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Fiscal Policy for Stable and Equitable Growth in Latin America*

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Abstract

The resumption of economic growth in Latin America is predicated on the successful restoration of fiscal discipline and stabilization. In restoring fiscal discipline, the mix of policy instruments should aim at maximizing efficiency in the use of domestic and foreign resources.

Poverty alleviation in Latin America is not likely to be achieved, in the near future, by economic growth. Policy should promote a more equitable distribution of income. While fiscal policy can play an important role in this process, it is important to realize that the current high domestic inflation in many Latin American countries implies that expanding social programs has high social costs. Fiscal policy should aim at increasing the income share for the poor by making the tax system more efficient and by reforming the existing social programs to make them more effectively targeted toward the poor.

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Summary

The paper starts with a brief discussion of the work of Raul Prebisch and its implications for fiscal policy in Latin America. The changing attitude toward the role of the state in the economy is subsequently discussed. It is argued that that role should be determined by what the state can do well rather than by some abstract concept of what the state should do.

Section III of the paper discusses the role of fiscal policy in stabilization and growth. The servicing of the external debt has created the need to generate a surplus in the trade account. It has also generated the need to improve the fiscal balance in order to buy, in an orderly way, the foreign exchange associated with that surplus to make foreign payments. The fiscal implications of alternative ways of transferring to the government the foreign exchange earned through the trade surplus are discussed.

In Section IV, the paper points out that economic growth alone cannot be an effective means of alleviating poverty in Latin America in the near future. In the present circumstances, decades of economic growth would be required for the region to achieve a substantial reduction in poverty. Therefore, it is crucial to reinforce efforts to promote growth with similar efforts to increase the income share of the poor. This must be done, however, without reducing the growth rate. Fiscal policy can play a vital role in this process.

Fiscal policy should promote price stability. A large fiscal deficit often is the primary source of inflation, which tends to aggravate poverty by reducing the real wages of unskilled workers. The tax system should be simple, cost-effective, and broad-based. Enhanced capacity for tax administration will enable governments to expand direct taxation and make it more equitable.

As middle-income countries, many Latin American countries are in a better position than low-income countries to alleviate poverty. The high domestic inflation rates prevailing in some of them imply, however, that the social cost of expanding social programs in order to protect the poor are higher than in many other developing countries. Expenditure programs--in particular, social programs--should therefore be more effectively targeted on the poor.

I. Introduction

In this paper, we discuss the role of fiscal policy for stable and equitable growth in Latin America. We focus on major contemporary, but not necessarily new, policy issues in promoting stabilization, growth, and equity in this region. Since Prebisch himself devoted some thinking to this topic and since he had much influence on a whole generation of economists and policymakers, we begin by reviewing briefly, in the second section, Prebisch's thinking on this topic. The third section discusses the role of fiscal policy for stabilization and growth. The fourth section reviews the recent evolution of income distribution and poverty in Latin America and explores the possible role of fiscal policy in promoting equity and poverty alleviation. The last section presents a summary and conclusions.

II. Raúl Prebisch and Fiscal Policy

Fiscal policy generally refers to the use of fiscal instruments aimed at specific policy objectives. The fiscal instruments are taxes and other revenues and categories of public expenditures. The policy objectives are those associated with stabilization, growth, and income redistribution. In practice, fiscal policy instruments are more frequently directed toward specific objectives such as equilibrium in the balance of payments, employment, and promotion of specific activities.

Fiscal instruments are not the only instruments available to policymakers. Policy objectives can be pursued through monetary and external sector policy measures. Furthermore, fiscal policy can be pursued to a considerable extent through various types of regulations. For example, a regulation that requires exporters to cede to the central bank the foreign exchange that they receive from their exports can be a substitute for an export tax when the official exchange rate is overvalued and there is a parallel market. This particular aspect of fiscal policy has not received the attention it deserves, and measurements of public sector activity have ignored the role of regulations. However, in recent years, there has been a fairly widespread view that economies have become overregulated and that deregulation of various economic activities would bring measurable benefits in terms of efficiency gains and, perhaps, in terms of reduction in corruption. Corruption is often an almost unavoidable consequence of the widespread use of regulations.

In his long and productive life, Raúl Prebisch did not address directly fiscal issues, although we are told that ". . . in 1931 [he] was a member of a team of economists who formulated the first federal income tax to be applied in Argentina" (Street, 1987, p. 649). However, his thinking did have a major indirect influence on fiscal policy in Latin America since

> ". . . Prebisch's strategy for Latin America development . . . included . . . intervention by democratic governments to promote domestic industrialization and redistribute income, and other measures for institutional reform that implied 'interference' with free-market forces" (Street, p. 654).

That intervention would inevitably have fiscal implications.

The same reviewer of Prebisch's work tells us that

> "In time . . . Prebisch became disillusioned with import substitution policy and recognized its limitations *as it had actually evolved*. Newly created industries often proved permanently inefficient, operating at high costs and requiring sustained protection and government subsidies" (Street, p. 654, italics added).

In other words, Prebisch came to recognize that results and intentions may differ and that policies ought to be judged by results and not by intentions. However, he continued to have a strong interest in an equitable distribution of income and continued to insist that "[there is no other] solution than the *macroeconomic regulation by the state of the process of accumulation and distribution*, and this implies very important institutional changes." 1/

Given that the state is so intimately involved in the working of the Latin American economies, it would be naive to assume that a realistic alternative would be that of complete laissez-faire, even if one could make a theoretical case for it. 2/ It is clear, however, that "very important institutional changes" are required in the present role of the state if the latter is to play a useful and positive role not just in the abstract but in the real world.

There is now a kind of ideological debate going on between those who would minimize the role of the state and those who continue to believe that the state (or better the public sector) should be the main actor in bringing about fundamental and needed changes in the Latin American economies. Some of those who participate in this debate argue

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1/ Raúl Prebisch, "Power Relations and Market Laws" in *Debt and Development in Latin America*, ed., Kwan S. Kim and David F. Ruccio (Notre Dame, Indiana: University of Notre Dame Press, 1985), p. 28, italics added.

2/ Interestingly enough, while the political winds have shifted almost completely in favor of the market economy, the purely theoretical case for laissez-faire has been challenged by economists such as Joseph Stiglitz, Andrei Shleifer, and other first-rate theorists.

that the IMF and the World Bank have an ideological bias against the role of the state. 1/ As Sergio Bitar has recently written:

> "The World Bank and the IMF assign priority to lifting price regulations, promoting openness in the field of finance and foreign trade, and the liberalization of labor regulations. In this view, the private sector should play the leading role, and they seek to reduce the role of the state" (Bitar, p. 49).

While the quotation by Bitar may accurately reflect the prevalent thinking in the two mentioned institutions, the attitude of the Bank and the Fund is not motivated by ideology but by experience. These institutions would agree that the state must play an important role in the process of growth, stabilization, and distribution but, they would argue, it must be a role consistent with what the public sector *can efficiently do* rather than what the public sector *should* do in some abstract sense. These institutions would have no disagreement with the statement that:

> "It is essential that the public sector should play an active role. Effective implementation of this policy calls for less red tape, less centralization, and the removal of a host of petty administrative regulations. *The functions of the state should be concentrated primarily on the strategic variables* . . ." (Bitar, p. 52, italics added).

In essence Fund and Bank staff's attitude vis-à-vis the role of the public sector would be guided by the experience of what the public sector can do better than the private sector rather than by ideological or a priori beliefs. However, much of the discussion on the role of the state is still characterized by a priori, normative attitudes. For example, Norberto González, writing in the April 1988 issue of *CEPAL Review*, states that ". . . the discussion [as to the role of the state] should focus on what functions the state *needs to perform*, directly and indirectly, and *what is the most efficient way for it to do so*" (Gonzáles, p. 15, italics added). If we interpret González correctly, he is saying that the role of the state must be established a priori, presumably on the basis of ideological or theoretical considerations, and what remains to be done is to find the most efficient way for the state to promote that predetermined role. Bank and Fund staff would prefer to assign to the state those functions in which the state has a *proven* rather than a theoretical comparative advantage. They would recognize that widespread public sector intervention is often influenced by vested interests of public employees, biases, rent seeking activities, and corruption.

1/ See, for example, the papers by Ricardo Ffrench-Davis, by Norberto González, and by Sergio Bitar in *CEPAL Review*, No. 34, April 1988.

