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Trends in the World Economy: Implications for Fiscal Choices

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TRENDS IN THE WORLD ECONOMY: IMPLICATIONS FOR FISCAL CHOICES

I. INTRODUCTION

The 1980s were difficult for Latin America. Per capita real GNP increased by only $30 (1.5 percent), and ten of the 27 countries in the region had a lower per capita GNP in 1989 than they had in 1980. Between 1981 and 1985, there was virtually no growth in the region. The situation did not improve markedly in the early 1990s. Per capita real GNP declined by 0.1 percent in 1990 and grew by only 0.8 percent in 1991.

The reasons for this poor economic performance in Latin America and in low- and middle-income countries elsewhere have been well studied and researched: the debt overhang; the worldwide recession in the early 1980s and the US recession at the end of the decade; a high real rate of interest; and a continuation of domestic policies that were not conducive to economic growth. With respect to the latter, the following are often listed:

- restrictions on trade to protect domestic industry slowed national (and international) economic growth;
- investment was hurt by high real rates of interest and by overvalued exchange rates;
- public sector enterprises proved to be an inefficient way to deliver many goods and services;
- government fiscal and tax policies led to deficits which have contributed to inflation, and failed to provide the best playing field for investors;
- meeting the needs brought on by immediate economic crises diverted the attention of governments away from investment in human capital through health and education programmes.

The world economic outlook for the remainder of the 1990s, according to the projections surveyed here, is for a continued but slow recovery through 1992, for world trade to increase and for economic growth to return (by the mid-1990s) to approximately its long-term path of about three percent per year. However, the variation in this growth rate among nations may be greater than in the past. Those countries with richer endowments of natural and human resources, and those with economic policies more compatible with growth, will do better. Indeed, there are reasons to be optimistic about the 1990s. The Inter-American Development Bank (IDB) labels the 1990s a decade of hope and points to the turnaround in domestic policy in Latin America at the end of the 1980s: "...reevaluation of past policies led to the adoption of a series of fundamental reforms aimed at correcting some of the existing macroeconomic disequilibria as well as some of the distortions in the countries' product and factor markets, in order to establish a more solid foundation for future growth." While it is too early to tell whether policy reform has gone far enough in Latin American countries, it is clear that the world market in which they will compete is likely to be very different from that of the 1980s.

This paper is about the prospects for the world economy in the 1990s and the fiscal choices that this environment implies. In the next section a number of projections are reviewed and compared with the actual economic performance of the past decade. Then we turn to a review of the broad trends and structural changes that will affect the competitive position and policy stance of low-income countries, and to the major uncertainties that may alter these trends. The final section of the paper outlines some of the important fiscal choices that will be forced.

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1. For good discussions of the problems, see Tanzi and Chu (1989); and Blejer and Cheasty (1990).

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II. PAST AND PROJECTED ECONOMIC PERFORMANCE

The weak performance of low-income countries in the past decade, and of Latin American countries in particular, is described in Table 1. There was little increase in per capita GNP in either group over the 1980-89 period, and the standard of living in many developing countries did not grow. Meanwhile, the growth among (high-income) OECD countries was robust enough that per capita GNP nearly doubled over this same period, and the gap between rich and poor countries widened considerably.

### TABLE 1
Economic Performance in the 1980s:
Selected Regions and Indicators

<table>
<thead>
<tr>
<th>Per Capita Real GNP (in 1987 US dollars)</th>
<th>1980</th>
<th>1990</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Latin America†</td>
<td>1920</td>
<td>1950</td>
<td>$30 (1.5%)</td>
</tr>
<tr>
<td>Low Income</td>
<td>310</td>
<td>330</td>
<td>$20 (6.5%)</td>
</tr>
<tr>
<td>OECD High Income</td>
<td>10650</td>
<td>19240</td>
<td>$8590 (80.7%)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Investment as a Percent of GDP</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Latin America</td>
<td>24.3</td>
<td>19.5</td>
<td>-4.8% of GDP</td>
</tr>
<tr>
<td>Low Income</td>
<td>25.5</td>
<td>28.4</td>
<td>2.9% of GDP</td>
</tr>
<tr>
<td>OECD High Income</td>
<td>22.0</td>
<td>21.8</td>
<td>-0.2% of GDP</td>
</tr>
</tbody>
</table>

† Including the Caribbean.

What of the 1990s? The results of several forecasts, based on econometric models, are summarized in Tables 2 and 3 (as reported in World Bank [1991a]). Some projections give both a "baseline" and a "pessimistic" forecast, based on a set of upside and downside assumptions. Shorter-term projections, prepared by the IMF, are shown in Table 4.

### A. Industrialized countries

For high-income industrialized nations the baseline projections for real GNP growth range from 2.8 to 3.2 percent per year. In other words, the models predict a growth no greater, on average, than the 3.1 percent that took place in the 1970s and 1980s. In fact, the average of these projections would have a slower growth rate than that of the last 20 years. All of the baseline forecasts, however, call for a substantial rebound from the dismal economic performance of the past few years.

The structure of this growth is expected to differ from that of the past decade. Four of the six forecasts see a lower rate of inflation, and all project a lower real rate of interest and an increased volume of exports.

