Chapter 1. Policy Coherence for Development

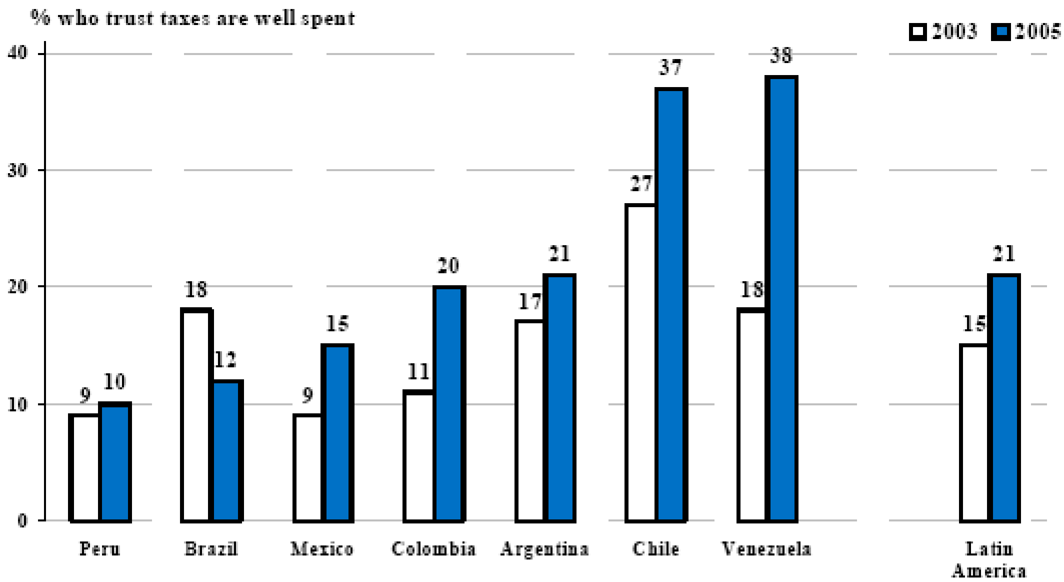
Fiscal policy and legitimacy in Latin America

Democracy puts fiscal policy at the heart of the relationship between citizens and the state. Fiscal policy, one of the region's main challenges today, will continue to be a major development issue for Latin America, as it is in the OECD countries. Latin America has the most inequality of any region in the world. Close to 40 per cent of the population, or more than 200 million people, live in poverty. Governments cannot ignore the challenges involved in fighting poverty and inequality while at the same time promoting stable and sustainable economic growth and development.

In many Latin American countries, fiscal performance and democratic governance suffer from low fiscal legitimacy. Good democratic governance paves the way to democratic legitimacy by building people's faith in democracy over all other forms of government and ensuring their acceptance of the way democracy works in their country. Analogously, fiscal legitimacy is a reflection of the confidence people grant their government's performance in collecting and spending its tax revenue.

Fiscal legitimacy is low in many Latin American countries. Less than 25 per cent of Latin Americans trust that their taxes are being well spent, according to Latinobarómetro surveys of local voters in the mid-2000s. Even allowing for some volatility or measurement error in those opinion surveys, there can be no doubt of the low orders of magnitude of fiscal legitimacy in most countries in the region, as those scores are corroborated by the views of local and multinational enterprises operating there. According to similar indicators and business-climate measures that allow for cross-regional comparisons, these companies consistently rate Latin American countries worse than those in other regions. An important explanation for this lack of trust in fiscal policy is that, in contrast to an important effect of fiscal systems in most OECD countries, taxes and transfers play little or no redistributive role in most Latin American states. When taxation fails to help bridge the gap between the rich and the poor, the credibility of the fiscal system suffers. Poor-quality fiscal policy hinders the generation of tax revenue, frustrates public expenditure, and undermines fiscal and democratic legitimacy.

Figure 1. **Percentage of Population Trusting That Taxes Are Well Spent**
Selected Latin American countries and average



Source: OECD Development Centre (2007); based on Latinobarómetro (2003, 2005) data.
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Fiscal reform in the 1980s and 1990s has already made significant progress and produced positive results in Latin America, where many governments are now trying to do a better job in terms of improving fiscal efficiency and promoting socio-economic equity. Successful reforms to strengthen fiscal institutions include the introduction of new rules to control public deficits, new fiscal-responsibility laws, and measures to enhance transparency. In part as a result of these reforms, much of the region now offers the world a new face: stable and predictable macroeconomic environments thanks to lower inflation, sounder public finances, more reasonable debt management and lower risk premiums.

