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WP/89/94

INTERNATIONAL MONETARY FUND

Fiscal Affairs Department

Fiscal Policy and Economic Reconstruction in Latin America\*

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November 2, 1989

Abstract

This paper surveys the fiscal landscape of Latin America. It analyzes external and domestic factors that over the years led to the deterioration of the fiscal accounts. It also discusses difficulties that are encountered in pursuing a sound fiscal policy under inflationary conditions. Issues such as the connection between external debt and fiscal policy and the role of public investment are also discussed. General guidelines are provided for a fiscal policy for the economic reconstruction of Latin America.

JEL Classification Numbers:

120, 320

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\* Paper presented at the conference on "Economic Reconstruction in Latin America," Getulio Vargas Foundation, Rio de Janeiro, August 7-8, 1989. It will be published in a conference volume edited by Rudiger Dornbusch and Fernando de Holanda Barbosa. The views expressed are strictly personal and do not necessarily reflect official Fund positions. I wish to thank Isaias Coelho, Ildefonso Guajardo, Alain Ize, Desmond Lachman, Claire Liuksila, Claudio Loser, A. Premchand, Eric Sidgwick, Peter Stella, and Teresa M. Ter-Minassian for comments and/or assistance on various parts of this paper, and Sonia A. Piccinini for excellent typing.

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### Summary

Fiscal policy has played a large role in bringing about the economic problems of Latin America. It must also play a major role in any program of economic reconstruction of the region. This paper is made up of four relatively self-contained parts. Section I provides an introduction. Section II outlines the current economic situation and the role that fiscal policy has played over the past two decades. It discusses external factors--changes in the real rate of interest and in the terms of trade--and domestic factors--changes in technical standards for screening investment projects, expansion of public sector activities, and so forth--which contributed to the fiscal deterioration. It is shown that public investment rose sharply during 1975-81 and fell afterward. However, private investment, which had not increased during 1975-81, fell much more than public investment afterward. The paper attributes this fall in private investment to the deteriorating economic environment and to the increased uncertainty regarding future policy. The growth of domestic debt and the connection between external debt and capital flight are discussed.

Section III outlines various difficulties faced by policymakers in promoting a sound fiscal policy, especially in periods of high inflation. These difficulties are related to (a) the high cost of fiscal actions, (b) conceptual problems, (c) statistical limitations, (d) inadequate government financial management systems, and (e) rising "fiscal tension."

Section IV outlines some general guidelines for fiscal restructuring. It discusses actions that could be taken on the spending side and on the revenue side. It argues that in view of the high interest rates that these countries must pay on their domestic debts, reductions in public spending have become much more urgent. External debt reductions are very important if they (a) do not weaken a country's determination to pursue more restrictive fiscal policies, and (b) reduce future uncertainty about the amount of debt servicing. This section also argues that in order to enhance the future prospects of these countries, it is far more important to reduce uncertainty as to the sustainability of good policy than to engage in additional public investment. Private investment is more likely to be deterred by a climate of uncertainty than by low current public investment. If uncertainty were reduced, repatriated flight capital could become an important source of private investment. Trying to raise domestic private saving without reducing uncertainty is likely to prove disappointing, since saving would likely become flight capital. Actions that can be taken on the revenue side to improve public finances are also discussed.



## I. Introduction

In recent years fiscal policy has been attracting a lot of attention by economists and policymakers. Especially for Latin America, there is now a widely-accepted belief that fiscal policy played a very important role in bringing about the economic problems that now characterize this region. It is also a generally accepted assumption that improvements in the public finances of the Latin American countries will be required if these countries are to pull out of the recent economic difficulties.

This paper deals with fiscal policy from three different but related angles. First, in Section II, it briefly, and somewhat informally, outlines the fiscal background to the current economic situation. Just what role did fiscal policy play? Was it a passive or an active role? Was it the central role, or were there other forces, perhaps external forces, that were equally, or perhaps more, important? How did these forces help shape fiscal policy? The discussion focuses on the region as a whole rather than on specific countries. However, given the importance of Argentina, Brazil, and Mexico, examples from these countries will often be used to support specific positions.

Section III discusses the difficulties faced by the policymakers of these countries in pursuing a successful fiscal policy. Perhaps much of what is contained in this section is generally known. However, the importance of some of the points made is not fully appreciated. This section highlights especially those difficulties that arise in situations of high inflation.

Sections II and III are diagnostic sections. Section IV is a policy-oriented section. It outlines some of the fiscal measures that these countries could take to promote growth with stability. The discussion in this section is inevitably general. Specific or detailed fiscal advice can only be given on a case-by-case basis taking into account the strength and weakness of each country's administrative setup, the priorities that policymakers attach to various objectives, the country's external debt situation, and so forth.

This paper does not deal specifically with the external debt situation. However, since external debt is an important issue in Latin America, and since it is closely interconnected with its public finances, a paper dealing with fiscal policy in Latin America cannot fail to touch on the question of the external debt.

## II. Fiscal Policy and the Current Economic Situation

### 1. The current economic situation

The decade of the 1980s is at times characterized as "the lost decade." This characterization may be misleading for some regions, say, Asia, but it may be appropriate for Latin America. This region has seen its annual rate of growth fall dramatically from the 1970-80 period, when GDP rose at an annual rate of 5.9 percent, to the post-1980 period, when it fell to very low or even negative figures especially on a per capita basis. The rate of inflation, that important index of economic difficulty, has also moved in the wrong direction, and by considerable amounts. While the inflation rate, as measured by the CPI index, averaged 39.8 percent per year for the region in the 1971-80 period, it rose to 126 percent for the 1981-88 period and has reached very high rates indeed in the most recent period in some important Latin American countries such as Argentina and Brazil. In 1988 the average for the region was 277.6 percent and, in some countries, the inflation rate has reached levels generally associated with hyperinflation.

External debt has become a household word. While in the pre-1982 period it was an arcane subject for a few specialists, it is now a major topic at summits of world leaders. For the developing countries of the Western Hemisphere the external debt reached US\$288.8 billions in 1981 and rose further to US\$412.2 billion by 1988. In 1988 this external debt was 305 percent of the region's exports of goods and services and the debt service payments amounted to 42 percent of exports of goods and services. Since 1983 the external debt has fluctuated around 46 percent of the region's total GDP. 1/

### 2. The need for adjustment

Just as individuals and families, countries face resource constraints: over the long run and in the absence of net transfers from abroad, they cannot spend more than they produce. When they try, the inevitable consequence is inflation and/or external payments difficulties. The essence of adjustment is the bringing of a country's spending in line with its income. If adjustment is accompanied by greater income generation (because of the removal of distortions); or, if it is accompanied by less foreign spending (perhaps because of voluntary debt reduction); or, if it is accompanied by the repatriation of some flight capital or by increased foreign investment, it can be consistent with an increase in domestic spending over time. In other

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1/ All the above information comes from the IMF, World Economic Outlook, April 1989. The 46 percent figure quoted above is held down by the economic weight of Brazil and by its relatively low debt/GDP ratio. For most other countries, the ratio was much higher and for some (Bolivia, Chile, Costa Rica, Jamaica), in 1988, it exceeded 100 percent.

words, if adjustment policies are well conceived and properly carried out, they should increase the country's permanent income, even when they require a reduction in its domestic spending in the short run.

The public sector's counterpart of the balance of payment constraint is the budget constraint. The fiscal problem, which arises when public spending, including the servicing of the foreign debt, exceeds 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. Thus, fiscal adjustment is a prerequisite to economic stability.

In Latin America, fiscal problems did not appear overnight, but were the end result of both external and domestic developments over many years. Two important external developments were the changes, between the 1970s and the 1980s, in the real rate of interest in international capital markets and in the terms of trade.