As already stated, in spite of the considerable evidence of a large difference between the theory and the practice of state intervention, much of the writing on this subject remains normative. 1/ This writing often minimizes or ignores the practical problems of policy implementations 2/ and, for example, it assumes that a country can start from a zero-base approach for taxation, for public expenditure, and for regulations. Unfortunately, policymakers do not have the luxury of a zero base, or a tabula rasa, alternative. They cannot bring the perfect "progressive taxation system which redistributes expenditure and reallocates productive resources" (French-Davis, p. 41). The tax system is already there with all its virtues and shortcomings, and so is the expenditure and regulatory system. We live in a world of second best in which tax systems, systems of public expenditures and regulatory systems reflect real life and difficult-to-remove constraints such as poor tax administration and often widespread evasion, vested interests, entitlements, clienteles built around given regulations and expenditures, foreign and domestic debt, inflation, fiscal deficits, and so on. The changes that the economic ministers may wish to introduce, even when they are well intentioned and well thought out, will be resisted by other ministers, by the legislature, by pressure groups, and by lobbies.

This does not mean that the government should be immobilized by these constraints. It does mean, however, that the proposed changes must reflect the range of what is realistically possible. At this juncture a reduction of the role of the state to the strategic macrovariables activity seems the best policy.

III. Fiscal Policy for Stabilization and Growth 3/

The prolonged world economic recession of the early 1980s and the debt crisis shocked the entire Latin American region. The average growth of GDP in the region dropped from 5 percent per annum during 1965-80 to virtually nil in 1981-85. Both lower-income and upper-income countries in the region suffered similar declines in their per capita income. Economic imbalances manifested themselves in severe domestic inflation. The annual rate of inflation in the region accelerated from 24 percent in 1965-80 to 87 percent in 1981-85 (Table 1 and Appendix Table 9) and to higher rates more recently.

1/ See, for example, the policy recommendations of the neo-structuralist paradigm in Ricardo French-Davis, "An outline of a neo-structuralist approach" in CEPAL Review, No. 34, April 1988, especially pp. 41-42.

2/ These are the problems that had made Prebisch become disillusioned with the way import substitution policy had actually evolved.

3/ Some of the ideas introduced in this section are also discussed at greater length in (Tanzi, 1989).

Table 1. Growth and Inflation in Latin America, 1965-85 1/

	Annual Rate of Increase			
	GDP		CPI	
	1965-80	1981-85	1976-80	1981-85
Average	5.0	0.2	24	87
Lower income countries	4.8	0.2	20	81
Upper income countries	5.3	0.2	32	102

Source: The World Bank, World Development Report, Washington, D.C., 1988.

1/ See Appendix Table 9 for country grouping.

Low growth and high inflation have many origins. Just like individuals, countries face resource constraints: over the long run and in the absence of net transfers, they cannot spend more than they produce. Good economic policy should aim at bringing a country's spending in line with its income. If this adjustment is orderly, well designed, and accompanied by sound structural reforms, the country's disposable income should increase; if not immediately, then in the medium run.

1. Fiscal policy for stabilization

The public sector's counterpart of the resource constraint is the budget constraint. The fiscal problem, arising from public spending beyond available public resources, is now central to the economic difficulties of many countries and especially of many Latin American countries. Inflation and external payments problems are almost always accompanied by fiscal imbalances. In Latin America, fiscal imbalances were caused by external and domestic developments.

a. Sources of the fiscal imbalance in Latin America

(1) Change in real interest rates

Between the 1970s and the 1980s, real interest rates turned sharply from negative to positive.

The sharp increase in real interest rates in the 1980s raised foreign interest payments for servicing of the external debt that by the early 1980s had become very large. 1/ However, real interest rates in the post-1974 period until the early 1980s were extraordinarily low by historical standards; they could not be taken as the norm for the 1980s. These low rates encouraged large-scale borrowing by public-sector entities and contributed to a considerable expansion of the scope of their activity. Given the large number of public entities in most countries and the large number of public and private creditors, and given the fact that this borrowing was totally uncoordinated and unmonitored, it was no surprise that borrowing exploded. It was only in recent years that countries were able to add up these debts to get a concrete idea of the magnitude of their total external indebtedness, which was much larger than they had expected. 2/ These large debts, combined with sharply higher real interest rates in the 1980s, created

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1/ For example, in Mexico the foreign debt rose from US$3 billion in 1970 to US$85 billion in 1982.

2/ Between 1978 and 1982 net capital inflow in Latin America was $143 billion. See Comisión Económica para America Latina y el Caribe (1988), Balance Preliminary de la Económia Latino Americana, Table 15, p. 24. For the 1971-80 period, the annual compounded percent change in export volumes for the developing countries of the Western Hemisphere averaged 1.8, while that for import volumes averaged 7.1.

serious difficulties for both the external and fiscal sectors of these countries.

Ideology may also have played a role in determining the form in which capital came into Latin America in the 1970s. Much writing of the early 1970s criticized foreign direct investment, since this implied that multinationals would come to control the Latin American economies. Direct borrowing by the public sector would presumably eliminate this danger. Capital inflow as equity declined; capital inflow as debt increased.

(2) Change in terms of trade

During the 1971-80 period, the terms of trade for the region increased by 55 percent, while for the 1981-89 period, they declined by 26 percent. 1/ The index of the terms of trade, with 1970 equal to 100, reached 155 in 1980, but fell to 115 in 1989. Since the fiscal accounts of many Latin American countries were strongly influenced by direct earnings of publicly owned resources, such as oil and copper, or by taxes levied directly or indirectly on foreign trade, the large deterioration in the terms of trade raised the fiscal deficits in many of these countries. The rents that the public sector could extract from either the exports of its resources or the external trade of the private sector were no longer sufficiently large to finance its own domestic and foreign commitments, especially since these had been inflated by both the many public sector programs introduced in the 1970s and the need to service the large external debt. Or, putting it in a less complimentary and more public choice perspective, these rents could no longer support the consumption standards of the various clienteles, such as pensioners, public sector employees, consumers of subsidized products, and producers of subsidized industries who had come to rely on the public sector for providing or sustaining their standards of living.

(3) Domestic developments

In addition to these external developments, some domestic developments that to be mentioned. Faced with cheap foreign credit, rising prices for their basic exports, and pressing needs that could be met through higher public spending, governments found it difficult to worry about the time when (i) real interest rates might rise sharply, (ii) the terms of trade improvements might reverse themselves, and (iii) creditors would be unwilling to extend additional loans.

Cheap foreign credit also probably produced a lowering of the standards for public project selection. Although it is difficult to prove it, much of the public sector investment made in the 1975-82 period was probably of highly questionable quality. As a consequence,

1/ Calculated on the basis of information available in the International Monetary Fund (1989).

the capital-output ratio increased considerably during this period. This increase in the capital-output ratio reinforced a low investment rate to reduce the growth of aggregate output in the 1980s (see Table 2 and Appendix Table 10).

The debt crisis brought with it, in several countries, an acceleration of inflation and, as a consequence, a reduction in real tax revenue, thus increasing the fiscal deficit. Stabilization policy became more difficult because of the debt overhang. The need to generate a trade surplus to meet the foreign obligations often required sharp devaluations. The policymakers were often unable to accompany these devaluations with sufficiently restrictive monetary and fiscal policy to prevent inflation.

b. Policy measures to reduce the fiscal imbalance

While the link between the debt crisis and the fiscal problems in many Latin American countries has been discussed in a variety of studies, some salient features might be mentioned. The external debt was accumulated in the process of financing (i) increases in domestic consumption, (ii) some good investments, (iii) some bad investments, and (iv) capital outflows. The capital outflow was stimulated by the belief that, given current and future domestic policies, the expected rate of return on domestically invested saving would be very low or negative. 1/

Of all these uses of the resources obtained through foreign borrowing, only the investment in efficient projects could be expected to generate a future stream of income, which would contribute to servicing the debt. The flight capital is a potentially important asset, which in time and under particular circumstances could make a substantive contribution to stabilization and growth for the Latin American countries. However, as long as the economic and political situation remains uncertain, and as long as inefficiencies remain, this capital is unlikely to return.

The part of the foreign debt which went into either straight consumption or bad investment projects will not generate the income for servicing the foreign debt. Thus, with the current low economic growth, particularly when accrued interest on foreign debt is capitalized, the book value of the foreign debt, unless it is reduced in some way, will tend to grow at a faster pace than the economy.

The resolution of the debt crisis has many facets. In this section, however, we focus on the debt servicing aspect. The servicing of the public debt, if it were to occur in a stable macroeconomic environment, would require two types of transfer: (i) the releasing of

1/ A Fund study estimated that capital flight for Western Hemisphere countries amounted to $107 billion for the period between end-1974 and end-1985. See Deppler and Williamson (1987).

