NEW EMPIRICAL EVIDENCE ON LINKS BETWEEN FISCAL POLICIES AND GROWTH IN LAC

Presentation by Teresa Ter-Minassian at the 26th CEPAL Fiscal Policy Seminar

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Motivation

A (very brief) summary of the literature on linkages between fiscal policy and growth

Overview of the case studies in the forthcoming IDB book on “Fiscal Policy and Growth in LAC”

Main findings and new insights
WHY REVISIT THE EFFECTS OF FISCAL POLICY ON GROWTH IN LAC?

- Because for decades LAC has lagged behind most other regions in its growth performance, and it continues to do so.

- Because shortcomings in fiscal policies are widely recognized to have contributed to its lack-luster growth performance.

- **Main (well known) fiscal impediments to growth in the region**
  - Stop-go and frequently pro-cyclical fiscal policies
  - Inappropriate fiscal-monetary policy mixes
  - Low public savings
  - Risks to debt sustainability in some countries
  - Pervasive lingering weaknesses in tax policies and administration
  - Pervasive rigidities in public spending
  - Poor quality of education and health spending, and large infrastructure gaps
WHAT DOES THE LITERATURE SAY ABOUT LINKS BETWEEN FISCAL POLICIES AND GROWTH?

- A vast theoretical and empirical literature on linkages between fiscal policies and growth

Main conclusions

- No robust empirical evidence of a relation between the size of government and growth
- Fiscal policy volatility hurts growth
- High levels of public debt also reduce growth potential
- The structure of taxation is more important for growth than the level of the tax burden
- Although there is consensus about the importance of quality spending on education, health and infrastructure for growth, robust empirical estimates of these effects remain limited
**An overview of a new IDB book on fiscal policy and growth in LAC**

The book includes

- **an overview chapter** on theory and empirical evidence (in LAC and elsewhere) on the linkages between selected fiscal policies and growth
- **8 new empirical case studies, carried out by regional think-thanks**
  - 3 cross-country, 5 for individual countries
  - 4 focus on taxation
  - 2 on public expenditures
  - 1 on public debt
  - 1 on fiscal rules

**Methods of analysis utilized**

- Panel regressions or data envelopment analysis (DEA) for cross-country studies
- CGE models or time series regressions for individual country studies
MACRO-FISCAL STUDIES

“Government debt and economic growth”, by C. Calderon and R. Fuentes, explores whether public debt hinders growth; and whether there are non-linearities in the relation between public debt and growth.

Based on panel regressions, the paper finds:

- Robust evidence of both
- Evidence that the detrimental effects of high debt on growth are moderated by quality of domestic economic policies and institutions, and by trade and financial openness.

“A cycle-adjusted fiscal rule for Argentina” by J. Zuniga and others explores the benefits of the adoption of such a rule, while recognizing the substantial political and institutional obstacles to it in Argentina’s current circumstances.

The paper uses a dynamic stochastic CGE model to estimate the macroeconomic impact of alternative fiscal rules. It finds that rules that reduce fiscal volatility (such as cycle-adjusted ones) would reduce macro-economic volatility as well, with significant beneficial effects on longer term growth.
STUDIES ON TAXATION AND GROWTH (I)

- *Taxation and economic growth in Latin America* by G. Canavire Becarreza, J. Martinez-Vazquez and V. Vulovic uses both VAR analysis for four LAC countries, and panel regressions for a broader (LAC and non-LAC) sample to explore effects of various tax instruments on growth.

- Main findings:
  - The growth effects of tax changes estimated through VARs have generally the expected sign, but are relatively small.
  - The panel regressions point to a small negative growth impact of PIT increases, and a positive one of a shift to indirect taxation.

- “Aggregate effects of a fiscal reform for universal social insurance” by A. Anton and J. Leal explores the productivity and distributional effects of a potential replacement of social insurance contributions with a uniform-rate VAT in Mexico, using a two-sector dynamic CGE.

