

ANATOMY OF PUBLIC SECTOR DEFICITS IN LATIN AMERICA:  
The Case of Colombia

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(Summary)

This document analyzes public sector deficits in Latin America, with particular attention to the case of Colombia. These deficits usually arise from political rigidities in the tax structure, which impede to properly tax personal income & wealth or to impose a universal VAT. During the 1990s, these tax rigidities were aggravated by structural reforms that increased expenditures on permanent basis, mainly, as a result of disorganized fiscal decentralization processes dealing with education & health expenditures. Although several Latin American countries succeeded in reducing actuarial pension deficits, by decreasing expected-benefits, serious “cash problems” arose as a result of the pension-transition from PAYG-systems to fully-funded-systems.

Classification JEL: Public Debt (H63); Latin America (N26).

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## **I. Introduction**

Fiscal deficits in Latin America during the 1990s were driven mainly by tax rigidities, accelerated fiscal decentralization processes, and “cash-problems” arising from pension transitions from PAYG-systems to fully-funded systems (privately-run). These were clearly the cases of Argentina, Brazil, and Colombia. Up-to a point, such tax rigidities are still present in Mexico and they represent a big fiscal challenge for the next decade. Chile, by contrast, has harbored well the transitional “cash-problem” by adopting structural changes that have assured wide VAT and income-tax bases, while reducing non-productive public expenditures.

In the case of Argentina, it has been extensively documented how political and fiscal struggles between the provinces (local governments) and the central government led to mounting fiscal inflexibilities (Torre and De Riz, 2002 p.223-316; Webb, 2003 p.192-4). The decentralization process generated two related problems. On the one hand, tax sharing with the provinces came to involve close to 30% of central government revenues by 2000-2001. The link between tax revenues and transfers to the provinces have impaired increasing public savings for the long-run, although tax revenues picked-up temporarily during the international boom of grain-prices (1995-1999), see IMF (2003a p.18) and Cuevas (2003 p.17-19).

On the other hand, such transfers generated the so-called “fly-paper-effect” by which education & health expenditures increased on permanent basis (Becker, 1996). Although hard to prove at the aggregate level, most analysts conclude that the system of tax “earmarking” has induced also laziness regarding local-taxation efforts. An alternative is to design a system that levies a VAT at both the local and the national level (Bird, 1999 p.17).

When exchange rate and fiscal difficulties erupted (2000-2001), the Government of Argentina forced additional funding through the private-pension funds in order to raise cash to pay-for the

pension transition. Furthermore, the Central Bank was forced by the government to reduce “reserve requirements”, in order to ease monetary policy at a time when international reserves were being depleted. All these made evident the unsustainability of the “currency-board” arrangement which had fixed artificially the exchange at-par with the dollar since 1991 (IMF, 2003a).

In short, the revenue sharing system inflexibility, the difficulties in raising additional tax revenues to honor pension payments (while having a “currency-board”), finally lead to floating the Argentinean Peso in late 2001 and triggered the greatest open-public-debt default of the XXth Century. One of the main lessons from this painful episode is that tax-sharing rigidities and overly rigid exchange-rate regimes are a recipe for macroeconomic disasters (Rogoff, 2004 p.65).

Regarding Brazil, the decentralization process was also very complex, especially over the mid-1980s through the mid-1990s (Rodden, 2003 p.216-21). In this case state-banks played a very disruptive role by way of printing their own money in order to complement central government transfers and to fund their local-pension payments. The result was several episodes of hyperinflation and changing systems of foreign exchange arrangements. Finally, a system of flotation was adopted for the Real beginning in January 1999 and successful political arrangements lead the Cardoso Administration to forbid state-banks printing money. All these help in returning money and foreign exchange policies back to a *de-facto* independent Central Bank (Fraga, et.al. 2003).

During 2002-2004, Brazil has managed to increase tax revenues to levels of 26% of GDP, although generating a complex and anti-technical tax structure, which impairs financial deepening (Giambiagi and Ronci, 2004 p.27). All in all, Brazil has avoided public-debt collapse over this period and, by delivering primary surpluses above 4% of GDP, the public gross debt/GDP ratio has been declining to nearly 86%. Furthermore, Brazil announced in late-2004 that recurring programs with the IMF will not be renovated, adopting in tandem a tighter fiscal policy, which aims at delivering primary surpluses close to 5% of GDP.