Table 2. Structure of Domestic Demand in Latin America, 1965 and 1986 1/

	Government Consumption		Private Consumption		Domestic Investment		Domestic Savings	
	1965	1986	1965	1986	1965	1986	1965	1986
Average	10	14	69	73	18	16	17	13
Lower income countries	10	14	75	77	18	17	15	13
Upper income countries	11	14	67	69	19	15	22	19

Source: The World Bank, World Development Report, Washington, D.C., 1988.

1/ See Appendix Table 10 for country grouping.

resources by the private sector to the public sector, and (ii) a transfer of the resources by the public sector to creditors. In other words, there must be a net positive change in the fiscal balance (i.e., a net transfer from the private to the public sector) which must accompany the external adjustment required to make the foreign payment (i.e., the trade surplus). 1/ Putting it differently the dollars associated with the trade surplus must be bought by the public sector so that payments to foreigners can be made. The transfer from the private to the public sector can occur through (i) higher taxation, (ii) a reduction in public expenditure, (iii) voluntary lending by individuals to the state, and (iv) inflationary finance. All of these alternatives have costs, and the minimization of these costs (especially the inflationary cost) must be one of the guiding principles of fiscal policy.

An increase in taxation would force a reduction in private spending, hopefully more in consumption than in investment. 2/ Thus, it is important that the choice of tax measures should aim at promoting a reduction in the least useful kind of spending, that is, unproductive consumption and unproductive investment. Particular care must be taken to avoid taxes with strong disincentive or distortionary effects, such as export taxes.

A reduction in public spending must be aimed at unproductive public expenditures and must try to safeguard the standard of living of the poorest sectors. Unfortunately, cuts in public spending have often been made in categories that may be highly productive, such as operations and maintenance outlays and efficient investments, but not in politically popular but unproductive activities. 3/

Voluntary lending would enable the government to sell bonds to the private sector, while the private sector would reduce its own spending sufficiently to generate a surplus that can be transferred to the government, which in turn would make the foreign payments. An increased sale of bonds by the government requires an increase in the private sector's saving rate, or a reduction in private investment or in net capital flight. It thus requires a rate of interest high enough in real terms to induce an increase in financial saving and/or a reduction in private investment. The studies available on the interest elasticity of private savings are inconclusive. This road may require very large percentage increases in real interest rate to induce modest increases in the saving rate. These studies imply that one should not pursue a high

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1/ On this issue, see Reisen and van Trotsenburg (1988); and Polak (1989), especially Chapter 5.

2/ Over the short run, individuals might reduce saving rather than consumption. Over the medium run, consumption will have to adjust if the tax increase is seen as permanent.

3/ Military spending has often proved resistant to cuts (see De Massi and Lorie, 1987).

interest rate policy under the assumption that it can stimulate a higher rate of savings. However, to the extent that high interest rates encourage financial savings to remain within the country, rather than to be channeled abroad, and to the extent that high interest rates discourage unproductive private investment, such as luxury housing, this policy can still be justified for other reasons. It is important, however, to keep in mind that there are long-term costs to domestic debt accumulation. To the extent that the servicing of foreign debt results in domestic debt accumulation and that domestic debt accumulation requires (and results in) high real rates of interest, this policy will imply an increase in future government spending to service domestic debt. It will, at the same time, result in a reduction in private investment which may contribute to a slowdown of economic growth. When a government relies on domestic borrowing to finance its expenditure, particular attention must be paid to the taxation of financial transactions. If the taxes on financial transactions are increased at the same time the government is trying to absorb resources from the private sector through voluntary means, the cost of this policy will be much higher.

Money creation, in a growing economy, would enable the government to finance some public spending without aggravating inflation. However, in stagnant economies with acute inflationary expectations, inflationary finance is unlikely to give the government significant net control over resources. By stimulating inflation, it will induce (a) more capital flight, (b) dollarization of the economy, (c) losses in tax revenue because of collection lags, and (d) efficiency costs to the economy in general.

The importance of simple and efficient tax systems and of well-developed budgetary controls cannot be exaggerated in these situations. It is a mistake to look for perfection in the tax system or to ask the tax system to do much more than raise revenue in a relatively neutral or broadly equitable way. Highly progressive income taxes can virtually never be implemented in high inflation. Highly differentiated value-added taxes are often accompanied by major administrative difficulties. In these circumstances, the golden rule is that of relatively low and undifferentiated rates on as broad tax bases as possible. The more governments insist on promoting high progressivity and on maintaining tax incentives to particular activities, the lower is likely to be the tax level and the more distorted is likely to be the effective tax system. It is also important that the government be in a position to monitor, precisely and in a timely fashion, the process of expenditure, not just in the central government, but also in the rest of the public sector.

Unfortunately, when inflation accelerates and macroeconomic difficulties become prevalent, the monitoring capacity of the government deteriorates, and it begins to lose sight of the true dimension of the fiscal problem. The measurement of the fiscal deficit itself gets distorted, either because the deficit is pushed away from where it can be easily measured to where it becomes difficult to measure, 1/ or because inflation itself distorts certain expenditure, such as domestic interest payments, and ends up giving a picture that is no longer a reliable reflection of reality.

In the final analysis, there are no magic formulas for achieving stabilization through fiscal policy. Given the level of expenditure, the total revenue needed to meet that expenditure must be mobilized without causing inflation or distortions. If this is not feasible, there is no alternative but to reduce public spending.

2. Fiscal policy for growth

It is difficult to separate the stabilization objective from the growth objective of fiscal policy. Growth is unlikely to take place in a period of great economic (or political) instability; thus, macroeconomic (and political) stability is often a precondition for sustained growth. When inflation is very high and volatile and when other macroeconomic imbalances are paramount, individuals are unlikely to invest their savings in activities which would contribute to the long-term economic growth and, in fact they are unlikely to save as much as in normal times. 2/ Rather, financial assets will be channeled either toward speculative activities or toward activities aimed specifically at protecting their real value.

An argument is often made in favor of foreign borrowing to promote growth by increasing investment. This argument ignores that some of the Latin American countries (as, for example, Brazil and Mexico) got themselves in the present precarious conditions in part because of this policy. They borrowed at high rates of interest and invested in activities with low rates of return. Borrowed resources can make a genuine contribution to growth only when they are channeled toward carefully screened projects, which have expected rates of return clearly higher than the long-run cost of borrowing. Under the circumstances that have prevailed in many countries, there has been no guarantee that this screening would be effective.

Countries that find themselves in situations of great instability might be advised to reduce new investments for a while. They would be better off by channeling the financial resources available toward improving the existing infrastructure (roads, schools, hospitals, plants, etc.). The existing infrastructure can accommodate much growth in the medium term if obstacles to its efficient use can be removed and if the necessary operations and maintenance expenditure keeps it in good

1/ For example, it may get pushed from the central government to the central bank.

2/ Available information indicates that national saving fell sharply in recent years in countries with debt servicing difficulties.

working condition. 1/ Wise operation and maintenance expenditures can substantially increase the capacity of the existing infrastructure. Poorly kept capital infrastructure is likely to create the impression that new capital investment is badly needed.

Fiscal policy for growth requires that a close look be given to the tax system, to the structure of expenditures, and to the various regulations. The objective would be to eliminate the many elements which interfere with the efficient allocation of resources.

The tax system can be greatly simplified in many countries. The simplification should aim at (i) the elimination of many unproductive taxes which confuse tax administrators, (ii) the elimination of many tax incentives which have outlived their usefulness if they ever had one, and (iii) the reduction in excessively high marginal tax rates which discourage work efforts, stimulate evasion, promote underground economic activities, and provide almost no revenue. Revenue generation should be the most important objective of the tax system.

Especially in periods of high instability and low growth, a country must scrutinize all its government programs to determine those with the highest priority. Do the existing programs require levels of expenditure that are no longer realistic, given the reduced public resources? The realization that a country is poorer, because of changes in its terms of trade or because of a high debt burden, implies that it is often necessary to scale down the level of public spending. This scaling down, however, must protect the poorest groups and the most efficient expenditures (see section IV).

Because of their close link with fiscal policy, it is also important to look at regulations. These regulations accumulate over the years. While many may have been justified at the time they were introduced, many may have lost their raison d'etre. Of all the regulations affecting credit allocation, investment, imports, and employment, how many still make economic sense? How many have outlived their objectives?

