Fiscal Policy Principles for Latin America and the Caribbean

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1. To adjust or not to adjust? When is debt a problem?

2. When to adjust? Fiscal policy along the cycle.

3. How to adjust? Fiscal policy for long term inclusive growth
Key messages

Policymakers will be better prepared for a possible downturn in the world economy by:

1. Evaluating the need for fiscal austerity based on both the marginal productivity of capital (MPK) and the risk-free (RF) rate of interest: Even if RF is low, public debt accumulation may have a negative impact on welfare, if MPK is high. In LAC, evidence points at the benefits of keeping public debt under control.

2. Avoiding the observed procyclicality bias of spending and taxation, which requires developing credible fiscal institutions such as fiscal rules (FR) and fiscal councils (FC), especially in countries that are rich in natural resources.

3. Making budgets more flexible: Rigid budgets limit the ability of using fiscal policy as a stabilization tool and hurt an efficient resource allocation, capping long-term growth. Reducing earmarking and enhancing budget management transparency are essential to contain the spread of spending mandates.

4. Targeting spending cuts: Protecting public investment in downturns and restraining current spending in upturns. Targeting inefficient spending when budget cuts are required.

5. Enhancing the operation of Public Investment Management Systems (PIMS) to reduce project cost overruns and delays and to make public investment more productive.
1. To adjust or not to adjust - Debt levels in LAC and other regions

General Government Gross Debt in 2018 (% GDP)

Source: Managing Public Wealth, Fiscal Monitor, Oct. 2018 IMF. Table A.15
Change in General Government Gross Debt, 2009-2018 (% GDP)

Source: Calculation based on Managing Public Wealth, Fiscal Monitor, Oct. 2018 IMF. Table A.15
When is public debt bad?

Negative (r-g) differential implies debt (as % of GDP) will decrease over time; the fiscal cost is manageable.

This differential (r-g) is negative for many countries (although, not in some key LAC economies). Then, why is fiscal austerity needed?

Because, even with low interest rates, a higher public debt will often imply lower capital accumulation. Also, the future income of a higher return on capital is uncertain and needs to be discounted at a risky rate. Hence, welfare effects have to be assessed with MPK to incorporate general equilibrium effects of public debt and uncertainty.

Why can MPK > RF rate? Risk Premium or rents derived from concentration or scale economies.
Projected interest rate-growth differential ($r-g$) is negative in most countries. It is positive in some, mostly from LAC. 2018-23 (percent)

Projected interest rate-growth differential (r-g), by country groups.

2018-23 (percent)

Advanced Economies: -1.2
Emerging Market and Middle-Income Economies: -3.9
Low-Income Developing Countries: -6.7

There is a wide spread between the required rate of return on investment (MPK) and the RF rate, specially in LAC, implying negative welfare effects of larger debt.

Higher debt constrains the role of public debt as a shock absorber

1. Debt limits fiscal space; may lead to procyclical fiscal policy.

2. Increases risk. As debt rises, its composition changes: maturity shortens, increasing rollover risk; or FX indexation is required to reduce investor uncertainty, but increases currency risk for the government.

3. Higher debt changes composition of spending and interest payments increase the budget rigidity.
As debt increases, maturity tends to shorten. As financial cost rises, debt managers tend to issue cheaper, short-term debt. “Snowball risks”
Most LAC countries avoided “original sin”, this time around.

Currency Composition of Government Debt (% of total)

- Local Currency
- Foreign Currency

Argentina

Brazil

Chile

Colombia

Mexico

Q4 2009

Q3 2018

Q4 2009

Q3 2018

Q4 2009

Q3 2018

Q4 2009

Q3 2018
As debt rises, interest payments increase their share in the budget. Higher debt implies higher financial cost and more budget rigidity.

Countries with more rigid spending have higher spending

Source: Rigid expenditure includes the wage bill, interest payments and a proxy for expenditure in pensions. Rigidity of Budget in LAC. World Bank Regional Study.
Countries with more rigid spending also have higher VAT rates

Source: Rigid expenditure includes the wage bill, interest payments and a proxy for expenditure in pensions. Rigidity of Budget in LAC. World Bank Regional Study.
Countries with more rigid spending have higher deficits

Source: Rigid expenditure includes the wage bill, interest payments and a proxy for expenditure in pensions. Rigidity of Budget in LAC. World Bank Regional Study.
Countries with more rigid spending also have higher debt

Source: Rigid expenditure includes the wage bill, interest payments and a proxy for expenditure in pensions. Rigidity of Budget in LAC. World Bank Regional Study.
Countries with more rigid spending also have lower efficiency.

Source: Rigid expenditure includes the wage bill, interest payments and a proxy for expenditure in pensions. Rigidity of Budget in LAC. World Bank Regional Study. Efficiency measures from Afonso et. al. (2013) Public Sector Efficiency: Evidence for Latin America. IDB.
When to adjust? Fiscal Policy along the Cycle

Procyclicality in LAC

In red are resource-rich countries

Source: Herrera, Kouame, and Mandon 2019 Why some countries can escape procyclicality trap and others can’t. World Bank. Budget Rigidities in LAC
## Procyclicality in LAC vs. Other regions

Procyclicality is being reduced in ECA and LAC, but other regions show stagnation, or even reversal.

