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Fiscal Policy in Argentina, Brazil, and Mexico and the 2030 Agenda for Sustainable Development

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ABSTRACT

Fiscal policy is useful as a government instrument for supporting the economy, contributing to an increase in employment, and reducing inequality through more egalitarian income distribution. Over the past 30 years, developing countries have failed to increase their real wages due to the lack of domestic value-added in the era of globalization, where global supply chains are the driving factor for attracting foreign direct investment. Under such circumstances, the role of fiscal policy has become an important factor in creating the necessary conditions for boosting the economy. With the end of commodity-export-led growth, Mexico experienced a moderate reduction of 5 percent in poverty between 2014 and 2018 due to the structural adjustment of social policies and its economic and trade relationship with the United States; during the same period there has been no change in poverty in Argentina, and Brazil has suffered a rise in poverty. Following the global financial crisis, greater attention has been paid to fiscal policy in developed and developing countries—specifically Argentina, Brazil, and Mexico (ABM)—in order to attain macroeconomic stability. One of the consequences of the financial crisis is rising income inequality and its negative effects on economic growth. Over the past decade, fiscal policy has been adopted for the economic recovery. However, the recovery has been accompanied by a decrease in real wages of the middle class. The purpose of the present research is to critically examine the results of fiscal policy in ABM and the United Nations' 2030 Agenda for Sustainable Development.

KEYWORDS: Wages; Inequality; Productivity; Full Employment; Sustainability; Government Policy

JEL CLASSIFICATIONS: E24; D63; J21; Q56; I38

INTRODUCTION

The importance of studying inequality within countries (using measures such as the Gini index), more specifically in Latin American countries such as Argentina, Brazil, and Mexico (ABM), is largely due to its correlation with income distribution and how it limits economic growth. It should be mentioned that one of the effects of globalization in those countries was the shift from the import substitution model (prevalent in 1960s and 70s) to the export substitution model. The import substitution model was an economic development policy (especially in Latin America) based on trade protection and industrial policy to stimulate exports. According to Kregel (2008), Latin America also experienced "economic miracles" of extremely rapid growth under these policies. For the 21 years from 1950 to 1970, the eight major Latin American countries (Argentina, Brazil, Chile, Colombia, Mexico, Peru, Uruguay, and Venezuela) grew at an annual average rate in excess of 5.25 percent with per capita incomes growing at over 2.36 percent. In Brazil, the increase in per capita income was over 3 percent.

However, commodity-intensive exports are no longer the key factor leading economic growth. In addition, Kregel (2019) noted that most countries have failed to enjoy a rise in value-added from participation in international trade and, as there is little beneficial impact on domestic income growth, this has led to the widening inequality between developed and developing countries. Like many countries, inequality was present in the aforementioned countries even at time of their golden ages. Although significant progress has been made over the past 15 years, Latin America and the Caribbean remains the most unequal region in the world, ahead of sub-Saharan Africa (the second-most unequal region), and features an average Gini index almost a third higher than that of Europe and Central Asia (ECLAC 2018). In this paper, the role of fiscal policy is considered as a key policy instrument for reducing inequality in ABM in the United Nation's (UN 2015) 2030 Agenda for Sustainable Development,[1] allowing us to first question mainstream economic logic and its effectiveness in terms of income distribution, and then to explore how "functional finance" can be used as a principal instrument to create full employment and thus a more equal income distribution.

[1] The Agenda is an update to the UN's Sustainable Development Goals (SDG). It was adopted by the UN General Assembly on September 25, 2015 as plan of action for the people.

A key component of the tenth goal of the 2030 Agenda for the Sustainable Development is to adopt policies—especially fiscal, wage, and social protection policies—to progressively achieve greater equality (UN 2015). However, ABM are more concerned about public debt, tax evasion, and government expenditure than poverty reduction. Over the past years, restrictive fiscal policy known as "fiscal consolidation" in ABM to reduce the government deficits and debt accumulation. Empirical evidence shows a "consolidation preference" instead of "functional finance" (Lerner 1943). As a result, the region's fiscal consolidation efforts have shrunk the public expenditure's contribution to growth and capital spending in Latin America fell from 3.6 percent of GDP in 2017 to 3.2 percent of GDP in 2018 (ECLAC 2019).

