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SERIE POLICY BRIEF

FISCAL SPACE AND PRO-GROWTH POLICY COORDINATION IN MERCOSUR

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Summary

In the current favorable macroeconomic context the fiscal stance of MERCOSUR countries is no longer under strain. A series of research projects undertaken by MercoNet for Argentina, Brazil and Uruguay has concluded that fiscal sustainability has broadened pro-growth fiscal space.[1]

However, despite some progress towards the implementation of national counter-cyclical fiscal policies, this has not led to region-wide pro-growth fiscal policies. This is problematic since MERCOSUR is in a region that has been falling behind in the race towards development.

The regional coordination of pro-growth policies could de a possible step to reverse this situation and to overcome the constraints associated to the political economy of fiscal deficits, the quality of bureaucracies and the availability (or lack thereof) of policy instruments.

Previous studies suggest the need to learn from successful experiences —such as the European and Asian— and encourage infrastructure development, innovation and self-discovery, and higher productivity by channeling resources of the present economic bonanza to foster regional economic growth.

MERCOSUR has made modest efforts in this direction —especially on institutional development, energy, micro-businesses, innovation, infrastructure and finance. It is thus urgent to consolidate and strengthen the set of initiatives already under way.

Our research makes specific policy recommendations. First, we find that it is necessary to consolidate and strengthen initiatives such as the structural convergence fund (FOCEM), as well as others in the field of energy, bio-fuels, small and medium-sized firms and innovation. Second, the relationship between MERCOSUR and the Initiative for the Integration of Regional Infrastructure in South America (IIRSA) needs to be reinforced and harmonized, with regional banks playing a bigger role in mobilizing financial resources (there has been some progress with the Bank of the South). Third, in a similar fashion to Asian initiatives on international reserves´ management, governments should implement policies that free resources to foster economic growth, such as the use of regional currencies for trade.

To sum up, and apart from the availability of resources, it is necessary to eliminate the constraints created by domestic conflicts of interest, lack of policy instruments and inefficient bureaucracies. This should be done through policies coordinated on a regional basis. It is vital for the region not to waste the current bonanza and to capitalize it by funneling more resources towards economic growth.

1 - The input for this document was the book Fiscal Policy Space for Growth in MERCOSUR, edited in 2009 by the Mercosur Economic Research Network. The book can be freely downloaded from the website: http://www.redmercosur.org/fiscal-space-for-growth-in-mercosur/publication/77/en/

1 - Introduction

The noticeable improvements recorded over the past few years in the macroeconomic outlook of the region (and especially in the two largest countries) have not been translated into relevant pro-growth regional policy initiatives. The region may thus be wasting a chance to benefit from this period of prosperity and to take its growth rate closer to that of other more dynamic regions of the world, thus reducing its productivity gap
.

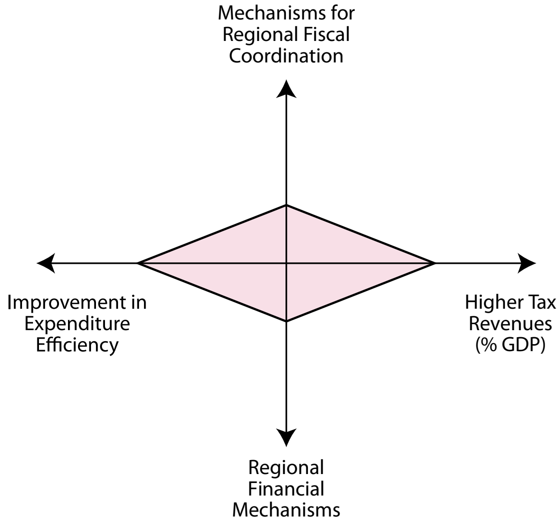
Through the analysis of existing fiscal space and other potential macroeconomic risks, the MercoNet research has shown that weak regional pro-growth policies were not the result of unfavorable macroeconomic or fragile fiscal positions. This raises the need to search for alternative hypotheses to explain this absence. This also begets the question of whether there are unexploited options for regional growth cooperation, given existing regimes and fiscal policy space. The rest of this article discusses these topics.

