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New Approaches to Closing the Fiscal Gap

Latin America and the Caribbean Economic Review

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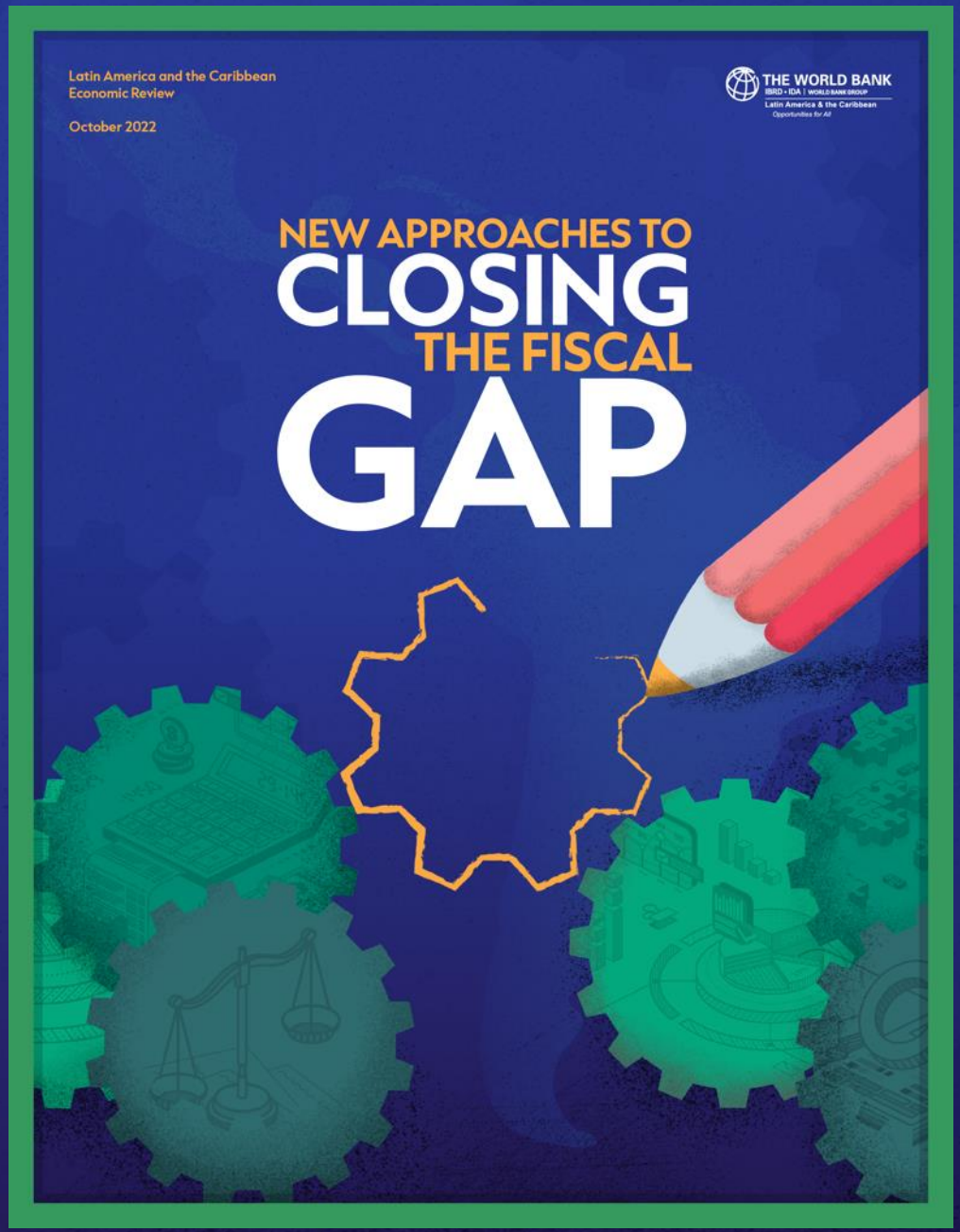
World Bank – October 2022

Chapter 1: Are We Back to Normal Yet?

Recovery, Inflation, and the Search for Fiscal Space.

Chapter 2: Closing the Fiscal Gap:

New Approaches



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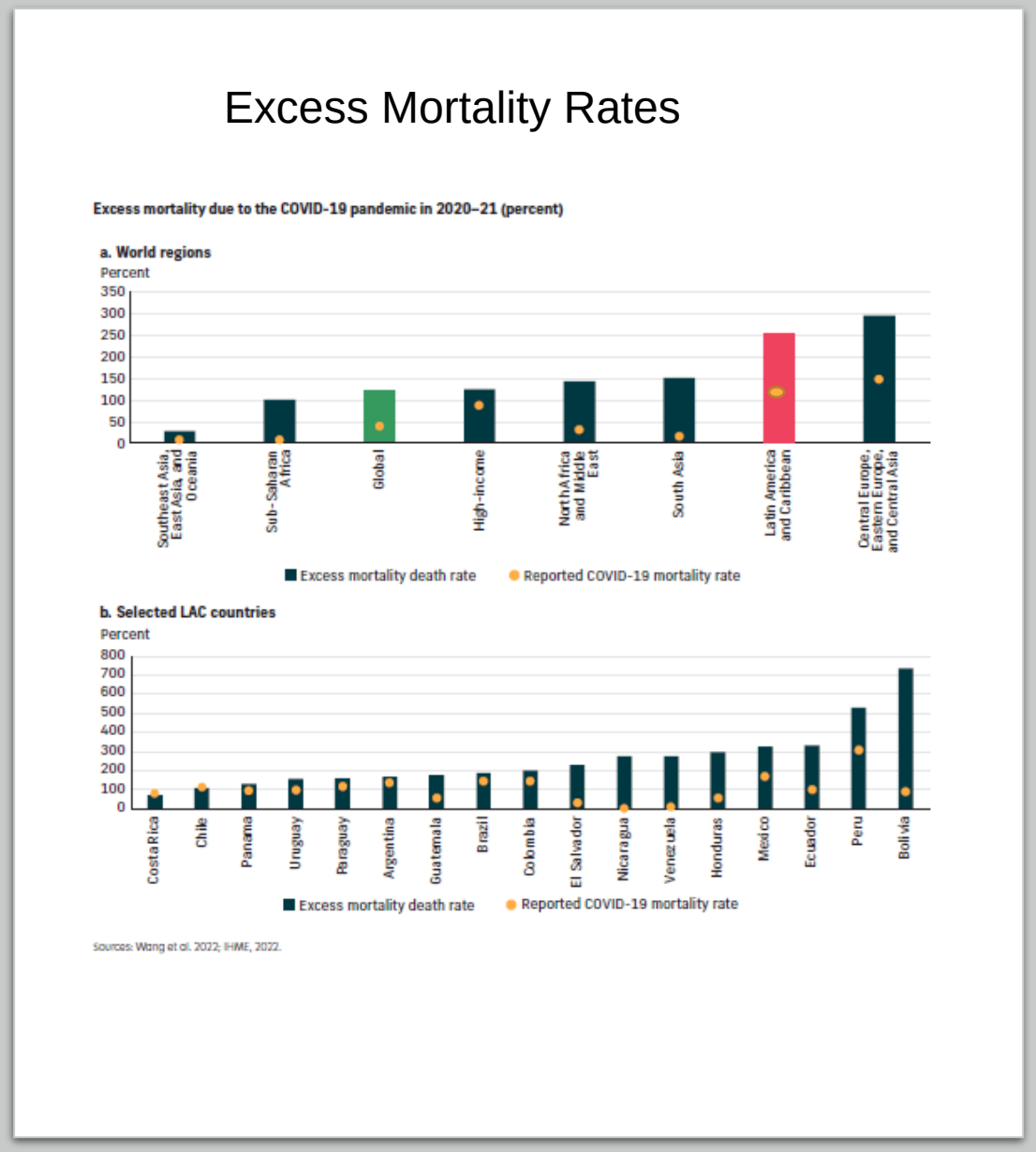
CH 1: Are We Back to Normal Yet?

Recovery, Inflation, and the Search for Fiscal Space

Retrospective: LAC was hit brutally by Covid.

- Excess mortality rates are now at global levels.

- Substantial under reporting in some countries.



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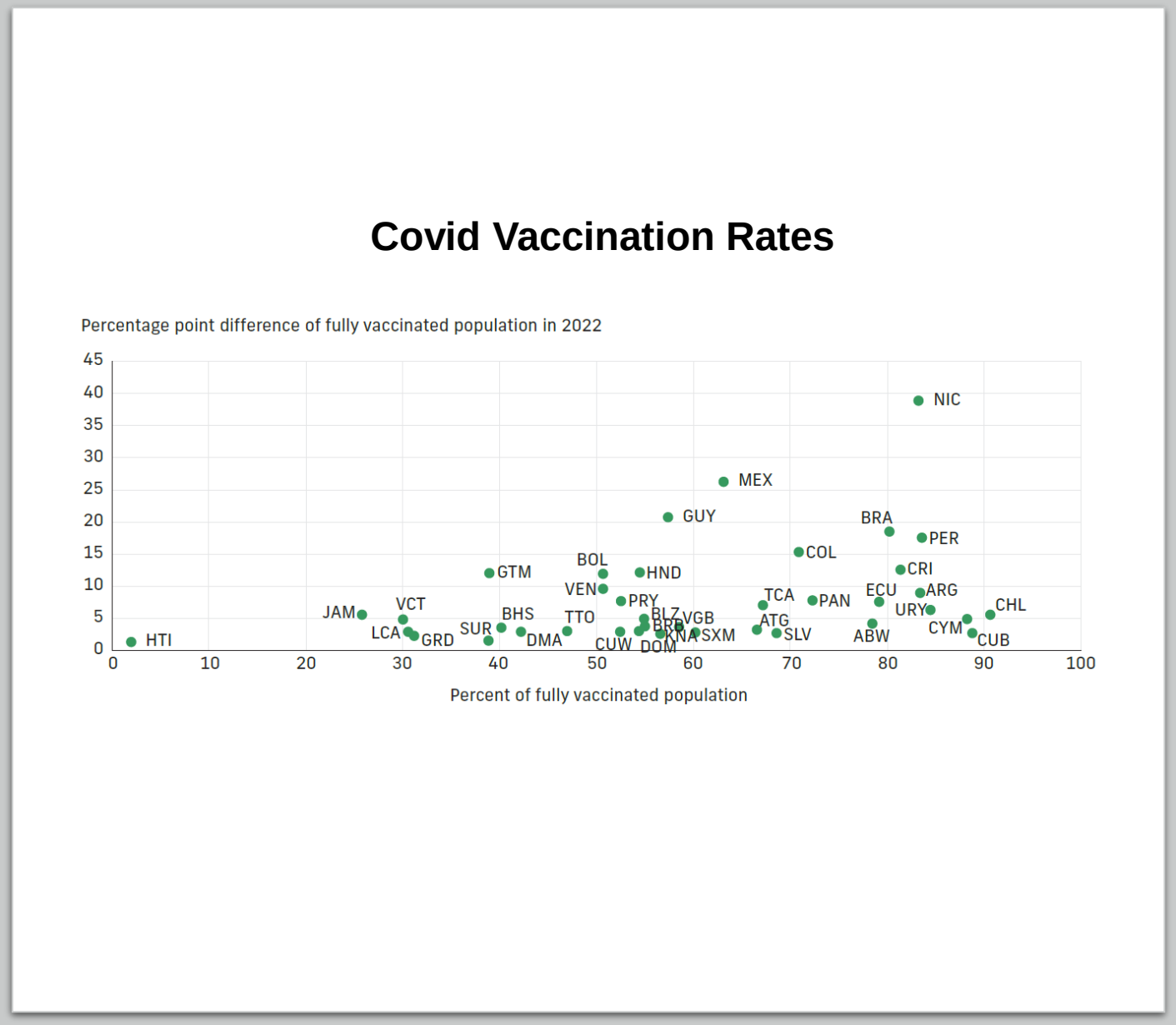
Great, but incomplete progress on Covid vaccines

- Caribbean and some CA remain vulnerable to new variants.