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<tbody>
<tr>
<td>1</td>
<td>ECA</td>
<td>Europe &amp; Central Asia</td>
<td>0.48</td>
<td>0.05</td>
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<tr>
<td>2</td>
<td>LAC</td>
<td>Latin America &amp; Caribbean</td>
<td><strong>0.20</strong></td>
<td><strong>0.09</strong></td>
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<tr>
<td>3</td>
<td>MENA</td>
<td>Middle East &amp; North Africa</td>
<td>-0.23</td>
<td>0.12</td>
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<tr>
<td>4</td>
<td>SEAP</td>
<td>South, East Asia &amp; Pacific</td>
<td><strong>-0.07</strong></td>
<td><strong>-0.02</strong></td>
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<td>5</td>
<td>SSA</td>
<td>Sub-Saharan Africa</td>
<td>0.23</td>
<td>0.22</td>
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</tbody>
</table>

Notes: LAC is not “the worst performer” but it still not countercyclical after 2008.

Source: Herrera, Kouame, and Mandon 2019 Why some countries can escape procyclicality trap and others can’t. World Bank. Budget Rigidities in LAC
**Why fiscal procyclicality matters**

- Fiscal procyclicality drives volatility, and volatility is associated with lower GDP growth.

- Volatility of public spending is positively associated with household consumption volatility, and hence lower household welfare.

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\[ \text{Consumvol} = 2.32 + 0.45 \text{FPvol} \]

\[ R^2 = 0.49 \]

Source: Herrera, Kouame, and Mandon 2019 Why some countries can escape procyclicality trap and others can't. World Bank. Budget Rigidities in LAC
Resource-dependence raises the procyclicality of spending

Source: Herrera, Kouame, and Mandon 2019 Why some countries can escape procyclicality trap and others can’t. World Bank. Budget Rigidities in LAC
Countries with fiscal councils show lower spending procyclicality

Source: Herrera, Kouame, and Mandon 2019 Why some countries can escape procyclicality trap and others can't. World Bank. Budget Rigidities in LAC
Countries with fiscal rules show lower procyclicality bias

Source: Herrera, Kouame, and Mandon 2019 Why some countries can escape procyclicality trap and others can’t. World Bank. Budget Rigidities in LAC
Fiscal Policy for Long-Term Growth: Supporting productive investment
Efficiency of LAC capital spending can be improved substantially

LAC achieves 57% of the level of infrastructure quality achieved by countries on the efficiency frontier

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<tr>
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<th>AFR</th>
<th>EAP</th>
<th>ECA</th>
<th>LAC</th>
<th>MNA</th>
<th>SAS</th>
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<tbody>
<tr>
<td>Quality of electricity supply</td>
<td>0.44</td>
<td>0.68</td>
<td>0.70</td>
<td>0.63</td>
<td>0.75</td>
<td>0.49</td>
</tr>
<tr>
<td>Transport infrastructure</td>
<td>0.48</td>
<td>0.67</td>
<td>0.53</td>
<td>0.54</td>
<td>0.63</td>
<td>0.54</td>
</tr>
<tr>
<td>Quality of air transport infra</td>
<td>0.57</td>
<td>0.71</td>
<td>0.62</td>
<td>0.66</td>
<td>0.71</td>
<td>0.60</td>
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<tr>
<td>Quality of port infrastructure</td>
<td>0.56</td>
<td>0.65</td>
<td>0.55</td>
<td>0.60</td>
<td>0.67</td>
<td>0.53</td>
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<tr>
<td>Quality of railroad infra</td>
<td>0.35</td>
<td>0.52</td>
<td>0.51</td>
<td>0.30</td>
<td>0.48</td>
<td>0.47</td>
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<tr>
<td>Quality of roads</td>
<td>0.52</td>
<td>0.66</td>
<td>0.51</td>
<td>0.57</td>
<td>0.70</td>
<td>0.56</td>
</tr>
<tr>
<td>Quality of overall infra</td>
<td>0.52</td>
<td>0.65</td>
<td>0.59</td>
<td>0.57</td>
<td>0.69</td>
<td>0.54</td>
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Cost Overruns in Infrastructure, Latin America and Rest of the World
(% of project cost)

- Dams
- Rail
- Power Plants
- Roads
- Total

Source: Calculations based on Mejor Gasto para Mejores Vidas, ed. Izquierdo, Pessino y Vuletin. BID.
Policymakers will be better prepared for the downturn by:

1. Evaluating the need for fiscal austerity based on country-specific MPK-RF: Data for LAC indicate that keeping public debt under control is a priority despite low interest rates.

2. Reducing the procyclicality of spending and taxation: That requires developing credible fiscal institutions (e.g., fiscal rules councils), especially in natural-resource-rich countries.

3. Flexibilizing budgets: Rigid budgets limit the role of fiscal policy as a stabilization tool and hurt resource allocation/long-term growth. Limiting earmarking and enhancing the transparency of resource management and the budget process are a must.


5. Enhancing the operation of Public Investment Management Systems (PIMS) to reduce project cost overruns and delays, and to make public investment more productive.
Thank you!
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