As for Mexico, the post-1995 period has been of economic recovery and the recent oil-price boom has helped in reducing gross public debt just below 50% of GDP. The decentralization process has been less traumatic than in other Latin American countries, although the coffee crisis prompted rural guerrilla insurgence in some poor areas. As a result of the NAFTA agreement, the financial sector avoided systemic risks by providing the “maquilla-industry” funding from abroad (IMF,2003b). However, social-expenditure needs represent great fiscal challenges ahead. In particular, analysts pinpoint the fact that central government tax revenues are rather low, hovering around 12% of GDP. The Fox Administration has (so far) failed in pushing through Congress the approval of an extension of the VAT-tax-base, while relying temporarily on the will-fall gains provided by the oil-boom (representing almost 1,5% of GDP).

Summarizing, we see that there are at least three common factors leading to structural fiscal deficits in many Latin American countries, including Argentina, Brazil, Mexico, and Colombia:

- On the revenue side, there exists a political problem in convincing Congress-people to raise revenues by increasing the VAT-rates or expanding the tax-base. Curiously enough, many of the large Latin American countries have succeeded in increasing income tax, although their revenues continue to be low (6% of GDP) when compared to European standards (14% of GDP), see Tanzi and Zee (2000 p.13). Personal income rates are perceived as relatively high, so Congress-people are prone to approving tax-brakes for specific pressure-groups, leading to loop-holes that increase tax-evasion. Certainly, tax-bases are subject to great improvement if exemptions are reduced.
- On the expenditure side, the characteristic of the past decade was the deepening of the fiscal decentralization process that had began in the early 1980s. However, this was done by means of increasing the central government revenue sharing with the local governments, which generate mounting inflexibilities for the expenditure side of the public balance. This problem has been especially acute in Argentina and Colombia, where revenue sharing

represented close to 30-40% of central government tax-revenues.

- Finally, these fiscal difficulties have been aggravated by “cash-requirements” from the central government as a result of the pension-transition from the PAYG into a fully-funded system. The overall result has been structural budget deficits close to 5% of GDP at the level of the central government and close to 3% for the Consolidated Public Sector, in the cases of Argentina, Brazil, and Colombia.

The purpose of this document is to analyze the anatomy of these structural imbalances, with particular attention to the case of Colombia. In section II we will present an overview of such recent imbalances in Argentina, Brazil, Colombia, and Mexico and some lessons are drawn by way of comparing such outcome with the interesting case of Chile. Section III focuses on the tax and expenditure structure of Colombia and Chile. Finally, section IV provides some concluding remarks.

## **II. An Overview of the Fiscal Structure in Large Latin American Countries**

### **A. The Revenue Structure**

Table 1 presents a summary of the Non-Financial Public Sector (NFPS) income and expenditure structure in large Latin American countries by end-of 2003. Total public revenues vary among the main Latin American economies according to the size and efficiency of the public enterprises, which determine the non-tax revenues. These non-tax revenues were small in the case of Argentina (2,8% of GDP), moderate in the case of Colombia (9,2%), but rather big in the cases of Brazil (13,8%), Chile (12,4%), and Mexico (11,6%). These differences are explained by the relative importance of public oil and mining companies within those economies.

Another source of variation comes from the tax-structure; but interesting enough, the levels of taxation fluctuate around 20% of GDP (excluding social security contributions). There are however

two notorious exceptions: Mexico, standing at a surprisingly low level of 12% of GDP, and Brazil, above the average at 25,6% of GDP. In spite of the “tax-war” between subnational levels and the national level (Bird, 1999), large Latin American countries converge to this figure of 20% of GDP, where VAT has been imposed over local excise-taxes or taxes on provincial gross receipts, while property and automobile taxes remain the principal sources of local taxation.

