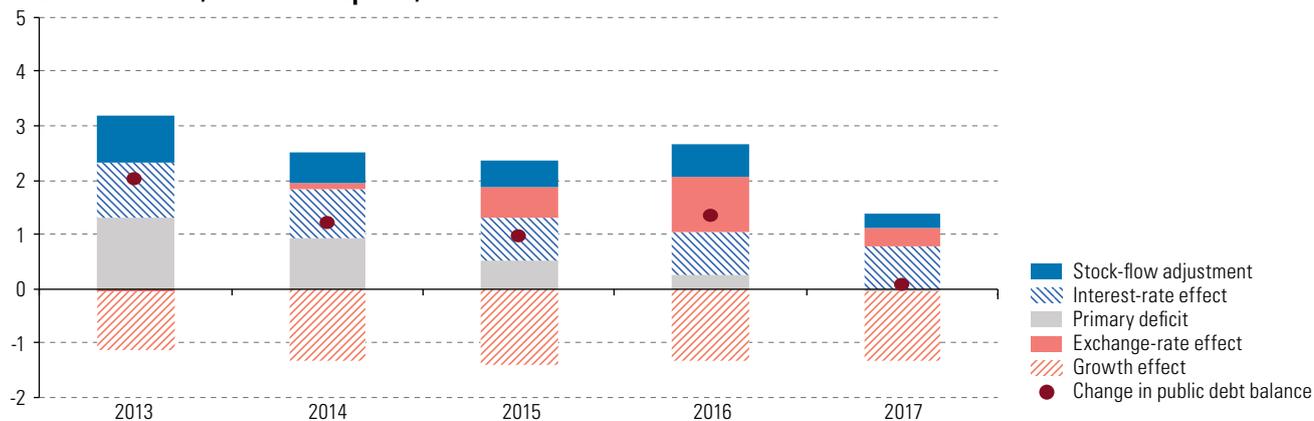
Despite the drop in average real interest rates in the region, debt service costs continue to rise, in line with the evolution of public debt. As figure I.9 shows, changes in public debt stock and in interest payments remained closely correlated in general, although other factors, including exchange-rate variations and the use of variable rate instruments, are also involved in interest payment trends at the country level.

**Figure I.8**  
Latin America: explanatory factors of public debt dynamics, by subregion, 2013-2017  
(Percentages of GDP)

**A. South America**

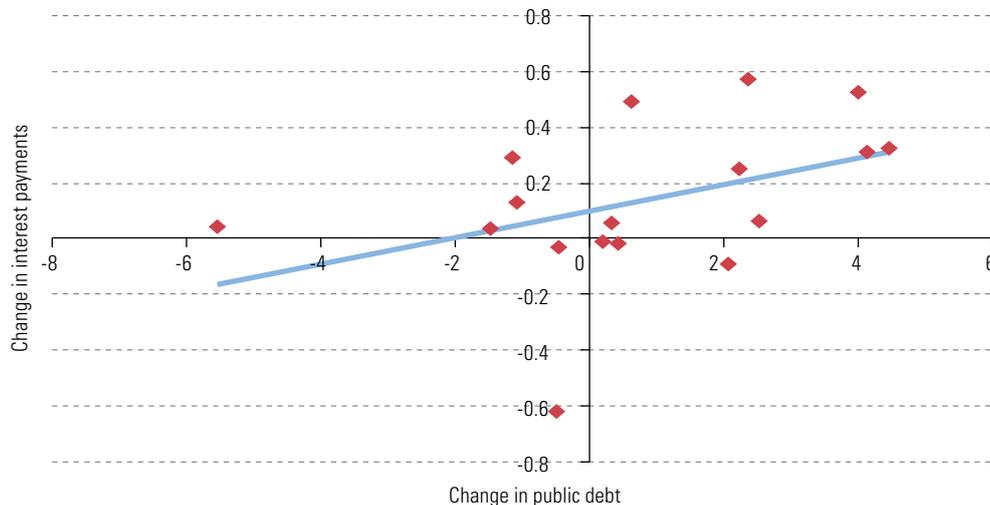


**B. Central America, Dominican Republic, Haiti and Mexico**



Source: Economic Commission for Latin America and the Caribbean (ECLAC).

**Figure I.9**  
Latin America: changes in interest payments and public debt, 2016-2017  
(Percentage points of GDP)



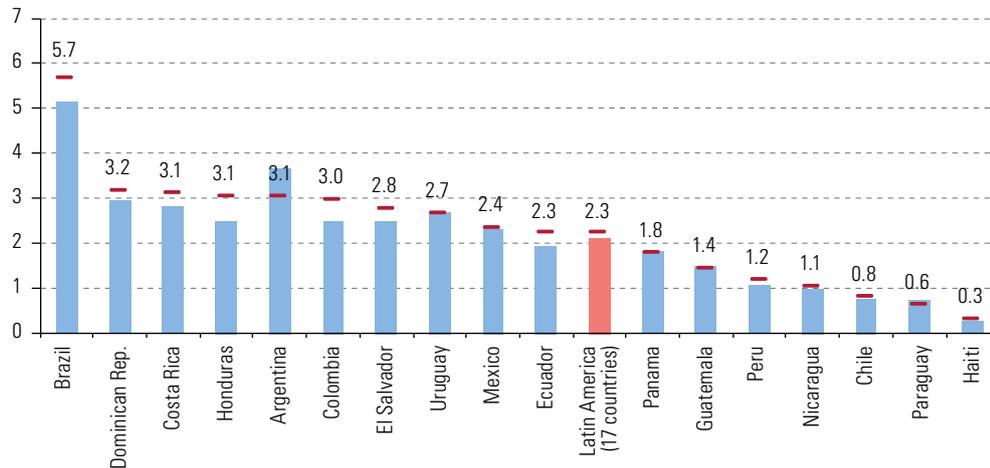
Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

In 2017, interest payments by Latin American countries stood at 2.3% of GDP on average, or 0.2 percentage points of GDP above 2016 levels. Brazil continues to bear the highest debt costs in the region at 5.7% of GDP, followed by Argentina, Colombia, Costa Rica, the Dominican Republic and Honduras, whose costs all reach or exceed 3.0% of GDP (see figure I.10). At the other extreme, with debt service costs under 1% of GDP, are Chile, Haiti and Paraguay. Interest payments by Caribbean countries stood at 3.4% of GDP, with Barbados and Jamaica recording the highest burdens on their fiscal accounts, at levels exceeding 7% of GDP.

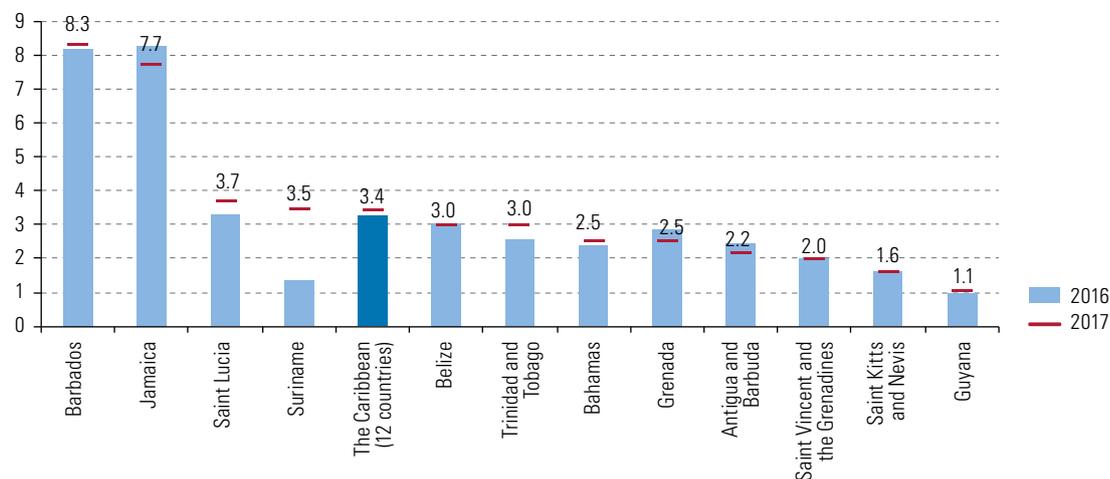
**Figure I.10**

Latin America and the Caribbean: interest payments on central government gross public debt, 2016-2017<sup>a</sup>  
(Percentages of GDP)

**A. Latin America (17 countries)**



**B. The Caribbean (12 countries)**



**Source:** Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

<sup>a</sup> General government for Peru, and federal public sector for Mexico.

## C. Fiscal consolidation efforts were evident in the containment of public spending growth

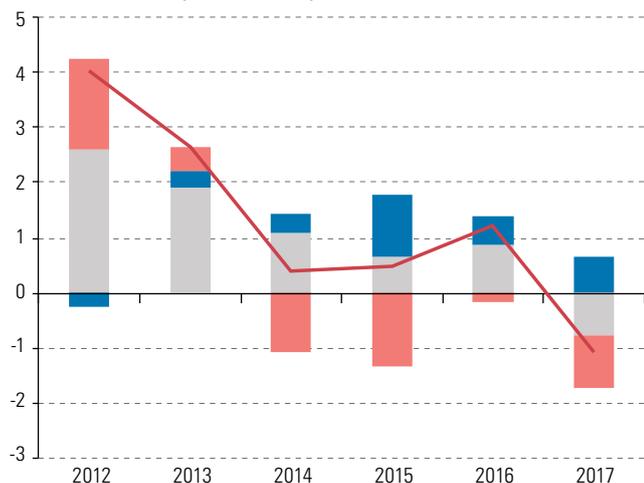
Public spending growth has been slowing gradually, albeit with certain subregional differences. As illustrated in figure I.11, the year-on-year variation in the public spending to GDP ratio has trended downwards in the most recent period. Spending has slowed sharply in Latin America since 2014, mainly led by the countries in the north of the region, in response to the fiscal crises in 2013 and 2014. In South America, this slowdown steepened in 2015 and, even more intensively, in 2016 and 2017. Adjustments in both subregions of Latin America occurred mostly in capital expenditure, which contributed negatively to spending growth. This negative contribution by capital expenditure was seen in the Caribbean as well, where it has been cut heavily in recent years—although it did rise in 2017—in order to contain overall spending.

**Figure I.11**

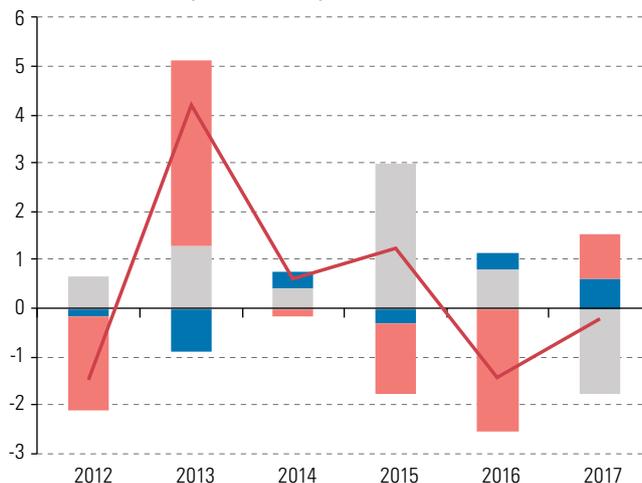
Latin America and the Caribbean: contribution of public spending components to year-on-year changes in the public spending to GDP ratio, 2012-2017

(Percentages)

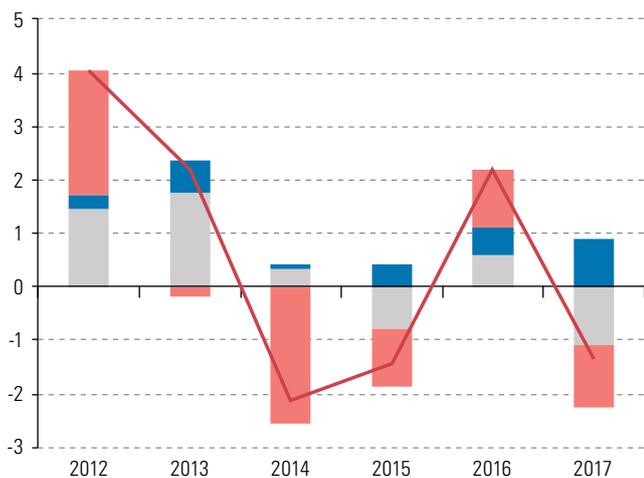
### A. Latin America (17 countries)



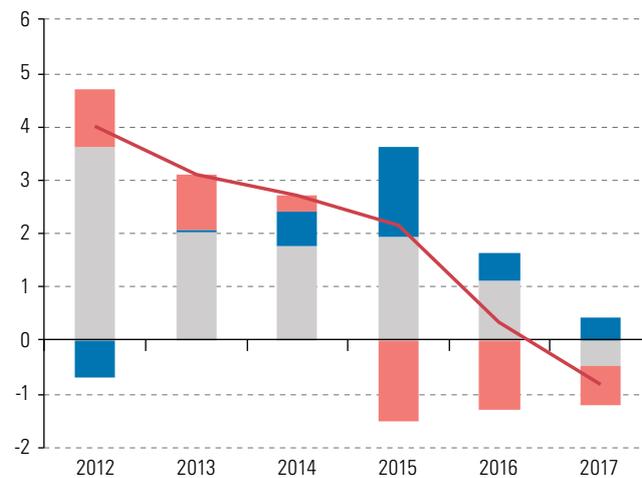
### B. The Caribbean (12 countries)



### C. Central American isthmus, Dominican Republic, Haiti and Mexico



### D. South America (8 countries)



Legend: Capital expenditure (red), Primary current spending (grey), Interest payments (blue), Total spending (red line)

However, as figure I.11 also shows, in 2017 the brunt of the adjustment began shifting towards primary current spending, which grew significantly less in proportion to output across all the subregions. This was evident in the budgets for 2017—and in the reasoning behind the budget proposals for 2018—which reflected an intention to limit current spending growth via cuts or greater efficiency.

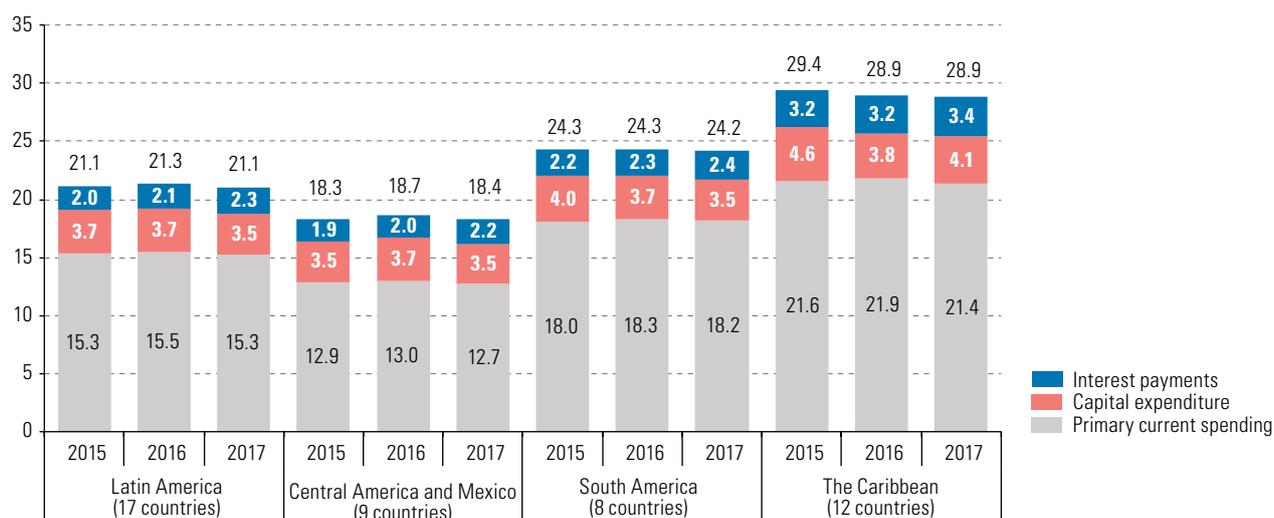
For example, Mexico's 2017 budget plan focused on (i) containing expenditures on personal services; (ii) reducing operational expenditures; (iii) prioritizing poverty reduction programmes that focus on reducing social deprivation; and (iv) prioritizing production investment over administrative investment (Ministry of Finance and Public Credit of Mexico, 2016). In a similar vein, Peru's Multiannual Macroeconomic Framework 2017-2019 forecasts keeping the rate of current spending growth below output growth to "ensure the commitment to fiscal sustainability" (Ministry of Economic Affairs and Finance of Peru, 2016). In the Caribbean, Antigua and Barbuda's budget proposed a balanced and pragmatic fiscal stance: securing long-term sustainability, while at the same time, ensuring that economic activity was not thwarted by fiscal policies that were too conservative (Browne, 2017).

As noted earlier, the higher public debt servicing costs are an important consideration in the region's fiscal policymaking. As illustrated in figure I.11, the rise in debt servicing has exerted additional pressure on fiscal accounts, which countries have countered by reducing primary spending. This became more evident for Latin America in 2017, especially among the countries in the north (where debt servicing contributed positively to public spending variation).

These trends have led to a change in the composition of total public spending in the region. On the one hand, as seen in figure I.12, interest payments throughout the region have increased as a percentage of total expenditure, compared to other components. This is perhaps most evident in the north of Latin America, where the public debt service reached 11.8% of total spending (2.2% of GDP) in 2017, compared to 10.5% (2.0% of GDP) in 2016. On the other hand, the reduction in primary current spending—amounting to 0.2 percentage points of GDP Latin America and 0.5 percentage points in the Caribbean—was very widespread, since it occurred in 10 of the 17 countries considered in Latin America and 7 of the 12 in the Caribbean.

**Figure I.12**

Latin America and the Caribbean: breakdown of total central government expenditure, 2015-2017<sup>a</sup>  
(Percentages of GDP)

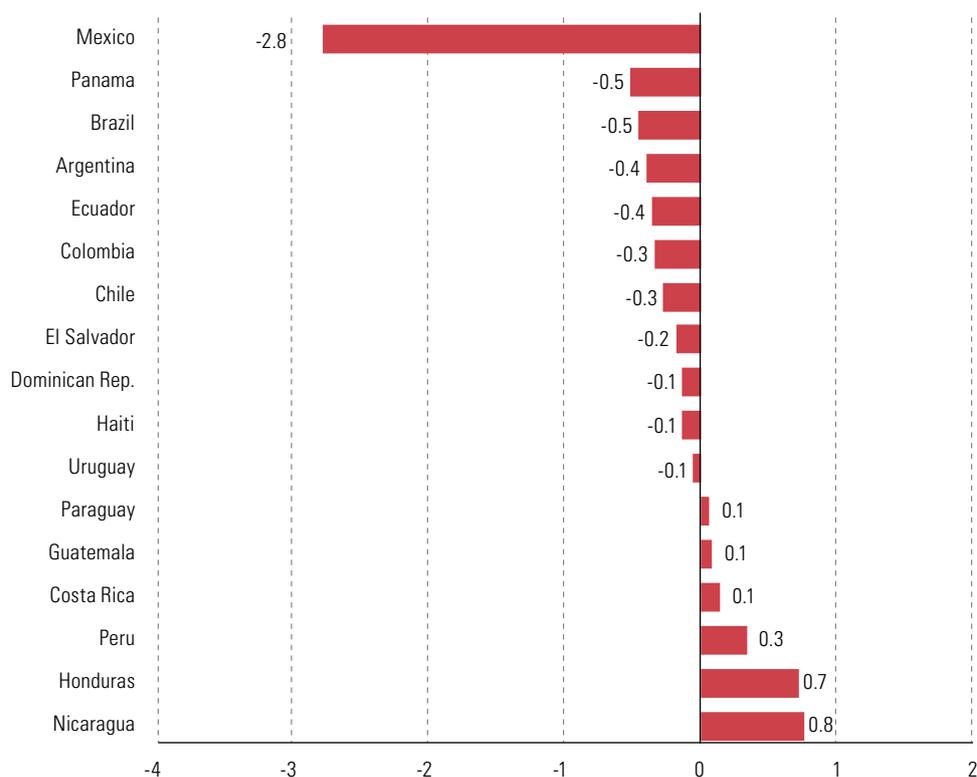


**Source:** Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

<sup>a</sup> Simple averages.

The large decline seen in capital expenditure in 2017, both in aggregate terms and in each subregion, is a source of concern (see figure I.12). As shown in figure I.13, capital spending was down in 11 of 17 reporting economies, with drops of 0.3 GDP points or more in Argentina, Brazil, Chile, Colombia, Ecuador, Mexico and Panama. The reduction in Mexico was explained mainly by the high basis of comparison with 2016, owing to certain financial transactions between the federal government and State-owned companies (Petróleos Mexicanos and Comisión Federal de Electricidad) in the framework of the energy reform adopted in 2013. In turn, capital spending was up in the Caribbean and Peru, partly because of reconstruction efforts in the aftermath of natural disasters.

**Figure I.13**  
Latin America  
(17 countries): changes in  
central government capital  
spending, 2016-2017  
(Percentage points of GDP)



**Source:** Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

**Note:** Figures refer to the federal public system for Mexico, and to the general government for Peru.

## D. Public spending adjustments also affected the region's socioeconomic targets

Another way of assessing changes in public spending evolution is to examine its proposed socioeconomic targets and their allocations in the public budgets of the region's countries. While the focus of the analysis of the recent period, between 2012 and 2017, has been on spending adjustments in public investment, the degree to which these adjustments influence policy objectives is just as important. In this sense, it is useful to examine the classification of the functions of government, which strictly speaking reflect the actual goals of disbursements (European Commission and others).<sup>3</sup> This

<sup>3</sup> System of National Accounts (2008).

classification allows for an analysis of the functions carried out by units of government through different types of expenditure (see table I.1). It is important that the region use this type of classifier alongside the economic classification: a unified functional and economic form of accounting will allow the countries to gauge the efficiency of their resource allocation in different social and economic areas and determine whether their policy objectives are being met.

**Table I.1**

Functional classification of public spending based on the classification of the functions of government

1. Economic affairs
2. General public services
3. Defence
4. Public order and safety
5. Environmental protection
6. Housing and community amenities
7. Health
8. Recreation, culture and religion
9. Education
10. Social protection

**Source:** United Nations, *System of National Accounts 2008*, New York, 2009.

Under this classification, in 2016 over 60% of total public spending in the countries of Latin America was allocated to the functions of general public services (27.1%), health (10%), education (18.1%) and social protection (19.4%) (see figure I.14). Compared to 2015, the structure of spending remained more or less the same. However, the composition of the lion's share of social spending differs when analysed by subregion; in Central American countries and Mexico, a larger percentage is spent on education (22.7%) and a lower weight is allocated to social protection (10.2%). By contrast, the countries of South America spend more on social protection (27.6%) and allocate a smaller proportion to education expenditure (13.9%). Health expenditures have a similar weight in the two subregions, at close to 10% of total public spending. An important point to note is that the functional classification includes expenditures on debt interest under general public services.

The Caribbean countries allocate greater weight to general public services expenditures, and in cases such as Trinidad and Tobago, this function accounts for more than 50% of total public spending. Social spending varied from 30% of total expenditure (Bahamas, Jamaica, and Trinidad and Tobago) to 40% (Barbados).

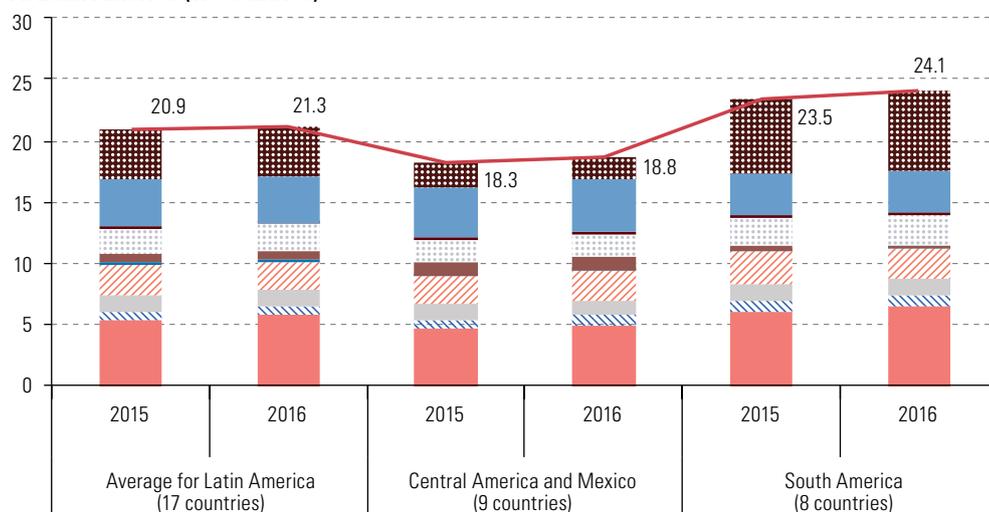
A cross-classification of public spending is very important for the region's countries, as it makes it possible to view the actual efficiency of spending through the lens of its economic and functional purpose. Figure I.15 shows the breakdown of public spending for Argentina, Chile, Mexico and Paraguay, both by functions of government and by economic purpose, and illustrates that the highest share of spending (more than 90% in most cases) on general public services, social protection and education corresponds to current spending. Capital expenditures, instead, represent a greater percentage of spending in the economic affairs and housing functions.

Figure I.14

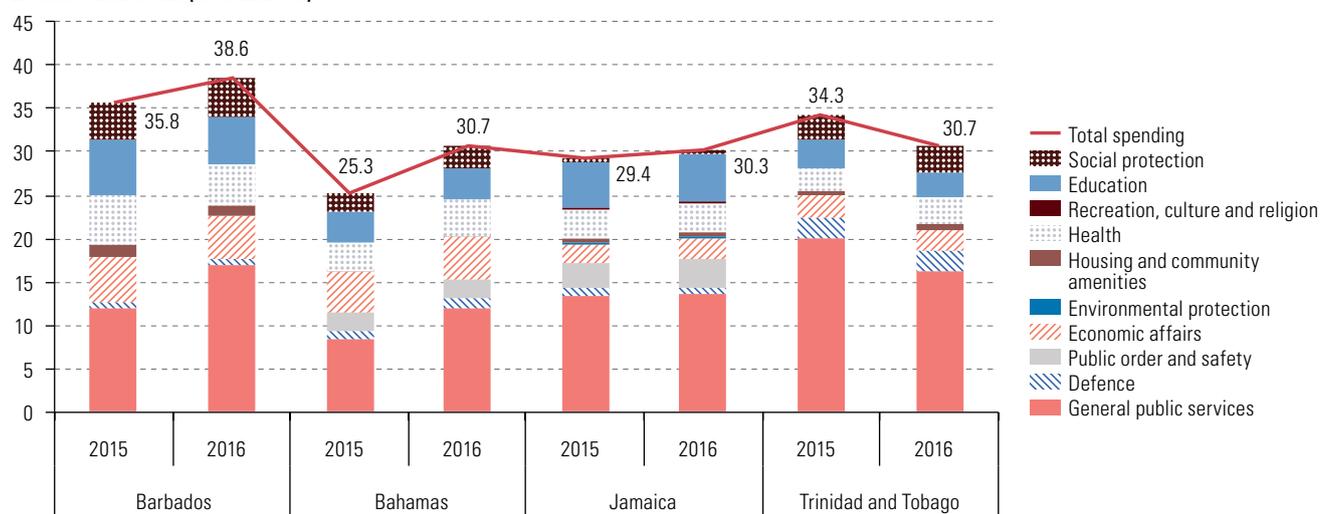
Latin America and the Caribbean (selected countries): breakdown of central government public spending, by function of government, 2015-2016<sup>a</sup>

(Percentages of GDP)

### A. Latin America (17 countries)



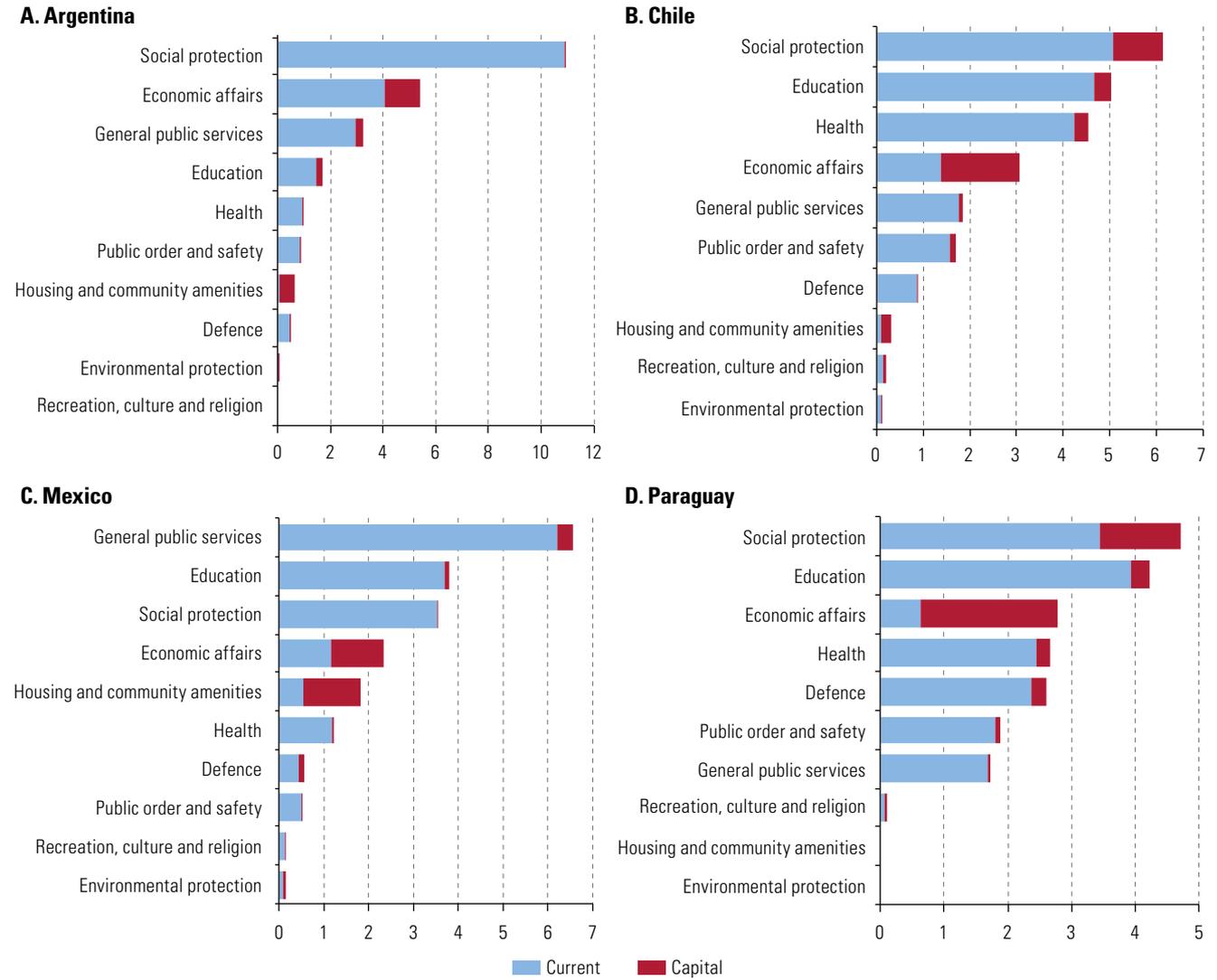
### B. The Caribbean (4 countries)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

<sup>a</sup> Simple averages.

**Figure I.15**  
Latin America (4 countries): cross-classification of total spending by central governments, 2015  
(Percentages of GDP)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

## E. Public revenue trends began supporting fiscal consolidation in 2017, especially in South America

Tax receipts in real terms from the main taxes in South America began to rise gradually as of the first quarter of 2017 (see figure I.16). This improvement can be attributed to a combination of policy and macroeconomic factors. First, after two years of economic contraction, the continent resumed growth during the year at a rate of 0.8% (ECLAC, 2018). Second, the drag on tax receipts caused by the drop in fiscal revenues from natural resources was offset by the rise in the international prices of these products. Third, several countries, especially Colombia and Uruguay, took measures to increase tax pressure in 2016. In the case of the two taxes examined in figure I.16, it was not until the third quarter of 2017 —after more than a year of contraction— that South America began posting positive year-on-year variation rates.

In the northern part of Latin America, by contrast, growth rates for the main taxes dropped slightly, reflecting the economic slowdown —as growth in Central America and Mexico went from 3.0% in 2016 to 2.5% in 2017— and the high basis for comparison in some countries in 2016. The slower growth in receipts was much more evident for value added tax, with the average year-on-year variation falling from 5.7% at the end of 2016 to 3.9% in the third quarter of 2017. Income tax also showed signs of slowing during the year, although they continue growing at a healthy rate, especially when compared to VAT, which in part reflects the fact that current income tax receipts are calculated in relation to the previous period's income levels.

In the Caribbean, tax receipts slowed in 2017, as reflected in the meagre growth of 0.1% for the year overall (ECLAC, 2018). Receipts from VAT (or from sales tax in countries without VAT) lost momentum after being boosted in 2016 by measures aimed at increasing tax collection in Antigua and Barbuda, and Saint Vincent and the Grenadines. Income tax receipts remained relatively stable, with virtually flat growth rates overall. Some countries recorded substantial contractions, however, especially Trinidad and Tobago.

**Figure I.16**

Latin America (14 countries) and the Caribbean (9 countries): 12-month cumulative year-on-year variation in real value added tax and income tax receipts, 2015-2017<sup>a</sup>

(Percentages)

### A. Value added tax

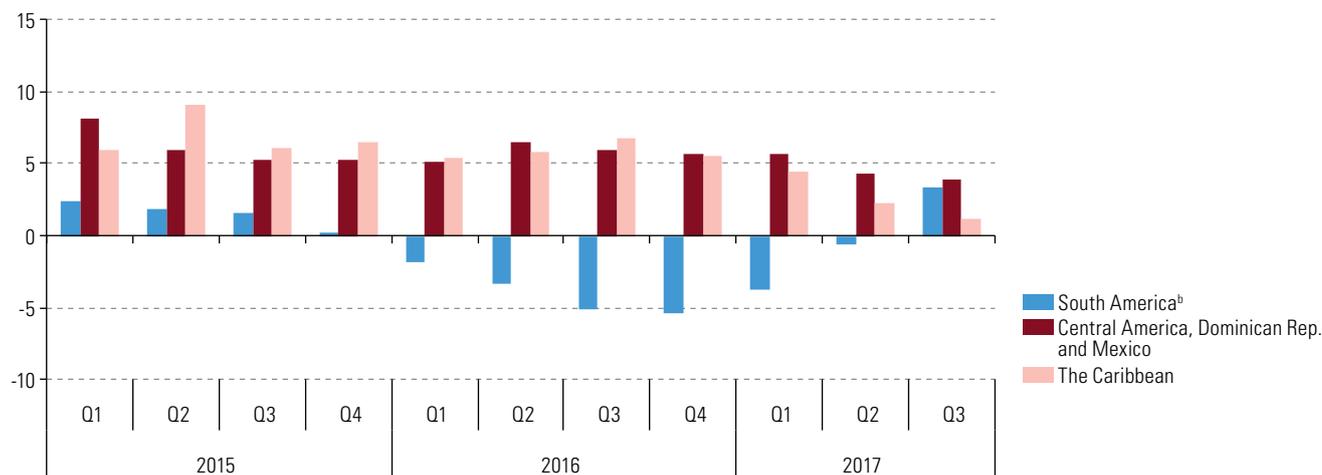


Figure I.16 (concluded)

**B. Income tax**

**Source:** Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

**Note:** Figures for South America refer to Argentina, Brazil, Chile, Colombia, Ecuador, Peru and Uruguay. Figures for Central America refer to Costa Rica, El Salvador, Guatemala, Honduras and Nicaragua. Figures for the Caribbean refer to Antigua and Barbuda, Dominica, Grenada, Guyana, Jamaica, Saint Kitts and Nevis, Saint Lucia, Saint Vincent and the Grenadines, and Trinidad and Tobago.

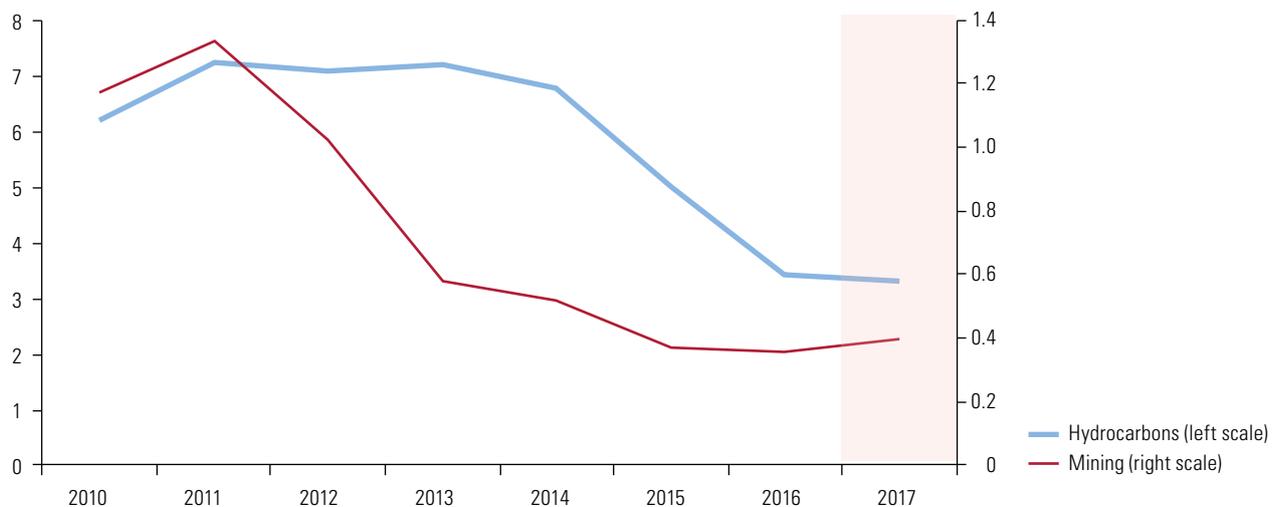
<sup>a</sup> Simple averages of variation rates.

<sup>b</sup> For analytical reasons, revenues from asset regularization programmes linked to income tax in Brazil and Chile are excluded. For Argentina, revenues from this programme are not accounted for as income tax receipts but rather as revenues from other taxes.

Importantly, the drag on public revenues from the sharp drop in fiscal income from raw materials eased substantially in 2017. Estimates are that revenues from the production and sale of hydrocarbons in the region will stabilize at around 3.3% of GDP on average, after falling sharply in 2015 and 2016 (see figure I.17). However, these revenues currently remain 3.9 points of GDP below their 2013 peak (7.2% of GDP). Tax revenues from mining remain low (at around 0.4% of GDP on average), despite the rebound in the international prices of several metals and minerals in 2016 and 2017.

Figure I.17

Latin America and the Caribbean (13 countries): fiscal revenues from non-renewable natural resources, 2010-2017<sup>a</sup>  
(Percentages of GDP)



**Source:** Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

**Note:** Mining figures include Argentina, Brazil, Chile, Colombia, the Dominican Republic, Jamaica, Mexico, Peru, the Plurinational State of Bolivia and Suriname. Hydrocarbon figures include Argentina, the Bolivarian Republic of Venezuela, Brazil, Colombia, Ecuador, Mexico, Peru, the Plurinational State of Bolivia, Suriname and, Trinidad and Tobago.

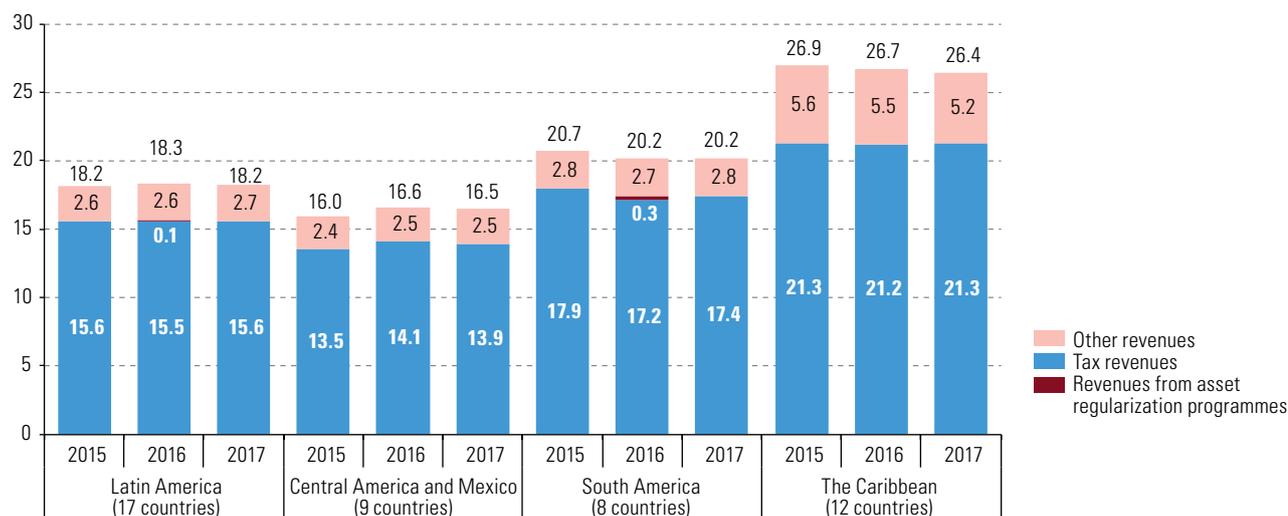
<sup>a</sup> Simple averages.

The combination of all these trends meant that total fiscal revenues for Latin America remained largely stable at 18.2% of GDP in 2017. Tax revenues, excluding non-recurrent revenues from asset regularization programmes in 2016, posted a slight increase from 15.5% of GDP in 2015 to 15.6% in 2017 (see figure I.18). Other revenues —mainly of non-tax revenues— edged up to 2.7% of GDP.

**Figure I.18**

Latin America and the Caribbean: breakdown of total central government revenues, 2015-2017<sup>a</sup>

(Percentages of GDP)



**Source:** Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

<sup>a</sup> Simple averages.

The increase in tax pressure in Latin America is largely attributable to South America, where the tax burden rose from 17.2% of GDP in 2016 (excluding tax revenues from asset regularization programmes) to 17.4% in 2017. Uruguay and Colombia both achieved notable increases in tax pressure, of 0.7 and 0.6 GDP points, respectively. In Uruguay, this was chiefly attributable to increased collections from income tax, which was modified in 2016 in the framework of a fiscal consolidation programme. In Colombia, the tax reform adopted in late 2016 included an increase in general VAT from 16% to 19%, which led to a substantial rise in receipts from that tax.

By contrast, in the Central America, the Dominican Republic, Haiti and Mexico, tax pressure declined slightly reflecting the slowdown in receipts from the main taxes. Receipts in Mexico were down by a hefty 0.9 GDP points, reflecting the large drop in collection from the special production and services tax on gasoline and diesel, as a result of a reduction in the rates applied.

In the Caribbean, total revenues fell from 26.7% of GDP in 2016 to 26.4% in 2017. However, this overall result masks substantial differences within the subregion. At one extreme, total public revenues in Trinidad and Tobago slipped from 30.8% of GDP in 2016 to 25.0% of GDP in 2017, owing to falls in tax receipts (2.0 points of GDP) and in other revenues (3.8 points of GDP), mainly as a result of lower earnings by State-owned companies and a decline in non-recurrent capital gains. At the other extreme, total revenues increased in Suriname (by 3.4 GDP points) thanks to higher non-tax revenues from mining, as tax pressure remained stable after having dropped off considerably in 2016.

## F. The countries maintained a high level of tax activism in 2017

As in 2016, the countries of the region maintained a high level of tax activism in 2017. Argentina implemented the broadest reform of all, including many changes to the tax framework. A gradual reduction was adopted in corporate income tax (from 35% in 2018 to 30% in 2019 and 2020, and 25% from 2021 onwards) and a withholding tax was introduced, to be levied on distributed dividends, at a rate of 7% on profits in 2018 and 2019, and 13% from 2020 onwards, with a view to stimulating profit reinvestment. The two measures combined imply that the tax burden on profit distribution will remain at the same level. Under this same rationale, Argentina established a new regime of early reimbursements of positive VAT balances for companies that have made investments.

The reform aimed to increase employment formalization by establishing a tax threshold based on a gross salary of 12,000 pesos for employers' contributions (beginning with a threshold of 2,400 pesos in 2018 and increasing gradually up to 12,000 pesos in 2022). At the same time, the contributions paid by the private sector are to be gradually unified (at 19.5%), and the programme of reduced contributions by geographic area will be discontinued.

