

# ECONOMIC AND FISCAL POLICY IN LATIN AMERICA

*Christina Wagner Faegri*  
*University of Southern California*

*Carol Wise*  
*University of Southern California*

**Federalism, Fiscal Authority, and Centralization in Latin America.** By Alberto Díaz-Cayeros. Cambridge: Cambridge University Press, 2006. Pp. xvii + 277. \$86.00 cloth.

**Does the Investment Climate Matter? Microeconomic Foundations of Growth in Latin America.** By Pablo Fajnzylber, J. Luis Guasch, and J. Humberto López. Washington, D.C.: International Bank for Reconstruction and Development and World Bank, 2009. Pp. xxi + 321. \$80.00 paper.

**Informal Coalitions and Policymaking in Latin America.** By Andrés Mejía Acosta. New York: Routledge, 2009. Pp. xi + 192. \$105.00 cloth.

**Growing Pains in Latin America: An Economic Growth Framework as Applied to Brazil, Colombia, Costa Rica, Mexico, and Peru.** By Liliانا Rojas-Suarez. Washington, D.C.: Center for Global Development, 2009. Pp. ix + 303. \$26.95 paper.

**The Political Economy of the Public Budget in the Americas.** Edited by Diego Sánchez-Ancochea and Iwan Morgan. London: Institute for the Study of the Americas and University of London, 2009. Pp. xii + 263. \$30.00 paper.

**Taxation and Latin American Integration.** Edited by Vito Tanzi, Alerto Barreix, and Luis Villela. New York: Inter-American Development Bank; Cambridge, MA: David Rockefeller Center for Latin American Studies and Harvard University Press, 2008. Pp. vi + 438. \$39.95 paper.

Nearly three decades after the fact, a substantial body of literature has emerged on the economic and political turbulence that rocked Latin America in the context of the 1982 debt crisis. Amid the immediate challenges

of stabilizing the economy and restarting growth, policy makers sought to define a new model of development, thereby kicking off a slew of policy prognoses and prescriptions. Despite differences in methodology and modes of inquiry, political scientists, policy makers, and economists have posed the same basic questions: What are the most important variables for spurring high sustainable growth? What combination of monetary and fiscal policies might best foster development, broadly defined?

Although economists have focused mainly on the determinants of economic growth, political scientists have sought to understand the political and institutional foundations of reform. Because of this difference, two parallel programs of research have dominated the study of Latin American development after the so-called lost decade of the 1980s. The first draws on neoclassical analyses of economic growth that date back to the 1950s and 1960s, an approach that stresses the importance of technological innovation, capital accumulation, and getting prices right. The second program posits the prime importance of institutions for igniting economic growth and rests on the work of Douglass North, which maintains that institutions encompass both formal rules and informal conventions that shape incentives for social, political, and economic behavior.<sup>1</sup> From this main point of departure, political science literature on institutional reform in Latin America has covered the spectrum of possible variables, from the executive to the legislature, political parties, civil society, and the organizational entities that constitute the state.

In this review essay, we straddle these two traditions to assess recent works that fall under the rubric of economic policy making in Latin America. At the same time, we highlight other publications that pertain to the political economy of fiscal policy. Although fiscal policy received top billing on the list of reforms that came under the rubric of the Washington Consensus, and was a central pillar of the adjustment programs that the International Monetary Fund and the World Bank pushed, this fundamental variable has, until recently, received comparatively short shrift in political economy literature.<sup>2</sup> Beginning with the work of a first group of scholars on the broader issue of Latin American growth, its lackluster performance since a wave of reforms in the 1990s, and the impediments associated with that underperformance, we focus on the various dimensions of fiscal policy, including the domestic politics of tax reform, legislative coalition building, and the potential for reaching viable fiscal bargains.

1. Douglass North, *Institutions, Institutional Change and Economic Performance* (Cambridge: Cambridge University Press, 1990).

2. John Williamson, *Latin American Adjustment: How Much Has Happened?* (Washington, D.C.: Institute for International Economics, 1990).