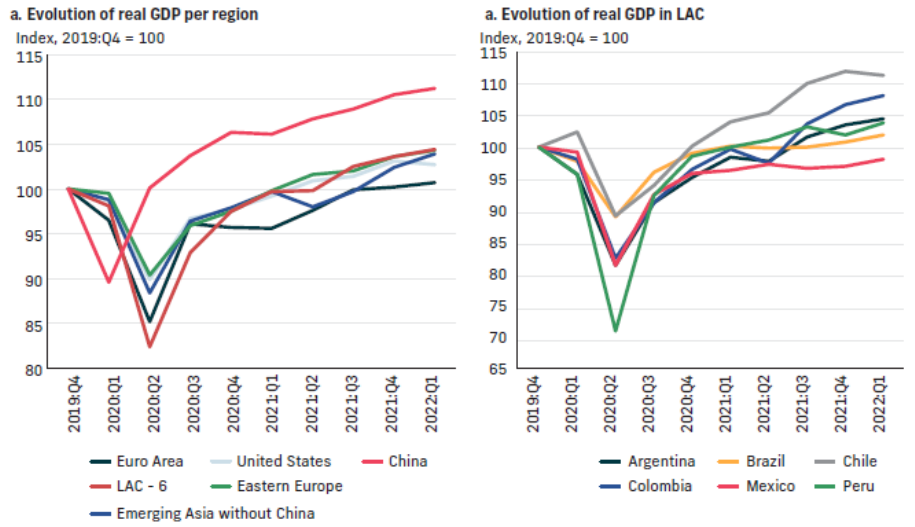
LAC has recovered pre-pandemic income levels, but medium term growth is weak

- Upgrade in forecast for 2022

Forecast	April	October
2022:	2.3%	3.0%
2023:	2.2%	1.6%
2024:	2.4%	2.3%

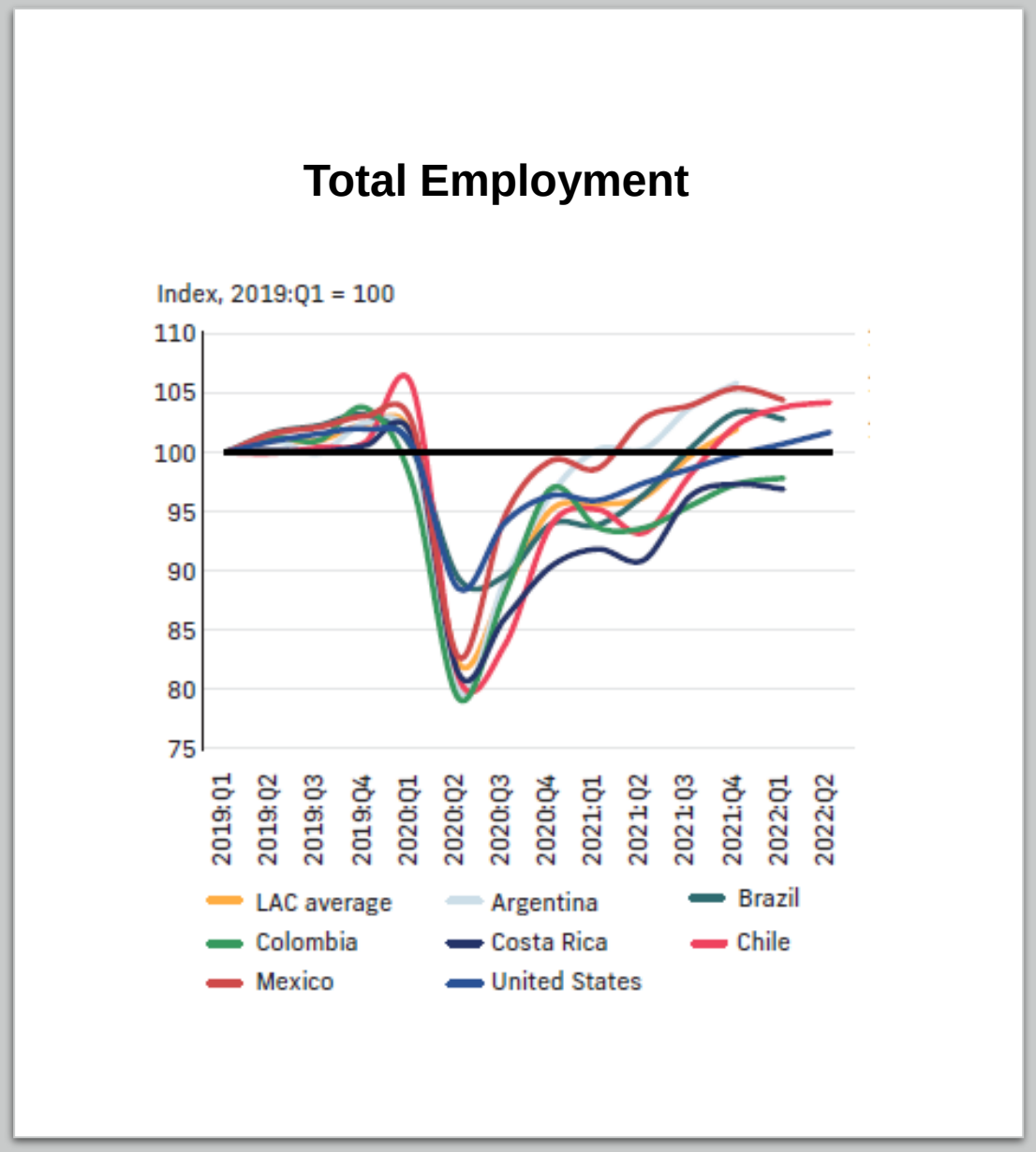
- Impact of Ukraine uneven, but less negative than other regions.
  - Food and fuel prices hit net importers and exporters differently

Growth in Real GDP



Social indicators have largely recovered, but long term scarring requires policy attention

- Employment largely recovered.
- Monetary poverty back to 2019 levels.
  - Excluding Brazil, region still lags.



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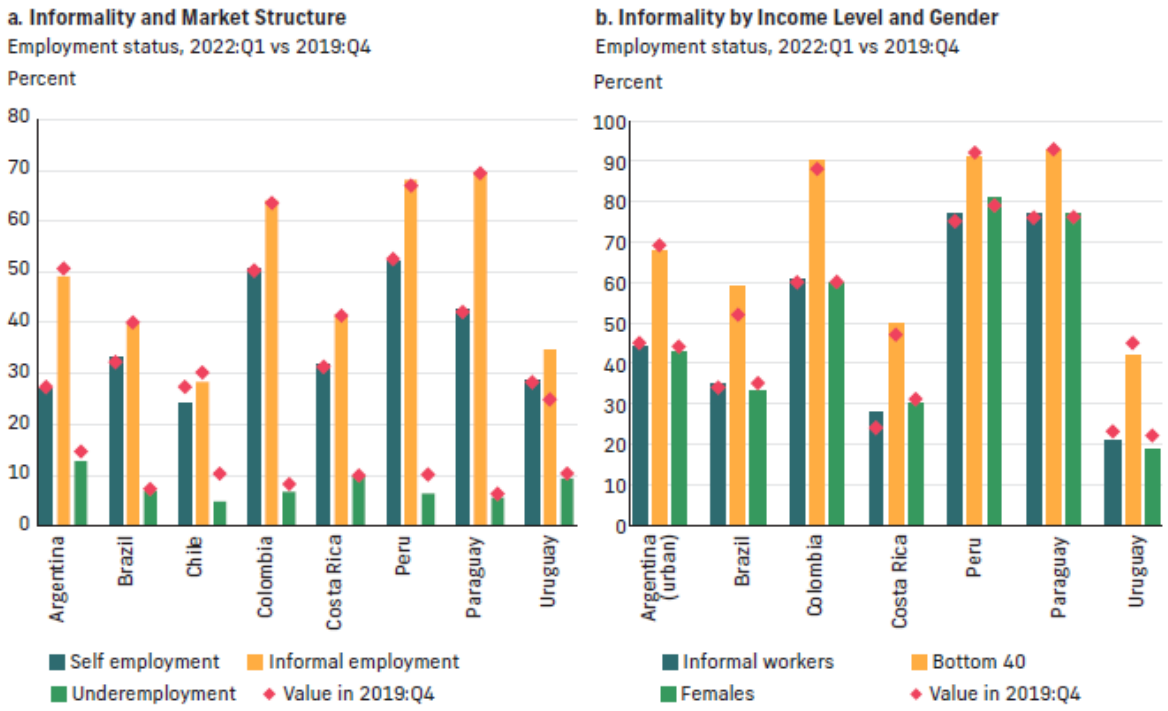
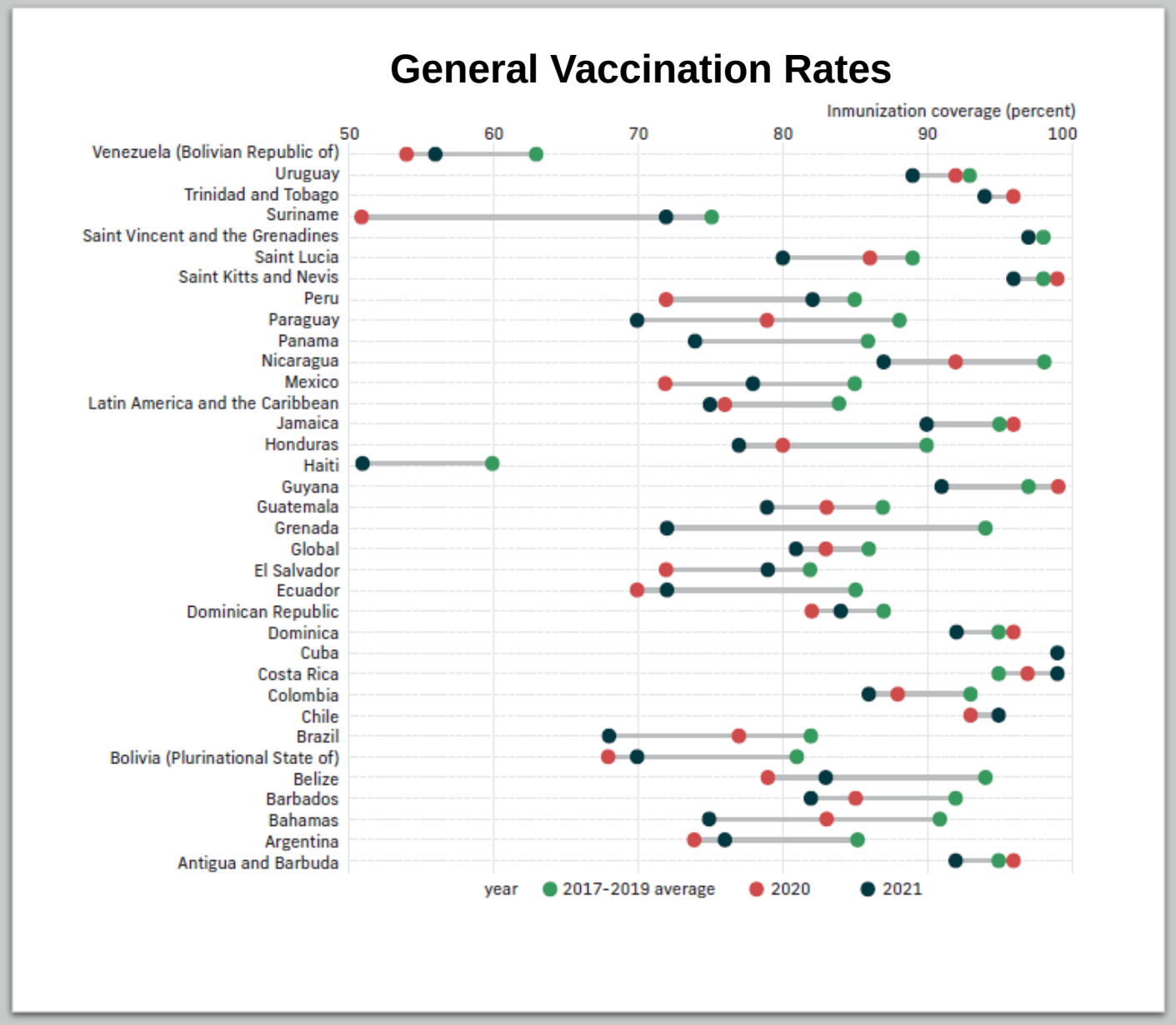