### 3. External factors in the fiscal deterioration

Between the 1970s and the 1980s, the real rate of interest turned sharply from negative to positive values. 1/ This sharp increase raised the cost of servicing the growing external debt that had become very large by the early 1980s. 2/ Furthermore, since the real rate of interest came to exceed the rate of growth of the economies, it put those economies on a dynamically precarious trend. Real interest rates in the post-1974 period and until the early 1980s were extraordinarily low by historical standards and foreign credit was easily available. As a World Bank study on Brazil put it: "At the time, Brazil faced a completely elastic supply of long-term loans at negative real interest rates in the world financial markets" (Martone, 1987, p. 4). In most countries these low rates encouraged large-scale borrowing by public sector entities and contributed to an expansion of the public sector. Public spending, and especially public investment, increased faster than GDP. 3/

Given the fact that the borrowers were often hundreds of public sector entities while the lenders were thousands of foreign banks and that this borrowing was largely uncoordinated and unmonitored, it was no

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1/ Between 1975-80 and 1981-86 the real LIBOR rate rose by almost 6 percentage points. The increase was much sharper if adjusted for changes in dollar export prices.

2/ For example, in Mexico the foreign debt rose from US\$3 billion in 1970 to US\$85 billion in 1982. In Brazil it rose from US\$5 billion in 1970 to US\$70 billion in 1982.

3/ Of course, the trends diverge from country to country. In countries which were major oil importers, such as Brazil, the difficulties began to appear before 1982.

surprise that the stock of debt increased much beyond the level which would have been considered prudent. The debt crisis of 1982 caught many by surprise. Only in later years were many countries able to add up these debts and get a concrete idea of the magnitude of their total external indebtedness. The latter often turned out to be much larger than expected. <sup>1/</sup> These large debts, combined with the sharply higher real interest rates in the 1980s, created serious difficulties for both the external and the fiscal sectors of these countries. Fiscal deficits grew and difficult-to-finance external and domestic imbalances became common. At this time the supply of foreign loans became quite inelastic.

During the 1971-80 period, the terms of trade for the region improved by 55 percent, while for the 1981-89 period, they declined by 26 percent. <sup>2/</sup> The index of the terms of trade, with 1970 equal to 100, reached 155 in 1980, but fell to 115 in 1989. <sup>3/</sup> Since the fiscal accounts of many Latin American countries are strongly influenced by direct earnings of publicly-owned resources, or by taxes levied directly or indirectly on foreign trade, the deterioration in the terms of trade in the 1980s affected the fiscal situation in many of these countries. The rents that the public sector could extract from either the exports of its own resources or from the taxation of the exports by the private sector were no longer sufficiently large to finance its own domestic and foreign commitments, especially since these had been inflated by the many public sector programs introduced in the 1970s, and by the need to service the large and more costly external debt.

#### 4. Domestic factors in the fiscal deterioration

In addition to these external developments, some domestic developments deserve mention. Policymakers tend to focus on the short run; they discount heavily costs and benefits that are likely to occur more than a few months down the line. Faced with cheap foreign credit, rising prices for their basic exports, and pressing social needs or political pressures that could apparently be ameliorated through higher public spending, policymakers found it difficult to worry about the time in the (possibly distant) future when (i) real interest rates might regain their historical levels (or, as it happened, might exceed them by a good margin), (ii) the terms of trade might reverse themselves, and (iii) creditors would present their due bills. Furthermore, it would be

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<sup>1/</sup> Between 1978 and 1982 net capital inflow in Latin America was US\$143 billion. See Comisión Económica para América Latina y el Caribe (1988), Balance Preliminar de la Economía Latino Americana, Table 15.

<sup>2/</sup> Calculated on the basis of information available in the World Economic Outlook of the IMF (April 1989). Again, the terms of trade started declining sharply before 1980 in some oil-importing countries such as Brazil.

<sup>3/</sup> Actually it fell even more if instead of 1989 an earlier year were taken.

some other policymakers who would have to deal with that unpleasant prospect. 1/ Furthermore, some policymakers and economists believed that part of the public expenditure (especially that for fixed investment and possibly that for education and health) would be self financing in the longer run. Thus, public spending generally rose, accompanied by an expansion in the number of public sector employees.

Cheap foreign credit also lowered the technical standards applied for screening investment projects. A cost-benefit evaluation that assumes negative real rates of interest over the life of a project and exaggerates the benefits on social grounds (employment creation, national security, income redistribution, self-sufficiency) is likely to approve projects that later, when real interest rates went up, would be judged to have been poor choices. Various types of evidence indicate that a high proportion of the public sector investment made in the 1975-82 period was of questionable quality. For sure, the capital-output ratio increased considerably during this period.

The already precarious fiscal situation of the Latin American countries deteriorated further in the 1980s. The Government Finance Statistics Yearbook of the IMF indicates that for the region as a whole the fiscal deficit of the central government rose sharply after 1980. This increase was caused more by an increase in public spending than by a fall in revenue. 2/ By and large, and with considerable difficulties, the Latin American countries managed to maintain over time the level of public sector revenue. 3/ The level of spending as a share of GDP rose significantly after 1980. In this period capital expenditure of the public sector fell somewhat while interest payments on the external debt rose sharply. The fall in capital expenditure has attracted considerable attention. This fall is discussed in the next subsection.

##### 5. Fiscal deterioration and public investment

Table 1 provides some information on the behavior of public investment in the 1980s for six major Latin American countries. Two observations can be made.

First, over the 1980-87 period, there was a considerable fall in public investment for most of the Latin American countries. Aggregating the figures indicates that public investment as a share of GDP fell by about 2 percentage points between 1981 and 1987. If instead of using

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1/ One could advance the hypothesis that in countries where the same policymakers expect to remain in power for a long time, the implicit rate of discount of future costs and benefits would be lower.

2/ Similar conclusions are obtained from other statistical sources.

3/ This statement is broadly correct if one looks at the behavior of the tax ratio over the long run. However, there were considerable short-run falls in the tax revenue to GDP ratio especially when inflation accelerated.

Table 1. Public Investment in Selected Latin American Countries, 1980-87

(In percent of GDP)

	1980	1981	1982	1983	1984	1985	1986	1987
Argentina	9.2	9.4	8.1	9.5	7.6	6.8	7.0	8.4
Brazil	8.0	9.0	8.7	6.4	6.0	6.2	6.2	6.9
Chile	5.4	5.2	4.8	4.9	6.3	6.9	7.6	6.9
Colombia	7.6	8.6	9.4	8.9	9.0	9.6	8.6	7.9
Mexico	10.9	11.7	10.4	7.6	7.1	7.0	6.1	5.4
Venezuela	<u>12.3</u>	<u>14.6</u>	<u>16.5</u>	<u>14.6</u>	<u>7.7</u>	<u>9.0</u>	<u>12.4</u>	<u>12.2</u>
Average <u>1/</u>	8.9	9.8	9.7	8.7	7.3	7.6	8.0	8.0

Source: Table based on information reported in Guy P. Pfeffermann and Andrea Madarassy, "Trends in Private Investment in Thirty Developing Countries," International Finance Corporation, Discussion Paper No. 6 (The World Bank: Washington D.C., 1989).

1/ This is the simple (unweighted) average.

public sector statistics, central government statistics had been used, the fall would have appeared more pronounced indicating that central governments, which had to meet the rising interest obligations, were forced to restrain controllable spending more than the rest of the public sector.

Second, to the extent that the interest payments (both domestic and foreign) contained some elements of amortization, part of these expenditures could be classified as "capital expenditure" even though they are not associated with the building of tangible capital. Domestic interest payments clearly contain a large element of amortization because of the high inflation rate. However, it is often forgotten that the same is true to a much lesser extent for interest payments on the external debt since the inflation rate has been well over zero especially in the United States.

