

Commentary: Public Sector Deficits and Macroeconomic Stability in Developing Economies

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First of all, I would like to thank the Federal Reserve Bank of Kansas City for the invitation to this conference. The comments I will make are based on my own personal experience in Chile, where I have been responsible for fiscal policy since the beginning of the democratic government in March 1990. What makes this experience interesting is that Chile has had a public savings rate of over 5 percent of GDP since 1988, and a budget surplus in excess of 1.5 percent of GDP for the same period. During this period, the economy has grown at 7 percent a year and inflation has been reduced significantly.

In a period in which maintaining a balanced budget has become a tough political objective, I would like to comment on the causes or factors that, according to our experience, have contributed to our budget surplus.

In the first place, I would like to stress the importance of a firm political commitment to the objective of fiscal equilibrium. If this objective is not given top priority and put before other political objectives, it is extremely easy for the budget to become an adjustment variable. Our past history of hyperinflation and very high rates of open unemployment contribute to the high priority now given to fiscal balance and macrostability. However, political commitment is not enough (as revealed by the large number of governments that are committed to this objective but fail to deliver). Many countries

fail because of the nature of the legal and institutional framework in which the fiscal policy decisions are taken.

In the Chilean system, decisions on fiscal policy are taken almost exclusively by the executive branch of government. This system avoids the competition for resources that takes place when members of Congress strive to raise those expenditures directed toward the area of the country they represent.

Under such competition there is no guarantee that the resulting budget decisions are consistent with the macroeconomic targets. In fact, from the 1940s to the 1960s, my country went through a period where fiscal policy was dominated by partial interests without the possibility of setting a desired balance.

In a democratic and pluralistic context, fiscal policy faces the challenge of representing the different interests of society without losing its capacity to be used as a macroeconomic policy tool, or even worse, becoming a source of instability.

Public sector structure

Certain aspects of the structure of our public sector have contributed to the results we have obtained.

The tax system

There are three aspects of the Chilean tax system that I consider to be important. In the first place, our tax structure is not subject to annual discussion or revision. In fact, the budget law cannot modify tax laws. This has allowed us to design a tax legislation that is more efficient, stable, and permanent than that which would have resulted if we permanently modified it to fit the specific needs of each budget. The possibility of a stable tax structure is partly due to the fact that our tax system is completely indexed to inflation. All accounting and tax payments take place in an accounting unit that is adjusted daily according to the rate of inflation. This mechanism protects government budget revenues from inflation and

eliminates the distortions that inflation usually causes in taxpayers' financial decisions.

Another important aspect is the composition of our taxes. The most important tax is a flat value added tax (IVA) of 18 percent applied to almost all economic activities. In fact, it is very similar to a personal expenditure tax. This VAT tax has been applied in Chile for the last twenty years.

Furthermore, our personal and corporate income taxes are completely integrated, so that taxes on dividends are considered credits for personal taxes. This mechanism encourages saving by both individuals and firms.

Third, the existence of a reasonably efficient tax administration, the simplicity and stability of this system, and a society that, in general, abides by current laws, lead to a relatively low rate of tax evasion.

These elements are responsible for tax revenues of around 19 percent of GDP (excluding social security payments). This puts Chile among the countries with the highest levels of tax revenue in the developing world. This contrasts strongly with the low rates of corporate taxes and wide exemptions for low income earners. This level of revenue and the stability of the overall system allows us to plan fiscal policy well in advance.

Finally, it is worth mentioning that we have managed to eliminate a traditional source of fiscal instability in developing countries: the excessive dependence of fiscal revenues on exports of commodities. In many of our countries, it is common that one or two export products contribute significantly to the government's revenue.

In the Chilean case this product is copper. To avoid the fiscal effects of variations in the price of copper a stabilization fund was created. In periods of high prices the excess revenues are deposited in this fund, to be used in periods of low copper prices. The main benefit of this system is that it avoids expenditure expansions in

times of high prices, that are politically very difficult to revert once prices drop. In this way government spending tends to adjust to the state's "permanent income."

Government structure of expenditure

A large government is extremely hard to fund and allows little flexibility for macroeconomic policy. Central government expenditure in Chile is around 22 percent of GDP, 70 percent of which goes toward social programs. By developing country standards, this level of expenditure is relatively large. However, there are other characteristics worth mentioning that give the government a relatively large degree of flexibility.

Central government employment is relatively low at 2.6 percent of total employment, due to the fact that, although the state finances a series of social services, it does not provide these services directly. They are provided by the private sector, which, in turn, is subsidized by the state on the basis of a grants system. Apart from promoting a higher degree of competition among suppliers of the social services, public employment is reduced, thus giving greater flexibility to government spending.

There are many examples of public services provided by private or decentralized institutions: grants for education follow students to whatever school they attend (private or municipal); local governments are funded according to the number of people registered in the local clinic; the banking system pays all the pensions; subsidies for poor households' housing can be used through private property dealers; small business can work with private banks that, in turn, receive a payment to compensate for the larger transaction costs involved in very small loans; school meals are provided by private contractors, and so on. All this contributes to better service and, as I mentioned before, to greater flexibility in public spending.

Another point worth mentioning is the nearly total inexistence of subsidies aimed at productive activities. These subsidies are usually very costly and not very efficient at increasing equity. Direct lending

by government agencies has been gradually eliminated and replaced by lending to the financial system in cases where the market is not well developed. Financial institutions have to do the lending and run the commercial risks involved.

Subnational governments, a traditional source of fiscal instability, do not have access to credit and therefore are restricted to spending their own resources or resources obtained from the central government. Their role is to prioritize projects, subject to the level of total public spending consistent with macroeconomic policy.