**Table 1: Fiscal Structure in Latin America: Selected Countries**  
( NFPS, % of GDP at end-of 2003 )

	<b>Argentina *</b>	<b>Brazil **</b>	<b>Chile</b>	<b>Colombia</b>	<b>Mexico</b>
<b>I. Total Revenue</b>	<b>25,9</b>	<b>44,7</b>	<b>34,5</b>	<b>31,2</b>	<b>25,4</b>
Tax	20,0	25,6	20,6	19,7	11,8
S.Security Contrib.	3,1	5,3	1,5	2,3	2,0
Non-Tax	2,8	13,8	12,4	9,2	11,6
<b>II. Total Expenditure</b>	<b>31,9</b>	<b>49,9</b>	<b>34,4</b>	<b>34,4</b>	<b>28,7</b>
Operational	10,3	26,6	22,0	10,7	14,5
Transfers	9,2	10,9	7,1	10,3	6,0
Social Security	5,2	7,1	5,4	7,0	na
Other	4,0	3,8	1,7	3,3	na
Interest	10,9	9,6	1,2	4,9	2,7
Investment	1,5	2,8	4,1	8,5	5,5
<b>Deficit (-), I - II</b>	<b>-6,0</b>	<b>-5,2</b>	<b>0,1</b>	<b>-3,2</b>	<b>-3,3</b>
<b>Primary Balance</b>	<b>4,9</b>	<b>4,4</b>	<b>1,3</b>	<b>1,7</b>	<b>-0,6</b>
Memo: Territorial Transf.	6,1	2,6	0,2	5,3	3,3

\* Includes unserved interest-payments&forced refinancing.

\*\* Consolidated Public Sector

Source: Our computations based on IMF-Data

The level of social security contributions is also quite different: Brazil stands high at 5,3% of GDP, followed by Argentina at 2,8% of GDP, while Chile, Colombia, and Mexico are close to 2% of GDP. The basic explanation has to do with the phase of the transition from public pension systems into private ones, but also with differences in social security coverage, which are rather low in Colombia and Mexico.

In summary, we see that large Latin American economies have different levels of total revenue, in spite of some convergence of tax-revenues to the mark of 20% of GDP (with the exception of Mexico). Such convergence of the tax-revenue ratio is somehow surprising when considering the different tax structures of national/sub-national arrangements and the different tax-pressures stemming from direct vs. indirect taxation (as we shall illustrate it later for the cases of Colombia and Chile). These variations in the ratio of total revenues/GDP have to do more with different levels of non-tax revenues stemming from oil and mining public companies. The ratio of total revenues/GDP is very high in Brazil (45%), moderate in the cases of Chile (34%) and Colombia (31%), and rather low in Argentina and Mexico (close to 25%).

#### B. The Expenditure Structure

The size of the public sector measured by total expenditures/GDP of the NFPS is also high in the case of Brazil (50%), moderate in the cases of Chile, Colombia and Argentina (32-34%), and low in Mexico (29%), as shown in table 1. The operational expenditures are driven by the incidence of large public companies, standing high in Brazil and Chile (22-27% of GDP), while they remain at moderate levels in Mexico, Colombia, and Argentina (10-14% of GDP). Transfers are determined mainly by social security expenditures, which are particularly high in the cases of Brazil and Colombia (7% of GDP) due to the pension transition, which requires additional “cash-payments” on behalf of the central government, as “contingent liabilities” become effective obligations (Clavijo, 2004). Chile began that transitional period in the early 1980s and by producing fiscal surpluses assured the required pension “cash-payments” over the 1990s (Diamond and Valdez-Prieto, 1994).

Note that in this consolidated structure the problem of high revenue-sharing does not appear explicitly. Put simply, territorial expenditures are disseminated in the different items (wages, social expenditure, investment). In order to pinpoint this revenue-sharing problem, we added in the memo-line (see Table 1) the ratio of territorial transfers made by the central government/GDP. Such transfers are high in the cases of Argentina and Colombia (5-6% of GDP) and come to represent

between 40-50% of central government taxes. Furthermore, these transfers are rather inflexible as their structure and percentages are often mandated either by Constitution or Laws requiring qualified majorities. In the cases of Brazil and Mexico such territorial transfers are lower (3% of GDP) and clearly do not represent a mayor obstacle in raising primary surpluses for the central government. Chile has avoided altogether the difficulties of fiscal decentralization, having in favor a large concentration of population in the capital of Santiago and vicinities (Clavijo, 1995).

Heavily indebted economies devote large portion of their expenditures to interest payments. This has been the case of Argentina (11% of GDP, including unserved debt and forced refinancing), Brazil (9,6% of GDP), and Colombia (4,9% of GDP) during 2003. By contrast, low indebted economies pay low portions in interest, like Chile (1,2% of GDP) and Mexico (2,7% of GDP).

