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Chairman: Mr. Magaña

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Fiscal policy in Latin America's economic development

NOTE: Participants wishing to make corrections in the provisional summary record of their statements, for inclusion in the final printed report, should submit them in writing to the Editorial Section, either through the Conference Officer (Miss Eyzaguirre) during the Conference, or subsequently, by post, before 31 December, addressed to: The Editorial Section, ECLA, Avenida Providencia 871, Santiago, Chile.

FISCAL POLICY IN LATIN AMERICA'S ECONOMIC DEVELOPMENT

Mr. URQUIDI said that the fundamental problem of fiscal policy in Latin America today was the lack of a prior definition of development policy. However fiscal policy was defined, and irrespective of whether it was assigned a broader or narrower scope, it was very difficult to carry out a consistent and rational fiscal and financial policy until such time as Governments, political forces and private sectors agreed on a minimum development plan or programme establishing sectoral targets and recognizing the work that both the public and private sectors must carry out to achieve it.

The formulation of adequate development programmes had not made much headway in Latin America and the implementation of important aspects of development policy was deficient. In those circumstances, many of the measures that formed part of fiscal policy were proposed or adopted without a clear understanding of the purposes they were intended to achieve or of their probable effects. Most of them were adopted rather to meet pressing financial needs or public expenditure or for the purpose of promoting or restricting some form of private activity.

However, there was an increasingly clear feeling that the trend towards development programming would have to be accompanied by a reshuffling of ideas on financing and on the use of different fiscal instruments, and that any public or private investment plan be in keeping with a fiscal and financial plan formulated with the utmost possible precision.

Fiscal policy could not be more precise than development plans; but that did not prevent evaluating it in terms of the targets that today were accepted as essential components of any development policy in Latin America, namely the need to increase the relative volume of public and private investment and to change its sectoral composition, to increase the public sector's current expenditure to provide essential services for economic development, and to improve the distribution of income. Fiscal policies could and should adhere to these aims at any rate in a very general way.

/In order

In order to do so, efficient methods should be adopted for the formulation and control of fiscal policy. In that connexion, it should be stressed that the financial administration of a country needed a unified command: the Minister for Finance should be in a position to coordinate taxation, expenditure and borrowing policies at all levels of government, as well as the financial and price or tariff policies of the semi-public sector, including social security, state banks, and the agencies responsible for regulating supplies.

Fiscal policy was the whole body of measures relating to the tax system, public expenditure, contracting of internal and external debt by the State, and the financial operations and situation of the autonomous and semi-public agencies and bodies, through the medium of which the amount and distribution of investment and public consumption as components of national expenditure were determined and the volume and composition of private investment and consumption were directly or indirectly influenced. The definition implied that the influence of fiscal policy on economic and social development depended in essence upon what each country conceived to be the role of the State. Paradoxically enough, even if it were assumed that in any given country the idea prevailed that the State should have as little as possible to do with matters of infrastructure and that it should only exceptionally undertake activities directly related to production or distribution, fiscal policy would be just as significant and important as in cases where the State played a substantial part in the creation of the infrastructure of development or in the establishment of agricultural, industrial or distribution enterprises, since it was responsible for guiding the multifarious decisions taken with respect to private investment and consumption, reconciling them with national economic development aims and adapting their tempo and distribution to the requirements implicit in the aims in question.

At the time of speaking, most of the Latin American countries were closer to the first than to the second extreme. There were few countries where the public sector accounted for more than 15 per cent of national expenditure, where public investment exceeded 33 per cent of total gross investment, or where tax revenue represented over 12 per cent of the gross

/product. Consequently,

product. Consequently, a fiscal policy conceived as a harmonious and consistent whole and defined with proper clarity was, in such cases, of supreme importance to programmes for the accelerated economic development of Latin America, since the behaviour of the private sector would largely condition the results achieved.