Though the assumptions in these forecasts vary from model to model, the World Bank baseline assumptions are perhaps representative. They assume (World Bank [1991a], p. 27) that:

- The real price of oil will not rise measurably, at least not until the second half of the decade. Petroleum prices will depend on the strength of the recovery of the industrial economies. By even the most optimistic forecasts, industrial growth will not be strong until the second half of the decade.
- The recession in industrial countries will end, but an "average" forecast is that G-7 countries will grow markedly slower than in the past decade (World Bank [1992], p. 7). Full recovery to higher levels of growth will not take place until the late 1990s.
- The United States will resolve its fiscal deficit problem. This assumption is probably overly optimistic since the US deficit has risen in absolute terms this year, and the Gramm-Rudman-Hollings target of a balanced budget in 1993 will not be achieved. The Congressional Budget Office (1991) estimated that the budget deficit will fall under present policies, but will not reach balance until 1996.
- Economic growth in Europe and Japan will remain strong as policy reforms lead to increases in productivity. An average forecast for the 1991-95 period is for Japan to grow at about 3.8 percent per year, compared to four percent in the 1980s. It is assumed that Japan's export growth will not be as robust as in the past, and the real rate of investment will be lower. Germany, by this same averaging, is expected to grow at 2.8 percent, well above its two percent growth in the previous decade. (World Bank [1992a], p. 7).
- Net flows of capital to developing countries will gradually expand. It is assumed that economic policies in developing countries will strengthen the competitive position of these countries in attracting capital, and that their creditworthiness will be restored.
- Real interest rates will not fall to as low a level as was achieved during most of the 1960s and 1970s, but will be well below those of the 1980-89 period.
- The GATT talks will be successful, except in agriculture.

The World Bank also produces a pessimistic forecast, made by altering the above assumptions. In this scenario the price of oil is higher, the GATT talks are unsuccessful in all areas, and overall world trade is slower, and both the United States, and Japan experience economic difficulties. By the lowest of the four forecasts reported, the G-7 countries grow by 2.3 percent per year between 1991 and 1995. This compares with an actual growth of 2.8 percent in the 1980s.

According to the Bank model, the downside scenario (compared with the baseline forecast) will lead to a higher rate of general inflation, a substantially higher real rate of interest, a reduction in the volume of world trade, and a reduced flow of capital to low-income countries.

3. The World Bank ([1990], at 39) reports that there was considerable progress in reducing poverty in the 1960s and 1970s, but that the picture for the 1980s is mixed. "In some regions the poor have suffered serious setbacks, whereas in others the progress of previous decades has continued and has even accelerated."

4. The four forecasts are Data Resources Incorporated, National Institute of Economic and Social Research, The Wharton Econometric Forecasting Association Group and Consensus Economics Incorporated (World Bank [1992a]).
The International Economic Climate in the 1990s:
A Comparison of Recent and Projected Indicators

Table 2: Projections for the 1990s

<table>
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<tbody>
<tr>
<td>High-income countries</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Real GDP (%)</td>
<td>3.1</td>
<td>3.1</td>
<td>2.6</td>
<td>2.9</td>
<td>3.1</td>
</tr>
<tr>
<td>Inflation (%)</td>
<td>6.6</td>
<td>3.8</td>
<td>3.7</td>
<td>3.6</td>
<td>3.4</td>
</tr>
<tr>
<td>Interest rate (%)</td>
<td>3.1</td>
<td>5.8</td>
<td>4.3</td>
<td>3.4</td>
<td>4.3</td>
</tr>
<tr>
<td>Real trade, %</td>
<td>4.1</td>
<td>5.0</td>
<td>5.5</td>
<td>4.5</td>
<td>4.3</td>
</tr>
<tr>
<td>Real price of oil</td>
<td>-0.6</td>
<td>-0.1</td>
<td>22.2</td>
<td>0.9</td>
<td>-3.0</td>
</tr>
</tbody>
</table>


The United Nations (1990) projections for the industrialized countries and the world economy generally agree with the results presented above. They project a real per capita GDP growth rate of 2.6 percent for the 1990-2000 period, a growth that is significantly below the long-term trend.

The medium-term outlook, as seen by the IMF (1992), is somewhat more optimistic (Table 4). For 1992 and 1993, they see a significant increase in real GDP growth, reaching 3.3 percent by 1993. This is higher than most of the long-term projections summarized in Tables 2 and 3, though it is lower than the Fund’s even more optimistic view in 1991 (IMF [1992], Chapter 1). The 1993 results are driven by assumptions of lower interest rates and a lower general rate of inflation, and by the projection of a significant increase in the volume of world trade by 1993.

B. Developing economies

The long-term projections for developing and middle-income economies, as reported by the World Bank, are reproduced in Table 3. According to the World Bank baseline scenario, it is expected that the average growth in per capita real GDP will increase at a higher rate than before. Developing countries will exceed the growth of the 1980s, but there are wide variations around this mean. Some countries, and even some regions, will not fare well. Low- and middle-income countries in Africa, the Middle East and Latin America are expected to grow at less than the international average rate. For the Latin American countries, the real per capita GNP growth rate is projected to be less than the average rate realized over the past 25 years. The reason for this expected weak performance in many countries is that they remain plagued by the same problems as in the 1980s: high real rates of interest, low commodity prices and the resource drain associated with the debt overhang. The performance of the world economy has two conflicting effects on Latin American countries. The slower growth in the industrial economies in the early 1990s will dampen export markets and therefore retard growth in exports by all low-income countries, and it will slow the flow of capital from the industrialized to the developing countries. On the other hand, the lower real rate of interest will provide some relief to heavily indebted countries.

Under the World Bank’s pessimistic scenario, the projected growth for all developing economies is 0.8 percent per year slower, and for Latin America is 0.5 percent slower (than the baseline forecast). In effect, it would be a continuation of the 1980s. Oil importers face particularly bad in this scenario, because of the assumption of a higher price for oil.

The United Nations (1990) projects that all developing countries will experience a per capita GDP growth of two percent between 1990 and 2000, but that countries in Latin America and the Caribbean will grow at half this rate. This projected poor performance for Latin America and the Caribbean would be well below the historical levels of growth in per capita GDP of 2.4 percent in the 1970s and 2.7 percent in the 1960s. The IMF medium-term projections for developing countries in the Western Hemisphere are for a modest growth in real GDP and per capita real GDP in 1992, but for a significant increase in both in 1993 (Table 4). The large increase in 1993 is associated with continued liberalization of economic policy, a significantly lower rate of inflation and a dramatically improved fiscal balance (IMF [1992], Chapter 3).
III. FACTORS SHAPING THE WORLD OUTLOOK

Some major issues lie underneath these long views of the growth of the world economy, and of the share of that growth which will belong to the developing countries. The first is the extent to which the process of global economic integration will continue. The second is the adequacy of the supply of investment capital for developing countries. This potential constraint to development is partly beyond the control of low-income countries, i.e. it is more a consequence of the performance of the world economy. However, the way in which investment capital is distributed among nations is partly a result of how government policy in developing countries faces up to the problem of imbalances in financial resource flows, i.e. the resource claims of debt repayment and domestic government expenditures on one side of the fiscal equation, versus the supply of resources available from taxes and external assistance on the other. The third major issue is the worldwide effects of trade and income growth of the new trade alliances in Europe and North America, and of the new economic order in Eastern Europe and the former Soviet Union.

