A STRATEGIC ACTION FRAMEWORK

FOR FISCAL POLICY AND MANAGEMENT

in Latin America and the Caribbean

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Introduction

The Latin American and Caribbean (LAC) region is one of the most unequal in the world and its growth rates are volatile and lower than those of other emerging countries (**see Figure 1**).

This represents a structural challenge that affects the region's social and economic development. A strategic fiscal policy and management is key for our governments to address these problems.

In addition, it is of vital importance for the region to respond to emerging challenges that make growth even more difficult: the strong vulnerability to climate change and the growing levels of debt and fiscal deficits that threaten fiscal sustainability.

FIGURE 1

	Inequality Level (Gini coefficient)	Average Growth Rate (1960-2019)
LAC	0.48%	3.1%
EMERGING ECONOMIES	0.38%	3.9%

Four Strategic Action Opportunities for Latin America and the Caribbean

At the IDB, our Fiscal Management Division team has developed a **Fiscal Management Sector Framework**, which defined four strategic opportunities for the Bank to work with the governments of the region to respond to these structural challenges in the short and medium term to accelerate economic growth with greater equity and sustainability.

OPPORTUNITY **1**

Increase the contribution of fiscal policy and management to economic growth

Fiscal policy and management in LAC countries is characterized by volatile macroeconomic environments, low quality and efficiency of public spending, and inefficient tax policy and management. Reversing this reality requires an intelligent fiscal management that allows accelerating long-term growth anchored on the mobilization of private sector resources (**see Infographic 1**).

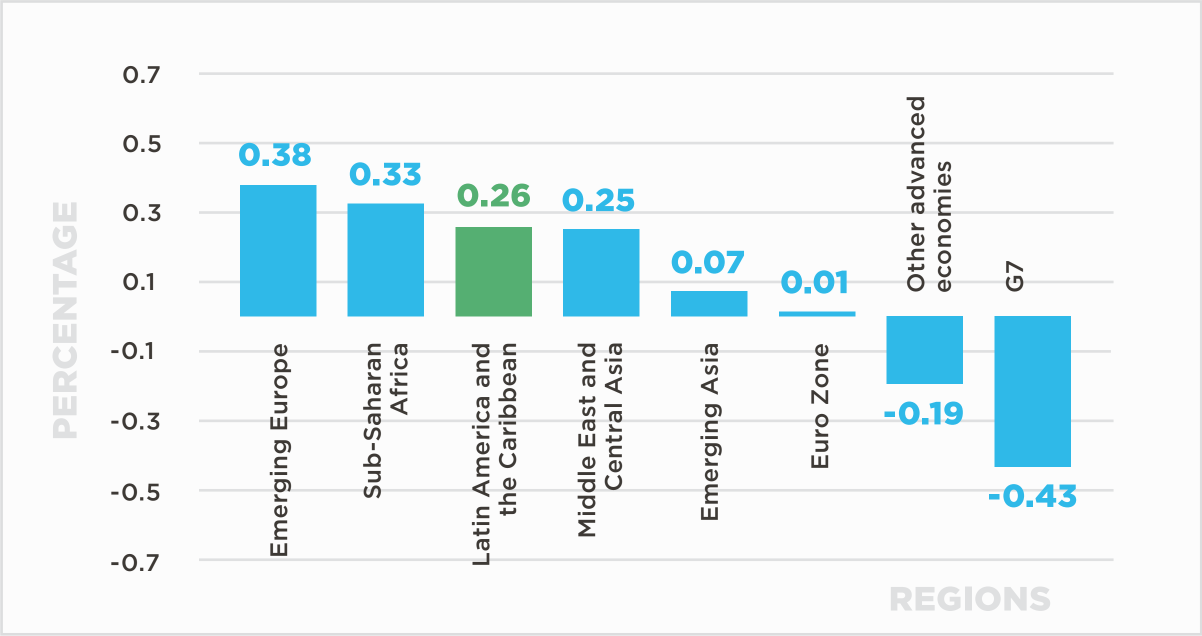
INFOGRAPHIC **1**

A PRO-GROWTH FISCAL POLICY REQUIRES...

A — Reducing fiscal procyclicality

Relative to other regions, LAC governments increase spending more in good times and cut back more in bad times, amplifying the volatility of economic activity and, above all, deepening recessions.

