

Rule-Based Fiscal Discipline

In the last fifteen years the countries of Latin America have made great progress in taming their budget deficits, helping to finally overcome the inflation that plagued the region before and during the 1980s. But in many countries deficit reduction still relies mostly on competent finance ministers, who in turn depend on the support of their heads of state, and on “emergency” revenue and tax measures that create their own inefficiencies and distortions. For example, Argentina, Brazil, Colombia, Ecuador, Peru, and Venezuela have all periodically boosted tax revenues by imposing a financial transactions tax, which at higher rates and over time has coincided with significant welfare losses and financial disintermediation.¹ Other countries have contained fiscal deficits by unduly compressing public investment and social spending—ultimately, an unsustainable option. In many countries, the costs of servicing debt remain high, requiring governments to run primary surpluses to contain further debt increases (table 1-1).

Missing in many countries are the institutional rules, political arrangements, and structural fixes—for example, reform of unduly generous and inequitable public pension systems—that would give investors confidence

1. Kirilenko and Perry (2004) estimates that, on average, financial transaction taxes have resulted in financial disintermediation of between 4 and 44 cents for every dollar in revenue, with well-above-average values of 46 cents in Argentina, 58 cents in Brazil, 64 cents in Colombia, 48 cents in Ecuador, 66 cents in Peru, and 49 cents in Venezuela. See also Baca-Campodónico, Mello, and Kirilenko (2006) and Kirilenko and Summers (2003).

TABLE 1-1. Public Debt and Primary Surpluses, 2003–06
Percent of GDP

Country	<i>Public debt^a</i>								<i>Primary surplus^b</i>			
	2003		2004		2005		2006		2003	2004	2005	2006
	Gross	Net	Gross	Net	Gross	Net	Gross	Net				
Argentina	145	125	132	111	89	n.a.	n.a.	n.a.	3.0	5.0	4.4	n.a.
Brazil	77	57	72	52	75	52	73	51	4.3	4.6	4.8	4.3
Chile	45	13	39	11	32	8	28	3	2.2	4.5	7.3	8.6
Colombia	53	45	50	39	46	34	45	32	1.5	3.2	4.0	3.1
Mexico	50	44	46	41	44	39	43	38	0.3	1.3	1.8	2.1
Peru	47	33	44	28	38	n.a.	32	n.a.	0.5	1.0	1.6	3.0
Uruguay	104	95	92	88	69	n.a.	64	n.a.	2.7	3.8	3.9	3.7

Sources: IMF, country reports; Panizza and others (2006); Banco Central do Brasil.

a. Includes domestic and external debt of the general government (central government, states or provinces, and municipalities).

b. Surplus net of interest on government debt.

that budget deficits will not get out of control in the future. Uncertainty persists about whether countries will sustain fiscal discipline when governments change from one administration to another or when political pressure grows during periods of low growth to spend too much and spend badly. Some countries suffer because excessively fragmented legislative bodies prevent the formation of stable coalitions or congressional majorities—or because decentralization undermines the government’s capacity to keep overall public sector spending in check.²

Fiscal indiscipline—seen when governments consistently spend more than they collect and more than they can easily finance through sustainable borrowing—has had high costs for the poor in the region. In most of Latin America past fiscal laxity too often induced governments either to print money, fueling inflation, or to issue large amounts of debt, driving

2. For example, in the 1990s Colombia more than doubled the share of centrally collected revenues transferred to local governments without transferring spending responsibility and political accountability. See Acosta and Bird (2003) and Alesina, Carrasquilla, and Echavarría Soto (2002) for further discussion on Colombia. Ahmad and García-Escribano (2006) reviews the challenges of fiscal decentralization in Peru, including the need to clarify subnational-spending responsibilities and financing sources that increase local accountability. On the experience of Argentina, see Cuevas (2003).

real interest rates to onerous levels.³ Inflation hurts poor people because their capacity to protect their earnings—through indexed savings, for example—is limited.⁴ In contrast, fiscal discipline protects poor people's consumption and allows for lower interest rates than would otherwise prevail, unleashing new investment and job creation. Public savings also allow governments to use countercyclical policy to protect poor and working-class families during economic downturns.

