

LATIN AMERICA AND THE CARIBBEAN IN THE FIRST QUARTER OF THE 21ST CENTURY. WHAT SHOULD BE REFORMED, WHAT CAN BE REFORMED, AND HOW TO THINK ABOUT IT?

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ABSTRACT

Latin American countries in the 2020's face many economic and social challenges, including low growth, low investment levels, low productivity, as well as high levels of poverty and inequality. Rising international interest rates might induce capital outflows and debt sustainability problems. A "reform agenda" discussion is on the table once again. This note provides some elements to think about a political economy of reform for Latin American countries in the 2020s.

In order to organize our thinking, we suggest a framework in which (a) vectors of public policies have effects on vectors of relevant social outcomes, and (b) political economy arguments explain extant policy vectors and potential obstacles to reform.

In the agenda reported in this paper, as a step towards that broader framework, we use fiscal vectors as primary anchor of analysis. In order to provide some guidance and general principles for a country-focused research agenda, we attempt to develop: (A) a fiscal diagnostic framework of what the main problems are and what priorities should be, and (B) a political economy framework to identify the main constraints in each case.

The logic in each case operates at two levels of aggregation, across countries, and within country across budget items (public programs). The note has the purpose to guide the analysis, starting from cross-country comparative indicators, and moving forward to more detailed diagnostics at the country level.

1. INTRODUCTION

Inequality is a crucial issue in Latin America and the Caribbean. The region's richest 10 percent of the population earns 22 times more than those in the bottom 10 percent, which is twice the ratio in developed countries (Busso and Messina, 2020). Worse than that, 32% of the region's total population lives in poverty, and 13% in extreme poverty (ECLAC, 2022). Poverty and inequality levels cannot be considered independently of the growth problem the region faces. Between 1980 and 2020, the average per capita growth rate of real GDP in Latin America and the Caribbean was below the world average. Other regions have narrowed the gap with the income per capita of the United States: the typical country in emerging Asia narrowed its gap from 11 percent in 1960 to 58 percent in 2017. Latin America and the Caribbean has not: on average, countries in the region closed only four percentage points, far less than the 47 percentage points achieved by East Asian countries (Cavallo and Powell, 2018). This is particularly important because growth tends to have a larger impact on poverty than redistribution does. For example, from 2009 through 2014, poverty reduction was estimated in 7.4 p.p., from which 6.2 p.p. were driven by average income growth and only 1.2 p.p. were the result of redistribution (World Bank, 2023). These estimates show that growth plays a critical role in how poverty changes and that all the redistribution efforts may be irrelevant if the average income is left unattended in the policymaking process.

Low productivity and low investment make growth impossible in the region. Private investment in Latin America and the Caribbean is lower than in the rest of the world; the only exception being Sub-Saharan Africa. Public investment is also low by international standards. The comparison with Emerging Asia is the most striking, with an investment gap equivalent to 10 percent of Latin America's annual GDP between 1980 and 2013 (Cavallo, Powell, and Serebrisky, 2020). The region invested only 2.8 percent in infrastructure over the last decade, half of Asia's investment (Cavallo, Powell, and Serebrisky, 2020).

In short, Latin American in the 2020's faces many economic and social challenges. The post pandemic fiscal situation of many countries has deteriorated, and with the rise of US interest rates some observers (Hallerberg, 2022; World Bank, 2022; Powell and Valencia, 2022; ECLAC, 2023) see a parallel to the 1980s, when the Volcker interest rate increases helped precipitate the debt crises.

The agenda reflected in this concept note attempts to provide elements for a “reform agenda” *aggiornata* to the current situation in the region and to the heterogeneity of country economic situation and political dynamics.

What “reform agenda” means now is less clear than it was back in the 1980’s when John Williamson came up with his ten commandments (Goldfajn et al 2021). Back in the old days, it was taken for granted that what needed to be done was clear, and “the political economy of reform” was about identifying obstacles of a political nature and strategies to overcome them (Rodrik 1996, Tommasi and Velasco 1996). Nowadays we still face many political challenges, but on top of that the reform agenda is less clear. What direction should Latin American countries be moving? There are a number of relatively clear targets in some “micro” components of the agenda, for instance early childhood, gender issues and environmental issues. Also, thanks to the magic of RCTs, we have a better understanding of how to choose among different ways of implementing various microeconomic objectives. Yet, in terms of the big traditional issues of growth, inequality, and poverty reduction, we are a bit at a loss at this point. We do not have clear criteria to provide guidance about the larger trade-offs that societies are facing.¹

In this concept note we suggest that we need to take stock of the situation in three main dimensions: (1) (as always) **macroeconomic issues** such as growth performance and prospects, inflation, fiscal sustainability, investment, and productivity; (2) **distributional issues** including redistribution and sustainable poverty reduction; and (3) **political issues** around 1 and 2, including discontent, mistrust, elite domination, populism, and missing social contracts. And this needs to be done in an integrated manner.²

In order to organize our thinking about these primary issues, and taking into account their interconnections, we suggest a framework in which (a) vectors of public policies have effects on vectors of relevant social outcomes, and (b) political economy arguments explain extant policy vectors and potential obstacles to “reform”. In the agenda reported in this concept note, as a step towards that broader framework, we use fiscal vectors as primary anchor of analysis. In

¹ See Akerlof (2020) for a related argument about current incentives in the academic economics profession for narrow focus with disregard for big issues. See also Cruces and Levy (2021) for an attempt to build a framework to think about social protection strategies taking into the considerations its interactions with incentives and productivity.

² There are valuable initiatives out there that take a good look at some of these issues “one at a time” – for instance, the LACIR initiative ([Home | LACIR - LACIR \(lse.ac.uk\)](#)) that, inspired in IFS-Deaton Review of Inequality in the UK ([Inequality: the IFS Deaton Review](#)), has the aim of understanding why inequality in Latin America and the Caribbean persists at exceptionally high levels.

order to organize our thinking in to provide some guidance and general principles for a country-focused research agenda, in this note we attempt to develop:

- (A) a fiscal diagnostic framework of what the main problems are and what priorities should be (*a la* “growth diagnostics”),³ and
- (B) a political economy framework to identify the main constraints in each case.

2. A FISCAL DIAGNOSTIC FRAMEWORK⁴

Long-term poverty reduction can be achieved through general economic growth, through redistribution, and through specific actions to increase long-term incomes of the poor. There are many instruments in the arsenal of public policies that impact on these three intermediate objectives. This agenda focuses on the fiscal ones that operate through the budget, that is, on the “fiscal vector”.⁵

We define the fiscal vector $\{\mathbf{Gt}, \mathbf{Tt}, \mathbf{dt}\}$ as the vector of all spending items, all taxes, and fiscal deficit at time $\mathbf{t}$. In order to explore how the budget affects poverty in the long term, we will analyze how the fiscal vector impacts on three intermediate objectives, growth, (re)distribution, and a third one that we define as transformation – and then at the effect of these intermediate objects on the final metric of interest, poverty, or poverty reduction. We will also speculate on possible ways of aggregating across these three channels in order to evaluate each component of the fiscal vector in terms of its comparative impact on poverty reduction. Later in the report we will focus on three fiscal vector “properties” – government size, redistribution, and efficiency – that will allow for country characterizations leading to political economy considerations.

It will be helpful to introduce a brief notation and conceptual scheme to clarify theoretical expectations. Imagine two periods, today and the future, and two types of agents, rich and poor.

³ Hausmann, Rodrik and Velasco (2008).

⁴ This section draws extensively from *Towards a Diagnostic Framework for Poverty Reduction*, M. Tommasi, March 2023.

⁵ For instance, we do not address here labor, product, or financial market regulations, which impact on pre-fiscal incomes. It seems quite natural to focus on policies that operate mainly through the budget, given its centrality in economic and social policy strategies, as well as the complementarities with macroeconomic policy. As will become clear throughout the note, this effort is complementary with prior and ongoing IDB initiatives such as DIA 2018 *Better Spending for Better Lives*, and LAPEF (*Laboratorio de Políticas para la Equidad Fiscal*).

This setup would imply a vector of four consumptions $\{C_1^p, C_1^r, C_2^p, C_2^r\}$, where C_t^i represents consumption of agent of type $i = \{p, r\}$ in period $t = \{1, 2\}$.⁶

We could map the three intermediate objectives mentioned above on this vector of consumptions. Growth increases consumption of both types of agents in the second period, C_2^r and C_2^p . Redistribution at time t affects the consumption ratio of the period in favor of the poor, increasing C_t^p/C_t^r . We define “transformation” as those time-1 actions that affect the incomes of the poor in time 2, and through that, they increase C_2^p .⁷

We proceed now to look at each of the channels.

2.1. Fiscal Vector and Growth (and Poverty)

We briefly review now theoretical expectations and previous empirical findings concerning the impact of fiscal variables on macroeconomic channels and, through them, on poverty. We focus on the primary channel of economic growth. Later in this concept note, we discuss possible ways to incorporate such effects in our line-by-line budget evaluation.

Since the classical studies by Vito Tanzi that ignited this literature (Tanzi and Lee, 1997), there have been numerous studies on how different taxes, spending items, and the macro-fiscal vector impact on growth.

This literature tends to establish that various components of the taxation vector (**Tt**) have different growth implications. To begin with, aggregate taxation itself, above some low threshold, has negative growth implications. Sixty-two percent of the studies reviewed in the meta-study of Martner et al. (2017) find a significant negative relation between taxes in general and growth. More recent evidence sheds light on tax cuts' positive impact on economic growth. For example, Mertens, K., & Montiel Olea, J. L. (2018) find out that a one-percentage-point decrease in the tax

⁶ We could, in principle, establish welfare weights over those four objects. If poverty reduction was the policy objective, we would be primarily interested in increasing C_1^p and C_2^p . In this simple example with a fixed number of two types of agents, this literally means reducing the poverty gap. It will mean reducing the poverty headcount (to zero) iff the reduction brings (all) the poor above the poverty line.