Public enterprises need to be looked at closely to decide whether they need to be privatized or reformed. Public enterprises played a large role in the accumulation of foreign debt and continue to play a large role in the determination of the fiscal deficit. The decision to privatize some of them should not be based on ideology, but on efficiency considerations. If these enterprises are efficient and profitable, they should be retained. If they have been losing money, however, the government should get rid of them, and the sooner the better unless there are overwhelming reasons for not doing so.

1/ For a detailed defense of this argument, see Tanzi (1988).

Fiscal policy for growth will inevitably have to pay some attention to ways of inducing capital inflow without mortgaging the country's economic future. Two important channels, which can potentially play a role, are foreign investment and the return of flight capital. Ideology probably played some role in the 1970s in discouraging the inflow of capital as equity and encouraging the inflow of capital as debt. 1/ The fear that the Latin American countries were becoming more and more controlled by foreign investors led many governments to actively discourage foreigners from investing directly in the countries. With the benefit of hindsight, one wishes that the inflow of capital had continued as equity, rather than as debt.

The inflow of foreign investment is likely to be highly sensitive to the macroeconomic situation. If macroeconomic imbalances remain predominant, it is unlikley that much foreign direct investment will come. One can say that a stable macroeconomic situation is a necessary condition for the flow of foreign investment. However, elements of the tax system and various regulations also play an important role in discouraging it. Countries should remove these negative elements for an eventual increase in foreign investment.

The other channel through which capital might come in is through the repatriation of flight capital. Here again, it is important to realize that a great disincentive for the return of flight capital is macroeconomic instability. However, one should pave the way for the possibility that, should economic stability return, flight capital is not prevented by legal or other obstacles from returning. For example, flight capital is often linked with tax evasion, and tax evasion is often a criminal offense. If people who have taken the money out of the country are faced with the probability of being punished for returning it, they will be reluctant to do so. Thus, there may be some point in allowing those who are willing to repatriate their capital to do so without penalties. Many people would feel that it is unfair to allow those who took the money out of the country to return it without punishment. This attitude, however, though understandable on more grounds, may prevent the return of flight capital. If countries have been willing to allow tax amnesties for domestic tax evasion, perhaps an argument can be made for extending this treatment to flight capital. This will not guarantee that money will flow back, but will at least remove a major obstacle.

Another factor receiving little attention in most discussions, but which is nevertheless very important for conducting good fiscal policy for both growth and stability, is the availability of good information on the part of those who make important policy decisions. Unfortunately, the information available on a timely basis to the policymakers

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1/ Mexico, which in the early 1970s introduced legislation to prevent the inflow of foreign investment, is now in the process of liberalizing the laws related to foreign investment.

is often very limited. At times, institutional or legal obstacles prevent them from getting up-to-date information, so that they base their decisions on estimated, limited, and often incorrect, outdated data. In Argentina, for example, the flow of information from the Contraloria to the Budget Office is not very timely. The improvement of information would not require many resources but would, in time, improve policymaking. Incidentally, the Argentine situation is hardly unique, as other countries have similar problems.

IV. Fiscal Policy for Equity

1. Equity and poverty in Latin America

Statistical data on income distribution are notoriously deficient. Data deficiency was serious 15 years ago, when almost two decades ago one of the authors was doing research on income distribution in Latin America; 1/ data deficiency is still serious today. In this paper, we attempt to use the still deficient data base to update the description of the pattern of income distribution. Not much appears to have changed since the early 1970s.

a. Evolution in the 1960s and the 1970s

Table 3 is based on some of the data used in Tanzi (1974) and more recent data from other sources (Part A). 2/ Data are available for the early 1960s, the early 1970s, and the early 1980s for only seven countries. The sample countries for these three time periods are not identical, thus making it difficult to discuss the evolution of the pattern of income distribution (Appendix Table 11). However, for any sample period, the income shares of the bottom 20 percent of the population were notably small for all the sample countries. As in the early 1980s, the share of income received by the bottom 20 percent of the population ranged between 2 percent and 6 percent for the seven sample countries; the average was 5 percent. Although the average of 5 percent was higher than 3 percent in the early 1970s and 4 percent in the 1960s, it is unclear that given the changes in the composition of the sample over the years, the small sample size, and the diversity of data sources, the higher income share in the early 1980s for the poorest 20 percent should be interpreted as a genuine improvement of their relative income share. Nor do the data tell about the most recent situation of the poor, although their situation appears to have

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1/ See Tanzi (1974).

2/ Some data on income distribution are compiled for groups of countries in various issues of the World Development Report; and in National Accounts Statistics: Compendium of Income Distribution Statistics (1985).

Table 3. Income Distribution and Poverty in Latin America, 1960s Through 1980s

Part A. Evolution of the Size Distribution of Income 1/

	Early 1960s		Early 1970s		Early 1980s	
	Lowest 20 percent	Highest 20 percent	Lowest 20 percent	Highest 20 percent	Lowest 20 percent	Highest 20 percent
Average	4	59	3	57	5	48
Lower income countries	4	62	4	57	5	47
Upper income countries	4	56	3	57	4	49

Part B. Evolution of Poverty

	1960	1970	1980			1985		
			Total	Urban	Rural	Total	Urban	Rural
Poor population								
In million	110	113	119	47	72	158	77	81
Share of total	51	40	33	21	55	39	29	59
Total population	216	283	361	229	132	405	267	138

Sources: Part A: Vito Tanzi, "Redistributing Income Through the Budget in Latin America," Banca Nazionale del Lavoro Quarterly Review, Vol. XXVII, No. 108, 1974, pp. 5-27; United Nations, National Accounts Statistics: Compendium of Income Distribution Statistics, Statistical Papers, Series M., No. 79; and The World Bank, World Development Report, Washington, D.C., 1988; Part B: International Labor Organization, Meeting the Social Debt, Geneva, Switzerland, 1988.

1/ See Appendix Table 9 for country grouping.

deteriorated since the early 1980s (see below). The situation in lower-income countries does not appear to differ from that in upper-income countries. 1/

The data indicate that the income share of the top 20 percent was almost 50 percent in the early 1980s, lower than in the early 1960s and the early 1970s. However, it is not obvious that the lower share indicates a genuine increase in the share of the middle-income group. In the two countries for which data are available for both the early 1970s and the 1980s, these shares changed in the opposite directions.

The severely uneven income distribution, particularly the small income share of the bottom 20 percent of the population, stresses the need to examine the extent of poverty closely. To discuss the extent of poverty, one needs to establish a poverty line and to estimate the number of people whose income falls below the poverty line. Part B of Table 3, based on a study conducted at the International Labor Organization (ILO), indicates how the extent of poverty has changed since 1960. 2/

Through 1980, in spite of a steady increase in the total population, the poor population had remained stationary at around 110-120 million, and the share of the poor population in the total population had declined from about one half in 1960 to one third in 1980.

What were the major factors underlying the evolution of income distribution and poverty? Given the size of aggregate income, its size distribution will depend on how the wealth (both human and physical) is distributed and how the rates of return to various types of wealth are structured. The stability of the relative income shares of the main income groups underscores the rigidity of the fundamental social and economic institutions and perhaps policies that prolong the status quo in the size distribution of income. 3/

The evolution of basic needs indicators confirm an improvement of the social conditions in Latin America between 1960 and 1980. Per capita calorie supply increased. The death rate declined. The primary

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1/ World Development Report classifies Latin American countries as either lower middle-income countries or upper middle-income countries. This paper refers to the former as lower-income countries and the latter as upper-income countries. See appendix tables for the list of sample countries in each group.

2/ ILO (1988).

3/ For this point, see Adelman and Robinson (1978), in particular, p. viii. The study indicates, however, that a pervasive "big push" package can generate a significant improvement.

school enrollment rate increased. The improvement was fairly widespread in both lower-income and upper-income countries (Table 4 and Appendix Table 12).

Given the relatively stable size distribution of income, the evolution of poverty apparently reflected the fluctuation in the aggregate income. Between 1965 and 1980, the increase (2.5 percent per annum) in per capita income contributed to the reduction in the share of the poor population in the total population, although the size distribution of income did not change substantially. The continued growth of the population, however, did not allow the countries in the region to reduce the poor population. 1/ While declining from over one half in 1960 to about one third in 1980 of the total population, the poor population had remained stationary at around 110-120 million. Through the 1980s, the expanding world economy, the relatively favorable external terms of trade, the availability of foreign financing had helped both lower-income and upper-income Latin American countries achieve the relatively high economic growth, although the external terms of trade had been volatile (Table 5 and Appendix Table 9).

