Fiscal Policy Issues in Latin America
Harris School of Public Policy

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Room 289A

Summary

This course is about economic policymaking in practice, with emphasis in Latin America. It is structured around a set of topics with particularly salient challenges in the region in areas widely related to fiscal policy both from the income and from the expenditure side and its implications from the macroeconomic perspective as well as for subnational governments, firms, and households. We will study and discuss some of the policy dilemmas in various areas of policy ranging from fiscal rules and tax policy to mining royalties to subsidies for poverty alleviation and access to finance. In addition, one overarching question in the course will be: why policies are often not optimal in spite of a common (or at least widespread) understanding of the desirable course of action? We will examine different types of obstacles: political economy issues (conflicts between interested parties), lack of resources (financial, human), coordination problems within government (between regions, sectors, agencies, branches of government), tradeoffs between economic efficiency and distribution, etc.

I will draw extensively from my own first-hand experience in Colombia, but will bring examples from other countries in the region (and occasionally outside of it) as well. Students will prepare and present case studies to be discussed in class.

Grading

Participation and class discussion	15%
Case Study paper	20%
Case study presentation	15%
Midterm	20%
Final Policy Memo	30%

1. Economics, politics and policies

Why is it so hard to reform? Even when there is "technical" agreement on how policy should change? O when there are at least Pareto improving alternatives? Why some groups get and maintain benefits despite the general interest? How these particular interests get to be protected and how they become impossible to revisit? How the textbook benevolent central planner equilibrium interact with the politically viable alternative in different contexts? We will study, the relationships between national and subnational governments, technocratic (and not so much) executive appointees and publicly elected officials, how interest groups gravitate around them and the role of the judiciary and the civil society. Plus, the influence of foreign countries and international organizations. We will also explore how the policy design and implementation outcomes can be suboptimal in terms of redistribution, flexibility, red tape, rent seeking opportunities, etc.; analyzing some specific policy areas related to fiscal and social policy.

Acemoglu, D., & Robinson, J. A. (2013). Economics versus politics: Pitfalls of policy advice. *The Journal of Economic Perspectives*, *27*(2), 173-192.

Besley, T. (2006). *Principled agents?: The political economy of good government*. Oxford University Press on Demand.

Acemoglu, D., Johnson, S., Querubin, P., & Robinson, J. A. (2008). When does policy reform work? The case of central bank independence. National Bureau of Economic Research WP No. w14033.

Gibson, Edward L. 2005. "Boundary Control: Subnational Authoritarianism in Democratic Countries," *World Politics,* 58 (1): 101–132.

Stein, E., Tommasi, M., Scartascini, C., & Spiller, P. (2008). *Policymaking in Latin America. How politics shapes policies,* IADB, Harvard University, New York.

Stein, E. (Ed.). (2005). *The politics of policies*. Economic and social progress in Latin America IDB.

2. Fiscal adjustment: fiscal responsibility

Macroeconomic stability, the ability to access international financial markets at favorable rates and to finance deficits so that not all necessary expenditures need to come from current incomes is one of the areas of economic policy in which there is consensus from defenders of either extreme of the political spectrum. However, expenditure pressures coming from different sectors, the difficulty of rising taxes, budget inflexibilities, and the political costs of reducing or eliminating rents for specific constituencies (teachers, the military, pension subsidies, territorial transfers, etc.) make fiscal adjustments very hard and usually belated. We will study the political economy of fiscal responsibility, the costs of delaying the adjustment, and the instruments (tax vs expenditures). In addition, some of the strategies that governments can use to work around adjustment like future budget appropriations, public private partnerships, divestiture (and privatization) of state owned assets, etc.

Alesina, A., & Drazen, A. (1991). Why are Stabilizations Delayed? *The American Economic Review, 81*(5), 1170-1188.

Alesina, A., & Perotti, R. (1995). The political economy of budget deficits. *IMF Staff Papers*, *42*(1), 1-31.

Alesina, Alberto, Silvia Ardagna, and Francesco Trebbi (2006), "Who Adjusts and When? On the Political Economy of Stabilizations." I*MF Staff Papers*, Mundell-Fleming Lecture, 53: 1-49.

Alesina, A., Hausmann, R., Hommes, R., & Stein, E. (1999). Budget institutions and fiscal performance in Latin America. *Journal of development Economics*, *59*(2), 253-273.