⁷ Following the logic of the modern literature on human development and anchoring on the notion of poverty as scarcity of assets and productive capabilities, we care about transforming life conditions and opportunities of the poor so that they can (in time) become more prosperous and more productive and can, hence, achieve higher levels of consumption by their own means. That is, transformation would imply an effective reduction of poverty by increasing the future income of the poor, and hence, their future consumption.

rate increases real GDP by 0.78%. Second, more progressive taxes tend to have more negative growth effects. The six studies reviewed in Martner et al. (2017) find a negative association between tax progressivity and growth. Studies also find that the more we tax income instead of consumption, the worse is growth performance – the five studies reviewed in Martner et al. (2017) find the impact of a change in the tax structure consisting of the increase in the weight of indirect taxation to the detriment of direct one improving economic growth. This conclusion is a clear example of a trade-off among intermediate objectives since consumption taxes tend to be less progressive.

The way in which the vector of public spending affects growth depends on a number of considerations regarding initial conditions, capital stocks, the ratio of public to private investment, crowding out effects at the margin, and the like. Synthesizing over many such discussions, by and large, the literature finds positive effects of public investment on growth (Aschauer 1989, Easterly and Rebelo 1993, De la Fuente 1997), positive effects of education spending on growth (Wolff and Gittleman 1993, De la Fuente and Domenech 2000, Barro 2001, Bleaney and Gemmel 2001, Buysse 2002, Bose et al. 2007), positive effects of healthcare spending on growth (Bleaney et al. 2001), and unclear growth effects of another social spending, including transfers – Korpi 1985, McCallum and Blais 1987, and Feldstein 1976 find adverse effects, Persson and Tabellini (1994) find positive effects, and many authors find no significant effects. More broadly, impact varies across countries and time periods, in a way that some authors have associated with state capabilities and the quality of institutions (see for instance Afonso et al. 2005).

Coming to the effects of budget disequilibria, it is well established that it has deleterious macroeconomic effects (See Bose et al., 2007). Various of those effects have negative implications on poverty. Budget disequilibria are a crucial factor behind macroeconomic instability, and macroeconomic instability is bad for poverty. On the one hand, macroeconomic instability leads to inflation, and the regressivity of the inflation tax has implications for poverty. Also, macroeconomic instability is associated with frequent macroeconomic crises, and crises themselves affect poverty and distribution, effects first highlighted in Lustig (2000). More recently, Messina (2021) shows that crises in Latin America decrease labor income, increase unemployment, and reduce labor formality, all effects that lead to worsening income distribution and increasing poverty. (See also Powell and Valencia, 2022).

Last but not least, we know that long-term growth has crucial effects on poverty reduction. It is essential to mark the words long-term, because, as Vegh et al. (2019) remind us, short-term

growth can lead to misleading interpretations regarding income poverty; that is, we can be “fooled by the cycle,” imagining sustainable effects on social indicators and poverty where there are none. In contrast, we know that long-term growth has important effects on poverty. For example, Gasparini et al. 2007 find evidence suggesting a strong and negative correlation between economic growth and poverty reduction for LAC countries using household survey data. Recent work by Gasparini, Tornarolli, and Gluzman (2019a and 2019b) brings the point home in a stark manner for the case of Argentina. Argentina had a dismal growth performance in the four decades from 1974 to 2014. The authors show, through simulation, that if Argentina in those decades had the average growth performance of Latin America, the poverty rate in 2018 would have been 14% as opposed to the actual one of 35%. Had it grown at the rate of the best performer Chile, poverty would have been 1/6 of what it was, that is, 6% instead of 35%.

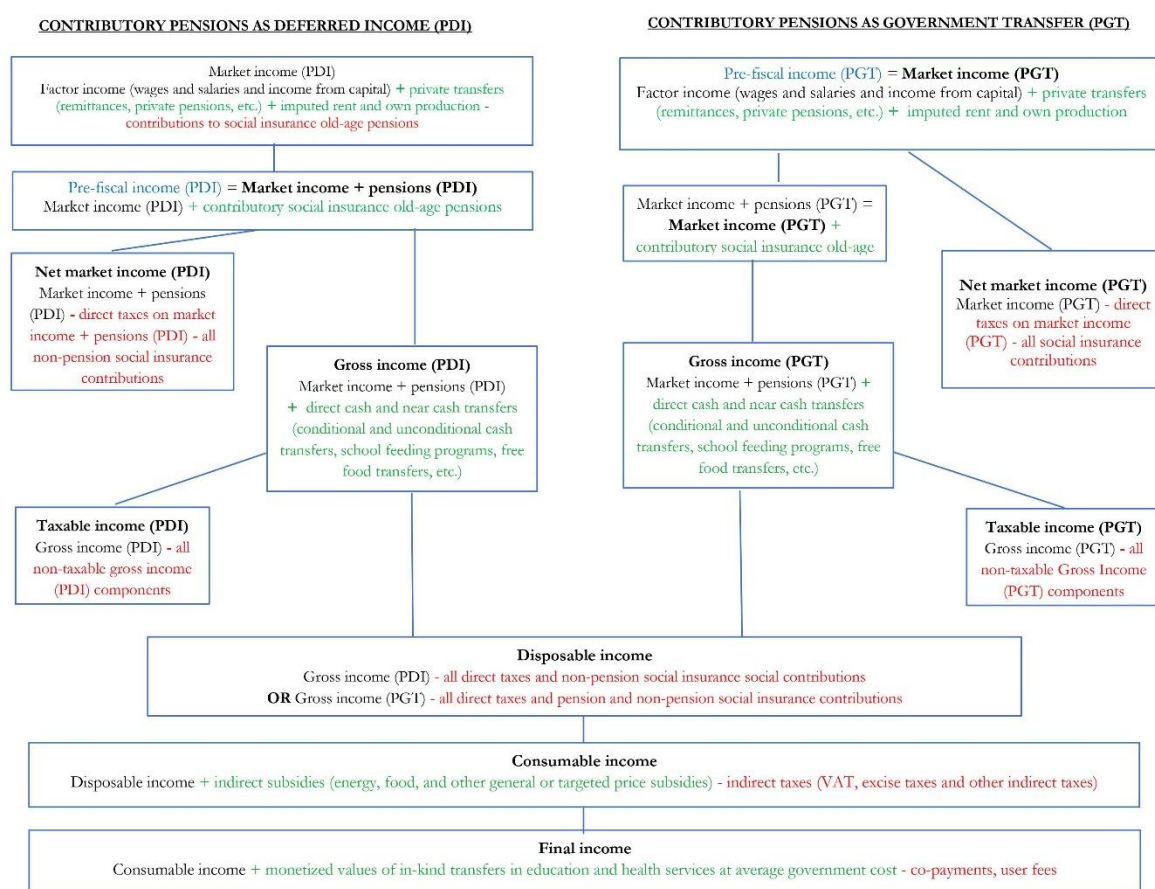
2.2. Fiscal Vector and Redistribution

We come now to the second channel, the way in which the fiscal vector affects income distribution. There is a vast literature on incidence analysis describing who benefits from government spending and who is burdened by taxation. We follow the methods developed by the Commitment to Equity Institute (CEQ – Lustig 2018 and 2022). Although it is possible to use incidence analysis to examine one particular expenditure or tax, the thrust of the CEQ analysis is to get a comprehensive picture of the redistributive effect of as many tax and expenditure items as possible. This analysis has been performed in many countries, enabling cross-country comparisons.

It is necessary to construct income concepts that incorporate the effects of fiscal interventions. The four core income concepts used: pre-fiscal income, disposable income, consumable income, and final income. Figure 1 shows these concepts:⁸

⁸ The analysis is carried out for two concepts of pre-fiscal income depending on the treatment of contributory pensions. If pensions are treated as a pure *government transfer* (PGT), the pre-fiscal income is market income. If pensions are treated as *deferred income* (PDI), the pre-fiscal income is market income plus pensions. Pre-fiscal income is the starting point for the analysis. Under the PGT scenario, the starting point is market income, including income from all sources (wages, salaries, and capital income), except for government transfers and *contributory public* pensions. The two “market incomes,” however, are not identical. Under the PDI scheme, market income does not include contributions to social insurance old-age pensions to avoid an intertemporal double counting of income. In contrast, contributory pensions are “forced saving” and, therefore, they are included in the pre-fiscal income.

Figure 1: CEQ Income Concepts



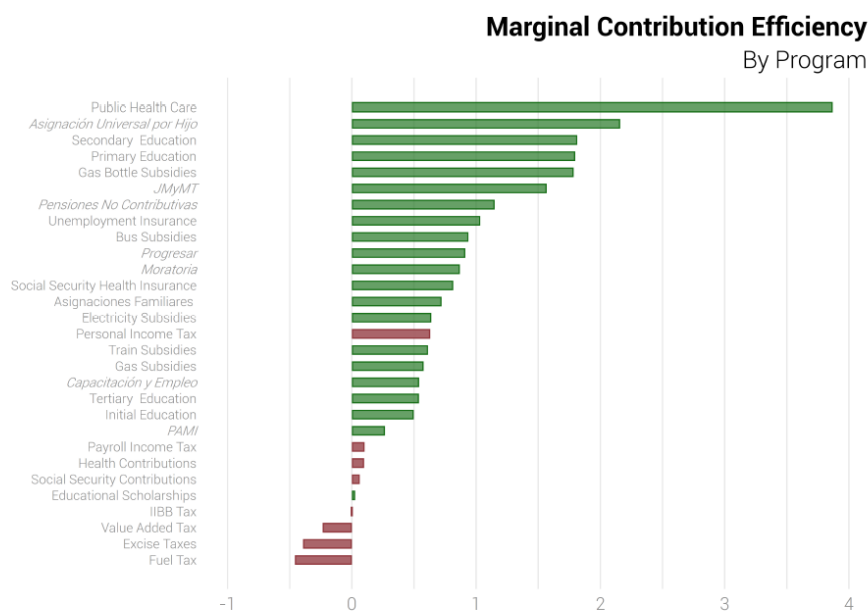
Source: Lustig 2018.