A tax on personal financial income was introduced, on sources that were previously exempt. The reform also increased the special deduction on income tax for own-account workers, which had historically been much smaller than the deduction for payroll workers. The property transfer tax (ITI) was abolished and replaced by a 15% capital gains tax on property sales, excluding residential homes.

The Argentine reform also proposed to reduce the distortions created by different taxes. It was established that the tax on bank debits and credits could be used as an advance payment on income tax. In addition, an agreement was reached with the provincial governments to reduce gross income tax and stamp duties.

Among the various measures under Argentina's reform were several changes to consumption taxes. For example, the VAT tax base was broadened to include digital services provided by companies abroad. Domestic taxes on unhealthy products (alcohol, fizzy drinks and cigarettes) were also increased, as were those levied on top-of-the-range aircraft and sea vessels, while those on electronic products and mid-range automobiles and motorcycles were lowered. The debate on the reform in the Chamber of Deputies resulted in cuts to VAT on chicken, pork and rabbit meat from 21% to 10.5%.

Ecuador passed the Organic Law for the Reactivation of the Economy, Strengthening of Dollarization and Modernization of Financial Management, which entailed changes to several taxes. The general rate for corporate income tax increased from 22% to 25%, while the rate for microenterprises and exporters was cut by three percentage points. For exporters, rates will only be reduced for companies that maintain or increase their headcount. Certain limitations were introduced to deductions for reinvested earnings, with incentives mostly limited to regular exporters and manufacturing companies. A rate of 22% will be offered to companies engaging in investment contracts during the first year after the law comes into force, if the projects contribute to a change in the production matrix or involve extraction mining. The reform also included reimbursements of the tax on outward foreign-exchange transfers for export firms.

The reform in Ecuador also included benefits for microenterprises and the agricultural sector. For microenterprises, a tax-exempt threshold of US\$ 11,290 was set, with new enterprises exempt from this tax altogether for three years. Another deduction of 10% was created for purchases by microenterprises from companies belonging to the system known as the people's and solidarity economy (EPS). As regards the agricultural sector, the reform repealed the rural land tax and exempted irrigation and drainage activities from VAT.

As for personal income tax, Ecuador's reform broadened the scope of tax-deductible expenses to include expenditures on dependent children (without age limitations) and parents. The original bill included some limitations on deductions for personal expenditures, depending on income levels and number of dependants, but these measures were discarded in the version passed by the National Assembly.

Beyond these broader reforms implemented by Ecuador and Argentina, tax measures were identified in many countries in 2017. Most were geared towards generating additional revenues to strengthen public accounts at both the national and subnational levels. In general, these measures can be divided into increases in three categories: corrective taxes, taxes on energy consumption, and taxes on international trade. During the year, progress was also made in tax policies addressing the digital economy in the region.

Some countries increased rates of corrective taxes which, aside from boosting tax receipts can serve other social policy objectives, especially in the area of health. For example, the Argentine tax reform hiked the domestic taxes on certain unhealthy products (alcohol, fizzy drinks and cigarettes). In Belize, the excise tax on beer consumption was raised, as well as the rate on cigarettes purchased in the free-trade zone. Similarly, Jamaica increased its excise tax on alcohol, tobacco and tobacco products, and in Uruguay the domestic excise tax on cigarettes was increased by 12%.

In a similar vein, Uruguay passed an accountability and balanced budget execution act which included several measures concerning taxes on gaming. A new excise tax became applicable to electronic gambling and automated betting with immediate results, with a levy of 0.75% on wagers. In addition, a new withholding tax was created on winnings from gaming and horse betting, consisting of a 12% levy on the difference between the reward and the original bet (with certain exceptions).

Several countries in the Caribbean increased taxes on energy consumption. Barbados raised its excise tax on gasoline and diesel, as did Belize, which also reduced the threshold on its general tax on electricity consumption, from 200 to 100 Belize dollars a month. Jamaica increased its tax on fuel consumption and reduced the tax threshold for electricity consumption from 350 kWh to 150 kWh per month, within the framework of general consumption tax.

Some countries also increased taxes on international trade. Barbados hiked the national social responsibility levy on imported goods and domestically manufactured goods from 2% to 10%, and Belize increased the environmental tax on imported goods from 2% to 3%. Ecuador, meanwhile, implemented a customs inspection services tax applicable to imports, at a rate of 0.10 cents on the quotient of a product's net weight and the control unit established for the respective product. Uruguay increased the consular rate for imports from the South American Common Market (MERCOSUR), from 2% to 3%, and for imports from the rest of the world, from 2% to 5%. Paraguay is considering the creation of a new tax on soybean exports (the proposed bill includes a 15% tax on exports of soybean in its natural state).

Several countries adopted measures related to taxing the digital economy. In Argentina, the tax reform broadened the taxable base for VAT on digital services provided to residents by foreign companies. In Brazil, the municipalities of Rio de Janeiro and São Paulo adopted a tax on services to be levied on direct broadcasting of audio, video, images or texts via the Internet, as well as on advertising services, the processing, storing or hosting of data, texts, images, videos, websites, applications and information systems, and on the development of IT programmes, including electronic games (at different rates in each municipality). In addition, most Brazilian states broadened the tax base for taxes on the movement of goods and services, including the sale of software and other digital goods, at a reduced rate of 5% (except for electronic games). Uruguay also expanded its VAT base to include services provided to residents by non-residents over the Internet, technological platforms, IT applications or similar alternatives.



Uruguay also altered the tax treatment given to income from international sources via Internet services, including it within the scope of income taxes. As from 2018, income from the production, distribution or intermediation of cinematographic films and tapes, and from direct transmission of television, will be considered to come entirely from a Uruguayan source and, accordingly, will be taxed in its entirety (whereas previous treatment allowed for a notional determination). Income received by non-residents from services delivered over the Internet, technological platforms and IT applications in the country will be subject to income tax. Uruguay will also tax income from the mediation and intermediation of services provided over the Internet, technological platforms and IT applications: this income will be taxed in its entirety when both parties to a transaction are located in Uruguay, or 50% when one of the parties is abroad.

As regards other measures, the Plurinational State of Bolivia increased, from 22% to 25%, the additional tax on corporate capital gains for financial intermediation firms, whenever their return on equity exceeds 6%. Brazil modified the tax base for its mining royalty, CFEM, which is now calculated on the basis of gross instead of net income. Higher royalty rates were also proposed for certain products: iron ore (3.5%, and 2% in the case of marginal fields), niobium (3%), diamonds (2%) and gold (1.5%).

El Salvador passed a reform to its Pensions Savings System Act with a view to making the system and its financing more sustainable. On the one hand, the rate of monthly payments into the system increased from 13% to 15%; from 6.25% to 7.25% for workers and from 6.75% to 7.75% for employers. An amount equivalent to 5 percentage points (to be cut to 2 percentage points by 2050) will be allocated to the solidarity guarantee account to help fund the government's pension system costs.

Importantly, several countries adopted tax measures to boost economic activity or stimulate certain economic activities. The Bahamas cut its general tax on company operating licences (from 1.5% to 1.25% of income) and limited this tax to 1% in the case of hotels with a turnover of 400 million Bahamas dollars or more. Brazil created new incentives for its domestic oil and gas sector, in particular, new rules related to deductions on exploration and production expenditures, and changes in the withholding tax levied on freight contracts. In addition, the special customs regime for the oil and gas sector, Repetro, was extended to 2040. Panama introduced a new special regime for the financing of the local and international maritime sector which, among other things, exempts certain activities from income tax for a period of 20 years.

Several countries implemented measures to improve tax compliance in 2017. In the international sphere, Argentina, Chile, Colombia, Costa Rica, Mexico and Uruguay signed the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting. Similarly, Argentina and Brazil signed an amendment protocol to the convention between the two countries for avoiding double taxation and preventing tax evasion for income tax purposes. Ecuador, El Salvador and Uruguay created or modified their respective lists of tax-free or low-tax jurisdictions, or jurisdictions considered tax havens. The Dominican Republic established the obligation to disseminate information on ultimate beneficial owners as a part of sworn corporate income tax returns in keeping with its Law No. 155-17 of 2017 on money laundering and the financing of terrorism.

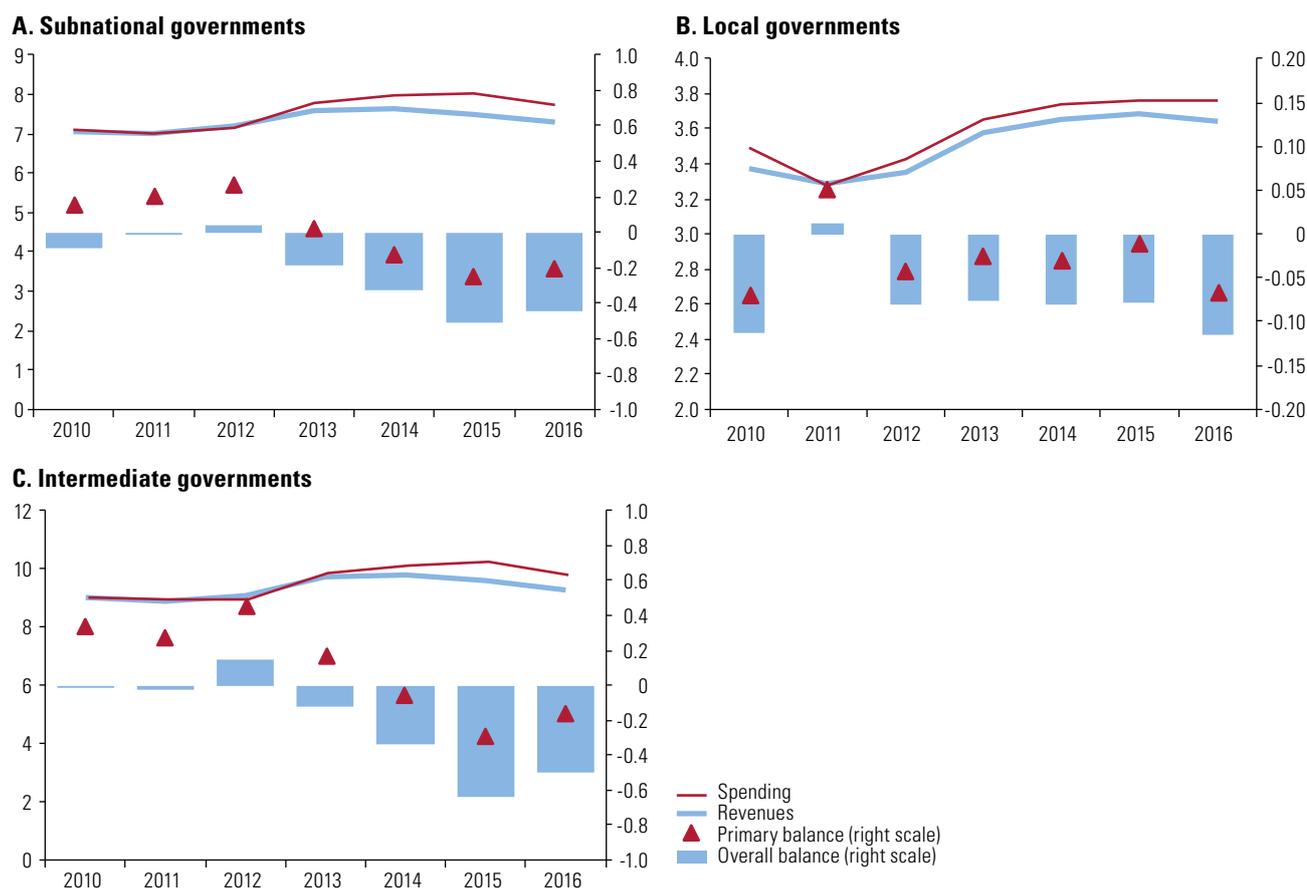
In the national sphere, Argentina's reform included measures to combat tax evasion; the criminal tax regime was modified with increased sentences for tax evasion, with imprisonment in most cases. Brazil reopened its programme for the regularization of unreported assets and created a new special tax regularization programme (PERT). El Salvador adopted temporary legislation to facilitate voluntary compliance with tax and customs obligations, under which tax arrears could be paid free of interest, surcharges or penalties for a three-month period. Guatemala also offered a three-month tax amnesty to allow taxpayers to clear their arrears with forgiveness of fines, penalties, interest and surcharges on a sliding scale going from 100% in the first month to 90% in the third.

## G. Subnational governments continued to adjust their accounts in response to the new economic context

The fiscal balances of the region's subnational governments began to show signs of improvement, although they remained in deficit on average during 2016 (see figure I.19). This small improvement was attributable to expenditure cuts in Colombia, Mexico, Peru and the Plurinational State of Bolivia, a rise in revenues in Brazil and legislative changes containing fiscal rules on responsible management of deficits and public debt.<sup>4</sup> Similar changes were observed at the intermediate government level. Only the local government level showed a slight deterioration, owing mainly to the fiscal accounts of these entities in Peru.

Figure I.19

Latin America (10 countries): fiscal performance of subnational, intermediate and local governments, 2004-2016<sup>a</sup>  
(Percentages of GDP)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

Note: The sample of subnational governments comprises Argentina, Brazil, Chile, Colombia, Costa Rica, Ecuador, Mexico, Peru, the Plurinational State of Bolivia and Uruguay. The sample of local governments comprises Argentina, Brazil, Chile, Costa Rica, Mexico and Peru.

<sup>a</sup> Simple averages.

<sup>4</sup> Fiscal rules aimed at controlling the deficit and limiting subnational government borrowing have been established in Argentina (2000, 2004 and even 2017, with the adoption of the new fiscal responsibility regime), Brazil (2000), Ecuador (2010), Mexico (2016) and Peru (2016). For more detailed analysis see Ter Minassian (2007) and Jiménez y Ruelas (2016).

In the comparison between countries (see table I.2), attention is drawn to the changes in the fiscal accounts of the regional governments in the Plurinational State of Bolivia and of the departmental governments in Colombia. Both countries are producers of non-renewable natural resources and recorded a substantial drop in revenues in 2016 that was accompanied by a similar reduction in expenditures which, in the case of Colombia, helped contain the deterioration of the fiscal balance.

**Table I.2**

Latin America (10 countries): fiscal performance of subnational governments, by type of institutional subsector, 2015-2016  
(Percentages of GDP)

Country	Government	2015				2016			
		Revenues	Spending	Primary balance	Global balance	Revenues	Spending	Primary balance	Global balance
Argentina	Intermediate	15.2	15.9	-0.4	-0.7	15.3	15.9	-0.3	-0.6
	Local	3.5	3.6	-0.1	-0.1	...	...	...	...
Bolivia (Plurinational State of)	Intermediate	11.7	12.8	-1.1	-1.2	9.8	11.4	-1.5	-1.6
Brazil	Intermediate	10.9	13.3	-0.9	-2.4	11.2	13.3	-0.8	-2.0
	Local	8.8	8.5	0.5	0.2	9.0	8.6	0.5	0.4
Chile	Local	3.6	3.5	0.1	0.1	3.7	3.7	0.1	0.1
Colombia	Intermediate	11.3	12.2	-0.8	-0.8	10.5	10.7	0.0	-0.1
Costa Rica	Local	1.1	1.2	-0.1	-0.1	1.1	1.3	-0.1	-0.1
Ecuador	Intermediate	5.0	4.2	0.8	0.8	5.1	4.1	1.0	1.0
Mexico	Intermediate	10.2	10.4	0.2	-0.2	10.1	10.2	0.2	-0.2
	Local	2.0	2.0	0.1	0.0	1.6	1.5	0.1	0.0
Peru	Local	3.1	3.7	-0.6	-0.6	2.8	3.7	-0.9	-0.9
Uruguay	Intermediate	3.0	3.1	0.1	0.0	3.1	3.1	0.2	0.0

**Source:** Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

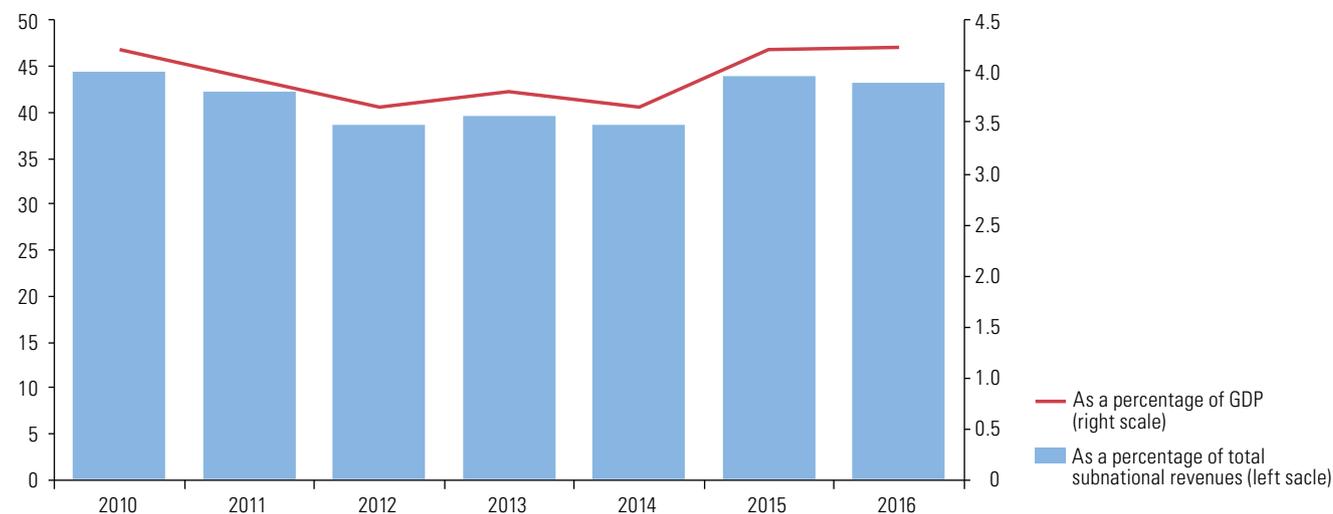
By contrast, the autonomous decentralized governments of Ecuador, the municipalities of Chile and the departmental governments of Uruguay have consolidated primary surpluses amounting to 1% of GDP in the case of Ecuador, and between 0.1% and 0.2% of GDP, respectively, in the other two. Similarly, the fiscal accounts of Mexico's state governments have undergone significant changes, from a primary deficit of 1.4% of GDP in 2008 to a primary surplus of 0.2% of GDP in 2016.

Subnational government public debt remains low in GDP terms, although it has risen from 3.6% of GDP in 2014 to 4.2% in 2016 (see figure I.20). Debt as a percentage of total revenues remains above 40%, which in aggregate terms should not threaten sustainability, although differences between countries are hidden in the simple average measure. Indeed, analysis by country and level of government unit shows a ratio of over 100% of total revenues in some cases, and under 10% in others (Jiménez and Ter Minassian, 2016; ECLAC, 2017a).

Figure I.20

Latin America (5 countries): subnational government public debt, 2010-2016<sup>a</sup>

(Percentages of GDP and of total revenues)



**Source:** Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

**Note:** Countries included are Argentina, Brazil, Ecuador, Mexico and Peru.

<sup>a</sup> Simple averages.

Interestingly, a large part of subnational government public debt remains within the boundaries of the public sector itself (see table I.3). Mexico and Brazil are the exceptions, as both countries maintain high levels of debt with the commercial banking sector (over 1% of GDP), representing more than 60% of total debt held by Mexican states and 17% of debt held by Brazilian states. Argentina's issuance of subnational bonds also stands out at 3.4% of GDP.

Table I.3

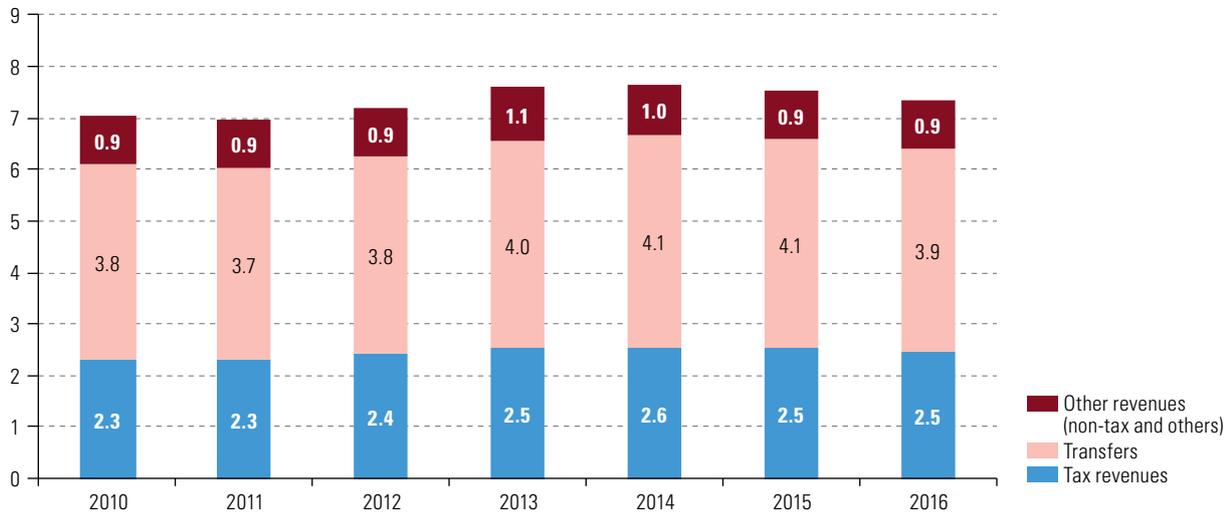
Latin America  
(5 countries): breakdown  
of subnational government  
public debt, 2016  
(Percentages of GDP)

Breakdown	Argentina	Brazil	Ecuador	Mexico	Peru
With the public sector	1.5	7.9	0.6	0.5	0.5
With the private sector or others	0.2	1.5	0.2	1.7	0.0
Bond issuance	3.4	0.0	0.0	0.4	0.0
External debt	0.6	1.6	0.4	0.0	0.0
<b>Total</b>	<b>5.7</b>	<b>10.9</b>	<b>1.3</b>	<b>2.6</b>	<b>0.6</b>

**Source:** Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

Changes in subnational fiscal account balances in 2016 can be attributed on average to a reduction in expenditures, as public revenues remained stable or even dropped slightly. The fall in revenues in 2016 is chiefly due to a reduction in central government transfers and, in some cases, to lower tax receipts from the extraction of non-renewable natural resources that are shared by the different levels of government (see figure I.21).

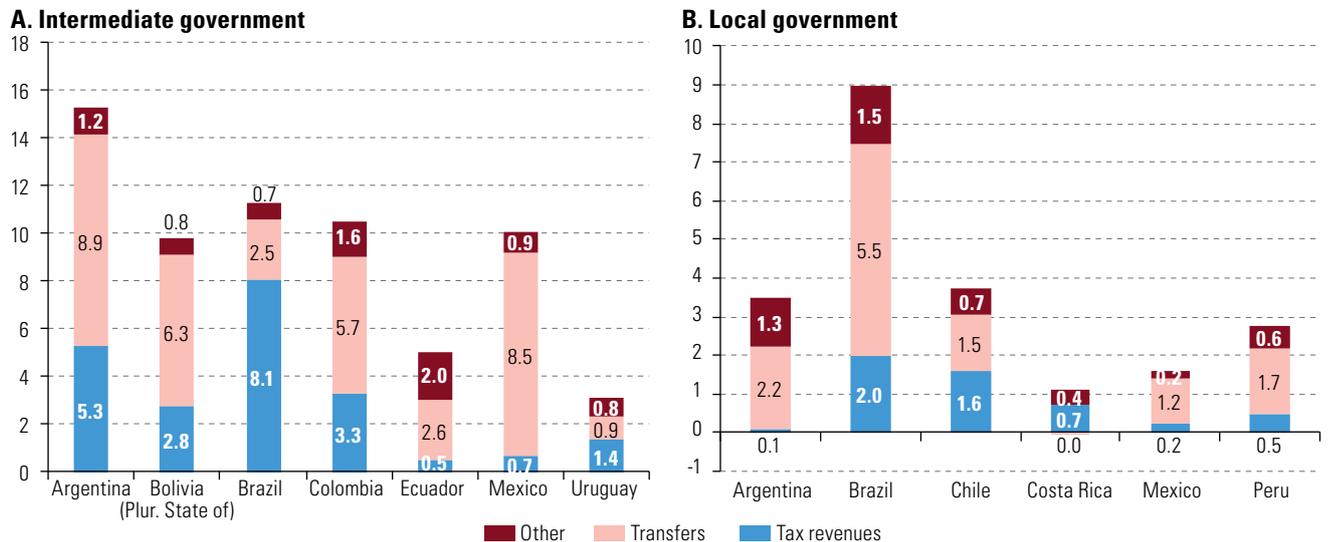
**Figure I.21**  
Latin America: public revenues of subnational governments, 2010-2016<sup>a</sup>  
(Percentages of GDP)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

As figure I.22 shows, although transfers have declined, they continue to represent a large share of total public revenues.

**Figure I.22**  
Latin America (10 countries): breakdown of subnational government public revenues, 2016  
(Percentages of GDP)

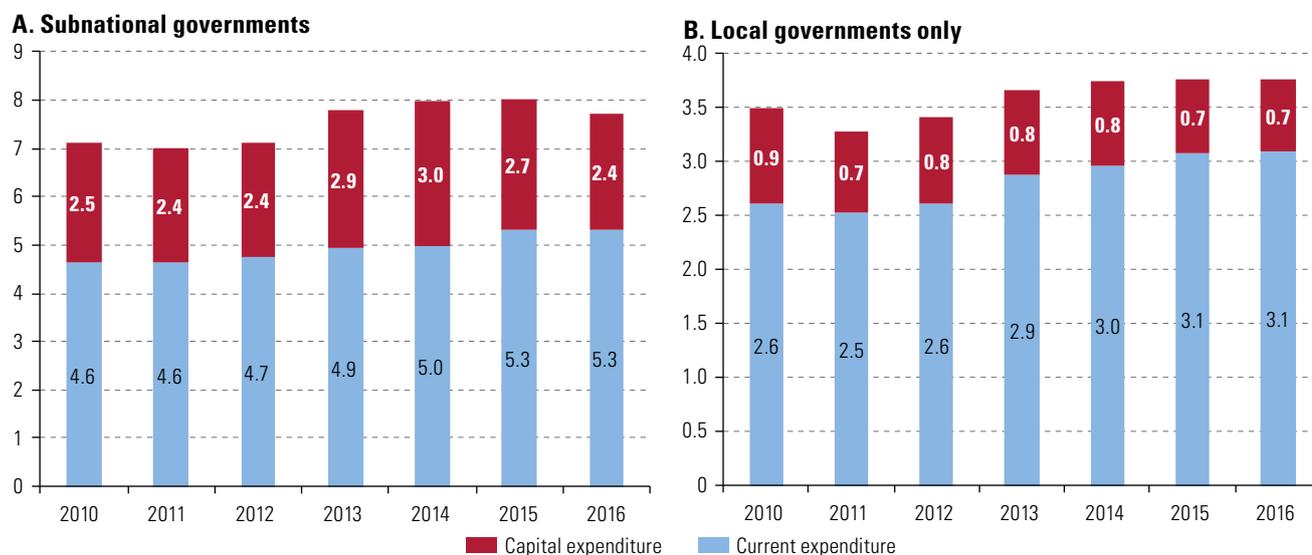


Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

Containment of subnational public spending was reflected in the reduction of capital expenditures. As may be seen in figure I.23, although current spending is the largest expenditure component, adjustments in 2016 occurred mostly in capital expenditure, which fell from 2.7% of GDP in 2015 to 2.4% in 2016 in the average figures. Notably, in countries that are producers of non-renewable natural resources, public investment by subnational governments tends to be financed through transfers from revenues collected from these activities. On the local government side, both current and capital expenditure remained stable in relation to output.

**Figure I.23**

Latin America (10 countries): subnational government public debt, 2010-2016<sup>a</sup>  
(Percentages of GDP)



**Source:** Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

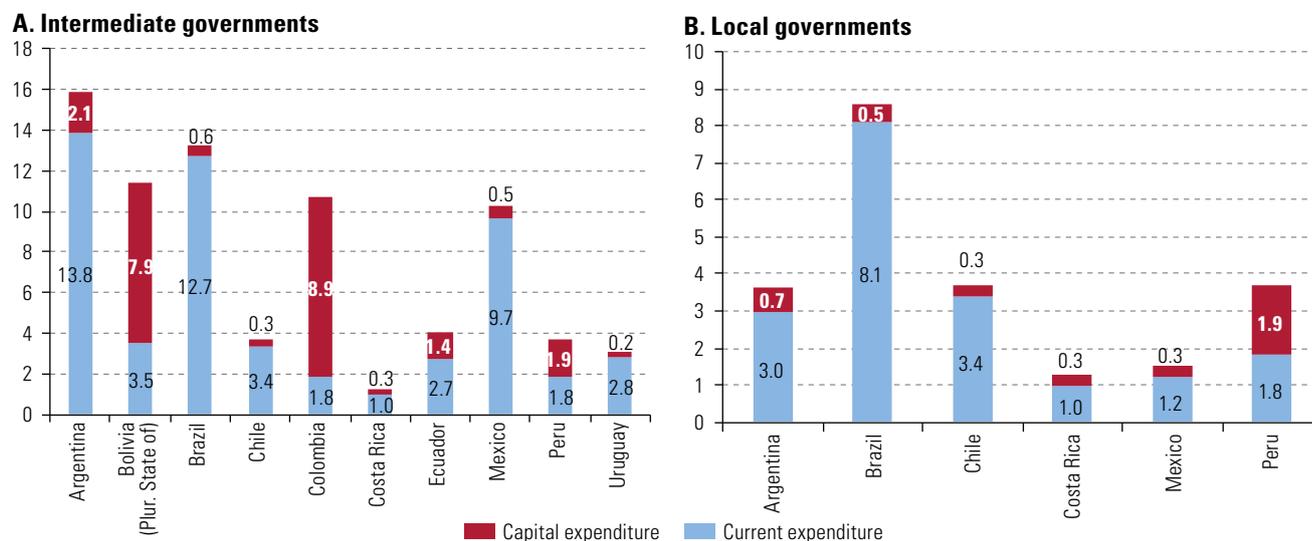
**Note:** The sample of subnational governments comprises Argentina, Brazil, Chile, Colombia, Costa Rica, Ecuador, Mexico, Peru, the Plurinational State of Bolivia and Uruguay. The sample of local governments comprises Argentina, Brazil, Chile, Costa Rica, Mexico and Peru.

<sup>a</sup> Simple averages.

In addition, both the Plurinational State of Bolivia and Colombia recorded a high level of capital expenditure and maintained their high levels of aggregate spending in 2016—around 8% of GDP in the case of the Bolivian regional governments and 9% of GDP in the case of Colombian departments—(see figure I.24). With regard to local governments, Peru's aggregate capital expenditure was close to 2% of GDP.

Figure I.24

Latin America (10 countries): breakdown of subnational government public spending, 2016  
(Percentages of GDP)

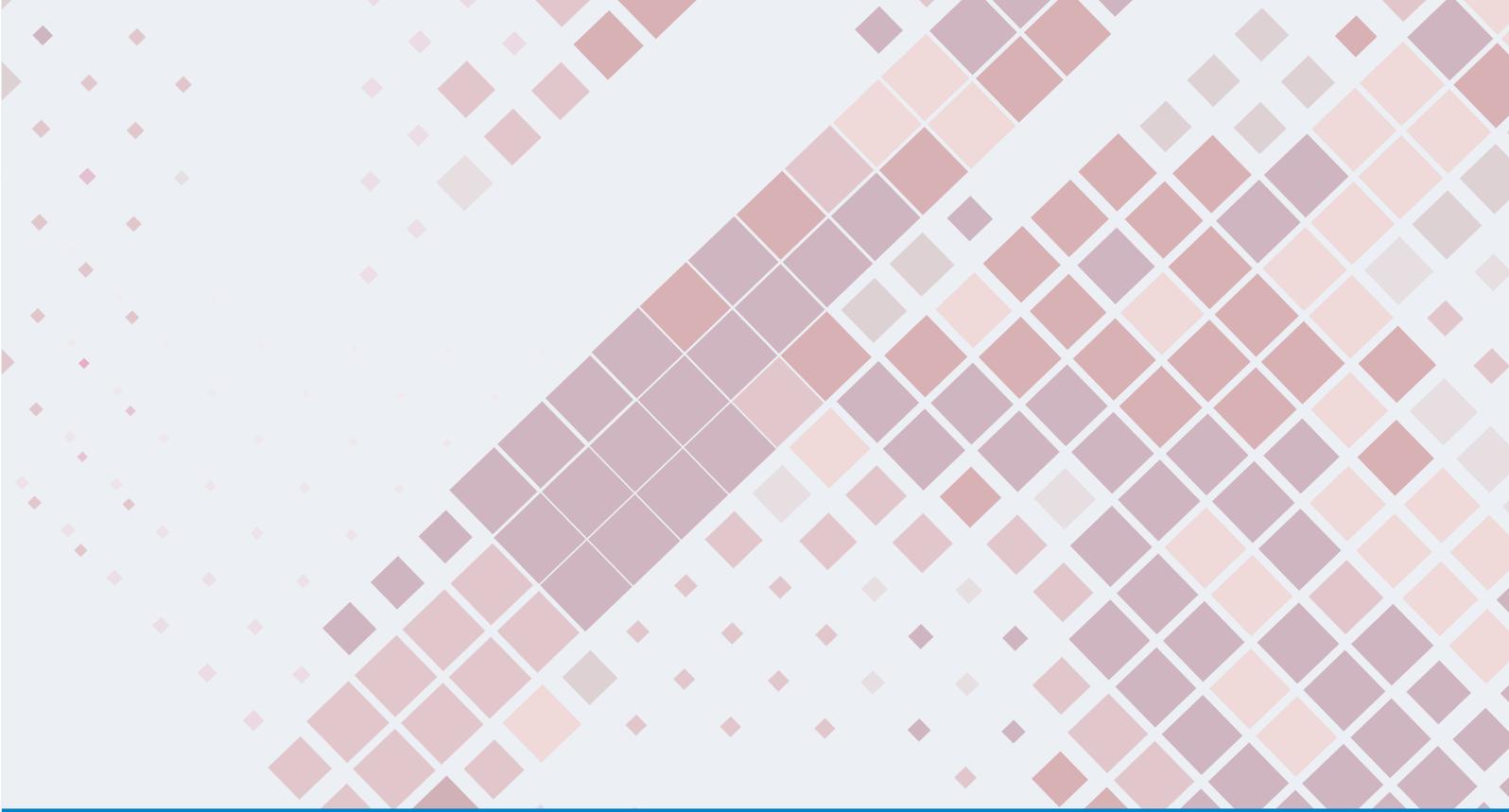


Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

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CHAPTER



# Public revenue in Latin America over the past 30 years: trends, challenges and guidelines for reforms

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## Introduction

- A. Public revenue in Latin America over the past 30 years
- B. Current challenges facing public revenues in Latin America
- C. Guidelines for reforming the region's public revenue mechanisms
- D. Conclusions

## Bibliography



## Introduction

At the United Nations summit for the adoption of the post-2015 development agenda, with the idea of establishing a viable path towards a sustainable future and ending poverty and inequality across the world, 193 Member States of the United Nations reached consensus on the outcome document “Transforming our world: the 2030 Agenda for Sustainable Development” (United Nations, 2015). It establishes a series of 17 Sustainable Development Goals (SDGs) with 169 economic, social and environmental targets, intended not only to promote human development and the fight against poverty, but also to guarantee food security, inclusive education, gender equality, the availability of water and energy, decent jobs and economic growth.

According to the consensus reached, there are three primary sources of income for financing the SDGs: (i) donations and official development assistance (ODA), (ii) foreign direct investment (FDI), and (iii) the available sources of domestic public revenue. In particular, the 2030 Agenda expresses a particular interest in strengthening “domestic resource mobilization, including through international support to developing countries, to improve domestic capacity for tax and other revenue collection” (target 17.1). The importance of domestic resources arises partly from the fact that they are relatively more stable and sustainable than other types of public financing. Furthermore, reduced use of official development assistance and foreign direct investment lowers countries’ dependence on a mass of income that can be affected by a string of external factors beyond the direct control of any State.

Latin American countries are facing a number of major challenges with the mobilization of domestic resources for meeting the Sustainable Development Goals by the 2030 deadline. They must both modify their institutional frameworks and identify ways to increase their fiscal revenues to secure the volumes of public funding that the SDGs demand.

In recent years, the need for structural reforms in public finance systems has become increasingly evident: not only to ensure the sustainability of those systems, but also to enable a leap forward in public funding and in the capacity of Latin American and Caribbean States to implement active fiscal policies that will help trace out a solid path towards inclusive growth. The countries must therefore both protect the major public revenue gains they have made over the past decade and, at the same time, work to increase their sources of funding (and to consolidate those that already exist) in order to raise the current funding base to a higher level in the coming years.

Against that background, the main objective of this chapter is to provide the region’s countries with a series of innovative fiscal resource guidelines (covering both taxation and non-tax revenues) for tackling the 2030 Agenda, based on the experiences of the past decades and on an analysis of the alternatives available for overcoming the significant structural obstacles that exist.

Following this introduction, the first section of this chapter analyses the evolution of public revenues in Latin America over the past 30 years, highlighting trends in the main fiscal instruments, the measures adopted and the reforms undertaken. The second section identifies the principal challenges facing the region’s countries in their efforts to strengthen and consolidate their income flows and thereby to ensure funding for the 2030 Agenda. The third section sets out a series of issues that define the prevailing context for the region’s countries and then offers a menu of policies to encourage and further the discussion on mobilizing the region’s domestic resources and strengthening its tax systems. The final section contains a number of conclusions and closing thoughts.

## A. Public revenue in Latin America over the past 30 years

### 1. General evolution of public revenues in the region

Latin America has undergone profound fiscal changes during the past 30 years. Particularly notable, over the period as a whole, were the substantial increase in the overall level of revenue—from both taxation and non-tax sources—and the progress made with the administration of the main revenue-raising instruments. It must also be said, however, that this process has not been at all stable over time and has fluctuated wildly at both the regional and country levels.

A number of distinct periods can be identified in the evolution of the region's public revenues. First, it can be argued that the 1980s were marked by fluctuating and unstable levels of fiscal revenues. Almost all the countries reported sharp reductions during the early 1980s, followed by periods of recovery—albeit not always offsetting the earlier losses—in the second half of the decade.

Those pronounced fluctuations in fiscal revenues were attributable to changes in both tax receipts and non-tax revenues. With regard to the former, the sharpest variations—particularly falling revenue receipts—were related to the worsening inflationary processes seen in countries such as Argentina, Brazil, Nicaragua, Peru and the Plurinational State of Bolivia, as well as to the deep recessions that occurred in most of the region's economies, which led to acute reductions in their tax bases and upturns in tax evasion and economic informality (ECLAC, 1992).

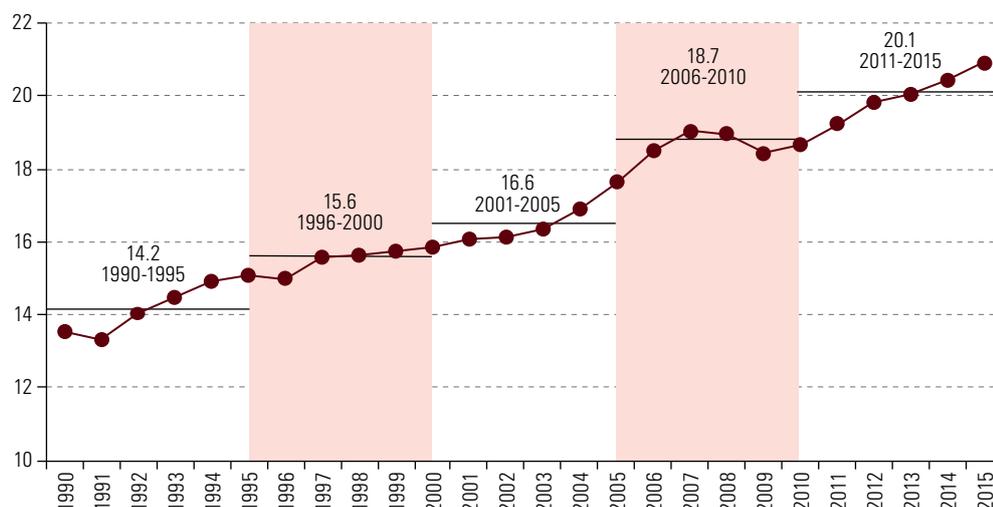
In the case of non-tax revenues, the most noticeable changes were related to the fiscal appropriation of private company income, especially in those States with high fiscal revenues from the export goods that were most vulnerable to the high levels of volatility seen in the international market prices for those products during that period. This phenomenon was particularly important in determining the rates of saving of public companies over the course of the decade, or at least of those involved in the exploitation of natural resources.

In that context, Latin American countries began to implement more stringent fiscal adjustments in order to attain macroeconomic stability and fiscal sustainability in the shortest possible time. On the income side, this was manifested in tax reforms that consolidated certain trends already underway, such as the gradual expansion of the tax base and hikes in general rates of value added tax (VAT). Another important element was the abolition of a large number of taxes that yielded low revenues but entailed high costs (simplification) and the replacement of specific consumption taxes with ad valorem equivalents (efficiency).

Through these and other measures, the region's average tax burden grew gradually but steadily during the 1990s, rising from 13.5% in 1990 to 15.9% in 2000 (see figure II.1). Of course, this evolution was influenced by the broader macroeconomic context, which explains the slowdown in the pace of growth of tax revenues in the second half of the decade, after the region's countries had been impacted by successive financial crises in emerging countries.

In the early 1990s, what is known as the Washington Consensus began to step up its influence on macroeconomic policy in the region's countries. As a result, in addition to tax reforms that clearly emphasized the goals of efficiency and simplification—to the

detriment of distributive concerns—the region experienced a wave of privatizations of State enterprises: primarily telecommunications and utilities, along with the hydrocarbon and mining industries. From the fiscal perspective, this process had a number of repercussions for public accounts (Chong and López-de-Silanes, 2005). Instead of the direct revenue the countries relinquished, they received injections of cash—which were promptly exhausted—and other permanent sources of income were created, such as tax revenue (which reinforced collections) and non-tax revenue (royalties and operating fees) paid by the privatized firms.



**Figure II.1**  
Latin America (18 countries):  
changes in average tax  
revenues, 1990-2015<sup>a</sup>  
(Percentages of GDP)

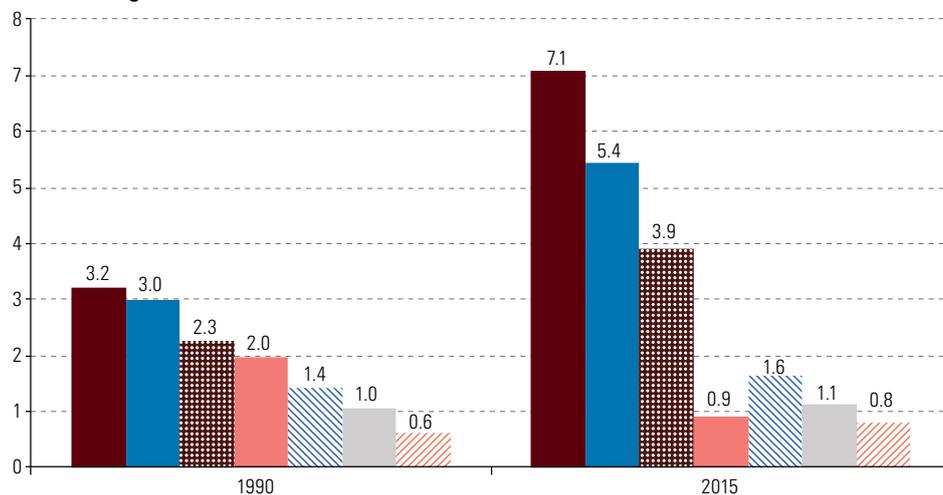
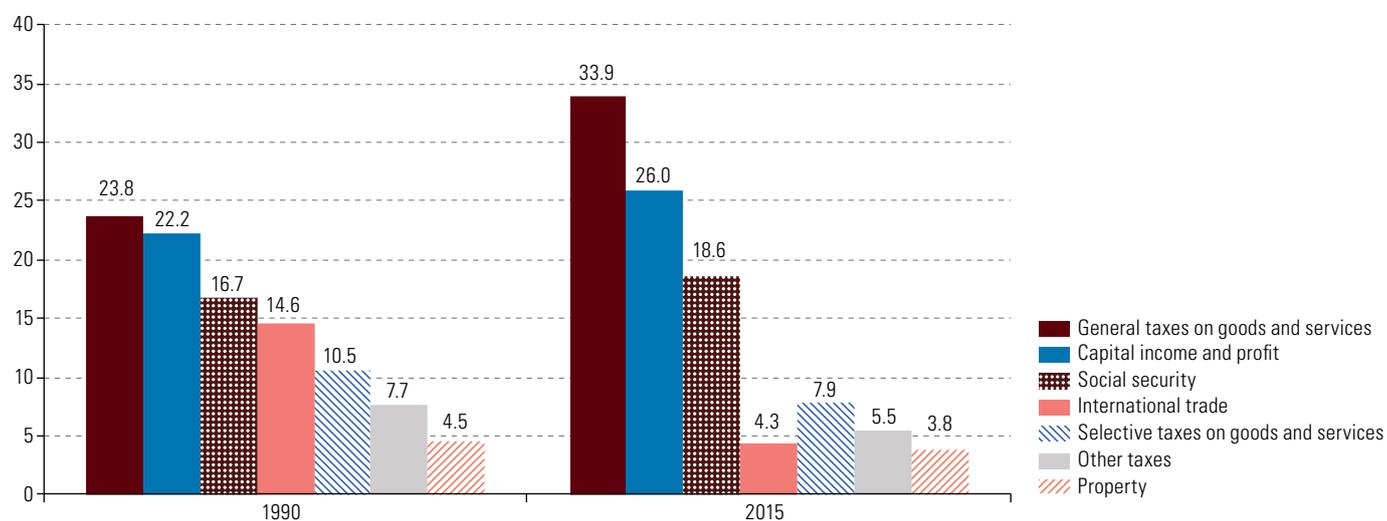
**Source:** Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of Organization for Cooperation and Development/Economic Commission for Latin America and the Caribbean/Inter-American Center of Tax Administrations/Inter-American Development Bank (OECD/ECLAC/CIAT/IDB), *Revenue Statistics in Latin America and the Caribbean 1990-2015*, Paris, OECD Publishing, 2017.