The picture that emerges from this analysis coincides with the one described in a recent World Bank study:

> "Growth went hand in hand with considerable social improvements. Between 1960 and the late 1970s, life expectancy at birth, perhaps the most important indicator of welfare, increased from 56 to 64 years, which is not far below the average for European middle-income countries. Clean water had been made accessible to more people--from less than 40 percent to more than two thirds of the growing population--and the share of the labor force in agriculture had fallen from one half to one third. And while income distribution remained extremely skewed in all but a very few countries, the income share of the lowest four deciles did not shrink; thus most of the poor saw their standard of living improve at about the same pace as the entire population." 2/

b. Development in the 1980s

Between 1965-80 and 1981-85, with the population growth remaining at roughly the same rate, the reduction in economic growth resulted in a reduction in the growth of per capita GDP from 2.5 percent per annum to negative 2 percent (Table 5). Both lower-income and upper-income countries suffered similar declines in their per capita income.

The events that had led to the region's economic decline in the first half of the 1980s have already been discussed (section III). What

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1/ ILO (1988), p. 21.
2/ World Bank (1985), p. 3.

Table 4. Basic Needs Indicators, 1960-85 1/

	Indicators			Percentage Changes	
	1960	1980	1985	1961-80	1981-85
Calorie supply	2,310	2,445	2,532	0.28	0.70
Lower income countries	2,172	2,318	2,416	0.33	0.83
Upper income countries	2,607	2,719	2,783	0.21	0.47
Death rate (percent)	12	9	8	-1.40	-2.30
Lower income countries	13	9	8	-1.40	-2.30
Upper income countries	10	8	7	-1.11	-2.60
School enrollment (percent)	93	102	104	0.50	0.40
Lower income countries	89	100	103	0.58	0.59
Upper income countries	101	109	108	0.38	-0.18

Sources: The World Bank, World Development Report, Washington, D.C., 1988.

1/ See Appendix Table 12 for country grouping.

Table 5. Growth of GDP, Population, and Per Capita GDP in Latin America, 1965-85 1/

	Annual Rate of Change					
	GDP		Population		Per Capita GDP	
	1965-80	1981-85	1965-80	1981-85	1965-80	1981-85
Average	5.0	0.2	2.5	2.3	2.5	-2.1
Lower income countries	4.8	0.2	2.6	2.5	2.2	-2.2
Upper income countries	5.3	0.2	2.3	1.9	3.1	-1.7

Source: The World Bank, World Development Report, Washington, D.C., 1988.

1/ See Appendix Table 9 for country grouping.

is unclear is how these external forces and the policy responses of the region's governments have affected the pattern of income distribution and poverty. In the absence of an adequate data base, it is not obvious how the relative income share of the population groups changed during this period. The ILO study suggests a significant increase in the capital share of the declining aggregate income, at the cost of a declining labor share. 1/ However, with the rural poor, including smallholders, remaining the largest poor group, it is not obvious whether the declining labor share suggests a declining share of income received by the poor group (Table 3, Part B).

The deterioration in economic growth reversed the earlier trend of declining poverty. The ILO study suggests that the poor population increased from 120 million in 1980 to almost 160 in 1985; its share in the total population increased from one third to almost 40 percent.

In spite of this evidence, it is difficult to assess the impact of the deteriorating external forces and the governments' policy responses on the social conditions. The methodological, theoretical, and empirical difficulties of assessing this impact have been pointed out in many studies. 2/ While the deteriorating external developments led to a decline in per capita income, an increase in unemployment in the formal sector, and possibly a reduction in government social expenditure, some governments responded to these developments by raising the relative price of tradables, implementing structural measures to improve economic efficiency, and improving the efficiency of existing social programs. The limited data on basic needs indicators in selected Latin American countries do not necessarily show a deterioration of these indicators. Actually, the data indicate a continued improvement in per capita calorie supply, in the crude death rate, and in the primary school enrollment rate (Table 4 and Appendix Table 12). This may be explained by the fact that per capita consumption declined far less than per capita income.

c. <u>The role of budgetary policy</u>

Tanzi (1974) points out that the social groups who tend to get the greatest benefit from public sector budgetary policy appear to be the urban middle-income groups. Many more recent studies have obtained a similar conclusion not only in the Latin American context, but also in

1/ ILO (1988), pp. 20-27.

2/ For example, see International Monetary Fund (1986); or Peter Heller, et al. (1988).

the context of the countries in other regions. 1/ In a sense, it is not surprising that government programs tend to benefit urban middle-income groups, since these are the most vocal and politically influential groups.

Tanzi (1974) also notes that on the revenue side, the relatively light tax burden, the predominance of indirect taxation, and the limited use of capital and income taxes made it obvious that taxation had no significant redistributive impact. The paper also noted the substantial difference between the de facto and the de jure tax systems; the former are much more progressive than the latter. On the expenditure side, it notes that even the supposedly pro-poor social expenditure had little effect on income distribution and that the group that seemed to get the greatest benefit was urban middle-income group.

Since the early 1970s, the tax burden in the region increased from 17 percent of GNP in 1972 to 21 percent of GDP in 1985 (Table 6, Part A). The increase was substantially larger in upper-income countries than in lower-income countries. However, the share of income and profit taxes in total current revenue increased by only 2 percentage points. The combined share of domestic taxes on goods and services and taxes on international trade remained at about one half. The changes in tax burden were diverse in the sample countries. Some countries (e.g., Argentina, Brazil, Chile, Costa Rica, Nicaragua, Panama, and Venezuela) increased the tax to GNP ratio substantially, but others (e.g., Bolivia, Dominican Republic, Mexico, and Paraguay) saw a decline in the ratio (Appendix Table 13).

The expenditure to GNP ratio increased from 20 percent in 1972 to 24 percent in 1986, entirely as a result of an increase in upper-income countries (Table 5, Part B). The share of two main categories of social expenditure (on education and health) in total expenditure declined from 26 percent to 21 percent. It is unclear how the pattern of expenditure incidence changed between 1972 and 1986. Assuming that it did not change significantly, one may conclude that both middle-income and lower-income groups were adversely affected by the decline in the share of these social expenditures.

In the 1980s, many Latin American countries, facing severe debt service burden, pursued both macroeconomic and structural adjustment

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1/ For example, see Kanbur (1988). This is true particularly in the case of universal schemes, such as food subsidies. Even in industrial countries, political forces often replace income-tested programs by universal programs, thus hurting the poor and benefiting middle-income groups. See Tullock (1982). Some have even argued that to be politically viable, a social program aimed at helping the poor should also benefit middle-income groups; a social program too narrowly and effectively targeted at the poor may not generate strong political support.

Table 6. Central Government Revenue and Expenditure in Latin America, 1972 and 1986

Part A. Revenue 1/

	Current Revenue in percent of GNP		Share in Total Current Revenue: Taxes on income and profit		Domestic indirect taxes		Taxes on international trade	
	1972	1986	1972	1986	1972	1986	1972	1986
Average	17	21	18	21	25	31	24	17
Lower income group	16	19	15	20	29	32	30	21
Upper income group	19	25	23	23	19	31	14	10

Part B. Expenditure 1/

	Expenditure in percent of GDP		Selected Social Expenditure: Total		Education expenditure		Health expenditure	
	1972	1986	1972	1986	1972	1986	1972	1986
Average	20	24	26	21	19	13	7	7
Lower income group	20	20	29	25	22	16	8	9
Upper income group	21	27	23	17	16	11	7	6

Source: The World Bank, World Development Report, Washington, D.C., 1988.

1/ See Appendix Tables 13 and 14 for country grouping.

policies. A dominant question in this regard has been how the poor could be protected from the possible adverse impact of some adjustment measures. Episodes of various targeted programs have been discussed, but the role of the government in these programs was diverse. For example, in the Latin American region, the much-publicized Emergency Social Fund in Bolivia bypassed much of the normal bureaucratic channels in government. 1/ Among the governmental programs implemented in the early 1980s, two have been often mentioned.

First, Chile's infant nutrition program (National Program for Complementary Food) aimed at using food supplements to induce mothers to bring their children to health centers for monthly checks on their nutritional status. The school lunch program aimed at maintaining adequate nutrition for school children. The implementation of these programs benefited from Chile's long history of intervention in the social sector dating back to the 1920s. The targeting benefited both from Chile's long history of intervention in the social sector and from fairly effective institutions that had existed prior to the adoption of the programs.