Of course, inflation has fallen dramatically in the region over the last decade, thus reducing its regressive effect.⁵ But creditworthy small firms and poor households still face high real interest rates. Since they have no alternative to the local market for their financing needs, this limits their expansion, and thus reduces overall investment and employment.⁶ To bring down interest rates requires a host of institutional and structural fixes, but good fiscal policy is key (box 1-1). Good fiscal policy entails holding down deficits, including in good times, both to allow for countercyclical public spending in bad times (see chapter 2) and to reduce reliance on public borrowing, which in the past has led to unsustainable

3. Real interest rates were very high in Latin America in the 1990s, reaching more than 10 percent on average for the majority of countries, compared with 6 percent on average in Southeast Asia (Indonesia, Malaysia, Philippines, South Korea, and Thailand) and about 5.6 percent in the United States in 1990–2000 (WDI 2006). Since 2001, interest rates have fallen against a backdrop of fairly low inflation in most Latin American countries, but they remain well above those in other regions, especially in Brazil (IMF 2007c; Gelos 2006; ECLAC 2006c).

4. See Easterly and Fischer (2001) for evidence on the impact of inflation on the poor. Estimates in Behrman, Birdsall and Székely (2001), based on household data from seventeen Latin American countries over the last two decades, suggest that inflation and volatility in per capita GDP worsen poverty.

5. The average inflation rate in Latin America declined from close to 600 percent in 1990 to just under 10 percent in the last three years of the decade, with more than half of the region's countries recording single-digit rates. In 2000–06 average inflation remained at around 7.3 percent in the region (IMF 2007a). Carstens and Jácome (2005) finds that institutional reforms aimed at increasing the central banks' autonomy and accountability in the region, together with macroeconomic policies, played a key role in bringing down inflation to single digits.

6. Interest rates remain high because, given high ratios of public debt to revenues, creditors price in default risk and because of high public borrowing (in part to finance servicing of existing debt). Although in the OECD higher real interest rates have been shown to contribute to higher unemployment (Blanchard and Wolfers 1999), estimates of the relationship show no statistically robust effect in Latin America. The data are, however, much "noisier" on real interest rates (due to noncaptured inflation volatility itself), the credit markets are much more segmented, and employment and unemployment data are less reliable.

BOX 1-1. The Fiscal Policy of Presidents Cardoso and Lula in Brazil

Throughout his presidency, Brazil's Fernando Henrique Cardoso (1995–2002) was widely criticized by the left for making macroeconomic discipline a priority at the expense of much-needed investments in the social sector. His successor, Luiz Inacio Lula da Silva (2003–), has faced similar criticism for continuing the disciplined macroeconomic approach, including from members of his own cabinet and Workers' Party. But their critics are missing the point. Fiscal discipline and sound management of the government's debt constitute good social policy. In effect, the vulnerability of the government's fiscal stance and of public debt to economic and financial shocks goes a long way toward explaining the high level of the domestic real interest rate.¹ Hence, additional and durable improvements on the fiscal and public debt fronts are important in the quest for lower real interest rates, which encourage job creation. Real interest rates in Brazil were extremely high during the 1990s, averaging 21 percent for 1997–99. They have stabilized since then but remain very high by international standards, averaging about 13 percent in 2003–06. In order to lower interest rates to single digits, Brazil will have not only to sustain the fiscal gains achieved to date but also to push through with further fiscal reforms, including politically difficult reforms in pensions and taxes.

1. World Bank (2006b).

levels of public debt.⁷ Some public debt (to finance small deficits) is reasonable, especially when economic growth ensures that the ratio of debt to GDP is not continuously rising beyond a safe range. In effect, there is a growing consensus that emerging market economies, with their history of inflation and volatility, should meet a tough standard of public debt to GDP—the IMF suggests no more than 30 percent—which is tougher than the standard for developed countries.⁸ In Latin America, only Chile currently meets that standard.

7. Although we emphasize surpluses and deficits, additional indicators are used to assess a country's fiscal solvency in the medium and long term, including accounting and economic measures of government net worth (see Easterly, Irwin, and Servén 2007; Traa and Carare 2007). Fiscal deficits are obviously easier to manage and make compatible with long-term public debt sustainability where economic growth is vigorous.