Disposable income is defined as pre-fiscal income minus direct taxes plus direct transfers. Consumable income is constructed as disposable income plus indirect subsidies minus indirect taxes. In terms of the “cash component” of the fiscal system, state action ends with consumable income. However, governments usually provide other transfers in the form of in-kind transfers: free or quasi-free services such as public education and healthcare. These transfers are monetized at average government cost and added to consumable income to obtain final income.

The primary data source is always the main national household survey, but this needs to be complemented by a number of additional country-level surveys useful for various more precise imputations of information not available in the primary survey. Applying the methodology involves several methodological steps and decisions, laid out in detail in the *Commitment to Equity Handbook* (Lustig, 2018 and 2022). Each application to a specific country case has to make some (guided) specific assumptions in response to data availability issues and circumstances of the country and of the programs.

To provide an example, we give some illustrations for the CEQ assessment for Argentina, from Lopez del Valle et al (2022), where the critical assumptions and imputation criteria are described in detail. Looking into the results disaggregated by program, we focus on the marginal contribution in order to see how much inequality is reduced (or increased) by the programs and taxes analyzed.⁹ We present in Figure 2 the marginal contribution divided by total spending in each item, as an intuitive measure of how much Gini is reduced by one GDP point spending in that program. We can see, for instance, that public health spending, the CCT AUH, and primary and secondary education spending are among the most progressive programs. At the same time, the Value Added Tax and some specific excise taxes are regressive.

Figure 2: Marginal Contribution by program in Argentina



It is important to bear in mind is that the basic CEQ methodology does not consider behavioral responses or general equilibrium effects of programs. Also, it is assumed that the whole burden of consumption taxes is shifted forward to consumers. Another crucial assumption is that the analysis takes place at one point in time. Below we suggest possible pathways for analyzing intertemporal incidence.

⁹ The incidence literature, including the CEQ methodology considers each program’s marginal contribution as the best indicator of its distributive benefits (Enami et al., 2021).

2.3. Fiscal Vector and Transformation

2.3.1. A logic of human development

In this section, we advance some ideas on how to introduce intertemporal effects when diagnosing the fiscal vector. The question is which budget items play a role in increasing the future income (and hence, consumption) of the poor in a sustainable manner. The answer, at a theoretical level, is those items that increase their capitals. These capitals include financial capital, physical capital, human capital, and social capital.

Focusing for a minute on physical capital, it is well known that public investment, especially infrastructure, has high multiplier effects, positively impacting on growth and hence on poverty reduction (Izquierdo et al., 2019). However, particular investments in (light, local) infrastructure are particularly beneficial for the quality of life and for the human and economic development of the poor. For instance, infrastructure that facilitates access to markets for small agricultural producers in rural areas; or investments that improve living conditions for urban children living in slums near garbage dumps. One can think of many collective capitals of local infrastructure that can improve the present and future lives of the poor. Regarding the quantitative assessment of such spending items, one needs to consider how to assign and value them. The benefits of such investments to different individuals and families would need to follow a distributive logic similar to the one described in the previous section. In these cases, geo-localization of the benefits and beneficiaries would be an essential tool. There are several challenges in attempting to extend the CEQ methodology to the assessment of public infrastructure. Three crucial ones are the following. First, benefits are observed long after the moment of spending, so decisions need to be made regarding the moment at which that spending is allocated at the household level. A second important decision is whether to focus on the stock of extant infrastructure (fruit of past spending) or on the change in that stock (fruit of current spending). Last, it is crucial to define how to quantify the effect: access, cost of provision, or incidence of the benefit.¹⁰

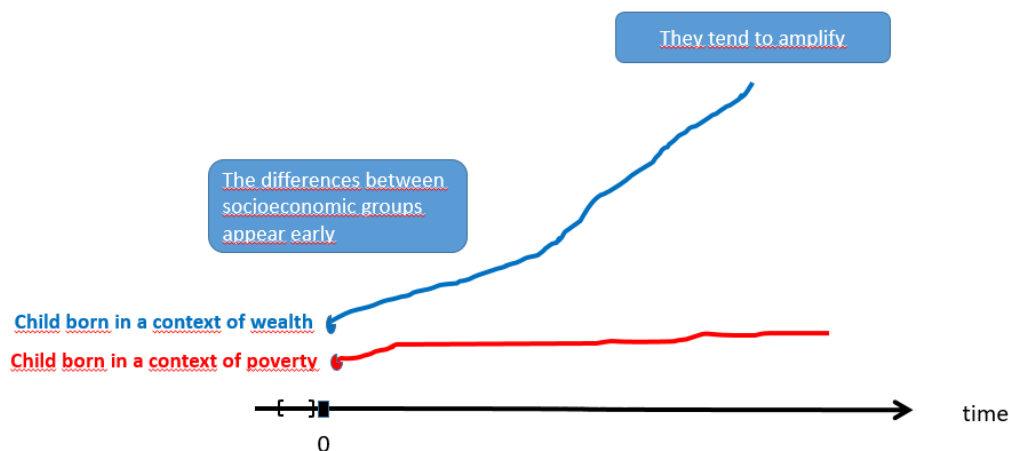
In the rest of this concept note, we focus on human capital, the primary form of capital for the poor. To do that, we follow a theoretical framework which authors such as James Heckman have christened as *the economics of human development and social mobility*, a line of thinking that draws from various disciplines.¹¹ Figure 3 synthesizes this ample logic in a holistic, informal way.

¹⁰ See for instance, Filc and Sanz (2022).

¹¹ See Heckman and Mosso (2014) for an excellent overview.

We compare the life trajectory of two persons, one born in a context of poverty with less-educated parents, and one born in a context of wealth with more educated parents. Many factors conspire to make these two people different the day they are born or even before. Differences in nutrition, healthcare during pregnancy, stress levels, habits of the pregnant mother, lead these children to be born different. These differences show up in observable dimensions (state variables) such as weight or survival probabilities from day 1. Such differences, unfortunately, do increase over time, in part through various institutional arenas such as the family, the education system, the labor market, financial markets, etc. There is a double play here. On the one hand, there is hysteresis; when you are born weighting 1.60 kg, your probability of being healthy and successful in school at age 15 is much lower than if you weighted 3.70 kg., even if all opportunities were the same from day 2; so that your origin matters a lot. Unfortunately, opportunities are never the same. Many other things that happen through life are correlated with that origin, mainly through family characteristics. In some sense, we could say that “it is the family, stupid.”¹²

Figure 3: Development of opportunities and abilities for children born in different contexts



A strategy of human development consists, then, in attempting to transform the trajectories of these children as early as possible, sustaining this transformation over time so that in the future they could take off independently and function more productively and successfully in the labor market and in other areas of life. The literature has established many dynamic

¹² See Tommasi, Edo, and Thailinger (2023) for a review of how family characteristics (and family structure) matter throughout different stages of individual development.

complementarities that make early investments in vulnerable children and youth the best social investment.¹³ Also, there are critical lifetime periods for intervention in which these investments are more productive than others. One crucial such stage is early childhood. Another essential node is adolescence, given the acute hysteresis effects of decisions taken at this stage.

Different budget items are likely to have different implications in terms of affecting these future paths. What are then the implications for our budget analysis? That is, how do we go about diagnosing the fiscal vector with these intertemporal effects in mind? Which budget items does this approach suggest we should be prioritizing?

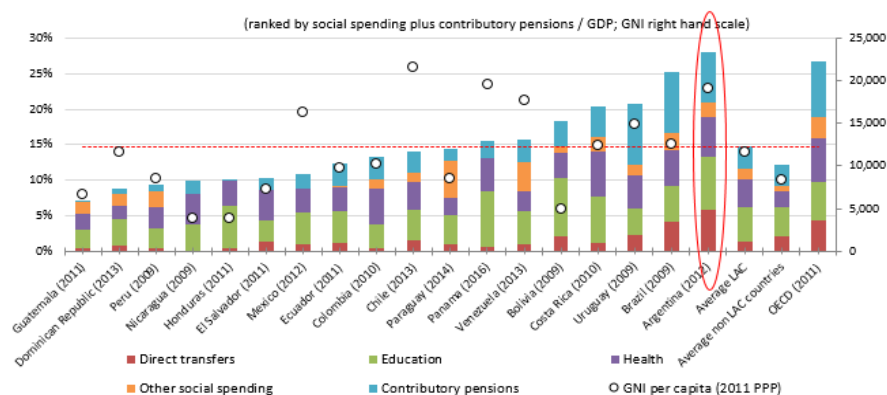
2.3.2. Macro fiscal diagnostic

Such diagnostics at each country level should proceed in two stages. First, it should look at an aggregate level to diagnose the macro-fiscal situation of the country, in order to understand at what margin we will be operating. From that standpoint, we can then look into individual budget items.

Figure 4 (from Lustig 2020) might help to provide us with a quick overview of the first step. It puts the levels of social spending of Latin American countries in comparative perspective. On one extreme, we have countries like Guatemala with social spending way below 10% of GDP. On the other end, we have Argentina, the country with the highest social spending in the region. Argentina has levels of social spending over GDP comparable to those of advanced OECD countries and four times higher than those of countries such as Guatemala or the Dominican Republic. This is a clear indicator that the macro-fiscal recipe will differ for Argentina than for Guatemala.