Second, Mexico's targeted food stamp program aimed at allowing the poor to have access to low-priced tortillas, the maize flatcakes which are the staple of the poor, thus protecting them from the increase in food prices resulting from a reduction of food subsidies. In addition, the Mexican government also expanded two existing targeted programs to distribute subsidized milk and to supply rural food stores. These programs required the establishment of a wide-scale infrastructure. 2/

2. Equity, poverty alleviation, and fiscal policy

Given the pattern of uneven distribution of income, an increase in the extent of poverty, and the nature of government programs, the critical questions are (i) how can the conditions of the poor be improved, and (ii) how fiscal policy can contribute to this improvement. In discussing these questions, one could focus on three related factors: (i) economic growth, (ii) population growth, and (iii) distribution of the gains of growth.

While all of these issues are important, we will focus on two: economic growth and distribution of the gains of growth. It is obvious that adequate growth is a necessary condition for poverty alleviation. The question is, however: is it sufficient? It is also obvious that

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1/ For a description of the Emergency Social Fund, see World Bank (1988).

2/ See World Bank (1988). There are many other episodes of targeting. For a discussion of targeting for nutrition and health in Latin America, see Pfeffermann and Griffin (1989).

distributing a large share of the increase in aggregate income to the poor would help alleviate poverty. The question is, however: would it adversely affect economic growth?

a. A stylized model of growth-poverty alleviation dynamics

These questions have both normative and positive aspects. In the following analysis, this paper focuses on two positive aspects. First, it will assess the duration required for the poor group to attain a certain level of income on the basis of alternative growth rates and redistributive policies. Second, it will discuss the relationship between redistribution and economic growth.

One way to assess the first aspect is to start from a situation resembling the present situation of the poor in the region and to ask how long it will take for a certain rate of sustained economic growth to increase their incomes to the poverty line. For this purpose, assume that the income share of the poor, say, the bottom 20 percent of the population, is 5 percent. This means that the average income of the poor is 25 percent of the average income of the entire population. Assume further that that income is 50 percent of the poverty line. The poverty line is 50 percent of the average income of the entire population. The population is growing at 2.5 percent per annum. Assume further that the government does not attempt any redistributive policy, that is, the income share of the poor groups remains at 5 percent. How many years would it take for the average poor to attain an income level equivalent to the poverty line? Table 7 suggests that it would take almost 30 years if annual economic growth were to remain 5 percent. The duration would be shortened by two thirds, to 10 years, if the pace of economic growth doubled to 10 percent (Table 7, column (1)).

This is a rather bleak picture. An annual growth rate of 10 percent appears to be virtually unattainable in the region at this time or at any time. Moreover, the goals in the simulations were rather modest in two senses. First, the assumption that the bottom 20 percent constitutes the poor population is a rather narrow definition of poverty; poverty is obviously more widespread than that. Second, even after the average poor have attained an income level equivalent to the poverty line, a substantial number of the population would still receive an income below the poverty line.

The government could attempt to pursue policies to distribute a larger share of the increase in aggregate income to the poor. For the sake of simplicity, assume that the government could carry out such policies without any political resistance or administrative costs. Table 7 indicates that on the basis of a sustained annual economic growth of 5 percent, distributing 10 percent of annual increase in aggregate income would bring the income of the average poor to a level equivalent to the poverty line in 13 years; on the basis of a sustained annual growth of 10 percent, similar policies would bring about the same result in 6 years.

Table 7. Growth, Redistribution, and Poverty Alleviation: Years Needed to Raise Income of the Average Poor to the Poverty Line 1/

Annual Growth Rate of Aggregate Income (percent)	Percentage Share of Annual Increase in Income to be Distributed to the Poor					
	(1)	(2)	(3)	(4)	(5)	(6)
	5	6	7	8	9	10
			Years			
10	10	9	8	7	6	6
9	12	10	9	8	7	6
8	14	12	10	9	8	7
7	17	14	12	11	9	8
6	21	18	15	13	12	10
5	29	24	20	17	15	13

1/ The annual rate of increase in the population is assumed to be 2.5 percent. It is also assumed that the growth rate and the distribution of the additional income of the population are independent; the average income of the poor is assumed to be 50 percent of the average income of the population; and the average income of the poor is assumed to be 25 percent of the average income of the population or 50 percent of the poverty line.

b. Equity, poverty alleviation, and economic growth

These results underscore the need to reinforce growth policies with redistributive policies in favor of the poor. Would such policies slow the pace of economic growth? The conventional analysis shows a number of channels through which more equity could reduce the pace of economic growth. First, more equal distribution of income might reduce work efforts. For example, a targeting scheme that guarantees a minimum level of income for the poor could take away any incentive to work from those whose original income was below the poverty line. Second, more equal distribution of income might reduce domestic aggregate savings and thus resources available for productive investment. Third, the administrative cost of implementing a redistributive scheme, such as programs targeted at the poor, reduces the amount of resources to be allocated for other productive investment.

The implications of income redistribution for economic growth, however, are more complicated than suggested by this conventional reasoning. The crucial reason is that the level of nutrition, health, and education may be a binding constraint of the work efforts of the poor. This is particularly true in the long run. Better nutrition, health, and education would strengthen the poor as productive units and would enhance their productivity. In some cases, better nutrition and health would enhance labor productivity even in the short run. Similarly, targeting could aim at relaxing the binding constraints of the work efforts of the poor. For example, increasing the availability of credit for the poor engaged in informal sector activities or providing employment opportunities to them would most likely enhance, rather than reduce, their productivity. The argument that equity would reduce the resources available for investment does not appear to be convincing if the increase in savings may not be invested domestically, but join the flight capital abroad (see section III). The last argument, that is, targeting requires resources that could be invested for growth, has merit, but the choice between more poverty alleviation and higher economic growth is not entirely a positive one, it involves normative judgment. Furthermore, it is not obvious that these resources would actually be invested for growth.

The conventional analysis might be correct with regard to redistributing income from the top to the middle-income groups; it may not be correct, however, with regard to redistributing income to the poor or the ultra-poor.

c. The role of fiscal policy for equity and poverty alleviation

How could the role of fiscal policy be improved for equity and poverty alleviation? There are two important ways.

First, fiscal policy should be more focused on efficiency gains for maximum growth. Fiscal policy should provide a less unstable macroeconomic environment. As discussed in section III, in Latin

America, as well as in other regions, fiscal policy has too often been a major source of shocks, instability, and uncertainties, all of which are obstacles to mobilizing domestic and foreign savings and utilizing resources for productive investment. Fiscal policy has often been a root cause of capital flight. 1/ Fiscal policy should also support more rational use of resources through appropriate structural measures. Macroeconomic stability, while promoting growth, is often crucial in protecting the poor. Both in Latin America and elsewhere, the poor are the most vulnerable to high inflation, since they are the least prepared to protect their assets and real earnings from the adverse impact of inflation. Indirectly, macroeconomic stability and the right macroeconomic policy would help the government's revenue efforts (see below). 2/ The structural role of fiscal policy should aim at providing an efficient tax system to mobilize sufficient domestic resources without causing distortions. While the effort is being made to enforce the tax law, efforts should also be made to make the tax base broader and the tax rate structure simpler and perhaps lower. 3/

Second, the government social programs should be improved to protect the poor and should be made more effectively targeted to the poor. A broadening of the tax base would be helpful in achieving a more equitable tax system. The present tax structure in Latin America relies excessively on indirect taxation, which is often more regressive than direct taxation. The reliance on a few commodities, such as alcohol and tobacco, has also been found to be adverse on some vulnerable groups. 4/ Expenditure programs should also be made more effectively focused on the poor. As indicated earlier in the section, many social programs in Latin America tend to benefit middle-income groups more than the poor. Investment in education needs to be focused more on primary than higher education. Studies suggest that both private and social rates of return to education are higher for the investment in primary education than in higher education (Table 8). 5/ Health and nutrition programs could also be made to focus more on the poor. For example, not only in Latin America, but also in many other developing countries, the investment in small-scale health clinics in both urban and rural areas has been found to be more effective in protecting the poor than large-scale medical centers. As mentioned earlier, targeting could be designed to relax the binding constraints of the work efforts of the poor, thus to enhance, rather than reduce, the productivity of the poor. Effective targeting requires a careful consideration of the cost

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1/ Ize and Ortiz (1987).

2/ Tanzi (1989).

3/ For an interesting discussion of a case for broad-based uniform taxation, see Harberger (1988).

4/ For example, an increase in the excise on tobacco or alcohol, rather than resulting in a reduction in consumption of these commodities, might alter the intra-family distribution of income and hurt women and children.

5/ For further details, see Psacharopoulos (1988).