<sup>a</sup> To calculate the regional average, the general government figures for 18 selected countries were used (includes social security contributions and subnational government tax revenues). The 18 selected countries are the following: Argentina, Bolivia (Plurinational State of), Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru, Uruguay and Venezuela (Bolivarian Republic of).

The first years of the new century saw the start of a new and important phase for the region's public revenues. After 2003 in particular, tax revenues rose sharply over the course of a few years, with some indicators reaching record highs. The average tax burden rose from 16.1% of GDP in 2002 to 19.0% in 2007 (see figure II.1). This remarkable outcome was made possible in part through improvements in the administration of VAT and income tax and by reducing large numbers of tax incentives that meant huge revenue losses. The introduction of taxes on financial transactions and minimum levies on incomes and assets also helped increase revenues, by raising the level of compliance and expanding the range of tax policy instruments available.

In addition to the increase in revenue levels, the first years of the new century also brought major structural changes above and beyond the specifics of individual tax systems. Accordingly, a tax structure model emerged in the countries of Latin America that rested on two basic pillars: value added tax and income tax. As shown in figure II.2, average receipts of general taxes on goods and services (primarily VAT) rose from 3.2% of GDP to 7.1% between 1990 and 2015, with which they accounted for a third or more of the total tax burden; meanwhile, tax revenues from income and capital gains taxes (primarily income tax) rose, on average, from 3.0% to 5.4% of GDP over the same period, accounting for a 26.0% share of total tax income.

Figure II.2

Latin America (18 countries): relative structure of the average tax burden, 1990 and 2015<sup>a</sup>**A. Percentages of GDP****B. Percentages of the average tax burden**

**Source:** Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of Organization for Cooperation and Development/Economic Commission for Latin America and the Caribbean/Inter-American Center of Tax Administrations/Inter-American Development Bank (OECD/ECLAC/CIAT/IDB), *Revenue Statistics in Latin America and the Caribbean 1990-2015*, Paris, OECD Publishing, 2017.

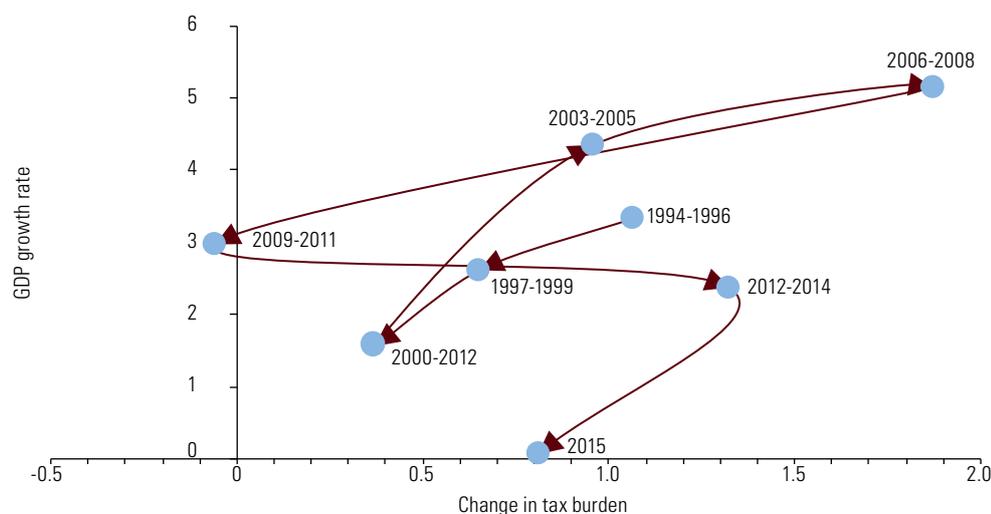
<sup>a</sup> General government level for 18 countries: Argentina, Bolivia (Plurinational State of), Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru, Uruguay and Venezuela (Bolivarian Republic of).

At the same time, contributions to social security funding were consolidated as a third pillar of the tax structure (albeit not in all the region's countries): they currently contribute an average of 3.9% of GDP and 18.6% of total revenue. Selective taxes on goods and services continued to account for a not insignificant share in most countries of the region, despite falling from 10.5% of the total burden in 1990 to 7.9% in 2015. Much greater was the drop, in absolute and relative terms, in taxes on international trade: by 2015, they had been relegated to a secondary plane, accounting for only 0.9% of GDP and 4.3% of the total. Finally, and in line with historic trends, property taxes in the region maintain only a weak presence, collecting a fraction of a percent of GDP and less than 4% of the total.

Predictably, the 2008 international financial crisis had a strong negative impact on the region's economies. However, once the most direct effects of the crisis had been overcome, the upward trend in the countries' public revenue was restored—particularly as regards tax revenues—and the regional average quickly attained historical highs, exceeding 20% of GDP in recent years.

Figure II.3 shows the combined evolution of the average tax burden (measured by percentage point changes) and economic growth (as a percentage rate), both expressed in three-year averages and in comparison to the preceding period. The differences between the various periods can be seen clearly. Starting with an average growth rate of close to 3% and an increase in the tax burden of slightly more than one percentage point for the 1994-1996 period (compared to 1991-1993), there is a downward trend in the rate of regional economic growth (but not in its actual level) and in the evolution of the tax burden, with average incremental values of 1.6% and 0.4 percentage points, respectively, for the 2000-2002 period.

After 2002, as already noted, there is a sea-change: a period of sustained economic buoyancy, with several of the region's countries posting extraordinary rates of growth, led to dramatic increases in the regional tax burden. After a maximum of 5.2% in annual growth (the average for 2006-2008) and a 1.8 percentage point increase in the average tax burden (up from 17.0% of GDP in 2003-2005 to 18.8% in 2006-2008) had been reached, the effects of the 2008-2009 financial crisis impacted both economic activity and, more intensely, the evolution of tax revenues in the region, which fell so far that the encouraging upward trend in place since 2003 was brought to an abrupt halt.



**Figure II.3**  
Latin America (18 countries):  
variation in the region's  
average tax burden and  
average gross domestic  
product, 1994-2015<sup>a</sup>  
(Percentage points of GDP  
and percentages)

**Source:** Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of Organization for Cooperation and Development/Economic Commission for Latin America and the Caribbean/Inter-American Center of Tax Administrations/Inter-American Development Bank (OECD/ECLAC/CIAT/IDB), *Revenue Statistics in Latin America and the Caribbean 1990-2015*, Paris, OECD Publishing, 2017; and International Monetary Fund (IMF), "World Economic Outlook Database", 2017 [online database] <https://www.imf.org/external/pubs/ft/weo/2017/02/weodata/index.aspx>.

<sup>a</sup> General government level for 18 countries: Argentina, Bolivia (Plurinational State of), Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru, Uruguay and Venezuela (Bolivarian Republic of).

Following the remarkable recovery in the growth rate of the tax burden between 2012 and 2014 (much more robust than the growth in average GDP), the most recent period is perhaps the one that poses the most questions for the region's countries. While still positive, the prospects for economic growth are lower than in previous years across the board, and the international context is currently favourable but clearly less

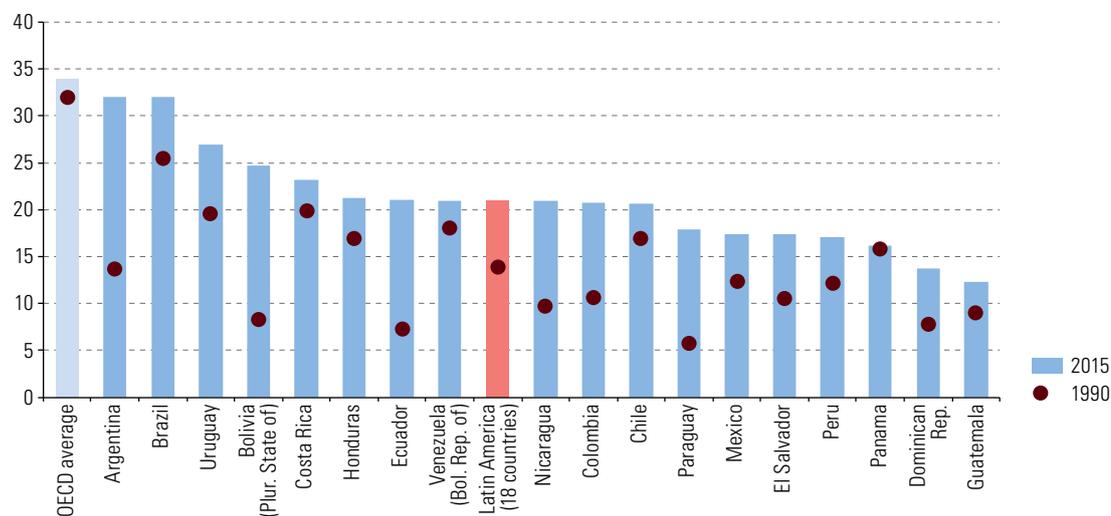
dynamic in macroeconomic terms; this, in the short term at least, limits the likelihood of a rapid rise in the tax burden. Against that backdrop, given the high public spending needs that exist in various areas, the introduction of fiscal reforms to increase the mobilization of domestic resources is of particular importance in all the region's countries, notwithstanding the significant differences that distinguish them.<sup>1</sup>

## 2. Diverse situations across the region

Currently, most of the public revenue available to the countries of Latin America to finance the work of the State comes from taxes of different kinds. There are only a few cases in which non-tax revenues play a significant part, and those countries primarily rely on (a) fiscal instruments applied to the extraction of hydrocarbons and minerals, or (b) public financing schemes derived from the economic exploitation of strategic resources (with the Panama Canal being the region's paradigmatic example). Regardless of the general trends that can be identified within the region as a whole, however, if there is something that characterizes public revenue in Latin America, it is the diversity of situations that exist.

A closer examination of the most recent figures (see figure II.4) reveals that some countries have tax burdens that are comparable to the average rate of 34.0% reported by the countries of the Organization for Economic Cooperation and Development (OECD) in 2015; Argentina and Brazil are examples of this, with figures of 32.1% and 32.0% of GDP, respectively. Also noteworthy are the figures for Uruguay (27.0%), the Plurinational State of Bolivia (24.7%, up 16 percentage points since 1990) and Costa Rica (23.1%), which place all three of them well above the average of 20.9% of GDP recorded over the most recent period for the selected panel of 18 Latin American countries.

**Figure II.4**  
Latin America (18 countries): tax revenue, 1990 and 2015  
(Percentages of GDP)



**Source:** Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of Organization for Cooperation and Development/Economic Commission for Latin America and the Caribbean/Inter-American Center of Tax Administrations/Inter-American Development Bank (OECD/ECLAC/CIAT/IDB), *Revenue Statistics in Latin America and the Caribbean 1990-2015*, Paris, OECD Publishing, 2017.

**Note:** Using general government figures for 18 selected countries.

<sup>1</sup> For an up-to-date discussion of this issue, see Cetrángolo and Curcio (2018).

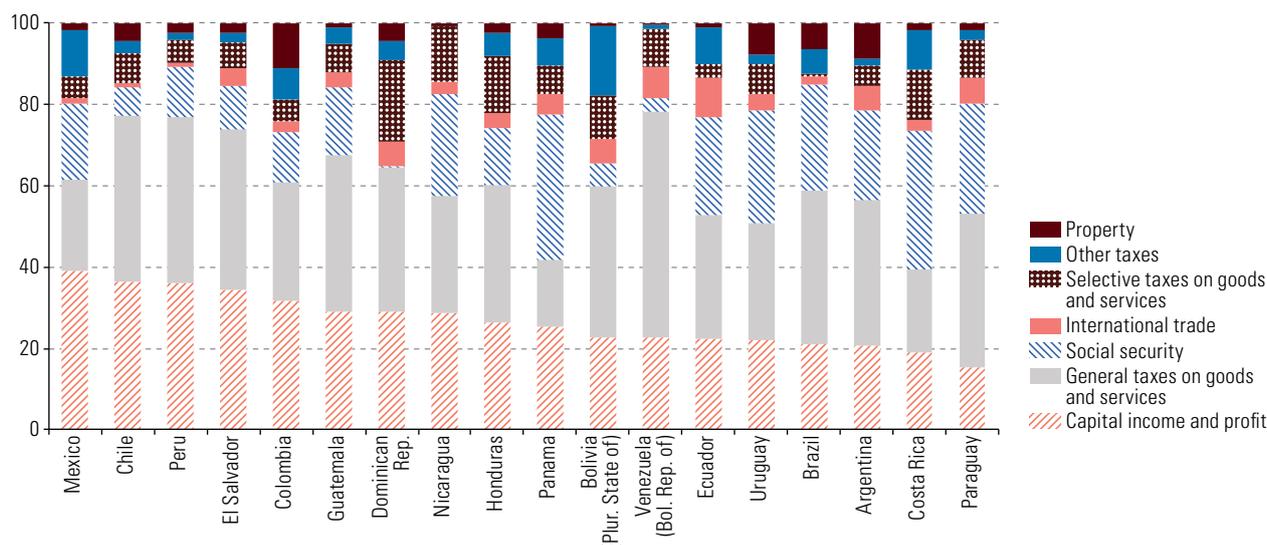
Around the average for the panel of 18 countries there is a group with tax burdens that, in 2015, ranged from 21.2% of GDP (Honduras) to 20.6% (Chile). The group also includes Colombia, Ecuador and Nicaragua, all with sharp increases over their 1990 levels. As can be seen in figure II.4, this positive trend was also observed in countries such as Paraguay (17.9% of GDP, up 12 percentage points since 1990) and El Salvador, and even in those countries where the tax burden still lags behind the regional average, such as the Dominican Republic and Guatemala. In contrast, this was definitely not the case in Panama, where the increase in GDP terms between 1990 and 2015 was negligible.

Latin America's tax differences are not limited only to revenue levels; there are also differences in the relative weights of the tax instruments currently in place. Thus, as shown by figure II.5, Mexico is the country in the region where income tax and capital gains tax account for the largest share (close to 40%); at the opposite extreme stands Paraguay, where only slightly more than 15% of total revenue comes from those taxes.

In contrast, the predominance of general taxes on goods and services (including VAT) is particularly noticeable in several countries, including the Bolivarian Republic of Venezuela and even Argentina, Brazil and the Plurinational State of Bolivia; it is not the case, however, in Costa Rica, Mexico and Panama, where those levies provide limited amounts of revenue. In any event, after selective taxes are included—the weight of which also varies from one country to the next—the majority of the cases confirm the bias towards indirect taxation. This has specific implications for the redistributive impact of the region's tax systems.

**Figure II.5**

Latin America (18 countries): relative structure of tax revenue, 2015  
(Percentages of total tax revenues)



**Source:** Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of Organization for Cooperation and Development/Economic Commission for Latin America and the Caribbean/Inter-American Center of Tax Administrations/Inter-American Development Bank (OECD/ECLAC/CIAT/IDB), *Revenue Statistics in Latin America and the Caribbean 1990-2015*, Paris, OECD Publishing, 2017.

The acute differences that exist in both the level of the tax burden and its structure from one country to the next are closely related to the reforms that the countries have been implementing over the past few decades. However, there are also other critical factors behind the differences between the various systems of public funding found in the region's countries.

One first area where the countries of Latin America do not follow a standardized pattern is their political organization, their degree of fiscal decentralization and the distribution of fiscal powers between the various levels of government, especially in the federal countries. Further distinctions arise from the existence of numerous and diverse public social security systems based on the payment of compulsory contributions, with widely different levels of development in terms of the domestic resources they generate. A third element that accentuates the region's heterogeneity in fiscal and taxation matters is the uneven availability of non-renewable natural resources, on account of the possibilities that their economic exploitation provides for generating large amounts of public resources for the State's coffers.

It should be noted that these three elements all arise from different factors and, accordingly, can be approached in different ways. While the first two (fiscal decentralization and contributory social security systems) are institutional in origin and, in theory, can be addressed from a political viewpoint, the existence of natural resources (be they renewable or non-renewable) is determined by happenstance beyond governmental control and, as a result, requires responses involving adaptation and economic use. Given the unequal importance of these three factors in the region's countries, reference will be made to them again in section B of this chapter.

### 3. Classification of countries by tax revenue structures

The existence of widely differing realities is a hallmark of Latin America, even compared to other regions in the world. While the countries share both remarkable achievements and structural weaknesses in the area of public funding, a wide range of economic and non-economic factors make it very difficult to devise common assessment methods for the region as a whole and even more difficult to establish standardized fiscal reform solutions.

Those caveats notwithstanding, since this document's purpose is to set general guidelines to assist fiscal and tax policymakers in the different countries, it offers a classification of the countries according to the main features of their public funding structures and provides different packages of concrete measures in line with their economic realities. While other options for categorizing them undeniably exist, the classification of the countries used herein is as follows:

- Group A: Argentina, Brazil and Uruguay

While in no way identical, these countries have consolidated tax systems that enable them to impose high tax burdens through the three main pillars of taxation used in the region (and also in the developed world): value added tax, income tax and social insurance contributions. This does not imply, however, that no improvements are needed to ensure compliance with the four basic principles of an ideal tax system: adequacy, equity, efficiency and simplicity in the application of the different fiscal instruments available.

- Group B: Bolivarian Republic of Venezuela, Chile, Colombia, Ecuador, Mexico, Paraguay, Peru and Plurinational State of Bolivia

These countries are highly dependent on fiscal resources deriving from their hydrocarbon and mineral extractive industries (Paraguay is included by reason of the

revenue it earns from hydroelectricity sales). While obvious differences exist between the countries, having an alternative source of income often leads to tax systems with less demanding fiscal burdens: in other words, systems that demand a lower fiscal effort and, in addition, are more exposed to volatility in their sources of financing.

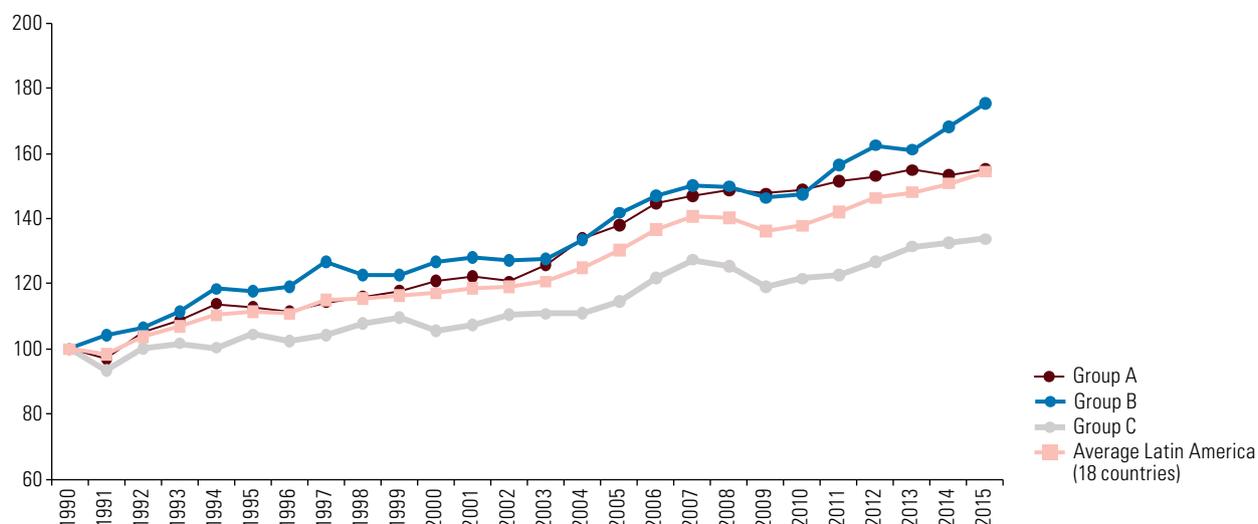
- Group C: Costa Rica, Dominican Republic, El Salvador, Guatemala, Honduras, Nicaragua and Panama

Because of their shared history and geographical proximity, these countries' tax systems have been converging: on occasions through cooperation among their respective and successive governments and, at other times, regrettably, through competition among them to attract more foreign direct investment. Likewise, most if not all of the countries have faced obstacles in consolidating the VAT and income tax pillars due to the persistence of high levels of tax evasion and economic informality, and there are sharp differences in the weight of social insurance contributions within their tax structures.

Figure II.6 shows the different evolution of the three groups in terms of their average tax burden. Taking the rates recorded in 1990 as the baseline, it can be seen that, in general, the three groups generally follow the upward trend of the regional average but with visible differences. Up until 2002, group A evolved in line with the region's average tax burden, group B rose above it (that is, experiencing a relatively more rapid pace of growth) and group C remained consistently below the regional average. In 2003, group A began to diverge from the average and, in the space of a few years, had equalled the historical evolution of group B; that situation changed, however, in 2010, when group B's growth surged upwards and group A began a gradual return in the direction of the regional trend. In turn, group C has been increasingly divergent from the regional average, and that gap embarked on a process of consolidation in the years following the financial crisis of 2008 and 2009 and its severe impact on the countries that make up this group.

**Figure II.6**

Latin America (18 countries): evolution of tax revenues by country groups, 1990-2015<sup>a</sup>  
(Percentages of GDP)<sup>b</sup>



**Source:** Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of Organization for Cooperation and Development/Economic Commission for Latin America and the Caribbean/Inter-American Center of Tax Administrations/Inter-American Development Bank (OECD/ECLAC/CIAT/IDB), *Revenue Statistics in Latin America and the Caribbean 1990-2015*, Paris, OECD Publishing, 2017.

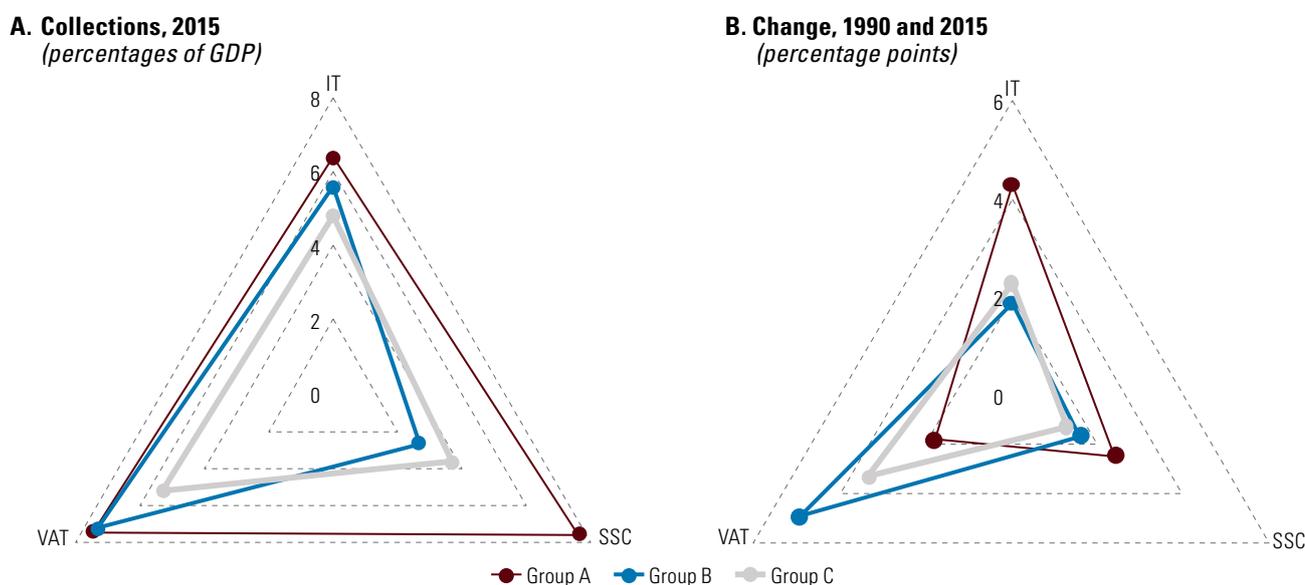
<sup>a</sup> General government level for 18 countries: Argentina, Bolivia (Plurinational State of), Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru, Uruguay and Venezuela (Bolivarian Republic of).

<sup>b</sup> Base year: 1990=100.

Finally, there are some interesting differences between the three groups in terms of the relative weight of the main components of the tax structure and how they have evolved over time. Figure II.7 shows that at present, group A has the region's highest tax burdens and, furthermore, that those burdens are balanced between the three basic tax pillars—value added tax, income tax and social security contributions—with each making similar contributions to total revenue in terms of GDP. If the change in revenues collected in percentage points of GDP is examined, it can be seen that group A's largest increase was in income tax, followed by social security contributions, with VAT rising the least.

In contrast, group B has a bias towards VAT (with an average level in GDP terms equal to that of the group A countries) and social security contributions account for a relatively low share, even smaller than that of group C, although it must be borne in mind that several of the group B countries have private social security systems for which the contributions are not included in the countries' tax burdens. As for their historical evolution, group B reports the highest relative growth in VAT receipts (in percentage points) and the lowest in income tax (see figure II.7). Finally, the group C countries exhibit the lowest levels of collection and the smallest changes in all three taxes, although there are significant differences between the countries that make up the group.

**Figure II.7**  
Latin America (18 countries): revenues from main taxes by country groups<sup>a</sup>



**Source:** Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of Organization for Cooperation and Development/Economic Commission for Latin America and the Caribbean/Inter-American Center of Tax Administrations/Inter-American Development Bank (OECD/ECLAC/CIAT/IDB), *Revenue Statistics in Latin America and the Caribbean 1990-2015*, Paris, OECD Publishing, 2017.

**Note:** The figures indicate value added tax (VAT), income tax (IT) and social security contributions (SSC). The totals shown for the suggested three groups are simple averages.

<sup>a</sup> General government level for 18 countries: Argentina, Bolivia (Plurinational State of), Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru, Uruguay and Venezuela (Bolivarian Republic of).

The classification suggested in this document does not, of course, aspire to be exhaustive: it is merely one possible alternative among many. Neither is it necessarily consistent with a classification by the structure or volume of public spending, since each country has its own rationale, preferences and context (see Cetrángolo and Curcio, 2018). However, it remains an useful way to organize both the assessments—starting with the identification of common problems and simultaneous achievements—and the main recommendations that could be offered for public revenue policies or for reform proposals intended to resolve the weaknesses that exist.

## B. Current challenges facing public revenues in Latin America

### 1. Level of available resources

First, the issue of whether the amount of resources a country has available is appropriate or sufficient is not a simple one to resolve, much less to quantify. The difficulty arises from the absence of a universal rule, given the countries' different public finance structures and the highly variable national idiosyncrasies that determine what levels of tax burden are "socially acceptable".

First, in comparative terms, the region's current level of tax revenue is much lower than in the OECD countries (see table II.1). However, using the funds that developed countries raise through taxation as a reference point might be a somewhat arbitrary and overly ambitious approach—at least in the short term—since it would require several of the region's countries to almost double their tax collections. That notwithstanding, if Latin America aspires to the sustainable financing of public goods and services with a scope and fiscal cost similar to those of the OECD countries, it is clear that the region's current levels of tax revenue are inadequate, even assuming similar levels of efficiency in public spending and despite the absence of observable evidence to that effect.<sup>2</sup>

	Latin America	OECD
Minimum	12.4	16.2
Maximum	32.1	45.9
Average	20.9	34.0
50 percentile	20.8	33.8
75 percentile	22.6	37.8
90 percentile	28.5	43.8

**Table II.1**

Latin America (18 countries) and Organization for Economic Cooperation and Development (OECD) (34 countries): average tax revenues, 2015<sup>a</sup>  
(Percentages of GDP)

**Source:** Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of Organization for Cooperation and Development/Economic Commission for Latin America and the Caribbean/Inter-American Center of Tax Administrations/Inter-American Development Bank (OECD/ECLAC/CIAT/IDB), *Revenue Statistics in Latin America and the Caribbean 1990-2015*, Paris, OECD Publishing, 2017; OECD.Stat [online database] <http://stats.oecd.org/>.

<sup>a</sup> General government level for 18 Latin American countries: Argentina, Bolivia (Plurinational State of), Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru, Uruguay and Venezuela (Bolivarian Republic of).

Second, various studies suggest that Latin America's tax revenue levels are failing to meet the potential indicated by various structural characteristics of their economies, such as their level of development measured in per capita GDP (Rossignolo, 2015). Despite the statistical limitations of studies of this kind, they are useful in that they identify and confirm the existence of some fiscal space or margin for the region's countries as they seek to strengthen their sources of public funds. While this potential is not uniform across countries or between different taxes, the study results suggest that the margin is larger for personal income tax and social security contributions, at least in those countries currently requiring a lesser degree of fiscal effort.

<sup>2</sup> ECLAC (2014) reviews the results of the main studies examining that question and confirms that public spending is less efficient in Latin American countries than in the developed countries, including some OECD members.

## 2. The distributive impact of taxation and the role of personal income tax

Over the past fifteen years, Latin America has taken great strides in reducing its levels of economic inequality. Nevertheless, the statistics show that it is still the most unequal region in the world, with 11 countries among the world's 20 most unequal (Duryea and Robles, 2016).

Fiscal policy can reshape the distribution of income determined by “market forces” in two ways. First, it can create direct improvements through transfer systems that assign public spending to the main functions of the State (health, education, care, social welfare and so on). Tax systems play a leading role in securing resources for funding those transfers.

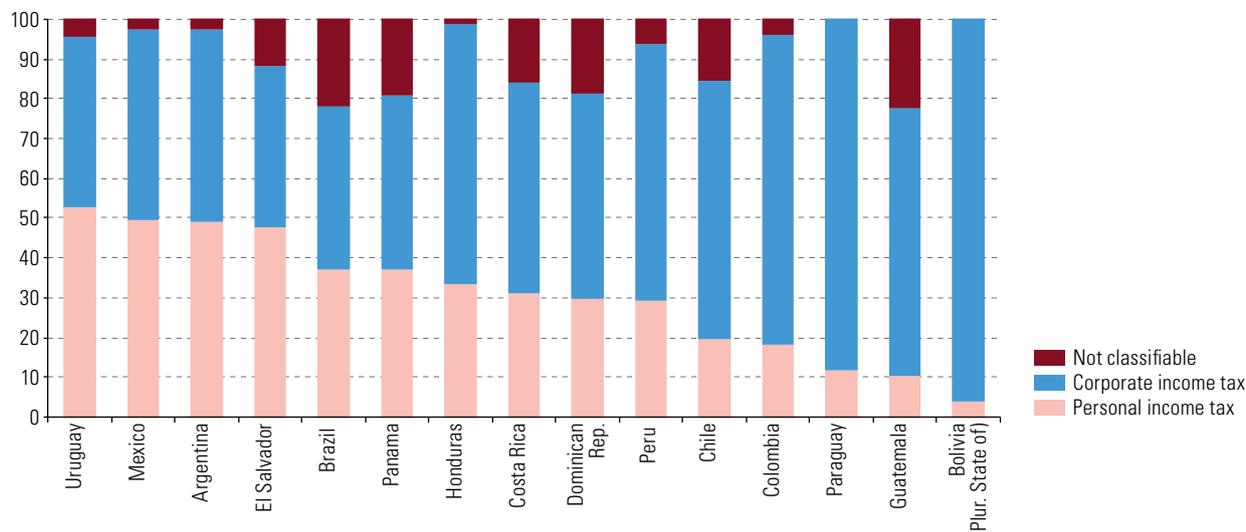
Second, and in parallel to the above, tax systems can be designed to abide by the principle of contributory capacity by requiring a greater effort from wealthier taxpayers: in other words, they can have a progressive impact on income distribution.

In Latin America, however, fiscal policy continues to play a limited role in improving the distribution of disposable income. While the region's countries start with market-determined levels of income inequality only slightly higher than those of OECD countries, in the latter group fiscal policy plays a significant role in reducing inequality: there, the Gini index falls by 36% after transfers and direct taxes, compared to a mere 6% in Latin America (Hanni, Martner and Podestá, 2015). Leaving to one side the clear differences that exist among the countries, on average 61% of Latin America's Gini index reduction comes from public cash transfers (including pensions), while taxation—mostly through personal income tax and the payment of social security contributions—accounts for only one third of the region's already meagre redistributive result.

There is some basic common ground among the region-wide findings, which indicate that taxation in Latin America is currently regressive or only barely progressive owing to the prevalence of indirect rather than direct taxation. With regard to direct taxation, most income tax revenue generally comes from companies; personal income tax accounts only for a minor share (see figure II.8) and, within that, most of the tax burden falls on salaried workers, whose tax is withheld at source; and, at the same time, capital gains are treated more leniently. As a result, the weakness of tax collection in general and the limited weight of the most progressive instrument—personal income tax—cannot counteract the regressive effect of taxes on goods and services, and the virtual non-existence of taxes on wealth does nothing to alter that bias (Gómez Sabaini, Jiménez and Rossignolo, 2012).

A closer analysis of how personal income tax functions as a redistributive tool shows, first, that its receipts are highly concentrated in the final decile of income in all the countries of Latin America (see figure II.9, right scale), with an average of 88.0% and all the individual results, with the exception of Uruguay and Argentina, above 80%. This stands in sharp contrast with the European Union's average of 39.2%. In other words, the revenue generated by personal income tax comes almost exclusively from those individuals with the highest incomes. This undermines both the potential receipts from the tax and its ability to reshape income distribution in more general terms. For that reason, the inclusion of the middle classes in the scope of income tax is, both currently and historically, one of the main challenges facing tax policy throughout Latin America (ECLAC, 2017a).

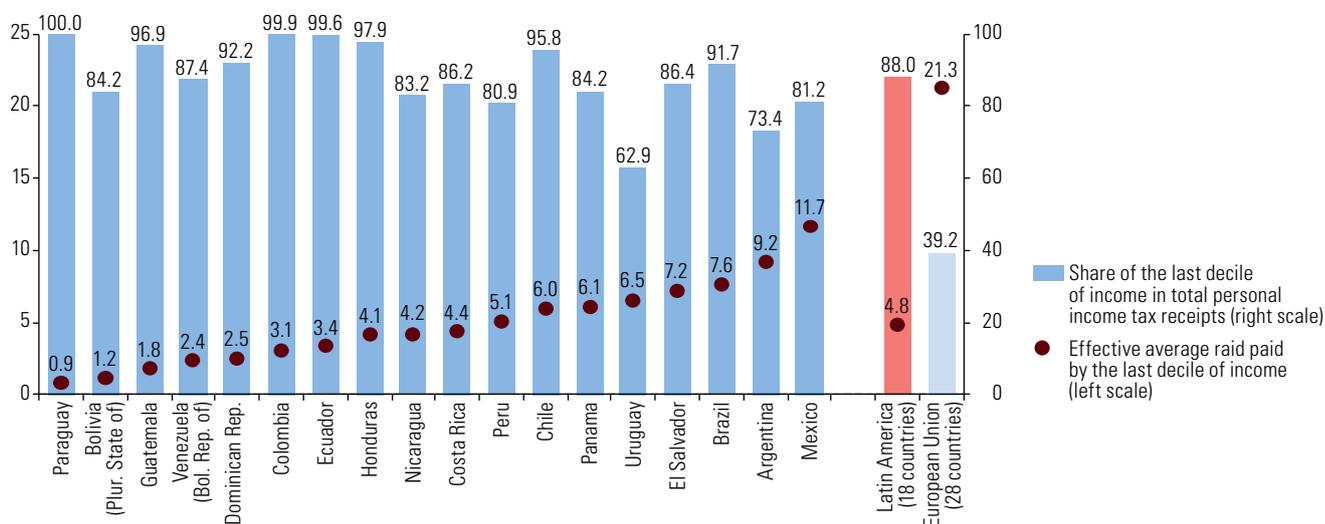
**Figure II.8**  
Latin America (15 countries): structure of income tax receipts, 2015  
(Percentage of total income tax revenues)



**Source:** Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of Organization for Cooperation and Development/Economic Commission for Latin America and the Caribbean/Inter-American Center of Tax Administrations/Inter-American Development Bank (OECD/ECLAC/CIAT/IDB), *Revenue Statistics in Latin America and the Caribbean 1990-2015*, Paris, OECD Publishing, 2017.

**Note:** A distinction could not be drawn between taxpayer types in the Bolivarian Republic of Venezuela, Ecuador and Nicaragua, and therefore those countries were not included in the figure.

**Figure II.9**  
Latin America (18 countries) and European Union (28 countries): average effective rate of personal income tax paid by the tenth decile and its share in the total, around 2014<sup>a</sup>  
(Percentages)



**Source:** Economic Commission for Latin America and the Caribbean (ECLAC), *Fiscal Panorama of Latin America and the Caribbean, 2017* (LC/PUB.2017/6-P), Santiago, March, 2017b.

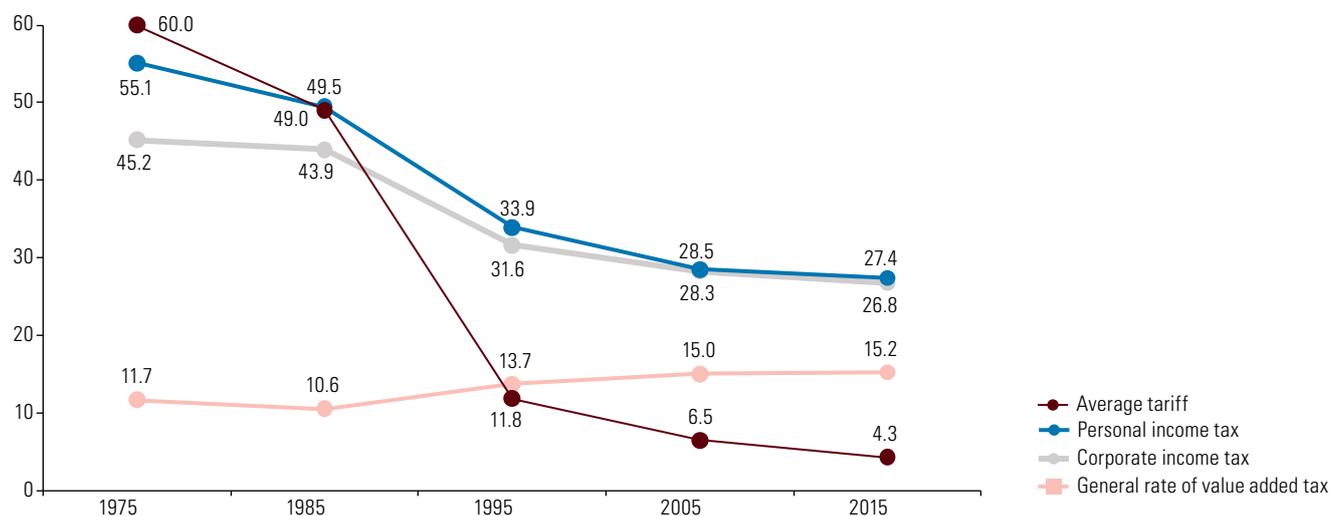
<sup>a</sup> Average effective rates are calculated from gross income before direct taxes.

The redistributive capacity of personal income tax is further constrained by the fact that in practice, wealthier taxpayers face a much lighter burden than the maximum rates set in tax law would indicate. As shown in figure II.9 (left scale), the actual average income tax rate paid by Latin America's richest decile was 4.8% in 2014, which again falls widely short of the average of 21.3% seen in the countries of the European Union. In practice, therefore, personal income tax is concentrated in a fraction of the economically active population; moreover, those taxpayers pay considerably less than they would in developed countries because they receive a relatively higher proportion of capital income, which is more lightly taxed.

There are a number of factors that limit personal income tax yields in Latin American countries. In line with the international trends that began in the 1980s, rates of corporate income tax have been falling across the board (see figure II.10). In the region's countries, those cuts were extended to the top marginal rates of tax and, as a result, they are now significantly lower than the prevailing rates in developed countries, particularly those of Western Europe.

**Figure II.10**

Latin America (18 countries): decade-on-decade evolution of average rates of main taxes, 1975-2015<sup>a</sup>  
(Percentages)



**Source:** Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of D. Morán and M. Pecho "Taxation over the last fifty years", *CIAT: 50 years in Latin American taxation*, Panama City, Inter-American Center of Tax Administrations (CIAT), 2017.

<sup>a</sup> The 18 countries selected for this figure are the following: Argentina, Bolivia (Plurinational State of), Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru, Uruguay and Venezuela (Bolivarian Republic of).

Furthermore, the large number of exemptions, personal allowances and tax expenditures (especially for capital income) erodes the tax base and therefore leads to reduced receipts. Recent years have seen encouraging developments in this regard with the introduction of dual schemes for taxing income, as a partial way of taxing all the income received by taxpayers. Following the pioneering example set by Uruguay in 2007, the countries of Central America, Argentina, Mexico and Peru have all adopted such reforms. However, even when included in the tax base, a large portion of that income is difficult for tax administrations to quantify and monitor, which leads to inequalities between taxpayers depending on the source of the income on which they are taxed.

High levels of evasion, avoidance and non-compliance are another factor that helps explain the feeble performance of income tax in Latin American countries. The available evidence, which is far from abundant, indicates levels of non-compliance in excess of 50% of the revenues that could theoretically be obtained if the tax were to function

optimally (Jiménez, Gómez Sabaini and Podestá, 2010). In turn, the vast dimensions of the informal sector in the region's economies favours underreporting or the direct concealment of taxable income earned by middle- and high-income individuals. This factor also influences effective receipts of corporate income taxes, particularly from the much more numerous smaller businesses that operate exclusively in the domestic market.

### 3. Tax expenditures and tax efficiency

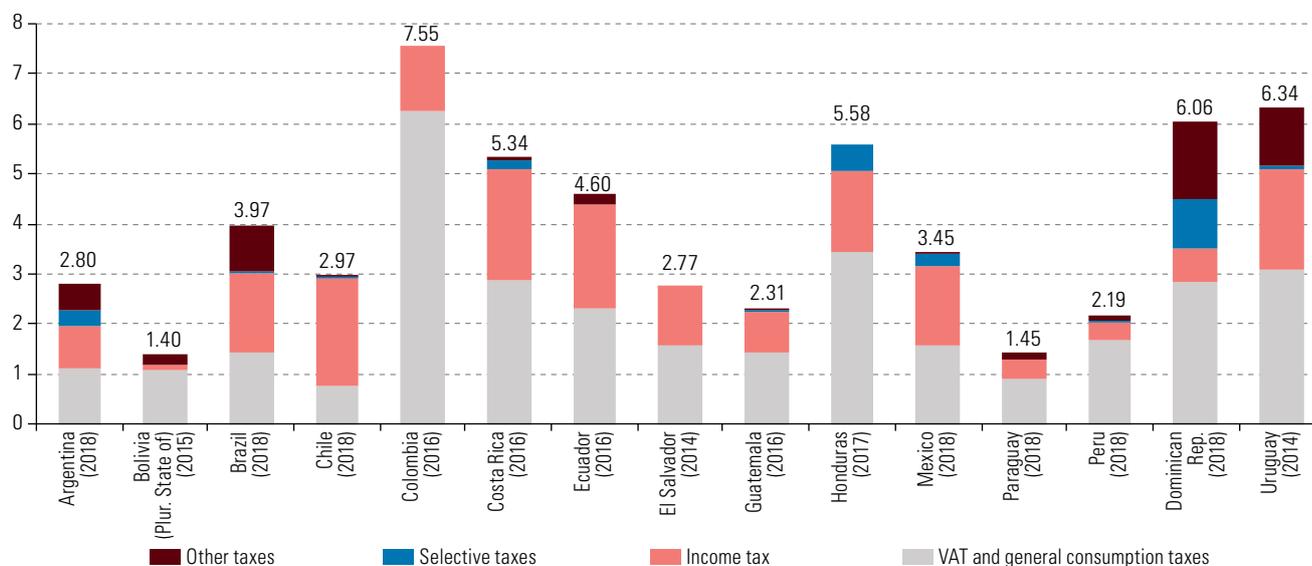
From the viewpoint of economic efficiency, the main taxes used in the region's countries (VAT and income tax) suffer from serious limitations or weaknesses in their tax bases on account of the numerous special forms of treatment that exist: generally exemptions, deductions, deferrals and reduced rates.