Table 2 provides additional information on the behavior of public investment for the 1970-87 period. It divides that period into three subperiods, 1970-74, 1975-81, and 1982-87. The second of these periods was characterized for the most part by very low real interest rates in the international capital market while the 1982-87 period was characterized by very high real rates, falling terms of trade and difficulties in servicing external debts. The table also shows information on private investment.

As it has been widely reported, there is a clear fall in public investment, as a share of GDP between the 1975-81 and the 1982-87 periods. However, if the reference period for comparison is not 1975-81, when public investment had risen sharply, but 1971-74, no fall is witnessed. Rather, by and large there was even an increase. This is an important point that should be kept in mind for the policy section.

The real dramatic fall occurs in private and not in public investment. Whether we compare the 1982-87 average of 9.0 percent of GDP with the average for the 1975-81 or with that for the 1970-74 periods, the fall is approximately the same: 4 to 5 percent of GDP. Once again, differences among the countries must be kept in mind. The large fall in private investment is likely to indicate that expectational factors and domestic distortions must have played a major role in depressing private investment. <sup>1/</sup> If these factors had not played such a role, the large capital assets held abroad by Latin American nationals could easily have been a major source of domestic investment. Given their assessment of future prospects for these economies, the citizens of these countries must have assumed that they could maximize their long-run returns by investing their money abroad rather than domestically. For this reason, it is not productive to look at the decline in the saving rate of the region as an explanation of the decline in the rate of private investment. A better explanation is

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<sup>1/</sup> On the role of expectation, see especially (Blejer and Ize, 1989).

Table 2. Public and Private Investment in Selected Latin American Countries, 1970-87

(In percent of GDP)

	1970-74	1975-81	1982-87
	<u>Public Investment</u>		
Argentina	8.0	10.8	7.7
Brazil	5.6	10.2	6.7
Chile	8.4	6.8	6.2
Colombia	6.0	6.9	8.9
Mexico	6.5	9.4	7.3
Venezuela	<u>7.1</u>	<u>13.6</u>	<u>12.0</u> <sup>1/</sup>
Average <u>2/</u>	6.9	9.6	8.1
	<u>Private Investment</u>		
Argentina	12.1	13.3	7.0
Brazil	18.4	14.4	11.1
Chile	6.0	12.1	7.1
Colombia	13.5	11.5	10.3
Mexico	12.6	13.1	12.1
Venezuela	<u>16.0</u>	<u>17.6</u>	<u>6.4</u> <sup>1/</sup>
Average <u>2/</u>	13.1	13.7	9.0

Source: Same as Table 1.

<sup>1/</sup> 1982-86.

<sup>2/</sup> Simple averages.

provided by the decline in the expected rate of return to domestic investment. 1/

6. Fiscal deterioration and the growth of domestic debt

In several countries the debt crisis brought with it an acceleration of inflation and, as a consequence of collection lags and other factors, a tendency for real tax revenue to fall. Governments had to use an increasing share of their political capital to neutralize this effect in order to maintain constant the level of revenue through discretionary and ad hoc measures. This made it all the more difficult to introduce tax reform that would increase the ratio of tax revenue to GDP. Stabilization policy became much more difficult because of the uncertainty created by the debt overhang, by the high rate of inflation, and by the continuous "tension" in the fiscal area. 2/ The need to generate a trade surplus to service the external debt often required sharp devaluations. These devaluations were not accompanied by sufficiently restrictive monetary and fiscal policy to hold down the price level. Consequently, at times they became engines of inflation. 3/

Given (a) the relative inflexibility of much noninterest (and noninvestment) government spending, (b) the growth of interest payments on the external debt, and (c) the difficulty to raise the tax ratio, the reduction in the availability of foreign capital after the debt crisis of 1982 induced many of these countries to increase their dependence on domestic borrowing. 4/

Data on domestic public debt are difficult to assemble; however, the information available indicates that in recent years it has been growing, as a share of GDP, in many Latin American countries. 5/ Since (a) domestic savings are low and declining, (b) implicit and/or explicit taxes on financial intermediation are often high, and (c) the inflationary environment and other uncertainties have made individuals reluctant to invest in domestic financial assets, the real interest rates that governments have to pay on the domestic debt tend to be much

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1/ For a theoretical analysis of the relationship between policy uncertainty and private investment in developing countries, see (Rodrik, 1989). For a general discussion, see (de Simovich and Koper, 1989).

2/ The term "tension" is defined later.

3/ The increase in the world real interest rate may have been a direct cause of at least a share of the total increase in inflation in Latin America (see Melnick, 1988). It has also been argued that the slowdown in the growth rate had inflationary implications (see Melnick and Sokoler, 1984).

4/ Net annual external borrowing of developing countries from the Western Hemisphere fell from US\$57.1 billion in 1981 to US\$7.4 billion in 1985. For 1988 it is estimated at only US\$3.2 billion.

5/ For example, in Brazil it has risen from 6.0 percent of GDP in 1980 to 20.9 percent in 1988.

higher, in real terms, than what they used to pay on foreign debt. From a fiscal point of view, domestic financing is very expensive financing. This implies that the cost of providing public services has risen sharply. High real interest rates also sharply increase the rate of return that private investments must generate. Thus, they discourage private investment. And, of course, when interest rates are high, it becomes progressively more difficult to keep the fiscal deficit under control.

The greater is the divergence between the rate of interest that must be paid on domestic debt, measured in terms of dollars, and the rate of interest on the foreign debt, the more difficult and costly it becomes to service the foreign debt through domestic borrowing. In some Latin American countries, governments have at times had to pay interest rates which measured in dollars were many times the LIBOR rate. This implies that in these situations debt reductions that resulted in reduction in net transfer abroad would substantially improve the fiscal situation. It also implies that tax reforms or cuts in noninterest expenditure that leave a "primary surplus" large enough to meet the foreign obligations are highly desirable.

To induce individuals to hold larger stocks of government debt, in addition to paying higher real rates, governments have pursued other policies with fiscal and macroeconomic implications. 1/ They have, for example:

(a) Shortened the maturity of the debt. As inflation accelerated, the maturity of the fiscal instruments became progressively shorter. As a consequence, government bonds became close substitutes for money. In some countries there are now bonds with one-day maturity. These bonds have become, essentially, indexed money. The growth of these financial instruments reduces the demand for money thus leading to stronger inflationary pressures. 2/

(b) Provided fiscal advantages to these bonds thus eroding the revenue basis.

(c) Forced some financing of the debt by public and private enterprises, by banks, and by social security institutions. The "forced saving" program of Argentina is an example of this approach. Of course, the money so used has not been available for investment.

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1/ Uncertainty about the future has induced many Latin American nationals to hold dollar bills, that pay no explicit interest, in preference to high yielding government securities.

2/ This means that the financing of a given fiscal deficit becomes progressively more inflationary.

7. External debt and capital flight

The external debt was accumulated in the process of financing (i) increases in domestic consumption, (ii) some good investments, (iii) many bad investments, and (iv) capital outflow. 1/ The capital outflow was, at least in part, stimulated by the perception that the current economic policies were not sustainable over the longer run and that inevitably the accumulation of debt would be followed by an increase in the tax burden and by other economic (and political) difficulties. 2/

Of the uses of the resources obtained through foreign borrowing, only the investment in efficient projects would generate a domestic future stream of income, which would help in servicing the external debt. This would be particularly so if the projects were in the tradeable sector. The capital that migrated is a potentially important asset which, given the high real rates of interest that have characterized the 1980s, must have been growing at a much faster rate than the gross domestic products of the Latin American economies. In time and under favorable circumstances it could make a substantial contribution to stabilization and growth in Latin America, especially if external debt does not increase or, because of debt reduction, if it falls as a share of GDP. In other words, the capital held abroad by Latin American citizens could become a progressively larger proportion of the external debt of these countries, thus facilitating a solution to the debt crisis. 3/ However, as long as the economic and political situation remains unstable, and as long as major distortions remain in these economies, this capital is unlikely to return except for sustaining the consumption standards of the families that own it. 4/

The higher are interest rates in the United States and the more attractive is the tax treatment of this capital in that country, the

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1/ Of course, investments that proved to be bad ones ex post may have appeared viable ones on the basis of the conditions that prevailed at the time they were made.