No permanent structural change in labor market, including for women.

- Self employment, underemployment, informal employment at pre-Covid levels.
- Females also back at traditional levels.
- Bottom 40% also largely recovered.

But, numbers hide longer term scarring

- Fall in overall vaccinations~10-5pp.
- 1.5 lost years of schooling may imply 10% lost lifetime earnings.
- Food insecurity led to rise in stunting (Mexico).



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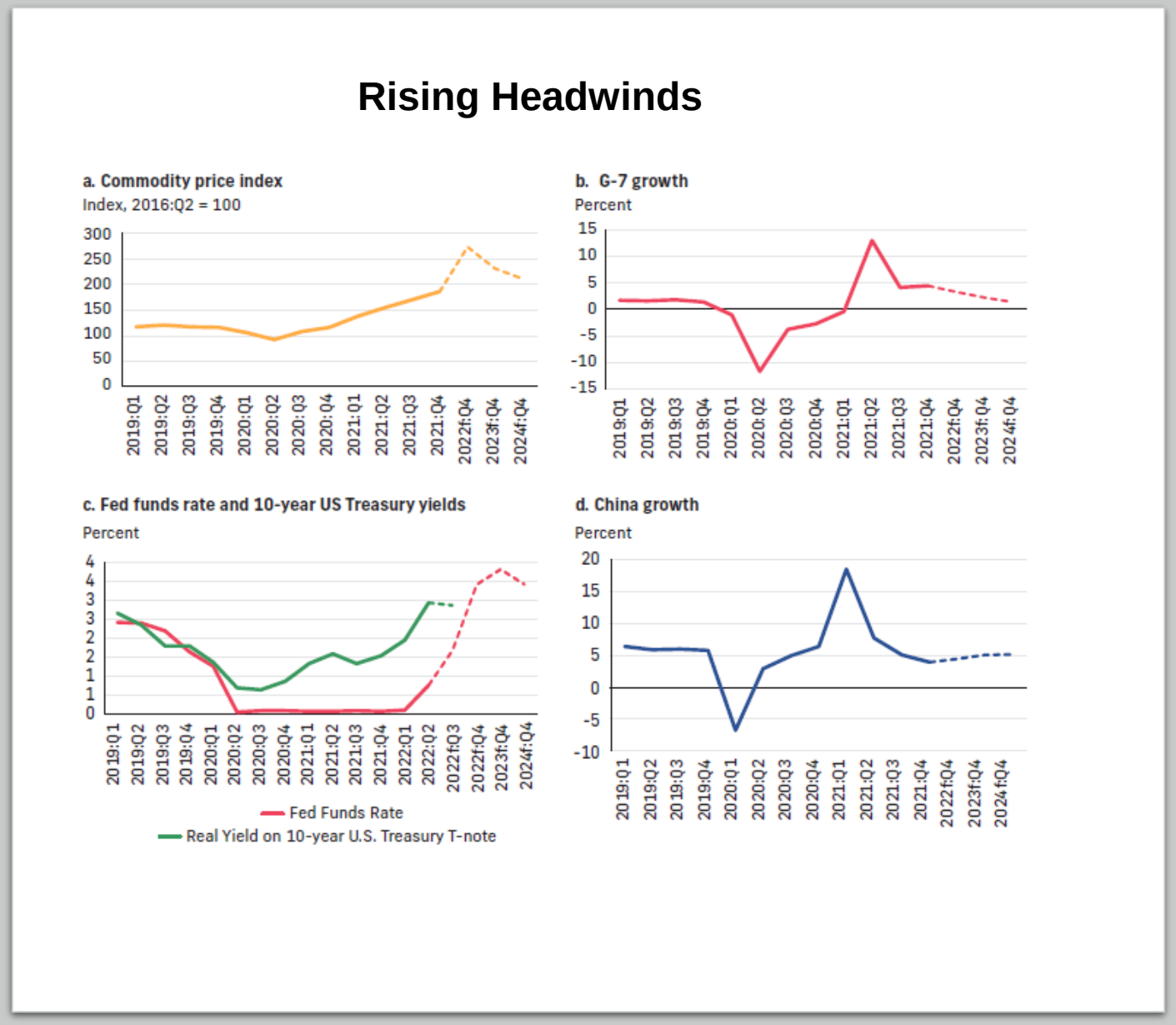
Rising headwinds

…….But more resilience than in the past.

Macro-Headwinds are rising

- 4 big drivers of LAC growth:
  - Commodity prices falling
  - G-7 growth falling
  - Interest rates rising
  - China growth stagnating

- Return to low growth rates of the 2010s implies a need to move on reform agenda!



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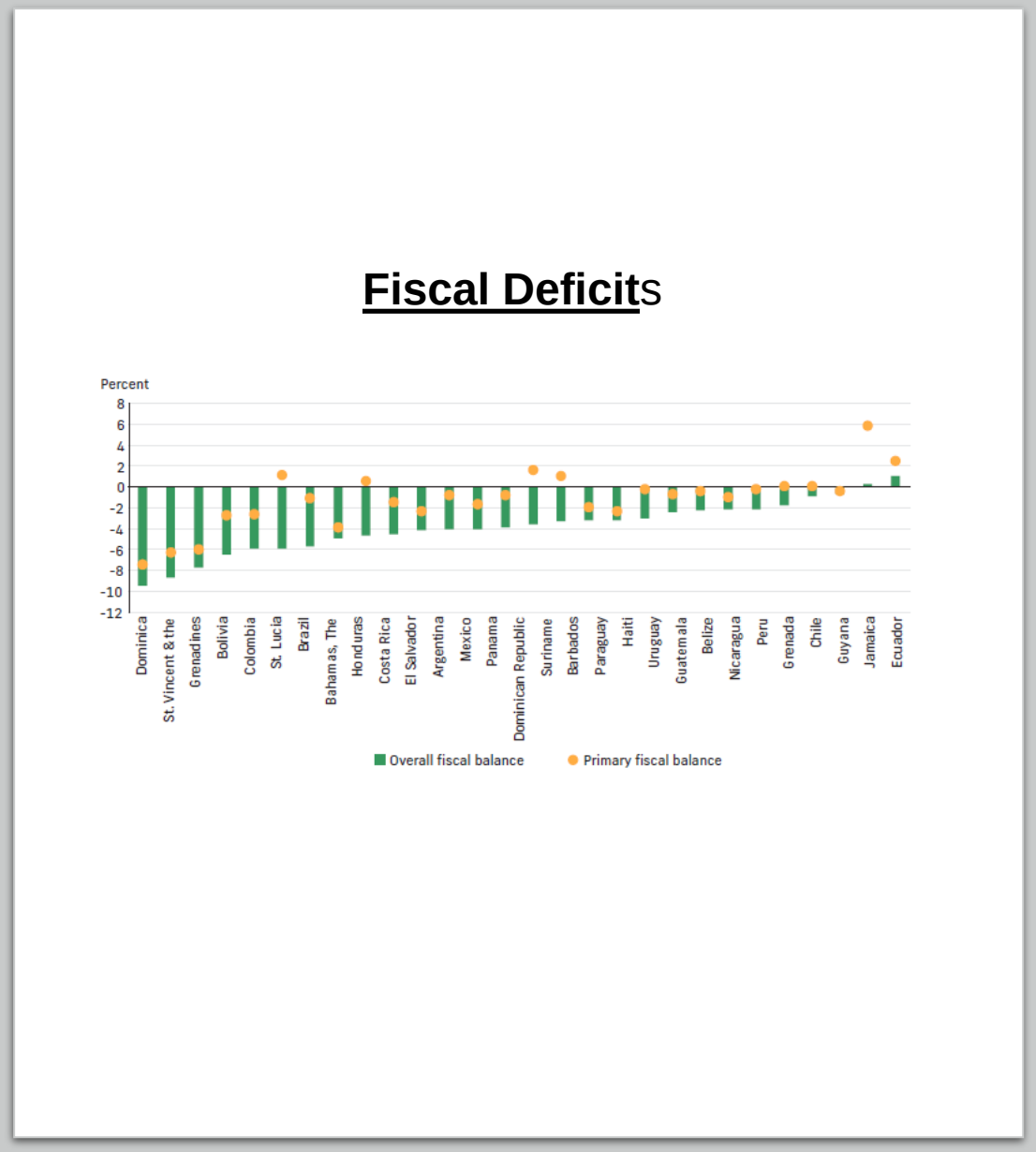
Deficits shrinking, but fiscal space remains a constraint to growth and equity measures

- Primary deficits fallen by .96% but higher interest payments leave overall deficits high.
- Limited fiscal space will constrain necessary investments in infrastructure, education, innovation.



