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THE ROLE OF TAX POLICY IN THE CONTEXT OF THE GLOBAL CRISIS: CONSEQUENCES AND PROSPECTS

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I. INTRODUCTION

The financial crisis has had a significant impact in Latin America and the Caribbean, moving through all of the various channels that connect Latin America with the rest of the world: trade, capital flows, remittances and foreign direct investment. This has resulted in a series of simultaneous negative effects on the region's economies: declining exports (in terms of both volume and price), severe limitations on access to capital markets, a decrease in remittances and a reduction in the flow of foreign direct investment.

These factors affect public finances, while at the same time limiting governments' ability to respond. Tax revenues are declining significantly as a result of the economic slowdown/recession and the drop in commodity prices. Moreover, the fiscal stimulus packages implemented by the countries will cause a further decline in their fiscal balances. To compensate for the distributive costs of the crisis, the countries have adopted contingency measures. Finally, in tandem with shrinking fiscal balances, the flow of external financing has slowed significantly. This worsening in fiscal performance comes on the heels of several years of improved performance in the region's public accounts, which had allowed for a lowering of the debt-to-GDP ratio.

The seriousness of the worsening fiscal situation, along with the possibility that it could lead to solvency problems, is closely linked to the pre-crisis fiscal position, and will be affected by how long the crisis lasts. The crisis and its impacts vary from country to country, demanding different responses, due both to differences in the causes and effects, and to countries' differing capacities and resources.

This document focuses in particular on the impact of the crisis on tax revenues, and on the countries' policy responses to the crisis. It also examines potential lines of action that countries could undertake.

The present report approaches this situation by analysing tax issues and examining how they interact with the current economic situation. It begins by presenting an assessment of the principal stylised features of the changing fiscal and tax policy of the last several years. It then looks at the possible impact of the crisis on this situation, and the level of risk to which each country is exposed. Following this, it examines the main fiscal and tax measures adopted, as well as issues of political economy that could hinder the implementation of reforms to address the crisis. Finally, it presents some thoughts on which paths would be most advantageous over the coming years.

II. WHAT HAS OCCURRED IN LATIN AMERICAN AND THE CARIBBEAN OVER THE LAST DECADE WITH REGARD TO FISCAL AND TAX POLICY?

The past decade has been marked by various fiscal-policy reforms. On the revenue side, the decade continued previous years' pattern of declining revenue from foreign trade, with import substitution leading to the rapid expansion and strengthening of value added taxes across the region.[1]

The downsizing of the public sector's role as a provider of various public goods and services was consolidated. This included attracting private capital to the development of public services infrastructure.[2]

[1] For more detail, see Cetrángolo and Gómez Sabaini (2007).

During the 1990s, many of the region's countries reassigned powers and authorities among the different levels of government, a process commonly known as "decentralisation", although the actual measures deviated from the concept.[3] As a result of this process, subnational governments now play a more important role in public administration, with greater participation in execution of the public budget.

Also during this period, a number of the region's countries reformed their pension systems, introducing components of individual capitalisation,[4] a trail that Chile blazed for the region in 1981. As will be seen in more detail below, these reforms have had a major impact on the public finances of the region's countries.

As regards the performance of public accounts, two periods of change in the last decade can be clearly distinguished, the first running from 1998 to 2001, the second from 2002 to 2008.

During the earlier of these two periods, fiscal policy unfolded against a challenging macroeconomic backdrop, both domestically and internationally. In some cases, aggravating factors, such as the weakening of the United States and a decline in the terms of trade among petroleum-dependent economies, also played a role.

In the more highly indebted countries, the volatility of capital markets, deteriorating international financial conditions, and the constraints this imposed on the ability of public sectors to access financing had a major impact.

Given this situation, the region's economies had less freedom in their fiscal policies. One manifestation of this was that most of the governments in those years were executing or negotiating programmes with the IMF involving restrictive economic policies —policies that, in some cases, unwittingly intensified the effects of the economic cycle.

Moreover, the unfavourable macroeconomic circumstances affected, directly or indirectly, the tax revenues of nearly all countries in the region.

While more expansive fiscal policy tools may have been called for during the recession years, few countries adopted a fiscal management approach during those years that would have provided greater political space to establish effective fiscal policies.

Furthermore, the various structural reforms carried out during the 1990s did not bring greater solvency to governments or solve the problems associated with high levels of debt. On the contrary, many of these policies postponed necessary reforms by creating temporary solvency, paving the way for major capital inflows (some involving privatisations), thus aggravating fiscal imbalances (lack of equitable reforms to social programmes in some countries), reducing government resources (through economic liberalisation and reduced tariffs) and intensifying pressures that led to increased spending (decentralisation).