A. Global integration

For the developing countries, the cornerstones of economic policy are to: find markets for exports; to find sources of capital for industrial and infrastructure development; and, increasingly, to develop competitive production technologies. The late 1980s saw major steps in the direction of economic integration, as countries liberalized their trade regimes and adopted macroeconomic policies that were more conducive to foreign and domestic investment. The outlook for the world economy in the 1990s is much stronger if this trend continues. The IMF (1990) provides some support for this argument in a study of 41 developing countries for the 1983-1989 period. They find that potential GNP grew by 7.7 percent per year in those countries with an "outward" trade ori-
orientation and by 2.2 percent per year in those with an "inward" trade orientation. However, Roemer and Radelet (1991, pp. 64-65) review a contrary literature and conclude that the now-conventional prescription of outward-looking policies is based more on economic principles than on empirical evidence.

There is, in fact, global evidence that a sorting out process is leading nations to find their comparative advantages (World Bank [1992a]). Total world trade has increased. In the manufacturing sector, trade increased at an average rate of 4.9 percent while output increased at a rate of 3.9 percent. The share of technology-intensive manufacturing has increased in the industrialized countries, while the share of labour-intensive manufacturing exports in developing countries has risen. Within manufacturing, there are many country-specific examples of specialization as firms have sought out cheap labour and taken advantage of lower transportation costs and newer communications technologies.

On the other hand, this specialization may not have gone so far as the rhetoric. The difference between the growth in trade in manufacturing and the growth in output is narrower now than it was a decade ago. Even the penetration of industrial country markets by LDC manufactured goods is not so widespread. The World Bank (1992a, p. 31) reports that the developing country share of industrial country imports of labour-intensive manufactured goods almost doubled between 1965 and 1989, rising from 9.8 to 18.8 percent. However, this increase is due entirely to East Asia, whose share increased from 1.4 to 12.4 percent over this same period. This means that the share of all other developing nations' actually declined during this period. The volume of trade, however, has increased substantially.

The impetus for global integration comes from several factors. The cost of transportation and communications has fallen, reducing the "distance" constraint to increased trade. The gap between the rich and the poor nations in the growth of income and the relative inflation of currency values has enhanced the labour cost advantage of low-income countries. The price of primary commodities has been low for some time in world markets. Finally, changes in production processes and strategies, such as the increasing variety of product lines and product quality, require a closer working relationship between importers and exporters. This enhances economic integration and development of the trade sector in developing economies.

To growing (but not yet industrialized) countries, global integration means gaining jobs, government revenue and access to foreign exchange. But it also means gaining the technology necessary to sustain a higher rate of productivity and growth in the long run. Productivity increases will lead development in the more competitive and more technically complex world economy of the 1990s. The World Bank (1991a, p. 88) notes that "... growth in productivity, the best proxy for technological change, has accounted for as much as 30 percent of GDP growth in the East Asian countries". A major issue of development policy, therefore, will be technology transfer. Removing barriers to the sharing of technology should be high on the list of priorities for stimulating development.

Three key areas will define the progress of global economic integration in the next decade. Labour mobility, capital mobility, and trade are the principal ways in which modern techniques of production and communication are spread, and the means by which comparative advantages are discovered and become part of a country's economic strategy. Increased international labour mobility could lead to substantial gains for the world economy; and for most countries involved in either the import or export of labour. Emigration to labour-short economies may relieve labour surplus economies of the pressures of a high unemployment pool, and therefore may lead to an overall improvement in the distribution of income. The main drawbacks are the problems of "brain drain" in some of the low-income economies, and the resistance by host country workers to being crowded out by migrant workers. There also is the advantage that movements of skilled labour are an important way to diffuse technology, and foreign labour has in many cases been invaluable to labour-short economies.

Capital mobility, especially in the form of direct foreign investment, is another important source of technology transfer that can stimulate economic growth and trade between countries. Case studies of Hong Kong and Mexico have shown that the presence of foreign firms has increased the diffusion of technology and improved the efficiency of local firms (World Bank [1991a], p. 94). The experience of foreign firms in management and marketing techniques can benefit local firms who are trying to gain a foothold in world markets. Moreover, the volume of trade with a country may be substantially increased by direct foreign investment simply because of the trade channels that are opened with affiliates. A recent study reports that in the early 1980s intrafirm trade within the largest 350 transnational corporations (TNCs) contributed about 40 percent of global trade. One need only imagine the opportunities for transfer pricing, tax evasion and tax avoidance to speculate on how daunting is the task of administering a tax system that does not have an export orientation.

Trade liberalization is perhaps the most important question mark in assessing the outlook for the world economy in the 1990s. It is clear that developing countries must gain access to the markets for manufactured goods in industrialized countries. LDCs in aggregate sell less than five percent of their manufacturing output to other developing countries, and more than four fifths of the world market is in industrialized countries. On the other hand, developing and industrialized countries alike have erected restraints to trade. The trade barriers in industrialized countries have not been significantly relaxed in the 1980s, with a few exceptions. Most observers seem to agree that developing country exports to industrialized countries could increase, even in the presence of the trade restraints that are in place (World Bank [1992a]). A successful GATT round, however, could lead to substantial gains for low-income countries. One estimate is that a five-percentage point reduction in manufacturing tariffs by industrialized countries would lead to a real GNP gain of 1.6 percent per year in low-income debtor countries, and 1.4 percent per year for countries in the Western Hemisphere (IMF [1990], pp. 74-75). However, if the GATT negotiations fail, industrial-
ized countries could move toward a new series of bilateral arrangements and developing countries could see their potential markets shrink.