¹³ See for instance, Heckman and Masterov (2007), Heckman and Mosso (2014), and Hendren and Sprung-Keyser (2020).

Figure 4: Social Spending as a Share of the GDP for LAC Countries



Source: Lustig (2020)

Additional information along similar lines can be glimpsed from Table 1 (Jiménez et al,2010), where the effective tax burden is compared to the potential tax burden. We can see that countries such as Brazil or Argentina are collecting more taxes than they should, while a country like Guatemala is collecting less tax revenue than it should.

Table 1: Effective tax burden vs Potential tax burden for LAC countries

CARGA TRIBUTARIA EFECTIVA Y POTENCIAL EN PAÍSES DE AMÉRICA LATINA, PROMEDIO 2007-2008
(En porcentajes del PIB)

País	Carga tributaria efectiva	Carga tributaria potencial	Diferencia absoluta	Diferencia relativa
	(a)	(b)	(a)-(b)	(a)/(b)
Argentina	29,9	24,3	5,5	1,23
Bolivia (Estado Plurinacional de)	20,9	18,6	2,3	1,12
Brasil	35,1	22,8	12,3	1,54
Chile	21,1	24,8	-3,7	0,85
Colombia	15,6	21,1	-5,5	0,74
Costa Rica	22,8	23,2	-0,4	0,98
Ecuador	15,4	21,7	-6,3	0,71
El Salvador	14,8	20,6	-5,8	0,72
Guatemala	12,0	20,0	-8,1	0,60
Haití	9,9	12,6	-2,8	0,78
Honduras	16,7	18,1	-1,4	0,92
México	9,8	24,4	-14,6	0,40
Nicaragua	21,9	16,9	5,0	1,30
Panamá	16,5	23,0	-6,5	0,72
Paraguay	13,2	18,8	-5,6	0,70
Perú	17,3	21,6	-4,3	0,80
Rep. Dominicana	15,5	20,7	-5,2	0,75
Uruguay	23,2	23,5	-0,3	0,99
Venezuela (República Bolivariana de)	15,6	23,9	-8,3	0,65
Promedio ALC	18,3	21,1	-2,8	0,87

Source: Jiménez et al.,2010

It should be clear from these examples that the macro-fiscal part of the diagnostic would give us a very different picture for a country such as Guatemala than for countries like Argentina or Brazil. In the first case, the magnifying glass should be on which taxes should be increased in order to finance (what type of) social spending, while in the latter, the concern should be on what spending items should be prioritized for fiscal adjustment and what social spending items should be protected, or even increased. The next subsection suggests ways of going about the latter.

2.3.3. How do we account for the intertemporal effects of budget items?

There are different ways of approaching this complex question. In a nutshell, the objective is to infer the effects of current social spending across different items on long-term poverty. In order to do that, we have to navigate and build upon a rich and multifarious literature.

Inferring the effects of categories of spending on long-term social objectives can be done at different levels of precision. The ambitious way of doing it consists of building upon and aggregating from existing impact evaluations of the programs. We will discuss how to progress on that agenda, given limitations in terms of data and previous studies in most countries. There might also be some intermediate strategies that might permit going at least part of the way somewhat faster. One such meso strategy might come from combining the static distributive effects studied so far in the Commitment to Equity agenda (section 2.2 above) with some of the initiatives focusing on the intergenerational effects of budgets, such as the National Transfer Accounts (NTA) project.¹⁴ The interpersonal focus of the former, combined with the inter-cohort focus of the latter might allow to map the different fiscal interventions into a matrix of, say, deciles and generations. Such mapping would have covered at least part of the way to assess the intertemporal effects of current budgets. Even simpler heuristics on that direction can be performed if one has data on the age composition of the distributive effects of different programs. We report one such example in section 3.1.2.

Focusing on the blueprint for the more ambitious way of estimating long-term effects of spending, imagine a list of all relevant programs in a given country, with their associated budgets. That would include things such as Children Orchestras, Youth Employment Programs, Prevention and Treatment of Drug Abuse, Subsidies to Local Production Networks, etc. Each of such

¹⁴ See for instance the *National Transfer Accounts Manual* (United Nations, 2013).

interventions could, in principle, be studied. Moreover, some of them, for some countries, have indeed been studied – more in countries like the US than in Latin America, and more in some Latin American countries than in others.¹⁵ From those studies, we know of the impacts of various interventions on several crucial state variables such as birth weight, infant mortality, nutrition, school outcomes, school completion at various levels, probability of outcomes such as going to prison and drug abuse, probability of being employed in the formal sector, etc. Following the logic of multidimensional poverty, these intermediate outcomes are good predictors of the future probability of being poor.¹⁶

Knowing some intermediate effects of social programs, we need to build a connection or bridge to cover the following step from intermediate outcomes to the final outcome of interest. This connection can be made in various ways.

One way, proposed by Athey et al. (2019), consists of regressing the long-term dependent variable of interest on the intermediate outcomes on observational data and multiplying the treatment effects from the initial impact evaluation on that regression coefficient to predict long-term impact. Athey and her coauthors consider such a method suitable in cases in which the intermediate outcome analyzed is expected to fully capture the effects of the intervention on the long-term outcome. More generally, they propose a method combining multiple short-term proxies through a “Surrogate Index.” They argue that even if no one intermediate outcome meets the surrogacy assumption by itself, a group of intermediate results may together span the causal chain between the treatment and the long-term outcome. In their paper, they develop a methodology to do that when sufficient underlying impact studies and observational data for the second stage are available.

Another possible way is through the use of synthetic panels to project future income given current values of the state variables affected by interventions. In that way, we may generate a simulated future income distribution with and without the intervention and compute the change in the poverty ratio (or any other relevant social indicator) induced by the policy intervention in question.¹⁷

¹⁵ The International Initiative for Impact Evaluation (3ie's) is a valuable reservoir of some of these studies. <https://www.3ieimpact.org/>

¹⁶ Callander and Schofield (2015) and Bolch et al. (2020) provide evidence that multidimensional poverty measures are better predictors of income poverty in the future than current income poverty.

¹⁷ This exercise is performed in Schmidt-Liermann and Tommasi (2021) for the case of AUH, the main CCT in Argentina, directed to vulnerable families with children.

There are many issues to be decided in constructing and bridging these two steps towards the type of dashboard for fiscal decision-making we are attempting to develop. One crucial question is the **metric** we should use to make aggregation and comparisons across programs. Some programs impact birth weight, others school completion, others employment. We need to translate that into something comparable. The first candidate seems to be future income. This naturally brings issues of **temporality**. Interventions at what point in time and outcomes at what point(s) in time? Impact evaluation analysis often brushes these issues quickly, but they are crucial for comparability here. Even if we focus, as it seems natural, on monetary measures, there are many questions regarding money when. This moves us into the realm of cost-benefit analysis and discount rates. We describe below one approach based on the notion of marginal value of public funds.

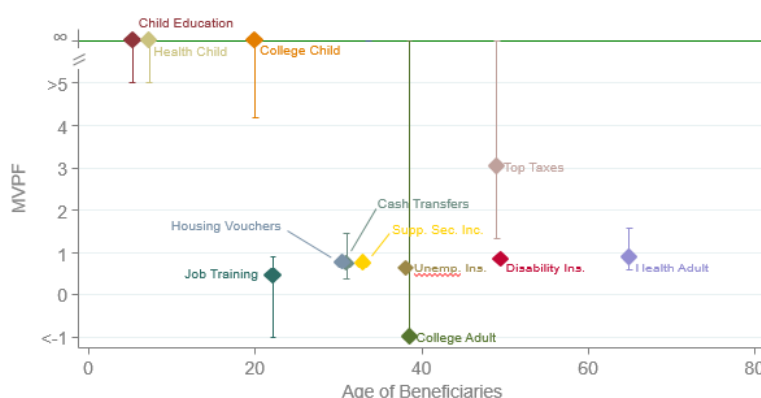
The way to go from the vector of social interventions in a given country to how much spending on each line helps to transform long-term poverty requires filling in various pieces of the puzzle. For some of them, we can draw from excellent extant impact evaluations for that particular program in that specific country. In other cases, we have to cleverly adapt some secondary literature that has analyzed similar programs in more or less comparable countries. This approach would require some further adjustments in various dimensions. For instance, we should take base levels into consideration. We do not expect the same quantitative impact of an intervention to increase school completion when we have 10% of kids in school than when we have 98% of kids in school. Some micro literature, for instance on *benefit transfer*, provides some guidelines for that translation.¹⁸

One example of where we should be headed is provided by a wonderful initiative of the Opportunity Insights group at Harvard (<https://opportunityinsights.org/>), which is summarized in Hendren and Sprung-Keyser (2020). They conduct a comparative welfare analysis of the 133 main social policy initiatives over the last 50 years in the US. They use, for each case, existing causal estimates to calculate the benefit each policy provides to its recipients, measured as their willingness to pay. They also consider the policy net cost, including its long-term impacts on the budget. As a metric to compare across programs they use the Marginal Value of Public Funds (MVPF) which is the ratio of the willingness to pay to the net cost to the government.

¹⁸ Four benefit transfer methodologies have emerged: benefit estimate transfer, benefit function transfer (as in the school completion example in the text), meta-analysis transfer, and preference calibration transfer. In meta-analysis, benefit estimates gathered from several studies serve as the dependent variable in regression analysis, and characteristics of the individual studies (substantive underlying variables, type of survey methodology) serve as the independent variable. (Dumas et al., 2005).

Some of their more important results are summarized in Figure 5, which shows the MVPF of the types of programs analyzed, arranged by age of the recipients, a very important dimension in the human development logic described earlier. Their results suggest that direct investments in low-income children health and education have historically had the highest MVPFs. Many such policies have paid themselves as governments recouped the cost of their initial expenditures through additional taxes collected and reduced transfers. They find smaller MVPFs for policies targeting adults.