2 - The analytical framework

The analytical framework of the Network studies was the concept of fiscal space.[2] We adopted the World Bank methodology, which identifies different ways to create fiscal space. Its core is a diamond which shows on its vertexes four factors that can potentially lead to the creation of fiscal space: regional financial mechanisms, higher tax revenues, mechanisms for regional fiscal coordination, and improvement in expenditure efficiency.

The first step towards evaluating fiscal space was to measure the importance of changes in the financial position of the public sector by employing methods that evaluate fiscal policy sustainability in a context of uncertainty. The next step was to estimate existing fiscal space, as an intermediate target to identify fiscal policy instruments that could be potentially subject to regional coordination in order to accelerate economic growth.

Means of fiscal space generation



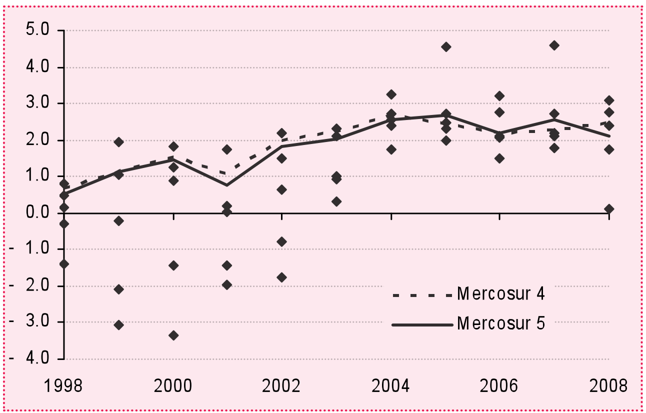
2 - Fiscal space is defined as the available resources in the public sector budget that provide the necessary means for desired expenditures, without altering the sustainability of its financial position or economic stability.

3 - More fiscal space without pro-growth MERCOSUR policies

Stronger fiscal accounts

The analysis of MERCOSUR primary fiscal balances shows a region-wide change in tendency as of 2001 and a shift to a surplus position with less dispersion. As a consequence, public sector debts also fell. On the other hand, the four countries recorded current account surpluses and faster rates of accumulation of international reserves. This confirms a clear improvement in the regional macroeconomic outlook.

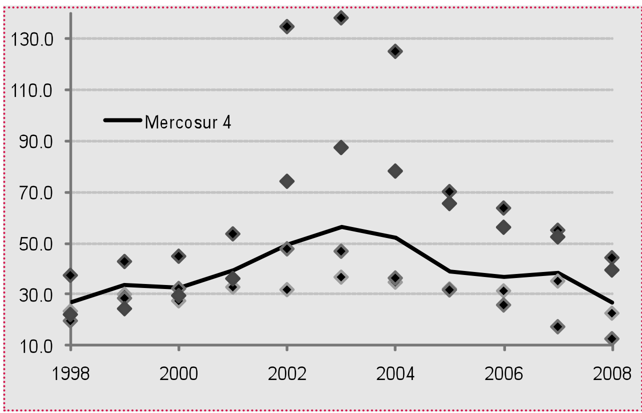
Graphic 1. Evolution of primary fiscal surplus in MERCOSUR (GDP %)



Source: own elaboration based on ECLAC data.

Note: the diamonds indicate the fiscal balance for each country and year. The dotted line shows the average for Mercosur. The full line shows the average for Mercosur+Venezuela.

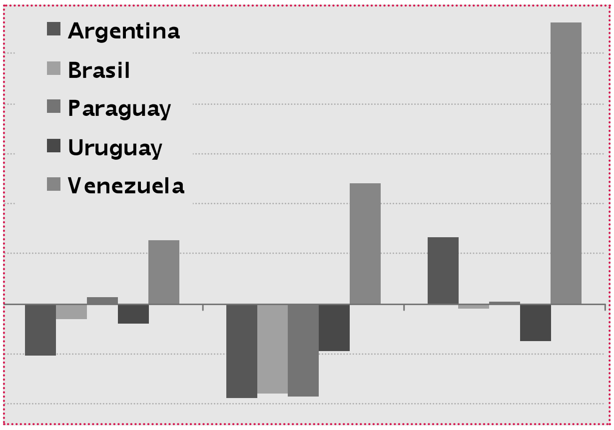
Graphic 2. Evolution of public sector debt in MERCOSUR (GDP %)



Source: own elaboration based on ECLAC data.