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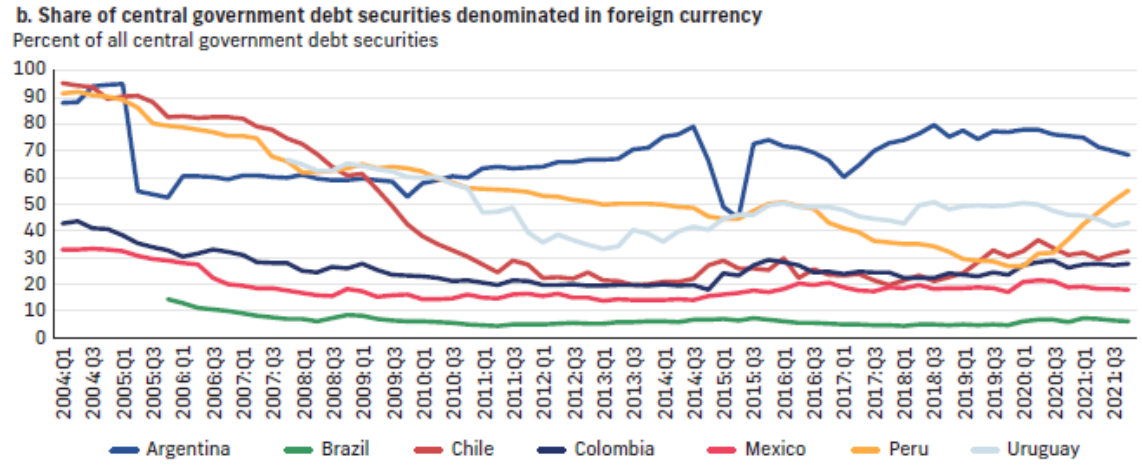
LAC is more resilient to financial stress than 20 years ago.

Debt denominated in foreign currency has fallen



Source: International Monetary Fund.

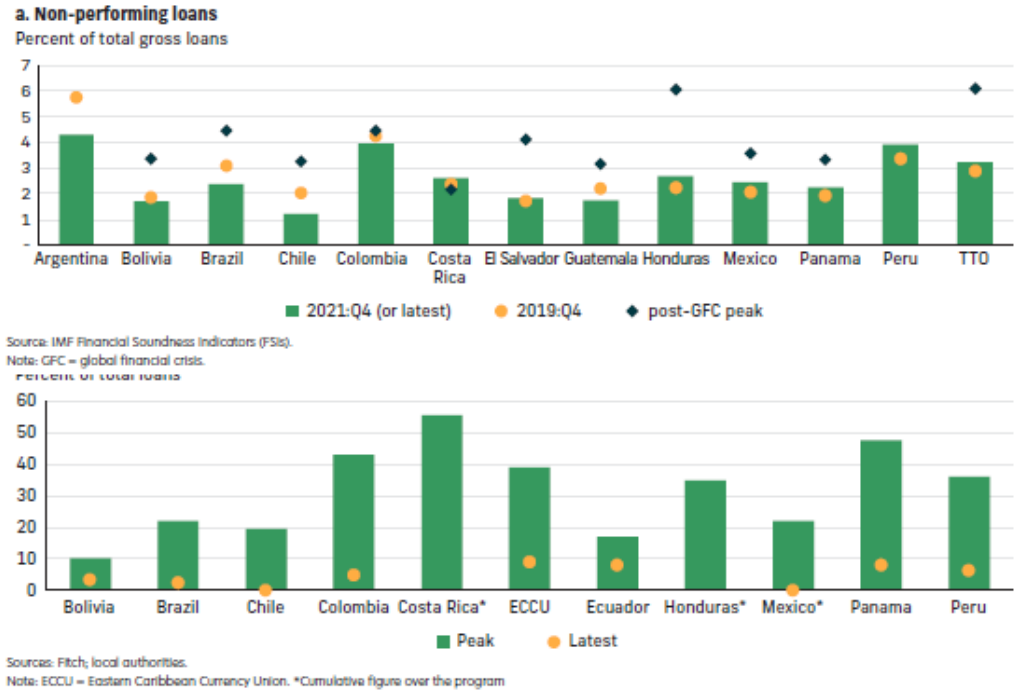
Reserve positions are stronger

Sources: International Monetary Fund; World Bank staff calculations.
Note: LAC (6) = Six Latin American and Caribbean countries (Argentina, Brazil, Chile, Colombia, Mexico, Peru). Observations for Argentina start in 1996 and for Mexico in 2000.

Banking sectors appear sound

- Non Performing loans have not risen again.
- Reprogrammed lending modest.

Figure 1.14. Non-Performing Loans and Deferrals Have Not Become a Major Problem



Source: IMF Financial Soundness Indicators (FSIs).
Note: GFC = global financial crisis.

Sources: Fitch; local authorities.
Note: ECCU = Eastern Caribbean Currency Union. *Cumulative figure over the program

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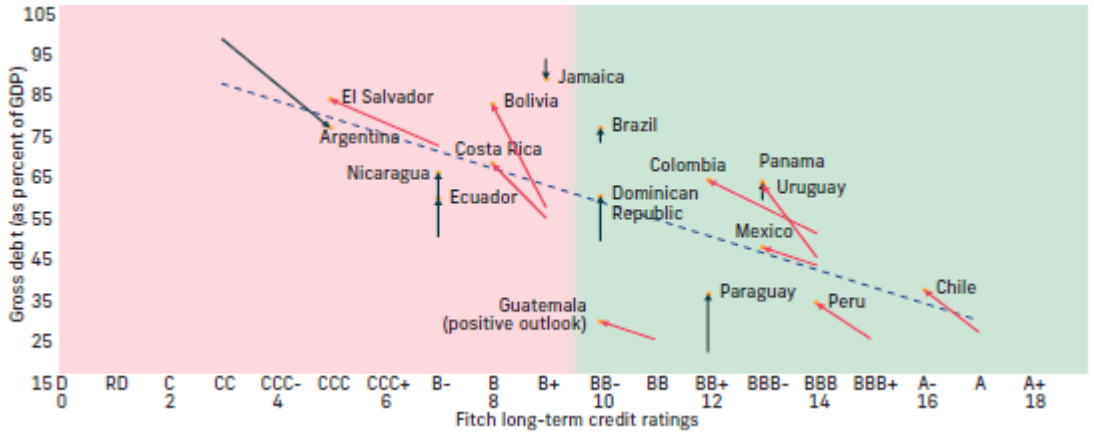
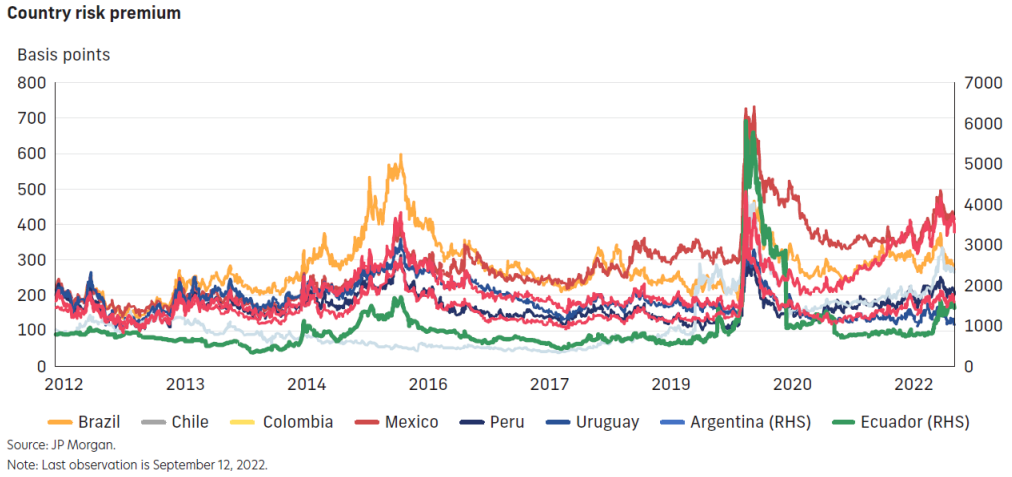
And the market is so far proving wary but not alarmed

Debt Increase vs. Ratings
(relative to pre-pandemic)



Emerging Market Bond Index, Global Diversified



Source: JP Morgan.
Note: Last observation is September 12, 2022.

Inflation: The unwelcome guest.

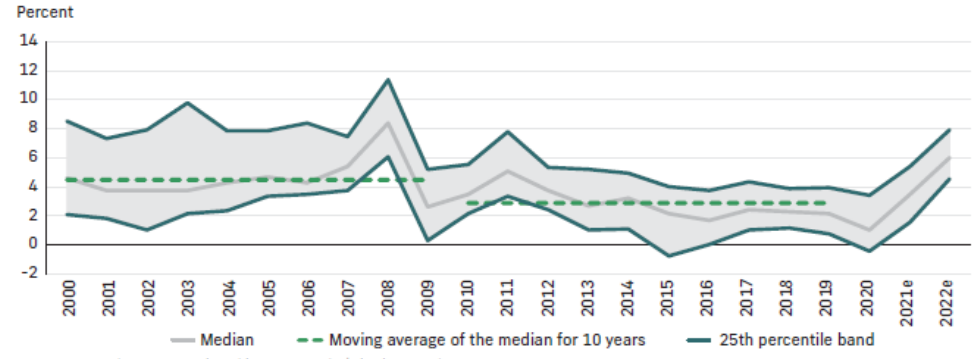
…….How long will it stay?

The return of inflation poses difficult policy trade offs

- Median: 6% Stubborn, but at OECD levels with some exceptions.
- Sharp increases in food and fuel prices challenge household budgets, especially among the poor.