That over-all concept of fiscal policy was not confined to the tax measures adopted by a country's central or federal Government, but also covered the sphere of state or provincial and municipal authorities. Any incongruities between the measures adopted by a central Government and a provincial authority, for example, might adversely affect the rate of private investment and exert an unfavourable influence on specific categories of productive investment. Similarly, the field of fiscal policy had to be extended to embrace autonomous or semi-public agencies and enterprises that were wholly or partially owned by the State, including official banks. If the tariffs or prices charged by such bodies were high, their effect was the same as that of a tax; if, on the other hand, they were low, they really represented a subsidy to the groups or sectors making use of the goods or services concerned.

Another special case that merited separate consideration was that of social security institutions, insurance and pension funds, etc. In some countries, the tripartite nature of the allotments to such institutions made it doubtful whether they could, strictly speaking, be regarded as belonging to the public sector. However, in view of the significance of social security systems for the community as a whole, it was necessary that they should operate as part of that sector, since the contributions made by workers and employers were analogous to a tax designed for a specific purpose, and the current surplus of income over expenditure (after the transfer of funds from the central Government to the Institutions in question had been taken into account) was often one of the principal sources of saving in the public sector; moreover, investment in hospitals, welfare centres and housing by social security agencies frequently acted as a substitute for the investment that should be directly effected by the State.

/Another factor

Another factor in fiscal policy that was not always fully recognized was the contracting of debt by the different branches of the public sector. The internal or external indebtedness of the central Government or of a provincial or municipal authority presented no problem, but difficulties did arise in relation to financial transactions in the subdivision constituted by semi-public agencies and enterprises. To be consistent with the theory hitherto sustained, debts contracted by semi-public enterprises should be treated as an aspect of fiscal policy, with the possible exception of short-term commitments (for less than a year) entered into purely for the purposes of current or cash operations.

Fiscal policy should also be taken to include exchange measures and the activities of central banks as well as the control mechanisms established by the State to facilitate the marketing of crops, guarantee minimum rural prices, absorb production surpluses, and regulate supplies and stabilize prices of food in urban areas.

To sum up, the legitimate field of fiscal policy was extremely broad, although in practice it was clearly difficult not only to arrive at the figures whereby the policy in question could be expressed in quantitative terms, but also to overcome the administrative, legal and political obstacles to the unification of fiscal and financial policy under a single authority.

With regard to the objectives of fiscal policy, those directly linked to economic development were of more importance than those of a social nature, and were three in number: (a) to create sufficient public savings to cope with the estimated volume of public investment, and to collect, by means of internal and external borrowing, such additional resources as it might be prudent to obtain from private or foreign savings; (b) to absorb from the private economy, by the most equitable and efficacious means, the income required to cover the provision of those public services which the community regarded as indispensable or desirable; and (c) to manipulate various tax, expenditure, exchange, price or tariff-fixing and other instruments, in such a way as to provide the private sector with sufficient incentives to generate the volume of savings required for economic development and to effect its proper share of investment.

/The foregoing

The foregoing basic objectives might be supplemented by others in respect of which fiscal policy could play a useful role, without necessarily being the best or the most decisive instrument. One of them was the modification or compensation of short-term fluctuations in the economy. In that case, fiscal policy alone, without the support of other aspects of government policy, could not assume responsibility for stabilization without neglecting objectives of more fundamental importance.

Another aim in which fiscal policy could co-operate, without being the most appropriate instrument, was the improvement of income distribution. But a more progressive income tax, and the various forms of taxation on net wealth and on luxury private expenditure, did not really reduce the disparities between levels of personal income. Such incomes might continue to be generated just as unequally as before, in consequence of a country's agrarian, commercial and industrial structure.