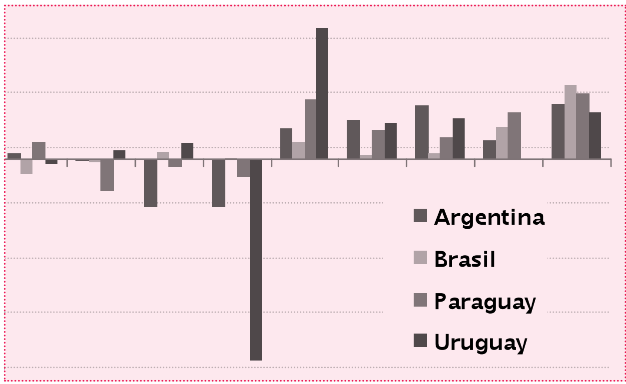
Note: the diamonds indicate the public sector debt for each country and year. The full line shows the average for Mercosur countries.

Graphic 3. Current Account in MERCOSUR countries (GDP %)



Source: own elaboration based on ECLAC data.

Graphic 4. Change in international reserves in MERCOSUR countries (GDP %)



Source: own elaboration based on ECLAC data.

Fiscal Sustainability

The past few years have witnessed a reversion in the region's traditional tendency to generate large, hard-to-finance fiscal deficits. As some evidence suggests, this may have positive effects on economic growth.[3] However, some forms of fiscal surplus could also be detrimental to economic growth. In fact, high tax pressure or an inadequate tax structure could adversely affect growth.

The region's fiscal surplus experienced a slightly lower growth than tax pressure, which means that public sector spending increased. This increase, however, was not channeled into pro-growth areas, as will be shown later on. The positive performance of the primary fiscal surplus had very positive effects on the sustainability of public sector debt. This indicator, however, may not be sufficient to assess how far off the next crisis might be. Other features such as the dollarization of the economy and the terms of public sector debt are also very important. However, even when these factors are taken into consideration, our research shows positive trends.

In order to assess the role of uncertainty we undertook econometric sustainability analysis, which yielded interesting results. In the case of Argentina the sustainability of public sector debt improved, but vulnerability may return in a high interest rates-low growth scenario. In the case of Uruguay the vulnerability of public sector finances has been reduced, but threats come from the sensitivity of public sector debt to the exchange rate and dollarization. Lastly, in the case of Brazil the public sector debt problem is more related to the term structure of the liabilities than to dollarization.

Taxes and Expenditures

The case studies conducted for Argentina, Brazil and Uruguay point to some fiscal policy characteristics that may have affected the growth patterns of the region and its ability to grow in the future. Our research identifies two main channels of influence: taxes and spending on investment, education and innovation.

Results show a persistent growth in tax pressure over the past years in all three countries, but particularly in Argentina and Brazil. It is also interesting to note that the effects on growth that can derive not only from the size of tax revenues, but also from its composition, potentially causing distortive effects.

Regarding the structure of expenditures, the main conclusion is that public sector investment has gradually receded since the eighties. Naturally, part of this fall is explained by the crises of the late nineties and 2001-2002, as well as the privatization of public sector firms which now contribute to total investment from the private sector. Nevertheless, recent studies (i.e. Fay and Morrison, 2007) turn down the notion of perfect substitution between public and private investment a consequence of privatization. Two key pro-growth public sector expenditures are resources allocated to education and innovation. Despite the fact that ECLAC (ECLAC, 2006) found that public spending levels in the three countries are consistent with their degree of development, regional expenditures on innovation are low when compared to more dynamic regions.

To sum up, the case studies conclude that over the past few years there has been an expansion of the fiscal space and a reduction in the threats stemming from debt sustainability. The stronger regional fiscal stance

3 - ECLAC (2005) and Kneller et al. (1999).

could enable the design of long-term policies. However, these improvements have not translated into an immediate expansion of pro-growth fiscal policies. This would suggest the existence of other constraints, such as the political economy of tax distribution, the quality of bureaucracies and policy instrument availability or lack thereof.