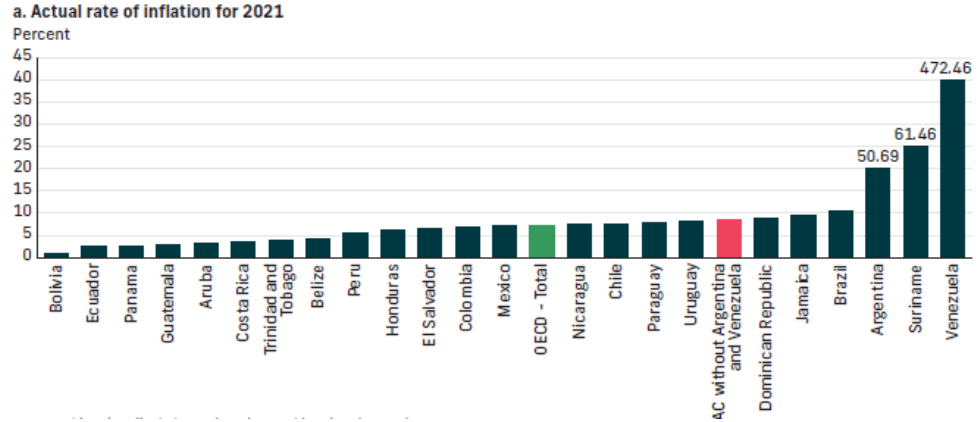
Inflation

Figure 1.24. Evolution of Headline Inflation in LAC 2000–22



Source: International Monetary Fund, World Economic Outlook database, April 2022.
Note: Annual percentages of average consumer prices are year-on-year changes. "e" = estimate.

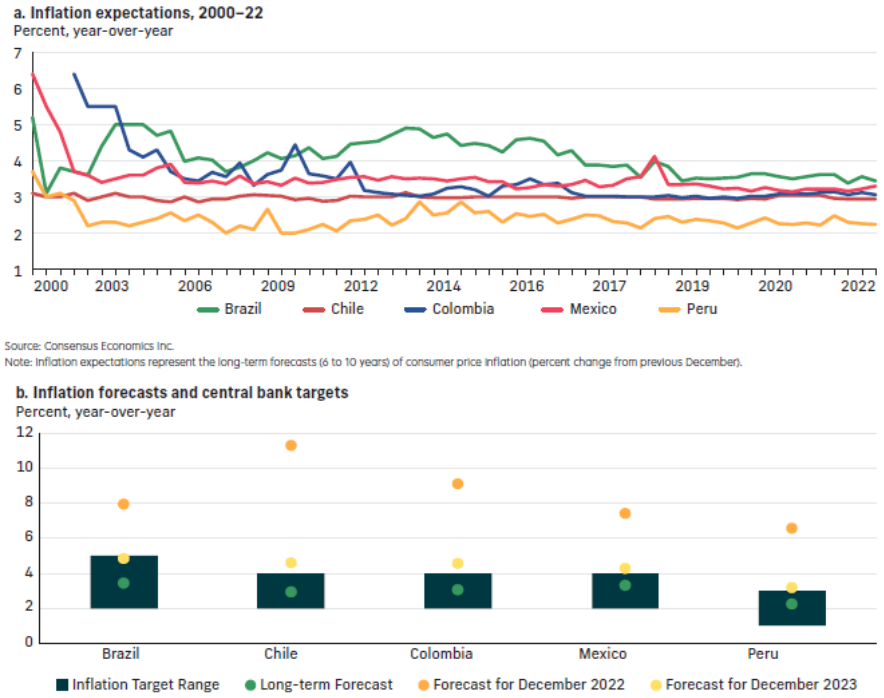
Figure 1.25. Headline Inflation for LAC Countries, 2021 and 2022



But so far seems manageable.

- Inflationary expectations remain anchored- not building into wages.
- Forecasted to approach targets next year.

Inflationary Expectations



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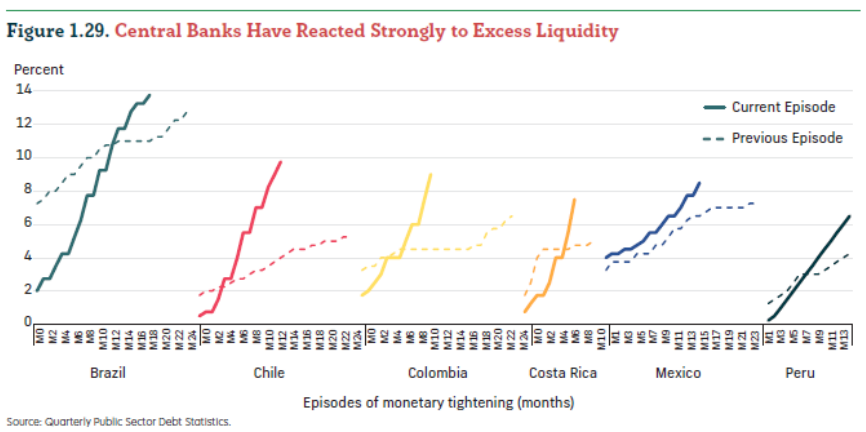
Monetary authorities have been much more aggressive than in the past (or than the US)

- But real liquidity (M1) remains roughly 10% higher than pre-Covid
- Velocity remains lower than pre-Covid
- Maybe more pass-through to come + strong dollar

Central Bank Tightening



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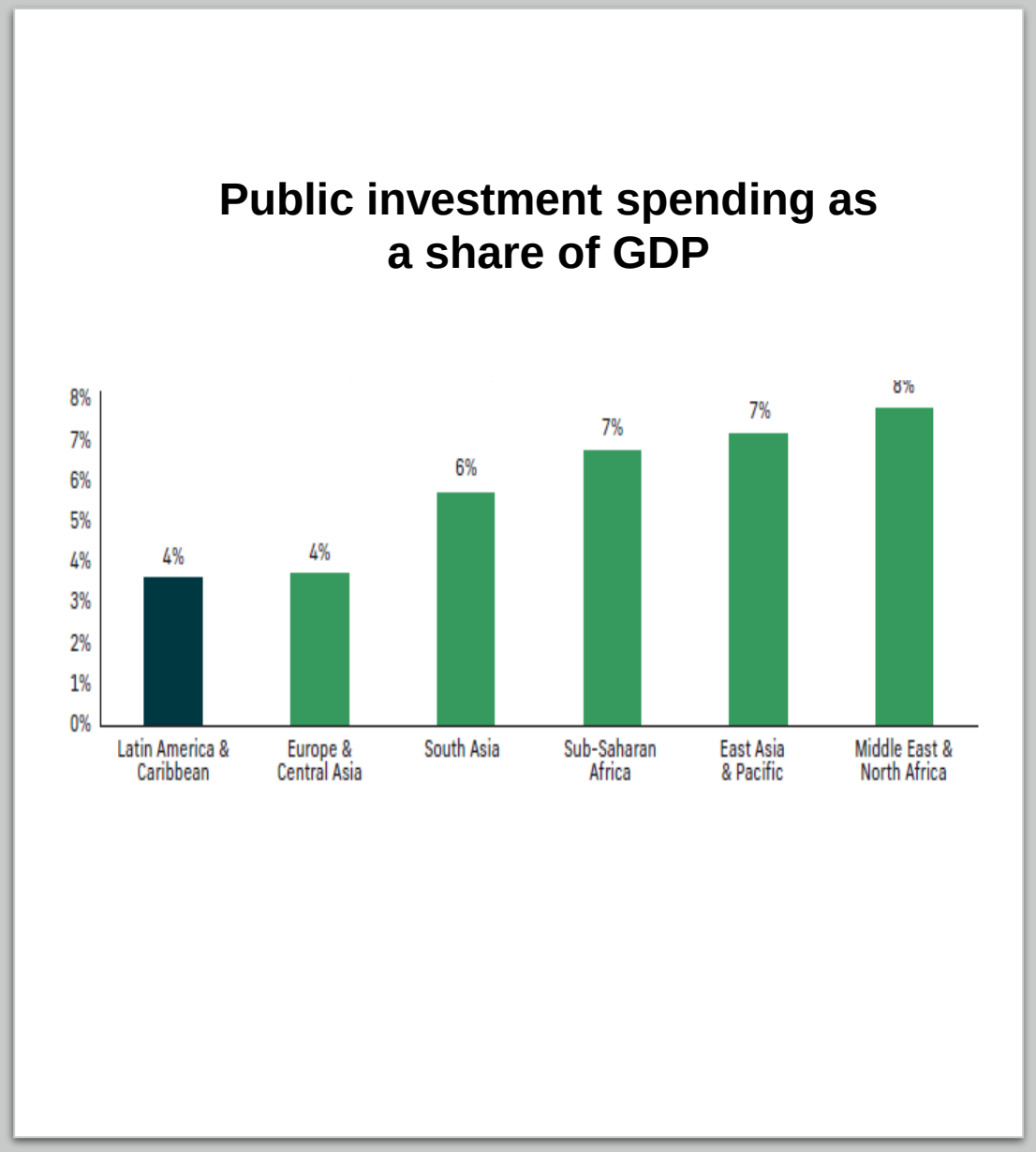
Chapter 2: Closing the Fiscal Gap