Whether they are objective (applied to a specific economic activity or manifestation of contributory capacity) or subjective (targeted at certain taxpayers by reason of specific characteristics), tax expenditures can be deployed for a broad range of purposes. In general, however, two main types can be identified: those used to influence the behaviour of economic agents and encourage certain effects or results arising from their activities (tax incentives),<sup>3</sup> and those intended to benefit certain groups within society by reducing the effective tax burden they bear (social tax expenditures).

The major drawback of tax expenditures in the region is the volume of tax revenue that is forgone. Albeit with a caveat about the complexity of comparisons between countries on account of the widely different methods used, Podestá (2018) finds that according to the most recent official estimates, the taxes forgone as a result of tax expenditures generally amount to more than two percentage points of GDP (see figure II.11). Only Paraguay and the Plurinational State of Bolivia report lower values (around 1.4% of GDP). At the other extreme are Colombia, Costa Rica, the Dominican Republic, Honduras and Uruguay, with tax expenditures in excess of 5% of GDP.

**Figure II.11**

Latin America (15 countries): tax expenditures by type of tax, 2018 or most recent year with data  
(Percentages of GDP)



**Source:** Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of A. Podestá, *El gasto tributario en América Latina: tendencias actuales, avances y desafíos*, Santiago, Economic Commission for Latin America and the Caribbean, unpublished, 2018.

<sup>3</sup> In addition to encouraging investment, the goals usually sought through tax incentives include the development of unprivileged regions, export promotion, industrialization, job generation, environmental conservation, technology transfer, economic diversification and the training and development of human capital.

In relative terms, according to Podestá (2018), these lost taxes are equal to between 15% and 30% of the amounts actually collected for most of the countries (Brazil, Chile, El Salvador, Guatemala, Honduras, Mexico, Paraguay and Peru). In other cases, the figure is relatively lower (11.4% in Argentina and 6.3% in the Plurinational State of Bolivia) whereas, in the remaining countries, it exceeds 35%.

The breakdown by type of tax shows that, in most countries, the bulk of the fiscal cost is borne by VAT and then by income tax. Thus, for value added tax, tax expenditures as a proportion of GDP are particularly high in Colombia,<sup>4</sup> Honduras and Uruguay (over 3% of GDP); at the other extreme, with fiscal cost levels below 1% of GDP, are Chile and Peru. For income taxes, tax expenditures amount to 2% of GDP or more in Chile, Costa Rica, Ecuador and Uruguay; interestingly, in most of the other countries, the fiscal cost of preferential corporate income tax treatment exceeds that of tax expenditures extended to personal income tax (Podestá, 2018).

Given the high fiscal cost they represent and loss of efficiency in receipts of the main taxes they entail, it would be logical to assume that the existence of tax expenditures was properly justified by the results. This gives rise to the second problem commonly associated with these instruments in the region: the lack of systematic evaluations of the sectoral and global economic impact of these forms of preferential treatment. In particular, there is widespread uncertainty about the benefits they yield when, ideally, not only should those results be congruent with the objectives sought, but also—and most importantly—they should be sufficient to offset the fiscal costs they entail.

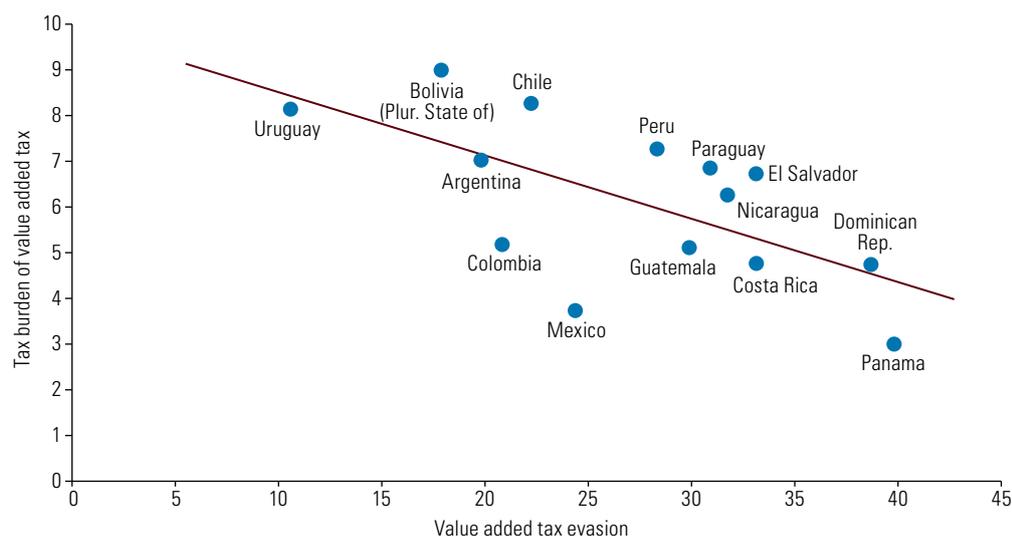
## 4. Domestic and international tax evasion

Tax evasion has traditionally been one of the main obstacles affecting public finances in the countries of Latin America and it remains so today. Whereas up until a few years ago, the prevailing approach focused on taxes levied domestically, the upswing in global operations by large multinational companies has forced countries to address the problem from a broader and more sophisticated angle.

In most of the region's countries, quantifying evasion remains far from an institutionalized undertaking conducted at regular intervals and with due disclosure of the results. Significant steps forward were taken with regard to value added tax between 2000 and 2008, but this came to a halt with the international financial crisis and, in recent years, progress has weakened or, in some cases, the gains made have been lost (Gómez Sabaini and Morán, 2016a). The most up-to-date estimates for most of the region indicate unacceptable levels of evasion, particularly in the Central American countries, the Dominican Republic and Panama: precisely those parts of the region where VAT generates the lowest amounts of revenue (see figure II.12).

In general, the countries that collect the most VAT are those with the lowest rates of evasion; there are exceptions, however, such as Colombia and Mexico, where VAT generates comparatively low levels of revenue, and Peru and Paraguay, which have healthy receipts despite non-compliance rates of around 30%. One striking feature is that contrary to what might be expected, the country with the highest rate of value added tax (Uruguay, with 22.0%) reports the region's lowest rate of VAT evasion and, predictably, one of the highest levels of VAT revenue. At the other extreme, Panama has the highest level of non-compliance (close to 40%) despite its very low general rate of VAT (7.0%) and, logically, it earns very little from the tax.

<sup>4</sup> Podestá (2018) argues that the methodology used in this case overestimated the fiscal cost for this tax because its definition of tax expenditure included certain exemptions for goods and services that it would not be feasible to tax and that therefore would not generate a loss in revenue.



**Figure II.12**  
Latin America (14 countries): value added tax receipts and estimated rates of value added tax evasion, 2014 or most recent year with data<sup>a</sup>  
(Percentages of GDP and percentage of theoretical receipts)

**Source:** Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of Organization for Cooperation and Development/Economic Commission for Latin America and the Caribbean/Inter-American Center of Tax Administrations/Inter-American Development Bank (OECD/ECLAC/CIAT/IDB), *Revenue Statistics in Latin America and the Caribbean 1990-2015*, Paris, OECD Publishing, 2017, for tax revenue figures; Gómez Sabaini, J. C., J. P. Jiménez and R. Martner, *Consensos y conflictos en la política tributaria de América Latina*, ECLAC Books, No. 142 (LC/PUB.2017/5-P), Santiago, Economic Commission for Latin America and the Caribbean (ECLAC), 2017; and official figures for estimates of VAT evasion.

<sup>a</sup> The data presented, for both VAT receipts and evasion, are: from 2007 for Argentina; from 2010 for El Salvador; from 2012 for Mexico and Panama; from 2013 for Costa Rica, Nicaragua and the Plurinational State of Bolivia; and from 2014 for Chile, Colombia, the Dominican Republic, Guatemala, Paraguay, Peru and Uruguay.

In contrast, as noted above, not only are there much fewer estimates available for income tax, but greater levels of non-compliance by both individuals and corporations have been detected. To provide a comprehensive view of the extent of the problem across the region, ECLAC has estimated that in 2015, while VAT evasion amounted to the equivalent of 2.4% of regional GDP, income tax evasion totalled 4.3%, with which the region's combined losses from the two taxes totalled some US\$ 340 billion that year.

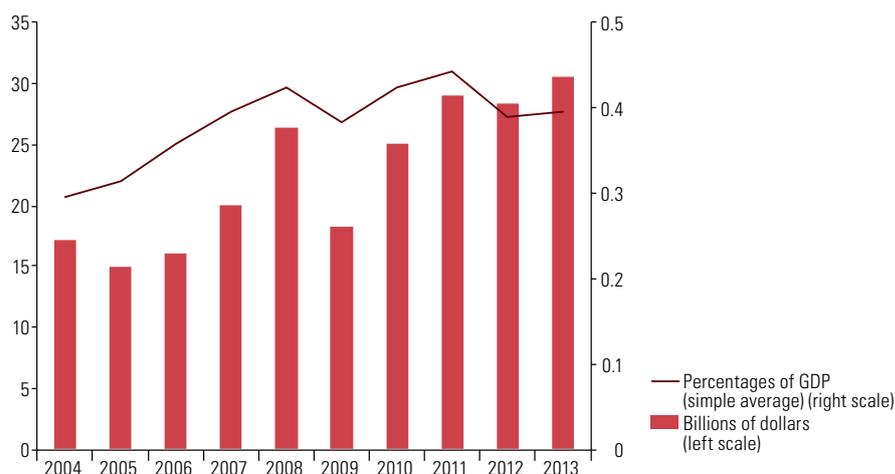
A similar claim can be made with respect to the other taxes in force in the region's countries, particularly those that account for significant revenues: social security contributions, selective taxes on certain goods and services and property taxes. The first of those represents a much more serious situation, in that it directly affects the funding of protection systems and their financial sustainability and, undeniably, has an impact on the quantity and quality of the benefits made available to the public (Gómez Sabaini, Cetrángolo and Morán, 2014).

Moreover, in recent years, and in light of evidence of massive transfers of capital from their countries of origin to other jurisdictions, where they are kept to benefit from legal and tax advantages, there has been a growing interest in addressing the international dimension of tax evasion. This problem involves both multinational companies which, as global entities, seek to minimize the tax burdens they bear, and individuals from very high income brackets who, in addition to paying less tax, are able to conceal their assets in foreign countries, out of the reach of national revenue services. Fortunately, awareness has been increasing regarding the harmful effects of this phenomenon which, seen from the viewpoint of individual countries, leads to the erosion of domestic tax bases and undermines the overall efficiency and fairness of any tax system.

To date, however, very little is known about the magnitude of this problem. Global studies produced by international agencies suggest that base erosion and profit shifting (BEPS) manoeuvres lead to extreme tax losses. For example, OECD (2015) estimated that the total net losses currently stood at between 4% and 10% of annual corporate income tax revenues, for a total of between US\$ 100 billion and US\$ 240 billion in 2014.

While there are no specific studies for the Latin American region, ECLAC recently made an effort to estimate the illicit financial outflows deriving from the manipulation of trade prices and the revenues foregone by treasuries as a result. According to Commission's calculations, the amount of tax revenue lost stands at around 0.5% of GDP (see figure II.13): in other words, approximately US\$ 31 billion a year, or the equivalent of between 10% and 15% of the total corporate income tax actually collected (Podestá, Hanni and Martner, 2017).

**Figure II.13**  
Latin America and the Caribbean (24 countries): tax revenue lost through price manipulation, 2004-2013  
(Billions of dollars and percentages of GDP)



**Source:** Economic Commission for Latin America and the Caribbean (ECLAC).

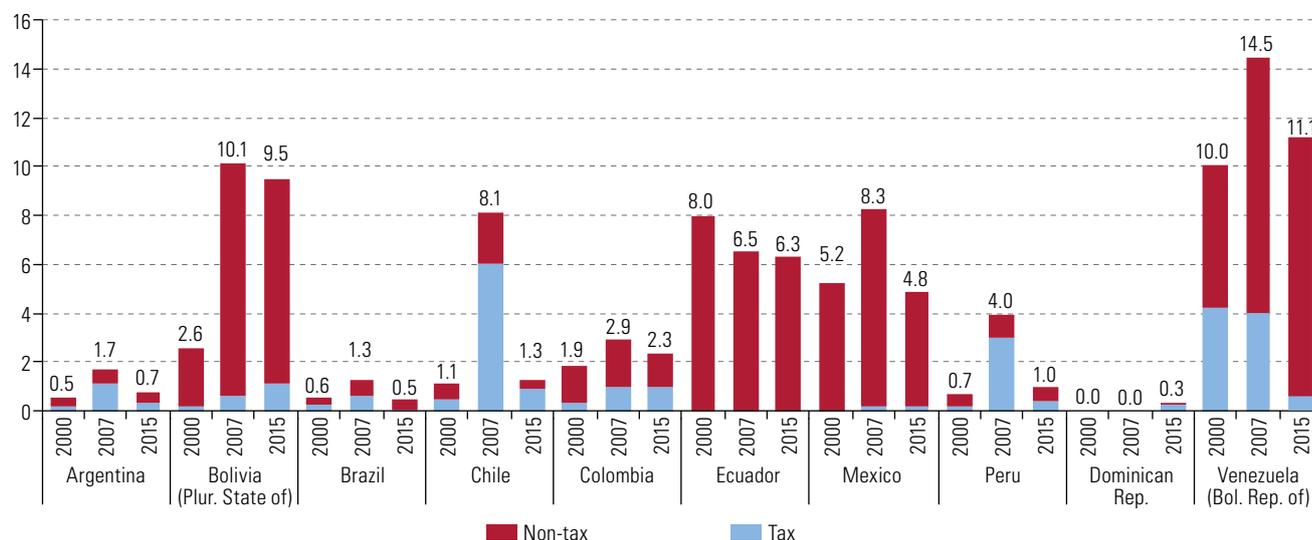
For more than a decade, and in direct response to the problem, the region's countries have been reforming their tax laws to include mechanisms designed to prevent or substantially curtail this serious phenomenon. After individual strategies proved inadequate, a rising number of countries have engaged with and committed their active participation in various regional and international forums intended to set the foundations for cooperation and joint activities and programmes for combating such manoeuvres by private actors. Particularly noteworthy among these efforts is the work of the OECD through its Base Erosion and Profit Shifting Project, both for its drafting of standard regulations and for its facilitation of meetings and discussions in pursuit of greater international financial transparency. In that context, great strides have been made in automatic exchanges of tax information among countries, at both the bilateral and multilateral levels, with around one hundred countries now implementing the Common Reporting Standard and the Multilateral Competent Authority Agreement (MCAA).

## 5. Fiscal dependence on non-renewable natural resources

Latin America's reliance on non-renewable natural resources is nothing new: such resources have traditionally been one of the region's main sources of foreign exchange. However, the boom in international commodity prices of 2003 to 2007 bolstered fiscal revenues from extractive industries to levels never before seen in several of the region's countries. In the wake of the financial crisis of 2008 and 2009, and despite the region's speedy recovery, the drastic fall in international crude oil prices in 2014, accompanied by a somewhat slower decline in the minerals sector, posed major challenges for most of the countries.

**Figure II.14**

Latin America (10 countries): fiscal revenues from the exploitation of hydrocarbons and minerals, 2000, 2007 and 2015  
(Percentages of GDP)



Source: Economic Commission for Latin America and the Caribbean (ECLAC).

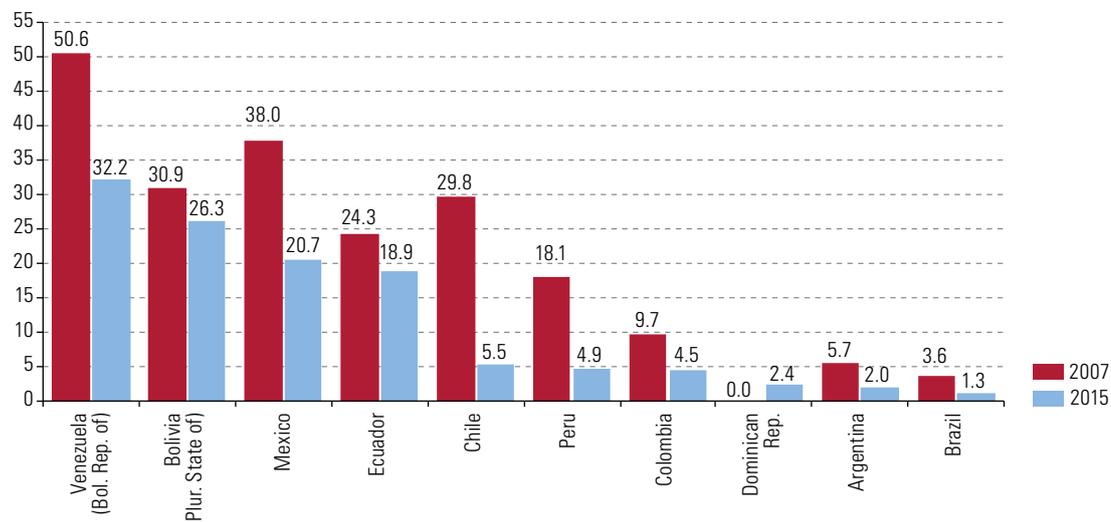
Figure II.14 shows the fiscal revenue figures for hydrocarbons and minerals in 2000, 2007 and 2015, with the totals for the two sectors combined but distinguished by the revenue-raising mechanism used (tax or non-tax). While the pre-eminence of non-tax instruments can be seen (mainly royalties, rights and State participation), in some cases the rising relative weight of tax revenues (corporate income tax and other supplementary mechanisms) directly linked to those extractive industries is also apparent. Regardless of the classification, however, what is clear is the supreme importance of these sources of fiscal revenue in some of the region's countries (currently, the Bolivarian Republic of Venezuela, Ecuador, Mexico and the Plurinational State of Bolivia), which means that they must be taken on board in designing reforms of public funding structures.

The evolution of these resources (and of their relative importance in State finances) reveals a series of implications with a direct impact on public revenue models. On the one hand, the international commodities boom of 2003 to 2007 revealed that several of the region's countries were highly dependent on fiscal revenues from non-renewable natural resources, which placed them in a financially dangerous situation on account of the high volatility in the international prices of those goods.

Figure II.15 shows evidence of this phenomenon, highlighting two key facts related to this indicator: (i) the decline in the importance of revenues from hydrocarbons and minerals (as a percentage of total State income) compared to the record levels attained in 2007, which has been dramatic for oil-based countries such as the Bolivarian Republic of Venezuela and Mexico as well as for mineral exporters such as Chile and Peru, and (ii) the persistence of very high levels of hydrocarbon dependence in countries such as the Bolivarian Republic of Venezuela, Ecuador, Mexico and the Plurinational State of Bolivia, despite the prolonged decline in international oil prices, a situation that was not replicated in countries where the mineral sector is of prime importance.

Figure II.15

Latin America (10 countries): fiscal dependence on extractive sector revenues (hydrocarbons and minerals), 2007 and 2015  
(Percentages of total revenues)



Source: Economic Commission for Latin America and the Caribbean (ECLAC).

Note: For the Bolivarian Republic of Venezuela, the most recent data are from 2014.

Furthermore, the volatility of fiscal revenues from non-renewable natural resources—which depends on a range of factors beyond governmental control, such as international reference prices and discoveries of deposits—can transmit considerable instability to total fiscal revenues (including tax receipts) and affect the fiscal sustainability of countries exposed to the phenomenon.

Last but not least, the uneven geographical distribution of deposits is a potential source of heightened inequalities between different territories within a given country. As a result, the region's countries have reviewed and strengthened their mechanisms for funding and solidarity-based redistribution between levels of government to prevent a worsening of the territorial gaps that already exist from one jurisdiction to the next and to soothe political tensions between them (Brosio and Jiménez, 2015).

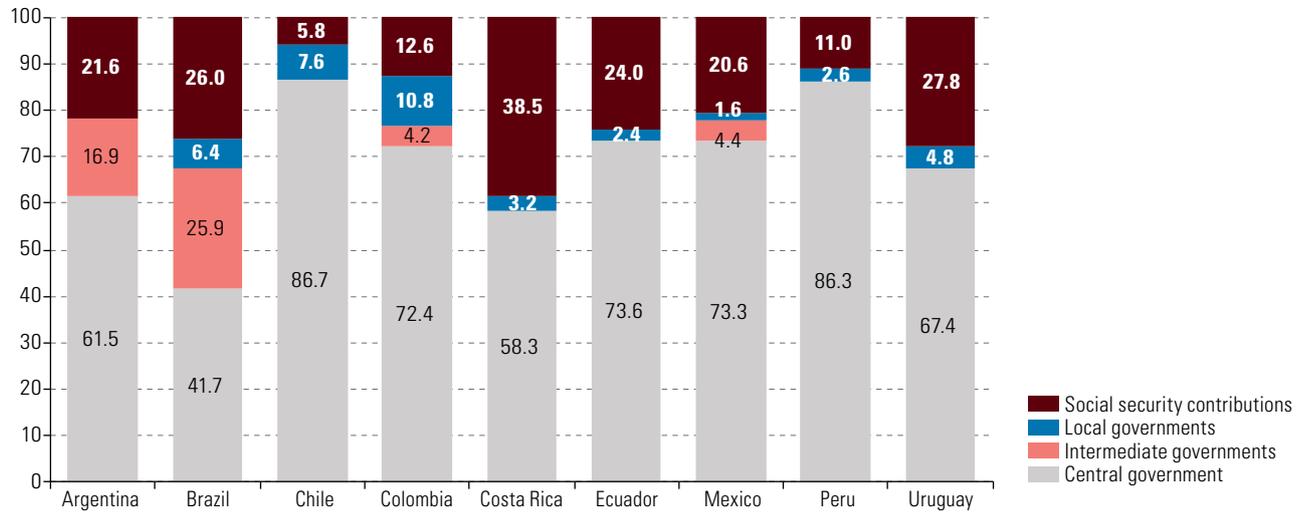
## 6. Financing of subnational governments

Because local governments are in more direct contact with the public, the 2030 Agenda assigns them a central role, both in communicating its global goals to communities and in ensuring their commitment towards the changes it demands. To achieve this, a fair distribution of domestic resources between a country's territories must be ensured, particularly as regards funding for infrastructure and basic services in developing countries.

In most of Latin America, however, the allocation of tax revenues is sharply skewed towards central Government; only a few countries report significant degrees of fiscal decentralization towards subnational governments (see figure II.16). In Brazil, for example, in 2014 the States and municipalities together accounted for over 32% of national tax revenues, while the subnational governments of Argentina and Colombia (provincial in the former; departmental and municipal in the latter) made contributions to domestic revenue of over 15% of the total. In contrast, lower levels of government have lower revenue-raising capacities in Chile (7.9%), Mexico (6.0%) and Uruguay (4.9%), while in the remaining countries of the region the corresponding contributions are negligible.

Figure II.16

Latin America (9 countries): tax revenues by level of government, 2014  
(Percentages of total tax revenues in each country)



**Source:** Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of Organization for Cooperation and Development/Economic Commission for Latin America and the Caribbean/Inter-American Center of Tax Administrations/Inter-American Development Bank (OECD/ECLAC/CIAT/IDB), *Revenue Statistics in Latin America and the Caribbean 1990-2015*, Paris, OECD Publishing, 2017, for tax revenue figures; Gómez Sabaini, J. C., J. P. Jiménez and R. Martner, *Consensos y conflictos en la política tributaria de América Latina*, ECLAC Books, No. 142 (LC/PUB.2017/5-P), Santiago, Economic Commission for Latin America and the Caribbean (ECLAC), 2017.

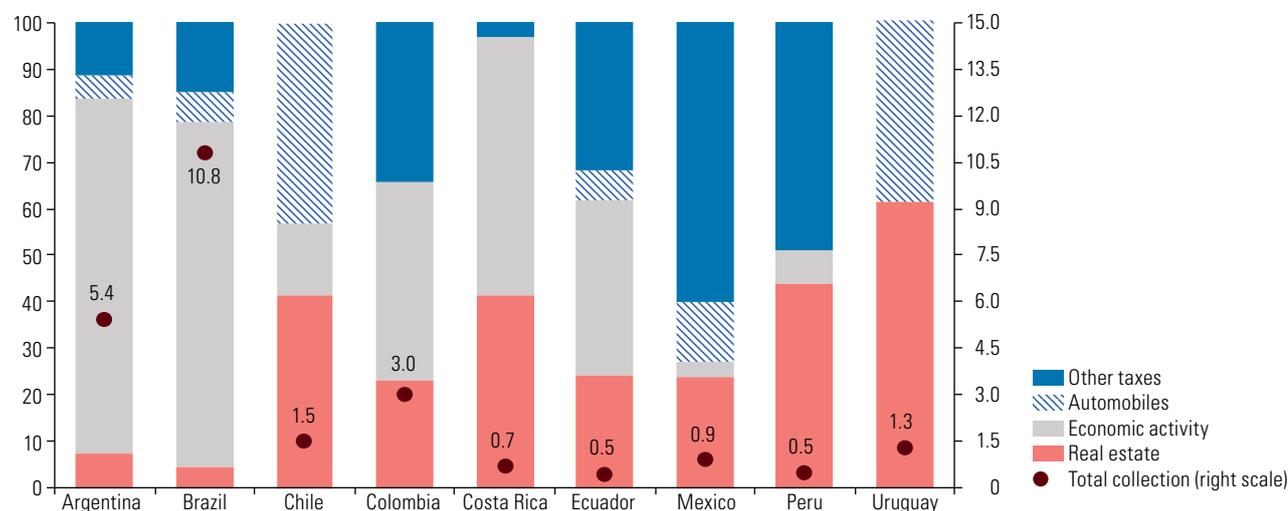
Given that situation, it is not surprising that in most of the region's countries, lower levels of government obtain much of their financing from transfer schemes through which central Governments assign the regions sizeable allocations from the revenues collected by the most important taxes. The limited allocation of fiscal powers to subnational governments therefore leads, in most cases, to their own cash flows (from both tax and non-tax sources) being extremely limited. The outcome of this is a situation of fiscal dependence between jurisdictions that is another major challenge facing the region.

The taxes collected by intermediate and local governments are generally levied on property ownership, essentially real estate and motor vehicles. Beyond the differences that exist, however, and as shown in figure II.17, in some cases —Argentina, Brazil, Colombia, Costa Rica and Ecuador, for example— taxation of economic activities (in the form of permits or levies on gross income) plays a leading role. Income taxes are virtually non-existent at the subnational level; the exception is Brazil, but even there, they are of marginal importance. This stands in sharp contrast to the OECD countries, where more than one third of average subnational revenues comes from income taxes.

Low wealth tax collection is a major problem for subnational governments and it entails three dimensions: (i) limited and narrow tax bases, (ii) low tax effort, accentuated by the existence of systems for transfers from the central Government, and (iii) technical limitations in the administration of the taxes assigned (Gómez Sabaini and Jiménez, 2017). Property taxes generally require sophisticated information systems, which increases the cost of collecting them. Keeping property records up to date is vital, but that is an area where some of the region's countries suffer from serious shortcomings. The situation is further complicated by the high visibility of the tax, which means that any attempt at reform that involves strengthening it as a real source of financing will have a high political cost.

Figure II.17

Latin America (9 countries): relative structure and level of subnational government tax revenues, 2014  
(Percentages of total subnational receipts and percentages of GDP)



**Source:** Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of Organization for Cooperation and Development/Economic Commission for Latin America and the Caribbean/Inter-American Center of Tax Administrations/Inter-American Development Bank (OECD/ECLAC/CIAT/IDB), *Revenue Statistics in Latin America and the Caribbean 1990-2015*, Paris, OECD Publishing, 2017, for tax revenue figures; J. C. Gómez Sabaini, J. P. Jiménez and R. Martner, *Consensos y conflictos en la política tributaria de América Latina*, ECLAC Books, No. 142 (LC/PUB.2017/5-P), Santiago, Economic Commission for Latin America and the Caribbean (ECLAC), 2017.

## C. Guidelines for reforming the region's public revenue mechanisms

### 1. Current context and circumstantial considerations

The main lesson to be drawn from this historical overview and from the current challenges indicated in the previous sections is that over the past three decades, public revenues in the region's countries have undergone a series of structural changes, which have been felt with different magnitudes and intensities in each specific case. However, the lesson would not be complete if it did not note that those transformations—and the waves of tax reform that drove them—took place in very different macrofiscal contexts, with different advantages and constraints.

In addition to the variable impact they had on the region's economies (partly as a result of the uneven application of countercyclical policies), the 2008–2009 financial crisis and the end of the extraordinary commodity price supercycle underscored the macroeconomic dangers threatening the countries of the region. In the years of recovery that followed, most Governments seized the opportunity to sharply increase the levels of fiscal resources available. More recently (between 2014 and 2016), slower rates of economic growth in the region and across the world again placed constraints on economic policy and compelled most Governments to establish fiscal consolidation—by controlling public spending and strengthening revenue—as the region's general model for public finances.

From the information contained in the report *Preliminary Overview of the Economies of Latin America and the Caribbean, 2017* (ECLAC, 2018), some general facts can be

deduced regarding the macroeconomic situation of the region's countries and the macrofiscal scenario they are likely to face over the coming years:

- The external context is now more favourable than during the past three years, with moderate global growth rates in the developed and emerging economies alike and encouraging forecasts for 2018. However, both the current and expected rates of dynamism are significantly lower than those seen in the past (during the most recent expansionary cycles, from 2003 to 2007 and from 2010 to 2012).
- Prices for the region's main exports are on the rebound. This will lead to improvements in the average terms of trade in the short term, particularly in those countries that export hydrocarbons and minerals.
- In the fiscal arena, the consolidation of public accounts has controlled and slightly reduced the fiscal deficit (notwithstanding the differences that still exist between countries), not only because of the slowdown in public spending, but also because of the slight increase in the volumes of public resources available.
- The region's average tax burden is forecast to remain stable; the increase expected in the South American countries as a result of the upturn in economic activity will be offset by a slight drop in the countries of Central America. The impact of various recent tax reforms (Colombia, Argentina, Honduras) is still unclear, but they are sure to affect future results.
- In contrast, tax and non-tax revenues from non-renewable natural resources are expected to increase gradually in line with the upswing in international reference prices, even if their importance as a source of income will be far short of the levels they enjoyed a decade ago.

In light of this situation, countries should take certain precautions in designing and implementing structural tax reforms: that is, those that do not simply change the rates of existing taxes but instead realign the mechanics of State funding by broadening existing tax bases or implementing new or redesigned collection instruments that can become stable generators of resources.

Following the crisis of 2008 and 2009, greater attention was paid to fiscal policy both in public debates and on government policy agendas. Over the years, increasing emphasis has been placed on its potential role as a creator of stimuli for economic growth (Feldstein, 2016). However, greater focus has also been placed on the role of fiscal policy as a countercyclical tool for smoothing out constant macroeconomic fluctuations. Countries must therefore strike a balance between the two functions of fiscal policy. Increased domestic resources are necessary for both functions, because they provide the basis for funding other fiscal policy measures. The way in which fiscal resources are raised is as important as the way in which they spent: they are two sides of the same coin.

Accordingly, the complexity of tax reform processes has increased, as they now pursue a range of objectives above and beyond the already difficult task of increasing tax revenues. Tax reform has become an exercise of negotiating and reconciling often conflicting goals, such as equity, efficiency, macroeconomic stability and environmental sustainability. Here, too, it is possible—and necessary—to strike a balance between the different goals, making them complement each other instead of competing.

Finally, issues of political economy related to tax reforms must also be taken into account. This requires a close examination of each country's specific situation and, as noted by Arenas (2016), an analysis of its economic, technical, institutional and political issues. Each imposes constraints that can determine the success or failure of any tax reform, regardless of the aim pursued.

The prevailing national and international context and the timing of a tax reform are also crucial elements in its chances of success. Since tax reforms often involve a series of political costs —sometimes major ones— consideration must be given, for each tax or set of taxes that will be affected by the reform, to the country's level of progress compared to international standards (and the ambitiousness of the proposed goal), along with the moment at which its inclusion in the tax system is suggested. For example, introducing new comprehensive reforms would be an unlikely proposition in countries that have carried out such processes only recently, such as Chile, Colombia and Argentina. This does not mean that improvements are impossible; instead, in those particular cases, emphasis should be placed on administering the taxes that have already been reformed, to raise compliance levels and ensure equitable treatment for all taxpayers.

## 2. Reform options for the region's countries

Now that the contextual framework and the restrictions it imposes on the region's countries have been considered, a series of alternatives or general guidelines for strengthening existing public revenues mechanisms can be offered. One good way to approach the analysis is to categorize the various reform options by the available instruments. Reference will first be made to traditional taxes within Latin America's tax systems, followed by the identification of novel alternatives for raising fiscal funds.

One of the main shortcomings of taxation in Latin American countries is its limited redistributive effect and, to reverse that situation, the relative weight of direct taxation within the tax structure must be increased. Thus, strengthening personal income tax is the main challenge facing all the countries, and this requires a two-pronged attack. First, consideration must be given to all the income received by the taxpayer within the levy's taxable base, regardless of whether it comes from employment, business or financial activities or a mix of those sources. The dual system, in which progressive rates are applied to labour income and proportional (lower) rates to capital income, has been adopted in several of the region's countries over the past ten years. This variant represents an intermediate point between the starting point of the current deteriorated state of personal income tax and the final destination of a global system of income tax that enshrines the principles of horizontal and vertical equity. In addition, corporate dividends and income from financial interests should receive the same tax treatment, in order to avoid skewing the funding structure of business projects.

At the same time, improvements in computer processing and the management of large databases, coupled with pay-as-you-earn collection mechanisms, now allow developments in tax systems that were beyond the reach of Latin America's tax administrations only a few decades ago. New mechanisms for countries to share information are emerging, which makes it possible for jurisdictional guidelines to be applied to global incomes. Given the known difficulty of effectively taxing wealthier individuals, and in spite of the inevitable resistance such a move would come up against, countries should consider imposing surcharges or additional taxes.

Future reforms to corporate income tax should carefully analyse the advisability (costs versus benefits) of maintaining the large number of tax expenditures and special forms of treatment in force in the countries of Latin America. The impact of those special regimes must be examined, in order to clearly establish whether their existence is justified in view of the high costs they entail for the public coffers. The additional tax revenue would provide some additional fiscal space, even for reducing corporate income tax rates in order to promote investment, supplemented by an increase in the rate applied to dividends that includes a credit for the income tax paid by the company.

These changes must also be coordinated with the treatment given to other forms of financial income, to avoid arbitration manoeuvres that could distort sources of corporate funding. This option has gained strength following the recent tax reform in the United States, whereby the tax rate on corporate income was cut to 21 %.

In the hydrocarbon- and mineral-producing countries (group B), income tax paid by companies (along with royalties and other fees) is of the utmost importance as an instrument for the State to take ownership of a portion of the income earned through extractive industries. Those countries should also strengthen all possible mechanisms for overseeing the operations of multinational enterprises and preventing base erosion and profit shifting. To resolve those countries' fiscal dependence on natural resources, they should pursue reforms to strengthen other tax options that are less exposed to volatile international markets. Thus, while stabilization funds undeniably offer benefits, fiscal hedging programmes for international reference prices using different financial derivatives may offer a more feasible alternative.

As part of the necessary process of additional fiscal decentralization, the region's countries must make a major effort to reassess the role of taxation on wealth as a source of subnational resources (Gómez Sabaini and Morán, 2016b). The vast majority of the countries face the same problems and, therefore, certain general recommendations apply: expanding the taxable base (by removing exemptions and special treatments), increasing tax rates and modernizing property registers and subnational tax administrations. Given their heavy dependence on transfers from central Governments, strengthening the institutional capacity of local governments for increasing their own revenue flows and the incentives for them to do so is essential. Alternatives such as new tax-raising powers—for example, surcharges on income tax, VAT or selective taxes—can provide opportunities within a framework of mutual engagement between different levels of government.

In pursuit of the equity that should characterize the tax system and despite the difficult negotiations that it will entail, more serious consideration should be given to imposing a levy on free transfers of assets (gifts, bequests and inheritances). Whether implemented nationally (such as in Chile, Ecuador and Uruguay) or at the subnational level (Brazil and Argentina), the importance of such taxes arises not from the meagre receipts they generate, but from their low efficiency cost and their clearly progressive impact on the distribution of income and wealth. To that end, efforts must be made to design levies that are both personal and global, with minimal exemptions (Gómez Sabaini and Rossignolo, 2014).

As noted above, value added tax receipts have increased across the region over the past two decades. Successive reforms aimed at expanding and strengthening VAT have made it the region's leading source of fiscal revenues and have enabled it to reach an acceptable level of maturity in most of the countries, with the exception of Mexico, Panama and Paraguay.

In any case, mention should be made of the resistance normally encountered by Governments seeking to increase the general rate of VAT. The grounds for its rejection are usually its potentially negative impact on growth and the regressive impact generally associated with it. As regards the first of those arguments, one very recent study shows that the effect of tax changes on GDP (the tax multiplier) depends on the original tax rate. An increase of two percentage points in the rate of VAT, which would have a significant impact on revenues across the board, would have almost no negative effect on GDP in countries with low tax rates, such as Costa Rica, El Salvador, Guatemala and Paraguay, and it could even be slightly expansionary in Panama, where the current rate is 7%. In contrast, the same increase would lead to a significant drop in output in countries where the VAT rate is already relatively high, including Argentina, Chile and Uruguay (Gunter and others, 2017).

As regards its distributive impact, most of the countries have reduced VAT rates for basic items. While this practice is fairly widespread, even in developed countries, the distributional impacts on each income decile of the population are not always the ones sought. In many cases, the objective and subjective exemptions that reduce the tax base should be reviewed. In any event, the future approach to VAT—and this applies to all the region's countries—should focus on introducing mechanisms to mitigate the tax's regressive impact: through compensation in the form of conditional cash transfer programmes for lower-income households, for instance.

Selective taxes are another type of consumption tax that can be used to increase the fiscal space. This is especially true of levies on alcohol, sugary drinks, tobacco and high-fat food, the consumption of which has negative externalities in that the price of those goods fails to reflect the harmful side effects their use has on others and on society as a whole. The price elasticity of most of these products tends to be low, which means that such taxes, at least initially, generate significant revenue, even though their purpose is to discourage consumption. For example, the World Health Organization (WHO, 2009) has estimated that an increase of between 5% and 10% in tobacco taxes could mean additional revenue of US\$ 1.4 billion a year in low-income countries and US\$ 5.0 billion a year in middle-income countries, while a 50% hike in the tobacco tax would cover about half the public health spending of certain developing countries.

One case worthy of note is that of Mexico which, as part of the fiscal reform package it adopted in late 2013, imposed a tax on sugary drinks and placed an ad valorem tax on high-calorie nonessential foodstuffs (snacks, desserts, chocolate and others). As reported by WHO (2016), similar experiments have been conducted in countries such as Denmark, Finland and France. According to one study by the Pan American Health Organization (PAHO, 2015), the positive outcomes seen included increased tax receipts, lower levels of demand, reductions in the negative consequences associated with the consumption of sugary drinks and greater consumption of drinking water in schools and public places. Recently, attempts were made to introduce such a tax in Ecuador and Argentina, but the proposals were ultimately withdrawn.

At the same time, discussions on taxes or payroll levies for funding social security programmes cannot take place in isolation; they must be considered in conjunction with the social protection benefits they provide. In any event, although the accepted level of contributions is agreed on through collective bargaining, it remains relatively low in some countries. Revenue raising by increasing social security contributions is associated, by its very nature, with expanded social security coverage. In countries such as Brazil, Costa Rica and Uruguay, such measures are linked to the introduction of innovations intended to increase the formalization of the labour market. This creates a virtuous circle in which, as more businesses migrate to the formal sector, more taxes and contributions are collected.

As social concern rises about the harmful effects of environmental pollution and traffic congestion in Latin America's main urban centres, environmental taxes offer certain advantages—within the wide range of tools available—that should be considered in future tax reforms. Based on observations already made in several OECD countries, concrete efforts could be made to strengthen the linkage between vehicle taxes (the most representative of this type of levy) and environmental policies, by adapting traditional taxes according to the fuel efficiency of engines, pollutant emissions, urban planning and transport policies. The options do not end there. They also include the carbon tax (which has been very closely studied of late, along with the recent experiences, within the region, of Chile and Mexico), taxes on the use of plastic bags and on the creation of polluting wastes in gaseous, solid or liquid form, along with other innovative mechanisms that can effectively contribute to an increase in the resources earmarked for specific uses (see box II.1).

**Box II.1**

Possible links between taxation and the 2030 Agenda for Sustainable Development in the countries of Latin America

Within the framework of the 2030 Agenda, general consensus exists that the mobilization of domestic resources is a key tool for achieving sustainable development. By way of illustration, the following links can be identified between the Sustainable Development Goals (SDGs) and new taxation alternatives for strengthening Latin America's tax systems. Those alternatives are summarized in the table below.

Innovative tax policy alternatives linked to a selected set of Sustainable Development Goals

Sustainable Development Goal	Tax policy reform
6. Clean water and sanitation	<ul style="list-style-type: none"> <li>• Taxes on water extraction</li> <li>• Sanitation fees</li> </ul>
7. Affordable and clean energy	<ul style="list-style-type: none"> <li>• Energy taxes</li> <li>• Incentives for the use of renewable energy</li> </ul>
8. Decent work and economic growth	<ul style="list-style-type: none"> <li>• Tax incentives for efficient consumption and production</li> <li>• Reduction of taxes that distort labour as a factor of production</li> </ul>
9. Industry, innovation and infrastructure	<ul style="list-style-type: none"> <li>• Tax incentives to encourage private investment in research and development (R&amp;D) into green technologies</li> </ul>
10. Reduced inequalities	<ul style="list-style-type: none"> <li>• Increased progressivity of tax systems</li> </ul>
11. Sustainable cities and communities	<ul style="list-style-type: none"> <li>• Environmental taxes: noise, air and water pollution</li> <li>• Taxes on the creation of refuse</li> </ul>
12. Responsible consumption and production	<ul style="list-style-type: none"> <li>• Economic incentives for the efficient use of natural resources: levies on forestry, taxes on refuse creation</li> <li>• Taxes on the use of plastic bags</li> </ul>

Tax policy plays a leading role in creating incentives for meeting the Sustainable Development Goals: not only through innovative instruments, but also by redesigning taxes that already exist. For example, the taxes levied on fuel and motor vehicles can be adapted to contribute to climate action (SDG 13) by channelling consumers towards low-carbon options. Similarly, levies on plastic bags or ship emissions can be a useful and viable mechanism to reduce sea and ocean pollution (SDG 14).

The pending reforms related to challenges that already exist in Latin America can also be connected with the Sustainable Development Goals. For example, strengthening personal income tax and wealth taxes can be effective in reducing economic inequality between countries (SDG 10). Likewise, reducing domestic tax evasion and illicit international financial flows is essential in ensuring the existence of peaceful and inclusive societies and quality institutions (SDG 16). In addition, tax system reforms can mobilize additional domestic resources (SDG 17, partnerships to achieve the Goals) that can be used to fund increased public investment for pursuing other objectives, such as fighting poverty and hunger and improving public health, quality education and gender equality (SDGs 1 to 5).

**Source:** Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of United Nations Environment Programme (UNEP), *Policy Brief: Fiscal Policies and the SDGs*, Geneva, 2016 [online] <http://www.greenfiscalpolicy.org/wp-content/uploads/2016/05/Fiscal-Policies-and-the-SDGs-Briefing-note.pdf>.

Much work is still needed in the area of tax evasion. First, further efforts must be made to expand the technical and operational capacity of tax administrations, especially as regards the segmentation of taxpayers, in order to apply differentiated strategies and mechanisms for overseeing, monitoring and contacting them. The size of the informal economy in the region's countries and the prevalence of small-scale taxpayers demands that the legal and administrative frameworks be adapted; simplified tax regimes have the potential to encourage progressive formalization, resulting in gains in the tax bases for levies such as VAT and income tax.