2/ A Fund study has estimated that capital flight from Western Hemisphere countries amounted to \$107 billion for the period between end-1974 and end-1985. See Deppler and Williamson (1987). Morgan Guarantee has estimated that, at the end of 1987, \$159 billion was held abroad by Latin American citizens.

3/ It would be interesting to calculate the current value of this capital assuming that it was left to grow at prevailing high interest rates and generally free of taxes. The value of this capital is now likely to exceed the "market" value of the foreign debt of the Latin American countries. For some calculations related to Argentina, see (Rodriguez, 1988).

4/ If consumption is the ultimate aim of all economic activity, flight capital will be eventually consumed either abroad or at home. If the owners do not migrate, much of it will have to return.

less incentive, *ceteris paribus*, will its owners have to repatriate it, especially if its explicit repatriation may lead to penalties for tax evasion and other legal violations. <sup>1/</sup> High real rates in Latin America would induce this capital to come back only if they could be guaranteed for a long period of time or if they were expected to remain high over the long run. Since most financial instruments have very short maturity, and real interest rates have fluctuated wildly, the pull provided by high rates is limited. The "illiquidity" in dollar terms of these instruments may also play an important role. Should anything happen, investors will not be able to withdraw the money from the country, given the balance of payment constraint. Thus, in spite of the very high interest rates, many will prefer to wait outside the country for the moment when expectations improve. Premature repatriation may prove to be very costly.

The orderly servicing of the external debt requires two types of transfers: (i) the releasing of resources by the private sector to the public sector, since much of the external debt is publicly held, and (ii) the transfer of resources to foreign creditors by the public sector. In other words, a net positive change in the fiscal balance must accompany the improvement in the trade account required to make the foreign payment. <sup>2/</sup> Or, putting it differently, the government, which must service the foreign debt, must be able to buy from the private sector the dollars generated by the trade surplus. The additional transfer from the private to the public sector can occur through (i) higher taxation, (ii) a reduction in noninterest public expenditure, (iii) voluntary lending by individuals to the state, (iv) involuntary lending by individuals to the state, and (v) inflationary finance. All of these alternatives have costs, and the minimization of these costs must be the guiding principle of fiscal policy. However, as already argued, these costs are likely to be much lower in connection with (i) and (ii) than in connection with the three other alternatives. Some of the possibilities are assessed in Section IV. Debt reductions, as proposed by the Brady initiative, by reducing the needed transfers abroad, would facilitate the process provided that they do not weaken economic discipline.

### III. Selected Implementation Problems

The next section will present some general fiscal guidelines that the policymakers of the Latin American countries can follow in their pursuit of growth with stability. That "advice" will inevitably be influenced by second-best considerations. The advice that one would give in a situation of high inflation and low growth is likely to be

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<sup>1/</sup> For the relationship between U.S. tax laws and capital flight from Latin America, see (McLure, Jr., 1988).

<sup>2/</sup> On this issue, see, *inter alia*, Reisen and van Trotsenburg (1988); and Polak (1989), especially Chapter 5. See also Bacha (1989).

different from the advice one would give to, say, Korea or other economically successful countries.

In this section a few problems that many Latin American policymakers face when they attempt to pursue a fiscal policy conducive to stability and growth are briefly addressed. These problems render economic policymaking very difficult. They help explain why it is so difficult for some of these countries to agree on a precise fiscal policy to be followed. Some of these difficulties would exist even in the absence of economic instability, but they are certainly aggravated by it.

#### 1. Cost of fiscal actions

When countries are undergoing situations characterized by high economic instability and inflation, it will often become progressively more costly, politically and administratively, to pursue policies that just aim at preventing the situation from getting worse. Let us take a few examples. In a situation of price stability it is relatively costless, in a political and administrative sense, to maintain constant the real prices charged by public enterprises. In this situation, this objective can be achieved by simply doing nothing. When the rate of inflation rises to a high level, however, it becomes progressively more difficult to do so. Any nominal increase in public utility tariffs, even when it just compensates with a lag for the rise in the general price level, will be resisted by the public. Demonstrations, even violent ones, to prevent these increases are unfortunately common. The political difficulty encountered in making the frequent adjustments in prices to keep them constant in real terms, together with the perennial and misguided hope that holding down these prices will somehow reduce the rate of inflation explain why public enterprises often become a big problem in situations of high inflation. 1/

Just how distorted these prices can become in a relatively short period of time can be seen in Table 3 which refers to Argentina's main public enterprises. The table covers the period between June 1985 and June 1989.

The same situation arises with excise taxes that are for the most part ad rem. Just to maintain these taxes constant in real terms requires the increasing use of political capital as the rate of inflation rises.

It is well known that collection lags lead to falls in tax revenue under inflation (see Tanzi, 1977). Some economists have dismissed this effect on the ground that high inflation countries, such as Argentina, Brazil, and Mexico, have somehow managed to maintain, over the longer run, the ratio of tax revenue to GDP. What is ignored is the high

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1/ A formal indexation of these prices is likely to help.

Table 3. Argentina: Real Public Utility Tariffs, 1985-89

(Constant values: 1980 = 100)

Public Enterprises	1985 June	1987 Dec.	1988 Aug.	1988 Dec.	1989 June
Y.P.F.	179.2	135.9	169.0	154.0	58.8
Gas del Estado	109.7	102.5	93.0	86.3	29.0
S.E.G.B.A.	90.8	75.5	94.0	84.8	30.3
A.y E.E.	92.9	115.1	101.4	92.1	32.5
Ferr. Arg.	79.3	64.2	85.9	76.2	36.6
A.A.	106.8	116.4	99.5	90.4	78.6
ENTel	60.1	39.5	45.7	40.1	14.6
O.S.N.	38.0	53.0	51.6	49.4	25.2
General Level	131.2	108.2	126.6	113.7	52.3

Source: IEERAL de la Fundación Mediterránea, based on data by SIGEP. From Novedades Economicas, Year 11, No. 101, May 1989. June 1989 data kindly provided by Carlos A. Givogri of IEERAL de la Fundación Mediteránea.

political and administrative cost (as well as the cost in terms of the time that policymakers had to devote to this problem) that made this possible. The economic ministers had to use valuable political capital and time and the tax administration had to use valuable administrative resources to stay close to a target that was in constant danger of getting away. 1/ Furthermore, the average level of taxation was in many cases maintained by the use of temporary and often highly distortionary taxes. Argentina, for example, had to rely on taxes on exports and taxes on checks to attempt to maintain the level of taxation. These changes almost surely affected the overall economic environment with predictable consequences for private investment and capital flight.