This period was one of major deterioration in the fiscal accounts of the region's countries, which, on average, did not show a primary surplus, making it clear that, even apart from the debt problem, governments were experiencing serious financial problems. In 1998, while the simple average primary

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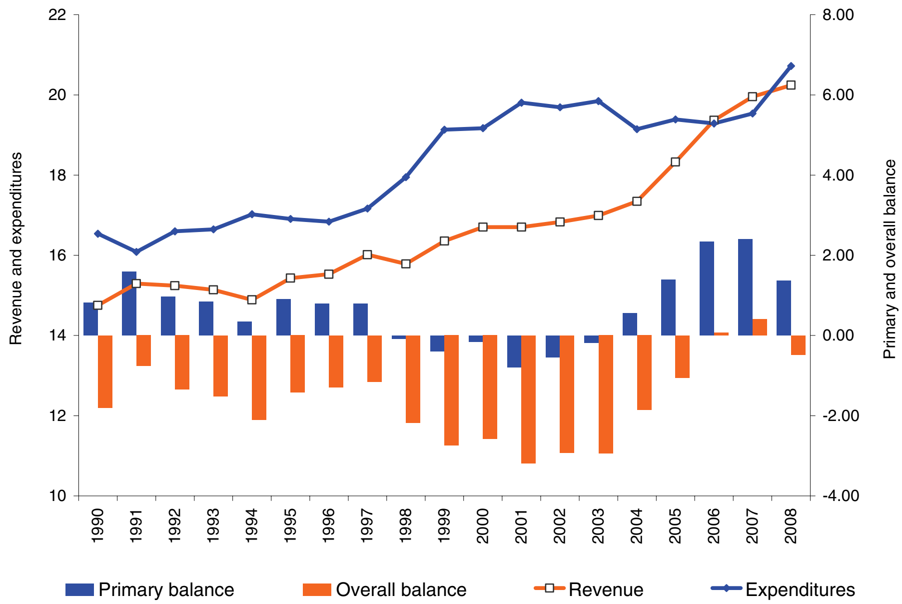
[2] For more detail, see Lucioni (2009).

[3] For an overview of fiscal decentralisation processes in the region, see ECLAC (2003).

[4] According to ECLAC (2006), the reforms introduced may be classified in three broad categories: substitutive, those that include parallel regimes, and those based on instituting mixed models.

balance for the central governments in the region was close to equilibrium, 2001 marked the highest primary deficit (0.7% of GDP) of the last ten years. If one takes into account the overall deficit (including interest on the public debt), the average deficit rose from 1.2% of GDP in 1997 to 3.3% in 2001 (see figure 1).

Figure 1
LATIN AMERICA AND THE CARIBBEAN: REVENUE, EXPENDITURES, AND PRIMARY AND OVERALL BALANCE OF CENTRAL GOVERNMENTS, 1990-2008
(Simple averages, as percentages of GDP)



Source: Prepared by the authors, on the basis of figures provided by the Economic Commission for Latin America and the Caribbean (ECLAC).

Thus, the fragile condition of the region's public sector left little room for using fiscal policy to foster macroeconomic stability. While uncertainty regarding resources forced governments to pare spending as much as possible, efforts to limit the deficit were hindered by negative effects from external factors. The attempt to achieve greater fiscal solvency conflicted with recommendations for a countercyclical fiscal policy. This, along with the difficulty of financing higher temporary fiscal deficits in the domestic and international credit markets during a crisis, skewed fiscal policy toward a distinctly procyclical bias.

At the same time, the emphasis during this period on rebuilding the credibility of macroeconomic authorities and on establishing budget deficit goals that would remain constant throughout the economic cycle partially weakened the effect of the automatic stabilisers, thus further increasing the procyclical nature of fiscal policy.

Capital expenditures proved to be the variable in budgetary spending adjustments, reaching, in 2000, their lowest level for the period. Capital investment and transfers, given their more flexible nature, were the areas of adjustment most frequently relied upon to meet fiscal goals. In much of the region, the norm was to cut infrastructure investment, as well as capital transfers to key productive sectors, while postponing public enterprise projects.

Finally, the slowdown in economic activity in 2001 directly affected the changing debt ratios of the region's countries. The macroeconomic reality and the budget deficits, added to currency depreciation in many of the countries, led, in many cases, to an increase in public debt. Thus, the end of this period saw a large increase in debt, adding even greater inflexibility to fiscal policy. The region's public debt as a percentage of GDP in the non-financial public sector rose from 43% in 1997 to a peak of 65% in 2002.

This situation illustrates a special characteristic of public finances in Latin America and the Caribbean: when capital flows fall drastically, the public sector's financing needs rise, both because of the slowdown in economic activity and because the cost of the external public debt, in national currency, increases.

In contrast, the 2002-2008 period saw a sharp improvement in the budgetary balance for the region's countries. Of the 19 countries commonly cited, only four still had a primary central government deficit as of 2008, a significant contrast with 2002, when 11 countries had such deficits.

The vulnerability of the region's countries to external factors decreased during this period, due to the improved public accounts balance and the decline in public debt as a percentage of GDP.

On the basis of changes in fiscal variables, this period can be subdivided into two parts, the first running from 2002 to 2004, the second from 2005 to 2008. While the fiscal improvement of 2002-2004 was based on greater tax revenue and the fact that spending, on average, grew less than GDP in the region,[5] the growth of the primary surpluses between 2004 and 2008 was due to a sharp increase in revenue that more than compensated for the increased public spending.