Finally, structural increases of public expenditures are usually associated with compression of public investment, as a result of territorial transfers and social security expenditures being associated with more consumption (i.e. increases in wages for teachers and health-workers and pension payments). This seems to be the case of Argentina where total public investment collapsed to 1,5% of GDP in 2003 and, to a lesser extend, the case of Brazil (2,8% of GDP, in spite of having a large public corporate sector).

However, in the case of Colombia public investment has actually increased from 6,4% of GDP in the early 1990s up to 8,5% of GDP (representing about a quarter of total public expenditure). Fiscal decentralization has entailed a significant change in public works. The central government portion (traditionally associated with large infrastructures) has declined in favor of the territorial public investment (now focused on sanitation, educational infrastructure, and local roads). Mexico is another example in which public investment has been maintained at relatively high levels (5,5% of GDP, which represents about a fifth of total public expenditure). In Chile, public investment as been declining due to a successful program of privatizations (Hachette and Luders, 1993) and currently amounts to only 4,1% of GDP, which represents 12% of public expenditure.



### C. Primary Balance and Fiscal Deficits

It is useful to compute the primary surplus (= deficit before paying interest) in order to judge the current fiscal effort in avoiding new public debt. Table 1 illustrates that Argentina and Brazil have been delivering large primary surpluses (above 4% of GDP) in order to reduce their high outstanding public debts. Likewise, Colombia (1,7% of primary surplus) is also making such efforts, while Chile actually runs slight fiscal surpluses (after interest payments), even with very low public debt. The worries about Mexico's fiscal prospects have to do not only with its low tax/GDP ratio (as commented before), but with running recent primary deficits (close to 1% of GDP in 2003).

Since late 1990s most Latin American economies have been running large fiscal deficits. As a result, the ratios of gross public debt/GDP have been increasing to dangerous levels: 146% in Argentina, 86% in Brazil, and 60% in Colombia by end-of 2003. In that year, the NFPS deficit amounted to 6% of GDP in Argentina, 5,2% of GDP in Brazil, and 3,2% of GDP in Colombia. Mexico also registered a relatively large fiscal deficit of 3,3% of GDP in 2003.

As mentioned before, these large deficits seem to be of a structural nature since they are rooted in imbalances between a hard-to-increase tax-base and inflexible expenditures associated with transfers resulting from fiscal decentralization processes and pension transitions. The exception in the region is Chile, where has been instituted a law mandating a cyclically adjusted fiscal surplus of 1% of GDP (Marcel, et.al. 2001 p.8-10). In fact, Chile presented a fiscal surplus of 0,1% of GDP and a primary surplus of 1,3% of GDP in 2003.

### D. On Balancing the Deficit

Some international experiences in dealing with structural deficits are summarized in Table 2, based on the Alesina and Perotti (2001) study for OECD-economies during the period 1960-

1994. These experiences indicate that fiscal programs focusing on reducing expenditures are more likely to succeed in controlling structural deficits than programs that emphasize revenue increases. For example, in 71% of the successful programs the adjustments focused on expenditure controls, especially on the operative and bureaucratic components. Only in 29% of the successful experiences the adjustment concentrated in increasing tax-revenues.

**Table 2: Quality of Fiscal Adjustments in OECD-countries: 1960-1994**  
(Percentage of the Cases Studied)

	Public Expenditure Reduction			Tax-Revenue Increases		
	Operationa l	Investment	Total	Corporat e	Households	Total
Successful	51	20	71	18	11	29
Failures	16	28	44	29	27	56

Source: Our Computations based on Alesina and Perotti (1997).

Regarding program that failed, about 56% of the cases attempted to increase tax-revenues and, in fact, their starting-point implied already high-revenue burdens. This situation was particularly hard to overcome for highly-taxed firms, most of which reacted by reducing their investment component and, finally, all these hurt growth and tax-collection prospects. These lessons are particularly relevant for the economies of Brazil and Colombia, where total tax-levels are already in the 20-25% of GDP-threshold. Fiscal programs are more likely to succeed at this stage if they focus on reducing public expenditures at the operational level (including the component of territorial transfers, especially in the cases of Argentina and Colombia).