## 2. Conceptual difficulties

It is not widely recognized how much a high rate of inflation, combined with other economic difficulties, obscures the real fiscal picture, thus making difficult an accurate determination of the size of the fiscal adjustment needed. In this subsection, some, but by no means all, of the difficulties faced by Latin American policymakers in the evaluation of the fiscal situation are briefly discussed. These difficulties significantly increase the time required by, and the degree of difficulties of, negotiations of stabilization programs between, say, the IMF and the countries' authorities. 2/

A government will be able to determine the required fiscal adjustment and hopefully to act on it only if it can develop an accurate picture of the fiscal situation. 3/ The development of such a picture depends on several requirements: (a) correct theoretical concepts must be developed; (b) these concepts must be translated into correct statistical measurements; (c) correct statistical measurements must be followed by appropriate policy actions; (d) these policy actions must be effectively introduced and implemented; and (e) these policy actions, if taken, must be durable, of a high quality, and believable. If the private sector does not believe that the government will have the skill and the stamina to continue with these policies, or if the policies have a self-destruct element as, for example, when they are clearly temporary, the results of these policies are likely to differ from the expectations. These issues are briefly discussed below and in the next section.

Most economists assume that the required fiscal policy actions can be easily derived from a clearly defined and objective concept of the

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1/ Inflation, especially if accompanied by price controls, almost always increases the tendency to evade taxes.

2/ Sometimes they even create divergence of views among international institutions such as the Fund and the Bank and among different entities within the same country.

3/ Of course, the determination of such a picture is a necessary but not sufficient condition for good fiscal policy.

fiscal deficit. 1/ The basic question in this case would be: what changes in revenue or in expenditure would be necessary to close the fiscal gap? Unfortunately, such a clearly defined and objective concept of fiscal deficit is not available, especially in conditions of high inflation.

Those familiar with these issues will be aware that in recent years the traditional (so-called "conventional") concept of the fiscal deficit has been subjected to strong criticisms since, in situations with significant domestic debt, the conventional deficit is highly sensitive to the rate of inflation. By increasing nominal interest rates and thus nominal interest payments, higher inflation sharply increases the conventional deficit. By the same token a country that freezes prices (as, for example, was done by Argentina under the Austral Plan and by Brazil under the Cruzado Plan) will experience an automatic fall in the ratio of the conventional fiscal deficit to GDP, especially if that country has significant domestic public debt. 2/ As a consequence, the "conventional deficit" becomes a misleading concept for assessing the size of the needed fiscal package necessary for stabilization. It will exaggerate the needed tax increase, or the decrease in non-interest expenditure, since there will be a kind of multiplier effect at work in deficit reduction if the fiscal measures reduce inflation and thus interest payments.

The "operational deficit"--which excludes from government expenditure the part of interest payment that is assumed to be a monetary correction (that is, the part that is assumed to compensate the holder of the domestic debt for the erosion of the value of the debt due to the country's inflation)--has been receiving increasing acceptability and has been used in some Fund-supported stabilization programs. It has been argued in some studies that the operational deficit is the concept that is more likely to be closely associated with the behavior of the current account of the balance of payment. However, much skepticism remains on the use of this concept and some refuse to accept its validity as a proper guide for policy. Valid questions can be raised, for example, on whether the rate of inflation that is used to calculate the operational deficit is the same as the expected rate of inflation, whether the price index has been manipulated intentionally or, more likely, through related policies (e.g., through price controls or through the freezing of the exchange rate). Furthermore, the operational deficit seems to be an inadequate reference index if the objective of economic policy is not just the balance of payment but also the rate of inflation. Very high inflation rates have, in recent years,

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1/ Many academic papers make this assumption.

2/ The fall in the ratio of the fiscal deficit to GDP will be caused by the fall in nominal interest payments and by the real increase in tax revenue. The real increase in tax revenue will affect all measures of the fiscal deficit while the fall in nominal interest payments will affect only, or mainly, the conventional measure.

been associated with very low operational deficits. One basic issue is that there cannot be any presumption that the "monetary correction," that is the part of the conventional deficit that is excluded to determine the operational deficit, would automatically be saved and reinvested in government bonds at similar conditions. 1/

Some of these questions, and more particularly the fact that the operational deficit is affected by the real rate of interest which is not directly controllable by the policymakers, has brought into increasing use, in Fund negotiations with countries, the concept of the "primary deficit" which excludes all interest payments from the calculations of the fiscal deficit. The main virtue of the primary deficit is that it relates to a concept of deficit that is associated with non-interest expenditures and with ordinary revenues. In other words, it is associated with items which, at least in theory, are directly controllable by the authorities. 2/ Thus, the size of a fiscal effort made by the country can be measured in an objective way through the changes in the primary (fiscal) deficit. 3/ The primary surplus also provides an idea of the total interest payments that a country is capable of making in a given year.

A shortcoming of the primary deficit concept is that real interest payments (and, perhaps, also "monetary corrections") have implications for aggregate demand and thus for inflation and the balance of payments. Therefore, while, in principle, the primary deficit is a good measure of the fiscal effort made or to be made by a country, it is an inadequate measure in assessing the effort needed. The primary deficit per se does not tell us much about how tight fiscal policy is in relation to the needed degree of tightness. Another practical shortcoming is that it cannot be measured from the financing side (i.e., from "below the line") so that its estimate depends on how good the accounting system of a country is in monitoring expenditure and revenue over time. This issue is discussed below.

Table 4 provides a dramatic illustration of the difficulties encountered in trying to assess the needed degree of fiscal correction in four major Latin American countries. 4/ The differences among the three concepts are particularly large, especially in Brazil and Mexico. The relative irrelevance of the conventional measure is shown clearly by its wild swings over the period. Nobody in his right mind would argue that, for example, between 1986 and 1988 the Brazilian

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1/ These and other relevant issues are discussed in (Tanzi, Blejer, and Teijeiro, 1987).

2/ Of course, legislative or political obstacles may substantially reduce the effective control of policymakers over these items.

3/ Even this is not totally correct since changes in the primary deficit may be brought about by exogenous factors such as change in economic activity, change in world prices, and so forth.

4/ See also (Dornbusch and de Pablo, 1988).

Table 4. Fiscal Balances of the Public Sector

(In percent of GDP)

	1980	1981	1982	1983	1984	1985	1986	1987	1988
<u>Argentina</u>									
Conventional	n.a.	n.a.	n.a.	-10.2	-7.6	-4.1	-2.5	-6.3	n.a.
Operational	n.a.	n.a.	n.a.	-10.2	-7.6	-4.1	-2.5	-5.6	n.a.
Primary	n.a.	n.a.	n.a.	-4.2	-2.6	-1.7	-1.7	-1.6	n.a.
<u>Brazil</u>									
Conventional	n.a.	-13.0	-17.3	-21.0	-23.8	-27.9	-10.8	-29.5	-45.3
Operational	n.a.	-6.2	-7.8	-5.4	-2.5	-4.3	-3.5	-5.5	-4.0
Primary	n.a.	-4.8	-5.4	-2.1	1.4	-0.6	1.0	-0.6	1.6
<u>Chile</u>									
Conventional	5.5	0.8	-3.4	-2.8	-4.4	-2.6	-1.9	-0.4	3.6
Operational	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-1.2	0.2	3.8
Primary	7.0	2.2	-1.0	1.0	0.3	3.1	2.8	4.3	8.0
<u>Mexico</u>									
Conventional	-8.1	-13.8	-17.7	-9.4	-8.4	-9.5	-15.6	-15.9	-12.9
Operational	-4.4	-10.8	-10.7	0.5	0.3	-1.0	-1.8	2.0	-4.4
Primary	-3.8	-9.1	-5.0	4.6	4.8	3.3	2.3	5.0	5.9

Source: Fund staff estimates based on national data.

Note: - indicates a deficit.

fiscal policy deteriorated by almost 35 percent of GDP. These swings largely reflect changes in the rate of inflation and the latter can change because of expectational considerations. In Argentina the conventional and operational deficits are the same until 1987 when they begin to diverge. The reason for this is that in the early 1980s the domestic public debt of that country had been wiped out so that, without domestic debt, the two concepts collapse into one. As domestic debt reappeared, so did the difference between these two concepts.