Table 8. The Return to Investment in Education in Latin America

	Primary Education	Secondary Education	Higher Education
		(in percent)	
Social rate of return	26	18	16
Private rate of return	32	23	23

Source: George Psacharopoulos, "Education and Development: A Review," The World Bank Research Observer, Vol. 3, No. 1, January 1988.

and benefit. It also requires the establishment of effective institutions. The Chilean experience with the infant and child nutrition program has demonstrated the usefulness of an effective and efficient institution for successful implementation of targeted programs.

d. Targeting as a means of poverty alleviation

Over the long run, sustained economic growth is the only viable means of poverty alleviation. Only those countries with the record of sustained economic growth have been able to reduce absolute poverty. Across the countries that have achieved rapid economic growth, however, the record of poverty reduction differs substantially in the industrial and developing worlds. In the developing world, the inadequacy of the poverty alleviation strategy relying only on economic growth is apparent in view of the many years it takes to reduce poverty.

Currently, targeting is being intensely discussed as a means to reinforce the growth strategy to alleviate poverty. Making the present social programs more effectively targeted to the poor is an important task facing Latin American governments. However, targeting is not without problems. This paper has already mentioned the possible impact of targeting on economic efficiency, possible costs, and political constraints. Successful targeting requires the fulfillment of strict political, institutional, and economic conditions. Various studies have discussed some of these conditions. 1/

Latin American countries, in comparison with most other developing countries, have both advantages and disadvantages in fulfilling these requirements. On the one hand, as middle-income countries, many Latin American countries have relatively more domestic resources to deal with poverty than many other developing countries. On the other hand, the high debt burden and the recent economic stagnation in many countries impose serious constraints on poverty alleviation efforts. Political conflicts that would arise from major government efforts to alleviate poverty could be more serious than in other developing countries where the majority of the population is poor.

Another constraint is high inflation. The average annual inflation in the region increased from 24 percent during 1966-80 to 86 percent during 1981-86. It is generally recognized that high inflation hurts the poor more than the nonpoor at least in the short run. Any attempt to expand government poverty alleviation programs, if accompanied by a higher inflation, could actually have a net negative effect on the poor. This macroeconomic constraint to targeting or poverty alleviation is serious, particularly when the targeting programs are not effectively focused on the poor.

1/ To name a few, see Kanbur (1988); and Nelson (1988).

To illustrate this point, a simple example may be used. Suppose a country's aggregate output (or income) is 100. The government taxes and spends 20. Suppose initially that the government does not run a deficit. Suppose further that the public holds 20 of income in the form of money. The share of income for the poor is 5 percent. The price level remains constant. In this economy, suppose the government, in an effort to expand its social programs, attempted to raise expenditure by 2 by running a deficit of 2, which is monetized. With the initial money stock of 20, in the absence of a change in real output or the velocity of money, an increase of 2 in the money supply would increase prices by 10 percent. What would be the net effect of the increase of 2 in government social expenditure and the increase of 10 percent in prices? To have a meaningful discussion, two crucial parameters should be known. First, the incidence of the increase in government social expenditure should be known. Suppose that the share of 2 that goes to the poor were 25 percent, substantially higher than the overall income share of the poor. Second, the speed with which the poor's nominal income responds to inflation should be known. In this example, on the basis of the assumptions made so far, if the nominal income of the poor were to remain fixed in the short run, the increase in social expenditure would result in an increase of 0.5 in the benefit for the poor, accompanied by a reduction of a same amount in their real income. The net benefit for the poor would be higher if the speed of the increase in nominal income for the poor were faster and if the share of the poor in the increase in government social expenditure were higher.

This example illustrates both the promises and the limitations of targeting. In Latin America, for targeting to be more successful, it is crucial that macroeconomic stability be enhanced and inflation be reduced. Moreover, it is crucial that revenue efforts be improved, the success of which, in turn, depends not only on efforts to reform tax systems, but also on sound macroeconomic policy measures.

V. Summary and Conclusions

In this paper, we discussed the role of fiscal policy for stable and equitable growth in Latin America. The role of fiscal policy should be determined more by what the public sector can efficiently do than by what the public sector needs to do. The cost of maintaining the functions the state needs to perform, even when the state succeeds in minimizing the cost to perform them, often is too high to justify them.

In discussing the sources of the fiscal imbalance in Latin America, we stressed the role of the fluctuations in real interest rates and the external terms of trade. The negative real interest rates and large increase in the external terms of trade during the 1970s, together with the short time hoizons of policymakers, eroded budgetary discipline, which eventually contributed to large-scale capital flight. The end results, aggravated by the deterioration of the world financial market conditions and external terms of trade, were growing external and fiscal imbalance, which led to worsening inflation and negative growth.

The resumption of economic growth in Latin America is predicated on successful restoration of fiscal discipline and stabilization. Without fulfilling these conditions, Latin American countries would not succeed in mobilizing domestic and foreign resources. The flight capital would not return for productive domestic investment. In restoring fiscal discipline and stabilization, however, it is crucial to use policy instruments to minimize distortions. Tax reform should aim at installing a fairly simple, broad-based system (with low marginal rates) that is easy to administer and does not create obstacles to external adjustment. Expenditure programs and their raison d'etre should be justified constantly in light of the most recent fiscal developments and their implications for the budget constraint. Stabilization, although it is necessary, may not be a sufficient condition for the return of the flight capital. To induce the repatriation of the flight capital, tax provisions should be reviewed and even changes in penal provisions on capital flight might be necessary.

While economic growth is crucial for poverty alleviation in Latin America, growth alone would not be sufficient to alleviate poverty among the ultra-poor in the near future. Targeting is important as a means of alleviating poverty and possibly as a means of promoting growth. While the conventional analysis points out possible negative effects of income redistribution on work efforts and savings, targeting could not only alleviate poverty, but also encourage work efforts among the poor and their productivity.

We, however, stressed the difficulties of targeting. The budget constraint poses the most immediate constraint. The benefit of targeting for the poor could be reduced drastically if it worsened inflation and reduced their real earnings. Therefore, we stressed the importance of improving the efficiency of existing public expenditure programs, including social programs, to focus them effectively on productive activities and on the poor.

Table 9. Growth of GDP, Population, and Per Capita GDP in Latin America, 1965-85

		Annual Growth Rate of Increase							
		GDP		Population		Per Capita GDP		CPI	
		1965-1980	1981-1985	1965-1980	1981-1985	1965-1980	1981-1985	1965-1980	1981-1985
Average		5.0	0.2	2.5	2.3	2.5	-2.1	24	87
Lower middle income	(L)	4.8	0.2	2.6	2.5	2.2	-2.2	20	81
Upper middle income	(U)	5.3	0.2	2.3	1.9	3.1	-1.7	32	102
Argentina	U	3.4	-0.8	1.6	1.6	1.8	-2.4	78	326
Bolivia	L	4.5	-3.0	2.5	2.7	2.0	-5.7	16	684
Brazil	U	9.0	2.7	2.4	2.2	6.6	0.5	31	157
Chile	L	1.9	0.0	1.8	1.7	0.1	-1.7	130	20
Colombia	L	5.7	2.4	2.2	1.9	3.5	0.5	17	23
Costa Rica	L	6.2	1.3	2.6	2.4	3.6	-1.1	11	32
Dominican Republic	L	7.3	1.1	2.7	2.4	4.6	-1.3	7	16
Ecuador	L	8.1	1.8	3.1	2.9	5.0	-1.1	11	30
El Salvador	L	4.3	-1.0	2.7	1.2	1.6	-2.2	7	15
Guatemala	L	5.9	-1.2	2.8	2.9	3.1	-4.1	7	11
Honduras	L	4.2	0.6	3.2	3.6	1.0	-3.0	6	5
Jamaica	L	1.3	0.0	1.5	1.5	-0.2	-1.5	13	20
Mexico	U	6.5	0.4	3.1	2.2	3.4	-1.8	13	64
Nicaragua	L	2.6	0.2	3.1	3.4	-0.5	-3.2	9	57
Panama	U	5.5	2.6	2.6	2.2	2.9	0.4	5	3
Paraguay	L	6.9	1.1	2.8	3.2	4.1	-2.1	9	19
Peru	L	3.9	-0.4	2.8	2.3	1.1	-2.7	21	100
Uruguay	U	2.4	-2.6	0.4	0.4	2.0	-3.8	58	50
Venezuela	U	5.2	-0.9	3.5	2.9	1.7	-3.8	9	9

Source: The World Bank, World Development Report, Washington, D.C., 1988.