Global integration could slow in the 1990s. The GATT agreements are the major issue of uncertainty. The slower growth in the industrial economies in the early 1990s almost certainly means that, compared to the 1980s, export markets will not be as robust and the flow of investment capital to the rest of the world will not be so great. The decline in transportation costs seems to be approaching a bottoming-out, hence that stimulus will not be as strong (World Bank [1991a]). Finally, there is the issue of whether the LDCs will stay their policy course of the late 1980s and continue to adopt investor- and trade-friendly policies.

B: Development finance

The projections reviewed above assume that the substantial capital resource constraint facing the developing countries can be relaxed. The three candidate sources of capital are direct foreign investment, return of flight capital and foreign assistance.

During the last half of the 1980s the level of direct foreign investment increased from $47 to $132 billion, at a faster rate than total world investment. This suggests a growing world economic integration. However, the share of direct foreign investment going to the developing countries fell from 24 percent to 13 percent over this same period. Two thirds of this amount went to East Asia and Latin America, and in the latter case primarily to Brazil, Argentina, Mexico and Colombia (Finance and Development [1992]). If the developing economies are to capture a greater share of foreign direct investment, they will have to continue the economic liberalization policies which began in the late 1980s. The IDB sees this as possible and expects that the attractive rate of return on foreign investment in Latin America will result in an increase in the volume of foreign direct investment by a factor of about 2.5 before the end of the century (IDB [1991], pp. 18-19).

The second source of external financing is the return of flight capital. The IDB (1991, p. 19) estimates the total amount to be about $170 billion, equivalent to about one third of the region's total external debt. The World Bank (1991a, pp. 124-25) estimated that, during the 1980-84 period, the amount was as high as $40 billion for Mexico and $27 billion for Venezuela. The IDB points out the potential of this source of finance with the following conjecture: if investors decided to hold constant the real value of their assets abroad, and bring home only the annual return, there would be a re-entry of about $10 billion by the end of the century (IDB [1991], p. 19). This is equivalent to about half the expected flow of direct foreign investment.

The determinants of capital flight and the determinants of investment capital inflows are much the same. Capital flight occurs because domestic macroeconomic policies (or political instability) cause investors to lose confidence in the economy, and seek alternative locations for their investments. They seek out locations which give them some combination of safety on their principal and a higher after-tax rate of return. The ability of developing nations to attract investment capital will depend on whether they can sustain policies that will restore confidence in their economies (Goldstein, et al. [1991], pp. 1-44). Greene and Villanueva (1991) found evidence that the rate of total private investment in developing countries is positively related to the rate of real GDP growth, the level of per capita GDP and the rate of government investment. They also found that the investment rate is negatively related to real interest rates, and the levels of inflation and debt. Latin American countries have liberalized trade to a significant extent in recent years. Argentina, Bolivia, Brazil, Colombia, Costa Rica, Ecuador, Honduras, Mexico; Peru and Venezuela have eliminated quantitative restrictions and lowered tariff levels. In some cases the reforms have been broad-based and have included reduction of the fiscal deficit, a cap on borrowing and significant privatization of industry.

Finally, there are the traditional sources of direct external assistance in the form of loans. These are expected to be modest for the Latin American region, declining from $9 billion in 1993 to about $4 billion at the end of the century (IDB [1991], p. 19). The result will be a very modest increase in total debt outstanding over the next ten years. Much of the borrowing requirements for Latin America will be filled by the World Bank, the IMF and the IDB.

Will the sources of direct foreign investment and official loans be sufficient to meet the financing needs of developing countries in the next decade? There are two reasons to be cautious in the forecast of what might be expected. One is the slower growth in the industrial economies in the first half of the 1990s. And since the US deficit problem does not appear close to resolution, the level of savings may be less than has been assumed in these forecasts. The other is the competition for funds from (a) the newly emerging economies in Eastern Europe, and (b) the countries of the European Community (EC) as they adjust to their new economic roles.

C: New markets and new economic power

The performance of the world economy over the next ten years will be shaped by two other important factors: the performance of the transition economies and the policy directions taken by the new trading blocs.

1. The transition economies

Before the 1990s end, the transition economies (Eastern Europe and China) may substantially impact the share of world economic growth gained by the developing countries by (a) providing new export markets, (b) providing a new competitor for exports to the industrialized countries, and/or (c) siphoning off some of the external capital flows that otherwise might have found their way to the developing countries.

How quickly might the new competition for the world export market occur? The answer will vary from country to country. The breakup of the Soviet Union and its economic influence zone is still in progress. The economic liberalization process that is now underway in much of Eastern Europe and in the former Soviet Union Republics will be painful, and now it appears that the transition will not be short-lived. There like-
ly will be a net transfer of resources to these countries from the rest of the world through the mid-1990s. However, both the IMF (1992) and the United Nations (1990) project a stronger growth in Eastern Europe and the former USSR than in most of the rest of the world.

Some Eastern European countries, however, may be able to move more quickly to take advantage of proximity to the European market. Czechoslovakia, Hungary, and Poland, for example, have recently signed an agreement that provides for a free trade area with the EC. Quantitative restrictions have been removed in all three countries, and tariffs are being lowered.

China is a different story. The adjustment process has been neither so swift nor so painful, and real output increased by about seven percent last year. The state enterprises have been brought under semi-autonomous management, given some autonomy in operating decisions, and switched from a remittance to a tax regime. All of this has occurred in less than a decade. The speed with which the Chinese economy develops and shifts to an export orientation is another major question mark under these long-term forecasts. The United Nations projects the Chinese economy to grow at a real rate of 5.6 percent between 1990 and 2000. This is well above the world growth rate, but below that experienced in China in the 1980s.