New approaches

Short sighted ways to close the gap

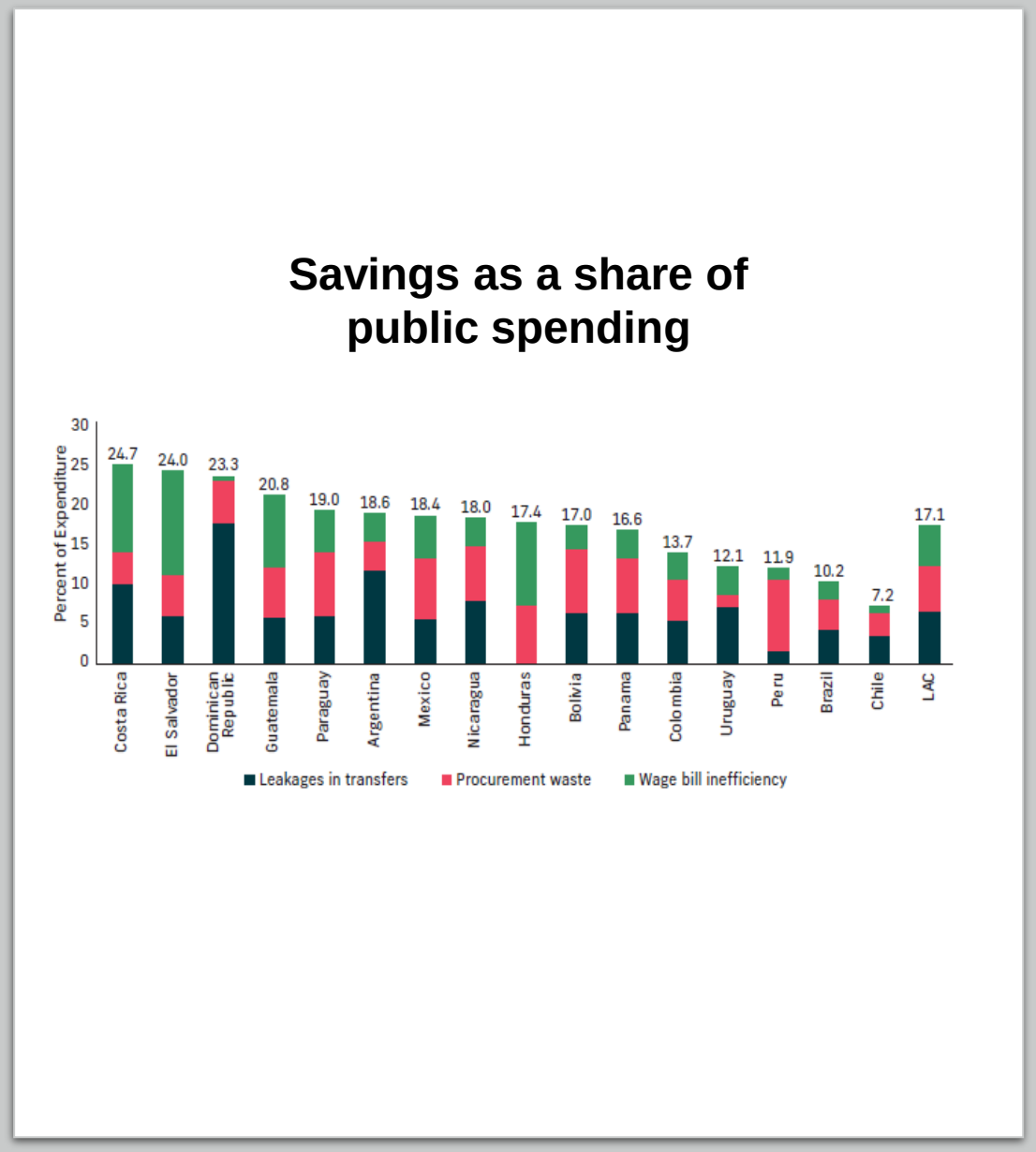
- Public investment spending:
  - LAC invests little, so expected returns are very high.
  - But, benefits occur in the future, so no constituency.
- Inflation erosion of transfers, especially pensions, is regressive and recessive.



Better: More effective public spending

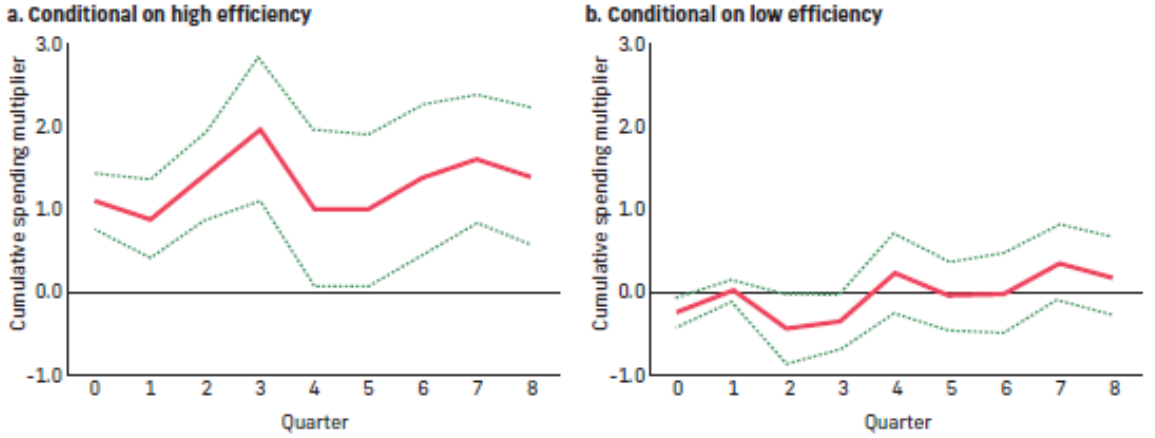
- Losses in transfers, procurement and wage bill
- Could save:
  - 4.4% of GDP
  - 17.1% of spending
- 2/3 of countries could balance budget with savings

Gateway to modernizing state and increasing public trust



Growth effects of wasted spending are much lower than high efficiency spending

Figure 2.18. Returns to Public Spending under Different Levels of Efficiency



Source: World Bank staff calculations based on Izquierdo et al. 2018.

Note: Dashed lines indicate the 95 percent confidence interval for the effect of current expenditure. Measures of efficiency draw on an index derived from the World Economic Forum on the quality of government institutions.

New work on taxation.

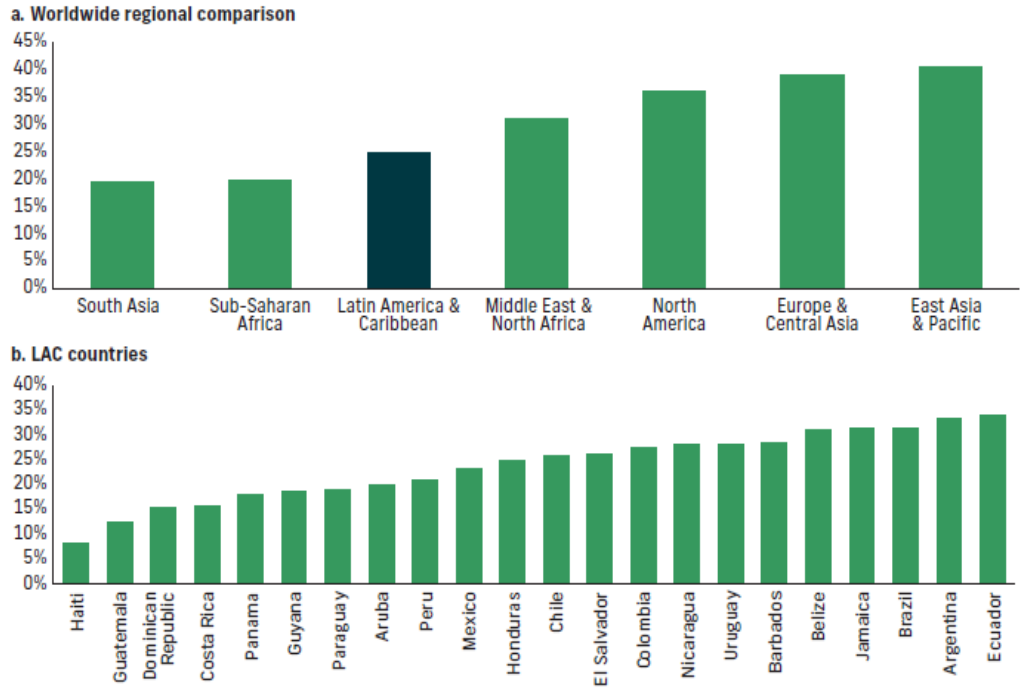
…….Balancing revenues, progressivity and growth

Is higher taxation the solution?

- LAC collection moderate, but varies greatly across the region.
  - Need to adjust for level of income: Wagners Law
  - OJO: treatment of pensions
  - Two LACs: South is close to OECD, CA, Caribbean very low.

- OECD literature: high taxes slow growth, but effect depends on level of taxation and type of tax.

Total taxation by region (% of GDP)

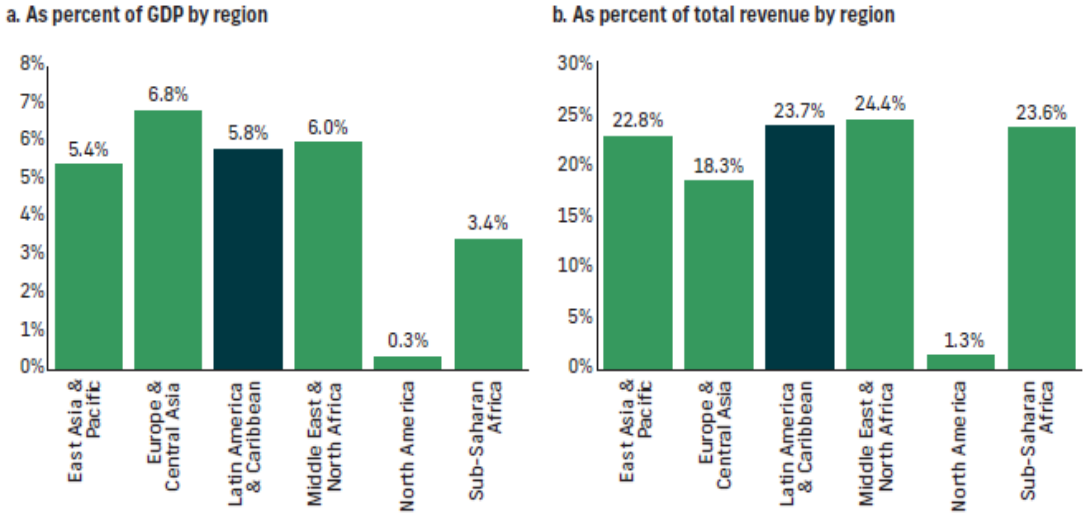


Source: World Economic Outlook (IMF).
Note: Panel B excludes ECCB countries.

LAC relies heavily on the regressive VAT… further hikes are likely to hurt growth

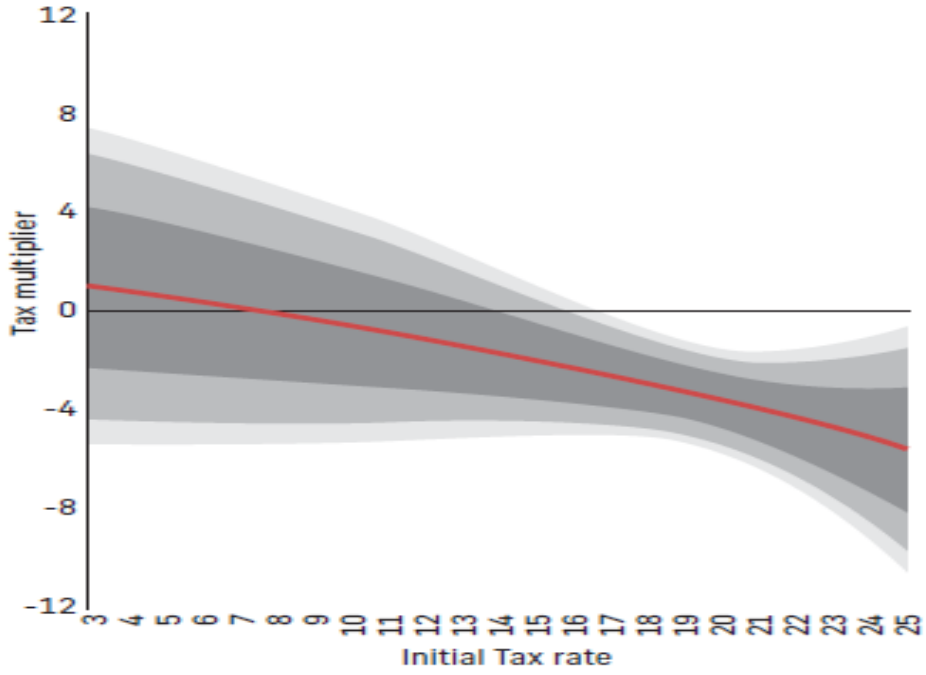
Value Added Tax

Figure 2.1. Value Added Tax Collection



Source: World Bank staff calculations based on Organization for Economic Co-operation and Development (OECD) Global Revenue Statistics Database and World Bank data.
Note: Country data corresponds to the consolidated government. Regional aggregates are built by weighting country data with their participation in regional GDP.