4 - Macroeconomic coordination and pro-growth initiatives

The fact that progress in debt sustainability and tax collection has not translated into a significant broadening of pro-growth fiscal space is bad news and need to be immediately reversed. Our research shows that regional cooperation has played no part in the shaping of national fiscal policies, despite attempts to set common targets.

Can regional cooperation help to take better advantage of pro-growth fiscal space? If so, our studies conclude that such cooperation should point not towards the creation of new resources, but rather towards the relaxation of other constraints that limit fiscal space and that may be key to improving pro-growth policies. Obviously, the alternatives will depend on the will of member countries to invest politically in a regional agreement. But this will be directly tied to the benefits that may accrue from such agreement. In the present circumstances, characterized by the availability of fiscal resources, it would be interesting to investigate if such opportunities exist.

Greater fiscal policy coordination may contribute significantly to macroeconomic stability and economic growth by improving the regional investment outlook by extending the planning horizon. However, the authors were not generally optimistic as to the possibility of coordinating fiscal targets in a near future.

This means that opportunities to act upon the constraints that limit fiscal policy space, if they exist, would relate to regional cooperation in the area of pro-growth policies.

A regional cooperation strategy to design of pro-growth policies that takes into account the lessons of the European Union and the Asian experience, and that takes advantage of the greater availability of fiscal resources, should meet four basic conditions. First, policy makers should choose areas of high returns in terms of growth acceleration. Second, high returns should rest upon the exploitation of comparative advantages for the region as a whole and not for each partner separately. Third, initiatives must generate regional interest groups willing to support policy continuity. And finally, initiatives should target policy instruments unavailable to each partner individually.

High return alternatives in terms of the acceleration of growth demand regional cooperation policies to address coordination failures that impede the exploitation of scale economies and agglomeration effects, as well as to deal with externalities that weaken innovation and self-discovery. Regarding coordination failures, MERCOSUR could contribute to infrastructure development and structural change facilitation. Infrastructure investment is functional to the exploitation of regional comparative advantages and the creation of regional interest groups, be it due to gains from location, cheaper supplies or taking part in construction.

From the fiscal space generation perspective, public investment is important for another reason. Expenditure planning for regional-level infrastructure could help to isolate it from domestic pressures. Therefore, regional coordination could help in the defense of pro-growth fiscal space by ear-marking specific funds.

Concerning the development of innovation and self-discovery activities, there are opportunities to move forward with initiatives to integrate national innovation systems and harmonize foreign investment policies.

Recent literature has emphasized the importance of productivity-enhancing industrial policies when aiming at developing potential comparative advantages. Specifically, these policies include initiatives geared to exploiting externalities in the discovery of new activities and interventions oriented towards solving coordination failures in the process of cluster formation.

MERCOSUR has undertaken some modest initiatives in this area, but largely isolated and, given the current availability of resources and the need to close the productivity gap with the developed world and to cope with the Asian challenge in industrial product markets, poorly funded.

5 - Why hasn't existing MERCOSUR fiscal space been dedicated to more decisive pro-growth policies?

A possible hypothesis is that the fiscal recovery improved public sector solvency indicators, but failed to broaden fiscal space enough to implement pro-growth policies.

Another plausible hypothesis, not incompatible with the aforementioned, is the existence of other constraints which limit public policy space and are independent of resource availability, such as the inability to act collectively, scarcity of policy instruments, lack of policy coordination or unavailability of an effective fiscal system to design and implement pro-growth policies.

A third hypothesis takes stock of the speed of the change in scenario. According to this explanation, policy conceptions and growth strategies may still be adapting to the new circumstances. Consequently, they are likely to be still influenced by the difficulties experienced during the critical 1999-2002 period.

The research undertaken by MercoNet tends to reject the first hypothesis, and to favor the second over the third.

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Fuente para este brief: *La exportación de servicios en América Latina: los casos de Argentina, Brasil y México*, Serie Red Mercosur Nº 17, Ed. Red Mercosur, Montevideo, Uruguay, 2010.
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Diseño gráfico:
Diego García

Esta publicación ha sido posible gracias al apoyo del Centro Internacional de Investigaciones para el Desarrollo de Canadá (IDRC).

IDRC CRDI