ECONOMIC POLICY MAKING: HALF-HEARTED REFORMS AND  
THE PAUCITY OF GROWTH

The collection of essays edited by Fajnzylber, Guasch, and López revisits the record of Latin American growth since the 1960s. As a whole, this economically oriented volume argues that the region has been unable to exploit the advantages of a favorable global economic climate. Hence the authors' overriding query: "What leads to poor performance on the (per capita) growth front?" (6). The introductory chapter by Alaimo, Fajnzylber, Guasch, López, and Oviedo suggests that a sluggish investment rate, poor returns on investment, and low-factor productivity—the capacity to maximize the inputs of production efficiently—remain the major bottlenecks to growth across the region. Consequently, the studies in this volume revolve around two critical questions: What are the conditions that deter investment and more productive returns in the region? Why do the rates of factor productivity growth in Latin American nations linger below those of other countries at similar levels of development?

*Does the Investment Climate Matter?* focuses mainly on the microeconomic features of the investment climate that impede growth in the region, including the quality of government institutions, regulatory frameworks, physical and financial infrastructure, and education and training. These aspects have not improved on par with considerable advances in the macroeconomic realm; in fact, extensive analysis demonstrates that most Latin American countries fall well below the levels of institutional quality that would be expected given their level of development. As a result, the authors conclude that there is substantial room, if not an urgent need, for institutional and regulatory improvement across the region.

Latin America's productivity growth is especially disheartening. In the period from 1971 to 2005, for instance, the average total-factor productivity (TFP) growth rate in Latin America was 1.6 percent, a rate similar to that of sub-Saharan Africa but well below that of East Asia, whose average TFP growth was 3.8 percent. Alaimo and coauthors' analysis of these figures suggests that differences in TFP gains, particularly in technology adaptation and innovation, drive roughly half the cross-country differences in per capita income. These results speak partially to the need to improve the quality of education and training, but, despite advances, Latin America still lags behind other developing regions in terms of human capital, and hence its loss of ground relative to other areas at comparable levels of development (see figure 1.18). Thus, in line with previous studies, Alaimo and coauthors recommend that the region give priority to investment in human capital and innovation.

A second chapter also by Alaimo, Fajnzylber, Guasch, López, and Oviedo provides a deeper analysis of the extent to which the institutional underpinnings of investment policy affect labor productivity, TFP, and wages in

Latin America. Using a pooled sample of more than ten thousand firms that encompasses most countries in the region and relies on microeconomic survey data, the authors examine the relationship between investment and growth. Their analysis suggests a strong relationship between institutional quality and economic growth. For example, lower levels of labor productivity characterize firms operating where enforcement of the rule of law is inadequate—as measured by indicators of crime, expenditures on security, and the incidence of bribes. The authors conclude that strengthening the rule of law and regulatory frameworks is essential for improvement in the overall investment climate, as those institutional variables are among the most essential determinants of company performance.

Delving further into the institutional foundations of growth, Alaimo and coauthors seek, in yet another chapter, to uncover the determinants of corruption in the region. The data they present on bribery indicate significant differences across Latin America, with Brazil, Ecuador, and Paraguay scoring highest on the corruption scale. Again, corruption is significantly lower where a credible judicial system enforces laws and regulations, in support of the general hypothesis that a weak institutional framework impedes investment and, by extension, long-term economic growth.

The propositions tested in this volume will interest economists and political scientists alike, as each chapter draws on both institutional and economic strands of the literature that have dominated the field of Latin American development. Although others have explored well the effects of these institutional variables on economic development, *Does the Investment Climate Matter?* advances this line of research by devising a range of sophisticated measures. At the same time, it avoids the critical question of institutional reform. Indeed, the challenge for the field in general involves understanding why and how reforms are successfully undertaken in some countries but not in others.