Where taxation was concerned, a tendency had been observable in Latin America in recent years to rely more on direct than on indirect taxes, at least in central government taxation, especially income tax. If a tax structure was to be efficacious, it had to be in line with country's institutional life, viewed both in retrospect and in its current patterns, and it also had to be properly in keeping with the ends pursued. Consequently, efficient fiscal and administrative technique must be combined with sound political judgment if a tax reform was to be anything more than a mental exercise and was to have the backing of the taxpayer. In that connexion, perhaps the first step ought to be a careful revision of many juridical theories which might be unnecessarily cramping the concept of taxable income, especially in relation to individuals, or which in one way or another tended to lessen the effect of progressive rates. The points which should be elucidated and reviewed included the ideas of imputed or potential income from rents; equity or inequity in respect of family exemptions or allowances at various income levels; retroactivity in taxation on capital gains accruing from immovable property; and income deriving from common property in the case of married couples.

/In most

In most of the Latin American countries the income tax system was schedular, with the resulting serious drawback that it precluded the equitable application of family allowances and left room for inequitable taxation on income from different sources through different progressive or proportional rates. It seemed essential that an attempt should be made to simplify income tax in the sense of making a single rate applicable to consolidated personal income and requiring returns from all persons whose income level exceeded a specified and relatively low figure. Nor should efforts to improve the income tax system overlook incentives to investment, which could be safeguarded by the adoption of scales that were not over-progressive and whose average maximum rate did not exceed about 35 to 40 per cent at very high income levels.

The problem of incentives to investment might be more significant, however, in relation to taxes on the gains or profits of enterprises than in relation to taxes on personal income, and that important aspect of tax policy had possibly been neglected in Latin America. Although there were various types of reliefs, the existing system of tax exemptions had not been properly rationalized with respect to its effects on investment. Accelerated depreciation had the advantage, in relation to exemptions, of being accorded in respect of investments already made and not of possible future investments subject to various contingencies. In addition, it was a more positive instrument, since it could be applied in different ways to different branches of industry and could thus be adapted to the growth projections incorporated in industrial development plans or programmes.

Zeal for modernization and improvement of the fiscal system should not lead to neglect of indirect taxation. Export taxes were in some measure a substitute for income tax as applied to primary activities, and had been particularly useful where the need had arisen to impose taxes promptly on the unforeseen profits accruing to exporters from a currency devaluation or an unlooked-for and abrupt increase in international prices. But it was a clumsy and inequitable device, since it did not differentiate between the various levels of productivity and efficiency normally reflected in costs, and was transferred back to the weakest link in the chain of production

/and distribution,

and distribution, almost always reaching the agricultural worker. Other taxes on transactions should be regarded primarily as a source of Government revenue, which meant that they should be sufficiently low, in _ad valorem_ terms, not to discourage production or mass-consumption patterns, but sufficiently high to make a substantial contribution to tax revenue.

However, no Government should neglect the opportunities that existed - even in conjunction with the trend towards imposing general sales or gross income taxes - for establishing special rates in respect of particular types of consumption that were associated with the higher income groups or were subject to more pronounced income-elasticity. Such taxes, besides representing an addition to fiscal revenue that might be considerable, constituted an equitable supplement to personal income tax and forestalled evasion by spending income for which no returns had been made.

Import duties were becoming increasingly difficult to rationalize from the tax standpoint. As industrialization progressed in Latin America and the scope of tariff protection was extended, import duties, if they were to be effective as a protectionist device, would have to become less effective as a tax instrument.

A special type of taxation that in some countries amounted to an important or even the principal source of public revenue was that applied to the profits and activities of foreign investment in primary commodities. Such taxes could be justified not only from the economic standpoint but also political grounds. In that connexion, two arguments stood out: (a) the extraction of primary commodities implied a drain on natural resources calculated to weaken the country's future economic capacity; and (b) such activities had often involved an inordinately rapid distortion of the economic structure which had made it more difficult to develop other sectors of the economy. Additional taxation on the foreign investments concerned would offset those negative factors, and would be an important element in fiscal policy if it were used to support economic development programmes through public investment in the infrastructure and through the financing of expanded domestic investment in agriculture and industry.