Another important conceptual issue has to do with whether the relevant measure should be one which relates to cash payments or to commitments. This issue can be dealt with at several levels of abstraction. Some economists, for example, have argued that all future commitments and revenues should be discounted to assess the net fiscal position of a country. 1/ Within our more practical discussion, the issue is much simpler. A government can reduce the cash measure of the deficit by postponing payments that fall due. This can be done with wages, payments to suppliers, and, especially, payments related to the servicing of foreign debt. If interest payment on the external debt falls due but is not paid, should the deficit include the payment due (commitment concept) or should it reflect only payment actually made? 2/ Do only payments actually made affect investment, consumption, prices, and so on? And, which is the relevant concept for fiscal policy? This last question is a particularly difficult one to answer. 3/ How significant the differences between cash and commitment basis can be is illustrated with data from Argentina (see Table 5).

### 3. Statistical difficulties

In the previous paragraphs, some conceptual difficulties that have arisen in recent years in the conduct of fiscal policy in Latin American countries were briefly discussed. This subsection addresses a few practical issues in statistical measurement.

It is generally accepted that once agreement has been reached on the proper theoretical concept of the fiscal deficit, the actual statistical measure must apply to the public sector as a whole and not to just parts of it. It is, however, very difficult, if not impossible, to measure the fiscal deficit of the whole public sector in a timely and complete manner. Information on local governments is often inadequate and, when it becomes available, it is fairly dated. Information on

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1/ This position has been most forcefully advanced by Kotlikoff (1986). See also Mackenzie (1988).

2/ By convention the same questions are not asked for payments of principal that fall due but that are not made. However, in terms of economic effects, similar considerations should apply.

3/ Some of these issues are discussed in Henri Lorie, "Financial and Fiscal Programming Under Debt Restructuring" (IMF Working Paper No. 89/61, July 1989).

Table 5. Argentina: Fiscal Balances of the Nonfinancial  
Public Sector

(In percent of GDP)

	Cash Basis			Commitment Basis		
	Overall	Operating	Primary	Overall	Operating	Primary
1983	-10.2	-10.2	-4.2	-17.5	-17.5	-11.5
1984	-7.6	-7.6	-2.6	-13.1	-13.1	-8.2
1985	-4.1	-4.1	1.7	-5.4	-5.4	0.0
1986	-2.5	-2.5	1.7	-4.8	-4.8	-0.9
1987	-6.3	-5.6	-1.6	-9.0	-8.3	-4.8

Source: Ministry of Economy and Fund staff estimates.

public enterprises is often equally poor. Central banks may come to play the role of fiscal agents and can run sizable deficits.

If the fiscal measure does not cover the whole public sector, it will, first, not reflect accurately the needed fiscal correction and, second, it will open the possibility that whatever improvement may be reflected in the measure used, it might have been neutralized by deterioration in the rest of the public sector. For example, in recent years, while the central government of Argentina, in its effort to reduce the fiscal deficit was trying to limit the hiring of government employees, the local governments were substantially expanding their public employment. <sup>1/</sup> In this case, the two developments were independent in the sense that one was not determining the other. In other cases, what happens in one part of the public sector may actually determine, or at least influence, what happens in other parts.

Unlike the situation in many industrial countries, the main components of the public sector of developing countries (central government, central bank, local governments, public enterprises, marketing boards, and social security institutions) are often highly interconnected. We may thus have a problem similar to that of transfer pricing for multinational enterprises. As profits can be shifted from high tax to low tax countries, by manipulating transfer prices, so fiscal deficits can be shifted from the parts of the government where they are unwanted and easily measured to those parts (as, for example, the Central Bank) where they are not easily measured.

In Brazil, for several years the federal budget was rigorously balanced but the so-called "monetary budget" financed dozens of programs, ranging from subsidies to price support to farmers and internal debt service. In Uruguay, a country where that type of data is available, in 1988 the central bank deficit was estimated to be about 3 percent of GDP or about three times the nonfinancial public sector deficit (NFPS). In that country central bank losses had reached 7.6 percent of GDP in 1983. In Chile, the remarkable surplus of 3.8 percent of GDP reached in 1988 in the overall NFPS balance was just enough to cover the losses of the central bank (3.7 percent of GDP). In Costa Rica, central bank losses averaged almost 5 percent of GDP per year in 1982-86 (see Robinson and Stella, 1987).

Additional and often even unnoticed problems may come up when inflation is high and unstable. In these circumstances, even simple measurements, such as the calculation of tax ratios or ratios of government expenditure to GDP, may become distorted. As a consequence, the deficit as a share of GDP may also be affected. For example, the ratio of taxes to GDP over the year is generally calculated by dividing

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<sup>1/</sup> Between 1980 and 1987 public employment in the public central administration increased by 16 percent while it increased by 26 percent in the local governments.

nominal tax revenue for the year into the nominal GDP of that year. However, when the rate of inflation is high and variable, and when the flow of tax revenue is not even throughout the year, this methodology may lead to significant distortions. In Argentina, for example, this method has given tax ratios that varied by as much as 1 percentage point of GDP compared with the more precise but rarely used alternative whereby tax revenue is deflated month by month. <sup>1/</sup> Similar calculations for Brazil have also shown significant differences, especially in 1988.

Similar problems arise in the determination of the fiscal deficit on an annual basis when the rate of inflation is high. A common methodology defines the real fiscal deficit on an annual basis as the ratio between the sum of the nominal quarterly deficits and the yearly nominal GDP for the same year. In countries with high inflation, this methodology gives more weight to the real deficits that occur later in the year. The measure of the deficit is thus distorted and an incentive may be created to try to shift the deficit toward earlier quarters. There are alternative methods of calculation that would remove this bias. Still the point is that one needs to be extra vigilant about proper measurements, especially when inflation becomes very high.

#### 4. Importance of government financial management systems

Economists rarely worry, or even think, about government financial management systems: budgeting, financial reporting, and monitoring systems. However, especially in period of substantial economic instability with high inflation, these systems can play an important role in facilitating or making more difficult the pursuit of good fiscal policy. Government budgeting basically involves the formulation of expenditure targets in selected areas which, presumably, reflect the needs of, and the resources available to, the country. The financial management systems of government have the dual task of enabling a realistic formulation of the targets and of providing facilities that would permit a tracking of the events as they take place during the fiscal year so that necessary and timely corrections could be made to these targets. The systems aim at providing information needed for fiscal policy formulation. Budgeting becomes very difficult in periods of high and unstable inflation and the need for good financial management systems becomes particularly important. The comparison of budgeting systems in Argentina and Chile is particularly illuminating.

In Argentina the budget is fragmented and the activities of decentralized institutions and special funds, which are quite sizable, are outside the budget. Of course, the important activities of the provinces and municipalities are also outside the budget. Government gives guarantees to many private sector initiatives thus expanding its own contingent liabilities. There is no effective follow-up of budget

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<sup>1/</sup> These variations were particularly significant in 1975, 1981, and 1985.

execution. When needed for cash management purposes, global cash limits are imposed but there is neither analysis nor awareness of the impact of such limits on the programs. The accounting system provides data only after long delay. The data available are incomplete, inconsistent, and not comparable over time. Budget documents do not provide actual expenditures for previous years.

Chile is one country where substantial progress has been made in recent years in improving government budgeting and accounting. This progress has greatly facilitated the conduct of fiscal policy and has contributed to the success of that policy. In Chile the budget now includes most public sector activities. Even public enterprise budgets are included in the government budget. A major feature of the new system is centralization of responsibility for resource allocation and decentralization of responsibility for program implementation. All accounting data are computer-processed and there is a wide network covering all projects. This system enables the spending agencies, the central ministries, and the accounting agency to have simultaneous access to the same data. Up-to-date information is available on transactions so that the Finance Minister knows precisely and quickly what is the budgetary situation at any one moment. He can, thus, take immediate corrective action to prevent overspending, if necessary.