In the following section we will use Chile's fiscal structure as a benchmark to analyze the current fiscal situation of Colombia. We will also provide a set of fiscal reforms which could lead to reduce the ratio of gross public-debt/GDP to reasonable levels.

### III. The Fiscal Structure of Colombia and Required Reforms

The fiscal evolution of Colombia over the 1980s-1990s can be summarized as follows:

1. *A rapid and disorganized fiscal decentralization*, leading to revenue sharing that compromised close to 50% of the central government's resources. There is some evidence that this revenue sharing arrangement induced scant fiscal efforts on behalf of the territorial entities and a "fly-paper" effect on educational and health expenditures. The only exception has been the Capital of Bogotá, where gasoline, housing, and automobile taxes have been increasing significantly, allowing the city to collect enough resources to modernize massive transportation, better organized education & health services, and to combat absolute poverty.  
After the 1996-1999 territorial fiscal crises, Law 617 was instituted in 2000 to reduce operational expenditures at the local level and to restrict territorial indebtedness. A set of interesting mechanisms were deployed that allowed voluntary debt work-outs between the local authorities and the local commercial banks, replicating a successful Chapter-11-type of arrangement. In order to better allocate education and health resources at the local level, a Constitutional reform was approved which led to Law 715 of 2001 in which a "capitation" scheme of territorial transfers was adopted. This demand driven mechanism should improve the efficiency of local expenditure with respect to previous practices (Law 60 of 1993). See Wiesner (2003 p.41-53).
2. *A system of national "bail-outs"* regarding energy crisis (especially during 1992-1997) and more recently related to pension transitions, as explained before. This has been particularly stressful as PAYG reserves have been totally depleted during 2000-2004 and yet the potential pensioners only comprise about 20% of the working population (Clavijo, 2004). The outcome has been a very regressive social expenditure structure, high pay-roll taxes on behalf of the firms, all of which induces increasing labor informality (currently running at 33% of the employed labor force).

3. *Increasing military expenditure*, to combat narcotrafficking which currently involves both right-paramilitary and left-guerrilla movements. Total military and police expenditure currently comprises 5% of GDP (including support from the so-called Plan Colombia). These resources have actually double with respect to GDP-share in the last decade and it is very hard to forecast the drug-war outcome in the short-run, unless the international community comes to address this issue at a global arena.

As a result of these mounting public expenditures pressures, central government gross public debt increased in Colombia from 30% to 53% of GDP during the 1990s. As mentioned before, the total public debt/GDP ratio of Colombia currently stands at 60% of GDP.

#### A. The Revenue Structure

Table 3 illustrates the evolution of Colombia's NFPS revenue and expenditure sides between 1990 and 2003. We here follow the standard accounting procedures of the IMF (see IMF, 2003c, 2004; Confis, 2004). The first result to highlight is that tax revenues have increased in the significant amount of 5,4 percentage points of GDP between 1990 and 2003, where total tax revenues currently amount to 17,4% of GDP. Central government's tax pressure is 14,1% of GDP, State's 1,4% of GDP, and municipalities' 1,9% of GDP. Furthermore, when including social security contributions, one finds that total "fiscal pressure" reached 19,7% of GDP during 2003 (representing a net increase of 5,9% of GDP with respect to 1990, as shown in the memo-line of Table 3).

These results also show some tax-laziness at the territorial level, since States' tax-revenues have only increased by 0,3% of GDP and municipality's by 0,4% of GDP, while the central government tax-revenues increased by 4,7% of GDP during the same period. In this regard it makes sense to propose a tax base expansion at the territorial level, especially by way of revamping the housing and

land taxes at the local level (Misión de Ingresos, 2002). The successful gasoline surcharge scheme adopted since early 2000s, and ordered by the central government to expand the revenues of the territorial entities, should be replicated in these others cases.