Table 10. Structure of Demand in Latin America, 1965 and 1986

		Government Consumption		Private Consumption		Domestic Investment		Domestic Savings	
		1965	1986	1965	1985	1965	1986	1965	1986
Average		10	14	69	73	17	16	17	13
Lower income group (L)		10	14	75	77	18	17	15	13
Upper income group (U)		11	14	67	67	19	15	22	19
Argentina	U	8	12	69	77	19	9	22	11
Bolivia	L	9	10	74	85	22	8	17	5
Brazil	U	11	n.a.	67	76	20	21	22	24
Chile	L	11	13	73	69	15	15	16	18
Colombia	L	8	12	75	68	16	18	17	20
Costa Rica	L	13	17	78	59	20	23	9	24
Dominican Republic	L	19	8	75	80	10	18	6	12
Ecuador	L	9	12	80	68	14	20	11	20
El Salvador	L	9	14	79	79	15	13	12	7
Guatemala	L	7	7	82	84	13	11	10	9
Honduras	L	10	17	75	70	15	17	15	13
Jamaica	L	8	15	69	65	27	19	23	19
Mexico	U	7	10	72	64	22	21	21	27
Nicaragua	L	8	45	74	57	21	19	18	-2
Panama	U	11	22	73	57	18	17	16	21
Paraguay	L	7	7	79	87	15	24	14	7
Peru	L	10	11	59	71	34	20	31	18
Uruguay	U	15	14	68	73	11	8	18	13
Venezuela	U	12	13	54	66	24	20	34	21

Source: The World Bank, World Development Report, Washington, D.C., 1988.

Table 11. Size Distribution of Income in Selected Latin American Countries, 1960s through 1980s

	Early 1960s		Early 1970s		Early 1980s	
	Lowest 20%	Top 20%	Lowest 20%	Top 20%	Lowest 20%	Top 20%
Average	4	59	3	57	5	48
Argentina	7	52	4	50	n.a.	n.a.
Bolivia	n.a.	n.a.	4	59	n.a.	n.a.
Brazil	4	54	3	62	2	64
Colombia	3	64	n.a.	n.a.	n.a.	n.a.
Dominican Republic	n.a.	n.a.	n.a.	n.a.	5	56
El Salvador	6	61	n.a.	n.a.	6	47
Guatemala	n.a.	n.a.	n.a.	n.a.	5	56
Jamaica	2	62	n.a.	n.a.	n.a.	n.a.
Mexico	4	59	n.a.	n.a.	4	54
Nicaragua	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Panama	5	57	2	62	n.a.	n.a.
Peru	4	64	2	61	6	28
Uruguay	n.a.	n.a.	n.a.	n.a.	6	29
Venezuela	3	58	3	54	n.a.	n.a.

Source: Vito Tanzi, "Redistributing Income Through the Budget in Latin America," Banca Nazionale del Lavoro Quarterly Review, Volume XXVII, 1974 (Nos. 198-111), pp. 5-87; United Nations, National Accounts Statistics: Compendium of Income Distribution Statistics, Statistical Papers, Series M, No. 79, New York, 1985; and The World Bank, World Development Report, Washington, D.C., 1988.

Table 12. Basic Needs Indicators in Latin America, 1965-85

		Daily Calorie Supply Per Capita			Crude Death Rate			Primary School Enrollment		
		1965	1980	1985	1965	1981	1985	1965	1980	1985
Average		2,310	2,445	2,532	12	9	8	93	102	104
Lower middle income (L)		2,172	2,318	2,416	13	9	8	89	100	103
Upper middle income (U)		2,607	2,719	2,783	10	8	9	101	109	108
Argentina	U	3,209	3,494	3,216	9	9	9	101	116	108
Bolivia	L	1,868	2,084	2,171	21	16	14	73	84	91
Brazil	U	2,405	2,447	2,657	11	8	8	108	93	104
Chile	L	2,591	2,790	2,544	11	7	6	124	117	109
Colombia	L	2,174	2,529	2,588	14	8	7	84	128	117
Costa Rica	L	2,366	2,766	2,807	8	9	4	106	108	101
Dominican Republic	L	1,870	1,980	2,530	13	8	7	87	108	124
Ecuador	L	1,942	2,181	2,005	13	9	7	91	107	114
El Salvador	L	1,859	2,031	2,155	13	8	9	82	74	70
Guatemala	L	2,028	2,045	2,345	17	10	9	50	69	76
Honduras	L	1,963	2,171	2,224	17	11	8	80	89	102
Jamaica	L	2,232	2,624	2,578	8	6	6	109	99	106
Mexico	U	2,643	2,791	3,126	11	7	6	92	120	115
Nicaragua	L	2,398	2,135	2,464	16	11	9	69	100	101
Panama	U	2,255	2,163	2,423	9	5	5	102	113	105
Paraguay	L	2,627	2,741	2,873	8	7	6	102	102	101
Peru	L	2,324	2,057	2,120	16	11	10	99	112	122
Uruguay	U	2,811	2,896	2,791	10	10	10	106	105	110
Venezuela	U	2,321	2,525	2,485	8	6	5	94	104	108

Source: The World Bank, World Development Reports, Washington, D.C., 1983, 1988.

Table 13. Central Government Current Revenue in Latin America, 1972 and 1986

		Current Revenue in percent of GNP		Share in Total Current Revenue: Taxes on income and profit		Share in Total Current Revenue: Domestic taxes on goods and services		Share in Total Current Revenue: Taxes on international trade	
		1972	1986	1972	1986	1972	1986	1972	1986
Average		17	21	18	21	25	31	24	17
Lower middle income (L)		16	19	15	20	29	32	30	21
Upper middle income (U)		19	25	23	23	19	31	14	10
Argentina	U	15	23	0	5	0	37	33	15
Bolivia	L	8	3	15	7	31	14	46	29
Brazil	U	19	27	20	18	35	16	8	2
Chile	L	30	32	14	12	29	44	14	9
Colombia	L	11	n.a.	37	n.a.	16	n.a.	20	n.a.
Costa Rica	L	16	25	18	11	38	28	18	21
Dominican Republic	L	19	13	18	19	19	34	40	34
Ecuador	L	14	18	20	65	19	14	52	17
El Salvador	L	12	15	15	20	26	32	36	41
Guatemala	L	19	n.a.	13	n.a.	36	n.a.	26	n.a.
Honduras	L	13	n.a.	19	n.a.	34	n.a.	28	n.a.
Jamaica	L	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Mexico	U	10	18	36	24	32	67	13	4
Nicaragua	L	13	40	10	14	37	48	24	7
Panama	U	22	28	23	23	13	15	16	11
Paraguay	L	12	10	9	12	26	26	25	11
Peru	L	16	13	17	22	32	47	16	23
Uruguay	U	23	24	5	8	24	44	6	14
Venezuela	U	22	32	54	58	7	5	6	15

Source: The World Bank, <u>World Development Report</u>, Washington, D.C., 1988.

Table 14. Central Government Fiscal Expenditure in Latin America, 1972 and 1986

		Total Expenditure in Percent of GNP		Selected Social Expenditure					
				Total		Education expenditure		Health expenditure	
		1972	1986	1972	1986	1972	1986	1972	1986
Average		20	24	26	21	19	13	7	7
Lower middle income (L)		20	20	29	25	22	16	8	9
Upper middle income (U)		21	27	23	17	16	11	7	6
Argentina	U	20	26	20	7	20	6	0	1
Bolivia	L	10	32	37	13	31	12	6	1
Brazil	U	17	26	15	9	8	3	7	6
Chile	L	43	34	22	19	14	13	8	6
Colombia	L	13	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Costa Rica	L	19	29	32	35	28	16	4	19
Dominican Republic	L	20	15	26	22	14	13	12	9
Ecuador	L	13	16	32	32	27	25	5	7
El Salvador	L	13	13	32	25	21	17	11	8
Guatemala	L	10	n.a.	n.a.	n.a.	19	n.a.	10	n.a.
Honduras	L	15	n.a.	n.a.	n.a.	22	n.a.	10	n.a.
Jamaica	L	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Mexico	U	12	27	21	13	16	12	5	1
Nicaragua	L	16	56	n.a.	17	n.a.	n.a.	4	n.a.
Panama	U	28	32	36	32	21	16	15	16
Paraguay	L	13	8	16	15	12	12	4	3
Peru	L	17	14	n.a.	n.a.	23	n.a.	6	n.a.
Uruguay	U	25	25	21	28	10	7	2	5
Venezuela	U	21	27	21	28	19	20	12	8

Source: The World Bank, World Development Report, Washington, D.C., 1988.

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