The other concern about the competition from the transition economies is that they will attract foreign capital that otherwise may have been destined for less developed countries. The World Bank (1992a, pp. 7-8) argues that this is not true in the case of non-concessional loans, though creditworthiness will be scrutinized more closely in the case of all potential borrowers. In the case of concessional loans, however, this concern about competition will be valid unless donors increase their aid budgets.

2. The new trading blocs

The performance of the new trading blocs is another important factor that can affect the long-term economic outlook for developing countries. The two major changes to consider here are the EC and the North American Trade Agreement. One view is that the preferences given to countries within the blocs will reduce the size of markets for exports from less developed countries (or for that matter, from any country outside the trading blocs). It is possible that increased intraregional trade promoted by the agreement will be accomplished at the expense of what otherwise might have been increased international trade. One is the (unlikely) policy of a "trade fortress" stance by one of the blocs. Another is the possible diversion of scarce skills from multinational to regional trade negotiations.7

The other view is that the 1992 EC initiative will lead to specialization in production and efficiency gains that will result in an overall economic growth and therefore an increased demand for imports that will offset any negative effects. Most students of this debate seem to be in this latter camp, and argue the further advantages that:

- Progress on multilateral trade negotiations may be enhanced because the number of parties in the negotiations is fewer.
- Export entry is easier because the rules for trading with a single bloc of countries are easier to learn than are the rules and institutions for a number of individual countries.

IV. FISCAL CHOICES FOR THE 1990S

Most analysts of the Latin American economic crisis of the 1980s are in agreement that domestic policy changes must be enacted and sustained if economic growth is to be restored. The last decade saw an interventionist approach in many countries, whereby domestic industry was protected from foreign competition in some cases and stifled by public enterprises in others, exchange rates were overvalued, and governments were in deficit and borrowed heavily. The next decade must see more of a laissez-faire approach to economic management and an opening of the Latin economies to take advantage of a changing international economy. The immediate objectives of this policy are to increase the rate of economic growth by increasing export volume, attracting external investment capital, increasing the efficiency of domestic industry, and providing adequate public services in an environment of stable prices.

The principles that lie behind the formulation of such domestic policies may be summarized as follows:

- The best approach to attracting foreign investment and re-attracting flight capital is a stable macroeconomic performance. Low and steady rates of inflation, small deficits on the government and trade accounts, and a stable exchange rate will do more to attract and retain economic activity than will even the most attractive package of targeted incentives.

- The government should not take an interventionist approach except where the presence of important externalities demands it. Tax, trade and industrial policies should be coordinated and should interfere as little as possible with the market.

- The rate of investment in health and education should be increased.

- Borrowing should be limited by the growth in taxable capacity, the present level of debt burden and the intrinsic value of projects.

In fact, the 1980s did see a major turnaround in macroeconomic policy in the Latin American region. The elimination of quantitative restrictions and the reduction in tariff rates in many countries reduced barriers to trade, and the results will be felt fully in the 1990s. Countries have come to grips with the burden of their external debt by negotiation with creditors, limiting future borrowing and more carefully scrutinizing the purpose of loans. Lower interest rates in the early 1990s will provide further relief. Substantial progress has also been made in the area of privatization of public enterprises, e.g. in Argentina, Brazil, Mexico and Venezuela.

Arguably, the area where reform is most necessary, and in some countries has been slowest, is fiscal and tax policy. This is not to say that substantial fiscal reform has not taken place. Many Latin American governments have undertaken adjustments and have moved to eliminate or substantially reduce the size of their fiscal deficits. And in many cases, they have been successful. An IMF survey of 31 Latin American countries during the decade ending in 1991 shows that the fiscal deficit fell in 20 countries and increased in 11. The average decline in the deficit for the 20 countries (between 1986-1988 and 1989-1991) was 4.7 percent of GDP, and the average increase in the 11 countries was 1.8 percent of GDP (IMF [1992], pp. 23-25).

Even in countries where policy reform has taken place, the economic impacts have often been compromised by a weak tax administration (Bahl and Martinez [forthcoming]). The challenge facing many Latin American countries is to reform their fiscal systems, including tax policy and tax administration, in a manner consistent with this general macroeconomic policy direction, and consistent with the constraints provided by the world economy. This will make the fiscal choices more difficult.

There will be a slower growth in the industrialized economies in the early 1990s (compared to the average of the 1980s), hence very likely a slower growth in capital flows to developing countries and an export market that does not expand as fast. This means more competition among developing countries for external investment and for export markets; therefore more of a competitive edge is needed in the fiscal policies that must be designed.

The remainder of this paper outlines the most important of the fiscal choices:

1. Should there be growth in government expenditures, or declines in taxes and borrowing?
2. Will the taxation of income be driven by economic efficiency concerns or by vertical equity concerns?
3. Should tax systems be redesigned to stimulate investment, with lower (or no) taxes on capital income?
4. Should government become more centralized, or should fiscal decentralization be pushed?

A. Will the government sector grow?

A continuation of the adjustment policies of the past few years would not suggest a growing public sector in Latin American countries in the 1990s. The results of the IMF survey of 31 Latin American countries showed that the average level of government expenditures fell from 24.4 percent in 1981-1985 to 20.6 percent in 1989-1991. The decline was due to a combination of lower debt service expenditure and lower expenditures for subsidies, transfer payments and public employee wage bills (IMF [1992], pp. 72-76).

The outlook for Latin America is for a stronger economic performance than in recent years, but not for a robust growth that is above the long-term trend. The baseline projections are for a rate of real per capita GDP growth that will approximately match that which took place on average over the 1965-1989 period. This implies that, if the tax share of GDP remains constant, the government sector will be able to expand its real expenditures by about two percent per capita per year. This outlook, coupled with the possibility of a reduction in the revenue share of GDP, implies a modest growth in expenditure programmes, and therefore a tight control over expenditure practices. By the World Bank’s pessimistic projections, and assuming no increase in taxes or borrowing relative to GNP, real per capita expenditure growth could be as low as 1.3 percent per year. If this less optimistic growth path prevails, then the fiscal situation is even tighter.