*Growing Pains in Latin America* does tackle the exigencies of institutional reform, albeit unevenly. In asking, “What can Latin American countries do to accelerate economic growth while ensuring its sustainability?” (5), Rojas-Suarez and her contributors seek more particularly to identify the variables that most strongly encourage or impede capital accumulation and productivity. Explicitly avoiding a straitjacket approach to the region’s problems, the authors construct an analytical framework tailored to the region’s peculiar economic, social, and political obstacles that should be targeted for reform. Through individual case studies that encompass market reforms in Brazil, growth policies in Colombia, political and institutional obstacles to reform in Costa Rica, and structural reforms in Mexico and Peru, the authors also address the conditions that affect policy making in each specific instance. Each chapter identifies local constraints and offers prescriptions that are conducive and complementary to the fundamentals of economic growth.

A first essay by Liliana Rojas-Suarez outlines three structural conditions that, she argues, complicate the prospects for institutional reform in the region. First, a high degree of financial openness makes Latin America more susceptible than other developing regions to external structural changes and global financial shocks. This proposition rests on a study from 2007 by Menzie D. Chinn and Hiro Ito that concluded that Latin America's financial-openness score is more than double that of the Middle East and North Africa, and triple that of Eastern Europe and Central Asia. Second, democratization may impede the process of reform across the region, as several studies have indicated that Latin America is the most democratic of the developing regions (see table 4). As the author notes, a backlash against the market reforms of the 1990s swept Latin America by the end of that decade, as deep cuts in social spending and government services adversely affected large numbers of people. The bottom line is that reforms not supported by broad segments of the population may be quite difficult to sustain over time. Third, the chapter reminds us that Latin America is the most unequal of developing regions in terms of social and economic indicators (see figure 4). Rojas-Suarez cites several studies that have found a negative relationship between income inequality and growth, although the nature of this relationship is still ambiguous. On the basis of such studies, Rojas-Suarez argues that inequality is "one of the constraints" that have prevented reforms from delivering sustainable productive growth in Latin America (53).

*Growing Pains in Latin America* offers a wealth of data and insights into the political economy of reform in Latin America. Most, if not all, of its case studies draw on theoretical insights from both political science and economics to foster an interdisciplinary research agenda for growth and development. Nevertheless, the individual case studies could be more tightly integrated into the volume's analytical framework, which holds that three structural conditions—financial openness, democracy, and inequality—affect the process of reform and distinguish Latin America from other developing regions. The way the introductory chapter frames these structural conditions leads one to expect that the case studies that follow will explore their impacts through a systematic study of reforms across the region. This systematic analysis is never fully realized, however. Although the case studies are well crafted in their own right, the gap between the theoretical and empirical parts of the volume dilutes its final impact.

Turning more particularly to policy reform, Mejía Acosta's study of economic reform in democratic Ecuador lays out a theoretical framework for analyzing the conditions under which relatively far-reaching reforms were enacted despite a highly unfavorable political environment, like that in Ecuador between 1992 and 2003. Observing that conventional analyses predict the failure of deep reforms in highly polarized legislatures, Mejía

Acosta introduces the concept of ghost coalitions to explain the political alliances that backed passage of major economic and political reforms by three different administrations during the period. As the term *ghost* suggests, such coalitions are clandestine in nature and entirely contingent on the convergence of disparate interests on a particular set of issues, in this case, reforms. In essence, this study suggests that such coalitions made economic modernization and stability possible during the administrations of Presidents Sixto Durán Ballén (1992–1996), Jamil Mahuad (1998–2000), and Gustavo Naboá (2000–2003).

Mejía Acosta focuses on the legislative strategies of the principal actors in the process of policy making—the president, key legislators, and party leaders—in which the latter particularly serve as brokers between the executive and individual legislators. These actors forged successful coalitions by bridging the president's need for reliable votes and demands by legislators for parochial benefits. Such efforts are ghost coalitions in that they offer the anonymity ambitious legislators prefer while maximizing the likelihood of realizing the legislative agenda of the executive. Mejía Acosta's model further postulates that, in politically polarized settings, both the executive and legislators lack incentives to build formal coalitions and thus prefer to deal with one another outside the formal policy-making process. That is especially the case if the incumbent government has weak public support and little chance of reelection. In such a climate, Mejía Acosta argues, opposition parties tend to fear that association with an unpopular executive will adversely affect their electoral prospects. In other words, ghost coalitions enable legislators to dissociate themselves from formal politics that could impede their long-term political aspirations.

