LATIN AMERICA: Fiscal fall raises efficiency pressure

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Abstract

Regional fiscal management challenges, in the context of easing commodities prices.

A joint report released by the OECD and the Inter-American Development Bank (IDB) on June 20 urges Latin American and Caribbean (LAC) governments to improve budget management and tax collection, backed by the creation of a professional civil service, in order to boost their countries' protection against future economic shocks. However, the report also highlights the very significant progress that many of the region's countries have achieved in this field since the late 1990s.

Full Text

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ANALYSIS: Impacts.

In response to revenue constraints, LAC governments are tending to relax fiscal targets.

Given the prospect of sluggish fiscal revenue growth, efficiency gains will be crucial.

Public-sector appointments in LAC are still based mostly on political allegiance, rather than merit.

The temptation simply to cut public spending would pose political risks at a time when demands for improved services are rising.

According to the new report Government at a Glance: Latin America and the Caribbean 2014, which compares public financial management in the region with OECD practices, structural fiscal reforms played a key role in cushioning some Latin American countries -- principally Chile, Colombia, Mexico and Peru -- against the effects of the 2008-09 international crisis. However, the study concludes that, even in these countries, further efforts will be required in order to address emerging new risks:

External factors.During the commodity price boom of 2003-08, the key fiscal challenge for the region's natural resource exporters was to avoid squandering windfall revenues. Now, by contrast, the moderation of commodity prices means that the challenge will be to tailor government spending to a lower level of revenues, with the resulting temptation to bend fiscal targets (see LATIN AMERICA: Commodity prices pose revenue risks - February 5, 2014).

Increased demands.This, moreover, occurs in a context of increased pressure for more public spending, due to factors that include citizen demand for better-quality public services, a population that is beginning to age, the increasing incorporation of women into the labour force with the resulting demand for childcare services and increasing demand for access to higher education (see LATIN AMERICA: Female employment gains salience - October 1, 2013).

Fiscal sustainability.

Fiscal deficits in LAC are, in general, relatively small and, in 2011, averaged 2.1% of GDP as compared to an OECD average of 3.5%. Similarly, at 41% of GDP, public debt in LAC was well below the OECD's 79%. However, the weight of non-renewable natural resources as a source of fiscal revenues in LAC makes fiscal sustainability particularly important.

The report notes the important advances that the region has achieved in this field:

Ten of the 17 countries surveyed have adopted numeric and procedural fiscal rules since the late 1990s.

All the region's main commodity exporters, except Bolivia, have also established stabilisation funds to smooth out fluctuations in commodity revenues.

Eight countries have introduced medium-term expenditure frameworks (MTEFs) -- or, in other words, a planning horizon that extends beyond the annual budget cycle -- and, in Chile, Colombia, Mexico and Peru, these are used to manage government spending counter-cyclically.

However, the report also notes that, with the stabilisation of commodity prices since 2010, there has been some backsliding on the commitments established in these rules. Chile, for example, has gradually modified its undertaking to maintain a cyclically-adjusted budget surplus equivalent to 1% of GDP and is currently running a deficit of around 1% (see CHILE: Tax reform makes swift progress - April 24, 2014). As a result, the report concludes that, in Chile as well as in Colombia, Mexico and Peru, a permanent counter-cyclical fiscal policy has yet to be fully embedded.

Similarly, according to the report, performance budgeting -- the allocation of funding based on results -- is limited in LAC. It identifies Brazil as the region's leader in this field and notes that Chile and Mexico have made significant progress but, in most of the rest of the region, the practice remains incipient.

Small public sector.

Public sectors in LAC are small compared to those of most OECD countries. In 2011, for example, government revenues in LAC averaged 25.6% of GDP -- ranging from 40.7% in Ecuador to less than 14.0% in Costa Rica, the Dominican Republic and Guatemala -- as compared to 41.9% in the OECD. In 2010, just 10.7% of LAC's labour force worked in the public sector as compared to 15.3% in the OECD.

Partly a legacy of the neo-liberalism that prevailed in LAC in the 1990s, this is, the report claims, a handicap for the region's governments at a time when their citizens are increasingly demanding public services and infrastructure on a par with those of industrialised countries. However, the smaller size of LAC's public sectors also reflects the fact that, in a key difference with the OECD, many countries have privatised pensions, healthcare and education.

Room for improvement.

The report recommends that LAC governments seek to improve their performance in a number of areas.

Cost of government .

In LAC, government consumption (compensation of employees, and acquisition of goods and services) -- or, in other words, the cost of merely running the government -- accounted for over 50% of fiscal budgets in 2011 as compared to 39% in the OECD, suggesting substantial room for efficiency gains.

Tax collection costs .

Similarly, the tax collection cost ratio, defined as administrative costs per 100 units of net tax revenue collected, averaged 1.4 in LAC in 2006-10 as compared to 0.92 in the OECD.

Public administration shortfalls.

According to the report, the creation of a formal professional civil service is one of LAC's most important pending challenges in order to boost the effectiveness and efficiency of public policies. A number of countries, including Brazil, Chile, Mexico and Peru, have implemented reforms to replace political appointments with merit-based selection processes, but these have yet to prove their effectiveness.

The report also draws attention to pay inequalities in the public sector as mirroring the region's extremely unequal income distribution. On average, compensation of public-sector employees in LAC is higher relative to GDP than in the OECD -- pay for a senior manager, for example, averages 11.3 times GDP per capita as compared to 5.9 times in the OECD -- but the ratio of a senior manager's compensation to that of a secretary is 6.7 as compared to 4.6 in the OECD. This may partially reflect the fact that a number of countries still employ a large number of low-skilled political appointees in the public sector, which reduces both average wages and capacity to implement policy.

CONCLUSION: With the end of the recent super-cycle of commodity prices and its impact on fiscal revenues in many Latin American countries, the key challenge for governments will no longer be the prudent management of abundance but, in a context of increasing social demands, to do more with less -- without undermining progress in areas such as legal limits on budget deficits and the use of savings held in stabilisation funds.

Details

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