Correlation between GDP and total primary expenditure (2000-2016)



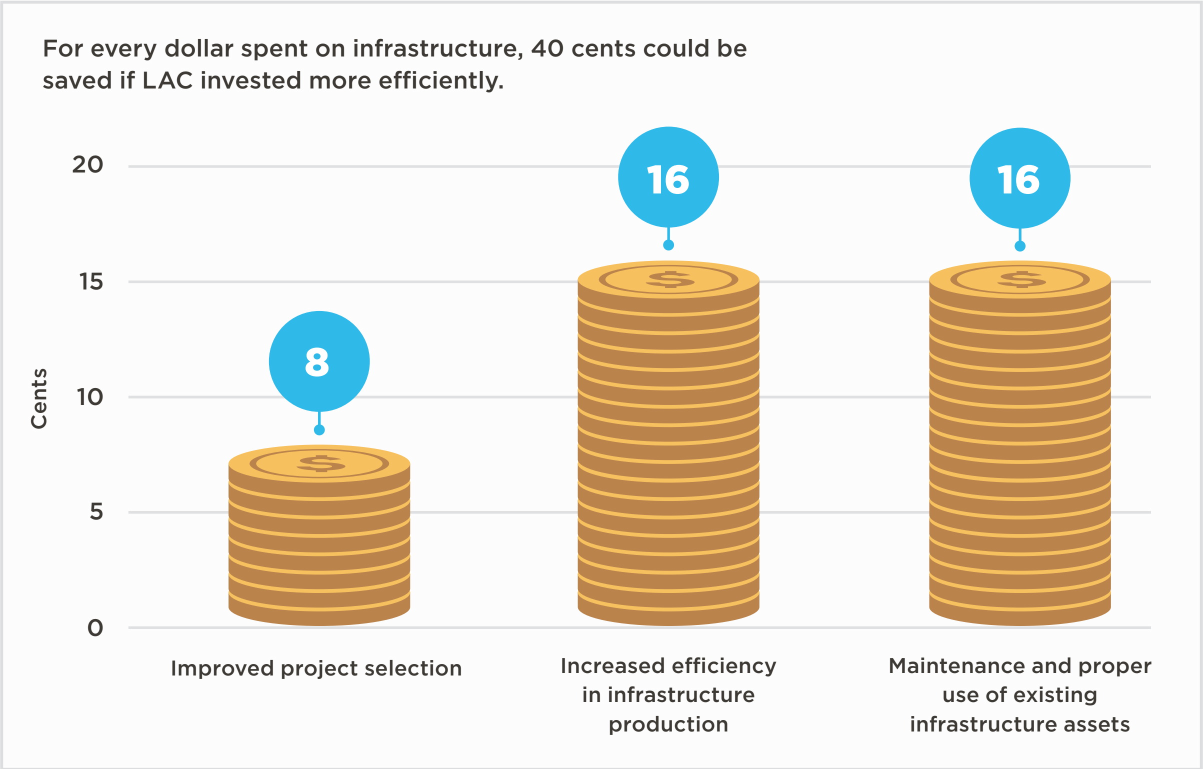
Source: Adapted from A. Izquierdo, C. Pessino, and G. Vuletin (2018), Better Spending for Better Lives: How Latin America Can Do More with Less. Development in the Americas series. Washington, D.C.: IDB.

INFOGRAPHIC 1 *(continued)*

B Improving the efficiency of public spending

LAC countries have high allocative and technical inefficiencies in public spending, which, together with a lack of transparency and persistent corruption, affect the quantity and quality of infrastructure, public services, and the human capital of the population, key inputs for attracting investment and economic growth.