Mejía Acosta contends that the modernization laws passed under Durán Ballén, like the dollarization reforms under Mahuad and Naboá, were made possible by clandestine coalitions, as none of these presidents enjoyed a legislative majority. Durán Ballén, for example, had a small minority of backers in the Ecuadorian congress and pursued a behind-the-scenes, informal alliance with the Social Christian Party (Partido Social Cristiano, or PSC), then the largest party, to pass modernization and market-oriented reforms in 1992–1994. This ghost coalition was finally exposed three years later, when Durán Ballén's vice president, Alberto Dahik, was impeached because of a corruption scandal.

Mejía Acosta suggests that his analytical framework, which places party leaders at the center, allows for more innovative approaches to the study of coalition formation. It also shifts attention from formal rules and procedures to informal practices, which are largely lacking from prior analyses of deal making. However, the study also raises important issues in regard to its methodology and the prospect of its replication in other contexts. First, insofar as the agreement between Durán Ballén and the

PSC was disclosed only because of a high-profile corruption scandal, how might one acquire reliable information about other secret deals for which no public documents exist? Second, what distinguishes ghost coalitions from old-fashioned rent-seeking activities or practices of corruption? Although these concerns are important, they should not be construed as an argument against the study of informal political practices. In the end, Mejía Acosta's study unquestionably enhances our understanding of coalition building, and it offers rich and rare insights into the politics of economic policy making in Ecuador.

#### THE ELUSIVENESS OF TAX REFORM: A CHRONIC FISCAL CRISIS OF THE STATE

Taxation and tax reform make up another strand of broader analyses of economic and fiscal policy. Despite the central role of taxation in economic development and growth, political economists have yet to develop a program of research that fully captures the politics of tax reform in emerging-market economies. Although legislative coalitions for economic reform have emerged in even the most contentious political environments, tax reform remains one of the more contested and understudied issues in Latin America. With few exceptions, countries in the region still collect less tax revenue than other states with comparable levels of development. Fiscal policies that might increase this revenue are consistently deterred because of political conflicts, typically involving collective action against a more even distribution of the adjustment burden. Because studies on fiscal policy remain largely detached from the politics of taxation, a major strength of the works reviewed here is that they take into account the viability of proposed policy changes. *Federalism, Fiscal Authority, and Centralization in Latin America*, by Díaz-Cayeros, represents the best of this emergent literature.

Focusing on the twentieth century, when Latin America witnessed several attempts at the federal level to centralize tax authority, Díaz-Cayeros argues that centralization occurred only when national politicians agreed to use the powers of the central government to protect regional politicians from electoral threats and other forms of political competition. By relinquishing the power to levy taxes, local governors agreed, in turn, to federally administered financial transfers. In essence, fiscal centralization took place because the federal government could offer a credible bargain. The central puzzle is, nevertheless, why regional governments agreed to such a pact, given the absence of assurances that the system of transfers would be maintained.

Although a good part of Díaz-Cayeros's book focuses on Mexico, he compares the political processes that led to the consolidation of fiscal authority there with those in Argentina, Brazil, and Venezuela. These cases show considerable variation in the extent of fiscal centralization in

Latin America, however. Among these cases, Mexico underwent the most dramatic change, as state governors gave up the authority to levy most local taxes, thus creating the centralized system that we associate with the country today. In contrast, Venezuela remained highly centralized, whereas Brazil witnessed movement toward consolidation under military rule but still remains one of the most decentralized federations in the region (see figure 1.1). The fiscal relationship between the provinces and the central government in Argentina stands out as the most complex and volatile, and, despite several concrete attempts at centralizing tax revenue, a fiscal bargain similar to that of Mexico was never reached.