/Tax reforms

Tax reforms would be difficult to justify unless at the same time the Governments of Latin America formulated and carried out public expenditure policies that were more in line with the development and welfare aims they had undertaken to achieve. The technique of programme budgeting, as yet applied only on a limited scale in Latin America, appeared to be the most suitable instrument for ensuring that public expenditure became more effective. By its means the Government budget could be reconciled with development plans, but its adoption entailed special training of budget office personnel and administrative or legal reforms.

Some semi-public bodies had difficulty in financing their own investment, but others were possible sources of savings or revenue for the treasury. They should at least be spurred on by the desire to serve the community as productively as possible, and should aim not at unduly large profits but at providing low-cost goods and services, creating financial reserves for future expansion and adding to the over-all resources of the public sector.

With regard to internal contracting of debts, it was important to consider a problem closely related to monetary policy: that of the limits of such borrowing. Capital markets in Latin America had not much absorption capacity, and it would be inexpedient for the Government to compete in them with the private sector. However, it could create, within the banking system, a growing market of internal debentures, provided that selective credit controls were maintained.

External borrowing was subject to one general and several specific limitations. The general limitation consisted in the borrower country's future capacity to pay. In determining it, some part was played not only by export prospects for goods and services, but also by the success of the development programme with respect to import substitution resulting from an increase in domestic production capacity in relation to the growth of aggregate demand. If the margin of external borrowing was to be broadened, dynamic import substitution would in its turn have to be based on a coherent public and private investment programme and, of

/course, on

course, on the complete and efficient utilization of domestic savings; in other words, there was a link between the possibilities for contracting debts and fiscal policy. Specific limitations included the credit patterns followed by the international agencies, and the inadequate capacity of fiscal policy to attract foreign private investment.

The enumeration of all the foregoing important aspects of fiscal policy clearly showed that fuller and better studies on the subject were required. Some recommendation might emerge from the meeting on the need for such studies to be carried out and for the private sectors to co-operate in the working out of fiscal policy.

Mr. PAZOS said that Mr. Urquidi's paper on Fiscal policy in Latin America's economic development was the best over-all study on the subject that he had read, and that he fully endorsed most of its arguments and recommendations. There was one point, however, on which he was not in agreement, namely, the secondary role assigned by Mr. Urquidi to fiscal policy as an instrument of income redistribution.

Before reading the paper under discussion, he had reviewed the instruments and policies which the Latin American countries could use to improve income distribution, and he firmly believed that in existing circumstances the only instrument whereby that aim could be achieved over the short term, without causing serious distortions in the Latin American economies, was fiscal policy.

He had arrived at that conclusion after careful consideration of a number of non-fiscal measures: (a) promulgation of legislation to raise wages; (b) promulgation of legislation on minumum wages; (c) strengthening of workers' organizations; (d) intensification of competition between the producer and distributor enterprises (limitation of monopolies): (e) payment of subsidies for foodstuffs and/or other essential goods and services; (f) promotion of technical advances in the agricultural sector, in order to expand food production and reduce costs; (g) agrarian reform; and (h) improvement of the productivity of labour as part of the development process.

/Generally speaking,

Generally speaking, the first three measures did not have the effect of increasing the real income of wage-earners, because as a rule the prices of essential goods rose accordingly. The fourth was difficult to put into effect in countries with markets as restricted as those of Latin America. The fifth was really an aspect of fiscal policy and had been mistakenly associated with the rest; and the remaining three failed to influence income distribution rapidly enough.

If the foregoing analysis was sound, and if the fiscal instrument was rejected as a means of appreciably redistributing domestic expenditure in favour of the lower income brackets, the appalling disparities in standards of living that were prevalent among the Latin American peoples would be indefinitely perpetuated.

In the context of the possibilities of fiscal policy as an instrument of redistribution of income, he, compared income distribution in the industrial countries with the situation in Latin America. There was a good deal more inequality in the Latin American countries than in the highly-industrialized group, for whereas in Canada, Japan, the United Kingdom and the United States 10 per cent of the households in the higher income brackets received about 30 per cent of monetary income, in Mexico the corresponding figure had been as high as 46.7 per cent in 1957, while in Venezuela it had amounted to about 45 per cent in 1958. Although those were only approximate figures, very similar results were obtained when other methods of calculation - also approximate - were adopted. The application of such methods to other Latin American countries showed that there too income distribution was much the same as in Mexico and Venezuela.