The depressive effect on growth rises with initial level of VAT

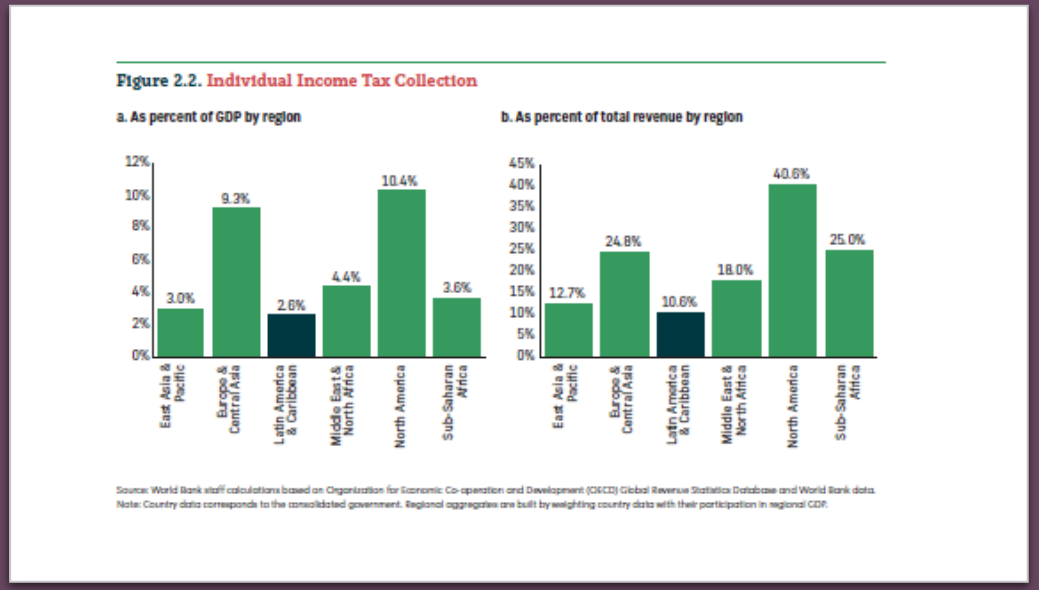


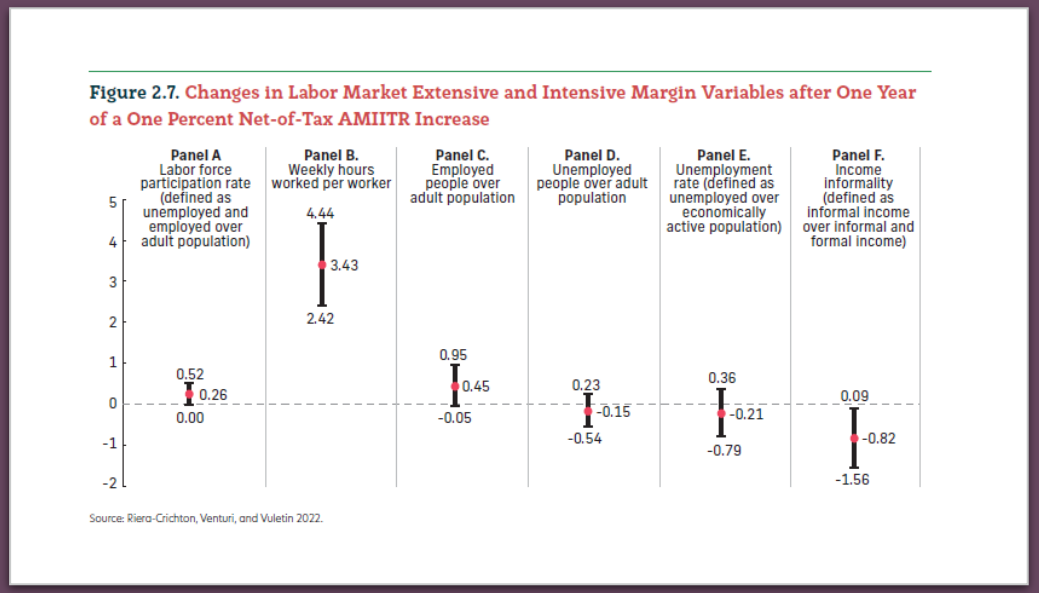
The income tax is potentially more progressive but poorly understood

- Average burden in LAC is low, but base is <20% compared to 80% in US...Top rates are high.

- Negative impacts on growth are double the US.

- Behavioral response makes revenues substantially below expected

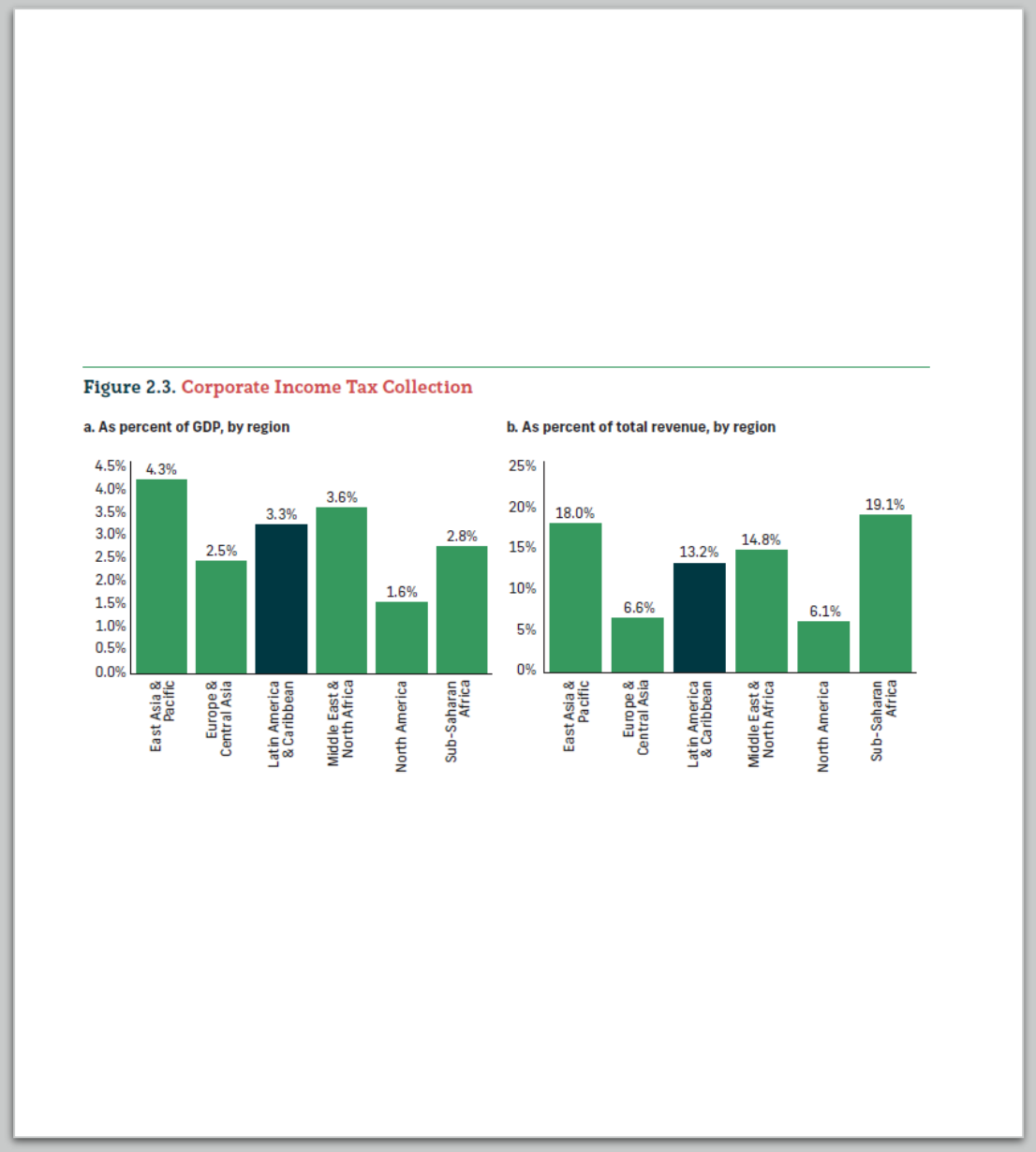




Corporate taxes- moderate level

- Probably progressive
- Fuzzy consensus on how much they affect growth.
- In LAC, effective rate is below statutory.
  - Could benefit from streamlining and enforcing more.
  - Part of larger formalization agenda

Stay tuned for Regional publications on spending and taxation!