Potential savings in infrastructure spending in LAC for every dollar invested



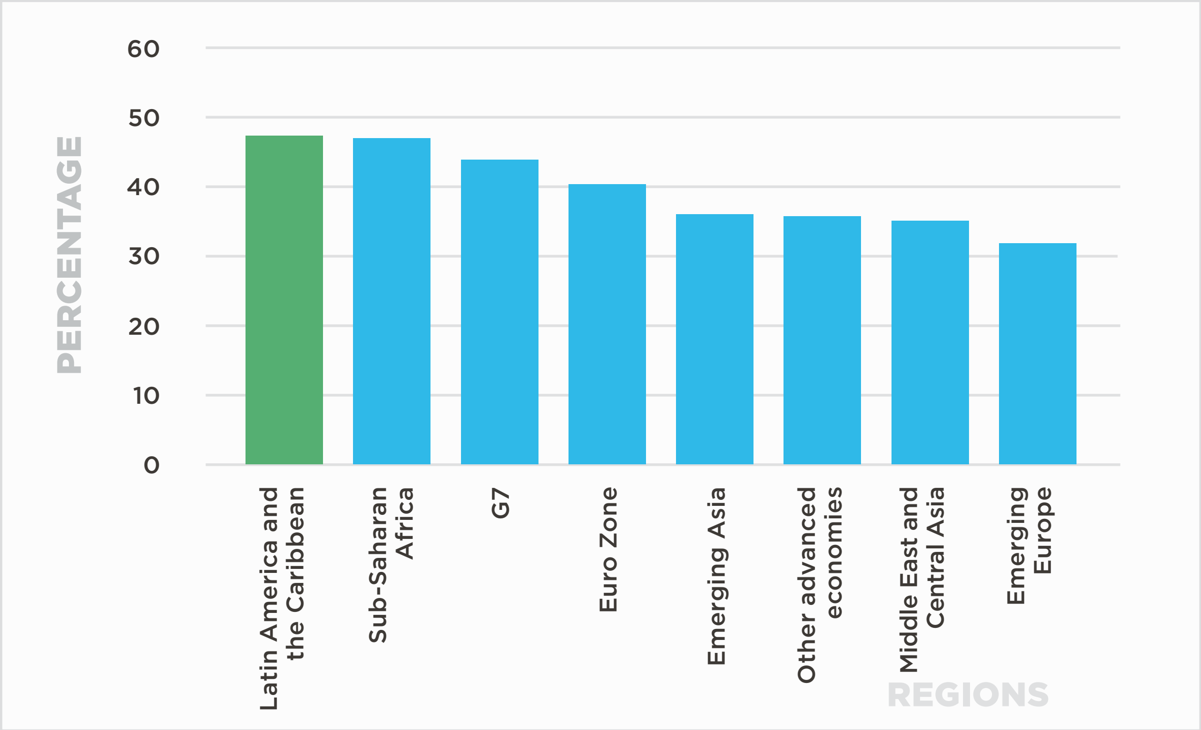
Source: A. Izquierdo, C. Pessino, and G. Vuletin (2018), Better Spending for Better Lives: How Latin America Can Do More with Less. Development in the Americas series. Washington, D.C.: IDB.

INFOGRAPHIC **1** *(continued)*

C Reformulating tax policy and administration

The tax structures of countries in the region negatively affect the business environment and economic growth. Businesses face high total tax burdens in most countries in the region, which affects investment attraction and private sector development. In addition, efforts to facilitate tax payment by tax administrations are insufficient.

Tax burden on a representative company in 2019 (as a percentage of profits)



Source: Authors' elaboration based on Doing Business Project (World Bank).

OPPORTUNITY **2**

Increase the redistributive impact of fiscal policy

One of the main causes of the high inequality in the region is the low redistributive impact of transfers and the tax system. Inequality of household market income in LAC is very similar to that observed in the Euro Zone. However, when analyzing disposable income, which corresponds to household income after receiving government transfers and paying direct taxes, LAC becomes much more unequal than the Euro Zone countries. The redistributive impacts of government interventions are also low when compared with other emerging countries (**see Figure 2**).

FIGURE 2

How much does fiscal policy reduce inequality?
(Gini coefficient change)

LAC
-5.3%

EMERGING COUNTRIES
-13.6%

To increase the redistributive impact of fiscal policy, it is necessary to:

- **Improve targeting, reduce leakage, and promote a gender and diversity** focus in social assistance and subsidy policies to ensure that these programs reach the citizens who need them most. Tax benefits aimed at supporting lower-income households should also be better targeted.

- **Reduce labor informality** through reforms of social security programs, conditional transfer programs, and simplified tax regimes to limit incentives for informality.

OPPORTUNITY **3**

Strengthen fiscal institutions to encourage the sustainability of public finances

Although the levels of indebtedness in LAC countries are quite heterogeneous, in most cases they have been growing because of the recurrent fiscal deficits present before the COVID-19 pandemic and due to the great efforts made to deal with the pandemic effects. To reverse the situation, the following actions need to be implemented:

- **Design fiscal consolidation plans** that protect investment in physical and human capital, so as not to affect the growth potential of economies.