Díaz-Cayeros's data reveal that an initial wave of centralization in Mexico began at the end of the revolution and concluded in 1948. During that phase, the federal government made at least two attempts to consolidate tax powers (at the tax conventions of 1925 and 1933), yet both were unsuccessful because of the government's weak authority and its inability to overcome the challenge of regional strongmen. This changed with the consolidation of Mexico's hegemonic party, the Partido Revolucionario Institucional (PRI), in 1940. The latter muted political quarrels, and local politicians accepted a new fiscal arrangement in return for attractive political appointments. The establishment of a federal sales tax less than a decade later buttressed this arrangement. In conclusion, the "comprehensive revenue-sharing system that exists today originated from a political equilibrium in which politicians at the local level retained their local aspirations but were willing to cooperate with politicians at the national level" (123). In 1979, the federal value-added tax (VAT) concluded the last wave of fiscal centralization, adding to the fiscal powers of the central government.

The focus on the politics of tax reform and the conditions that permit political bargains is unquestionably important. Nevertheless, the specificity of Mexico's case raises questions for future studies using Díaz-Cayeros's model. In particular, the rise of a hegemonic party and of a system of rewards and political appointments implies that the PRI's constitution itself altered the incentive structure of political actors, thus allowing the party to co-opt regional politicians into supporting tax centralization at the federal level. Given this, questions arise as to the viability of similar bargains in fragile multiparty democracies, as political stability of the sort the PRI provides is unlikely in these other settings. Hence, the question: can such pacts be reached where credible commitment is by definition tenuous? Second, it may well not be possible to uncouple the long-term credibility of Mexico's bargain from the seventy-one-year tenure of the PRI. Overall, however, this book is a must-read for students of political economy and those interested in the politics of fiscal policy reform in Latin America.

Turning instead to the issue of budget structures, the volume of essays edited by Sánchez-Ancochea and Morgan focuses on the politics of the



budget in the nations of Latin America and in the United States. As the editors note, the Americas are made up of small fiscal states, a term used to describe nations with a low taxation and low spending equilibrium. The volume rests on the assumption that the maintenance of small budgets is problematic, as the region as a whole faces increasing demands for infrastructure and public services, thus causing many states to risk high deficits to satisfy demand.

Sánchez-Ancochea and Morgan suggest that a particular set of economic and political conditions explains the prevalence of small fiscal states in the Americas. On the one hand, in many Latin American nations, authoritarian regimes and right-wing governments effectively curtailed debates over welfare spending, and by implication the expansion of the state. Consequently, the political impetus for the development of welfare states remained relatively weak. On the other hand, Latin American political parties suffered from a combination of low levels of institutionalization and personalistic rather than programmatic ties to voters, thereby leading to policies more attentive to parochial interests than to the common good. Sánchez-Ancochea and Morgan argue that these two factors explain the historical roots of the low tax revenue and low spending equilibrium that characterizes the region as a whole today.

Turning to the challenges of reforming the fiscal state, Colin M. Lewis and Andrew H. Mitchell examine the relationship between the state's ability to collect taxes and its ability to provide public goods. Focusing on Argentina, their chapter argues that when taxpayers do not believe that they receive services commensurate with their contributions, the state faces not only opposition to reform but also widespread tax evasion. That is to say, taxpayers are unwilling to support the expansion of the state if they do not trust its administration of resources. The lack of trust results in a low tax and low capacity equilibrium; the state cannot increase services, and citizens are disinclined to support its expansion and its efforts to increase tax revenue.

The chapter by Manuel R. Agosín, Roberto Machado, and Aaron Schneider looks more specifically at recent tax reforms in the Central American Common Market (CACM). As in most of Latin America, the tax capacity of Costa Rica, El Salvador, Guatemala, and Nicaragua is less than the average of developing countries. Agosín and coauthors' hypothesize that tax capacity varies in accordance with gross domestic product (GDP) and income distribution, so that wealthier and more equal states collect the most taxes. This suggests that the middle class not only is larger in egalitarian societies but also asserts greater pressure on social and economic decision making, as the middle class is usually the user of state-provided services.

This volume makes a significant contribution to the relatively small body of literature on tax policy and tax reform in Latin America, par-

ticularly by formulating testable propositions on the relationship between tax policies and political and social variables such as income inequality and political polarization. Several chapters also discuss the challenges involved in defining key concepts such as trust and credibility, laying the groundwork necessary for future research on the politics of taxation. The work by Lewis and Mitchell on tax policy in Argentina is particularly relevant in this regard.