One choice, therefore, is fiscal austerity. At the extreme, this would imply no increase in the tax share, i.e. that taxes will grow no faster than the rate of growth in GNP. It also implies no increase in borrowing, other than for long-lived projects with a demonstrable payback. Even here, however, any new debt incurred would have to be supported within the limits of revenue that the present tax system will generate in the future. The austerity scenario poses major problems for some countries, in particular those which already have high levels of taxes relative to GNP. It leaves precious little to invest in new infrastructure and in health and education, which are cornerstones in the strategy to increase the competitiveness of low- and middle-income nations. It also cramps government initiatives to redress inequalities in the distribution of income through the improvement of public services to the poor.

The other choice is to resume an expansionary fiscal programme, by increasing the effective average tax rate (relative to GDP) and/or by borrowing to expand infrastructure and to cover annual deficits. Certainly there are reasons to argue in favour of a larger public sector. There will be more investment in infrastructure and in human capital, and more scope for providing redistributive services. The costs of environmental protection, an issue which the world must discover in the 1990s, will claim a substantial amount of resources. The World Bank (1992b, Chapter 9) estimates the cost at two to three percent of the GDP of developing countries by the end of the 1990s. Though all of this will not be government sector costs, the amounts involved are equivalent to ten percent or more of the budgets of most developing countries.

There also are the political advantages of higher expenditures, which appear to outweigh the political disadvantages of deficits, at least over the expected tenure of elected leaders. The downside of this strategy is that resources will be drained from the private to the public sector, with whatever that implies for the overall rate of growth, in investment (versus consumption) in the economy. If the expansion is financed with higher taxes, then the competitive position of the country may be compromised, and the return to investors may be less attractive. There may be a feeling that the business climate is not right for new investment. If the expansion is financed by borrowing to cover annual deficits, then the economy will be less stable and less attractive to foreign capital and to the return of flight capital. Confidence in economic management will not be restored.

Are there compromises on these choices? Is it possible to spend more without raising taxes or sacrificing important public expenditure programmes? The answer is that the fiscal choices will be difficult if the world economy does not grow.
faster than projected, but there may be some amount of relief that will allow important expenditure programmes to be better covered. Expenditures may be reallocated to infrastructure and human capital investment (1) if interest rates fall and the debt service claims on the budget are less; (2) if privatization reduces the claim on government resources; and (3) if the financing of some government-provided services is shifted to beneficiaries. There is some evidence that new resources will materialize because of initiatives in these three areas, but the amounts may turn out to be modest. The IMF (1992) projects that debt service payments as a percent of the total value of exports of goods and services will fall in Western Hemisphere countries from 31.5 percent in 1991 to 28 percent in 1997.

There is also the question of whether any new-found resources actually will be allocated to essential purposes. The 1990s will be a time in many countries when there will be pressures to subsidize prices in the aftermath of privatization, increase public employee compensation and restore lost tax preferences. However, the IMF survey of 31 Latin American countries (IMF [1992]; pp. 72-76) indicates that the education and health expenditure share of GDP increased in the 20 countries where the deficit was reduced and fell in the 11 where it was not. The results of this analysis also showed that the share of capital expenditures in GDP did not fall significantly in the deficit-reducing countries.

Adjustments made on the tax side also can lessen the pain associated with hard fiscal choices. Reductions in the average tax rate for all present taxpayers can be realized if a more efficient tax administration broadens the tax net and captures those who have successfully evaded or avoided payment. There are many opportunities to do this, because typically the tax base in low-income countries is quite narrow. Perhaps the best targets of opportunity in this area are the self-employed under the individual income tax, value-added tax exemptions, import tax exemptions or preferential rates, and real property.

The pain of this fiscal choice will vary from country to country, depending on the situation from which they start. Jamaica, with a tax-GDP ratio now approaching 30 percent, has a quite different situation from that of Guatemala, with a ratio of under ten percent: The difference between the situations in these two countries is illustrative. To compete effectively in the 1990s, Jamaica will have to find a way to slow the growth in the public sector. It cannot afford a fiscal deficit with the present instability in its economy; and tax increases would seem out of the question given the present high rate of taxation in the economy. The hard choice facing Jamaica is how to cut expenditures when expenditure needs are so great. Guatemala’s situation is better. There is ample room for a tax increase to cover the expenditure needs of its population, and the fiscal deficit is not a great one.

The most difficult choice in Guatemala is whether to risk an increase in taxes in a country with a long tradition of resistance to higher taxation.

B. How will personal income be taxed?

Most developing countries are beset with policy and administrative problems in their individual income-tax systems. The revenue yield is often not up to the mark because of loopholes that have narrowed the tax base and because of poor administration and widespread evasion, especially among the self-employed. A common reaction is for the government to raise the rate, which leads to more avoidance, evasion and undesirable allocation effects, and the cycle continues. This pattern neither builds confidence in the government’s ability to lead macroeconomic policy, nor does it contribute to a sound revenue base to support a balanced budget. Individual income tax structures in low-income countries, and in Latin America, are often complicated and usually have multiple objectives. The main goal is revenue generation, but many government officials and political leaders would argue that income redistribution is another important objective. Accordingly, in many countries, income taxes are characterized by progressive rate structures, relatively high floors and special deductions to protect the poor. Some countries use the income tax to achieve other allocative goals — everything from the stimulation of the life insurance industry to the encouragement of savings to relieve the cost of commuting to work.