##### 5. Fiscal tension

In assessing the size of the needed improvement in the public finances, it is important to keep in mind that fiscal disequilibrium of the magnitude that has characterized many Latin American countries is often accompanied by what could be called, for lack of a better term, "fiscal tension." By this term we mean the difference that exists between the measured actual deficit, however defined, and the underlying or "core" deficit that is the deficit corrected for all transitory effects, be these on the revenue or on the expenditure side.<sup>1/</sup> The actual deficit is often reduced by policies that are not sustainable. It has, for example, been common for Latin American countries, forced by serious fiscal imbalances, to attempt to remedy or improve the situation by (a) compressing real public sector wages to levels that are well below what is, in the medium run, politically sustainable or desirable in terms of efficiency; (b) putting temporary and highly inefficient taxes (e.g., "impuesto a los debitos bancarios" in Argentina); (c) postponing essential operation and maintenance expenditures thus reducing the productivity of the public infrastructure and often sharply reducing the usable life of valuable assets (roads, buildings, cars, etc.); (d) building up of arrears vis-à-vis domestic suppliers and

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<sup>1/</sup> In other words, the "core deficit" is the difference between the permanent level of expenditure and the permanent level of revenue. For a description of the "core deficit," see (Tanzi, 1983).

foreign lenders; and (e) running down the inventories of public enterprises. 1/

Fiscal tension increases economic inefficiency and anxiety about the future. By increasing uncertainty about the future, it is likely to discourage both private investment and capital repatriation. A program of fiscal restructuring must aim at reducing or even eliminating this fiscal tension. The needed fiscal correction must be assessed against a measure of the deficit that has not been distorted by these factors and it must be associated with a sustainable and clear long-run plan of fiscal adjustment.

#### IV. General Guidelines for Fiscal Restructuring and Conclusions

The two previous sections have discussed the fiscal background to the current economic situation in Latin America and selected obstacles to good fiscal policymaking. The discussion pointed to the need for fiscal improvement. Although there may be disagreement on the size of the needed adjustment, there should be little disagreement as to the direction. The fiscal balance needs to be improved.

##### 1. Actions on the spending side

Expenditure decisions should not be made in isolation from current macroeconomic constraints. Especially in periods of high instability and low growth, a country has to assess whether it can still afford all the existing expenditure programs. Do all these programs still clearly serve their original objectives? Do they require levels of public expenditure that are no longer realistic, given the lower public resources available to the government? The overall level of public expenditure should not be determined on the basis of "needs," as policymakers often argue, but on the basis of resource availability. 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 by eliminating many existing programs. This scaling down must be done with a clear eye to protecting the poorest groups and the most efficient expenditures. Unfortunately, often efficient expenditures and those that truly benefit the poorest groups have been eliminated, while unproductive expenditures with strong political constituency have survived. In many countries programs have not been eliminated but have

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1/ This raises the question of the "quality" as distinguished from the "quantity" of fiscal adjustment. For a detailed discussion of this aspect, see (Tanzi, 1987).

just seen their funding sharply reduced thus raising the problem of "fiscal tension" discussed earlier. 1/

As discussed earlier, two major trends stand out in the behavior of public spending. One is the large increase in interest payments, both domestic and foreign. The second is the fall in capital spending.

Domestic nominal interest payments will be reduced only if (a) domestic debt is prevented from growing as a share of GDP; (b) inflation is held at low levels, and (c) as a consequence of (a) and (b), anxiety about the future is reduced. The growth of domestic debt should be a major worry. If that growth is not prevented, domestic public debt will become as serious a problem as is now foreign debt. Domestic debt contributes to negative expectations about the future which directly discourage private investment; additionally, by maintaining high the real level of interest rates, public debt discourages private investment even more.

Interest on foreign debt has been the other item of public expenditure that has grown significantly. In Mexico, for example, in recent years this item has absorbed between 4 and 5 percent of GDP. In Argentina, it has absorbed between 2 and 3 percent. In Brazil, it has absorbed between 3 and 4 percent. Much has been written about the difficulties that are created by these transfers for both the budget and the balance of payment. Here, a few comments will suffice.

As long as there is a large debt overhang; as long as it remains uncertain how much of that debt will be paid; and, as long as the market value of that debt is influenced by the policies of the debtor countries or the actions of the creditors, there will be an incentive to play strategic games for both creditors and lenders that would negatively affect economic behavior. 2/ It is clearly better for economic policy when policymakers know for sure that the servicing of the debt will require, say, a future constant payment of 3 percent of GDP, so that they can adjust their policies accordingly, rather than knowing that there is a 50 percent probability that the payment will be 1 percent and a 50 percent probability that it will be 5 percent of GDP. Perhaps one of the greatest burdens associated with the debt crisis has been the creation of this uncertainty. Another has been the large amount of time that the policymakers had to allocate to this problem.

The fiscal situation of these countries would be immediately improved by a reduction in the interest payments that they make on their

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1/ This is the case with public sector employment. Often real wages have been reduced while nothing has been done about the very large number of public employees. In time real wages are likely to rise.

2/ Indirectly also the economic policies followed by the major industrial countries will affect the market valuation of the external debt of the Latin American countries.

external debt since the increase in these payments was one of the major factors that led to the worsening in the public finances in the 1980s. Such a reduction would also reduce the net transfer of resources from these countries to the rest of the world. A reduction in real interest payments on the external debt can come (a) through a fall in real interest rates on the world capital markets promoted by the macro-economic policies of the industrial countries; (b) through voluntary agreements between creditors and debtors aimed at reducing the value of the debt and/or at reducing the interest rate on that debt; (c) through unilateral actions by debtors which result in the accumulation of arrears vis-à-vis their creditors. All these alternatives would improve the cash measure of the fiscal balance, but only the first two alternatives would result in a genuine improvement.

A fall in the world real rate of interest would clearly be very beneficial. Each percentage rate fall would mean several billion dollars less per year in government expenditure and in net transfer abroad. However, like manna from the sky, this is an event that cannot be influenced by the policy actions of the Latin American countries themselves. So that it is better not to set domestic policies on the hope that this event will occur. If it does, it should be treated as a random positive bonus.

Debt reduction agreements between debtors and creditors would also be highly beneficial. However, developing countries can promote these agreements through their domestic policies. These policies should be aimed at removing domestic obstacles toward a better utilization of the available resources. They will, thus, require major structural changes within the countries. The Brady Plan has provided a political environment that should facilitate the reaching of these agreements. The governments of the industrial countries as well as the international organizations are now backing this option and the recently concluded discussions between Mexico and the creditor banks provide the first example of these debt reductions. To the extent that these agreements become common, they will bring a substantial improvement in the public finances and the external accounts of the region.

The unilateral stopping of payments that fall due, resulting in the accumulation of arrears to foreign creditors, would also "improve" the cash measure of the fiscal deficit and would reduce the net transfer of resources to the rest of the world, but this is hardly genuine improvement. The cost would be a worsening of expectations within the defaulting country and the exclusion of the country from further credit. Both of these factors are likely to neutralize any advantage associated with the reduction in interest payments.

The fall in interest payments discussed above would lead to an important improvement in the public finances of the Latin American countries provided that it does not result in an expansion of other public sector spending or in a fall in tax revenue. But what about public investment? Hasn't this been highly depressed in recent years?

Shouldn't this be increased to put the countries back on a growth path? Obviously, increasing capital spending by the public sector would put renewed pressures on the public finances.