Figure 5: Marginal Value of Public Funds by Age (Hendren and Sprung-Keyser 2020)



Source: Hendren and Sprung-Keyser (2020)

3. Putting Things Together; Towards a Fiscal Diagnostic Heuristic

3.1 Towards a Fiscal Diagnostic Heuristic at the Program Level

Having developed the three channels from the current fiscal vector to poverty, in this section, we provide some preliminary suggestions on possible ways to integrate these channels into a methodology to evaluate and rank the elements of the budget vector. For brevity and concreteness, we focus on social spending items.

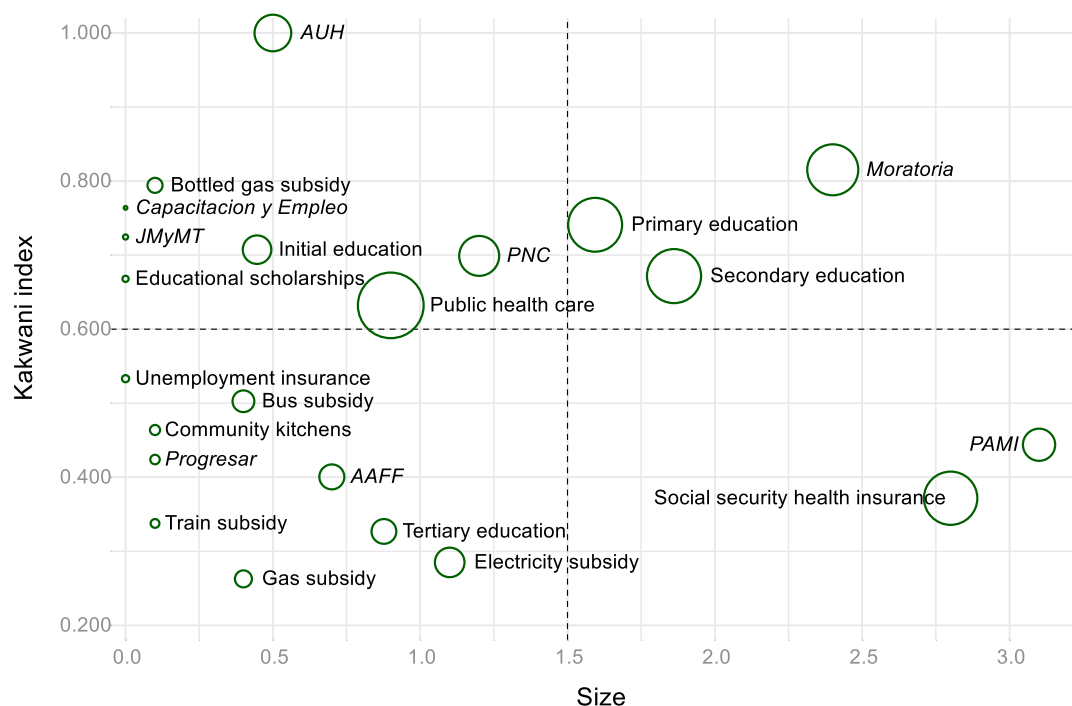
Of the three channels, the second one, redistribution, is the one in which previous methodology – CEQ methodology – is better grounded. For that reason, in this preliminary effort, we suggest possible ways of modifying the CEQ metrics at the program level, incorporating each of the other two channels. To exemplify the logic, we use the case of Argentina, for which we have personal expertise with the details of CEQ data and analysis.

3.1.1 Towards incorporating macroeconomic considerations into CEQ Assessments

In order to connect with the macroeconomic channel, we start by reminding ourselves of the discussion above, that each within-country analysis should proceed in two stages. The first step needs to consider the fiscal and macroeconomic situation of the country before looking into individual budget items. As mentioned in that section, Argentina has a substantial public sector, large social spending, and a dire macroeconomic situation. For that reason, in the case of Argentina, we should pay special attention to the size of spending programs in order to identify priorities for budget cuts as well as programs that need to be protected.

Remember that we evaluated the distributive effects of different programs by using their Marginal Contributions. Figure 6, from Lopez del Valle et al (2022) represents a possible way of seeing how effectively government resources are spent. The circles indicate the size and progressivity for each spending item. The horizontal axis shows the amount of spending as a share of GDP. The vertical axis shows the Kakwani index of progressivity. The size of the circles reflects the magnitude of the marginal contribution: more significant marginal contributions are represented by larger circles.

Figure 6: Size, Progressivity and Marginal Contribution



Source: López del Valle et al (2022).

Figure 6 raises some questions regarding the allocation of government resources. More extensive programs tend to be more equalizing (larger circles), even if the programs (such as social security health insurance or *PAMI*) are less progressive. On the other end, several relatively small (labor and education) programs are not particularly equalizing —despite being quite progressive – because of their small size. Despite being slightly equalizing, various utility subsidies (gas, electricity) and tertiary education stand out as the least progressive. AUH, while relatively small, is an outlier in terms of progressivity and manages to be among the most equalizing programs.

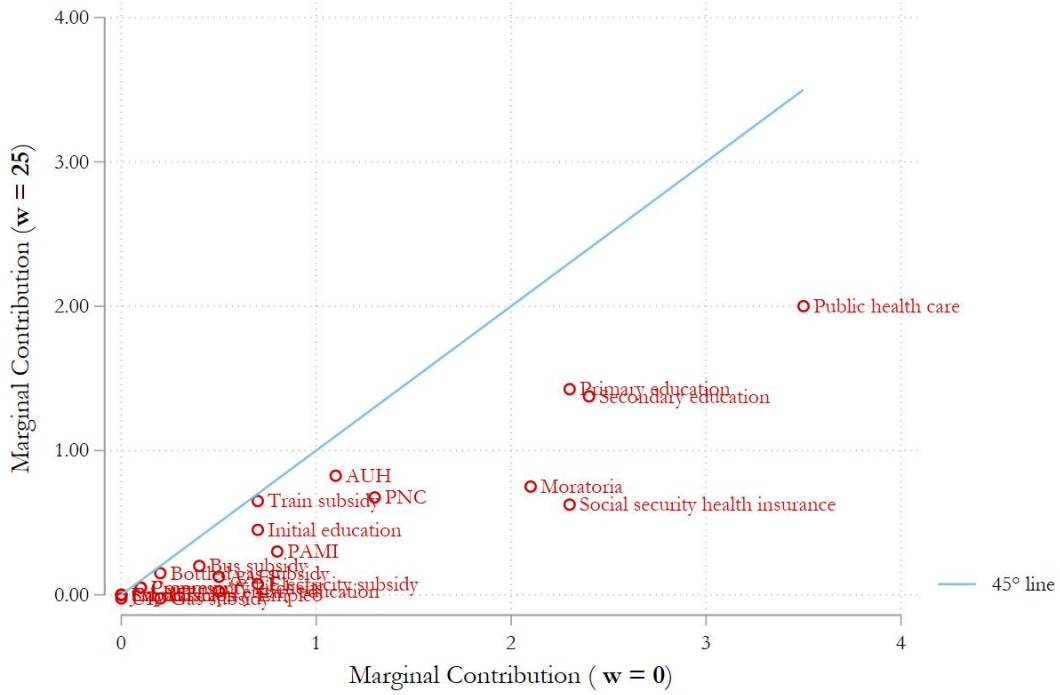
One possible way to comparatively assess programs incorporating their potential implications in Argentina's dire fiscal and macro situation, consists of penalizing their budget size. Taking marginal contributions as the best indicator of distributive effects, one possible way of assessing each program's impact inclusive of the macroeconomic channel might be to subtract a size penalty from the marginal contribution of each program. Finding the most suitable weight between direct distributive and indirect macro effects would require further theorizing and empirical analysis. However, we present a simple exercise as an illustration below.

We use the following formula:

$$Net\ MgContribution_i = 100 * (MgContribution_i - w * Size_i),$$

where $Net\ MgContribution_i$ is the marginal contribution of each program after imposing a penalty for the budget size of the program, and w is the weight of that penalty. The case of $w = 0$ corresponds to the baseline case without considering any possible macroeconomic externalities. Figure 7 compares that baseline with the net marginal contributions with a weight of 0.25 for the size penalty. We see that some large programs, such as social security health insurance, *Moratoria* (a pension program for individuals who didn't have full contribution histories), and primary and secondary education, receive substantially more significant discounts than smaller programs such as AUH or train subsidies. For some weight parameter values, the ranking of the desirability of programs might change. In this example, after the penalty for budget size, the pension program moratoria and social security health insurance become less desirable than the conditional cash transfer program AUH.

Figure 7: Comparison of Marginal Contribution (w=0) to Net Marginal Contribution (w=0.25)



3.1.2. Towards incorporating intertemporal considerations into CEQ Assessments

Moving into possible ways of incorporating intertemporal factors in assessing intertemporal incidence, we provide a simple heuristic that builds from easily available data and takes us part of the way in incorporating these various channels.

We want to be able to assign values and rank different components of the fiscal vector by constructing an indicator that considers the growth channel, the redistribution channel, and the *transformation* channel. For instance, if data on income and age for spending component's i mean (or median) recipient is available, one could calculate an indicator that uses age of beneficiaries as a rough proxy of the intertemporal effects of the program, since, as we saw in section 2.3, earlier social investments are the most productive ones.

Consider, as an example, the following indicator of how desirable the program (in terms of the channels from spending in it to poverty reduction) is:

$$Indicator_i = \frac{\alpha \left(\frac{1}{\sqrt{\frac{Income_i}{\sigma_I}}} \right) + (1 - \alpha) \left(\frac{1}{\sqrt{\frac{Age_i}{\sigma_A}}} \right)}{(1 + r)}$$

where $Income_i$ is the average income of recipients of program i , and Age_i is the average age of recipients of program i .

