# LATIN AMERICA: Fiscal deficits may prompt budget cuts

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## Abstract

Latin America's fiscal challenges.

Most of the region's countries are on a reasonably sound fiscal footing to face another year of sluggish economic growth and weakening revenues from commodity exports, according to a report released by the UN Economic Commission for Latin America and the Caribbean (ECLAC) on March 9. They will, however, confront challenges in attempting to ensure a stable flow of commodity revenues without discouraging investment -- and while improving the limited effectiveness of tax systems in mitigating income inequality.

## Full text

SUBJECT:Latin America's fiscal challenges.

SIGNIFICANCE:Most of the region's countries are on a reasonably sound fiscal footing to face another year of sluggish economic growth and weakening revenues from commodity exports, according to a report released by the UN Economic Commission for Latin America and the Caribbean (ECLAC) on March 9. They will, however, confront challenges in attempting to ensure a stable flow of commodity revenues without discouraging investment -- and while improving the limited effectiveness of tax systems in mitigating income inequality.

ANALYSIS: Impacts.

Some countries, including Argentina and Brazil, need to improve their primary fiscal balance by over 3% of GDP to stabilise public debt.

Latin America's revenues from hydrocarbons could drop to below 5% of GDP this year, down from almost 7% in 2014.

Despite progressive income tax rates of up to 40%, the effective rate for the richest tenth of Latin Americans averages 5.4%.

Since 2012, many countries in Latin America and the Caribbean (LAC) have seen their fiscal deficits widen gradually. In 2014, these reached an estimated average of 3.0% of GDP, up from 2.3% in 2012. This was largely the result of slower GDP growth and weaker commodity prices and, in some countries, counter-cyclical government spending. However, as ECLAC's new report, Fiscal Panorama of Latin America and the Caribbean: Policy Space and Dilemmas, points out, this has not generally been reflected in an increase in public debt which, in Latin America, has held steady at around 34% of GDP since 2012, thanks mostly to favourable borrowing conditions.

ECLAC anticipates that, as a result, most countries will have some fiscal space for stimulus measures in 2015. It forecasts that LAC's growth, at 2.2%, will remain sluggish -- albeit up from 1.1% last year (see LATIN AMERICA: Tepid recovery on the cards for 2015 - December 3, 2014). In a few countries, including Argentina and Brazil, the report detected early warning signs of fiscal tension but noted that others, particularly those with low public debt such as Chile and Peru, are taking the opportunity to boost public and private investment ( see CHILE: Government will raise spending to fund reforms - October 3, 2014).

Public debt.

From more than 60.0% of GDP in 2002-03, Latin America's gross public debt (including domestic and overseas borrowing) dropped during the commodity boom to a low of 31.6% of GDP in 2011 before increasing again slightly to 34.4% of GDP in 2014. There are, however, important differences between countries and between Latin America and the Caribbean:

Heavy borrowers .

Brazil has by far Latin America's highest gross public debt/GDP ratio, at 63.5% in 2014, similar to its level in the mid-2000s. In net terms, however, it reached only 37.4%, comparable to countries with a smaller gross debt such as Colombia, Mexico and Uruguay. In contrast to many other LAC countries, Brazil's public debt is primarily domestic, rather than external.

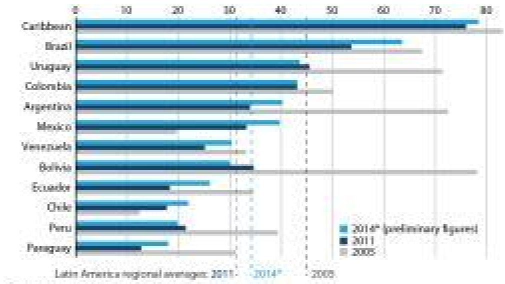
Public debt in the Caribbean is much higher than in Latin America. From an average of almost 90.0% of GDP in the mid-2000s, gross debt dropped to a low of 68.8% in 2008 before rising again to 78.4% in 2013 and 2014, with a large component of overseas borrowing. Several Caribbean countries have signed debt restructuring agreements with the IMF or announced fiscal reforms. ECLAC expects that, combined with stronger growth, these could gradually reduce debt levels ( see JAMAICA: Austerity may worsen growth, poverty woes - May 12, 2014).

Moderate borrowers .

Many South American and most Central American countries have modest debt levels, ranging between 25-45% of GDP.

Low borrowers .

Chile, Paraguay and Peru are LAC's lowest borrowers with gross debt/GDP ratios in 2014 of 21.9%, 18.0% and 19.8%, respectively. In the case of Chile, this represented an increase from 12.4% in 2005 but, in net terms, represented only 1.6% of GDP.




**Gross public debt** (% of GDP)
Source: ECLAC

## Commodity price challenge.

In 2014, the impact of weaker commodity prices on fiscal revenues differed between hydrocarbon and mineral exporters:

Oil and gas exporters. According to ECLAC, fiscal revenues from hydrocarbons dropped from an average 7.8% of GDP (seven countries) in 2013 to 6.7% in 2014. The report notes that in Bolivia, Ecuador, Mexico and Venezuela -- where hydrocarbons accounted for between 30% (Bolivia) and 45% (Venezuela) of fiscal revenues in 2010-13 -- the impact of lower prices was compounded by low growth or even a reduction of output.

Mineral exporters. By contrast, fiscal revenues from mining held steady as a percentage of GDP in 2014 largely because the price drop began in 2011 and had already taken the sector’s income tax contribution back to pre-boom levels. ECLAC estimates that, as a net effect of lower prices, increased output and exchange-rate depreciation, it will also hold steady in 2015.

Lower commodity prices force governments to face the challenge of maximising the stability of fiscal revenues from natural resources without deterring the private investment needed to develop new reserves (such as Brazil’s pre-salt deposits and Bolivia’s and Ecuador’s conventional hydrocarbons reserves). Beyond the stabilisation funds set up by, for example, Chile during the price boom, this implies complex choices such as that between taxing profits and output. The latter, because it does not take into account production costs nor, in some cases, the sale price, provides a more predictable revenue stream than the former but increases investor risk.

## Income distribution.

Income inequality remains one of the region’s most pressing challenges, According to ECLAC, tax systems are hampering progress (see LATIN AMERICA: Austerity may risk poverty progress - February 4, 2015). In addition to heavy reliance on (regressive) indirect consumption taxes (see LATIN AMERICA: Commodity prices pose revenue risks - February 5, 2014), they are ineffective in taxing the richest sectors of the population. Evasion, avoidance, exemptions and deductions, and preferential treatment of income from capital undermine the impact of ostensibly progressive personal income tax rates.

The report finds that, on average, income before direct taxes and transfers is only slightly more unequal in Latin America than in the OECD. On average, however, the Gini coefficient falls by a mere nine percentage points after direct taxes and transfers as compared to 23 points in the OECD.

In 2014, Chile, Colombia and Peru implemented tax reforms with the dual aim of increasing fiscal revenues and reducing income inequality (see CHILE: Tax reform makes swift progress - April 24, 2014). These reforms will, however, come into full effect only gradually over the next four years.

CONCLUSION: In 2015, countries with a low level of public debt, particularly Chile and Peru, will be able to boost GDP and investment growth by fiscal stimulus. However, in a context of lower commodity prices and possibly less favourable international financing conditions, more indebted countries may have to make budget cuts to avoid widening their fiscal deficit and increasing their debt burden.

## Details

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