An argument is often made in favor of additional foreign borrowing to promote growth by increasing public investment. This argument ignores that some Latin American countries (as, for example, Brazil and Mexico) got themselves into economic difficulties in part because of this policy. 1/ They borrowed at rates of interest that turned out to be high over the longer run and invested in activities with low rates of return. Borrowed resources can make a genuine contribution to long-term growth only when they are channeled towards carefully screened projects, which have expected rates of return clearly higher than the long-run cost of borrowing. Under the circumstances that have prevailed and that continue to prevail in many developing countries, there has been no guarantee that this screening would be effective (see Tanzi, 1988).

Countries that find themselves in situations of great instability might be advised to limit new investment while channeling for a while the financial resources available toward improving the existing infrastructure (roads, schools, hospitals, plants, etc.). Reductions in operation and maintenance expenditure are a far greater obstacle to growth than reduction in fixed investment. Much growth can often be squeezed out of the existing infrastructure if obstacles to its efficient use can be removed and if the necessary operations and maintenance expenditure keeps it in good working condition. 2/ Repairing existing roads should take precedence over building new ones. Providing existing hospitals with nurses and medicines should take precedence over the building of new hospitals. Such a position always provokes a strong negative response because of the widely held belief that growth always requires additional capital. This position has been formalized in many growth models. But the evidence on this is controversial at best.

In a simple, and some would say, simplistic exercise, the growth rate of 25 Western Hemisphere countries was correlated against the ratio of investment to GDP for the same countries. This was done for a period that extended from the mid-1970s to the mid-1980s in order to rule out year-to-year variation in growth. The results were hardly a strong endorsement for the importance of investment. 3/ A more sophisticated

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1/ In 1982 it used to be said that these countries had a liquidity but not a solvency problem since investment would eventually pay for itself.

2/ See (Tanzi, 1988) for a defense of this position.

3/ The equation obtained was

$$\dot{G} = 0.2671 + 0.1603 \text{ I/GDP} \quad \bar{R}^2 = 0.0176 \\ (0.14) \quad (1.20)$$

exercise in the April 1989 World Economic Outlook of the IMF (pp. 61-67) applied to the 15 most heavily indebted countries has concluded that

" . . . even in the most favorable case [for the importance of new capital] (i.e. that with the smallest initial capital-output ratio and largest share of capital), the investment shortfall can account for only about a third (1.1 percentage points) of the slowdown in growth." (IMF, p. 66)

It would thus be a mistake to use whatever fiscal space is created by reductions in interest payments to rush into another program of expansion of public sector capital expenditure. <sup>1/</sup> This expansion may be accompanied by a further slowdown in private investment if economic uncertainty is increased. For the next several years fiscal consolidation, together with structural reforms, may contribute more to growth than public sector's capital expenditure. As Schumpeter put it in his classic book on The Theory of Economic Development:

"The slow and continuous increase in time of the national supply of production means and savings is obviously an important factor in explaining the course of economic history through the countries, but it is completely overshadowed by the fact that development consists primarily in employing existing resources in different way, in doing new things with them, irrespective of whether those resources increase or not" (Schumpeter, p. 12).

Schumpeter's quote should be particularly appropriate when countries can carry out major structural changes and when they need to reduce spending to stabilize their economies and, thus, to improve expectations. <sup>2/</sup>

## 2. Actions on the revenue side

It was stated earlier that, with considerable effort, the region, as a whole, managed to maintain broadly constant the ratio of tax revenue to GDP. In view of this, the question must be raised as to whether it would be realistic to aim for an increase in that ratio in a policy of fiscal restructuring, especially at a time when high tax ratios are still criticized by many who regard their disincentive effects as serious. In the view of the author of this paper, such an objective, while difficult to achieve, is not beyond the range of the

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<sup>1/</sup> It may be worthwhile to recall (see Table 2 above) that the share of public investment in GDP in the 1982-87 period, while generally lower than in the 1975-81 period, was not lower than in the 1970-74 period. However, private investment in 1982-87 was significantly lower than in the earlier periods. The economic environment must have been a major factor.

<sup>2/</sup> See also (Kuznets, 1965, pp. 37-38) for similar conclusions.

possible and, given the need to reduce fiscal deficits, it may be a desirable objective. However, to be achieved, such an objective would require (a) a more stable macroeconomic environment with less inflation, and (b) a substantial simplification of the tax system. The relationship between tax revenue and macroeconomic policy has been discussed in detail in a recent paper so that it will not be discussed here (see Tanzi, 1989). We shall focus on the issue of simplification.

The tax system can be greatly simplified and its efficiency greatly increased in many Latin American countries. The simplification would aim at (i) the elimination of many unproductive taxes; <sup>1/</sup> (ii) the elimination of most tax incentives and exemptions; and (iii) the reduction or elimination of multiple rates, and especially of very high rates, with which tax bases are often taxed. <sup>2/</sup> A tax system should not lose sight of the fact that revenue generation is its most important objective, especially when fiscal deficits are high. The more objectives are assigned to the tax instruments, the more complex and inefficient the tax system becomes, especially in periods of high inflation. For example, if a country insists on having a value-added tax with multiple rates and many exemptions, and if, additionally, as, for example, in Argentina, even regional tax incentives are channeled through this tax, it should be no surprise that the tax becomes largely unproductive. It should be noted that with similar rates, the Chilean value-added tax generates three times as much revenue, in proportion to GDP, as Argentina's. This comparison should be food for thought.

It is often argued that equity considerations require differential tax rates so that by advocating simplicity and, to a large extent, statutory proportionality, one abandons the objective of equity. The truth is that in most Latin American countries statutory progressivity for the income tax and highly differentiated rates for the other taxes (sales taxes, import duties) have not resulted in particularly equitable tax systems. What they have done is create many administrative headaches. And, of course, if they have reduced the ability of the government to raise tax levels, they may have hurt exactly the people they wanted to help through inflation, economic instability, and so forth. Thus, at this stage, the pursuit of income redistribution through the tax system should take a backstage position to revenue generation. In more normal times, governments, if they wish, could bring this objective forward once again. <sup>3/</sup>

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<sup>1/</sup> When the author of this paper worked in Argentina in the mid-1970s, there were about 100 taxes in the tax system of that country.

<sup>2/</sup> Recent tax reforms in Bolivia and Chile have broadly followed these guidelines.

<sup>3/</sup> The poorest groups can be protected through selective and well-targeted expenditure programs.

Other changes in the tax system should aim at: (a) reducing the impact of inflation on the tax system by, for example, reducing as much as administratively possible the size of collection lags and by eliminating, or indexing, ad rem elements of the tax system; 1/ (b) reducing taxes that interfere with the development of the financial market; (c) making the tax system more dependent on domestic as compared with external sector taxes; (d) removing elements that discourage foreign direct investment; and (e) creating tax conditions that would make possible for citizens the repatriation of their capital without excessive penalties.

One revenue source that has not been fully exploited in most developing countries is the monopoly power of public enterprises. 2/ Those public enterprises that are in a monopoly situation should generate a significant positive net balance. 3/ This is one of the most administratively easy way of raising revenues. Enterprises that cannot do this should be privatized unless there are overwhelming practical, and not just theoretical, reasons to keep them public.

In conclusion, there are no magic formulas that would improve the public finances of the Latin American countries. But economic reconstruction will not be possible without substantial improvements in fiscal policy, both in its stabilization and in its allocative aspects.

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1/ There are increasing costs to the administration and the taxpayers when collection lags are sharply reduced. Brazil has introduced daily monetary correction for tax arrears. The administrative and compliance costs of this policy must be considerable.

2/ The exception is the taxation of public enterprises that produce or distribute petroleum products.

3/ If possible, these monopoly gains should be extracted through taxes, not through the transfer of profits.

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