The individual income tax can play a very important role in low-income countries, and it does in many countries. It can be a major revenue raiser, it can siphon off the administrative resources of the tax department, it can impose high compliance costs on payers, it can add progressivity to the overall revenue system and it can have a direct effect on the ability to save, invest, take risks and work harder. Another important feature of income taxes is that the nominal tax structure is very visible to voters while the actual pattern of effective tax rates is not. As a result, political leaders are quite sensitive about making even rational changes in the nominal tax structure; because it might give the appearance of providing a special tax treatment to the higher income.

One choice for individual income taxation is simplification, a path that many countries in the region have already taken. This may involve adopting a flat rate, eliminating most deductions and credits, and broadening the tax base to include all forms of income. The advantage of this approach is that it eliminates the horizontal inequities in the system by taxing all income at the same rate, and it gives no special preferences. Because it is simple, it reduces both compliance and administrative costs. Because it is applied to a broad base, the (nominal) flat tax rate is low by comparison with the previous marginal tax rate; therefore savings, investment, risk taking and work effort are encouraged. A more difficult issue is what to do about capital income taxation. Here the issue becomes whether countries should opt for a consumption tax.

There are some disadvantages to a broad-based, flat-rate tax regime. The most important is that it is not consistent with the ability-to-pay cannon of justice in taxation. Since the sacrifice of a dollar in taxes is greater for a low-income than for a high-income person, it is thought fair to tax the lower-income person at a lower rate. Since a flat tax does not do this, it imposes a greater burden on the poorer family. The result is that flat taxes are usually perceived as inequitable, and in fact may be regressive in their distribution of tax burdens. Other disadvantages may arise in connection with the base-broadening that accompanies the flat tax regime. Because some
loopholes are almost certain to remain in the system; the fairness objective will be compromised. Another problem is that broadening the tax base often means bringing interest income into the tax net, and possibly discouraging savings or encouraging capital flight.

The other choice is to hold to the more narrowly based, progressive rate structure. It is nominally progressive and seems to provide incentives for savings and investment by providing preferential treatment for capital income; many countries exempt capital gains and interest income, and give credits or deductions for certain types of investments. Progressive rate structures are popular with politicians because they at least give the illusion that the rich are being treated differently under the tax system. The biggest disadvantage is that the narrow base forces a high marginal tax rate, which in turn discourages investment and work effort, or encourages evasion and avoidance. The progressivity of the graduated rates is often lost to the special treatment of capital income; the provision of loopholes to mitigate against the high marginal tax rates and contribute to the success of higher-income individuals in evading the tax. Bird (1992, p. 93) notes that even if one is not willing to go so far as the flat-rate tax; steeply progressive rates have no place in a well-designed income tax in developing countries.

The trend around the world (and in some Latin American and Caribbean countries) has been in the direction of simplification, base-broadening and less rate graduation. For example, Jamaica adopted a broad-based, flat rate (33 1/3 percent) individual income tax in 1986 (see Alm, Bahl and Murray [1991]), and Argentina has recently proposed a 30 percent flat-rate individual income tax, with the exemption of dividends paid to local and foreign shareholders (Asorey [1992]).

C. Should the tax system be structured to encourage investment?

The superficial answer to this question is "yes", and the possible shortage of capital flow to developing countries and the power of the new trading blocs makes it even more important that tax systems be export- and investor-friendly. On the face of it there seems to be no choice involved, but there are endless suggestions about how one restructures a tax system to encourage investments. And there are major tradeoffs involved, in that an investment-friendly tax system may also be one that is less friendly to income distribution or to fairness objectives. Hence the choice.

One alternative is to follow an interventionist policy and use tax policy to attract investment. Low- and middle-income countries could adjust their tax systems to increase the after-tax rate of return to investors in many ways:

- Reduce marginal individual income tax rates.
- Provide special income tax treatment of fringe benefits received by higher-income individuals.
- Exempt dividends from the individual income tax.
- Exempt interest income from taxation, but allow it as a deductible cost.
- Enact a value added tax (VAT), or increase reliance on the VAT, and zero-rate all exports.
- Allow repatriation of profits without penalty.
- Reduce corporate income tax rates, accelerate depreciation allowances and provide a proper inflation adjustment.
- Provide tax incentives for "preferred" investors.

Many of these are adjustments that should be made in the tax system no matter what strategy is being followed (e.g. elimination of the double taxation of dividends, repatriation without penalty, zero-rating of exports). But particularly the issues of whether special tax incentives for investors should be allowed; whether higher-income individuals should receive a friendlier treatment and whether interest income should be free of tax, raise serious questions. Proponents argue that lower income tax rates on higher-income individuals leave them free to save more and give them an incentive to invest more. These individuals have the highest marginal propensity to save and are the entrepreneurs of the economy: the ones most likely to take investment risks. Many countries have bought into this argument and provide escapes from high individual income tax rates, which higher-income individuals are best equipped to use. These include tax-free interest income, non-taxable fringe benefits and the effective exclusion of capital gains from the tax base. Company tax preferences might include tax holidays and accelerated depreciation for incentive firms. (Typically, the VAT is not used as a major part of the incentive package.) Such incentives are thought to attract particular industries and to show signs of a hospitable business climate for foreign and domestic investors. The pressure to adopt incentives grows with the use of such programmes by neighbouring countries.

The disadvantages of the interventionist approach are that each of these preferences imposes a cost that must be made up with a higher tax rate somewhere else in the system. These higher nominal rates, and the distortions of economic choices introduced by the preferences themselves, introduce an inefficiency into the economy and have a real cost likely measured in terms of slower growth. There are few places in the tax system where the lost revenue can be regained. Among the possibilities are a higher income tax rate for lower-income workers, a lower standard deduction under the income tax, higher income tax rates for those companies that are not on the preferential treatment list, higher "sin" taxes on alcoholic beverages and cigarettes and fewer exemptions under the VAT. The result is likely to be that the overall tax system will be less progressive, or even regressive, and this will be a cost of adopting the interventionist approach.