- **Strengthen macroeconomic and fiscal risk management capacity.**

- **Strengthen fiscal institutions**, including fiscal rules, medium-term fiscal frameworks, and independent fiscal councils. This would encourage compliance with established fiscal targets and promote greater fiscal sustainability and market confidence.

OPPORTUNITY 4

Increase the contribution of fiscal policy and management to mitigation, adaptation, and management of fiscal risks related to climate change

LAC countries are heavily exposed to climate change. This is a consequence of the region's geographic location, the strong dependence on natural resources that characterizes its economies, high population density, and population growth. The region's capacity to adapt to climate change is also weak due to high levels of poverty, weak institutional governance of key sectors, and insufficient funding for adaptation projects.

Finance ministries play an essential role in helping to respond to the challenges of climate change, not only because they allocate public resources to finance climate actions but also because they can take a leadership role, using fiscal tools that modify the incentives faced by the private sector and establishing rules, mechanisms, processes, and controls that help ensure that public program and project decisions lead to an orderly, fair, and inclusive transition so as to avoid future costs (**see Infographic 2**).

INFOGRAPHIC **2**

HOW FISCAL POLICY AND MANAGEMENT CAN CONTRIBUTE TO STRENGTHEN GOVERNMENTS' RESPONSE TO CLIMATE CHANGE

A Supporting the definition of comprehensive strategies and adaptation to climate change, with concrete actions by the public sector and incentives for the private sector, and leveraging public investment.

B Encouraging emissions reductions through public investments in renewable energy, incentives to the private sector to limit emissions, and carbon pricing policies, including the reduction of fossil fuel subsidies.

C Strengthening adaptation to climate change by increasing the resilience of public assets to climate events and better managing the fiscal risks associated with such events.

D Managing fiscal risks related to the transition to low-carbon economies.

E Supporting the mainstreaming of climate change initiatives through green public procurement strategies, resilient and low-emission public investment, and green public financial management, among others.

How Does the IDB Work with Countries on Fiscal Policy and Management?

The IDB is a key ally in the design and implementation of fiscal reforms, for which it has a team of specialists with high technical capacity who are familiar with local realities and maintain a permanent dialogue with member countries to advise them on the design and implementation of effective fiscal management policies and practices.

The Bank has different instruments—loans, guarantees, cooperation, and technical assistance—that allow it to provide comprehensive support during the different phases of fiscal interventions.

Four IDB Action Lines

To respond to the structural challenges mentioned in this publication, the IDB has defined four lines of action:

1 Increasing the contribution of fiscal policy to economic growth

CHALLENGES	MEASURES WE SUPPORT
Macro-fiscal stability	• Strengthening fiscal rules and stabilization funds • Design and implementation of automatic fiscal stabilizers
Quality and efficiency of public spending	• Strengthening expenditure quality governance • Review of budgeting, investment, and public procurement policies and processes
Tax policy and administration	• Rationalization of tax systems • Digital transformation of tax administrations

2 Increasing the redistributive impact of fiscal policy

CHALLENGES	MEASURES WE SUPPORT
Targeting	• Strengthening the policy and management of subsidies and monetary transfers • Analysis of the redistributive impact of tax and expenditure policy targeting alternatives
Formalization	• Strengthening of incentives to promote formal employment for low-income workers • Improving the design of simplified tax regimes for companies
Gender and diversity	• Implementation of gender-sensitive schemes in budget management and public procurement • Capacity building for the inclusion of gender and diversity perspectives in fiscal policy

3 Supporting fiscal consolidation processes and strengthening fiscal institutions for the sustainability of public finances

CHALLENGES	MEASURES WE SUPPORT
Fiscal consolidations	• Definition of fiscal strengthening programs that protect investment and social spending
Fiscal risks	• Strengthening the management of contingent liabilities • Strengthening public debt management
Fiscal institutions	• Strengthening the design of fiscal rules and savings funds • Creation and strengthening of independent fiscal councils

4 Increasing the contribution of fiscal policy to climate change management

CHALLENGES	MEASURES WE SUPPORT
Mitigation	• Design of fiscal incentives for emissions reductions • Strengthening national public investment systems to align investments with decarbonization strategies
Adaptation	• Managing fiscal risks related to climate change • Development of processes to foster resilient public investmen
Fiscal institutions	• Capacity building in finance ministries to contribute to the development of national decarbonization strategies • Development of comprehensive green public financial management strategies

Learn More about Our Work

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