As fuller information was currently available on income distribution in the Latin American countries, the time had come to modify earlier ideas - still upheld by Mr. Urquidi - as to the narrowness of the tax base for income tax in the economies of the region. The great concentration of income in the hands of the top decile of the population afforded a splendid basis for income tax and for the tax system as a whole. On the assumption that 45 per cent of the personal income accruing to the highest decile was equivalent to 37 per cent of gross domestic production, and that income tax took 20 per cent, the revenue thus obtained would amount to 7 per cent of the gross domestic product, instead of the 2 per cent postulated, a figure which in any case was probably higher than the average for the

/Latin American

Latin American countries. Moreover, if taxes on luxury consumption, after payment of income tax, took 20 per cent of the income of this upper stratum of the population, the corresponding revenue would be equivalent to 6 per cent of the gross domestic product, which again would be a figure in excess of that assumed. By means of those two items, the benefits of the expenditure of the top decile could be effectively redistributed among the remainder of the population, to an amount equivalent to 7 per cent of the gross domestic product.

However, the possible effects of such a redistribution on the top decile would have to be taken into account. The assumption was that the volume of investment would decrease, as a result of diminished resources and a reduction of the incentives to invest. As far as the first of those factors was concerned, it was currently recognized that (as Mr. Urquidi himself had acknowledged) the decision to invest had no connexion with prior formation of savings and that probably personal savings represented a relatively small fraction of private saving in the Latin American countries. Even so, it was possible that private saving might decline at first as a result of redistribution, but in all probability consumption would be readjusted after a year or two and the level of saving would rise as high as or even higher than before.

With respect to the reduction of investment incentives, and the decrease in investment which Mr. Urquidi feared might result, he thought that was unlikely to happen, for several reasons: first, because the bulk of real and directly productive investment was effected by corporations - which should be taxed at a uniform and not unduly high rate, and should not be subject to progressive taxation - and saving on their part would increase inasmuch as a high personal income tax discouraged the distribution of profits; secondly, because the action of the higher income groups was not prompted solely by desire for profit but by other motives, and they would continue to invest in order to keep their establishments ahead of their competitors; and thirdly, because the limitation of their gains also limited the investors' fear of risks.

In view of all the arguments he had put forward, he thought it might be suggested to the Latin American countries that they should tax persons in the highest-income decile of the population more heavily in order to increase fiscal revenue by the equivalent of 5 to 10 per cent of the gross domestic product.

/Mr. PINTO

Mr. PINTO agreed in general with the observations made by Mr. Urquidi, but said he would like to enlarge upon one or two points that he considered to be particularly important.

The first concerned the scope of the State's sphere of action in Latin America and the nature of the instruments it employed. The region was not yet fully aware of the scale and variety of the resources and instruments at the disposal of its Governments and tended to assess them according to the share of public expenditure in the gross national product, which did not give a true picture of the situation. It was thought in some circles that the State had a limited field of action, but in many Latin American countries the Governments had almost complete authority over foreign trade, the monetary system, public utilities, some basic industries, the social security systems and wage and salary negotiations. In fact, the State had a great potential at its disposal which was often not used to its full extent.

Its failure to make use of it was largely due to the constant addition of new agencies to the public sector, which simply overlaid the traditional administrative machinery without replacing or being assimilated into it. The ensuing duplication of work and responsibilities could be found in other parts of the world but was particularly marked in Latin America.

A minor but still significant factor was the widespread tendency to regard legal provisions and their administrative corollaries as substitutes for practical solutions.