3. Fiscal rules and institutions

A big debate in policymaking is the convenience of rules versus discretion, of commitment versus flexibility. This dilemma permeates multiple dimensions of economic policy. We will discuss it in the context of fiscal policy, exploring not only the tradeoffs involved, but also asking about the root cause of the problem. Why might governments want to surrender discretion? Which are different ways to tie their hands for the sake of fiscal responsibility? What forces might push them to have costly "time inconsistent" choices? How are some of these problems different for developed/developing countries? We will explore how different agents interact around the issue of fiscal responsibility: Government (national and subnational), Congress, expert committees and blue ribbon commissions, think tanks, corporations, international financial institutions, credit rating agencies, etc., and we will draw from some specific experiences in the last 20 years in Latin America

Tentative case studies: Stabilization: Argentina and Colombia early 2000's
Fiscal Rules: Chile and Brazil 2000, Mexico 2006, Colombia 2011

Drazen, Allan (2000). *Political economy in macroeconomics*. New Haven: Princeton University Press. Chapter 4.

Alfaro, Laura and Kanczuk, Fabio (2017), Fiscal Rules and Sovereign Default, NBER Working Paper No. 23370

Poterba, J. M., & Von Hagen, J. (1999). Introduction to" Fiscal Institutions and Fiscal Performance". In *Fiscal Institutions and Fiscal Performance* (pp. 1-12). University of Chicago Press.

Fiscal Policy in Latin America: Lessons and Legacies of the Global Financial Crisis

Corbacho, A., & Schwartz, G. (2007). Fiscal responsibility laws. *Promoting fiscal discipline*, *58*, 71.

4. Raising taxes: The "structural tax reform"

Taxes are usually the main source of financing for governments and thus the stepping-stone for policy. Not only taxes are a source of financing but they are also a policy instrument to reduce inequality and to induce and deter behavior. They also play an important role on shaping the structure of production in the economy and the optimal share of investment and employment. There is wide consensus on some taxation issues such as the desirability of simple schemes with wide tax bases and low rates, progressivity, or on taxing "bads" like cigarettes or pollution. However, there are other areas with more dilemmas such as taxes on dividends or tax incentives for specific industries or regions. We will study some consensus and dilemmas around tax policy and explore the difficulties of implementing tax reform, even when there is academic consensus on how reform should look like. Reducing exemptions, creating new taxes to induce behavior and rising taxes, even for the wealthiest are challenges to the status quo that are hard to pass. The interaction between government, Congress, industry, think tanks and the media shape the outcome of reform.

Tentative case studies: Colombian tax reforms of 2012, 2014 and 2016
Private incentives in Perú 2016
Taxing obesity: Costa Rica, Mexico, Colombia and California

Hettich, W., & Winer, S. L. (1988). Economic and political foundations of tax structure. *The American Economic Review*, 701-712.

Gadenne, Lucie. (2017). "Tax Me, but Spend Wisely? Sources of Public Finance and Government Accountability." *American Economic Journal: Applied Economics*, 9(1): 274-314.

Vito Tanzi, 2013. "Tax reform in Latin America: a long term assessment" Commitment to Equity (CEQ) Working Paper Series 15, Tulane University, Department of Economics.

OECD (2010) Tax Policy Reform and Economic Growth. OECD Publishing

World Health Organization. (2016). Fiscal policies for diet and prevention of noncommunicable diseases: technical meeting report, 5-6 May 2015, Geneva, Switzerland.

5. Mining royalties and their distribution

Oil, gas and mining contribute Gross Domestic Product in many developing countries; they can also have a heavy fiscal impact due to high revenue from income taxes and royalties they pay. However, it is not clear that the economic activity and the fiscal revenues they produce are good for development and wellbeing. There is extensive evidence of what has been called "the natural resource curse" in which resource-richer countries underperformed compared to their counterparts. Since natural resources are not a blessing or a curse in itself, we will go beyond studying the basic macroeconomic challenges (price volatility, Dutch disease and poor diversification of the economy); to understand the institutional underpinnings that determine success or failure of natural resource management (rent seeking and low institutional quality, conflict) and discuss policy instruments to address them. We will also consider matters of regional distribution of royalties within countries, and issues of revenue decentralization. The interaction between different actors including national, regional and local governments, communities, state owned, private and multinational firms shape the future of an industry with much to improve to be sustainable.

Tentative case studies:
Resource nationalism in Bolivia and Venezuela vs more liberal approaches in Mexico and Colombia

Regional Distribution of Royalties in Colombia and Bolivia vs National royalties in Mexico and Venezuela

Collier, P. (2010). The political economy of natural resources. *social research*, *77*(4), 1105-1132.

Torvik, R. (2009). Why do some resource-abundant countries succeed while others do not?. *Oxford Review of Economic Policy*, *25*(2), 241-256.

Barma, N., Kaiser, K., & Le, T. M. (Eds.). (2012). *Rents to riches?: The political economy of natural resource-led development*. World Bank Publications.

Frankel, Jeffrey A. 2012. The Natural Resource Curse: A Survey of Diagnoses and Some Prescriptions. HKS Faculty Research Working Paper Series RWP12-014, John F. Kennedy School of Government, Harvard University.