Furthermore, in order to reduce tax evasion, the legal powers and capacities of national tax administrations must be strengthened so they can conduct effective inspections of large multinational corporations. In this regard, the current international efforts aimed at promoting automatic exchanges of information between tax agencies represent a crucial step towards sustained progress in combating international tax evasion. As at the national level, it is imperative that countries commit to increasing their understanding of tax evasion and to improving the accuracy of their quantitative estimates of the volumes involved, so that the phenomenon can be brought into check.

Ultimately, the fiscal reforms that the Latin American countries need cannot be adopted easily or swiftly and, for them to yield sound results and facilitate permanent change, they should form part of a complex process of political negotiation among various social actors, in order to agree on the fundamental aims—beyond increasing available resources—that are to guide State funding in the coming years. Any preliminary step that helps overcome existing obstacles and ensures progress towards the medium-term horizon set in the 2030 Agenda will be welcome and may be taken as a reference point by other countries of the region for adaptation to their own economic, social and institutional contexts.

## D. Conclusions

Over the past 30 years, Latin America has made profound changes to its public revenue policies. Although the process has taken different paths in different countries, from a long-term perspective two large waves of tax reforms can be identified.

First, in the 1980s and 1990s, the influence of Washington Consensus had a series of both positive and negative repercussions for fiscal matters, and these, in a way, laid the foundations on which State funding in the region's countries currently stands. The privatization of public enterprises, efforts to bring inflation under control after it had long affected the sustainability of public finances, the consolidation of value added tax, the elimination of taxes on international trade (some exceptions notwithstanding) and the abolition of a vast number of minor taxes are all examples of this first generation of tax reforms.

In the early years of the new millennium, the resurgence of issues of distributional equity (neglected in decades past) could be seen in a series of tax reforms in which income tax was the main player. The highly favourable international context, falling poverty and inequality, and the consolidation of sustained growth led to rising public revenues, from both tax and non-tax sources, and a significant improvement in the fiscal position of the Latin American countries. This enabled them to successfully weather the effects of the financial crisis of 2008 and 2009 and, in the following years, to continue to raise their average tax burdens, in spite of the sharp slowdown in the pace of economic growth. Recent innovative tax reforms, such as those of Mexico (2013), Chile (2014) and Colombia (2016), have reaffirmed the eagerness of the region's countries to increase the amounts of resources they have available without neglecting the question of equity.<sup>5</sup>

However, after travelling this long path and despite the significant achievements made, the general consensus is that a majority of the region's countries continue to

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<sup>5</sup> The Argentine tax reform, adopted in late December 2017, is the only one to go against the regional trend, in that it entails a drop in the overall tax burden. However, it also includes some progressive measures, such as the imposition of a standard rate on financial earnings.

suffer from structural weaknesses in the area of public revenue, which prevent that revenue from consolidating its position as the foundation of State funding and distort its potential economic effects.

There are several obstacles. Revenue levels in most countries remain below their potential: not only because of weaknesses in tax design and administration, but primarily because of high rates of tax evasion, both domestically and internationally, and the existence of substantial tax expenditures. Personal income tax remains the Achilles' heel of the region's tax systems, with top marginal rates much lower than those found in developed countries, excessive levels of exemptions in some cases, differential treatment for capital income and inadmissible rates of non-compliance. This all leads to another large regional shortcoming: the limited redistributive capacity of taxation, with tax structures dominated by regressive indirect taxes, while in spite of the progress made in that regard over the past decade, Latin America remains the world's most unequal region.

Numerous countries in the region require tax reforms, but the specific needs vary from one country to the next. Thus, given the great strides made with this tax and the degree of consolidation it enjoys in most of the region's current tax structures, the guidelines related to VAT are only valid for a number of countries. In contrast, the income tax recommendations—particularly those related to personal income taxes—are generally applicable in all the countries analysed, at least as regards expanding the tax base, dealing with capital income and reducing the unacceptable levels of non-compliance. The relative weight of tax revenues obtained from the exploitation of non-renewable natural resources in some of the region's countries demands that attention be paid to how corporate income tax functions, especially as regards oversight of multinational enterprises and their operations. In connection with this, the usefulness of reducing the rate to bring it into line with international averages should also be examined.

Furthermore, given the burgeoning funding needs of most of the region's countries and the difficulties they have encountered in attempting to raise the available volume of domestic resources, consideration must be given to a series of innovative instruments that could not only generate more revenue for the State, but also offer the possibility of influencing private behaviour, discouraging practices that undermine sustainable development or encouraging actions that could contribute to that goal. The best examples of this are the broad range of environmental taxes that exist: carbon taxes, levies on the use of plastic bags and on the production of polluting waste, and taxes on tobacco and sugary drinks.

In order to improve the progressivity of tax systems, consideration could also be given to different forms of solidarity-based taxes on higher incomes (for example, taxes on international tourism) and levies that were scorned in the past, such as taxes imposed on free transfers of wealth (donations and bequests). The latter offer an additional benefit in that they affect the concentration of wealth, which is even greater than the high concentration of income that characterizes the region.

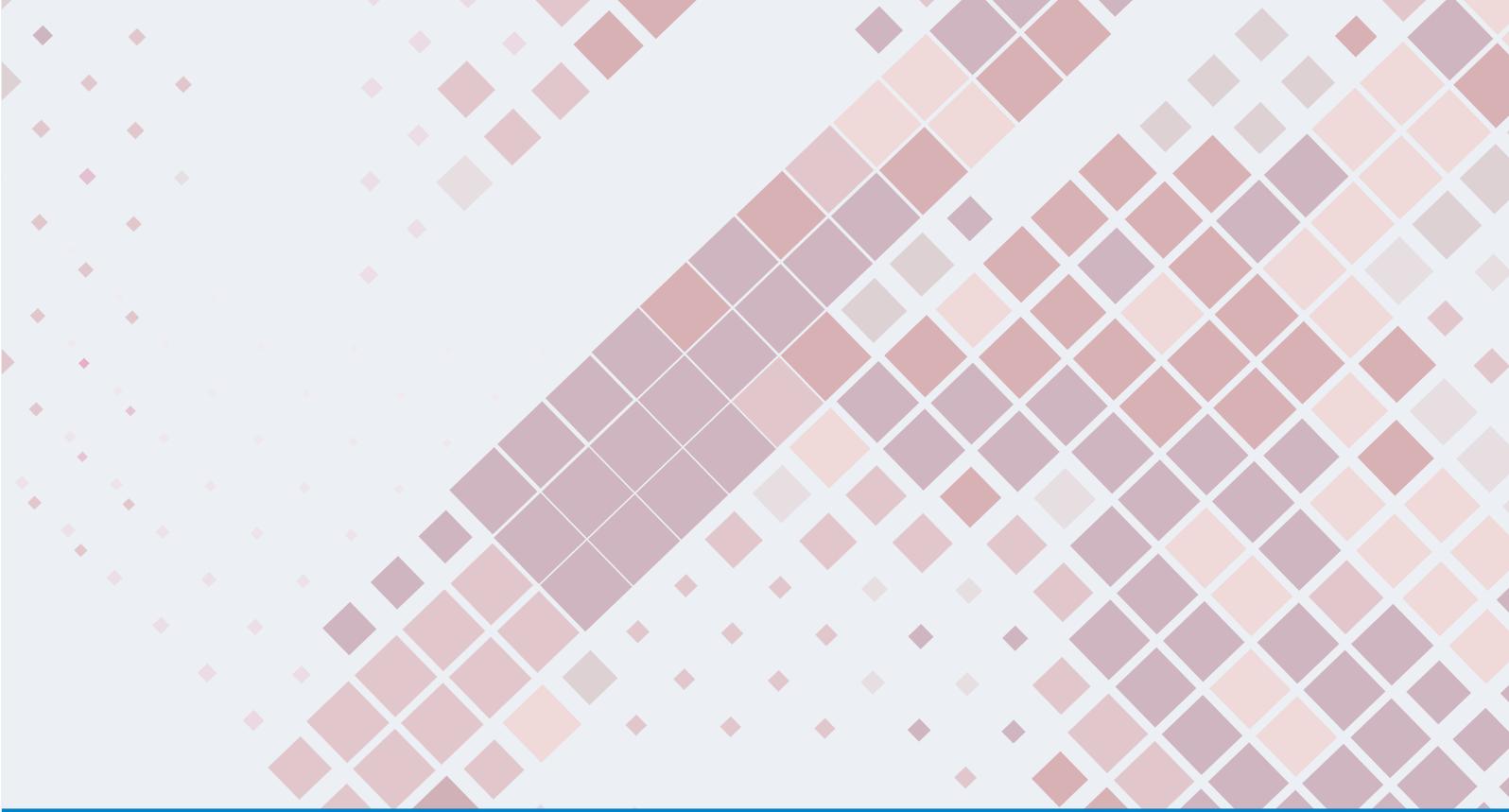
In implementing the 2030 Agenda, the issue of funding has assumed a central role and, among the alternative sources available, emphasis has been placed on the importance of mobilizing domestic resources. Among these, on account of their alignment with the collective priorities, those earned through taxation are the most important. For that reason, expanding the tax base, improving the design of the tax system, strengthening tax administrations and eliminating channels used for tax avoidance and evasion are key tasks in the improved funding of sustainable development and inclusive growth in the region's countries.

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CHAPTER



# Public expenditure in Latin America and the Caribbean over the last 30 years

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## Introduction

- A. There have been marked differences in the pattern of public spending over the last three decades
- B. Latin America's main publicspending challenges
- C. Concluding remarks

## Bibliography



## Introduction

The last 30 years have brought profound changes in the economic development model and the institutional arrangements that had anchored sustained economic and social progress, particularly in the developed world, during the post-war period of the past century. The crisis of the 1970s marked a turning point which, in Latin America, was highlighted by the onset of the debt crisis, giving rise to a period known as the “lost decade” —in terms of economic indicators— but which in many cases coincided with the restoration of democratic regimes.

In this context, progress in the area of civil rights was not matched by the needed improvements in the area of economic, social and cultural rights. There are still challenges to be faced in legitimizing democracy as the best way of boosting people’s well-being and securing social cohesion. The effort to achieve a more cohesive and territorially integrated society with full access to social services for the entire population is still a work in progress. The great majority of Latin American countries suffer from high levels of poverty and inequality, which heightens tensions between the growth of democracy and the economy, the quest for equity, and measures to overcome poverty.

The scourge of inequality is still a fundamental issue in Latin America and the Caribbean. In various institutional documents, ECLAC has proposed an agenda for equality as the driving force. Those documents argue that, in order to achieve greater equality, structural changes are needed in three principal areas: promoting dynamic and sustained growth that will generate more jobs of better quality; establishing a productive structure consistent with a better distribution of the factors of production, universal social protection, and skills development; and promoting environmental sustainability, by changing the patterns of consumption and production (ECLAC, 2014a, 2012 and 2010).

Similarly, the 2030 Agenda for Sustainable Development and its 17 Sustainable Development Goals (SDGs), adopted in 2015 by the 193 member states of the United Nations, constitutes a collective call for action that will shift the course of the world’s common destiny toward a more equitable and sustainable development model.

The purpose of this chapter is to assess the performance of public expenditure in the countries of Latin America during recent decades. It goes on to indicate the challenges that lie ahead for expenditure policy in the region, contrasting the situation in different groups of countries and highlighting the specific aspects of each sector policy. Because the topic allows for different approaches, some clarifications are called for with respect to the focus adopted in this case, while recognizing that a more complete study would have to incorporate further aspects and analyses that go beyond the scope of this paper. In particular, it should be borne in mind that other chapters of this publication deal exhaustively with the macroeconomic aspects of public spending and with topics related to the stabilization function of public policies, their financing, and tax policy. The limitations relating to the area analysed should also be clarified: the central core of the study refers to Latin American countries, but some considerations are also offered with respect to the Caribbean States, when the relevant information is available.

The chapter is divided into three sections, in addition to this introduction. Consistent with the proposed objectives, the first section analyses changes in expenditure aggregates and their structure, in an effort to link fiscal performance with other indicators used to qualify different situations. The second section focuses on the situation of each group of countries, and seeks to identify similarities and differences that can be used to define future challenges more precisely. The third and last section considers some conclusions.

## A. There have been marked differences in the pattern of public spending over the last three decades

Changing circumstances in the macroeconomic environment and in the international economy, together with the prevalence of differing concepts of economic performance over the last three decades, suggest a succession of periods characterized by different visions of public intervention. This section presents an overview of the situation across the region as a whole, and its determining factors, which is examined in more depth in the subsequent analysis by country group. To this end, after a brief definition of these periods, the chapter describes the level and structure of average spending in the region over these different stages, and examines the factors behind that evolution, based on certain public policy reforms.

### 1. Defining the periods

In the last quarter of the twentieth century, changes in public policies defined a particular trend in the level and structure of public expenditure. During those years, there were changes that reflected the decisive impact of shifting regional and international contexts.

Firstly, the debt crisis unleashed at the beginning of the 1980s was the sole cause of a macroeconomic scenario dominated by high volatility and fiscal insolvency, the severity and duration of which differed depending on the country. During that period, the new democracies had to look for approaches that would consolidate that political system and meet the multiple demands of society for public policies that could meet the expectations created by the new governments. At the same time, those governments faced severe constraints in the form of restrictions on financing and the inherent economic volatility, which in many cases led to high inflation rates. The primary concern of public policies at that time was crisis management.

The 1990s marked the beginning of a second period, when the crisis of the 1980s and the difficulties encountered in overcoming it provided fertile ground to experiment with ideas that were coming to dominate debate in other parts of the world. Of particular interest for this publication is the fact that, in line with the new concepts of the role of the State, governments undertook broad programmes of structural reform that embraced a great variety of areas, including the privatization of state-owned enterprises, the decentralization of public policies, the deregulation of markets, and the withdrawal of the State from areas that had until then been dominated by the public sector (for example, the pension system). During this period, the overriding objective of public expenditure policy reforms was to enhance efficiency.

At the beginning of this century, thanks to an international backdrop of economic expansion, rising commodity prices and abundant liquidity in capital markets, there was a shift in the aims of many public policies which produced changes of varying magnitude in several countries across the region. The thrust of reform policies came to be dominated by concern for equity and distributive aspects.

Today, while the vast majority of countries in the region are complying with the conditions of democratic government and consolidating political rights, they must address high and persistent levels of poverty and inequality. The obstacles encountered in balancing economic growth with greater equity are, in most cases, difficult to overcome and will be the main public policy hurdle in the years to come.



As a first approximation to the changes in the definition of State intervention in the economy, table III.1 shows that, thanks to more public policies and a more favourable macroeconomic environment, the most commonly used social indicators have improved considerably during the last decade, indicating a major step forward compared with the preceding decade. Total public expenditure as a percentage of gross domestic product (GDP) (simple average of countries for which information is available) rose by 15% between 1995 and 2005, and by nearly 20% between 2005 and 2015.

Indicators	1995	2005	2015	Growth (percentages)	
				1995-2005	2005-2015
GDP per capita <sup>b</sup>	6 644.60	7 589.46	9 042.91	14.22	19.15
Gini coefficient <sup>c,d</sup>	0.52	0.51	0.47	-0.58	-8.98
Poverty <sup>c</sup>	45.80	39.70	28.20	-13.32	-28.97
Unemployment	9.40	9.00	6.60	-4.26	-26.67
Informality <sup>e</sup>	...	63.39	53.20	...	-16.08
Total public expenditure	20.07	22.93	27.29	14.25	19.04

**Table III.1**  
Latin America  
and the Caribbean:  
selected socioeconomic  
indicators, 1995-2015<sup>a</sup>

**Source:** Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of data from the International Labour Organization (ILO).

<sup>a</sup> Simple averages.

<sup>b</sup> Dollars at constant 2010 prices.

<sup>c</sup> Data available for 1994, 2005 and 2014, and for Latin American countries only.

<sup>d</sup> Urban area only.

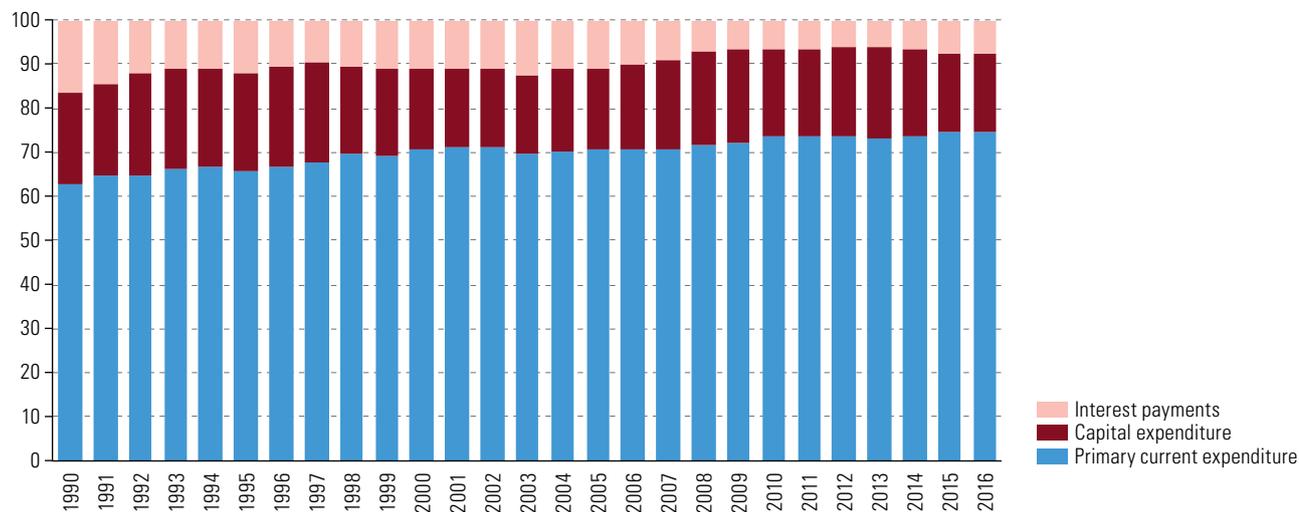
<sup>e</sup> Data from the International Labour Organization. Simple averages were calculated for the countries for which information was available (in 2005: Costa Rica, Dominican Republic, Ecuador, El Salvador, Mexico, Nicaragua, Panama, Peru; in 2010, Colombia, Guatemala, Honduras, Paraguay and Uruguay were added; in 2015, or 2013 and 2014, Brazil, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Panama, Paraguay, Peru, Uruguay). The agricultural sector is not included.

There was an increase in total public equivalent to 7.4 percentage points of GDP over a period of two decades (a cumulative increase of 37% over 20 years), during which time GDP per capita rose by 36% in constant dollars. At the same time, there was a substantial improvement in social and labour market indicators, although that progress was insufficient and wide gaps persist.

## 2. Changes in the economic structure of expenditure

The main characteristics of the different periods can also be seen in the changes in the structure of expenditure. From an economic point of view, the dominant trend in the 1990s was the withdrawal of the State, which led to a reduction in the share of capital spending in public expenditure in the government accounts, from 23% in 1992 to less than 18% during the first half of the 2000s. This share later recovered, reaching 22% in 2014 (see figure III.1). In recent years, however, there has been a new contraction, in response to the decision to adjust spending levels to current circumstances. As can be seen in figure III.1, this trajectory coincides with a gradual decline in the cost of debt interest and relatively stable levels of primary current expenditure.

**Figure III.1**  
Latin America: structure of public spending by economic classification, 1990-2016  
(Percentages)



**Source:** Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

The pattern of public investment clearly reflects the main features of each of the periods through which public spending policy has passed in the last three decades. First of all, there were the obligatory cuts in those economies that had to deal with the crisis of the 1980s. That decline in public expenditure led to greater spending by the private sector, in the quest for enhanced efficiency. Lastly, the public sector began to spend more, although the greater importance accorded to distributive goals meant that priority was given to spending for other purposes.

As figure III.2 shows, public investment in infrastructure was cut drastically at the end of the 1980s, when average investment in the region was 3.6% of GDP, after reaching an all-time high in 1987, when it was 4.7% of GDP. The external debt crisis forced States to reduce their spending level and, with it, the level of public investment.<sup>1</sup>

Subsequently, under totally different macroeconomic conditions, the region saw a certain recovery in public investment, which became apparent in the middle of the 2000s, and even withstood the crisis of 2009. Land transportation was the main recipient of that investment.

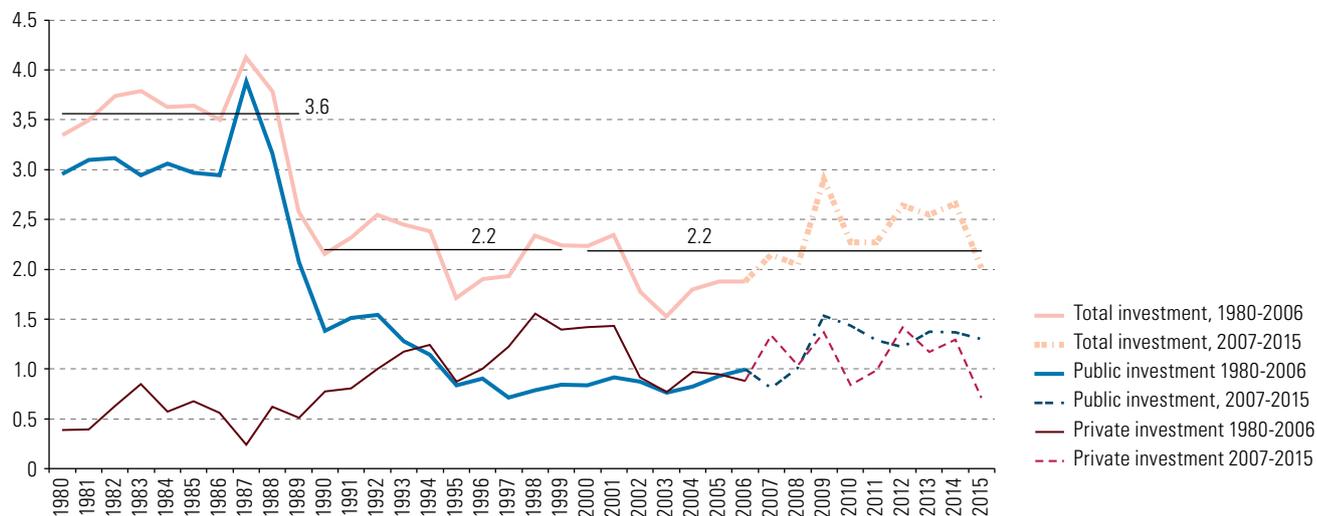
When analysing public expenditure in the region during these three decades, special attention must be paid to developments in current spending. As the crisis gradually dissipated, interest payments accounted for smaller share of public expenditure, which was offset by growth in current spending on transfers and subsidies (see figure III.3). The gradual increase in spending on wages and salaries, and on the purchase of goods and services during this time, is particularly noteworthy, as is sharp jump in these items following the global economic and financial crisis of 2008-2009, which reflects the countercyclical policies adopted by several countries of the region.

<sup>1</sup> While private investment played a more important role during this period, it was not able to offset the lower share contributed by the public sector. Private investment was highest in 1997 and 1998, as a result of the sale of telecommunications and power companies in Brazil, the acquisition of a majority stake in the Chilean energy firm Enel by the Spanish company ENDESA S.A., and the granting of highway concessions in Argentina, Chile, Colombia and Mexico (Rozas, 2010).

Figure III.2

Latin America: infrastructure investment in the public and private sectors, 1980-2015

(Percentages of GDP)



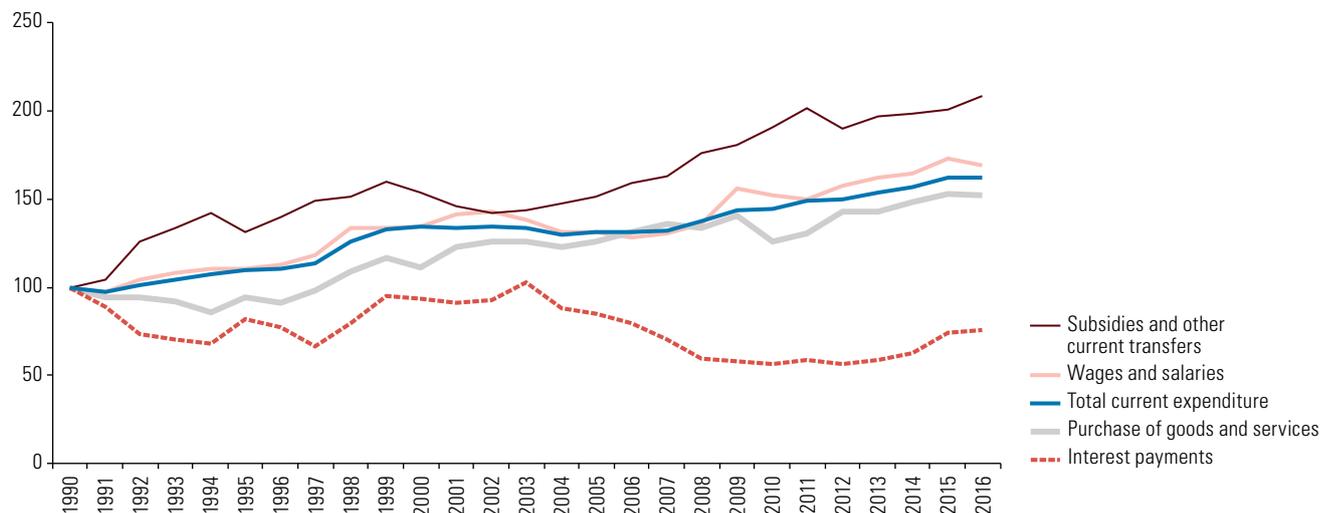
**Source:** Sánchez and others, "Inversiones en infraestructura en América Latina: tendencias, brechas y oportunidades", *Natural Resources and Infrastructure series*, No. 187 (LC/TS.2017/132), Santiago, Economic Commission for Latin America and the Caribbean (ECLAC), 2017.

**Note:** Includes the following countries: Argentina, Brazil, Chile (except in 2015), Colombia, Mexico and Peru. Also includes the following sectors: transport, energy, telecommunications, water and sanitation. Transport includes only roads and railways, except public investments in Argentina, which include all modes of transport. Energy refers only to electricity.

Figure III.3

Latin America: current public spending by economic classification, 1990-2016

(Percentages of GDP, index 1990=100)



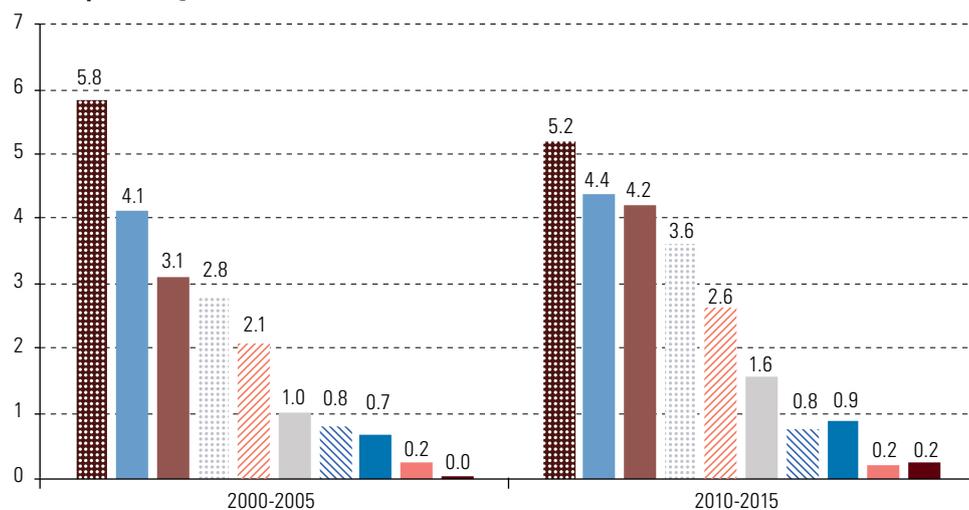
**Source:** Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

### 3. Shifts in public spending by function at the beginning of the new century

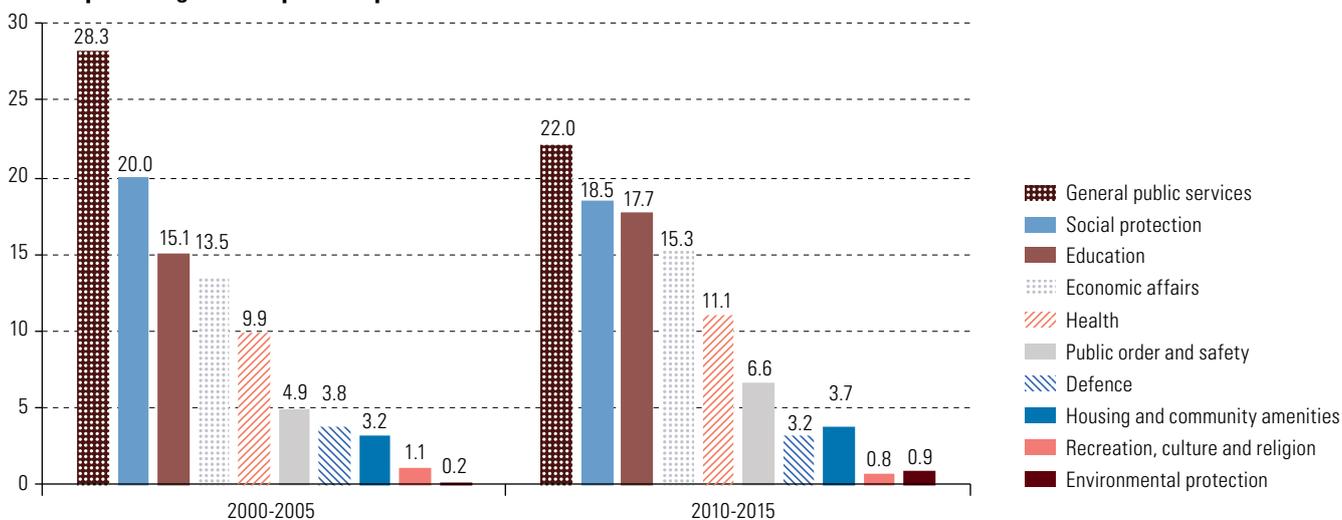
The information available as a result of the functional classification of public expenditure clearly shows the shift in direction of public policies at the beginning of the new century. Public spending in the region reflects a greater emphasis on the social sphere and public investment. As noted above, the macroeconomic context and the reduction in the public debt also brought about this shift, which greatly reduced the relative weight of general public services—including interest payments—in the region (see figure III.4).

**Figure III.4**  
Latin America (17 countries): public expenditure by purpose and function, 2000-2005 and 2010-2015<sup>a</sup>  
(Percentage of GDP and percentages)

#### A. As a percentage of GDP



#### B. As a percentage of total public expenditure



**Source:** Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

**Note:** The information given corresponds to the central government of each country, with the exception of Brazil, Colombia, Argentina and Mexico. In the first two instances, general government information is used, and in the last two, data from the non-financial public sector.

<sup>a</sup> Simple averages for each period.

Figure III.4 shows that public spending on social services increased significantly between the periods 2000-2005 and 2010-2015, particularly education spending, which rose from 3.1% of GDP to 4.2% on average, and accounted for 17.7% of public expenditure in the latter period. Spending on health and social protection also rose, but to a lesser degree.

Expenditure on economic affairs, a category that covers the bulk of public investment, also increased, reflecting the recovery in capital spending during this period (see above). Similarly, investment in housing and community services rose.

It is interesting to compare changes in public expenditure on defence with that spent on public order and safety. While there were no major changes in defence spending during the period under examination, spending on public order and safety jumped from 1.0% of GDP to 1.6%, equivalent to 7% of total spending in the latter period.

## 4. The main thrust of public expenditure policies

In addition to the shifts in average functional expenditure and its main categories, analysed in the previous section, it is important to review the principal guidelines that set out the provision of public spending functions, their priorities and the evolution of their composition.

One of the budget items that has grown the most is education spending, covering primary, secondary and higher education, which has risen across the board in the last 25 years. As noted above, countries' real GDP rose significantly during the period under analysis, consequently expenditure growth in constant currency terms was even greater, reflecting the higher priority accorded to the education sector in Latin American economies and societies.

When viewed from this perspective, there appear to be no differences between the periods identified above. However, during the 1990s, when the quest for greater efficiency was paramount, many countries were focused on reallocating functions between the different levels of government, which in many cases led to expenditure being decentralized from the central government to subnational authorities. Given the production and territorial inequalities that characterize Latin America, and the differences in each government's management and human resource capacities (ECLAC, 2017c), and against a backdrop of decentralized public services, intergovernmental financial transfers and their coherence with sectoral policies play a fundamental role in preventing development gaps widening among different areas of the same country.

These challenges are not confined to the education sector, but they are more evident because of the role education plays as a driver of development. In countries that have highly unequal territories, as in Latin America, the quest for cohesion calls for a rethink of the hierarchical role of central governments to compensate for differences and connect sectoral policies that, while they may have different degrees of decentralization, have a common thread (Cetrángolo and Goldschmit, 2011). If central governments cannot fulfil these goals, the poorest regions will be particularly disadvantaged because they have the narrowest tax base to finance local public spending priorities, of which education is increasingly one (Cetrángolo, Goldschmit and Jiménez, 2009; ECLAC, 2017c).

As public spending on education has increased, secondary education enrolment rates in the region have improved and some progress has been made in terms of quality. With regard to enrolment, given the relatively high levels already reached in primary education in Latin America over the past century, there has been slow growth in enrolment at this level in recent decades, fluctuating around 92% of the corresponding age group. Meanwhile, secondary education enrolment grew steadily over the period under review, although the 2013 average of 75.7% suggests that there are still some

significant obstacles to expanding secondary education coverage in the future. It should be noted that the primary school enrolment rate for girls rose faster than that for boys over the last decade, meaning that equal numbers of girls and boys are now enrolled in primary schools, thereby overcoming the historic gender discrepancy. In the case of secondary education, gender inequality works in the opposite direction, as female adolescents far outnumber males at this level.

With regard to public spending on health, it must be borne in mind that, in terms of institutional organization and financing, Latin America has tended to favour hybrid systems which has generally made it difficult to ensure universal access to high quality health services. Health-care services are provided by a wide range of institutions and financing, regulatory and delivery mechanisms, in which a public subsector (mostly financed by general taxes), social security (financed by payroll contributions) and the private subsector (on the basis of private insurance or out-of-pocket payments) all coexist. The manner in which these three subsectors are coordinated (or not) gives rise to different health systems and determines how efficiently resources are used and how equitable the systems are. Thus, in order to understand the direction of sectoral policies, analysis should not focus on the public sector alone.

The fact that policyholders incur out-of-pocket expenses when accessing health services or medications is a sign of the weakness of public policies and is widely recognized as a major source of inequity. It is therefore common to define the degree of health-care inequity in terms of the share of out-of-pocket payments in total health spending (PAHO, 2002; WHO, 2010a). On average, private health costs account for 43% of total health expenditure in the region, with figures exceeding 60% in Guatemala. Of that regional average, direct payments by households account for 78.1%, while the remaining 17.9% is spent on prepaid health-care plans (WHO, 2010b). By this criterion, the region's health-care systems are highly inequitable.

In addition to the fragmentation among subsectors, there is also a significant degree of fragmentation within each subsector (public, social security and private) in many countries. The decentralization of public provision, which was strongly advocated (although not exclusively) during the 1990s, improved coverage within each country. Given that the financing structure of the health-care system is not equitable, the existence of a dual public provision and social security institutional structure had negative effects on the financing and the delivery of services. In addition to duplicating functions and wasting resources, health-care systems became differentiated according to social strata. In turn, the difficulties of regulating the private health-care subsector, which in Latin America accounts for a significant proportion of total health spending, have exacerbated the inefficient use of the resources that society allocates to the health sector.<sup>2</sup>

In recent decades, the countries of the region have taken different approaches to integrating the various subsectors. Costa Rica was in the vanguard, but that integration preceded the period under review here. The second attempt to integrate the subsectors was carried out as a matter of urgency by Brazil, following the constitutional reform of 1988, which made insurance contributions voluntary rather than mandatory. Thirdly, following the example of Chile, many reforms undertaken during the 1990s sought to boost efficiency (beyond decentralizing public provision) by targeting of public expenditure towards specific areas and introducing the private sector into the field of social security. Lastly, so far in the twenty-first century, public debate and policies have been focused on the quest for universal coverage (Titelman, Acosta and Cetrángolo, 2014).

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<sup>2</sup> The more important the public subsystem is, the greater the redistributive effect of the health-care system and the more homogeneous its coverage. Conversely, if out-of-pocket expenditure accounts for a greater share of health spending, the system will be characterized by less redistribution and greater inequity. The fact that private expenditure accounts for close to half of total health spending, and out-of-pocket spending makes up around 37%, reflects the failure of the region's public health and social security systems to provide effective health-care coverage.

Social welfare spending levels have perhaps the greatest impact on the total volume of public expenditure, particularly in South American countries. On one hand, this is a reflection of the maturing of pension systems in the region. On the other hand, it is also the result of reforms that over the past three decades have affected the organization and financing of social protection when it comes to providing incomes for older persons.

Many countries undertook structural reforms of their pension systems in the 1990s, following models that were based to varying degrees on the Chilean reform of the early 1980s. While some countries tried to replace the traditional pay-as-you-go schemes with systems based on individual capitalization (Chile, the Plurinational State of Bolivia), others (Colombia, Peru) established parallel systems in which the two schemes coexisted, and others (Argentina in 1994, Uruguay) introduced mixed systems with both pay-as-you-go and capitalization features, combining private and public benefits. In addition to these structural changes, and regardless of the scheme adopted, there has been a general trend towards introducing parametric changes in the region.

The structural reforms of the 1990s did not deliver the outcomes promised by their supporters. Firstly, the capitalization schemes failed to improve the levels of expected benefits because they did not reduce labour informality or increase coverage or national savings. Secondly, these new schemes had high intermediation costs. Lastly —and perhaps most importantly for the arguments put forward here— the fiscal cost of the transition was very high, which had a significant impact on the public accounts of the countries that followed this route (Mesa Lago, 2004).

Given the need to address the structural problems of traditional pension systems and the shortcomings inherent in the reform processes, major changes have been made in recent years to the social protection systems for older persons. The clearest examples of countries making crucial amendments to previous reforms are the structural changes introduced in Argentina in 2008 and in the Plurinational State of Bolivia in 2010, when it was decided to reverse the previous process and to put an end to the experiment with the capitalization system, transferring the accumulated funds to the public sector.

Beside these extreme cases, there is growing debate over the need to improve each country's systems through parametric changes (in Uruguay, for example) and other reforms. Chile undertook major institutional reforms of its pioneering private capitalization scheme in 2008, giving the State a greater say in the regulation and overall organization of the system, and taking steps to improve coverage of the most vulnerable sectors (Arenas de Mesa, 2010).

Perhaps most importantly at the regional level was the growing concern about broadening pension coverage in countries where labour informality is widespread and entrenched. In this situation, a large percentage of the older population does not meet the requirements to access contributory benefits.

Lastly, the public expenditure component that has been examined in most detail in recent years is that of conditional cash transfer programmes, which has had significant political repercussions as well as a modest impact on public accounts. As will be seen, this component has evolved considerably in recent years, a period characterized by growing concern over equity and the distributive effects of public spending.

During the second half of the last century, the general trend of growing unemployment and job insecurity revealed failings in the contributory social protection system to provide coverage to a large sector of the population. In response to this shortcoming, Latin American countries began to introduce cash transfer programmes in the mid-1990s, which set conditions for accessing benefits. These initiatives have been expanded and now cover nearly all countries of the region (Cetrángolo and Goldschmit, 2012; Cecchini and Atuesta, 2017).

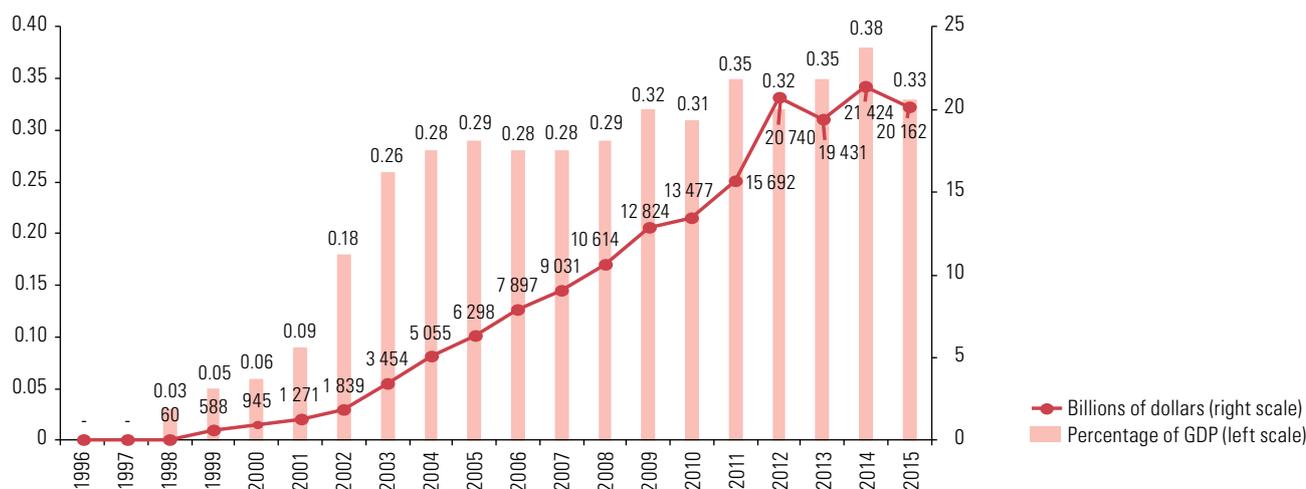
These programmes are key instruments of policies to reduce poverty and extreme poverty in most countries. During the early 2000s, they represented a genuine reform of poverty reduction plans because they did not adopt the social insurance model and its contributory system and, in turn, moved away from the hitherto dominant practice of providing “food stamps” (Fonseca, 2006).

According to the assessment by Cecchini and Atuesta (2017), public spending on conditional cash transfer programmes rose in most Latin American and Caribbean countries over the last two decades, both in monetary terms (current dollars) and as a proportion of GDP. On average, public investment in these programmes increased from 0.06% of regional GDP in 2000 to 0.33% in 2015 (see figure III.5).

**Figure III.5**

Latin America and the Caribbean: public expenditure on conditional cash transfer programmes, 1996–2015

(Percentage of GDP and billions of current dollars)

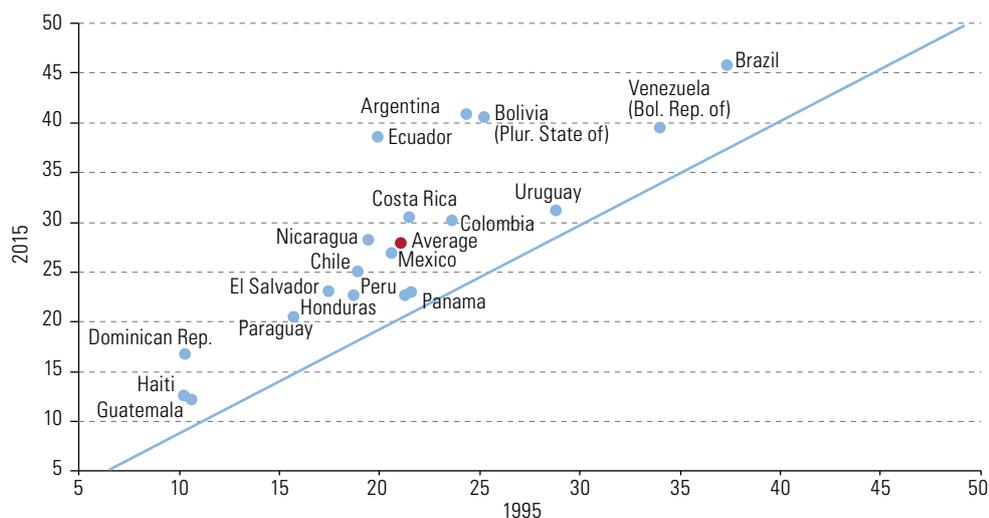


**Source:** S. Cecchini and B. Atuesta, “Conditional cash transfer programmes in Latin America and the Caribbean: coverage and investment trends”, *Social Policy series*, No. 224, Santiago, Economic Commission for Latin America and the Caribbean (ECLAC), 2017.

## 5. Classification of countries based on spending levels

It goes without saying that the situation examined in the previous section reflects a regional average, behind which there is a great diversity of situations. Total public expenditure is highest (greater than 40% of GDP) in Brazil and Argentina, which are also the two countries that have the highest tax burden (Gómez Sabaini and Morán, 2018). The regional average given in table III.1 indicates that economies with highly diverse levels of public spending coexist in the region, ranging from the two aforementioned countries to those where public expenditure amounts to less than 20% of GDP (Haiti, Guatemala and Paraguay).