A strict control of debts contracted by autonomous or semi-independent public entities is essential for the success of expenditure controls. In many cases, excess autonomy or ease of access to debt has led to large deficits in public companies or other decentralized public entities.

In short, the structure of revenues and expenditures of the public sector is crucial in determining the capacity of government to use the budget as an effective tool for macroeconomic policy.

Budget authority

Apart from the importance of the structure of the budget it is important to mention the existence of a centralized government budget authority. It is common that autonomous entities such as public enterprises, regional, and local governments are completely or partially out of the control of the budget authorities, weakening their capacity to control fiscal policy.

In the Chilean case the budget is comprehensive, including all the transactions of government entities. Local governments and other autonomous entities are restricted to spending their own revenue. To be able to contract loans, they require previous authorization from the national budget authority.

Tax earmarking is another source of rigidity and sometimes leads to a misallocation of revenues. With one or two exceptions, earmarking

is ruled out of our budget practice. Thus, it is possible to allocate the resources according to each year's priorities, giving the fiscal authority the needed flexibility to set fiscal targets.

Fiscal flexibility

Nevertheless, we consider that the current level of fiscal flexibility is insufficient. It is well known that greater degrees of integration into the world economy reduce the role of monetary policy and increase the importance of a flexible and responsible fiscal policy.

Exchange rate fluctuations are extremely important in a small open economy, where exports account for over 30 percent of GDP. Because of this we have tried to attain greater independence of our domestic interest rate from international rates by imposing a reserve requirement on the capital inflows.

Although this mechanism is far from perfect, it has been reasonably successful in limiting capital inflows to an amount compatible with a gradual and moderate exchange rate appreciation. It is clear that there will always be rigidities in the fiscal policy of a country that, like Chile, has a high degree of social inequality. In this case, it is of great importance that the government contributes to improve the opportunities and address the essential needs of the poorer households. Likewise, fiscal resources are required to overcome a lack of infrastructure that could eventually limit the country's growth. This is why a certain degree of monetary policy autonomy is required, which can be obtained through the control of capital flows.

In addition to that, it would be desirable to have some extra flexibility in fiscal policy. Not forgetting the importance of stability in the overall tax structure, it would be very convenient to have some degree of control of the tax rates for the sole purpose of macroeconomic management. This would allow fiscal policy to play a more effective role in reaching macroeconomic targets. In short, the requirements placed on fiscal policy, in a small open economy that aims for growth with equity are very demanding.

The private pension system

Let me finally make a few remarks about pension reform. A particularly interesting topic for the issues analyzed in this conference is the private pensions reform which was introduced in Chile almost fifteen years ago. At that time, a public pay-as-you-go social security system was replaced by a privately funded pension scheme. The compulsory private pension system now covers 90 percent of employed workers and has accumulated a pension fund equivalent to 50 percent of GDP.

There are many aspects that one could comment on this topic; however, I will only touch on two aspects relevant for today's discussion.

With regard to the new system's contribution to aggregate saving: on one hand, private savings rise due to the compulsory deposits that start being deposited in private accounts. On the other hand, the public sector starts showing a deficit because it has to continue paying pensions but is no longer receiving the payroll tax contribution. The government is faced with several alternatives to finance its deficit.

On one extreme, it can issue debt that will coincide with the new private pension accounts, so that, on the whole, nothing will happen to aggregate savings.

On the other extreme, the government may reduce expenditures and/or raise taxes. If this does not induce a reduction in private savings, then aggregate savings will rise. Thus, the net impact of the introduction of a privately funded system will, at least during the transition period, depend on the way the government finances the deficit produced by the reform. In the Chilean case, the government has made a huge effort to raise savings and has issued almost no debt to finance the deficit. Thus, it has contributed to a rise in savings, which are being accumulated in the new pension funds.

The previous effect is very important during the three to four decades of transition when the fund accumulates.

Another relevant change is the substitution of a defined benefit pension scheme for a defined contribution system. Contrary to social security where the benefits are legally determined, in this new system only the contributions are legally defined and the pensions are determined by lifetime contributions, financial investment returns, and the market for annuities. Thus, when life expectations change, the consequences are different in the two systems. A rise in life expectations will typically result in higher public pension expenditures in the “pay-as-you-go system.”

In the private pension system, it will result automatically in lower pensions, unless an extra amount of voluntary saving is done to compensate for the longer retirement period.

Pension schemes play an important role in the government budget and in aggregate savings. The experience of transformation provides interesting insights on its relationships which are worth examining in greater detail.

There are other relevant aspects worth explaining. They refer to the implications of this reform for financial markets and the microeconomic working of the system, and, of course, its political economy consequences. But I will have to stop at this point.

Table 1
Central Government Savings of Chile 1989-94
As a percent of GDP

	Government Revenues			Savings	Recognition Bonds** (pensions)	Deposits Copper Stabilization Fund
	Current Revenues	Taxes*	Current Expenditure			
	(1)	(2)	(3)	(4)=(1)-(3)	(5)	(6)
1989	25.7	14.8	22.4	3.4	0.4	3.7
1990	23.0	14.5	20.6	2.4	0.5	2.3
1991	23.0	16.7	19.8	3.4	0.4	0.7
1992	22.8	16.9	17.9	4.9	0.5	0.3
1993	22.4	17.6	17.6	4.8	0.6	-0.2
1994	22.1	17.1	17.4	4.7	0.7	0.2

*Excludes social security, copper taxes, local government

**Should be added to savings since are included as current expenditures in spite of being long-term savings