SOME THEORETICAL APPROACHES TO FISCAL POLICY

During the last two decades fiscal policy has risen in prominence as a tool in world economies, playing an important role in the nature of economic phenomena, and thus the need to use dynamic fiscal policy as a redistributive instrument, not only to reduce inequality, but also to facilitate economic growth. Due of its positive dimension in reducing poverty, many researchers share this vision, in particular that fiscal policy represents a crucial point in the economy as a whole. In this regard, Lerner (1943) suggested that government could use what he called "functional finance," that is fiscal policy as a tool for maintaining prosperity, he argued:

> The central idea is that government fiscal policy—its spending and taxing, its borrowing and repayment of loans, its issue of new money and its withdrawal of money—shall all be undertaken with an eye only to the results of these actions on the economy and not to any established traditional doctrine about what is sound or unsound. This principle of judging only by effects has been applied in many other fields of human activity, where it is known as the method of science as opposed to scholasticism. The principle of judging fiscal measures by the way they work or function in the economy we may call Functional Finance. (Lerner 1943)

What is most important about Lerner's contribution is that he formulated some laws to support functional finance. The first law states that government should merely concentrate on keeping the total rate of spending at an appropriate level to prevent inflation and unemployment. The second law indicates a use for contractionary fiscal policy in which Lerner does not deny the

effects of government borrowing, but only if it is desirable that the public should have less money and more government bonds in order to reduce inflation by increasing the interest rate.

Mott and Slattery (1994, 392) sound much like Lerner on the principles of functional finance. They noted that: “post-Keynesian/Kaleckian tax incidence theory […] takes into account the effect of taxes on spending out of different types of income, which affects output, employment, and income distribution in ways that determine ultimate incidence effects. What neither of these two approaches has done is to join macroeconomic concerns about changes in the levels of output and employment with the microeconomic concerns of how individual economic agents respond to taxes.”

In addition, recent studies question the effectiveness of monetary policy and have shown that during the last several decades, monetary policy in ABM mainly has focused on setting the interest rate and controlling inflation. Arestis and Sawer (2003) noted that the shifts in aggregate demand (arising from shifts in confidence and world demand) cannot be readily offset by monetary policy. Fiscal policy, however, remains a potent tool for offsetting major changes in the level of aggregate demand.

Following Lerner’s functional finance, a similar proposal has also been developed in 2019 by the Global Competitiveness Report: “As monetary policies begin to run out of steam, it is crucial for economies to rely on fiscal policy, structural reforms and public incentives to allocate more resources towards the full range of factors of productivity to fully leverage the new opportunities provided by the Fourth Industrial Revolution.”

What is important to note is that government uses fiscal policy as a potent tool in time of economic weakness, but most of the time they apply what Hannsgen and Papadimitriou (2012) called a “fiscal trap,” which they describe as “a self-imposed spiral of economic contraction resulting from a fundamental misunderstanding of the role and function of fiscal policy in times of economic weakness.”

For example, Kregel (2010) presents a view of “fiscal responsibility” in a sense to channel the private vices into public virtues, at the same time he answers the question to whom should the government be responsible in the design of its tax and expenditure policy, mentioning that: “The idea is that government should be responsible to the needs and desires of its citizens, but that this should go beyond physical security and education, to economic security […]. Here the government can intervene to make private vices into public virtue by encouraging prodigality when the private sector desires to be frugal. Government prodigality is the equivalent of supporting public virtue! This is the fiscal policy of a responsible government, responsible to ensure that private sector decisions can be achieved rather thwarted by the law of unintended consequences.”