The marked increase in fiscal revenues of recent years has brought public resources, on average, to unprecedented levels in the region. While tax collections averaged 15.6% of GDP during 1990-1995, they rose to 17.4% in 2001-2005, and to 20% for the last three years of the period.

A number of factors converged in the latter years to produce the high levels of tax revenue. The significant increase in economic activity had a strong impact on tax collections. Indeed, the higher level of activity produced a rise in tax revenue not only because of the changing composition of GDP, but also because of improved tax enforcement.[6] At the same time, increasing prices for some countries' primary products have contributed to higher tax revenues.[7] [8]

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5 This situation is largely a result of the change in relative prices caused by the devaluation of some of the region's currencies (Argentina, Brazil, Uruguay) at the end of the last decade and the beginning of the current one. While public spending is, for the most part, denominated in local currency, the income generated from the tradables sectors of the economy changes in tandem with the dollar. To see this effect at work in the end of convertibility in Argentina, see Cetrángolo and Jiménez (2003), and for more detail regarding the effect of exchange rate shocks on fiscal sustainability, see Levy-Yeyati and Sturzenegger (2007).

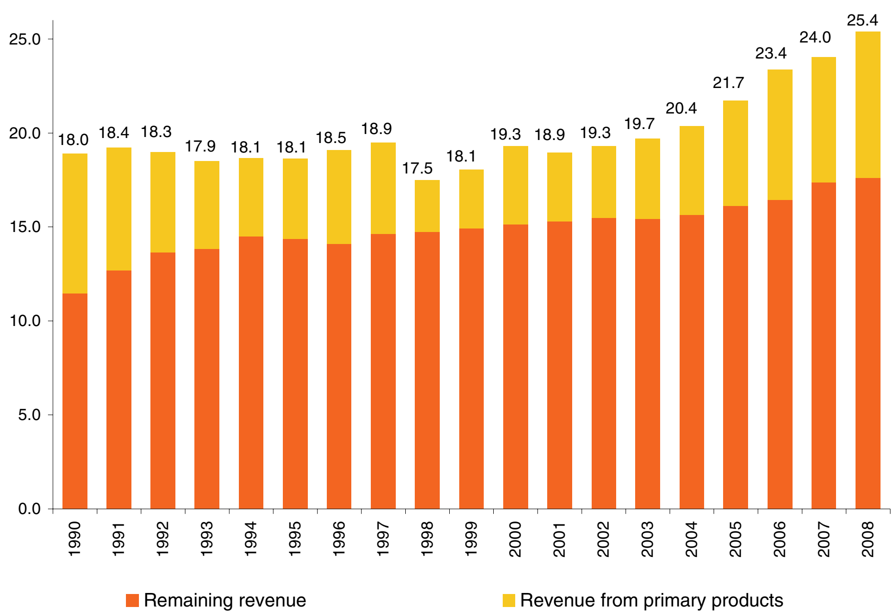
6 In general, the elasticity of tax collections is greater than one. In the expansion phases of the cycle, they increase more than proportionally, due to the fact that growth produces an increase of the formal economy and generates more than proportional growth in imports and the associated taxes. In recessive phases, on the other hand, collections fall more than proportionally due to the fact that the same mechanisms operate in reverse, as well as from increased tax evasion.

7 An additional explanation of this increase is the large rise in tax rates over of the last few years. As regards the value added tax (the main source of tax revenues in the region), its average rate as of May 2007 was 14.7%, whereas it was 11.7% in 1994.

8 In addition, it should be noted that a number of the region's countries have fully implemented taxes that are normally considered emergency measures, including the financial transactions tax currently in place in Argentina, the Plurinational State of Bolivia, Brazil, Colombia and Peru.

This increase in prices of the region's commodities exerted a significant upward pressure on tax revenues. The governments of the region have developed different ways of taking fiscal advantage of these resources. In the case of agricultural products, Argentina has financed a substantial portion of its spending with funds generated by export duties. The governments of countries with major non-renewable resources have various mechanisms for using this circumstance to fiscal advantage, and the Plurinational State of Bolivia, Chile and the Bolivarian Republic of Venezuela created new taxes to increase revenue from their non-renewable resources.[9] Taken together, income from these sources led to average growth in total fiscal revenue in the Plurinational State of Bolivia, Chile, Colombia and Mexico of 27.9%, 7.7%, 8.3% and 29.4%, respectively, during the 1990s, and of 34.3%, 17.8%, 13.6% and 37.1% in 2006-2008, thus exerting a major effect on total revenues (see figure 2).

Figure 2
LATIN AMERICA (8 COUNTRIES)[a]: FISCAL REVENUES OF COUNTRIES SPECIALISING IN PRIMARY PRODUCTS
(Percentages of GDP)



Source: Prepared by the authors, on the basis of figures provided by the Economic Commission for Latin America and the