While it is not possible to compare the public spending patterns of all countries of the region at the same level of government, a very reasonable approximation is given in figure III.6, where central government figures are used in the case of countries with low levels of expenditures at the subnational level. Between 1995 and 2015, public spending levels increased in all countries and, at the regional level, rose from 21% to 27.5% of GDP, approximately. Figure III.6 also reveals the special situation of three countries that recorded high growth: Argentina, the Plurinational State of Bolivia and Ecuador.<sup>3</sup>



**Figure III.6**  
Latin America: public expenditure by country, 1995 and 2015 (Percentages of GDP)

**Source:** Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

The regional evolution of expenditure since the end of the 1990s clearly corresponds to the average of very different national situations. Figure III.7 shows the evolution of public expenditure in four groups of countries, classified according to their current spending levels. These are:

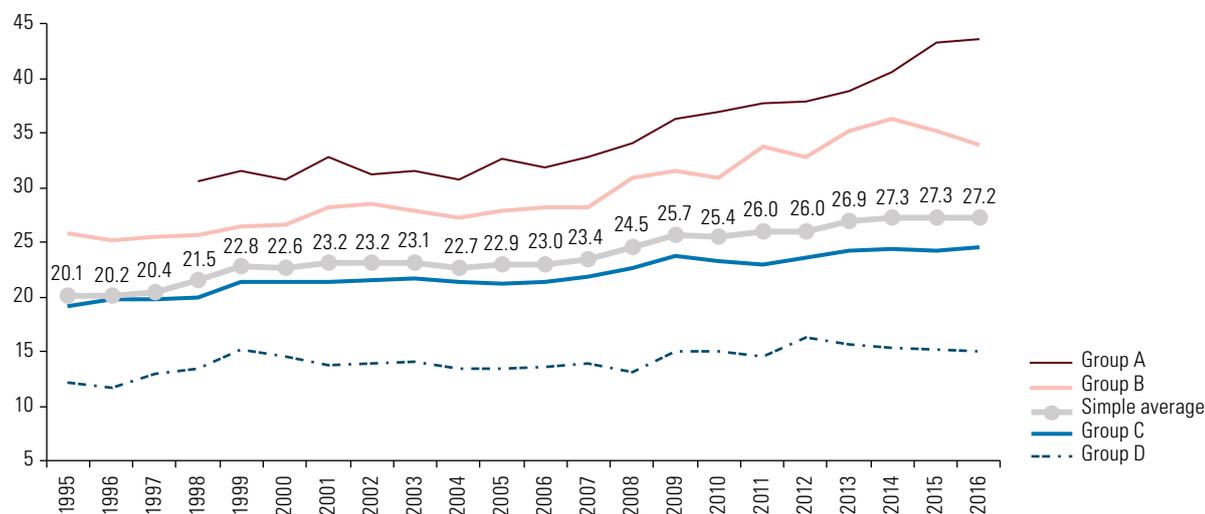
- Group A: countries with a public spending level higher than 40% of GDP (Argentina and Brazil). They follow a much steeper trajectory and present increases that are much greater than the average, particularly in the last 10 years.<sup>4</sup>
- Group B: countries with a public spending level between 30% and 40% of GDP (the Bolivarian Republic of Venezuela, Costa Rica, Ecuador, the Plurinational State of Bolivia and Uruguay), which grew at similar rates to those of group A, until they began to fall in recent years.
- Group C: countries with a public spending level between 20% and 30% of GDP (Chile, Colombia, the Dominican Republic, El Salvador, Honduras, Mexico, Nicaragua, Panama and Peru), where the pattern is very similar to the regional average.
- Group D: countries with a public spending level below 20% of GDP (Guatemala, Haiti and Paraguay) and lower rates of growth.

<sup>3</sup> Of particular interest is the evolution of public spending in Argentina, which grew by more than 15% of GDP between 2005 and 2015. During that period, the tax burden increased by about 10 percentage points of GDP, leading to an exceptionally large fiscal imbalance (between 6% and 7% of GDP) (Cetrángolo, Gómez Sabaini and Morán, 2015).

<sup>4</sup> Although total expenditure in the Plurinational State of Bolivia reached a level equivalent to 40.6% of GDP in 2015, this was the result of an exceptional situation in 2014 and 2015. In 2016, public spending in that country returned to a level similar to the average for the last decade (34%) and it is therefore included in group B.

Figure III.7

Latin America: total public spending by groups of countries, 1995–2016  
(Percentage of GDP)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

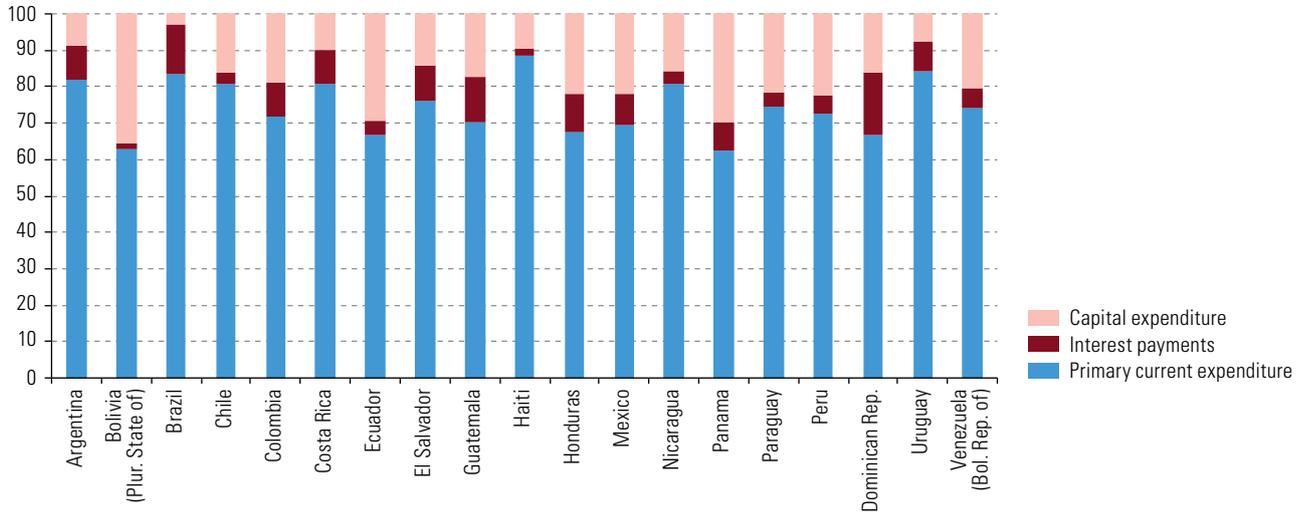
Note: Group A: public spending exceeding 40% of GDP; Group B: public spending between 30% and 40% of GDP; Group C: public spending between 20% and 30% of GDP; Group D: public spending less than 20% of GDP.

In addition to the classification of the countries, it is interesting to analyse some particular national situations. The differences among countries' expenditure structures are examined below, focusing in particular on spending corresponding to different public policies in selected sectors that deserve special attention.

As a result of the different paths taken by the Latin American countries, an initial analysis of the economic structure of public spending in country reveals, firstly, which have capital spending levels that exceeds 20% of total expenditure. This group includes some of the countries that rely on revenues from natural resources (Ecuador, Mexico, Paraguay and the Plurinational State of Bolivia).

Secondly, there are some countries —Brazil, Colombia, the Dominican Republic and Guatemala— where debt interest payments account for more than 10% of total spending. In the other countries under consideration, primary current expenditure accounts for more than 80% of the total, with the exception of Honduras. That country is a special case, as capital spending accounts for more than 20% of the total and interest payments for more than 10%, so that its primary current expenditure makes up only 67.5% of the total (see figure III.8).

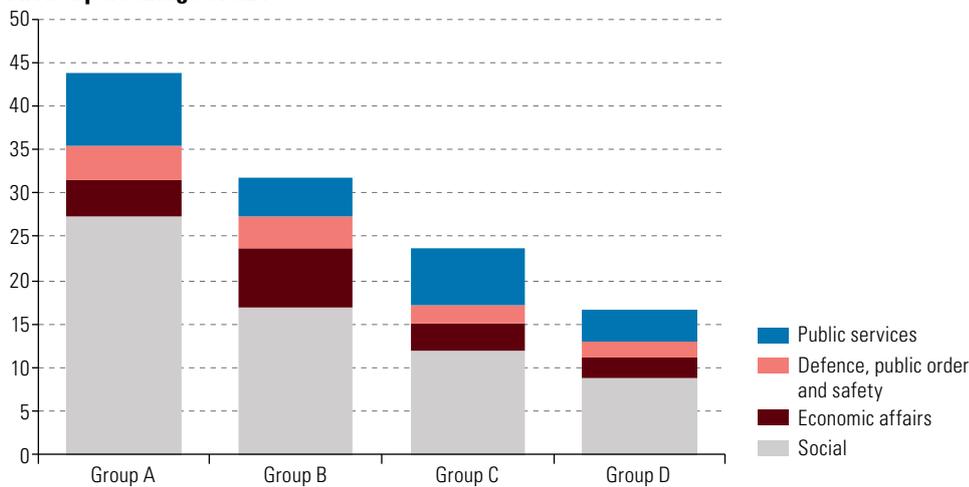
**Figure III.8**  
Latin America (19 countries): public expenditure by economic classification, around 2016  
(Percentages)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

Figure III.9 shows the levels and the composition of the structure of public expenditure of groups of countries from a functional perspective. It indicates that higher expenditure levels are linked to increased social spending, in particular on social protection. As will be seen in the following section, countries with the highest public expenditure tend to be those that have developed more extensive welfare states. Nevertheless, the countries of group B devote a significant proportion of spending to economic affairs, reflecting their higher public investment levels.

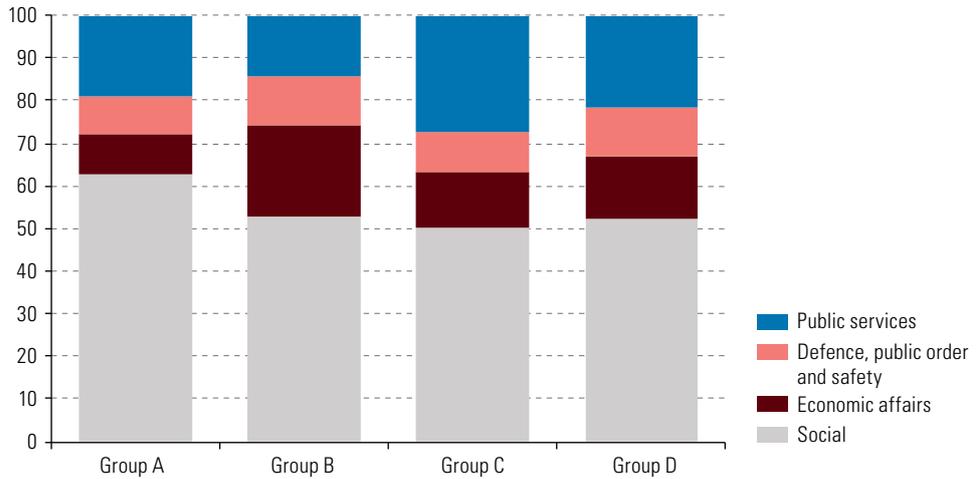
**A. As a percentage of GDP**



**Figure III.9**  
Latin America: public spending by functional classification, by groups of countries, 2015  
(Percentages of GDP and percentages)

Gráfico III.g (concluded)

**B. As a percentage of total public spending**



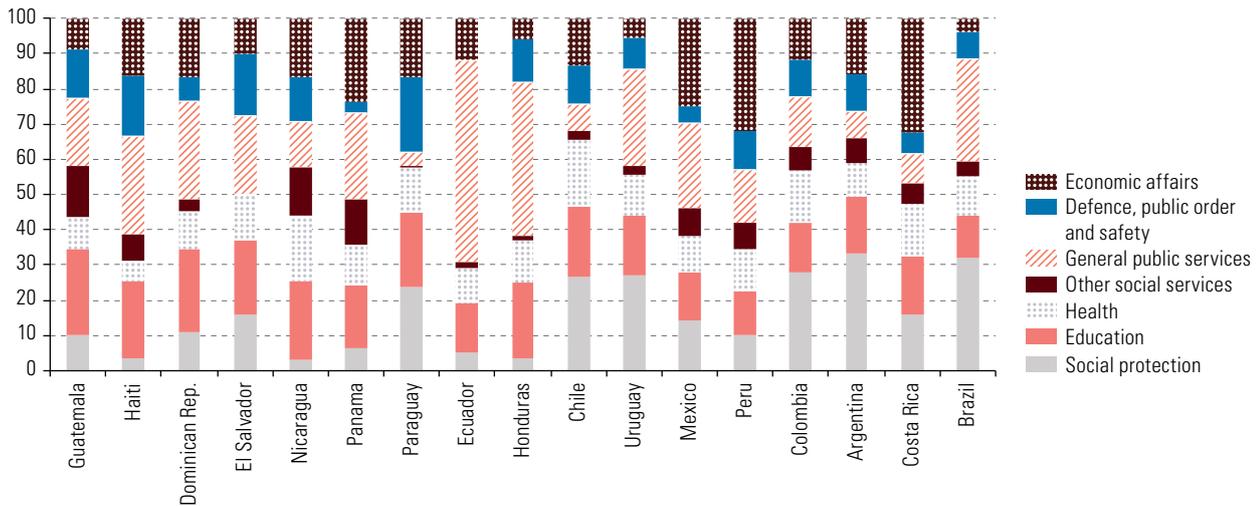
**Source:** Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

**Note:** Group A: public spending exceeding 40% of GDP; Group B: public spending between 30% and 40% of GDP; Group C: public spending between 20% and 30% of GDP; Group D: public spending less than 20% of GDP.

To supplement this information and better assess each case, figure III.10 presents the data as percentages of public spending in each country. The lion's share is clearly devoted to social spending, although the weight of the different government functions varies. As a simple regional average, spending on social services accounts for 57% of total expenditure, with levels above 63% in Argentina, Chile and Colombia. This is despite the fact that private expenditure accounts for the bulk of spending on pensions in Chile, and to a lesser extent in Colombia. At the other end of the scale, social spending makes up less than 40% of total expenditure in the Dominican Republic, Ecuador and Honduras.

**Figure III.10**

Latin America (17 countries): composition of public spending by function of government, 2015 (Percentages)



**Source:** Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

## B. Latin America's main public spending challenges

Having examined the main general features of the evolution and current situation of public spending in Latin America, this section looks at the main challenges for the future in each case. To this end, it examines the circumstances and characteristics of sectors that are key recipients of spending, making reference to the policies that have affected the relative weight of those sectors in each country. In particular, policies on social protection for older persons, health, education, transfers to the most vulnerable sectors and public investment are analysed, in the light of their special significance for understanding the dynamics of countries' public spending.

### 1. Consolidating inclusive education systems and improving their quality

Some patterns common to most reforms may help to understand the repercussions of rising public expenditure on education. Reforms include making secondary and preschool education compulsory, ensuring a minimum of classroom hours, extending the school day and broadening the curriculum, as mechanisms to expand horizontal and vertical coverage. In the past, this usually meant increasing education budgets, with the payment of salaries and the (uneven) expansion of infrastructure given priority, against a backdrop of increasing decentralization, a process that is proceeding at different rates across the region.

The current debate over the scope and content of the right to education and the alternatives for giving effect to that right shows that progress has been very uneven across the region. This can also be seen in the number of pupils who repeat a year or dropout. Similarly, "over-age" enrolment has a negative impact on pupils' school careers and on teaching and learning. The result of these combined variables suggests that current levels of education quality and performance are highly uneven.

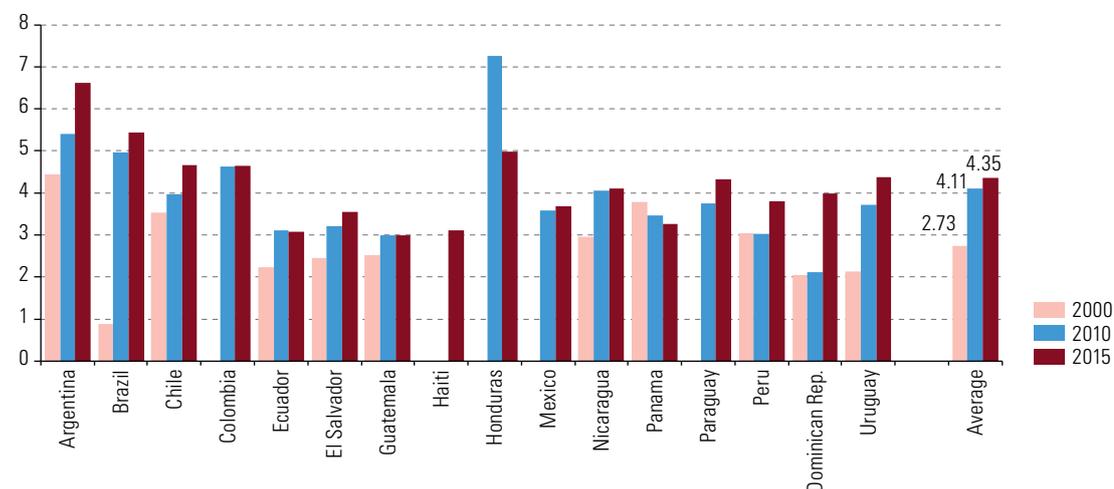
Figure III.11 shows that there has been a steady increase in education spending as a proportion of GDP in the vast majority of countries of the region over the last 15 years. Honduras and Panama, which saw significant cuts, are clear exceptions, while this indicator has remained stable in Colombia, Ecuador and Guatemala. Between 2010 and 2015, the growth in average regional spending slowed, although expenditure in Argentina, Chile, the Dominican Republic, Paraguay and Peru rose faster than before (Cetrángolo and Curcio, 2017).

If education quality is analysed on the basis of the Second and Third Regional Comparative and Explanatory Studies (SERCE and TERCE), developed by UNESCO, it is clear that, between 2008 and 2013, educational performance—as measured by the test results under consideration—improved in the great majority of the region's countries, except Costa Rica (where performance was stable at the primary level and declined slightly at the secondary level), Paraguay and Uruguay (where the test results at the secondary level fell between the two evaluation exercises).<sup>5</sup> Nevertheless, the results of the education systems of Costa Rica and Uruguay are well above the regional average. The data also reveals that the results at the secondary level are much lower than those of primary pupils in all countries, with wide variations among the different countries (see table III.2).

<sup>5</sup> These were the second and third versions of the studies to measure and evaluate the quality of education systems in Latin America, prepared by the Latin American Laboratory for Assessment of the Quality of Education (LLECE). The Laboratory was set up in 1994 as a network of national education quality assessment units across Latin America. The second study was conducted in 2006, assessing students' skills in mathematics and reading in the third and sixth grades, and in natural sciences in sixth grade. The third study was carried out in 2013, and covered the same subject matters and year groups as SERCE.

Figure III.11

Latin America (16 countries): public spending on education, 2000, 2010 and 2015  
(Percentages of GDP)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

Table III.2

Latin America: synthetic indicator of educational quality by country according to the SERCE<sup>a</sup> and TERCE<sup>b</sup> tests  
(Simple average of test scores in mathematics, language and sciences)

Country	Primary		Secondary	
	SERCE	TERCE	SERCE	TERCE
Argentina	507.70	522.87	502.73	513.37
Brazil	504.30	529.44	509.87	521.78
Chile	545.75	576.86	531.69	568.76
Colombia	479.97	518.99	503.99	522.25
Costa Rica	550.51	550.18	556.26	540.35
Dominican Republic	395.55	451.03	421.14	445.51
Ecuador	462.74	516.30	453.47	501.91
Guatemala	452.03	497.78	453.64	488.51
Mexico	531.27	534.33	535.77	547.27
Nicaragua	471.29	481.36	465.43	470.64
Panama	465.13	492.04	465.39	473.07
Paraguay	477.35	484.39	464.27	459.82
Peru	473.96	527.07	477.06	511.12
Uruguay	530.59	537.36	551.23	538.41
<b>Average across countries</b>	<b>490.94</b>	<b>515.72</b>	<b>488.78</b>	<b>502.09</b>

Source: O. Cetrángolo and J. Curcio, "Financiamiento y gasto educativo en América Latina", *Macroeconomics of Development series*, No. 192, Santiago, Economic Commission for Latin America and the Caribbean (ECLAC), November 2017, on the basis of United Nations Educational, Scientific and Cultural Organization (UNESCO), *Informe de resultados: Tercer Estudio Regional Comparativo y Explicativo (TERCE)*, Santiago, July 2015.

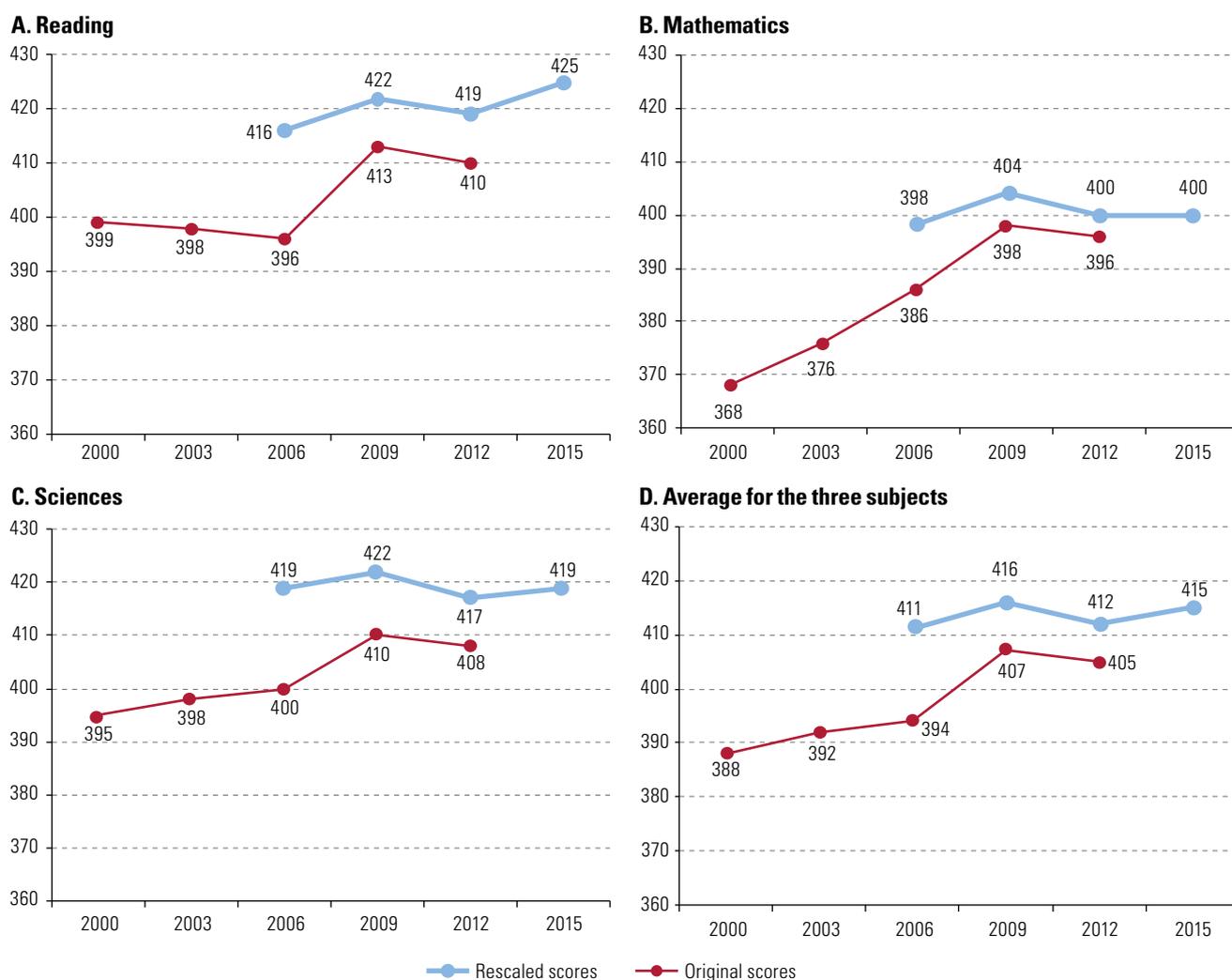
<sup>a</sup> Second Regional Comparative and Explanatory Study (SERCE).

<sup>b</sup> Third Regional Comparative and Explanatory Study (TERCE).

Education quality can also be measured using the results of the reading, mathematics and science tests for 15-year-old students, conducted as part of the Programme for International Student Assessment (PISA), developed by the Organization for Economic Cooperation and Development (OECD) (see figure III.12). According to Rivas and Scasso (2017), changes can be seen in education quality in the seven Latin American countries that participated regularly in the PISA tests between 2000 and 2015 (Argentina, Brazil, Chile, Colombia, Mexico, Peru and Uruguay). The score scale was modified in that study to allow for comparison over time, revealing that in some countries there had been a significant improvement in all national and international evaluations during the period under consideration. For example, Peru shows a clear improvement from a very low starting point. Chile appears to have improved during the 2000s, but its test performances have stagnated in recent years. Brazil, Mexico and Argentina showed slight improvements at the primary level, but not at the secondary level. Colombia and Uruguay have remained stable since the measurements began (Rivas and Scasso, 2017).

**Figure III.12**

Latin America (selected countries): average score on PISA tests (by subject matter), original and rescaled scores, 2000–2015<sup>a</sup>



**Source:** A. Rivas and M. Scasso “¿Qué países mejoraron la calidad educativa?: América Latina en las evaluaciones de aprendizajes”, *Documento de Trabajo*, No. 161, Buenos Aires, Center for the Implementation of Public Policies Promoting Equity and Growth (CIPPEC), 2017.

<sup>a</sup> The rescaled scores are given to facilitate comparability following the methodological change adopted by the Organization for Economic Cooperation and Development (OECD)-Programme for International Student Assessment (PISA) in 2009.

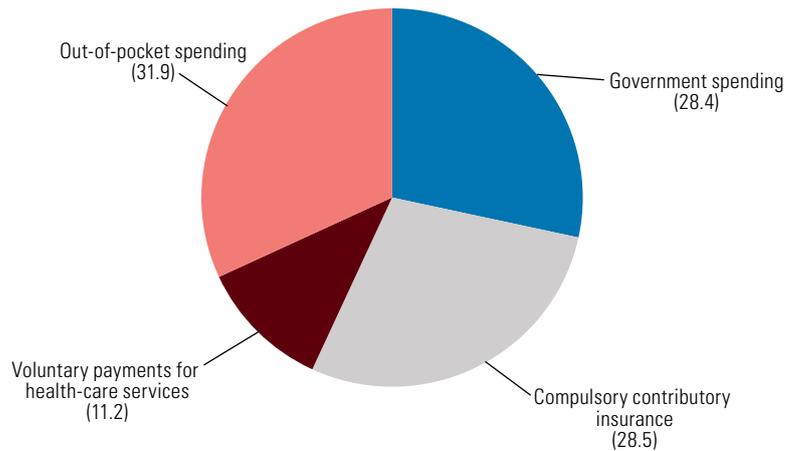
It would seem that the most complex and pressing public policy challenges are to be found in the area of education spending. Socioeconomically speaking, school systems are not very inclusive, they suffer from significant quality and performance shortcomings and have failed to become drivers of growth and equality. Steps must be taken to combat the segregation of learning by socioeconomic status, territory, gender and ethnicity, as only education can lay the basis for the much-desired social and labour mobility that will reduce existing gaps. Education must also be improved to incorporate the technical progress, innovation and enhanced productivity that the region's economies need. Specific aspects of education spending that are considered essential for solving problems include the availability of materials, the incorporation of new technologies and learning methods, the improvement of school infrastructure, the provision of teacher training and sharing of good teaching practices, for example teacher attendance and punctuality are factors that are recognized to have a positive impact on learning.

However, these spending factors alone would seem unable to reverse the current weaknesses of education systems. Given that the socioeconomic and cultural environment have a significant impact on learning outcomes, the existence of a vicious circle that perpetuates the intergenerational reproduction of vulnerabilities must be acknowledged, and it must be broken. While these issues may be common to all social spending, the education sector offers the clearest opportunities for reversing them.

Lastly—and this point applies not only to education services, but also to health-care and other public services that can be provided in a decentralized manner— there is the additional challenge of the financial and management capacity disparities across territories. Unfortunately, no ideal and agreed solution has yet been found to overcome these difficulties. However, one option that deserves more careful analysis is the recent attempt to earmark transfers for specific uses, especially in the light of the difficulties of expanding public budgets in a limited fiscal space.

## 2. Reducing the fragmentation of health-care systems to achieve universal coverage and address the epidemiological transition

In Latin America, the changes in public spending on health in recent decades reflects the pro-market reforms that then gave rise to a growing preoccupation with expanding the coverage of and access to high-quality health-care services. In most countries, this led to recognition (to varying degrees of formality) of the need to ensure universal access to health-care services. Yet there are few clear and explicit references to the level of guaranteed coverage. Today, average spending on health across the region is equivalent to 7% of GDP. Of that amount, 28% is borne by the public sector and a similar percentage is covered by compulsory insurance. Consequently, as figure III.13 shows, the most significant fact is that voluntary private insurance and out-of-pocket expenses account for some 43% of total health spending.



**Figure III.13**  
Latin America: structure  
of health spending, 2015  
(Percentages)

**Source:** Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of information from the World Health Organization (WHO).

**Note:** Simple average of 20 countries.

The aforementioned fragmentation of health spending, which takes different forms across Latin America, means that analysing the share of State spending in the sector is much more complicated. Table III.3 shows health expenditure levels and structure, revealing that total spending in Uruguay, Argentina and Brazil is close to 9% of GDP, with compulsory insurance accounting for a high percentage of that spending in the first two countries. However, insurance plays a lesser role in Costa Rica, Chile and Colombia where —under different systems— much of the reform effort has been concentrated on social security.

Country	Total health spending as a percentage of GDP	Government spending	Compulsory contributory insurance	Voluntary payment for health-care services	Out-of-pocket spending
Argentina <sup>a</sup>	9.0	33.5	45.2	8.0	13.4
Bolivia (Plurinational State of)	6.4	40.3	28.7	5.1	25.9
Brazil	8.9	43.3	0.0	28.4	28.3
Chile	8.1	2.2	58.6	7.0	32.2
Colombia	6.2	11.8	59.0	10.9	18.3
Costa Rica	8.1	9.7	66.3	2.5	21.5
Dominican Republic	6.2	27.6	20.0	8.7	43.7
Ecuador	8.5	28.9	21.1	6.3	43.7
El Salvador	6.9	37.7	28.6	5.8	27.9
Guatemala	5.7	17.8	15.9	10.5	55.8
Haiti	6.9	11.8	1.9	50.0	36.3
Honduras	7.6	33.1	12.1	5.7	49.1
Jamaica	5.9	53.6	5.8	16.9	23.7
Mexico	5.9	23.8	28.4	6.5	41.4
Nicaragua	7.8	36.3	24.0	3.8	36.0
Panama	7.0	37.8	24.6	7.1	30.5
Paraguay	7.8	34.3	19.3	9.9	36.5
Peru	5.3	32.6	29.1	7.4	30.9
Uruguay	9.2	27.7	42.2	13.9	16.2
Venezuela (Bolivarian Republic of)	3.2	20.3	27.4	6.5	45.8
<b>Simple average</b>	<b>7.0</b>	<b>28.4</b>	<b>28.5</b>	<b>11.2</b>	<b>31.9</b>

**Table III.3**  
Latin America: structure  
of health spending  
by country, 2015  
(Percentage of GDP  
and percentages)

**Source:** World Health Organization (WHO), for Argentina: official figures from the public and social security subsectors.

<sup>a</sup> Data for Argentina were obtained by reformulating its national accounts.

By definition, the most progressive mechanisms are those where the entire population is included in a single system financed by general taxation, and where coverage is independent of people's capacity to pay. This in turn should be reflected in lower levels of out-of-pocket expenses. Within the region, this is the case in the English-speaking Caribbean countries, Cuba and Brazil (ECLAC, 2006). In Brazil, however, private spending represents a high proportion of total expenditure (3.7% of GDP), while public spending amounts to 3.6% (PAHO, 2011).

In the rest of the region, where financing is still partially dependent on payroll deductions, the systems tend to be fragmented. While some countries have attempted to integrate contributory systems funded by these deductions with tax-funded public schemes, others continue to clearly separate these two forms of financing.<sup>6</sup>

Current health-care coverage is inadequate and unevenly distributed, with little capacity to combat the inequalities that exist in the countries of the region. The objective of universal health-care coverage is in fact much more ambitious than the goal of ensuring that each citizen has access to "some" coverage, and it assumes that all residents of a country have a right to standardized and sufficient (both in terms of quantity and quality) coverage, which will necessarily be contingent on financing. Universal coverage implies equitable access and financial protection. From a public policy perspective, coverage provided from compulsory funding sources (general revenues and payroll deductions) should not discriminate on the basis of income, as is often the case in fragmented systems where formal workers (and in some countries, their families) can access higher levels of coverage than the rest of the population (Titelman, Acosta and Cetrángolo, 2014).

Moreover, the picture would be very incomplete if the importance of coordinating social services with the different agents of the private sector were not considered. In each country, the presence of the private sector affects the modelling of the supply and financing of health-care (and of other social services as well) and the implementation of the necessary reforms, thus creating new challenges. Failing to properly regulate the presence of private companies in the different sectors, especially health and education, would seriously hinder sectors' ability to achieve their objectives.

The lack of universal health-care coverage also magnifies the challenges of formulating public policies that address the issues arising from the epidemiological transition in the region. That is, mortality from non-communicable diseases rising, while that from infectious and parasitic causes is falling (Di Cesare, 2011). In the first case, changes in lifestyle and eating habits have increased the incidence of obesity considerably, which in turn has led to a jump in cases of chronic illnesses, especially diabetes (Kain and others, 2014). This situation will demand significant investment, as the costs of treating these illnesses are much higher than those of communicable diseases. In this respect, there is a pressing need for cross-cutting health policies that will strengthen health-care systems and, at the same time, invest in prevention programmes.

<sup>6</sup> As intermediation services expand, the fragmentation of health-care systems often leads to an increase in health sector spending, which does not necessarily produce greater benefits, instead it leads to a duplication of costs and services.

### 3. Ensuring minimum levels of social protection and sustainable contributory pension systems for older persons in a context of demographic transition

With regard to spending on pensions and, more generally, on the protection of the older population, many traditional social security systems in the region reached maturity during the period under review and, undoubtedly, the greatest number of debates and reforms covered this area. As noted above, the countries pursued various reform paths and towards the end of the last century there was widespread dissatisfaction with the existing systems, which offered inadequate coverage and were, for the most part, costly and unsustainable.

The different countries also followed a great variety of paths to deal with the problems of coverage for older persons. Perhaps the most notable feature has been the concern for fairness, in line with other social policy reforms that sought to address the income rights of different population groups, particularly in the most recent period. Thus, non-contributory programmes have proliferated to supplement the coverage provided by contributory ones. As these are financed by tax revenues, countries have had to contend with the traditional restrictions on the region's ability to increase the tax burden.

While countries have taken various approaches to resolving this problem, thereby widening regional differences, the general trend has been to include non-contributory programmes. Rofman and others (2013) identify permanent systems established in Brazil, Chile, Colombia, Costa Rica, Ecuador, El Salvador, Mexico, Panama, Paraguay, Peru and Uruguay.<sup>7</sup> These programmes are considered to be targeted, although several programmes state explicitly that they are targeted in order to achieve universal enjoyment of rights.

The Plurinational State of Bolivia and Argentina deserve special mention. The *Renta Dignidad* (decent income) programme, established by the Plurinational State of Bolivia, made pension benefits universal following the reform of a special scheme under which a benefit, financed by the privatization of the national oil company, was extended only to those people living in the country at the time of the privatization.

By contrast, Argentina experimented with providing very broad but temporary coverage. The introduction of the so-called pension moratorium granted contributory benefits to all persons who had not met the contributory requirements, but only as an emergency measure and for a limited time. It was not until 2016 that older persons were granted the right to a universal benefit.

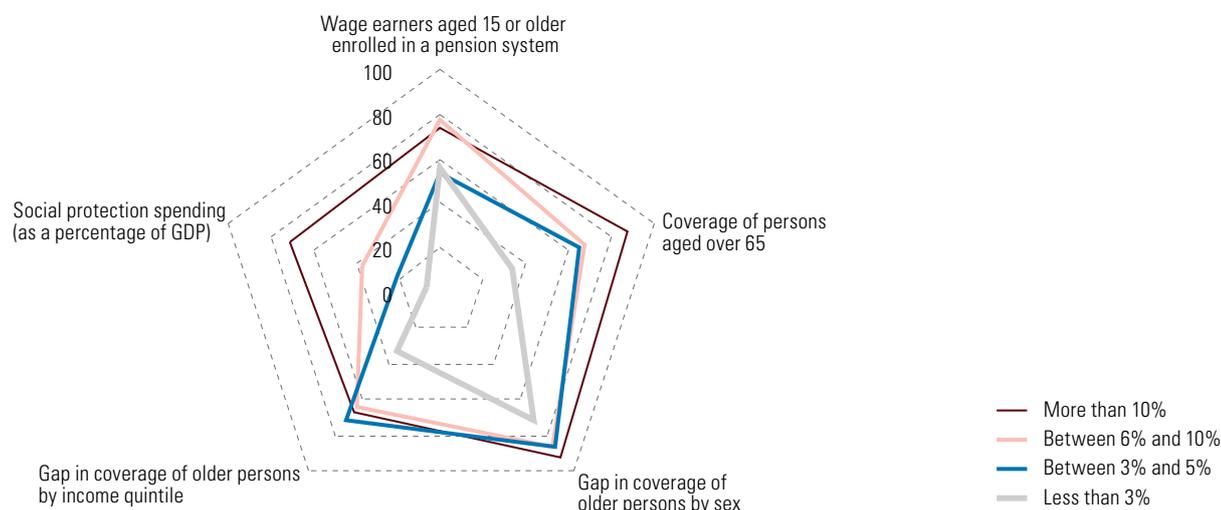
Figure III.14 summarizes the regional situation and its challenges, using data from the countries, which are classified into four groups by their level of public spending on social protection for older persons. For each group, information is provided on the coverage of wage earners enrolled in pension systems and of the population aged over 65, as well as on the coverage gaps between the first and last income quintiles and between men and women in each country.

In the first place, the importance of this type of spending is evident from the fact that the countries with the highest level of spending on this function (more than 10% of GDP) are the same countries as those that have the highest levels of government spending: Argentina and Brazil. That group has the highest coverage levels, for both wage earners enrolled in pension systems and for the population aged over 65, although the greater coverage of the population aged over 65 indicates that there is wider range of pension schemes. This group also has the smallest coverage gap between women and men.

<sup>7</sup> In the case of Chile, as part of the 2008 reform to set up an integrated system.

Figure III.14

Latin America: indicators of protection for older persons in countries grouped by spending levels



**Source:** Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of *Social Panorama of Latin America, 2017* (LC/PUB.2018/1-P), Santiago, February 2017.

**Note:** The gender gap in coverage was calculated by taking the coverage of women of retirement age as a percentage of that of men. The coverage gap by quintiles is defined as coverage of persons aged over 65 years in the first income quintile as a percentage of that of the fifth quintile. Countries' social protection spending was rescaled so that 14.60% of GDP = 100. The groups comprise the following countries: "More than 10%" includes Argentina and Brazil; "Between 6% and 10%" includes Chile, Colombia and Uruguay; "Between 3% and 5%" includes the Bolivarian Republic of Venezuela, Costa Rica, Mexico, Paraguay, Peru and the Plurinational State of Bolivia; and "Less than 3%" includes the Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras and Panama.

In second place are those countries that spend between 6% and 10% of GDP on this function. This group includes three countries that undertook significant reforms in recent decades: Chile, Colombia and Uruguay. A criticism of this group, is that coverage of the older population is low in Colombia, while, on the positive side, there is no discrimination against women in Uruguay, and coverage of the population in the first income quintile is relatively high in Chile. The lower coverage of older persons explains the lower level of expenditure in relation to group A, although given that coverage levels for wage earners enrolled in pension systems is similar for both groups, it is assumed that in the medium term they will coincide.

In third place are several countries where social protection spending on older persons varies between 3% and 5% of GDP. These countries also have much lower coverage rates of wage earners enrolled in pension systems, although with similar gender and income level gaps. This group consists of the Bolivarian Republic of Venezuela, Costa Rica, Mexico, Paraguay, Peru and the Plurinational State of Bolivia. The remaining countries spend less than 3% of GDP and perform worse with regard to the indicators of coverage and of gender and income gaps.

Lastly, it should be noted that this classification is based on public spending on pensions and other forms of protection for older persons. In countries where private sector participation has been expanding, special attention must be paid to the type of reforms implemented in order to interpret the coverage data. Table III.4 provides country information that will help to qualify each particular situation.

Table III.4

Latin America: indicators of the protection system for older persons, around 2014-2015  
(Percentages)

Country	Wage earners aged 15 or older enrolled in pension systems	Coverage of persons aged over 65	Coverage of men of retirement age	Coverage of women of retirement age	Coverage gap for older persons, by income quintile	Social protection spending (percentage of GDP)
Brazil	78.0	84.2	87.2	75.2	62.10	14.60
Argentina <sup>a</sup>	68.9	90.0	84	81.3	70.44	13.95
Colombia	62.3	26.7	30.7	20.5	1.42	9.17
Uruguay	88.4	87.4	76.3	79	86.35	6.94
Chile	81.3	87.1	86.3	74.6	102.57	6.23
Paraguay	38.8	46.2	34.2	34	60.85	4.92
Bolivia (Plurinational State of) <sup>b</sup>	40.8	96.4	66.6	52.5	98.74	4.38
Costa Rica	74.5	66.8	73.7	60.7	71.45	4.00
Mexico	44.0	70.6	75.6	66.4	94.33	3.82
Venezuela (República Bolivariana de)	72.6	60.4	53.5	47.8	21.94	3.58
Peru <sup>b</sup>	53.5	47.8	54.3	42.2	83.42	3.12
El Salvador <sup>b</sup>	50.7	16.4	17.6	10.7	5.99	2.73
Dominican Republic <sup>b</sup>	70.7	17.2	19.3	11.2	25.86	1.82
Guatemala <sup>b</sup>	37.9	19.3	22.7	15	15.49	1.26
Panama	76.1	78.6	75	57.9	64.59	1.18
Ecuador <sup>b</sup>	63.0	62.8	62.4	63.1	83.66	1.12
Honduras	37.8	9.6	11.5	7.2	3.60	0.84

**Source:** Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of *Social Panorama of Latin America*, 2017 (LC/PUB.2018/1-P), Santiago, February 2017.

<sup>a</sup> Urban area only.

<sup>b</sup> Information relates to affiliation to the pension system.

Bearing in mind the magnitude of pension spending in many countries of the region, as well as the expected maturing of the systems and ageing of the population (see ECLAC, 2016), the analysis of this function of government is essential to understanding the current situation and the fiscal outlook of individual countries. The challenge is to build and consolidate systems that will guarantee some type of income for all older people that will be sufficient to meet their basic needs and provide workers who remained in formal employment with contributory benefits that are proportional to the contributions made, thereby strengthening incentives for formalizing employment—all of this in a framework that simultaneously offers predictability and sustainability in the medium term.

#### 4. Extending guaranteed minimum levels of income protection through cash transfer programmes

As a result of the high degree of informality in the economy and the need to assist the most vulnerable population (boys and girls of the poorest sectors of society), various conditional cash transfer programmes have been developed and widely disseminated, although they fall far short of an adequate solution to these problems.

In this context, the United Nations System Chief Executives Board for Coordination adopted the Social Protection Floor Initiative as one of the priorities for addressing the global crisis. Minimum levels of social protection should ensure universal enjoyment of, at least, the following basic guarantees: (i) access to essential health-care services, including maternity care; (ii) basic income security for children; (iii) basic income security for working-age persons who are unable to work (for example, persons with disabilities or the unemployed); and (iv) basic income security for older persons, as discussed in the previous section.