**Table 3. Colombia: NFPS Structure**  
( % of GDP at End-2003 )

	<b>1990</b>	<b>2003</b>	Difference 2003 / 1990
<b>Revenues</b>	<b>23,7</b>	<b>31,2</b>	7,5
Tax Revenues	12,0	17,4	5,4
Central Government	9,4	14,1	4,7
Departments (States)	1,1	1,4	0,3
Municipalities	1,5	1,9	0,4
Non-Tax *	9,9	11,5	1,6
Social Security **	1,8	2,3	0,5
<b>Expenditures</b>	<b>24,3</b>	<b>34,4</b>	10,1
Operational	9,2	10,7	1,5
Transfers	4,8	10,3	5,5
Social Security	1,5	7,0	5,5
Other ***	3,3	3,3	0,0
Interest	3,9	4,9	1,0
Investment	6,4	8,5	2,1
<b>NFPS Deficit (-)</b>	<b>-0,6</b>	<b>-3,2</b>	-2,6
Primary Surplus	3,3	1,7	-1,6
Memo:			
Territorial Transfers	3,3	5,3	2,0
Tax Revenues+S.Sec. Contr.	13,8	19,7	5,9

\* Includes profits from public enterprises.

\*\* Contributions to public entities (ISS, Cajanal, etc.)

\*\*\* Includes statistical discrepancies.

Source: Our computations based on IMF and Central Bank.

Personal income tax rates increased significantly in Colombia, passing from 30% in 1990 to 38,5% in 2003-2004 (including a 3,5% temporary surcharge). Table 4 illustrates that personal income tax now starts at low income-levels (five-times the official minimum wage) and runs at a progressive rate from 0,3% to 38,5%, according to Law 863 of 2003. This is a scheme similar to Chile's, where rates start at 5% and reach 40%, covering a wide range of income levels. Interestingly, the revenue yields at the personal incomes tax are similar in Colombia and Chile (close to 2% of GDP, as shown in Table 5). However, Colombia incurs in too many distortions that, if avoided, could actually revamp tax-collection.

**Table 4: Income Tax and VAT Rates: Colombia and Chile**

	Tax Rates ( % )	
	Colombia	Chile
<b>Income Tax</b>		
Personal	From 0,3 to 38,5	From 5 to 40 *
Corporate	35 + 3,5 = 38,5	17 **
<b>VAT</b>	7-10-16-20-45	19 ***

\* Máx. rate reduced from 45% down to 40% during 2002-2004.

\*\* Increased from 15% to 17% during 2002-2004;  
Shares held by individuals pay the personal tax rate.

\*\*\* Increased from 18% to 19% during 2004-2007 to  
substitute for trade taxes declining from 8% to 6%.

Source: Our computations based on IMF and Central Banks.

Regarding corporate tax, we observe that Colombia applies a rather high tax rate (38,5% including a temporary surcharge of 3,5%), but the “double taxation” of dividends has been dismantled since late 1980s. By contrast, Chile uses a low tax rate which has been gradually increased from 15% to 17% over 2002-2004, but dividends received by individuals are taxed at the personal income rate. What is interesting is that Chile, with a much lower tax rate, actually collects almost 1% of GDP more

than Colombia (4,6% vs. 3,8%) due to the existence of numerous tax-brakes being applied both on temporary and permanent basis in Colombia.

**Table 5: Tax Collection: Colombia and Chile**  
( NFPS\* at End-of 2003 )

	Tax Revenue ( % of GDP )		
	Colombia ( 1 )	Chile ( 2 )	Diference ( 3 ) = ( 2 ) - ( 1 )
<b>Income Tax</b>	<b>6,0</b>	<b>6,5</b>	<b>0,5</b>
Personal	2,2	2,0	-0,3
Corporate	3,8	4,6	0,8
<b>VAT</b>	<b>5,9</b>	<b>8,8</b>	<b>2,9</b>
(% Efficiency)	37%	49%	
<b>Income &amp; VAT</b>	<b>11,9</b>	<b>15,3</b>	<b>3,4</b>
(% Share on total)	60%	74%	
<b>Other Taxes</b>	<b>7,8</b>	<b>5,3</b>	<b>-2,5</b>
Transaction Tax	0,7	0,0	
Local Taxes	3,3	2,2	
Social Security	2,3	1,5	
Other	1,5	1,6	
<b>Total Tax Revenues **</b>	<b>19,7</b>	<b>20,6</b>	<b>0,9</b>

\* Non-Financial Public Sector (NFPS)

\*\* Including Social Security Contributions

Source: Our computations based on IMF and Central Banks.