  - It finds significant positive effects of such a reform on productivity and GDP growth. Its impact on net real wages in the formal and informal sectors is found to vary depending on the value workers attribute to social insurance benefits, and on the weight of the goods subject to an increase in the VAT rate in their consumption basket.

  - Since, by these criteria, the lowest income deciles would be more likely to be affected adversely by the proposed reforms, it would be desirable to compensate them through targeted cash transfers.
STUDIES ON TAXATION AND GROWTH (II)

“Taxation and economic growth in Colombia” by R. Steiner explores the growth effects of reductions in the rates of the corporate income tax (CIT) and of payroll taxes for Colombia.

It finds that a 10 pp reduction in CIT rate would have an only modest beneficial impact on the user cost of capital and on private investment, but a high budgetary cost (almost 1 percent of GDP).

In contrast, simulations of the impact of a payroll tax cut (conducted using Fedesarrollo’s CGE model) suggest that it would significantly boost output and formal employment. Moreover, over time the reform would pay for itself.

“Normative fiscal policy and growth: some quantitative implications for the Chilean economy” by E. Espino and M. Gonzalez-Rosada explores the growth and welfare effects of a revenue-neutral switch to an optimal composition of the tax system in a small open economy characterized by significant labor informality.

The paper argues that an optimal tax structure in Chile would involve lower taxes on capital, negative taxes (subsidies) on labor and higher taxes on consumption. Under such a tax structure, labor would be reallocated towards the formal sector, and leisure (and thus welfare) would increase. However, the growth rate of GDP would rise only slightly.
STUDIES ON PUBLIC EXPENDITURES AND GROWTH (I)

- The paper “Impact of Public Expenditures in Education, Health and Infrastructures on Economic Growth and Income Distribution in Peru” by J. Baca Campodonico, J. Peschiera Cassinelli, and J. Mesones attempts to analyze, using a dynamic CGE model, the scope for boosting growth, reducing unemployment, and improving income distribution in Peru, by changing the level or mix of spending on health, education and infrastructure.

- The model simulations suggest that uncompensated increases in public investment would lead to long-term increases in growth, and reductions in unemployment, poverty and income inequality. However, they would also result in a significant deterioration of the external current account balance and loss of net international reserves.

- In contrast, prioritizing public investment in education and health over infrastructure would generate long-term gains in growth, and reduce unemployment, poverty and inequality, without adverse effects on the external accounts.
STUDIES ON PUBLIC EXPENDITURES AND GROWTH (II)

“Public sector efficiency: evidence for Latin America” by A. Afonso, A. Romero and E. Monsalve represents a first attempt at measuring the efficiency of public spending for a sample of twenty-three LAC countries over the period 2001-2010

The paper constructs sectorial indicators of public sector performance, and uses them to calculate relative efficiency scores for different categories of public spending, and to rank the sample LAC countries accordingly

The paper also uses DEA to estimate relative efficiencies in aggregate public spending across countries

Based on its analysis, the paper argues that efficiency in public spending is inversely correlated with the size of government, and that outcome indicators could be improved by nearly 20% on average, using the same level of spending. It also suggests that efficiency scores are positively correlated with transparency and regulatory quality.
SOME CONCLUSIONS

- The case studies make significant new contributions to the literature on fiscal policy and growth by shedding light on issues of key importance for the LAC region.

- While most of the results of the studies are broadly in line with the previous literature on these issues, they also bring new evidence and insights on, for example, the following facts:
  
  - The adverse effects of public debt on growth can be mitigated by the quality of countries’ policies and institutions.
  - A shift from labor to consumption taxes can promote a significant decline in labor market informality, as well as increases in the size of firms, productivity, and the net wages of workers.
  - In countries still characterized by major deficiencies in human capital, investments in education and health have a larger impact on long term growth than investments in infrastructure; and
  - Most countries in the region lie well below the efficiency frontier for public expenditure, and could therefore significantly improve the quality of their public services without spending more.
I hope to have raised your interest in reading the book when it is released...

Thank you for your attention!