The other choice is to go for a tax system that is neutral with respect to economic choices. The basic argument here is that there is no strong evidence that targeted incentives work, and so why introduce distortions into the tax system? This strategy would involve broadening the tax base and lowering the rate for all taxpayers. Such a system would tax all income at the same rate; zero-rate exports, not penalize repatriated profits; equalize the individual and company tax rates and find a way to approximate true economic depreciation. It might adopt a flat-rate income tax, but it would not provide preferential treatment either to high-income individuals or to businesses. The advantage is that the market and not the govern-
ment would be allocating the resources (and governments do have a bad record of picking winners), and the tax system would be more fair.

The disadvantage is that the government, by not matching the incentives provided in the neighbouring country, may give the impression that the business climate is not hospitable to new domestic and foreign investors. Moreover, there is the question of: what to do about the existing incentive programme? It may be politically entrenched and its removal could have a high transaction cost. Moreover, the market may long ago have capitalized the effects of this preferential treatment. Blejer and Cheasty (1990, pp. 68-81) mention yet another disadvantage: The adoption of trade liberalization programs may lead to substantial short-run fiscal costs; in the form of reduced tax revenue and pressures to provide subsidies to those individuals and companies hurt by the reform.

D. Will government be centralized or decentralized?

There has been a worldwide reaction against the over-centralization of government. This has held for low- and high-income countries alike. Especially in large countries, there has been an erosion of confidence in the ability of the central government to decide on what is the best package of services for each local area, and to deliver that package of services. On the tax side, there is a reaction against what are perceived to be high taxes that are not returned in the form of services with identifiable local benefits. Fiscal decentralization, and whether to pursue it, are new questions being debated in countries such as China and Russia, and old questions of concern in countries such as Colombia and Argentina.

Why is this a hard fiscal choice? On the face of it, it seems a reasonable proposition that as economic development and urbanization proceed, the local level should be more involved in the tax and expenditure decision-making process. But if the next decade places a high premium on macroeconomic policy to make developing economies more stable and more attractive to foreign investors, then central governments need even more control over the major fiscal instruments.

Consider first the implications of fiscal decentralization, i.e., giving more taxing powers and expenditure responsibilities to the lower levels of government. The advantage is that government is brought closer to the people, in that they may now have more say in choosing the mix of services they receive and the level of taxes they will pay. It is also possible that overall revenue mobilization may be improved, because some taxes are inherently better administered at the local level (e.g., property taxes), and because there is a substantial untapped fiscal capacity that lies below the cutoff point for central government income and value-added taxes. The instruments of fiscal decentralization are local tax powers, the assignment of local expenditure responsibility and the design of a grant system that guarantees local governments a claim on central resources. Such assignments reduce the flexibility of the central government to pursue a stabilization programme, to equalize services within the country and to implement its development spending priorities.

The other direction is continued fiscal centralization. If the central government controls the major instruments of taxation, expenditure and debt, it is more able to pursue the programme of macroeconomic policy that is seen as so vital for the development of Latin America in the next decade. Moreover, if budgets are to be austere, all the more reason to allow the centre to decide on the purpose and location of infrastructure investments, and all the more reason to give the centre discretion to pursue whatever equalization is affordable. If education and health expenditures are key investment areas for growth in the next decade, then central direction (if not central control) over these expenditures would seem critical.

The problem is that especially large countries, where populations have diverse needs and preferences, are not easily governable from the centre. Central government bureaucracies break down, people (and investors) become disaffected and local-level development opportunities become lost.

There are relatively few ways out of this difficult choice. In many countries the local governments have been given only minor expenditure responsibilities, and no control over a broad-based tax. There has been no major attempt to invest in their capacity to provide good government, and they have no certain claim on central revenues. To continue this policy by making minor adjustments will not be a true move toward fiscal decentralization. In other countries (Brazil is a good example), subnational governments do have a definable claim on total government revenues, and such a claim cannot be easily backed away from in the name of a need for greater central control.

V. CONCLUSIONS

The outlook for the world economy is for a resumption in real economic growth after the dismal performance of the past two years. Growth will be slow until the mid-1990s, but thereafter is projected to be stronger. The structure of this growth, according to the average of the forecasts examined here, is for a lower rate of inflation and a lower real rate of interest.

Overall, however, the 1990s will not bring a real growth for most developing and industrialized countries that is any greater than that realized in the 1980s, and most projections expect it to be slightly lower. The implications of this outlook are that export markets in industrialized countries will not grow as fast as had been hoped, and that capital inflows to developing countries may be of lesser magnitude than had been hoped. Should a more pessimistic set of assumptions be adopted (increases in oil prices, failure of the GATT negotiations, and a failure to bring the US budget deficit under control), then the outlook would appear even less favourable for low-income countries.

Most analysts advise lower-income countries to adopt a strategy of stabilizing their economies and restoring the confidence of investors. This is said to be best accomplished by trade, price and exchange rate liberalization; control of inflation by a stable money supply; exchange rate adjustments; privatization of industry where appropriate; and fiscal bal-

8. The subject of fiscal decentralization is reviewed in Bahi and Linn (1992, Chapters 12 and 13.)
It is the last area where many developing countries have made the least progress. This is partly because some combination of economic liberalization, a slow-growth world economy and the fiscal sins of the past has put countries in the position of making some very hard fiscal choices. Among these are:

- Should government expenditure growth be capped in order to control the deficit, or should taxes be increased?
- Should the entire tax system be adjusted to become more investor-friendly, even at the cost of making it less progressive? Should this be done by providing special preferences to targeted taxpayers?
- Should taxing and expenditure powers be decentralized to lower-level governments, or should centralization be continued?

Finally, there is a more rosy outlook – the possibility that the 1990s will see a turning point that the modellers have not picked up. Countries have learned the lessons of specialization and gains from trade in the 1980s; Asian and Latin countries have made remarkable policy adjustments; and even the industrialized United States is taking a more outward view. Central economic planning is on the decline in most places, and these are:

- Should taxing and expenditure powers be decentralized to lower-level governments, or should centralization be continued?

REFERENCES