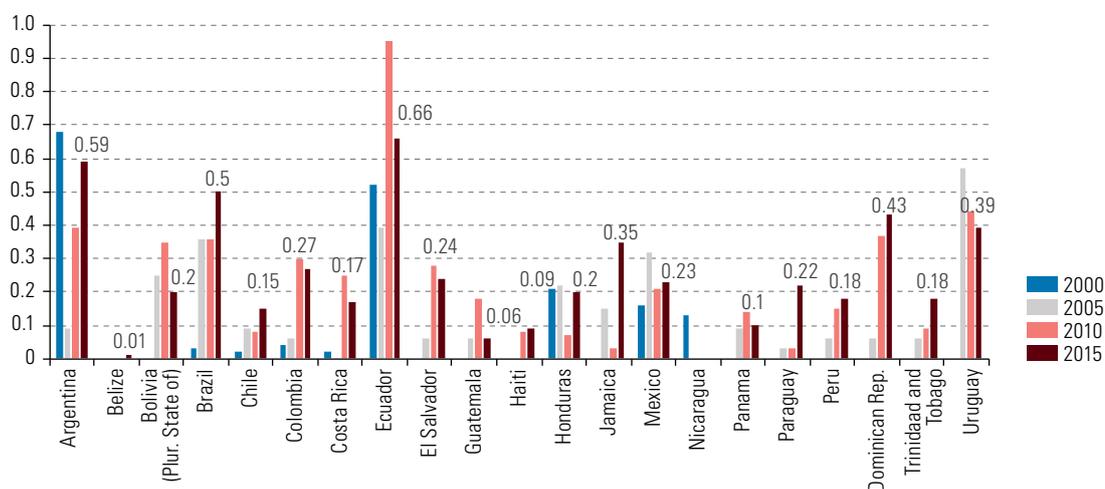
The most important innovation in terms of the region's social policies has been the nearly universal introduction of conditional cash transfer programmes in recent years.<sup>8</sup> In 2015, the regional average amount invested in these programmes was 0.33% of GDP. Among the countries that invested the most in such programmes as a percentage of GDP were Argentina (0.59%), Brazil (0.50%), the Dominican Republic (0.43%) and Uruguay (0.39%).<sup>9</sup> At the other end of the scale, the countries of the region that invested the least in these programmes in 2015, as a percentage of GDP, were Belize, Guatemala, Haiti and Panama (all below 0.1% of their respective GDP).

These figures reflect fairly different situations. In Belize and Haiti, the programmes are very small and need to be strengthened in order to provide effective coverage for the target population and to reduce levels of extreme poverty and poverty. In Guatemala, the budget for the *Mi Bono Seguro* programme was cut by 45% in nominal terms between 2014 and 2015. In Panama, it is the result of the combination of a slight decline in spending under the Opportunities Network in 2014 and 2015, and high rates of GDP growth.

An analysis of changes in expenditure on conditional cash transfer programmes between 2000 and 2015 (see figure III.15) shows that, in Brazil, investment in these programmes rose steadily from 0.03% of GDP in 2000 to 0.50% of GDP in 2015. Between 2005 and 2015, Argentina and the Dominican Republic recorded the greatest increases in investment in these programmes as a percentage of GDP, up by around 0.50 and 0.37 percentage points respectively. Over that same period, a number of countries (Honduras, Mexico, the Plurinational State of Bolivia and Uruguay) saw a reduction in investment in conditional cash transfer programmes as a percentage of GDP, reflecting slower growth in such spending.

Figure III.15

Latin America and the Caribbean: investment in conditional cash transfer programmes, by country, around 2000, 2005, 2010 and 2015 (Percentage of GDP)



Source: S. Cecchini and B. Atuesta, "Conditional cash transfer programmes in Latin America and the Caribbean: coverage and investment trends", *Social Policy series*, No. 224, Santiago, Economic Commission for Latin America and the Caribbean (ECLAC), 2017.

<sup>8</sup> The conditional cash transfer programmes developed in the region's countries are considered innovative for several reasons, including their targeting mechanisms, the provision of cash rather than in-kind benefits, and the conditions for receiving them, which in many cases require beneficiaries to take certain actions, such as ensuring that children of the household attend school and have health check-ups, vaccinations and booster shots (Hailu and Veras Soares, 2009).

<sup>9</sup> Although the Human Development Grant of Ecuador represented an investment in conditional cash transfer programmes equivalent to 0.66% of GDP in 2015, it is excluded from this analysis because those funds included not only conditional cash transfers to families with children (equivalent to 0.26% of GDP), but also pensions for older persons and benefits for persons with disabilities.



While it would be preferable if there were no need for programmes to ensure basic incomes for the most disadvantaged groups, the current situation and medium-term expectations (particularly concerning the labour market) make it unlikely that countries can dispense with cash transfer programmes for the most vulnerable households. These programmes combine the short-term poverty reduction or assistance objectives with the long-term one of eliminating poverty completely through human capital accumulation strategies. This is based on the idea that, as the crisis-coping strategies adopted by the poorest groups can lead to human capital dissavings and may thereby perpetuate poverty, a programme geared towards addressing both the consequences and the causes of poverty could interrupt its intergenerational reproduction (Villatoro, 2007).

In the near future, the horizontal and vertical coverage of these programmes should be expanded to provide sufficient coverage to the entire population in need. While support programmes for families with children are quite widespread, they have still to reach some major population groups and, even in cases where programmes do provide coverage, it is often far from adequate.

## 5. Strengthening public investment by redirecting it towards programmes with greater impact on development

Lastly, this brief review of the current status of the main public spending policies would be incomplete without mention of the widespread, persistent and considerable infrastructure gap, which has resulted from low levels of public investment in the sector.<sup>10</sup> One group of countries (including Argentina, Chile, Puerto Rico and Trinidad and Tobago) has succeeded in guaranteeing access to electricity for the entire population. Yet less than 38% of the population of Haiti has access to electricity. In 2015, the gap in the energy sector was 2.98%, an improvement over 1990, when the gap was at least 14.4% (Sánchez and others, 2017). With regard to the coverage of telecommunications infrastructure, in 2016 the Latin America and Caribbean region had on average of 126 telephone lines per 100 inhabitants, 87% of which were mobile telephony lines (see table III.5).

Notwithstanding the limitations inherent in any synthetic indicator of such diverse variables and with highly complex explanatory factors such as those concerning public access to infrastructure, an approximate classification can be produced through the relative ordering of each indicator. Thus Uruguay, Argentina, Chile and Costa Rica have the best levels of coverage in the four sectors analysed, while service access levels in Brazil, Paraguay, Mexico, the Bolivarian Republic of Venezuela, Panama, Colombia, El Salvador and Ecuador are relatively close to the regional average. Lastly, the indicators reveal that access is most limited in the Dominican Republic, Peru, Guatemala, Nicaragua, Honduras, the Plurinational State of Bolivia, and Haiti.

A look at the current structure of public investment in countries for which recent information is available shows that the bulk of public investment goes to the transport sector. At one extreme, Belize allocates 33% of its public investment resources to that sector, while at the other extreme, Guatemala earmarks 90% for transport. Energy and telecommunications receive a little investment following the consolidation of the privatization process that took place in both sectors (see figure III.16).

<sup>10</sup> A number of authors have estimated that to close this gap, the region would have to invest approximately 5% of GDP in infrastructure over a prolonged period of time (Serebrisky and others, 2015). For a more in-depth analysis of this topic, from different perspectives, see ECLAC 2017a, 2015a and 2015b.

The efficient delivery of infrastructure services is essential for the spatial, economic and social cohesion of a population, not only because they unify the territory, but also because they provide the services necessary for production and for improving peoples' living conditions and quality of life (Correa and Rozas, 2006). In this respect, infrastructure development boosts productivity and, consequently, economic growth, by reducing production costs, facilitating human capital accumulation, creating jobs and diversifying the production structure (ECLAC, 2015a; Serebrisky and others, 2015).

Table III.5

Latin America and the Caribbean: access to infrastructure indicators by country, around 2016

Country	Access to electricity (percentages) <sup>a</sup>	Access to drinking water (percentages) <sup>b</sup>	Access to sanitation (percentages) <sup>b</sup>	Telephone lines (per 100 inhabitants) <sup>c</sup>
Argentina	100.00	99.10	96.40	174.05
Belize	92.45	99.50	90.50	70.34
Bolivia (Plurinational State of)	90.04	90.00	50.30	98.49
Brazil	99.65	98.10	82.80	139.31
Chile	100.00	99.00	99.10	146.29
Colombia	97.79	91.40	81.10	131.29
Costa Rica	99.36	97.80	94.50	175.56
Dominican Republic	98.47	84.70	84.00	93.32
Ecuador	98.98	86.90	84.70	99.13
El Salvador	95.13	93.80	75.00	155.18
Guatemala	85.49	92.80	63.90	125.40
Guyana	86.90	98.30	83.70	85.28
Haiti	37.94	57.70	83.70	60.59
Honduras	88.65	91.20	82.60	96.38
Jamaica	97.10	93.80	82.60	126.55
Mexico	99.17	96.10	85.20	103.70
Nicaragua	81.85	87.00	67.90	
Panama	91.60	94.70	75.00	188.15
Paraguay	99.00	98.00	88.60	109.92
Peru	92.92	86.70	76.20	126.81
Puerto Rico	100.00		99.30	109.87
Trinidad and Tobago	100.00	95.10	91.50	180.78
Uruguay	99.66	99.70	96.40	181.07
Venezuela (Bolivarian Republic of)	99.11	93.10	94.40	111.42
Latin America and the Caribbean	97.02	94.63	83.15	125.97
OECD countries <sup>d</sup>	99.92	99.31	97.78	155.77

**Source:** World Bank, "World Development Indicators", 2017 [online] <https://datacatalog.worldbank.org/dataset/world-development-indicators>.

**Note:** The information in this table reflects a special methodology used in the cited source, and may not coincide with census or other widely used indicators. For more information see World Bank (2017).

<sup>a</sup> Data are for 2014.

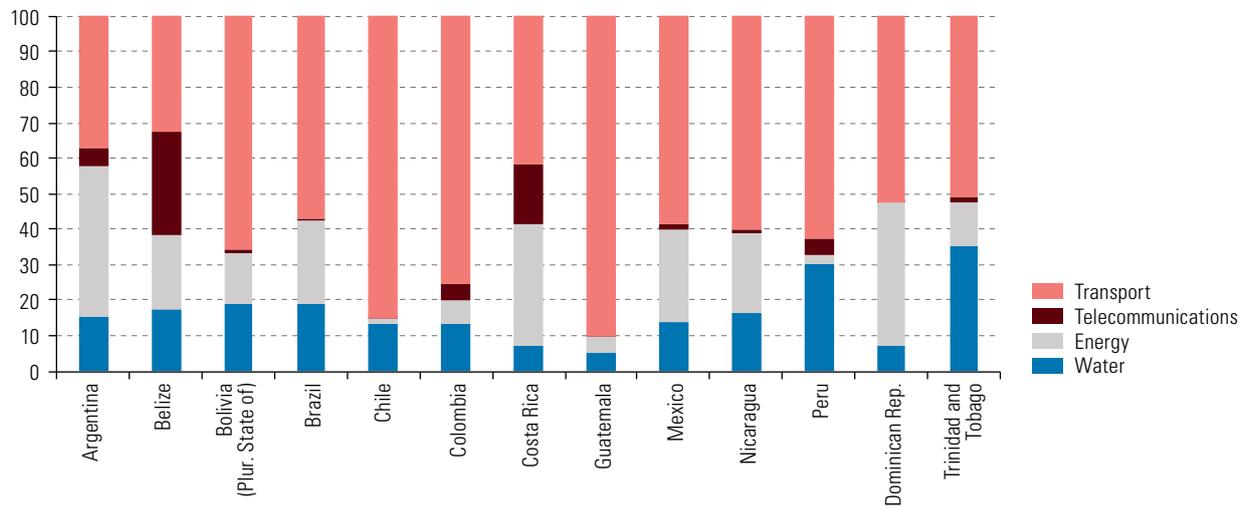
<sup>b</sup> Data are for 2015.

<sup>c</sup> Data are for 2016.

<sup>d</sup> Organization for Economic Cooperation and Development (OECD).

**Figure III.16**

Latin America and the Caribbean (13 countries): structure of public investment in infrastructure by sector, 2015  
(Percentages)



**Source:** Economic Commission for Latin America and the Caribbean (ECLAC) on the basis of Economic Infrastructure Investment Data in Latin America and the Caribbean (INFRA LATAM) [online database] <http://www.infralatam.info/>.

## C. Concluding remarks

After reviewing public policy and expenditure trends over the last 30 years, as well as current interventions by Latin American governments, a degree of dissatisfaction is unavoidable over the demonstrated coexistence of two phenomena: the growing presence of the State and, at the same time, its weakness or inadequacy in dealing with the serious social and economic problems facing countries of the region. Shortcomings remain the rule in terms of achieving acceptable levels of inclusion, equity and equality in fulfilment of people's rights.

Despite the great diversity of situations, however, there is a clearly growing concern to make government interventions more effective. Countries' public expenditure levels are the result of a variety of situations but, in general, shifts in spending coincided, to a certain extent with the policies adopted in response to the crisis of the 1980s, attempts to improve efficiency through the withdrawal of State intervention in the 1990s and—in special conditions created by the greater availability of funds and a rethinking of the previous direction of reforms— a greater concern to improve education and expand social protection coverage, which imply the need to improve income distribution and establish more equitable public policies.

After the various ups and downs seen in the different countries, which have failed to fully accomplish any of their proposed objectives, the challenge now is to develop an integrated response that will overcome the different situations and focus on creating solvent and efficient public sectors that can bring about sustained and sustainable improvements in the quality of interventions, in economic development and in income distribution.

As an aid in defining the required set of policies, this chapter has presented the principal challenges involved, by groups of countries and selected sectors. However, the overview of the challenges would be incomplete if it did not include the difficulties of addressing public policy objectives that are not immutable and, consequently, must be considered "moving targets." Government responses must have the necessary flexibility to react to more or less predictable changes. Some changes may be the result of factors

that can, unexpectedly, affect the macroeconomic environment or the international situation, as well as technical changes or shifts in the performance of each sector. Others may be much more predictable, such as climate and demographic changes that affect medium- and long-term trends and require a clearer definition of public policies.

It is essential, then, to consider medium-term strategies for following a reform path that is neither unique nor permanent and that must be able to adapt to the particular features of each policy anytime and anywhere. It is not just a matter of discussing the endpoint of this path, but also the functioning of the systems during a transition period, which will certainly be prolonged and will require major redefinitions during the process. There is no doubt that governments' capacity to navigate these routes and the bargaining power of the different sectors involved will be crucial for defining each particular path. To varying degrees, every reform of expenditure policies has a specific impact on different sectors of society that, depending on their bargaining or veto power, may limit the intended reforms.

The 2030 Agenda for Sustainable Development, adopted by the States Members of the United Nations, contains a set of 17 Sustainable Development Goals (SDGs) to end poverty, combat inequality and injustice, and address climate change. These Goals and their 169 targets are intended to continue and intensify the efforts initiated by countries upon assuming the Millennium Development Goals, and to guide government action over the period leading up to 2030.

One of these Goals, SDG 10, emphasizes the concern for equity, by seeking to "reduce inequality within and among countries." The specific targets for this Goal include such broad initiatives as progressively achieving and sustaining income growth of the bottom 40% of the population at a rate higher than the national average; empowering and promoting the social, economic and political inclusion of all, irrespective of age, sex, disability, race, ethnicity, origin, religion or economic or other status; ensuring equal opportunity and reducing inequalities of outcome, including by eliminating discriminatory laws, policies and practices and promoting appropriate legislation, policies and action in this regard; and adopting policies, especially fiscal, wage and social protection policies, and progressively achieving greater equality.

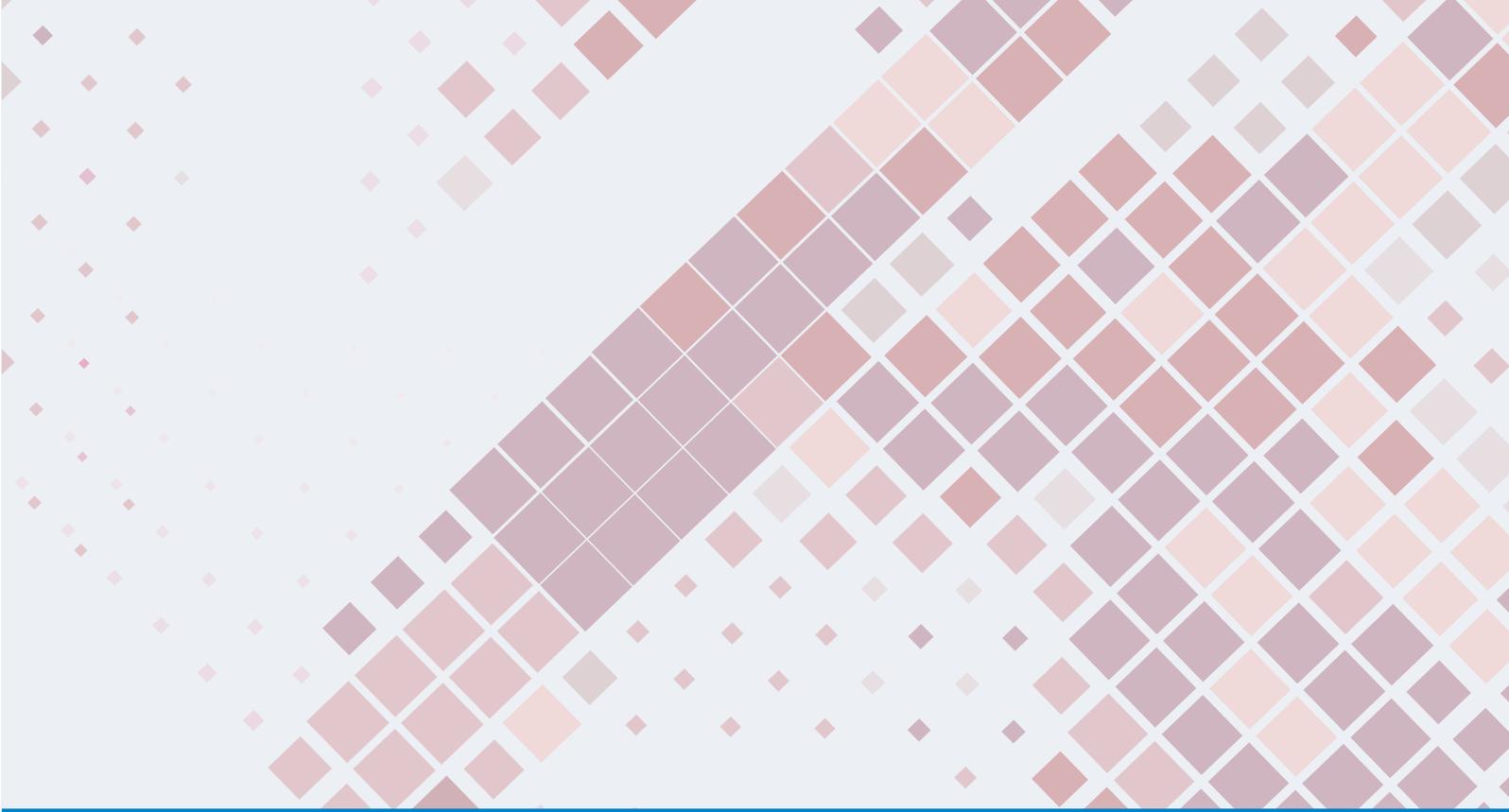
Recognizing the complexity of the stated Goals, the Third International Conference on Financing for Development, held in Addis Ababa, renewed the global commitment to financing and mobilizing resources with a view to achieving the SDGs. Countries' ability to achieve the SDGs will depend on the successful implementation of public policies—particularly social policies—in the coming years. Only a suitable and timely mechanism for State intervention will make it possible to achieve the aim of the United Nations General Assembly to move towards a sustainable future that will offer a decent life for all and leave no one behind.

Lastly, it must be recognized that the likelihood of fulfilling the broad and complex reform agenda proposed here will depend on strengthening State bureaucracies. The absence of a civil service with a reasonable capacity to implement reform initiatives may cause many of these initiatives to fail or, in any case, may induce the more realistically-minded governments to undertake less ambitious reforms that can be implemented by the existing bureaucracies. An ongoing challenge for all public spending policies is modernizing and consolidating a dynamic, flexible and efficient State bureaucracy.

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CHAPTER

# IV

## The stabilizing role of fiscal policy in Latin America and the Caribbean: the new debates

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Introduction

- A. The fiscal policy consensus before the crisis and the debate about a new fiscal policy
- B. The new fiscal policy debate and its relevance to developing countries such as those of Latin America and the Caribbean
- C. Conclusions and challenges

Bibliography



## Introduction

The global financial crisis (2008-2009) and its short- and medium-term impact on growth in the developed world and some developing economies has created an awareness of the need to debate and rethink macroeconomic theory and policy. This extends to a number of areas of action, including financial regulation, macroprudential policy, international and domestic monetary policy, the administration of exchange rates and financial flows, and of course fiscal policy.

Fiscal policy has been brought to the fore in these debates for a number of reasons. These include the prevalence of low interest rates, which limits the role of monetary policy, thus creating scope to promote growth with policies of other kinds; prolonged low growth, often below potential, in the most developed economies; and the more proactive and countercyclical role taken on in some economies by fiscal policy. Some ideas that seemed obsolete, such as the Keynesian multiplier, higher borrowing limits and greater fiscal discretion, now look like viable options, and indeed are viewed by some authors as being among the elements and considerations that could go to shape a new fiscal policy. Needless to say, these proposals have detractors who remain committed to a rigid, less proactive fiscal policy and are more hawkish about fiscal balances. Even so, while there is no settled consensus, the debate is open and far from over.

The current macroeconomic debate has basically centred on the developed countries, and especially on the economies closest to the source of the global financial crisis and those most affected by it. On the whole, and with some exceptions, this debate has passed developing economies by, particularly those of Latin America and the Caribbean. The present chapter sets out to analyse and expound some of the new ideas about fiscal policy and take a broad look at their applicability in Latin America. More precisely, it reviews the region's fiscal policy options in the light of the new fiscal policy being discussed at the global level.

It should be stressed, however, that the contrast between present and past is not as marked in Latin America and the Caribbean as in the developed world. For one thing, the global financial crisis did not strike the region as hard as the developed countries. Unlike others, this crisis did not arise in the developing world. Furthermore, since the region's high macroeconomic volatility by no means moderated during the second globalization, concern about fiscal policy and its stabilizing capacity and sustainability never abated. Lastly, not all the new proposals are applicable to Latin America and the Caribbean, a very heterogeneous region in terms of fiscal capacity and space.

This chapter will be arranged as follows. The current consensus around fiscal policy and its relationship with the stabilization function before the crisis and its channels of transmission will first be examined, after which the analysis will turn to the way it has been reformulated since the global financial crisis of 2008-2009. The main characteristics of Latin American fiscal policy and trends in the region before the crisis will then be reviewed and the region's options in the light of the new fiscal policy debate analysed. Lastly, some conclusions will be offered and continuing challenges identified.

## A. The fiscal policy consensus before the crisis and the debate about a new fiscal policy

### 1. Commonly accepted ideas about fiscal policy before the crisis

Before the crisis, and particularly during the period of the great moderation, a term coined to describe a particular period lasting over two decades (1980-2006) that was characterized by the increasing stability of prices and gross domestic product (GDP), commonly accepted ideas about fiscal policy were guided by the canons dictated by the new neoclassical synthesis or new macroeconomic consensus.

This latter is based on three ideas: (i) the existence of “natural” levels of output and interest rates to characterize long-term positions; (ii) the introduction of microeconomic rigidities and imperfections grounded in rational expectations; and (iii) short-term analysis (cycle and aggregate demand) cast in terms of current variables deviating from their natural levels.

A first economic policy implication of this approach is the primacy of monetary policy as conducted by the management of interest rates relative to the natural interest rate in order to administer the cycle, and of aggregate demand in general, with the hierarchical objective of maintaining price stability. This framework also has two properties that justify its validity in economic and social terms and are crucial to its acceptance. These are the countercyclical character of monetary policy and the idea that stabilizing inflation around its target is equivalent to stabilizing real output around its natural level, or the equivalence between nominal and real stability (the “divine coincidence”) (see Blanchard, 2006 and Blanchard and Gali, 2005). The only way of increasing the natural level of output or its growth rate, or of reducing the non-accelerating inflation rate of unemployment, is through supply-side policies, including structural reforms in the labour market.

### 2. Fiscal policy within the new macroeconomic consensus and transmission channels

In this framework, fiscal policy is seen as subordinate to monetary policy goals. The government adheres to the idea of balancing the budget or establishing fiscal rules to stabilize gross public debt around a particular share of GDP. An active fiscal policy does not have a great impact on growth. There are three transmission channels that justify this conclusion.

A first transmission channel is crowding out. The essence of the argument is that fiscal spending is inefficient because it replaces and disincentivizes private activity and spending. The traditional reasoning is as follows: higher public spending financed by new debt absorbs saving and thus depletes the money market of funds that could have been used to finance private investment. The crowding out mechanism has expanded to encompass a multitude of channels through which higher public spending has a negative or zero effect on output and employment. Foremost among these channels is the absorption of private saving by the public sector to finance its spending. This transmission channel assumes that private sector and public sector saving are independent of each other.

A second transmission channel is higher interest rates driven by increased public spending. As in the previous case, this argument assumes that there is a given volume of saving. If this is so, public spending can only be financed by transferring resources from the private to the public sector or from the external to the public sector, or a combination of the two. This transfer is secured by competing for funds through higher interest rates. In turn, the increased interest rate discourages investment and causes the exchange rate to appreciate. Through one or the other mechanism, higher public spending results in a drop in aggregate demand.

A variant on the crowding out argument is that aggregate demand falls because higher public spending drives up prices. As in the first case, there is a given volume of saving competed for by the public and private sectors. Also as in the previous example, resources shift from the private to the public sector. Here, however, the transfer of resources takes place through price rises that reduce the purchasing power of economic agents and act as a tax. In sum, on this argument, the government increases spending and thence aggregate demand, and this translates into rising prices that in turn reduce the purchasing power of economic agents.

A third channel of transmission, and perhaps the one most often invoked now, is so called Ricardian equivalence. This argument is organized around another of the most important concepts in neoclassical economics, the permanent income hypothesis.<sup>1</sup> The Ricardian equivalence argument is that a rise in public spending financed by debt will sooner or later force the government to raise taxes to pay it down. If economic agents perceive that they will have to pay more taxes in future, they may decide to save the extra income they receive because of the increase in public spending. Thus, higher public spending does not lead to greater aggregate demand.

Besides these transmission channels, the time fiscal policy takes to feed through to the economy is longer than a typical recession, which greatly limits the role of fiscal policy in smoothing business cycles (Blinder, 2004). On this reasoning, countercyclical fiscal policy tends to intensify the expansion and recession phases of business cycles.

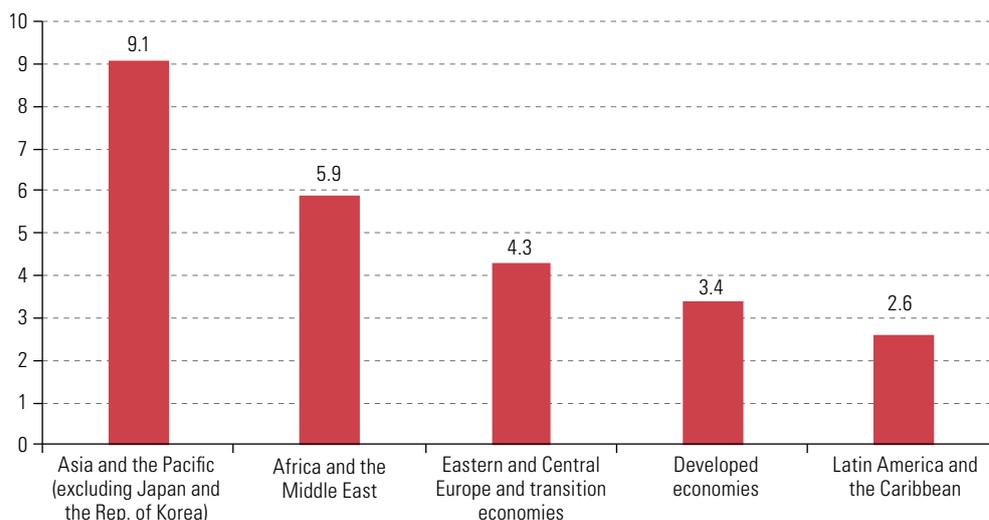
### 3. The global financial crisis and fiscal policy

The global financial crisis and its consequences call this logic into question. First, the central banks of the United States and Europe reacted by lowering monetary policy rates to close to zero, rendering conventional monetary policy inoperative as an aggregate demand stabilization instrument. When the financial difficulties in the subprime mortgage market began in mid-2007, the United States Federal Reserve decided to lower the federal funds rate. Between July 2007 and the collapse of Lehman Brothers in 2008, the federal funds rate dropped from 5.26% to 1.81%. It fell yet further after the Lehman Brothers episode, bottoming out at 0.16% in December that same year.

This meant, at least at the outset, that fiscal policy could be brought back into service as an aggregate demand stabilization instrument. In fact, the available evidence shows that the different regions of the world, both developing and developed, did use fiscal policy to cope with the impact of the global financial crisis. Fiscal stimulus packages were worth 9.1%, 5.9%, 4.3%, 3.4% and 2.6% of GDP in Asia-Pacific, Africa and the Middle East, Eastern and Central Europe, the advanced economies and Latin America and the Caribbean, respectively (see figure IV.1)

<sup>1</sup> On this hypothesis, economic agents base their spending decisions on their permanent income. This is defined as the long-term income trajectory.

**Figure IV.1**  
World (selected regions):  
fiscal stimulus, 2008-2009  
(Percentages of GDP)



**Source:** L. Laeven and F. Valencia, "The real effects of financial sector interventions during crises", *IMF Working Paper*, No. 11/45, Washington, D.C., International Monetary Fund (IMF), 2011.

More specifically, the fiscal response in Latin America varied considerably by country. From late 2008 onward, central banks following inflation targeting systems opted to lower interest rates. Besides the fact that this was done not only out of countercyclical considerations but also in pursuit of a policy aimed at avoiding rising quasi-fiscal costs deriving from sterilization operations, monetary policy proved to be an inadequate countercyclical instrument, which went against the tenets of inflation targeting theory and the new macroeconomic consensus generally. Without exception, countries with inflation targeting resorted to a "discretionary" fiscal policy.

As figure IV.2 shows, discretionary fiscal stimulus programmes, whether measured in terms of their net effect on overall fiscal balances as a share of GDP (fiscal stimulus 1) or in terms of primary spending growth, the cyclically adjusted primary balance as a proportion of potential GDP (fiscal stimulus 2), were particularly large in Peru (2.5% and 6.9% on these two measures, respectively) and in Chile, the country that has been the most orthodox in pursuing an inflation targeting system. Fiscal stimulus was greater in Chile than in the other countries with inflation targeting (5.0% and 9.6% on the two measures, respectively).<sup>2</sup>

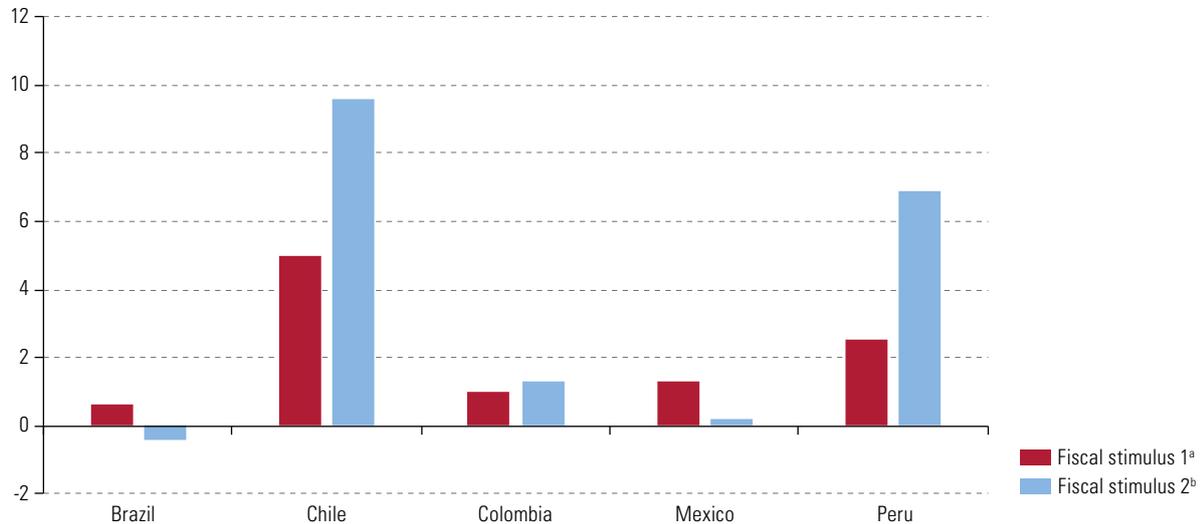
This change in fiscal policy orientation was supported by international agencies such as the International Monetary Fund. Thus, *World Economic Outlook: Housing and the Business Cycle* (IMF, 2008a) referred to the important role of fiscal policy in stabilizing the economy and emphasized that, in addition to the timely fiscal support that automatic stabilizers could provide, there was justification for additional discretionary stimulus in some countries.<sup>3</sup> The book warned, though, that any such stimulus must be timely, well targeted and quickly unwound. Similarly, the Group of 20 (April 2009, São Paulo) supported an unprecedented coordinated fiscal expansion that would save millions of jobs.

<sup>2</sup> Although there was less fiscal stimulus in Brazil than in the other countries, other measures besides the monetary policy rate were employed there to counteract the effects of the global financial crisis. In particular, the public sector banking system and the Brazilian National Bank for Economic and Social Development (BNDES) played a highly influential countercyclical role.

<sup>3</sup> See also IMF (2008b) and Lavoie (2016). Guidelines for coping with the global financial crisis were provided by Spilimbergo and others (2008), who stated that automatic stabilizers ought to fulfil an important function by making it possible to temporarily increase the number of jobs (though not pay) in the public sector, cut taxes and expand the State's role as a financial intermediary. The aim of all this was to repair the financial system and create demand in order to restore the confidence lost because of the crisis.

**Figure IV.2**

Latin America (5 countries): fiscal stimulus, 2008-2010  
(Percentages of GDP)



**Source:** L. Laeven and F. Valencia, "The real effects of financial sector interventions during crises", *IMF Working Paper*, No. 11/45, Washington, D.C., International Monetary Fund (IMF), 2011.

<sup>a</sup> Fiscal stimulus 1 comprises discretionary fiscal stimulus packages as announced, measured by taking the net effect on fiscal balances in 2008-2010 relative to real GDP.

<sup>b</sup> Fiscal stimulus 2 is the sum of changes in the cyclically adjusted primary balance relative to potential GDP over the same period.

A second factor of change was the persistent gap between real and potential output, which created greater scope for the use of aggregate demand to expand output and highlighted the importance of the Keynesian multiplier. Indeed, traditional estimates of the Keynesian multiplier first began to be questioned in those years on the basis that they underestimated its value, resulting in fiscal adjustments that were larger than necessary. According to IMF (2015), multipliers are also important elements that need to be taken into account in policy design and advice. Underestimating multipliers may lead countries to set unattainable fiscal goals and miscalculate the adjustment needed to reduce their debt ratio, which could affect the credibility of fiscal consolidation programmes. Furthermore, the authorities could end up undertaking repeated adjustment rounds in an attempt to make fiscal variables converge on official targets, undermining confidence and setting off a vicious circle of slow growth, deflation and further adjustment.

Traditional estimates derived from econometric models, usually on the basis of vector autoregressions, suggested a multiplier in the range of 0 to 1 in normal periods. The literature also stressed that spending multipliers were generally larger than tax multipliers.

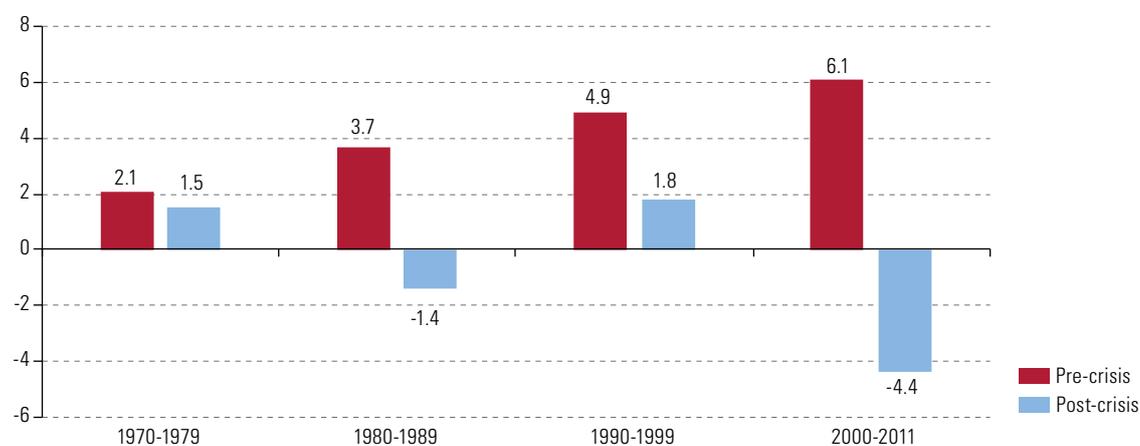
These estimates have been questioned in recent years. First, the most recent studies have shown that multipliers can be greater than 1 when the economy is in recession or when the monetary policy transmission mechanism is not working. Second, estimates show that spending multipliers are no greater than income multipliers.

A customary explanation for these differences in multiplier estimates puts them down to the different methodologies used, these being the vector autoregression model and the narrative approach model. A variety of characteristics of the economies analysed (Ilzetzki, Mendoza and Vegh, 2013) or the state of the business cycle (Auerbach and Gorodnichenko, 2013) can also be important reasons for these differences in multiplier size.

The argument for using fiscal policy as an aggregate demand stabilization instrument is strengthened by the fact that the most recent crises, being of a financial character, have had a prolonged impact on both output and investment. Figure IV.3 shows the average rate of investment growth in the five years before and after financial crises for the periods 1970-1979, 1980-1989, 1990-1999 and 2000-2011. The rate of growth in gross fixed capital formation was invariably lower after them.<sup>4</sup> This is consistent with the fact that investment cycles are shorter (i.e. more volatile) than GDP cycles in the great majority of regions. Financial crises and investment volatility translate into a greater perception of uncertainty (Baker, Bloom and Davis, 2016), which in turn complicates investment decision-making. The lingering effects of crises, i.e. of abnormal periods, seriously call into question one of the core arguments against countercyclical fiscal policy, namely that the time required for the fiscal policy transmission mechanism to take effect is longer than a typical recession (Blinder, 2004).

**Figure IV.3**

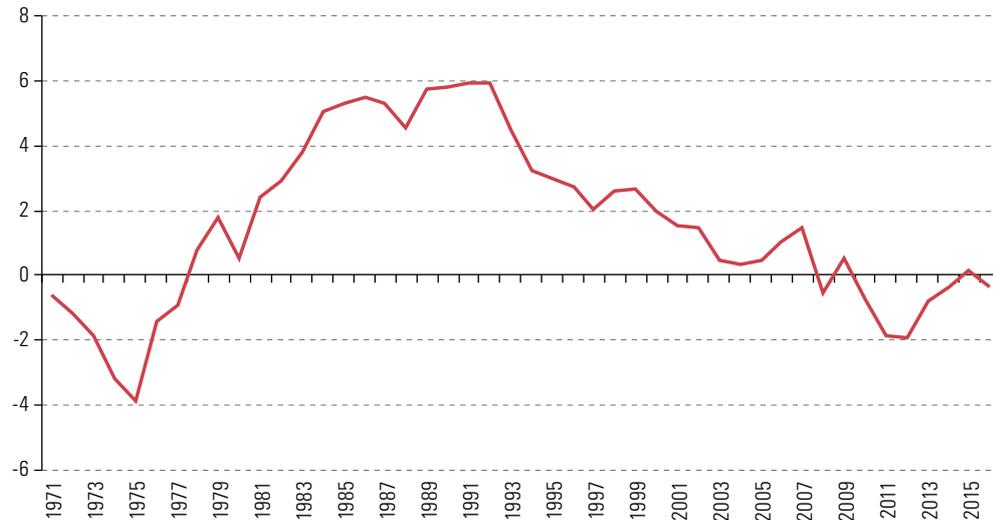
Developed countries: gross fixed capital formation growth in the five years before and after financial crises, 1970-2011 (Percentages)



**Source:** Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of International Monetary Fund (IMF) figures.

A third factor that has brought fiscal policy to the fore is the prevalence of low real interest rates in the developed countries since the 1990s or thereabouts (see figure IV.4). The decline of real interest rates over time has been due to different factors.

<sup>4</sup> The decline in the long-term trend growth rate of these economies did not start with the global financial crisis (2007-2009) or with the euro crisis (2009-2013), contrary to the assertion by IMF (2015) that the global financial crisis led to a structural shift in the long-run growth rate of the most developed economies.



**Figure IV.4**  
Developed countries:  
average real interest rates,  
1971-2015  
(Percentages)

**Source:** Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of International Monetary Fund (IMF) figures.

Nonetheless, a macroeconomic environment with low trend interest rates has major implications for fiscal policy. First, if an economy's growth rate is higher than the interest rate at which the government borrows, there is room to expand government spending or cut taxes. The public deficit sustainability condition is expressed as:

$$(1) (x - r)b = D_p \Leftrightarrow b = \frac{D_p}{(x-r)}$$

Where,

$r$  = real interest rate;  $x$  = real GDP growth rate;  $D_p$  = primary deficit relative to GDP;  $b$  = fiscal borrowing relative to GDP

As equation (1) shows, the impact on debt of the difference between the growth rate and the real interest rate will always be greater than the impact produced by reducing the primary deficit. Furthermore, as long as the growth rate in the economy is positive and greater than the real interest rate, a positive primary deficit is associated with a decline in the ratio between public debt and GDP. Thus, austerity programmes are not needed to reduce public debt.<sup>5</sup> The evidence available for the developed economies is that, as a rule, the real interest rate has always been lower than the growth rate. Kogan and others (2015) show this to have been the case in the United States over the past two decades.<sup>6</sup>

According to some authors (DeLong, 2016), this situation reflects a problem of dynamic efficiency in the financial markets that has been pushing up prices for risky assets and lowering those for risk-free assets, such as sovereign debt. The solution suggested for this market failure is to increase public debt. Ultimately, there is no reason not to use low-risk assets to finance public investment.

<sup>5</sup> See Taylor and others (2012) and Alesina, Stantcheva and Teso (2018) for two opposing points of view on this issue.

<sup>6</sup> According to these authors, the rate at which the United States Government has borrowed over the last 200 years has averaged 100 basis points less than the growth rate of the economy.

## B. The new fiscal policy debate and its relevance to developing countries such as those of Latin America and the Caribbean

The current fiscal policy debate has contributed three subjects of interest. First, fiscal policy can contribute to stabilization, depending on an economy's specific circumstances and the context. Second, it is important to have estimates for the fiscal multiplier and the different spending components. Third, the current debate has brought to prominence the need to estimate the impact of automatic stabilizers and improve their design. This debate has led to traditional public debt thresholds being called into question.

These three subjects are of interest not only for developed economies but also for developing ones, including those of Latin America and the Caribbean. The region has gone through half a decade of low growth. Although some central banks have lowered their monetary policy interest rates, this has not fed through to real activity as hoped. At the same time, favourable external conditions, both real and financial, have not translated into higher growth in GDP or investment.

Against that background, the relevance of this approach for evaluating and improving the stabilization capacity of fiscal policy in the region and the main characteristics of this policy will now be analysed.

### 1. The main characteristics of fiscal policy in Latin America and the Caribbean

Fiscal policy in the countries of Latin America and the Caribbean has traditionally been characterized as procyclical and volatile.<sup>7</sup> This procyclical character has usually manifested itself in government consumption falling and taxes rising during recessions in the region's countries, with the opposite happening during expansions.

Furthermore, fiscal policy in the region's countries has been highly volatile, mainly because of sharp fluctuations in their fiscal revenues, which have affected the availability of resources for implementing policies sustainably.

Macroeconomic volatility affects fiscal revenues through fluctuations in tax bases, GDP, consumption or commodity prices. Tax revenues are almost three times as volatile on average in the region as in developed countries (Kacef, Fanelli and Jiménez, 2011).

Excessively volatile fiscal revenues have the greatest impact on the most vulnerable sections of the population, both directly through fluctuations in public social spending and indirectly through infrastructure spending.

This positive relationship between revenue, tax bases and the cycle would not be a problem if fiscal policy offset this behaviour through discretionary measures or institutions of a countercyclical character, or by the strength of automatic stabilizers, whether on the side of public spending or access to financing.

However, the lack of countercyclical mechanisms, the weakness of stabilizers, the paucity and volatility of fiscal resources and the scale of unmet social demands may limit the fiscal space available and result in public spending policy closely tracking the business cycle.

<sup>7</sup> This line of research was pioneered by Gavin and Perotti (1997). Other authors, such as Sutton and Catão (2002), Alesina, Campante and Tabellini (2008), Bello and Jiménez (2008), Kaminski, Reinhart and Vegh (2004) and Talvi and Vegh (2005), have reached similar conclusions. See Ardanaz and others (2015) for a recent estimate of the fiscal position relative to the cycle.