8. IMF (2003a) estimates a benchmark debt-to-GDP ratio for emerging markets at 25 percent of GDP and for developing countries at 30 percent of GDP. Artana, López Murphy,

In short, a fiscal policy aimed at sustained “fairness” for the great majority of citizens today requires building an institutional culture of rule-based discipline and in many countries managing a string of primary surpluses that are demonstrably sustainable—that is, not based on unrealistic spending cuts and distortionary taxes inimical to efficiency and growth.⁹ Until the markets are convinced that deficit spending is justified by the prospect of high growth and investment-intensive public spending, the hard reality is that most countries of Latin America will benefit their poor most by managing actual (not just primary) surpluses in good times to build confidence and in bad times to create space for deficit spending (see chapter 2).¹⁰ In fact, despite a few exceptions in the last couple of years (most notably Chile), governments in the region have run overall fiscal deficits since 1993.¹¹

Maintaining fiscal discipline from one administration to another requires a budget process that is fully institutionalized within a country’s legal and regulatory systems and in its legislative procedures.¹² Examples of fiscal discipline measures include the following:

and Navajas (2003) suggests a Maastricht-type debt limit of 30 percent of GDP for the region once reasonable levels of indebtedness are reached, which is half the EU level. That reflects Latin America’s narrow domestic capital markets, higher interest, and lower revenue shares relative to GDP. See also Reinhart, Rogoff, and Savastano (2003).

9. Dervis and Birdsall (2006) notes that governments now are stuck with high primary surpluses in order to finance debt service while minimizing total deficits. Calderón, Easterly, and Servén (2003a, 2003b) estimates that over half of the total fiscal adjustment in Argentina, Bolivia, Brazil, Chile, and Peru during the 1990s reflected infrastructure compression, which in turn may have lowered long-term GDP growth by more than 1 percent a year. A similar case of excessive budgetary rigidity is found in the example of Ecuador in Cueva (2007), which estimates that about 90 percent of central government expenditures are nondiscretionary. In most highly indebted countries, achieving a positive fiscal balance that is demonstrably sustainable will require structural fixes—pension reform and so forth—that are politically very difficult. For high-debt countries, Dervis and Birdsall (2006) recommends a large facility at the IMF or World Bank that would be used to lend at below-market rates to help them reduce the debt that creates the need for primary surpluses, without cutting back on key investments in development.

10. In the short run, given existing debt-service burdens, the primary surpluses needed just to get a zero fiscal surplus or deficit would be as high as 8 percent in Brazil and near 6 percent in Uruguay (estimates based on 2003–06 data from IMF country reports.) In the medium term, the real issue is the ratio of net debt to GDP and revenue base. Some nominal deficit would be consistent with avoiding increases in these ratios.

11. ECLAC (2006c, 2000).

12. An example of movement in this direction is Brazil’s Fiscal Responsibility Law, which since its approval in 2000 has encouraged fiscal consolidation across all levels of government

- ◆ Prohibition of unfunded expenditures (defined over the business cycle, with saving taking place during good times and dis-saving during bad times)¹³
- ◆ Legal ceilings on total public sector indebtedness relative to GDP
- ◆ Standards and obligations for disclosure of the entire fiscal cycle—budget preparation, approval, and execution—to improve accountability of fiscal authorities and enable better monitoring by voters
- ◆ An independent source of published estimates of actual and projected government revenue and expenditures (as in the case of the U.S. Congressional Budget Office) to provide the public an alternative to the executive branch’s estimates
- ◆ Fiscal contingency funds that set aside unexpected revenue due to high world prices of oil, copper, and other natural resources (see also chapter 2).

and increased fiscal transparency. In Colombia and Peru, following a generally poor start and repeated modifications, fiscal responsibility laws recently have helped to contain discretionary procyclical spending (Corbacho and Schwartz 2007, forthcoming; Mello 2006). For a comprehensive analysis of different instruments and approaches (including various types of fiscal rules, fiscal responsibility laws, and fiscal agencies) to improve the incentives for governments to maintain fiscal discipline, see IMF (2007, forthcoming).

13. In Brazil, recognizing the risk of a continuously rising tax burden—which in turn has been pushed up by ever-increasing current expenditures—the government introduced a new measure in the 2006 budget law to establish ceilings, as a share of GDP, for the federal government’s revenue and expenditure estimates in the annual budget law. Unfortunately, the measure did not survive congressional scrutiny without an amendment that basically undermined its original intent, and the government decided not to include the same or a similar proposal in the budget for 2007 (World Bank 2007a).