The inability to make good use of the resources and mechanisms at the State's disposal was, however, not attributable to those factors alone. He himself thought that the main reasons were twofold: firstly, the fact that the State's responsibilities and, by extension, its relations with the private sector were not clearly defined in terms of policy. In many influential circles the participation of the State was still looked upon as proper for emergencies only instead of as a normal and indispensable part of the economic development process. There was a tendency to pay lip service to such concepts as "free enterprise" while ignoring the public responsibilities involved therein. The divorce

/between words

between words and deeds had not prevented the State from acting but it had undoubtedly hampered the rationalization of its activities and created antagonism between the public and private sectors. The second reason was the difficulty of adopting criteria and taking decisions in particular sectors or situations in the absence of an integrated economic policy and an over-all picture of the aims pursued.

With reference to Mr. Urquidi's remarks on the problems besetting public enterprises, he first wished to lay stress on the increasing importance of State-productive enterprises administered which, in view of the more complex and exacting stage of development that the Latin American countries were entering upon, would make government action, either in isolation or in close association with the private sector, indispensable.

One question that still remained to be clarified concerned the criteria by which the efficiency of public or semi-public enterprises was to be determined. He considered it equally unsatisfactory that the latter should be governed by the same standards as private firms or that they should discard the yardsticks used by private firms before devising others that would be more suited to their particular functions. One measure of efficiency that should be used was the technique of programme budgeting which needed to be more generally taught and applied.

A prerequisite for solving the problem was, as Mr. Urquidi had pointed out, to make the general public aware of the purpose and social implications of the work of State enterprises and thus dispel the scepticism and indifference that was current in the Latin American countries.

But the problems involved were not merely technical. They also derived from the balance that had to be struck between the need for public enterprises to preserve their autonomy in technical and administrative matters while adhering to the policy laid down by the Government. No definite line of demarcation could be drawn, but it would be helpful to study specific cases in Latin America so as to establish some basic criteria for future action.

With regard to another point - that of taxes themselves - he considered that the time for weighing the relative merits and demerits of different types of taxes was past. What needed to be done was to lay down some

/general guide-lines

general guide-lines that could be adapted to the requirements of individual countries. In that respect, he stressed three considerations: first, one way of resolving the conflict between the prevailing belief that income tax should play a more important part in Latin American tax systems and the administrative difficulties involved was to levy it particularly on the wealthy minority e.g. on persons with a net income at least ten times the average figure. Secondly, other taxes, such as those levied on net wealth and various types of fixed assets, particularly real estate, should make a greater contribution than in the industrialized countries. In doing so, they would help to widen the tax base and to facilitate tax administration. Thirdly, the importance of excise taxes should be maintained without enhancing the regressive nature of income distribution. Some other way of classifying excise taxes should therefore be devised that would take into account their social implications. It would be difficult to do so, except for the fact that the pattern of consumption in the lower and intermediate income groups in Latin America was fairly easy to determine. Provided that that pattern was respected and the possible repercussions of a progressive public expenditure policy allowed for, virtually all indirect taxes would be progressive to some extent.

With respect to the final results of fiscal policy, he pointed out that the tendency to increase transfers of funds for social security purposes was unfavourable in comparison with the alternative of increasing expenditure on education and health which, apart from being intrinsically more equitable, was more apt to raise the real income of the population.

Lastly, he had two objections to make to Mr. Urquidi's observations on the role of fiscal mechanisms in income distribution and compensatory policy. On the first point, he agreed that such mechanisms could not have the same significance in Latin America as in more developed countries. Although any endeavour to change income distribution would have to go beyond fiscal policy, the latter would have an important part to play. In order to determine its responsibility it was essential to understand the different ways in which fiscal policy could bring about a redistribution. One was to take income away from the higher income groups and

/transfer it

transfer it to the less well-off. Another was for the State to tax the wealthy and use the revenue to provide goods and services for the poorer classes, and a third was use the same source of revenue to influence the factors that underlie income distribution.

He agreed that compensatory policy faced many difficulties in Latin America, but should none the less be resorted to when foreign trade was declining, to maintain the levels of employment and income and to prevent the rate of economic development from slackening.

The meeting rose at 6.10 p.m.