VAT rates have also increased in Colombia from 10% in the early 1990s to 16% in 1999 (Shome, 1992; Shome, et.al. 1999), although there are too many differential rates that hamper tax collection (see Table 4). In the case of Chile, there is a unique VAT rate that has been temporarily increased from 18% to 19% during 2004-2007 in order to substitute for trade taxes being reduced on average from 8% to 6%. This tariff reduction has been the result of various trade agreements implemented recently in Chile.

In the case of Colombia, both the lower rate and the lack of a universal tax-base has resulted in rather low VAT-collections (5,9% of GDP) when compared to Chile's (8,8% of GDP), a difference close to 3% of GDP. Note also that, when considering tax evasion and avoidance, the ratio of VAT-collections/VAT-Rate, an indicator of tax-efficiency, reached only 37% in Colombia at end-of-2003, while in Chile was almost 50% (see Table 5). These figures have not changed significantly from the mid-1990s (Shome, 1999 p.9).

Note that in Colombia Income and VAT taxes represent close to 60% of tax revenues, while in Chile they amount to 74%. The problem with having low collections in income tax or VAT is that the tax structure tends to be more distortive. This has been the case of the "financial transaction tax" (FTT), used extensively in Colombian and Brazil (at rates of 0,2-0,4% for long periods of time) and in Ecuador and Venezuela (at higher rates of 1%, which tend to defeat the permanence of these taxes), see Coelho, et.al. (2001 p.12).

In the case of Colombia the FTT has been collecting between 0,5-0,7% of GDP, but causing several financial and capital market distortions. In Brazil and Colombia, there have been several unsuccessful attempts to phase-out the FTT, but Congress-people perceive that this is a "progressive tax" being paid by a wealthy financial system. The truth of the matter is that in Colombia, for example, the FTT-revenues come only in about one-third from the financial institutions own-business, while the other two-thirds are effectively levied on households and firms who use financial services. One convenient way to start dismantling such a distortive tax is to apply FTT-collections as a with-holding tax to be applied to income tax on households and firms. Similar conclusions can be drawn when analyzing distortive taxes paid through payrolls, which in the case of Colombia have aggravated labor markets informality and diminished social security coverage (Clavijo, 2004).

In short, Colombia has made a significant effort in increasing tax collection, both by increasing income-tax rates to 38,5% (an increase of 8,5%) and VAT-rates to 16% (an increase of 6%) during



1990-2003. Tax-bases have also been expanded, but certainly there is ample room to improve in this matter. The result has been a net increase of almost 5% of GDP in total tax collections in the last decade. However, there seems to be further room for increasing tax-revenues in about 2% of GDP, which can be the result of extending the tax bases in personal-income and imposing a quasi-universal VAT that properly addresses the concerns of the Constitutional Court regarding the 2% VAT rate on basic consumption goods and services (see ruling C-776 of 2003).

#### B. The Expenditure Structure

One would have expected Colombian central government's accounts to attain fiscal balance as a result of a net increase in tax revenues of nearly 5% of GDP over the last decade. The result, on the contrary, has been a structural fiscal deficit close to 5% of GDP due to significant increases in total expenditures.

We saw in Table 3 that NFPS total expenditure in Colombia had increased in nearly 10% of GDP during 1990-2003, reaching 34,4% of GDP. Operational expenditures have increased only in 1,5% of GDP, while transfers have done so in 5,5% of GDP. The level of transfer related to social security is currently 7% of GDP, as commented before.

This structure clearly indicates that central government's bureaucratic expenditures explain only partially the expenditure increases (1,5% of GDP out of a net increase of 10,1% of GDP). In fact, expenditures pressures in Colombia are rooted mainly in:

- A disorganized decentralization process that has increased local education and health expenditures in about 2% of GDP (as can be inferred from the increased in territorial transfers and partially from the increase in capital expenditures);
- Additional "cash-requirements" from the central government as a result of the pension-

transition from the PAYG into a fully-funded system; we estimate that about 2% of GDP (or about half of the net increase in social security transfers) are related to funding this pension-transition;

- Additional interest payments of about 1% of GDP, where the total interest payments is high at almost 5% of GDP.