This indicator incorporates the three channels in the following way:

- **The redistributive channel** enters via the square root of the inverse of income. Current income is the main target of income redistribution, so it sounds sensible that it makes its way into this objective function. The term is under a square root to give a relatively higher weight to those components that go to the relatively poorer recipients. σ_I standardizes $Income_i$ by the standard deviation of $Income_i$ across spending component.
- **The transformation channel** enters via the square root of the inverse of age. As discussed above, early childhood investments in human capital are the more productive ones, and this productivity falls relatively fast with age, therefore the square root. σ_A standardizes Age_i by the standard deviation of Age_i across spending components.
- **The growth channel** enters via the real interest rate at which the country can take debt, r . We can think of r as summarizing the macroeconomic environment and penalizing spending when the fiscal condition is fragile.¹⁹ This discount factor only makes sense when comparing between countries and not within a country.²⁰ See the previous subsection for a way of penalizing macro effects at the program level.

α is the weight the policymaker gives to the redistributive channel and $(1 - \alpha)$ to the transformation channel. $\alpha = 1$ would be the baseline incidence analysis without taking into consideration intertemporal effects.²¹

We implement this formula with the Argentine CEQ data. Pre-fiscal income is taken as $Income$. Since the methodology entails identifying the individual recipients of the different components,

¹⁹ The notion of fiscal space (Albrieu & Fanelli, 2019) would be more appropriate for this purpose but is somewhat more cumbersome and entails more assumptions.

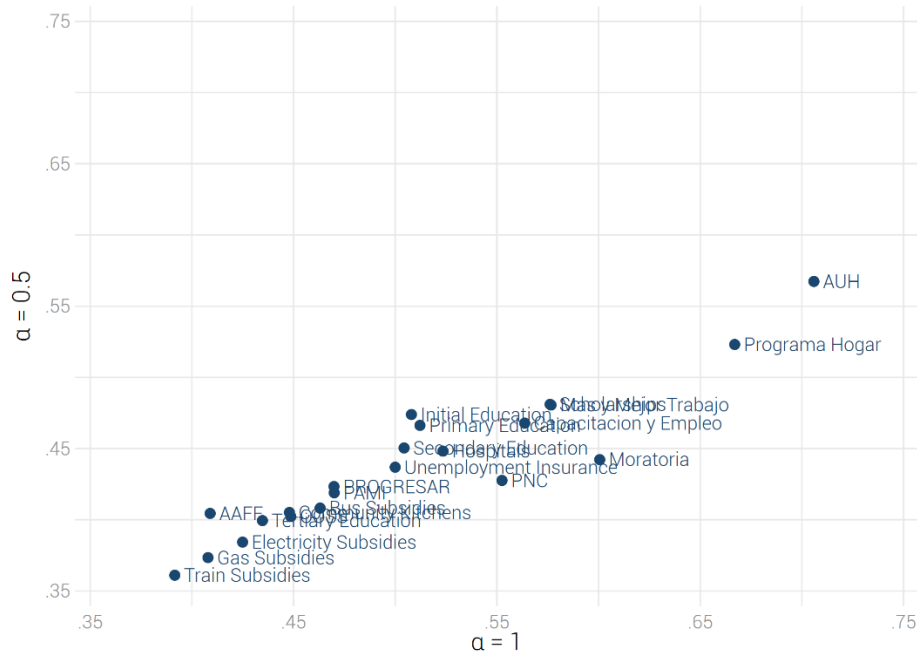
²⁰ For instance, for the case of Argentina we could “calibrate” r to 20% according to Yosovitch (2021), reflecting Argentina’s precarious macroeconomic situation.

²¹ One could think of an alternative specification that includes an interaction term between the

redistributive channel and the transformation channel: $Indicator_i = \frac{\left(\frac{1}{\sqrt{\frac{Income_i}{\sigma_I} \cdot \frac{Age_i}{\sigma_A}}} \right)}{(1+r)}$. In that specification, individuals who are both poorer and younger are weighted more.

we can also recover the age of component's i mean recipient. Figure 8 presents a comparison between the results for $\alpha = 0.5$ to the baseline CEQ case of $\alpha = 1$.

Figure 8: Comparison of program desirability with ($\alpha=0.5$) and without ($\alpha=1$) taking age of recipients into consideration



As expected, programs that focus largely on young children, such as Initial Education, move up in the ranks vis a vis some programs, such as Moratoria or Non-Contributory Pensions (PNC) which focus on the elderly.

3.2. A Fiscal Diagnostic Heuristic at the Country Level

In 3.1. we provided some heuristics on how to characterize each component of the fiscal vector within any given country, in order to define a sequence of reforms necessary to improve outcomes such as growth and poverty reduction. In this section we take a more aggregate, cross-country comparative perspective, in the spirit of the first macro step described above. For that purpose, we focus on three properties of the fiscal vector: (i) **size** (how large the State is), (ii) **distributiveness** (how effective is fiscal activity in redistributing income in an equalizing manner, and (iii) **efficiency** (how well does the State do, whatever it does). We measure these three concepts across countries and come up with a typology. The purpose of this typology is to

provide potential country teams with a guide on analytical and reform priorities, as a complement to the more detailed program by program analysis of the previous section.

Before proceeding with the typology, a few words about these three concepts and the variables used to capture them. The two traditional measures of government size are revenue and spending. We use data on general government total revenue as share of GDP from the World Economic Outlook (IMF, 2023) to capture size, since revenue is a more direct measure of the distortions introduced to the economy by fiscal policy. We measure redistribution as the percent reduction in the Gini index from the market income distribution (before any government intervention) to the disposable income distribution (after considering direct taxes and subsidies and contributions to and benefits from the contributory social insurance system), i.e., how much direct taxes and subsidies and the contributory pension system reduce inequality from the original income distribution. For countries in Latin America and the Caribbean, and some other developing countries, we rely on data from the Commitment to Equity Standard Indicators (CEQ, 2023; see a rich description and discussion of the methodology in Lustig, 2018), while data on redistribution in the OECD countries is retrieved from the Income Distribution Database (OECD, 2023).

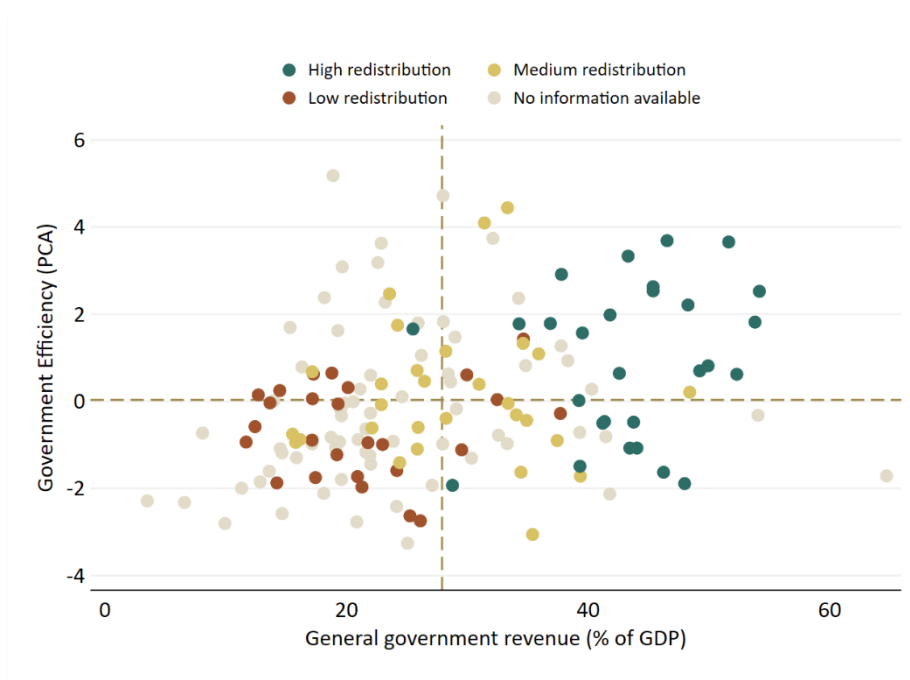
With regards to the concept of efficiency, for the purposes of providing a typology of country situations, we need to think about some aggregate country-level comparisons. Ideally, we would like to build from the bottom up, aggregating the individual transformational assessment of each budget item for each country into a country aggregate index. We discussed in 3.1 how to progress in that direction, but since we are far from there yet, we have to use a rougher approximation for the time being.²² As a proxy for government efficiency (and support for growth), we take the first principal component of four opinion-based indicators from the Global Competitiveness Report of the World Economic Forum: wastefulness of government spending, the burden of government regulations, quality of the education system, and quality of overall infrastructure. Together, these indicators aim to capture some sense of (the perception of) long-term efficiency, as they incorporate how well-executed public spending is, how well-designed regulations are, and how good the quality of the physical and social infrastructure provided by the government

²² Developing such indicators at the program level and aggregating them at the county level is an important part of the agenda ahead.

is. Therefore, this index attempts to capture how the government spends its resources and how much the government favors/hinders growth.²³

Based on these indicators for government size, redistribution, and efficiency, as an illustration, in Figure 9 we divide the resulting sample of 88 countries into twelve clusters using the mean value of government size and efficiency and the terciles of redistribution as the cut-off points. LAC countries are concentrated in the quarter of low-efficiency small governments and show some variation in their level of redistribution, while the OECD countries gather around high levels of efficiency, large government, and high redistribution.²⁴

Figure 9. Government Size, Redistribution, and Efficiency



Source: Guizzo, Scartascini, and Tommasi (2023).