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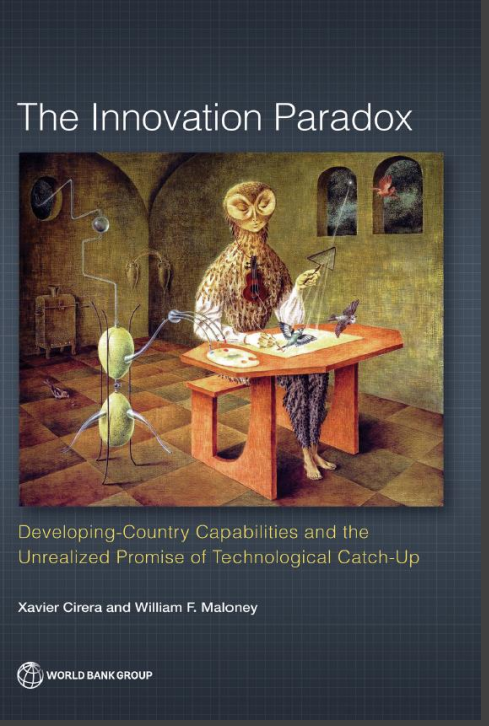

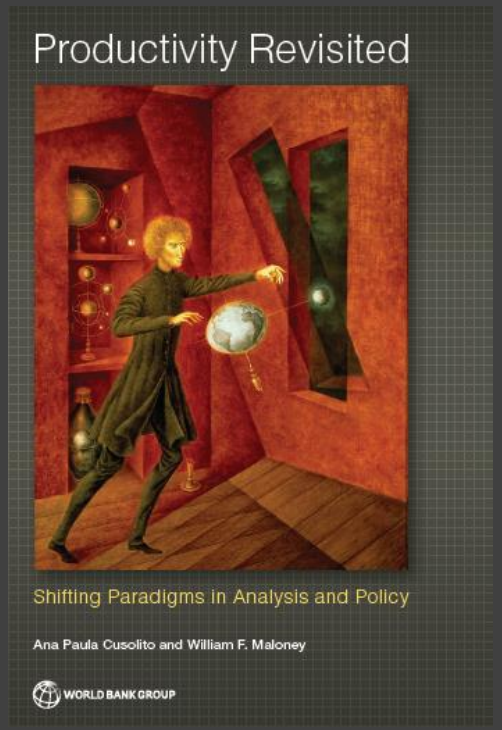

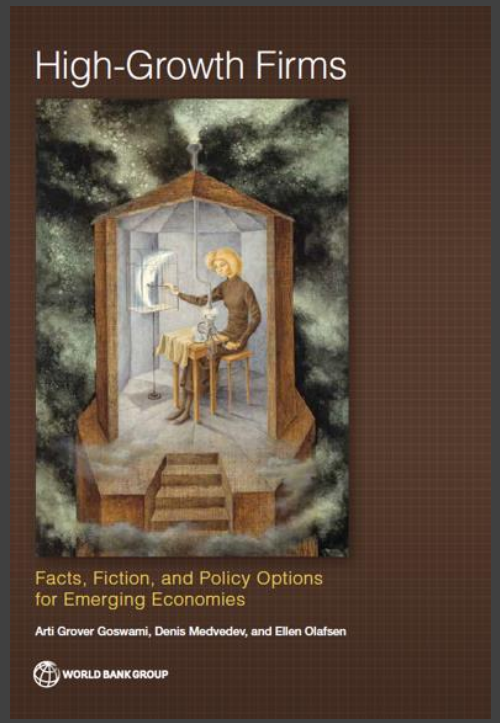

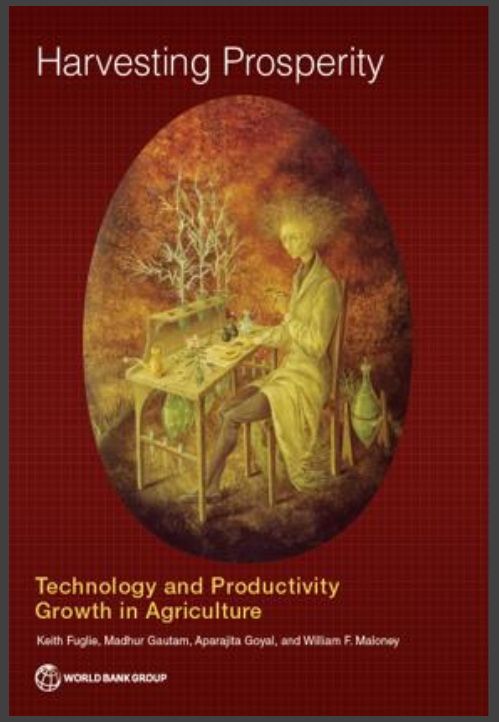

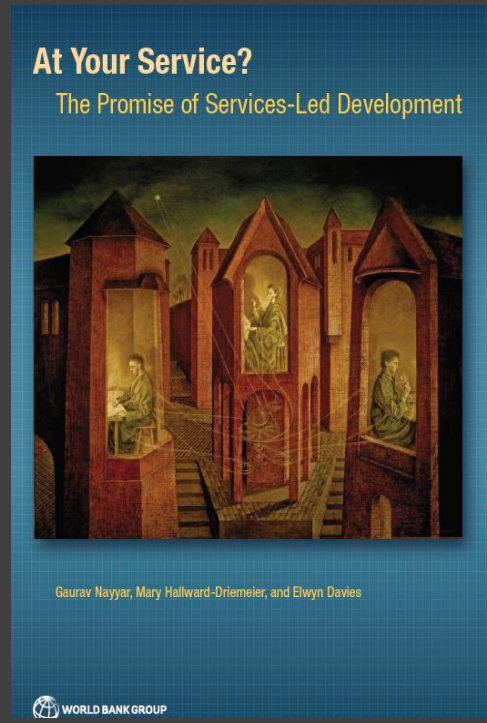

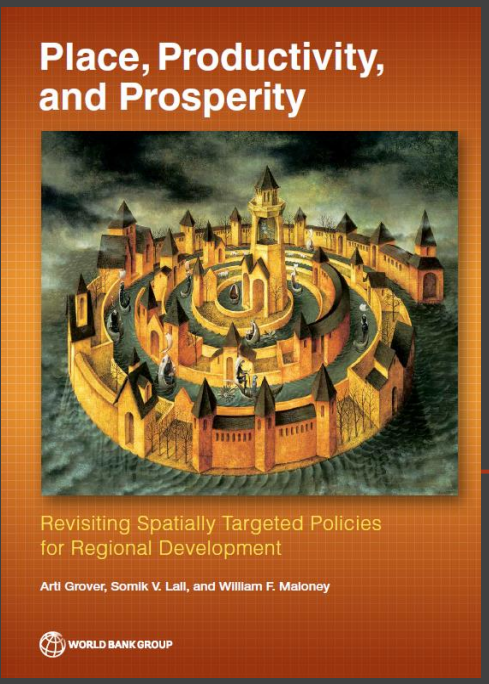

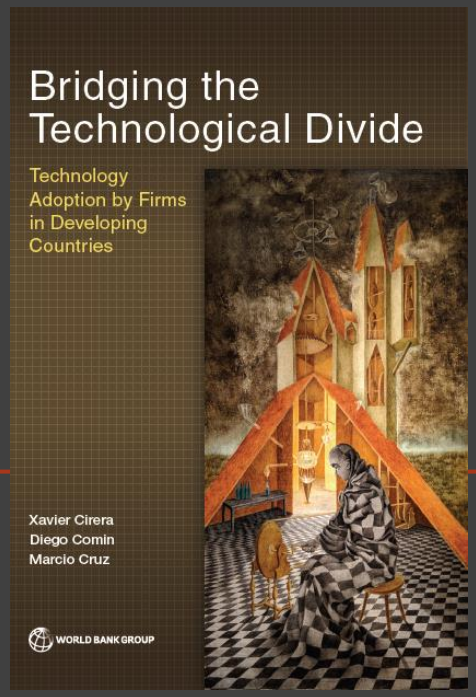

“Fortune favors the prepared”- Pascal

World Bank Productivity Project

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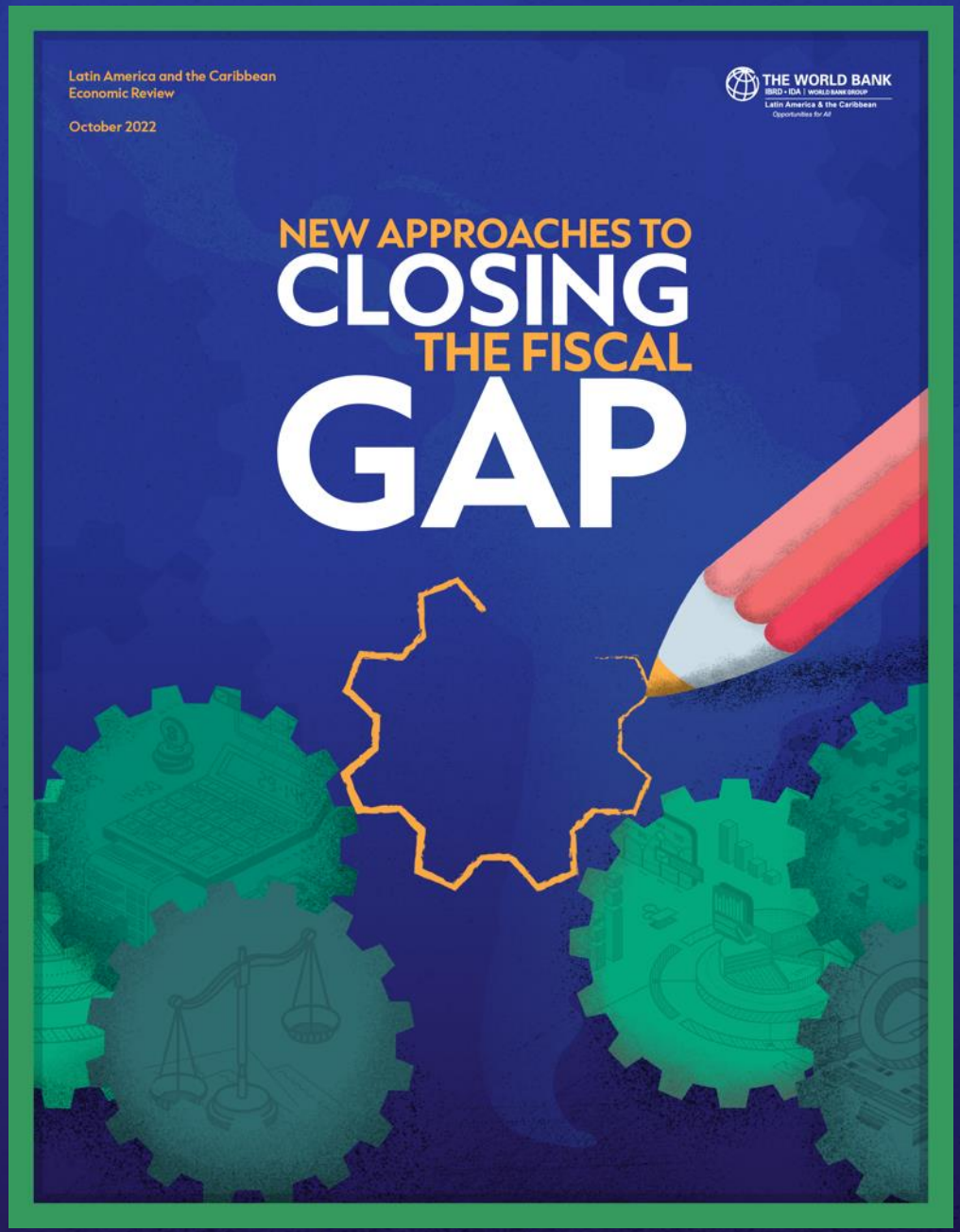
Thank you



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