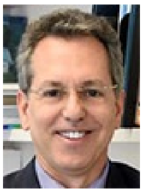
Latin America and the Caribbean needs to do more with less and set its sights on the future



Growing national income in Latin America and the Caribbean is feeding demands for more and better government services. But after raising expenditure during the years of the commodity boom, many governments now face less favourable external conditions and need to adjust. These external headwinds mean there is more pressure to look for domestic sources of growth. As LSE prepares to host the **2018 Annual LSE-IDB Conference on Latin America and the Caribbean** *(**register here**) on 1 November 2018,* the *Inter-American Development Bank's Chief Economist* **Alejandro Izquierdo** *looks at what can be done to make ends meet.*

The central argument of the Inter-American Development Bank's new flagship report *Better Spending for Better Lives* is that the key to solving the fiscal conundrum facing Latin America and the Caribbean lies in doing more with less, and in reallocating spending without shortchanging the future.

Governments are aiming to keep growth up despite external headwinds (detail of Gerardo Pesantez/World Bank, CC BY-NC-ND 2.0)

Nothing indicates the region can't make that leap. But governments will have to carry out much needed reforms that ensure smarter and more efficient spending while explaining their actions to their citizens. Greater efficiency would have many benefits. Among other things, it could create a virtuous circle by convincing citizens that they can trust their governments to invest their taxes well over the long haul rather than squandering them in waste and corruption.

More capital spending needed

One of the big losers when it comes to public expenditure has been capital spending, a key ingredient for growth. Much of the increase in public expenditure during the years of the commodity boom went towards current expenditure, not capital expenditure.

Moreover, in times of fiscal consolidation, the brunt of adjustment went into capital expenditure cuts, even though capital expenditure's impact on output – it's multiplier effect – is much greater than that of current expenditure. Private investment, another key driver of growth, is also affected, as private investors are loath to sink their money into places with low capital spending where they may find inferior roads and ports.

This problem of expenditure allocation becomes evident when looking at the numbers: between 1980 and 2018, current spending per capita in Latin America and the Caribbean rose by 72 per cent – an increase in line with the rest of the world. But capital expenditure per capita in real terms remained stagnant. Indeed, as a share of overall spending, it declined significantly – more than that of any other developed or developing area of the world.

Investing in children and the future

Another way not to shortchange the future is by investing in children, the cornerstone of human capital accumulation and growth. Yet, when examining how much the region spends on children vis-à-vis the elderly, some startling figures emerge: on average, the region spends $4,000 dollars on each pensioner but only $1,000 on each child. This calls for a better balance in how the region spends on the present versus the future.

"Investing in children is the cornerstone of human capital accumulation and growth" (Colores Mari, CC BY-SA 2.0)

If adjustment is needed, there are various sources of inefficiency that can be tackled for substantial savings. This is where "doing more with less" comes into play.

Taking three key components of public expenditure, namely the wage bill, transfers, and public procurement, our report finds that, on average, the region could save as much as 4.4 per cent of GDP if those expenditures were made efficiently.

Wage differentials between the public and private sector – particularly for low-skilled workers – are on average close to 25 per cent, meaning that a worker in the public sector earns one quarter more than his or her counterpart in the private sector.

Moreover, several transfers – including cash transfers and non-contributory pensions which in principle should go to the poor – end up in the hands of those who are not poor. These leakages should be avoided. Yet another issue is that of public procurement: as much as 17 per cent of acquisitions could be the result of either improper pricing or corruption. With this type of performance, it is no surprise that citizens have little trust in government.

Yet our report goes further, by analysing what type of expenditure citizens demand when trust in government is low. A key finding is that with little trust, citizens prefer transfers over more profitable long-term expenditures like education or infrastructure that may or may not materialise. In this sense, the old saying "a bird in the hand is worth two in the bush" largely applies.

The importance of democratic institutions in this effort is crucial. Most people in the region live in well-established democracies. But legislative institutions tend to be weak, providing few incentives for members of congress to build a career. This leads to an inability to think long-term and forge inter-temporal negotiations that can be key to supporting long-term expenditures.

Thus, both on the demand and the supply side of expenditure, transfers win over human and physical capital accumulation. Put another way, the present wins over the future.

Greater efficiency to break a vicious cycle

Greater efficiency in spending is the only way to break this vicious cycle. Governments need to be able to do more, but with less or the same amount of resources. They must show that they can deliver better services, and, in the process, earn trust in their ability to make long-term investments that will improve citizen welfare.

This will require changes, ranging from new fiscal rules that protect capital investment to transformations in political institutions that favour long-term progress over short-term interests. It may also involve creating mechanisms to allow citizens to better monitor government spending.

Ultimately, there are no alternatives. If Latin America and the Caribbean is to break out of its productivity slump and achieve the standards of living of more developed countries, it needs to do more with less, increase capital spending, and set its sights on the future.

• *Sign up for the 2018 Annual LSE-IDB Conference on Latin America and the Caribbean on 1 November 2018*

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• *The views expressed here are of the authors and do not reflect the position of the Centre or of the LSE*
• *This article is a slightly modified version of a post that first appeared on the IDB Ideas Matter blog*
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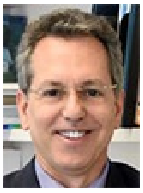

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Alejandro Izquierdo is the interim Chief Economist and Manager of the Research Department of the Inter-American Development Bank (IDB). He previously held positions as Principal Technical Leader, Regional Economic Advisor for Mexico and Central America, and Principal Economist across the IDB. Alejandro spearheaded the IDB's Annual Macroeconomic Report for several years and is currently co-director of the Columbia University-IDB executive program on international financial issues in emerging markets. He has also led IDB's flagship product, the Development in the Americas, on issues such as credit and public expenditure in Latin America. Before his career at the IDB, Alejandro worked at the World Bank in the Department of Economic Policy, and taught courses on macroeconomics and international finance at several Latin American universities. He has several publications in professional journals and edited volumes. He holds a Ph.D. in Economics from the University of Maryland, an M.S. from Instituto Torcuato Di Tella, Argentina, and a B.A. in Economics from Universidad de Buenos Aires, Argentina.