This has meant that fiscal policy has often heightened growth volatility instead of playing a stabilizing role.

Taken together, furthermore, fiscal policies have traditionally had a deficit bias in many countries, resulting in uncertainty about debt sustainability and about financial conditions for the private sector. Because of this bias, fiscal adjustments have been implemented in pursuit of greater solvency even in periods when an expansionary policy might have been warranted. This characteristic inspired the proposals for fiscal responsibility laws and fiscal rules that have been implemented in the region since the 1990s.

Fiscal policies in Latin America have usually involved setting budgetary balance rules (primary surplus, current balance) and spending or debt rules (limits or ceilings on growth or size) (ECLAC, 2016). Policies based on quantitative rules usually work well in normal circumstances, but as economic structures change and shocks occur, whether on the supply or demand side, they may become less relevant or too rigid (Ocampo and Vos, 2008). In addition, because the risks and uncertainties for the economy may prove non-stationary, i.e. passing shocks may permanently alter the trajectory of the main macroeconomic variables, at times of strain or crisis there needs to be a degree of latitude to combine policies in a way that minimizes the risk of very large macroeconomic losses.

It has been argued that the right fiscal policy tool for avoiding these problems is the adoption of structural or cyclically adjusted deficit measures and goals.<sup>8</sup> This is not without strains and conflicts, though, given the difficulty of identifying the long-run trend in many of the region's economies, and considering that the structural changes characterizing fiscal policy there have affected the stability of parameters and thus made it harder to estimate spending and tax elasticities. In addition, it is not easy to adapt to unusually large shocks. The incentive for applying an austere fiscal policy in the upturn of the cycle is to have resources during the recessionary phase. However, if a shock is prolonged over time, the incentive to spend the "excess" surplus will increase. Besides the problems cited, in federal or highly decentralized countries there are also those arising from the need for coordination between the different levels of government (Jiménez and Ter-Minassian, 2016; Grembi and Manoel, 2012).

This is why stabilization-oriented fiscal policy in the region has discretionary components that are essential for good fiscal responses. Consequently, automatic stabilizers, while they do operate, are less important than in the developed countries, which have larger public sectors, unemployment insurance and progressive taxation, and discretionary responses play a larger role.

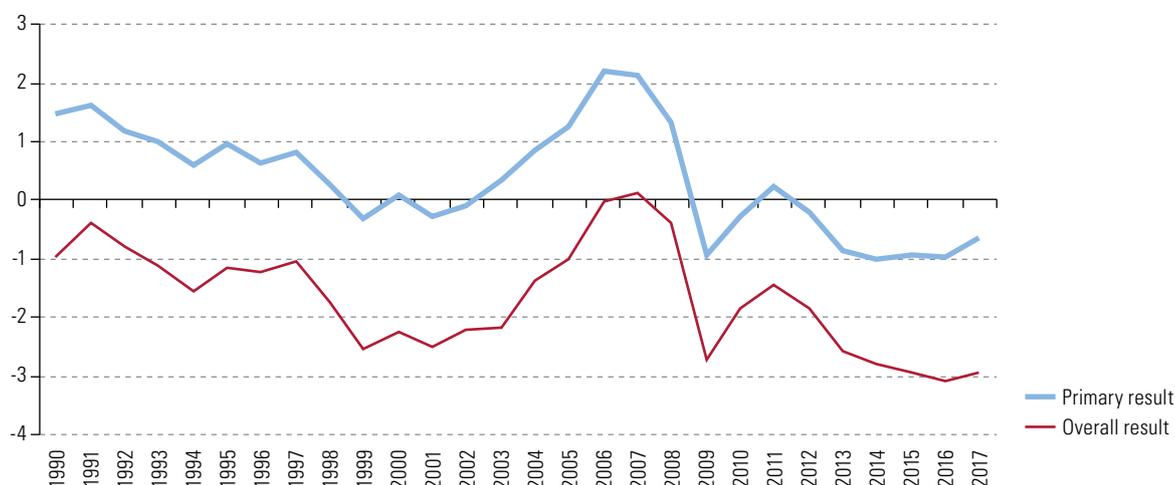
## 2. Fiscal policy trends before the 2008-2009 crisis

The fiscal policy of the 1990s in the region was very heavily influenced by the debt crisis of the 1980s. The main policy thrust was increased fiscal discipline aimed at reducing the macroeconomic imbalances which had characterized the 1980s (ECLAC, 2000). Within the structural reform framework, the countries cut public spending and, to a lesser extent, increased fiscal revenues with the goal of supporting anti-inflation efforts while ensuring the sustainability of the public debt. In consequence, they began to generate large primary surpluses, especially in the first half of the decade. These averaged 0.9% of GDP between 1990 and 1997, and the public debt fell substantially as a share of GDP, from an average of 60.8% in 1990 to 37.0% in 1997 (see figure IV.5).

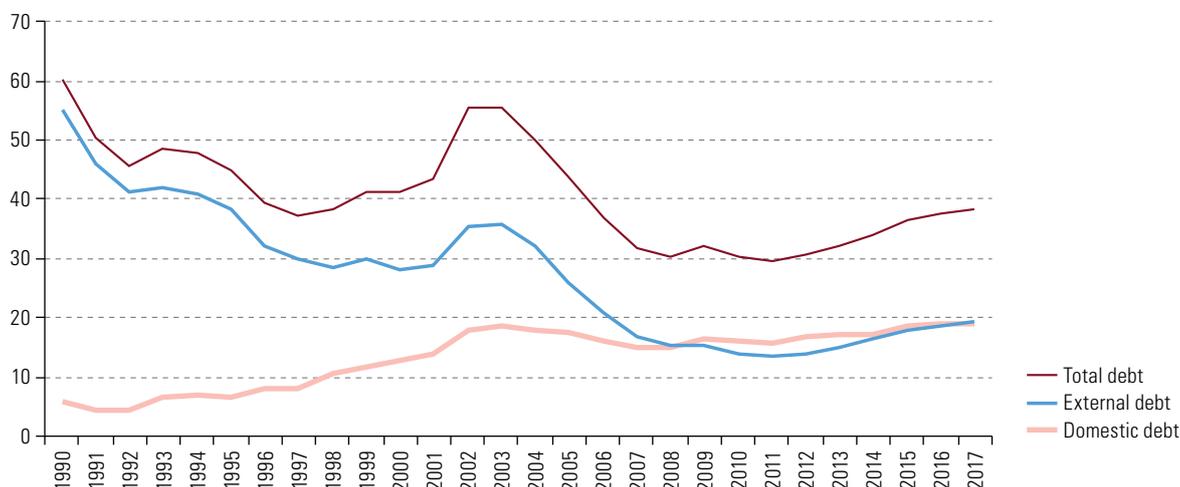
<sup>8</sup> According to the specialized literature, different indicators can be used to analyse the cyclical character of fiscal policy. The technique most often used is to estimate structural or cyclically adjusted fiscal balances, i.e. to correct balances for the impact of the gap between real and potential GDP on budgetary revenues and outgoings. These estimates are supplemented by other adjustments, such as those used to correct for the fiscal impact of cycles on commodity prices or for temporary fiscal measures. The resulting balances are defined as structural.

**Figure IV.5**  
Latin America (18 countries): fiscal results and gross central government public debt, 1990-2017<sup>a</sup>  
(Percentages of GDP)

### A. Fiscal results



### B. Gross public debt



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

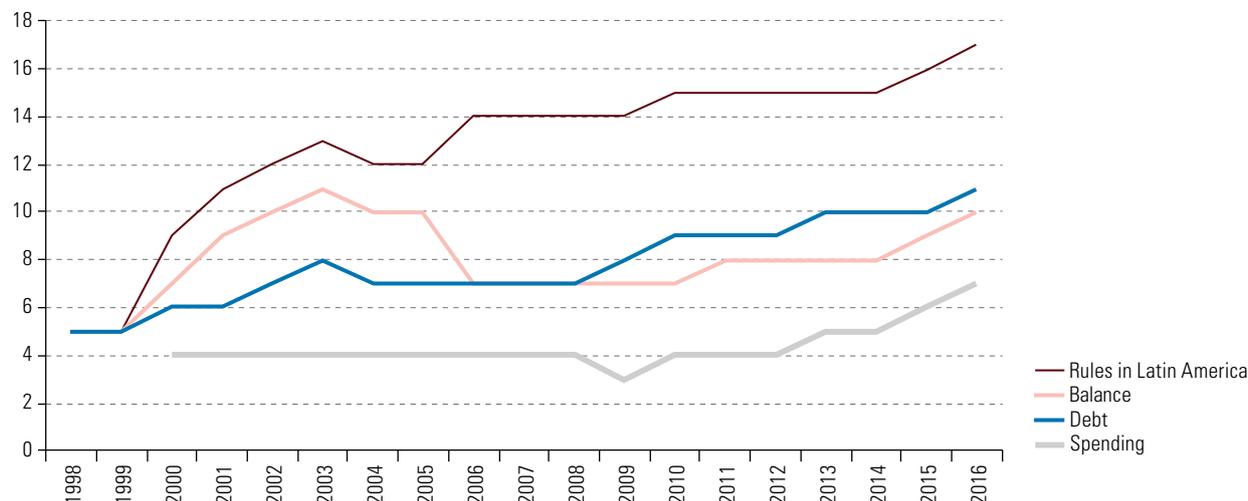
<sup>a</sup> Simple averages.

There were a number of serious inconsistencies in the fiscal policy of the period, however (ECLAC, 2000). Countries sought to reduce or eliminate their fiscal deficits, but these efforts were neutralized by other measures included in structural reform packages. For example, fiscal revenues were undermined by tax reforms that reduced tax rates and by import liberalization, which led to a large drop in tariff receipts. Furthermore, fiscal decentralization during the period exacerbated central government fiscal deficits, as resources were transferred to other public sector bodies, but not the obligations that went with them.

This fiscal policy approach strengthened yet further in the 2000s because of the Asian crisis, which broke out in the late 1990s and triggered crises in Argentina (1998-2002) and Brazil (1999). Fiscal results worsened in this period and public debt increased again. In response, as figure IV.6 shows, a growing number of countries in the region adopted institutional frameworks and fiscal rules with an emphasis on balancing the fiscal accounts, not only in the short term but in the medium term too (ECLAC, 2011).



**Figure IV.6**  
Latin America: countries with fiscal rules, by rule type, 1998-2016  
(Numbers of countries)



**Source:** Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of figures from the International Monetary Fund (IMF).

There was a general improvement in the region's fiscal accounts from 2004, led by the countries of South America. Rising prices for the commodities exported by the region, particularly crude oil and minerals and metals, drove fiscal revenues higher, and the countries began to generate primary surpluses, which sped up the decline in public debt as a share of GDP.

The region's countries used this extra fiscal space during the global economic and financial crisis of 2008-2009 to successfully smooth the impact of this shock on aggregate demand. In some cases, the countries were forced to alter or suspend their fiscal rules during this period so that a more countercyclical policy could be pursued (ECLAC, 2011).

### 3. Latin American fiscal policy in the light of the new fiscal policy debate

In accordance with what was set out in section A of this chapter, the region's fiscal policy will now be analysed in relation to three core aspects that have come out of the debate on a new fiscal policy:

- (i) In a low interest-rate environment, the issue of public debt sustainability needs to be revisited, even in countries where debt is currently high;
- (ii) The impact of public spending on aggregate demand needs to be improved, with priority for infrastructure and human capital investments;
- (iii) Automatic stabilizers should be strengthened, with a focus on designing better instruments.

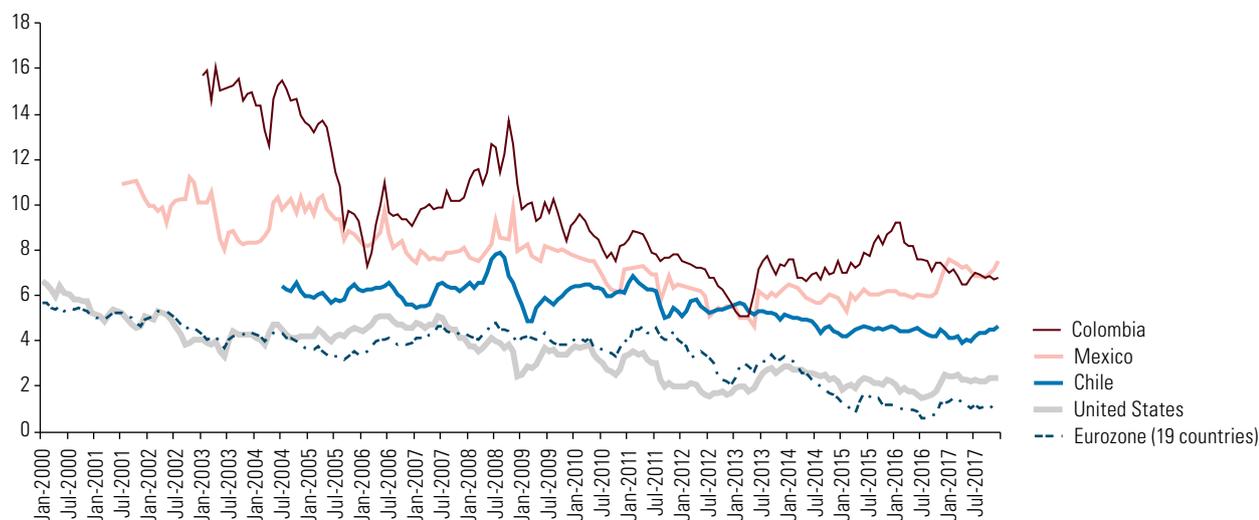
### (a) Is there room for more discretion in public spending given the low interest-rate environment in international financial markets?

In the context of the new normal described earlier, the persistence of slow growth and low interest rates in the developed economies (so-called secular stagnation) raises certain questions about the use of public debt to drive economic activity. In other words, in a hypothetical situation where real interest rates remained below the real growth rate, governments could sustain large debt-financed fiscal deficits without fear of an explosive increase in the ratio between public debt and output (Blanchard and Summers, 2017).

This argument is easier to demonstrate for developed economies because of today's exceptionally low interest rates, consistent with a declining trend that began in the 1980s (Yi and Zhang, 2016; Obstfeld and Tesar, 2015). As figure IV.7 illustrates, interest rates in these economies have displayed a downward trend in the long term, and are likely to remain below even the most pessimistic estimates of potential GDP growth in real terms.<sup>9</sup> It should be noted, though, that while historical analysis shows this differential to be usually negative in developed economies, there is marked volatility, and the likelihood of reversion to positive values, which would place strong upward pressure on the public debt, may be significant (Mehrota, 2017).

**Figure IV.7**

Selected countries: long-term interest rates (10 years), 2000-2017  
(Percentages)



**Source:** Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of Bloomberg L.P. and Organization for Economic Cooperation and Development (OECD), OECD.Stat [online database] <http://stats.oecd.org/>.

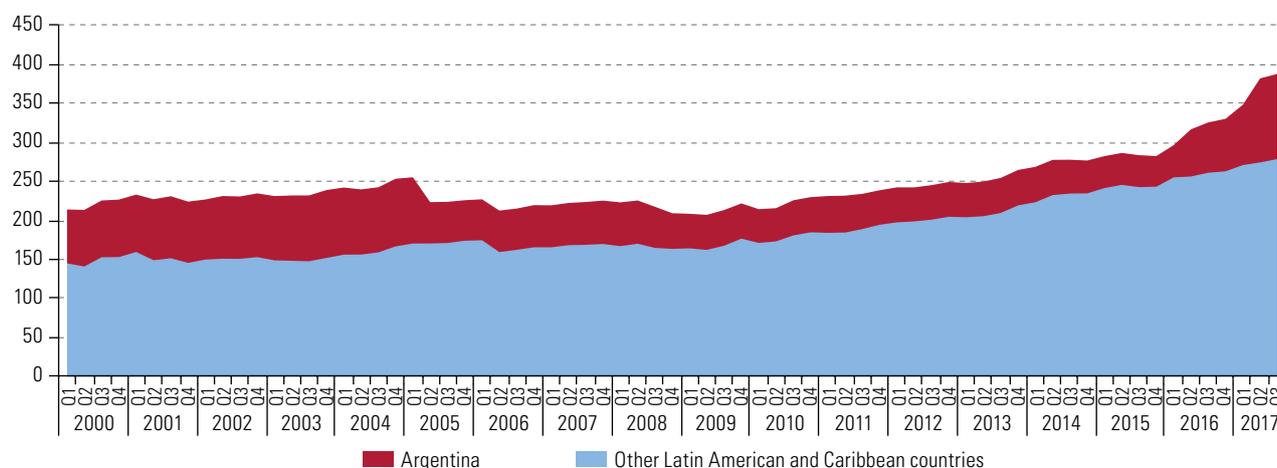
In the region, as figure IV.7 shows, nominal long-term local-currency interest rates also show a downward trend but have generally remained higher than the rates of GDP growth and expected inflation. This is something of a constraint on these countries' ability to issue additional debt in the domestic market. Furthermore, local financial markets in the region do not necessarily have the depth to absorb a rise in public debt without repercussions on the evolution of other real interest rates in the economy, which would have a negative impact on growth and complicate monetary policy management.

<sup>9</sup> This is particularly true of some European countries, such as France, Germany, the Netherlands, Sweden, Switzerland and the United Kingdom, where the implied real yields on 10-year bond issues remain negative, in some cases strongly so (IPF, 2017).

Consequently, the region's countries have to go to the international financial markets and issue debt in foreign currency if they are to take advantage of low global interest rates. The consolidation of the region's macroeconomic institutions and a decline in sovereign risk have indeed enabled the countries to engage increasingly with international markets and issue debt on very favourable terms. As figure IV.8 shows, the balance of outstanding debt securities issued by the general governments of the region on international markets has increased greatly, particularly since 2014. Although this increase is accounted for in absolute terms by Argentina, it is important to stress that 17 countries of Latin America and the Caribbean issued sovereign bonds in 2017 (ECLAC, 2017a).

**Figure IV.8**

Latin America and the Caribbean: general government debt securities outstanding on international markets, first quarter of 2000 to third quarter of 2017  
(Billions of dollars)



**Source:** Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of statistics from the Bank for International Settlements (BIS).

The region's growing financial integration, manifested in its participation in international sovereign bond markets, also creates certain risks. Its history has been marked by debt crises with negative effects on the subsequent evolution of its economy, as well as in the social sphere (ECLAC, 2014). In particular, the risks involved in issuing debt in foreign currency cannot be overlooked. Although most of the region's countries have large international reserves, there are risks associated with exchange-rate movements and also with the structure of debt, since this could create liquidity problems. Conversely, there could be less of a risk from interest-rate changes in an environment of persistently low rates, especially if instruments are issued at a fixed rate.

Even so, a situation of continuing low interest rates in the international market might seem to create scope for generating fresh resources to invest in public goods with high economic and social rates of return. A simple examination of public debt sustainability in the countries of Latin America suggests that, on average, a rise in debt-financed public spending between 2018 and 2030 in a context where the real interest rate held at between 0% and 1% would translate into a debt increase far smaller than the accumulated deficit (see box IV.1). Indeed, this increase in debt relative to output could be even smaller in view of the possible dividends in the form of higher growth, given the increase in public investment in these scenarios.

**Box IV.1**

## A look at debt sustainability in Latin America

It is interesting to look at some simple scenarios in order to establish how the international financial context might affect the evolution of public debt in the region. Setting out from a calculation of debt dynamics based on the primary fiscal balance, the real interest rate and the real growth rate, four scenarios have been established, involving an increase of 1 percentage point in the primary deficit (reflecting a rise in public spending) and an improvement or deterioration of financial conditions, reflected in the real interest rate. These scenarios do not include potential changes in the real exchange rate.

The following table shows the assumptions for the different scenarios. The baseline scenario takes the current situation in 2017, with a primary deficit of 0.7% of GDP. For the other scenarios, the primary deficit is increased by a percentage point to 1.7% of GDP and the real interest rate is changed to 0% in a favourable outlook, 1% in a neutral one and 3% in a less favourable one. These scenarios do not consider the possibility that these investments might be self-financing because of a rise in economic growth, as DeLong and Summers (2012) suggest.

Interest-rate and primary fiscal balance scenarios for public debt projection

Baseline scenario	Scenario 1	Scenario 2	Scenario 3
Conditions in 2017	$r = 0\%$	$r = 1\%$	$r = 3\%$
$pb = -0.7$	$pb = -1.7\%$	$pb = -1.7\%$	$pb = -1.7\%$
$n^* = 2.6$	$n^* = 2.6$	$n^* = 2.6$	$n^* = 2.6$
$r = 1.8\%$	$r = 0\%$	$r = 1\%$	$r = 3\%$

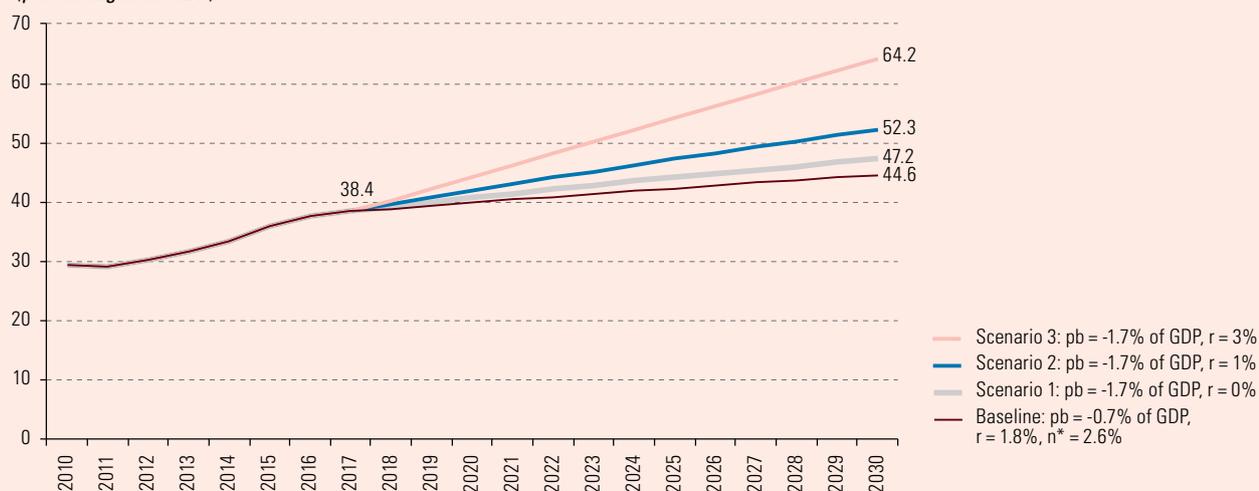
**Source:** Economic Commission for Latin America and the Caribbean (ECLAC).

**Note:**  $pb$  = primary balance,  $n^*$  = potential rate of output growth,  $r$  = real medium-term interest rate estimated for emerging countries.

As the following chart illustrates, the increase of 1.0 percentage point in the primary deficit leads to public debt rising as a share of GDP in all the scenarios. It is important to take the measure of this increase, however. During the period 2018-2030, this policy would result in a cumulative primary deficit of 22.1 percentage points of GDP, 13.0 percentage points of which would come from the new spending, on new public investment in this case. However, the increases in public debt are much smaller in scenarios 1 and 2 (as the rate differential remains negative), at 8.8 and 13.9 percentage points, respectively. In a scenario with less favourable rates, debt begins to display more of an accelerating trend.

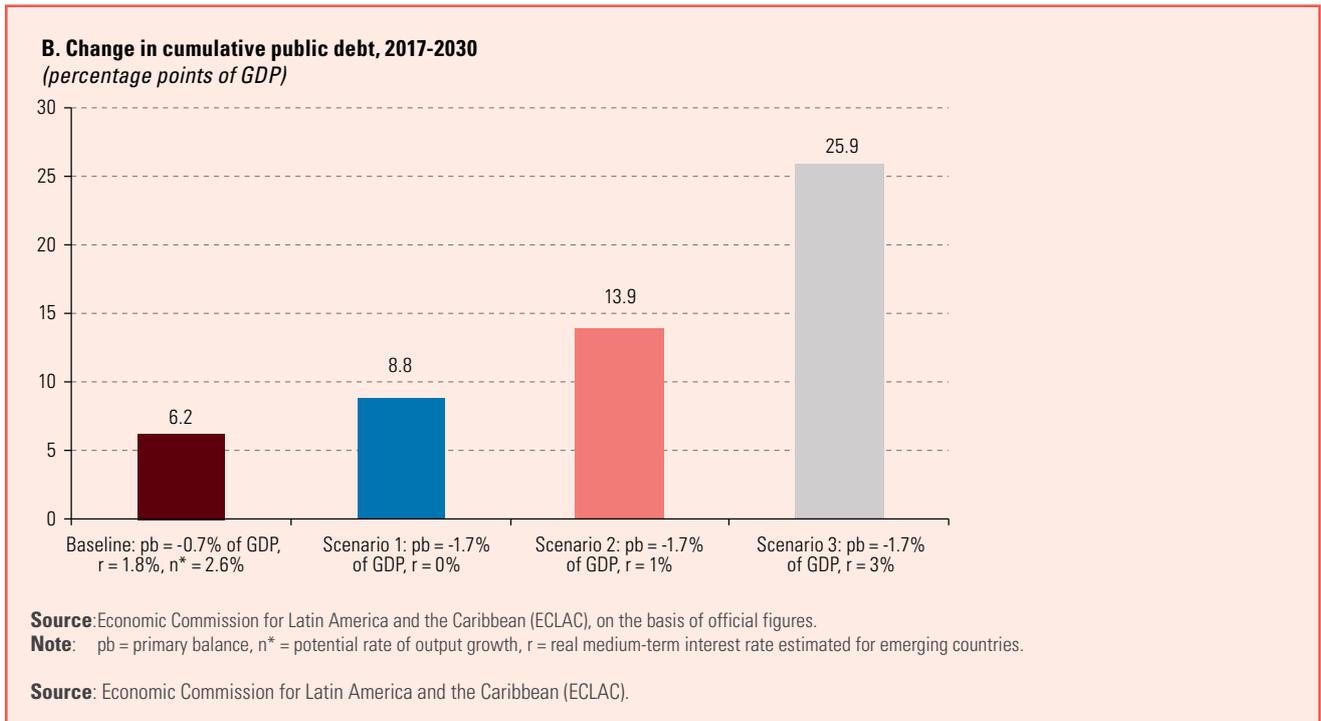
Latin America: medium-term public debt to 2030 in different interest-rate scenarios with a 1 percentage point increase in the primary deficit

**A. Public debt, 2010-2030**  
(percentages of GDP)





## Box IV.1 (concluded)



The question must be whether there is scope for a more discretionary fiscal policy in the low interest-rate environment described by Blanchard and Summers (2017). The evidence suggests that, given certain macroeconomic and financial conditions, the countries could use the international markets to generate financing for a more active fiscal policy. Nonetheless, the risks associated with external financing cannot be overlooked. In addition, making greater use of these markets would run counter to the regional consensus, arising after the debt crisis, that debt of this type should be reduced.

### (b) Can public spending boost aggregate demand?

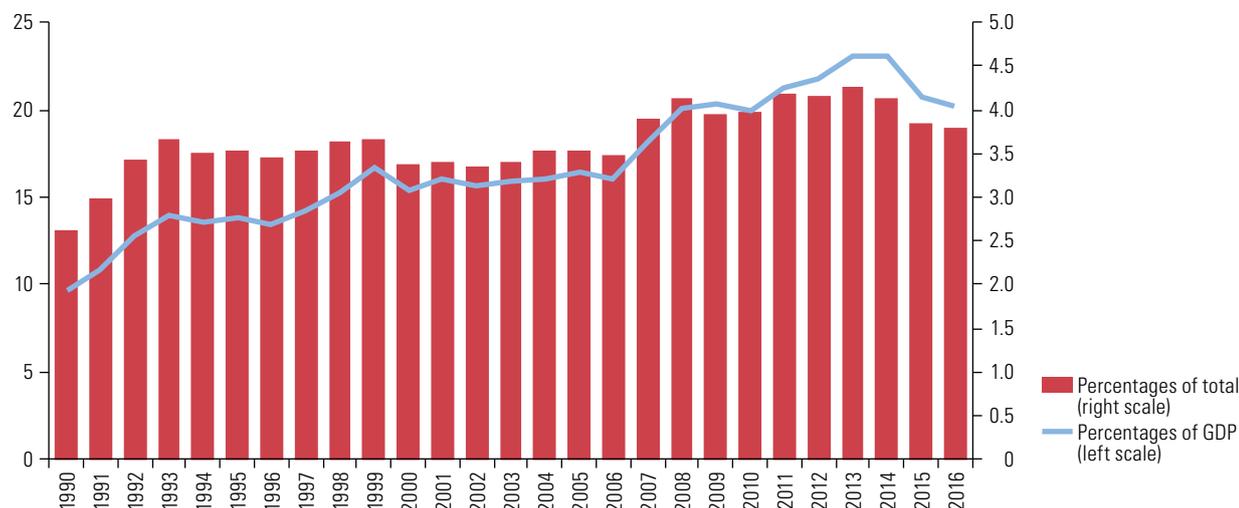
The new fiscal policy debate about the role of public spending concerns not just its level but also how its composition can be improved to enhance its contribution to the dynamics of potential output.

Particular emphasis is laid on the importance of public investment as a bridge towards the future (ECLAC, 2015). Several recent studies have found a positive relationship between public investment and long-run economic growth, although most have focused on developed countries (Fournier and Johansson, 2016; Ganelli and Tervala, 2016; Abiad, Furceri and Topalova, 2015). This largely reflects the fact that the fiscal multiplier is higher for public investment than for current primary spending.

There are fewer studies for developing countries, but those there are also suggest possible dividends in terms of higher growth as a result of increased public investment. For example, IMF (2014) examines 120 cases of increased public investment, mainly in emerging economies and developing countries, and finds a highly positive impact, with a cumulative public investment multiplier of between 1.0 and 1.3 after five years. Riera-Crichton, Vegh and Vuletin (2015) estimate a cumulative multiplier of 2.7 for 16 countries of Latin America after five years for capital spending, which contrasts with a multiplier of 1.6 for current spending.

The region has made progress with public investment. As figure IV.9 shows, capital spending by central governments in the region has increased substantially in the last decade. Between 2007 and 2017, this spending was equivalent to 20% of total outlays, as compared to an average of 17% between 1990 and 2006. The increase relative to output was even more striking, with an average of 4.2% of GDP in the period 2007-2017, as compared to an average of 2.9% of GDP in previous years.

**Figure IV.9**  
Latin America (19 countries): central government capital spending, 1990-2016  
(Percentages of GDP)



**Source:** Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

Capital spending in the region has dropped sharply since 2015, however, in the wake of declining public revenues, particularly those from non-renewable natural resources. As was detailed in chapter I, the brunt of public spending cuts in the region in recent years has fallen on capital spending. This shows how important it is to take steps to protect public investment from the vagaries of the business cycle. In particular, it highlights the need to rethink the fiscal rules currently operating in the region so that they can leave more space for public investment, precisely in order to improve long-term fixed capital accumulation (ECLAC, 2017b).

It is also necessary to stress the importance of raising the efficiency and effectiveness of public spending in general and public investment in particular so that any change in the spending structure can be taken full advantage of. In general, there is evidence that even in a difficult economic environment, the countries of Latin America do have scope to improve the quality and quantity of public services and could produce still more with the resources available (see ECLAC, 2014 for a review of recent studies).

Improving the quality of spending in the medium and long run must involve not only refining fiscal policy instruments but also consolidating processes, systems and institutions with the aim of ensuring that spending goes on public policies and programmes which, ultimately, are the goods and services provided to citizens whereby development goals can be met.

In the area of public investment, a number of authors have found that, besides the actual amounts spent on investment, other dimensions of projects that have a bearing on their impact need analysing as well (Dabla-Norris and others, 2011; Armendáriz and others, 2016; ECLAC, 2017a). In particular, they highlight weaknesses in project implementation and the monitoring of public assets in the region (Cerra and others, 2016).

Another issue that cannot be disregarded in the debate about the employment of fiscal space concerns governments' capacity and room for manoeuvre when it comes to fiscal policy measures to spur economic growth. A number of authors have found a high level of inflexible spending in Latin America (Ruiz del Castillo, Cetrángolo and Jiménez, 2009; Hallerberg, Scartascini and Stein, 2009; Crispi and others, 2004; Echeverry, Fergusson and Querubín, 2004). On average, over 80% of the public sector budgets of the Latin American countries are constrained by some type of guideline or obligation that limits the scope for reallocating spending or altering its structure.

### **(c) Can automatic stabilizers in the region be strengthened?**

As already noted, the economic literature has found the size of automatic stabilizers (taxes and transfers) to be relatively modest in Latin America, especially in comparison with industrialized countries. Martner (2000) puts budget sensitivity (the change in the fiscal result resulting from a percentage point change in the output gap) at an average of 0.15 points of GDP for 12 countries of Latin America, as compared to an average of 0.50 points of GDP for the European Union countries. More recently, estimates by Daude, Melguizo and Neut (2010) for a group of eight countries in the region indicate an average budget sensitivity of 0.21 points of GDP, or almost half the value for the countries of the Organization of Economic Cooperation and Development (OECD).

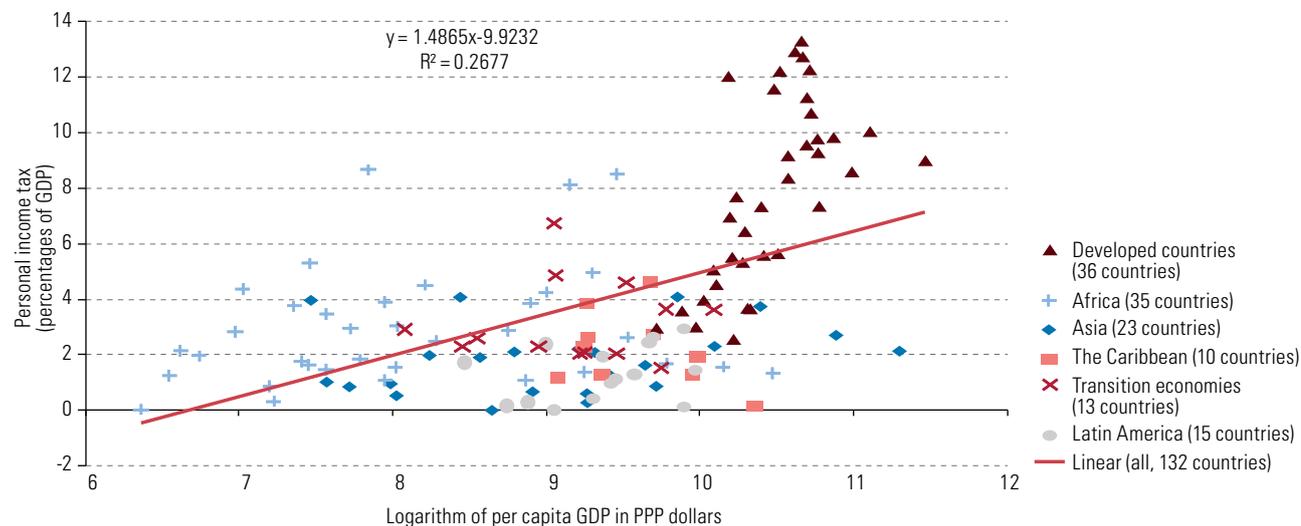
Again, a recent study by IMF (2015) suggests that the sensitivity of the overall results in the countries of Latin America is limited by comparison not only with the developed countries but with other emerging and developing countries. The countries of the region included in the study sample display a median fiscal stabilization coefficient (derived from an ordinary least squares regression of the overall budget balance with the output gap and a constant) of 0.35 points of GDP (0.29 points of GDP on average), as compared to a median of 0.77 points of GDP for the developed economies and 0.58 for emerging markets and developing economies.

These findings for Latin America may not be surprising given that the ability of automatic stabilizers to cushion macroeconomic shocks not only depends on how they respond to changes in output (elasticity) but is proportional to their absolute size relative to GDP. The instruments associated in the literature with automatic stabilizers, namely taxes and spending associated with social protection programmes designed to provide a buffer against economic shocks, are smaller in the region than in developed countries and, in some cases, than in other developing regions.

On the tax side, a major weakness can be observed in personal income tax in the region. The proceeds from this tax in Latin America are exceptionally small relative to other regions, even when development differences represented by per capita GDP in purchasing power parity (PPP) are taken into account (see figure IV.10). Thus, although Daude, Melguizo and Neut (2011) find that the elasticity of this instrument to changes in output in Latin America is high, and indeed higher than in the OECD countries, the low level of revenue greatly limits its stabilizing power.

Figure IV.10

Personal income tax as a share of GDP and per capita GDP, around 2013  
(Percentages of GDP and purchasing power parity (PPP) dollars in terms of per capita GDP)



**Source:** Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of Organization for Economic Cooperation and Development/Economic Commission for Latin America and the Caribbean/Inter-American Center of Tax Administrations/Inter-American Development Bank (OECD/ECLAC/CIAT/IDB), *Revenue Statistics in Latin America and the Caribbean 1990-2014*, Paris, 2016; Organization for Economic Cooperation and Development/African Tax Administration Forum/African Union Commission (OECD/ATAF/AUC), *Revenue Statistics in Africa 1990-2014*, Paris, 2016; International Monetary Fund (IMF), World Revenue Longitudinal Data (WoRLD) [online database] <http://data.imf.org/?sk=77413F1D-1525-450A-A23A-47AEED40FE78>.

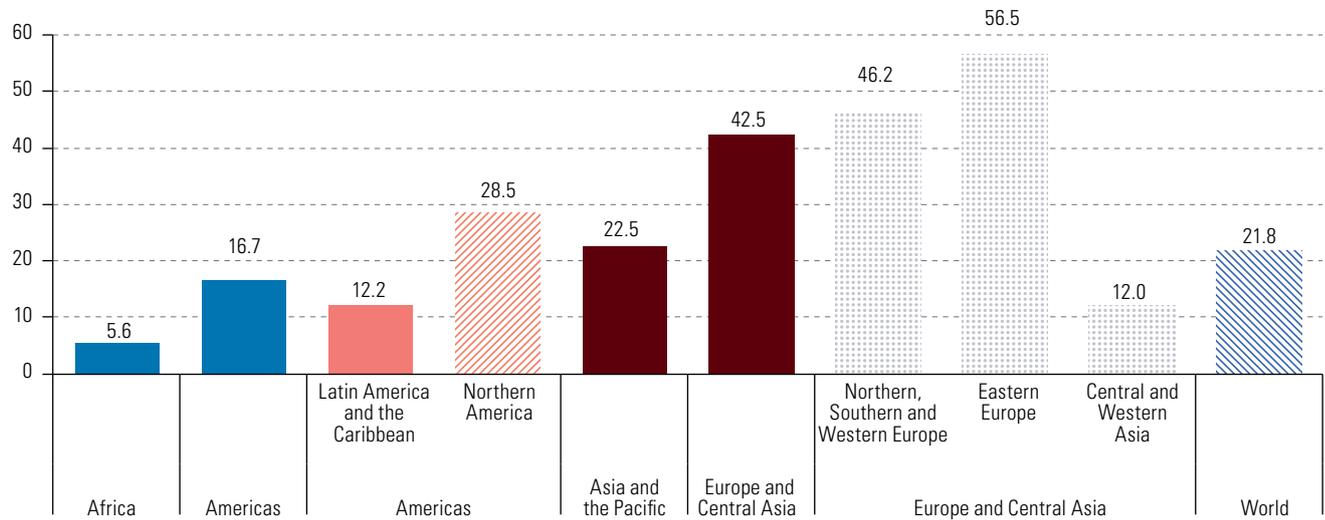
Again, on the public spending side, social protection floors in the region's developing countries provide only limited support during cyclical recessions. For example, a key element in the literature on automatic stabilizers is the availability of unemployment insurance for workers at times of economic recession. However, as figure IV.11 reveals, cash unemployment benefits reach relatively few workers in Latin America and the Caribbean, with ILO (2017) putting the proportion at some 12.2%. It is usually assumed that current primary spending in Latin America does not automatically respond to the cycle, and accordingly this aspect is not included in the estimates (Martner, 2000; Daude, Melguizo and Neut, 2011). In the OECD countries, conversely, social protection floors, particularly unemployment insurance programmes, play a key role.

In this situation, there is clearly room to strengthen automatic stabilizers in the region, not only to cushion macroeconomic volatility but to give effect to the fundamental human rights set out in the 2030 Agenda for Sustainable Development. For example, a more progressive income tax with a wide tax base would more effectively perform its redistributive function while playing a greater stabilizing role. Similarly, a stronger social protection floor would not only help to stabilize aggregate demand in the event of negative shocks but would also speed up progress towards other key targets of the Sustainable Development Goals, such as combating poverty and inequality, empowering women and improving social cohesion (ILO, 2011).

Besides strengthening their existing automatic stabilizers, however, the region's countries ought to take advantage of the international debate on the design of new instruments (Blanchard, Dell'Ariccia and Mauro, 2010; Blanchard and Summers, 2017). Unfortunately, there are few studies on the subject as yet, although a valuable contribution has been made by McKay and Reis (2016), whose analysis examines the changes implicit in the design of social insurance when its role as an automatic stabilizer is considered. Nonetheless, the current environment requires the countries to innovate in this area.

**Figure IV.11**

Cash unemployment benefits, latest year available  
(Percentages of unemployed benefiting)



Source: International Labour Organization (ILO), *World Social Protection Report 2017-19: Universal Social Protection to Achieve the Sustainable Development Goals*, Geneva, 2017.

Future studies need to consider the potential of new instruments to protect vulnerable populations from falling into poverty (by means of tax credits or stimuli triggered automatically by an economic criterion such as an increase in the unemployment rate) or to support fixed capital formation (tax credits linked to the cycle) or smooth subnational fiscal accounts (transfer frameworks linked to the cycle).

## C. Conclusions and challenges

As mentioned, considerably greater importance has been attached to the stabilizing capacity of fiscal policy since the global financial crisis of 2008-2009 and great use has been made of it for this purpose in both developed and developing countries.

The new approach to the stabilizing role of fiscal policy in the developed countries has given a fresh impetus to the debate about fiscal and macroeconomic policy, and although the resulting proposals for a more flexible and proactive fiscal policy cannot be applied automatically in the region, analysis of the ideas put forward in this debate has given us a basis for setting forth a number of objectives that could improve the stabilization capacity of fiscal policy.

A fiscal policy for stabilization cannot be designed without considering the nature and type of shock confronting an economy. In Latin America, fiscal policy for stabilization needs to be more than a countercyclical policy and must take account of the characteristics of aggregate volatility (type of shock, size of cyclical fluctuations, frequency of crises). Study of the region has shown that stabilization initiatives include a wide range of factors and are not confined to countercyclical initiatives and automatic stabilizers. Among other things, they include structural adjustment policies and anti-crisis policies.

There is a clear need to strengthen the automatic stabilizers of fiscal policy on both the spending and revenue sides. Reinforcing social protection systems and personal

income tax would yield a twofold benefit by improving both the stabilization role and the redistributive impact of fiscal policy.

It is important to improve estimates of the fiscal multiplier in order to have a better idea of the size, persistence and determinants of the impact of fiscal policy on aggregate demand.

It is crucial to the analysis and design of fiscal policy to refine the concept of discretionary fiscal policy. This requires a good typology of the fiscal rules used in the region and of the different forms of discretionality, one that is theoretically grounded with properly identified empirical correlates. Dichotomic ideas, like that of “rules” as opposed to “discretionality”, lack any clearly determined empirical basis and consequently are of limited use when it comes to considering policy recommendations.

Lastly, infrastructure spending needs to be prioritized, and it is particularly important to pursue public investment as a bridge towards the future and to strengthen the contribution of public spending to the dynamics of potential output. In addition, the quality of capital spending needs to be improved by consolidating processes, systems and institutions with a view to optimizing effectiveness, efficiency and accountability.

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In 2017, the prevailing policy thrust in the region was towards fiscal consolidation, which has been reflected in an improvement in the primary balance, although some countries are still running large deficits. This consolidation was achieved by containing the growth of public spending and boosting tax revenues, while the stronger fiscal position and the upturn of economic activity also slowed the growth of public debt in the region.

*Fiscal Panorama of Latin America and the Caribbean 2018* reviews the evolution of fiscal policy over the past three decades and the future challenges regarding the implementation of the 2030 Agenda for Sustainable Development and the achievement of its Goals. Undoubtedly, the Agenda's adoption by the countries requires a recasting of the role of fiscal policy in the region in relation to both expenditures and revenues.

This edition also offers a regional perspective on the debate that has surrounded fiscal policy challenges since the 2008-2009 crisis. The new approach to the stabilization role of fiscal policy applied in developed countries has brought a breath of fresh air to the fiscal and macroeconomic policy discussion in Latin America and the Caribbean.



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