In a more detailed characterization, available upon request, we have partitioned each variable in three levels: high, medium, and low, giving 27 types, as in a Rubik cube. We provide a brief typology focusing on the starkest types – that is, on the 8 corners of that Rubik cube. These 8 archetypes help us present the more general principles. Specific country cases will be a mix of these situations, which need to be analyzed at each country level.

²³ The main reason why we use these indicators has to do with coverage in terms of years and countries. Other potential variables do not capture well the concepts we are trying to capture or have lower coverage in either dimension.

²⁴ See Guizzo et al (2023) for more detailed description of the data and analysis.

It is worth highlighting that, in terms of optimality we believe that the best cell to be at is <medium, high, high>. We believe such a case would characterize a State that has the ability to tax its citizens but does not take it to the point where it crowds out the private sector or risks macroeconomic imbalances, while it also redistributes a fair amount towards the bottom of the socioeconomic distribution, and it does all of the above in a relatively efficient manner. Since such cases are very rare in our CEQ sample (and non-existent, for instance, in Latin America), we proceed to analyze the 8 extreme archetypes, and to discuss more general principles with the visual help of Table 2.

Table 2

Typology of cases

CASE	Size	Redistr	Effic	MAIN PROBLEM	PRIORITY FOR ACTION
1	Large	High	High	Spending too high Some macro risks	Macroeconomic prudence
2	Large	High	Low	Unsustainable macro Limited LT poverty reduction Missaligned incentives	Reallocate Budget Increase efficiency Reduce corruption
3	Large	Low	High	Universalistic spending which is not pro-poor enough	Focalize programs on the poor
4	Large	Low	Low	Much spending not pro-poor Rent- seeking state Missaligned incentives	Focalize programs on the poor Increase efficiency Reduce corruption
5	Small	High	High	Unlikely case	Might consider increasing taxes and providing moderate social insurance
6	Small	High	Low	Unlikely case	
7	Small	Low	High	Low taxation Little redistribution	Increase taxation Redistribute
8	Small	Low	Low	Low taxation Little redistribution Inefficient State	Tax the rich Build State capacity Social protection for the poor

Each of these cases will typify a different fiscal, distributive, and economic situation for countries. As mentioned, any particular real-world country might present some intermediate features, in which case the recipe will be more mixed, and it will require of a more detailed country diagnostic. Countries within each category will have some elements in common but also will vary in some specific details. For brevity, we provide a synthetic list of possible syndromes for each type of case. Our typology here should serve to orient country experts towards the malfunctionings which are more worrisome in each case, helping in that way identify which are the relevant binding constraints to economic and social progress. This will, in turn, lead to the main political economy constraints in each case.

Case number 1 <H,H,H> represents the situation of countries with large public sectors, high levels of redistribution, and a fairly efficient state.²⁵ Such situations might achieve the desired distributive objectives in the short term, but they might hide potential risks especially at the macroeconomic level. High levels of spending might imply an opportunity cost of public funds, they might leave little fiscal space to react to shocks and crisis situations and might even lead to potentially unsustainable macroeconomic paths. Country efforts should start by analyzing a number of macroeconomic indicators, such as, for instance, the 30 indicators in the cross-country database of fiscal space compiled by the World Bank (Kose et al 2022) and attempt to move the relevant indicators to prudent levels. (See also Valencia et al, 2022).

Countries in situations such as those of Case 2 <H,H,L>, with high levels of spending, adequate levels of redistribution and various types of inefficiencies, will face a number of challenges. These challenges might include potentially unsustainable macroeconomic stances, limited success in reducing poverty in the long term (that is, in raising families out of poverty), as well as some misaligned incentives in labor and other markets. Large, and possibly corrupt, bureaucracies will often also characterize these countries.

The specific configuration of Case 2 types of countries is a good point at which to raise some more general issues about this typology and how to move from here to country-level diagnostics. If your country is in a situation like that of Case 2, the generic advice is “budget reallocation.” But, leaving aside for now political feasibility considerations, further line-by-line analysis would be required. That would imply using the logic of fiscal vector at the program-by-program level described in section 3.1. Budget would need to be reallocated towards programs that are effective in redistributive terms at relatively low fiscal costs, and that are efficient. Previous sections discuss some possible simplified metrics of comparison, in order to establish a sequence of budget items which should be prioritized or not. For instance, programs that take a large fraction of the budget, but that do not effectively distribute towards the poor, and that have little to none long-term impact, will be candidates for reduction. This will clearly face political challenges, a topic to which we turn in the next section.

The next two cases consider situations of high government spending but low levels of redistribution. This possibly encompasses in 3 <H,L,H> countries in which States function relatively well, but that are in an equilibrium in which the type of government spending and redistribution undertaken is not so focused on the poor. This might include cases of fairly

²⁵ Even though the first column is more properly labeled Large and Small, we use the notation H and L (High and Low) to keep a binary logic consistent with the labels of the other two columns.

universal social policies. But once we move to the next row, Case 4 <H,L,L>, and have the combination of high spending, low redistribution and also low efficiency, we are probably looking at countries characterized by situations of rent-seeking states and/or specific forms of spending that redistribute towards some non-poor segments of the population. While in the case of the former one would need to focalize programs that benefit the poor, in the latter, further adjustments would be necessary, in order to increase efficiency and possibly reduce corruption.

Cases like 5 <L,H,H> will be countries with small but effective States, which have good focus on their redistributive policies. In such (probably rare) cases, the main suggestion would be to explore increasing taxes and providing some moderate levels of social insurance. It may also be unlikely to find a country with a small and inefficient state, that at the same time is effective in redistributive terms, as Case 6 <L,H,L> typifies.

Other configurations such as 7 <L,L,H> are more common, probably as the outcome (as it will be discussed below) of particular political-economy equilibria, with a rather cohesive elite that controls the State, avoids much taxation and redistribution, but in which the rather limited set of activities undertaken by the State are performed in an efficient manner.²⁶ Increasing taxation and redistribution might be the recommendation for such cases.

Countries falling into Case 8 represent a typical syndrome (common in the past and even today in Latin America) of low-taxation / low-redistribution equilibrium, with an inefficient and likely corrupt State. The recipe in that case would require taxing the rich, building State capacity, and providing social protection, especially for the poor.

4. A POLITICAL ECONOMY FRAMEWORK²⁷

Latin American countries can be characterized by a variety of different symptoms in terms of their social outcomes, fiscal structures, and politico-institutional functioning. Our objective in this section is to suggest a framework in which country situations could be characterized as political economy equilibria, leading to different configurations of the various fiscal outcomes of

²⁶ Many observers would have suggested Chile (at least until recently) as fitting that description, and indeed Chile falls in that cell in our typology.

²⁷ This section draws extensively from Guizzo, Scartascini and Tommasi (2023).

interest, characterized in the previous sections. Each of these configurations would relate to a particular political economy situation, which might be associated with some of the predominant syndromes of Latin American politics.

As in the logic of section 3.2. for Fiscal Diagnostics, here we provide elements of a framework to characterize political economy configurations at the country level. This work should be continued by specialized country teams, that having identified the reform priorities in each case, should look at the political economy constraints for each of those policies.²⁸

We saw in the previous section that different countries present different configurations of fiscal and socioeconomic outcomes. We believe that in order to explain such configurations we need to find a way to integrate various strands of literature that have addressed some of those outcomes in isolation. In Guizzo et al (2023), we review several such branches of political economy: the political economy of redistribution (or lack thereof), the political economy of redistribution and growth, the political economy of inefficiency, the political economy of intertemporal cooperation, and the political economy of agency. In this section we hint at a framework for putting some of those pieces together. Following Guizzo et al (2023), and drawing from those previous strands, the framework we are suggesting should incorporate the following features.

1. There are elements of conflict but also of commonality of interest among different social actors. In any society, there are many divisive issues, such as the distribution of income. But beyond distributional conflict, there are valence dimensions, that is, a common interest in things such as larger output, economic efficiency, effective public services, and a healthy macroeconomy.
2. Social actors do not decide and implement policies by themselves, but they do so through elected representatives.
3. There are formal institutions (federal arrangements, electoral rules, legislative procedures, judicial procedures) that regulate the access to and exercise of (*de jure*) political power.
4. Social groups do have *de facto* political power in addition to their *de jure* political power.
5. Elected representatives are not perfect agents of their constituents. There are political agency issues relating to outcomes such as corruption, patronage, clientelism, and other distortions connected to state inefficiencies and waste.
6. The political game takes place over time.

²⁸ Each policy has its own politics, and its own set of potential veto actors, such as the rich for some tax reforms, the elderly for some pension reforms, teacher unions for some education reforms, and the like.

7. Repeated interactions open the possibility of cooperation among different social and political actors.

In the rest of the section, we summarize an initial attempt, presented and analyzed in Scartascini and Tommasi (2023), that captures several elements of this logic in a simple model. In that model, there are two social groups: the rich and the poor. There is a very simple economy in which the rich decide on investment, and investment determines output (growth). After economic decisions are made, policy decisions are made in a simplified political system with two political parties, one representing the rich and the other representing the poor.

We assume that political parties solve the collective action within each social group to allow them to behave as unitary actors (“the rich” and “the poor”). Still, they do so at a cost, which we interpret as a political agency cost. The political party that is in power at any moment in time gets to decide a policy of taxation and redistribution, and also its own level of appropriation of output, i.e., of graft. The objective function of political representatives includes the welfare of its constituency as well as its own appropriation, with a trade-off parameter that captures the political agency distortion, that is, the tendency of politicians towards corruption or other uses of public funds not directly benefiting their underlying social constituency.