Yet much remains to be done. A comparison of Brazil and Mexico serves to illustrate the challenges the region faces today in trying to improve the quality of fiscal policy. Brazil collects and spends a lot: at about 35 per cent of GDP, its tax revenue is close to the average for OECD countries and far above the average of 17 per cent for Latin America as a whole. More is not better, however, as Brazil does not rank much better than most other Latin American countries — and does poorly by OECD standards — on numerous social indicators that reflect the quality or effectiveness of public spending. Mexico, whose tax revenue is below 15 per cent of GDP, stands at the opposite end of the spectrum in terms of the ratio of tax revenues to GDP, by regional as well as OECD standards. But less is also not better, as Mexico, like Brazil, scores poorly on numerous measures of the quality of public goods. At opposite ends of the regional spectrum in terms of their tax-revenues-to-GDP ratios, Brazil and Mexico, like many other countries in Latin America, need both better collection systems and better public spending.

Looking ahead

Latin America's fiscal reforms can succeed by strengthening democratic governance. People will support fiscal reform, including tax reform, if they see results. First, public spending should be targeted better. The region needs better, fairer and more public spending, certainly on health and education, but also on infrastructure and innovation. In many countries, fiscal policy is regressive because wealthier households receive most of the benefits. Social-insurance programmes, in particular, are notably regressive throughout the region. Conditional cash-transfer programmes, such as *Bolsa familia* in Brazil or *Oportunidades* in Mexico, on the contrary, are very progressive but still relatively minor.

In terms of tax reform, a major pending challenge is to make collection systems fairer and more balanced through elimination of special exemptions from direct and indirect taxes. Such reforms will operate as a disincentive for tax evasion and increase revenue, and thus broaden the tax base. Revenues from indirect taxes, value-added taxes (VAT) in particular, play a large role in tax collection.Tax structures can only be balanced by increasing the share of revenue coming from direct taxation.

Fiscal performance and democratic governance

Having experienced major fiscal reforms in the 1980s and 1990s, the region is now moving into a new set of reforms. An open debate on public policies will enhance not only the approval process of reforms and new tax mechanisms but also their implementation. Expectations are growing for measures that can help strengthen accountability mechanisms and bring official policies closer to the population and public scrutiny. Transparency should reinforce citizens' perceptions that they are getting value for their money and that taxes are being well spent.

Local think tanks can play a very important part here. Their independent monitoring of public spending and fiscal policy-making can strengthen a sense of public ownership over democratic processes. In many Latin American countries, think tanks already play an important role, but their ability to criticise is limited by scarce funding and limited human resources. The creation of larger endowments would be an important step in providing Latin American think tanks with greater and better resources they need to analyse and evaluate public policies. Financial means and stability are also important elements for securing their independence from public players, so allowing them to exert their watchdog functions and express dissenting views.

Decentralisation can also play an important role in strengthening accountability and democratic governance by reinforcing the capacity, authority and accountability of subnational governments, especially through direct taxation. New ways of empowering local governments in taxation need to be explored, as these are not without challenges. In Brazil, for example, where states have been granted authority over VAT rates, there is evidence of harmful “tax wars” amongst different states.

Governments can enhance fiscal legitimacy, in sum, by: *i)* involving independent third parties in the auditing and evaluation of public policies to strengthen transparency and accountability; *ii)* promoting better, fairer and more public spending; *iii)* broadening the tax base and making tax systems fairer and more balanced; and *iv)* reinforcing the capacity, authority and accountability of sub-national government bodies, especially with regard to direct taxation. Fiscal legitimacy is not only an issue of capacity, however, and strengthening administrative capabilities can only take tax administration part of the way. The case of Peru during the Fujimori administration shows that even the most capable administration can be manipulated and misused. While tax administration and tax *policy* may be one and the same thing, as some fiscal experts have asserted, tax administration is not the same as tax *politics.*

In their efforts to enhance fiscal legitimacy and reinforce democratic governance, Latin American countries need to bring politics back into tax and fiscal policy-making, explicitly and transparently. Fiscal reform should aim at broadening benefits and bringing people and the state closer. An open and informed political debate, which can only happen if there is more transparency in the system and more public access to information, is an excellent way of achieving this goal. Independent actors with the capacity and the financial independence to carry out a critical evaluation of policies and proposed reforms can powerfully enrich such a debate. In the process, fiscal policy will help strengthen democratic governance.