One quibble: although Sánchez-Ancochea and Morgan point out that Latin America and the United States have similar budget structures, including low tax burdens and low levels of social spending, the difference in their tax burdens is significantly large to challenge this comparison. For example, data presented on tax receipts as a percentage of GDP from 1900 to 2000 show that Argentina never collected more than 16 percent of GDP in taxes. Only in recent years did it collect more than 12 percent of GDP (see figure 2.2). Although the volume lacks comparative data for the United States, it cites a well-known study on taxation in the United States, Great Britain, and Sweden from 1900 to 1990, which indicates that the United States collects around 30 percent of GDP (see figure 2.8).<sup>3</sup> Although the difference may not seem large, it is important to compare the figures to the overall scale of taxation. Sweden, which has among the highest tax-to-GDP ratios in the world, collects around 47 percent of GDP, whereas some Latin American countries—for example, those of the CACM—collect around 10 percent, which places them at the lower limits of the scale. Consequently, the difference in tax-to-GDP ratios across the Americas is substantial. Indeed, Sánchez-Ancochea's econometric analysis later finds a strong relationship between GDP and tax capacity (see figure 10.3), which suggests that future studies would benefit from holding the level of development constant.

*Taxation and Latin American Integration* looks more superficially at the changes that tax structures in the region have undergone since the debt crisis. Luis Villela, Jerónimo Roca, and Alberto Barreix note in their chapter that tax systems in the region have faced increased external pressures since the debt crisis of the 1980s, including the loss of taxes on trade—the most important source of revenue—because of widespread commercial liberalization. First among changes in fiscal policy is the widespread adoption of a value-added tax (VAT). Although many Latin American countries instituted the VAT before the debt crisis, its importance, measured in terms of revenue collection, increased significantly afterward. The VAT is today a pivotal source of revenue across the region, albeit not an uncontroversial one, as it effectively shifts the tax burden to the consumer. The VAT is also heavily criticized as regressive, in that lower-income groups

3. Sven Steinmo, *Taxation and Democracy: Swedish, British, and American Approaches to Financing the Modern States* (New Haven, CT: Yale University Press, 1993).

spend a greater proportion of their resources on consumer goods than do higher-income groups. This is a welcome addition to research on fiscal policy, because, with a few notable exceptions, there have been relatively few comparative studies on the implementation and design of the VAT.<sup>4</sup>

The chapter by Reuven S. Avi-Yonah turns to the relationship between globalization and taxation. As frequently noted, globalization has put pressure on governments to lower corporate and income taxes to attract portfolio and foreign direct investment. There is some evidence that this has led to increased competition among states to attract foreign capital, which may further undermine the capacity of the state to set tax policy autonomously. Historically, income taxes have constituted a small proportion of total tax revenues in Latin America; global pressures may make it more difficult to expand such taxes in the future. The chapter by Eduardo Wisner further points out that regional integration, though still incipient in Latin America, is also expected to put pressure on domestic tax policies, as governments will face a greater need for collaboration and tax harmonization. Overall, *Taxation and Latin American Integration* suggests that, because institutions are relatively weak in Latin America, governments there may not be able to mitigate external pressures as effectively as developed countries.

#### CONCLUSIONS

Together, the six books under review bring us closer to integrating the study of the determinants of economic growth and the study of the political and institutional foundations of reform. Despite different emphases, methodologies, and measures, most of these studies reach very similar conclusions: countries with mutually reinforcing economic strategies and political frameworks perform best on the growth front; those with comparatively weak political and economic institutions will continue to lag behind and be more prone to externally imposed or internally driven boom and bust cycles.

4. For exceptions, see Richard M. Bird and Pierre-Pascal Gendron, *The VAT in Developing and Transitional Countries* (Cambridge: Cambridge University Press, 2007); Junko Kato, *Regressive Taxation and the Welfare State* (Cambridge: Cambridge University Press, 2003).