The political mechanism is such that in each period, with probability p , the party of the rich is in power, and with probability $(1 - p)$, the party of the poor is in power; and whoever is in power gets to decide policies. We interpret p , “the power of the rich”, to include the *de facto* power of the rich discussed by Acemoglu and Robinson (cite); as well as their additional *de jure* (institutional) power in a richer bargaining model with instruments such as legislative overrepresentation of certain districts, ballot restrictions and the like.²⁹ This stage game is repeated infinitely, and the players discount the future.

In Scartascini and Tommasi (2023), we solve the game, identifying the set of the parameter space for which cooperative equilibria can obtain, characterizing the solution for cooperative and non-cooperative equilibria, and providing comparative statics both within and across equilibria.

The intuition of some of these results can be summarized in Table 3, which shows the type of political economy equilibria and the resulting levels of investment and redistribution as a function of two characteristics of the political system: the distribution of power, and the extent to which political agency problems are well controlled. The first row represents those cases considered in the canonical Latin American case of elite domination and low redistribution. The

²⁹ It also might subsume the probability that the middle class allies with the rich in a model with a richer social and political structure (as in Lupu and Pontusson, 2011, or Iversen and Soskice, 2006).

level of investment and, hence, economic performance will depend on whether the party or State representing the rich is corrupt (*non-cooperative configuration 2*) or not (*non-cooperative configuration 1*). In the latter case, we will observe low redistribution with high investment; in the former, we will have low redistribution and low investment. The situation in which there is alternation (or balance) of power and politicians are not corrupt is the one in which the *cooperative equilibrium* with good economic performance and reasonable redistribution is more likely.³⁰ The bottom right corner of the table represents a situation in which a corrupt party, representing mainly the poor tends to dominate the political system. Such case, resembling left-wing populism in Latin America and the Caribbean, will generate high taxes and redistribution but inefficient policies and poor economic performance.

Table 3
Political Economy Equilibria as a function of characteristics of the Political System

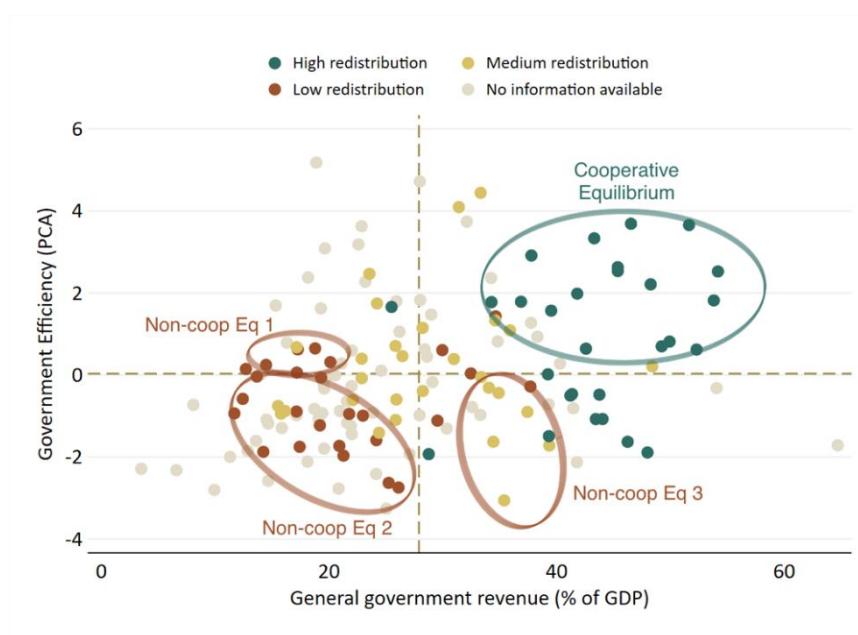
	Parties as Agents of Constituency	
Distribution of Power	GOOD	BAD
The Rich are very powerful	<i>Non-coop Eq 1</i> {high investment, low redistribution}	<i>Non-coop Eq 2</i> {low investment, low redistribution}
Balance / alternation	<i>Cooperative Equilibrium</i> {high investment, reasonable redistribution}	
“Left” Party dominant		<i>Non-coop Eq 3</i> {low investment, high redistribution}

To suggest that the logic proposed here is a good first step to explain the empirical patterns described earlier, Figure 10 fills in Figure 9, showing that: *non-cooperative configuration 1* corresponds to the North-West quadrant, including countries such as Chile, a country of good economic performance and low amounts of redistribution; *non-cooperative equilibrium 2* corresponds to the South-West quadrant, including countries such as Guatemala, a country of poor economic performance, a small and inefficient state, with little social spending and redistribution; *non-cooperative equilibrium 3* corresponds to the South-East quadrant, including

³⁰ This is the one that would correspond to the vector <medium, high, high> in the typology of section 3.

countries such as Argentina, a country of poor economic performance, a large and inefficient state, with abundant social spending and redistribution. The *cooperative equilibrium* corresponds to the North-East quadrant of Figures 9 and 10, representing the typical Northern European society characterized by a large and efficient state, high productivity, and a reasonably redistributive welfare state. Unfortunately, none of the Latin American cases at this point seems to fit that case.

Figure 10. Set of Political Economy Equilibria



Source: Guizzo, Scartascini, and Tommasi (2023).

5. CONCLUSIONS AND EXTENSIONS

Latin American countries in the 2020's face many economic and social challenges, including low growth, low investment levels, low productivity, as well as high levels of poverty and inequality. Rising international interest rates might induce capital outflows and debt sustainability problems. A "reform agenda" discussion is on the table once again. This note provides some elements to think about a political economy of reform for Latin American countries in the 2020s.

We suggested a framework in which (a) vectors of public policies have effects on vectors of relevant social outcomes, and (b) political economy arguments explain extant policy vectors and potential obstacles to reform. As a step towards that broader framework, in this note we

use fiscal vectors as primary anchor of analysis. In order to provide some guidance and general principles for a country-focused research agenda, we provide elements for: (A) a fiscal diagnostic framework of what the main problems are and what priorities should be, and (B) a political economy framework to identify the main constraints in each case. The logic in each case operates at two levels of aggregation, across countries, and within country across budget items (public programs).

The initial steps undertaken in this paper need to be complemented in both the empirical and the theoretical front. In terms of the characterization of the fiscal vector, measuring size is relatively straightforward, but the other two concepts are much more multifaceted and harder to grasp conceptually and in terms of data availability.

Regarding the redistribution data, the CEQ methodology provides the most comprehensive analysis of how taxes and social spending affect income inequality and poverty in a country, in a way that is comparable across countries. The problem is that CEQ assessments have only been produced for some countries for some years. On the other hand, the CEQ data is also more granular and complete in terms of the steps of fiscal redistribution (the way to compute the incidence of indirect taxes and spending, spending on education, health, pensions, and the like) than other data sets with wider coverage. In this note and in Guizzo et al (2023), we have juggled between quality and completeness of the analysis on the one hand, and coverage on the other. We chose an intermediate path, but that left us with a particular set of countries and years and with a concept of redistribution that tends to underestimate the degree of redistribution in developing lower-redistribution countries, which tend to do more through in-kind spending and less through direct taxes and transfers. While waiting for more CEQ assessments, future analyses should explore alternative ways of dealing with those methodological trade-offs.

There are even more difficulties with regards to the efficiency data, where no equivalent of CEQ efforts of such depth and amplitude are available. The lack of harmonized objective measures led us to prioritize subjective over objective proxies with limited country-year coverage. On the one hand, extending the country-year coverage of useful efforts such as IADB (2005) or Izquierdo et al (2018) would be very valuable. On the other, focusing on the inequality and poverty concerns of LACIR initiative, it would be crucial to develop adequate metrics of the intertemporal incidence (or to put it more directly, of the long-term impact on poverty reduction) of public interventions. Doing that presents formidable methodological and data challenges, which are discussed in Tommasi (2021) and World Bank (2022). The most comprehensive analysis of that sort for one country is provided in Hendren and Sprung-Keyser (2020), who use the marginal value of public funds (MVPF) and build from evidence on policies' impacts and costs available

for the 133 main social policy changes in U.S. history. Finding a short-cut to move in that direction within current international availability of data and of previous impact and cost-benefit analyses would be of essence.³¹

Regarding the political economy analysis, the model in Scartascini and Tommasi (2023) summarized in section 4, provides an initial step in terms of the framework we suggest. That simple model provides a prototype, which should be extended to address several of the issues we want to discuss in this agenda.

Part of the results of the model are driven by whether social actors cooperate among themselves or not. It would be interesting to explore such cooperation more directly, perhaps by looking at the degree of trust (i.e., positive beliefs about other social groups) using evidence of the sort explored in Keefer and Scartascini (2022). Such data, regarding trust in government officials could be also used to explore the agency microfoundations of the logic: to what extent different social groups trust their representatives.

Relatedly, in Scartascini and Tommasi (2023) the political rules of the game are characterized very starkly by just two parameters, the probability of the representatives of each group being in power, and the degree of agency distortion. We need to open that black box by modelling some explicit political decision-making procedures which could be related to more realistic *de jure* institutions such as forms of government, electoral systems, legislative rules, characteristics of party systems and the like. Similarly, the additional *de facto* power of business elites (and the way that interacts with *de jure* institutions), should be analyzed in a cross-country comparative perspective.

Another natural set of extensions would be moving from the comparative statics analysis of countries in different equilibria to the comparative dynamics of countries that seem to be moving towards different equilibria. For instance, are Latin American and Caribbean countries condemned to jump from exclusionary to populist polities? How can we attempt to build more inclusionary, yet more efficient, States?

³¹ Tommasi (2021) provides some tentative suggestions for that endeavor. For instance, given that a large modern literature suggests, and Hendren and Sprung-Keyser (2020) confirm for the U.S., that social spending on children has much higher social rates of return than spending on adults and on seniors, adequately weighting the age composition of spending in CEQ assessments would constitute one step in the right direction.

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