In short, we have seen that these large deficits in Colombia are also of a structural nature. They hinge on hard-to-increase tax-base and inflexible expenditures associated with transfers resulting from fiscal decentralization processes and pension transitions. In order to overcome this situation, a set of structural reforms need to be approved by Congress. On the revenue side, it is required to expand both income and VAT-tax-bases, aiming at increasing tax revenues in about 2% of GDP. Critical years are 2006-2010, when some temporary taxes will be fading-away and the pension transition will be more acute. On the expenditure side, it is required to de-link territorial transfers from growth of central government's tax-revenues or at least to freeze-them in real terms (currently they grow in real terms at 2,5% annually). Additionally, local expenditures on education and health should be determined to demand-determined subsidies (according to Law 715 of 2001). Finally, the long-term stability path needs to be reinforced with a second generation of pension reforms that adopts "parametric" adjustments in line with increases in life-expectancy.

#### **IV. Concluding Remarks**

In this document we have analyzed the anatomy of public sector deficits in Latin America, with particular attention to the case of Colombia. As seen, these deficits arise from rigidities in the tax structure, which impede to properly tax personal income & wealth or to impose a universal VAT. During the 1990s, these tax rigidities were aggravated by structural reforms that increased expenditures on permanent basis, mainly, as a result of disorganized fiscal decentralization processes dealing with education & health expenditures.

We found at least three common factors leading to structural fiscal deficits in large Latin American countries, including Argentina, Brazil, Mexico, and Colombia:

- On the revenue side, there exists a political problem in convincing Congress-people to raise revenues by increasing the VAT-rates or expanding the tax-base. Curiously enough, many of the large Latin American countries have succeeded in increasing income tax, although their revenues continue to be low (6% of GDP) when compared to European standards (14% of GDP). Personal income rates are perceived as relatively high, so Congress-people are prone to approving tax-brakes for specific pressure-groups, leading to loop-holes that increase tax-evasion. Certainly, tax-bases are subject to great improvement if exemptions are reduced. For example, we found that the ratio of VAT-collections/VAT-Rate, an indicator of efficiency, is only 37% in Colombia, while in Chile is almost 50%.
- On the expenditure side, the characteristic of the past decade was the deepening of the fiscal decentralization process that had began in the early 1980s. However, this was done by means of increasing the central government revenue sharing with the local governments, which generate mounting inflexibilities for the expenditure side of the public balance. This problem has been especially acute in Argentina and Colombia, where revenue sharing represented close to 50% of central government tax-revenues. As we discussed it, tax-sharing rigidities and overly rigid exchange-rate regimes are a recipe for macroeconomic disasters.
- Finally, these fiscal difficulties have been aggravated by “cash-requirements” from the central government as a result of the pension-transition from the PAYG into a fully-funded system. The overall result has been structural budget deficits close to 5% of GDP at the level of the central government and close to 3% for the Consolidated Public Sector, in the cases of Argentina, Brazil, and Colombia.

We have seen that large Latin American economies have different levels of total revenue, in spite of some convergence of tax-revenues to the mark of 20% of GDP (with the exception of Mexico). Such convergence of the tax-revenue ratio is somehow surprising when considering the different tax structures of national/sub-national arrangements and the different tax-pressures stemming from direct vs. indirect taxation. The variations in the ratio of total revenues/GDP have to do more with non-tax revenues stemming from oil and mining public companies.

Fiscal deficits in large Latin American countries seem to be of a structural nature since they are rooted in imbalances between a hard-to-increase tax-base and inflexible expenditures associated with transfers resulting from fiscal decentralization processes and pension transitions. The exception in the region is Chile, where has been instituted a law mandating a cyclically adjusted fiscal surplus of 1% of GDP.

We concluded that large fiscal deficits in Colombia are also of a structural nature. In order to overcome this situation, a set of structural reforms need to be approved by Congress. On the revenue side, it is required to expand both income and VAT-tax-bases, aiming at increasing tax revenues in about 2% of GDP. Critical years are 2006-2010, when some temporary taxes will be fading-away and the pension transition will be more acute. On the expenditure side, it is required to de-link territorial transfers from growth of central government's tax-revenues or at least to freeze-them in real terms.

Finally, the long-term stability path needs to be reinforced with a second generation of pension reforms that adopts "parametric" adjustments in line with increases in life-expectancy. The required primary surplus to stabilize "gross" public debt should be increased to 3% of GDP, including about 1% of GDP per-year due to contingent liabilities. Ignoring these effects of contingent liabilities would lead to further deterioration of the "explicit" public debt-GDP ratio, as happened in most emerging markets during 1997-2003.

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