Haslam, P. A., & Heidrich, P. (Eds.). (2016). *The political economy of natural resources and development: from neoliberalism to resource nationalism*. Routledge.

Dube, O., & Vargas, J. F. (2013). Commodity price shocks and civil conflict: Evidence from Colombia. *The Review of Economic Studies*, *80*(4), 1384-1421.

Martínez, Luis R. (2017), "Sources of Revenue and Government Performance: Evidence from Colombia", Harris School of Public Policy.

6. Poverty and Conditional Cash Transfers

Developing countries and Latin America in particular face challenges to reduce poverty and inequality. A large share of the population experience difficulties to generate enough income to cover basic needs, while the state is often unable to provide free or affordable quality services to address them. In this section of the course, we will discuss the pros and cons of strategies to reduce poverty based on targeted subsidies vs the provision of public goods. Conditional Cash Transfers have been widely spread as a policy instrument to provide subsidies so that poor households can complement their income, and commit to send their kids to school and to medical check-ups. While these programs aim to overcome the policy dilemma of assistentialism by conditioning the subsidy on investments on human capital -so that poor kids can have better opportunities when they grow up- and have been in general effective on improving school and health care attendance, food consumption and women empowerment; they face institutional challenges that undermine their potential. Incentives to stay in the informal market, to have more kids (and thus higher subsidies), to use subsidies to influence elections are undesirable side effects. More recent debates question whether conditionality is all that relevant.

Tentative case studies: Progresa- Opportunities in Mexico
Familias en Acción Colombia

Diaz-Cayeros, Alberto, Federico Estevez, and Beatriz Magaloni (2016). *The political logic of poverty relief: Electoral strategies and social policy in Mexico*. Cambridge University Press, 2016.

Fiszbein, A., & Schady, N. R. (2009). *Conditional cash transfers: reducing present and future poverty*. World Bank Publications.

Camacho, Adriana and Emily Conover. (2011). "Manipulation of Social Program Eligibility." *American Economic Journal: Economic Policy*, 3(2): 41-65.

De La O, A. L. (2015). *Crafting Policies to End Poverty in Latin America*. Cambridge University Press.

Levy, S. (2010). *Good intentions, bad outcomes: Social policy, informality, and economic growth in Mexico*. Brookings Institution Press.

Edmonds, E. V., & Schady, N. (2012). Poverty alleviation and child labor. *American Economic Journal: Economic Policy*, *4*(4), 100-124.

Baird, S., McIntosh, C., & Özler, B. (2011). Cash or condition? Evidence from a cash transfer experiment. *The Quarterly Journal of Economics*, qjr032.

7. Savings, loans and household shocks: vulnerability and access to finance

Financial inclusion has become increasingly interesting for policymakers. This area is full of market failures but can offer a safety net to reduce the need and the cost of state intervention. Some have oversold microfinance as a miracle tool to beat poverty, though this magnified view is unfortunate, the ability to borrow when cash constrained, to secure resources for future consumption, or to pay small amounts periodically (insurance) to avoid a big outflow when experiencing shocks can be extremely useful. However, vulnerable households have difficulties accessing financial services. Banks, and even microfinance institutions, are not as widely spread as to cover individuals in remote areas. Even in urban settings, asymmetric information and adverse selection reduce supply and leave people underserved. Taking advantage of this gap, moneylenders, and savings and loans ponzi schemes emerged, posing high risks for individuals who recur to alternative providers in lack of formal coverage. Policies and regulations to expand the scope of electronic payments, to extend branches and other bank services providers beyond the traditional sources, to adapt loan policies so that informal customers are not discriminated against, can make a difference. We will also explore some of the behavioral science approaches to deepen access, use, quality and impact of financial services.

Tentative case studies: Mobile payments and banking in Peru
Improving access to credit in Colombia

Beck, Thorsten, Asli Demirgüç-Kunt, and Ross Levine. 2007. "Finance, Inequality and the Poor." *Journal of Economic Growth* 12 (1): 27–49.

Banerjee, A., Duflo, E., Glennerster, R., & Kinnan, C. (2015). The miracle of microfinance? Evidence from a randomized evaluation. *American Economic Journal: Applied Economics*, *7*(1), 22-53.

Dean Karlan, Jonathan Zinman. Microcredit in Theory and Practice: Using Randomized Credit Scoring for Impact Evaluation. Science 332, June 2011

Cadena, X., & Schoar, A. (2011). *Remembering to pay? Reminders vs. financial incentives for loan payments* (No. w17020). National Bureau of Economic Research.

Ashraf, N., Karlan, D., & Yin, W. (2006). Tying Odysseus to the mast: Evidence from a commitment savings product in the Philippines. *The Quarterly Journal of Economics*, *121*(2), 635-672.