KEYNES, INCOME DISTRIBUTION, AND AGGREGATE DEMAND

Unlike Marx, Keynes thinks that income distribution can be controlled through state power over aggregate demand and sufficient purchasing power, and that the beast (i.e., the capitalist system) is susceptible to taming (Keynes 1936).

Following Epstein’s (2009) interpretation of Keynes “capitalism is a good idea, but without adequate control it can have destructive consequences for society, as much for owners of capital as for consumers […] capital controls and government control over important aspects of social investment, could tame capitalism, even bringing about the euthanasia of the rentier.”

Thus, fiscal policy is one way the government can achieve greater equality, social public needs and provide for a more distribution of income.

According to Keynes, the market economy cannot stabilize on its own. This categorically rejects the classical economists’ idea of the invisible hand, because for them wage reduction should incentivize the holders of the means of production to invest more, creating sources of work. Keynes disagrees with the conventional wisdom that it is pessimism and the lack of “animal spirits” that impedes the smooth functioning of the economy in general.

Keynes explains that income distribution happens mainly through aggregate demand. When government spending and investment is reduced during a recession, demand declines and unemployment increases in a vicious circle. At this point, the question would be how can confidence be restored when companies do not invest and unemployment increases?

Government expenditures in periods of depression can boost consumption and investment, having a positive effect on the economy, which Keynes (1936) calls a “multiplier effect.” In this case, the logic of the multiplier effect can be summarized as follows: “If the proportion to be consumed in several hypothetical circumstances is known and we conceive that monetary authorities or other policies (such as the fiscal) take measures to stimulate or delay investment, the change in the amount of employment will be a function of the net change in the volume of investment.” That is, a growth in government spending immediately translates into an increase in tax revenues and income distribution.

The Keynesian contribution to economics has never been as relevant as it is today. After applying this theory, which helped the economy emerge from the crisis of the 1930s, great threats to the economy continue to be witnessed in phenomena such as international crises, bank failures, and economic stagnation, bringing with them increased unemployment. All these disequilibria directly affect income distribution.

According to King (2015), within the post-Keynesian school, Kalecki can be seen as the economist who has most emphasized the issue of income distribution through his theory of investment. The distinction between workers and capitalists is very important in Kalecki’s theory, because capitalist spending (investment) is the key to the business cycle in the sense that the rate of investment represents the significant variation in economic activity. In this way, Kalecki notes a clear difference between the saving propensities of capitalists and workers. In other words, “workers spend what they get; capitalists get what they spend” (Kalecki 1971).

In this context, one can see income distribution’s significance to the overall economy. If workers spend what they earn, it is essential that they have enough income to allow them to increase aggregate demand and thus generate a better rate of profit for the investor.

KALECKIAN APPROACH AND GOVERNMENT INVESTMENT

Consequently, Kalecki's theory of investment is one of the most relevant contributions in the Keynesian and post-Keynesian school of thought regarding income distribution. For Kalecki, variable investment has the capacity not only to increase employment and aggregate demand, but also would result in an increase in income distribution in favor of the working class. In this respect, his theory adequately explains how investment helps to achieve effective demand. Using this approach, it must be said that Kalecki categorically rejected Say's contribution, which said that supply generates demand (Hein 2015).

In addition, when there is not enough investment to stimulate demand, entrepreneurs would have difficulty selling products at predetermined prices. Therefore, there would be a decrease in the economy's productive capacity because aggregate supply will be higher than aggregate demand.

For Kalecki, in an open economy system, gross domestic product (GDP) is equal to: $C + I + G + S$, where I is gross investment, C is consumption, G is government spending, and S is the surplus of international trade. Here, Kalecki (1954, 50) points out that "investment must be understood as private investment, since public investment is incorporated into government spending."

According to Kalecki, the most important variable in this equation is investment, because gross profit after taxes is equal to gross investment plus consumption by capitalists. In turn, consumption depends to a large extent on investments made by the government. From this perspective, he concludes that "once investment has been made, it automatically provides the savings necessary for financing it" (Kalecki 1954, 50).

Moreover, purchasing power in developing countries is regularly centered on a small social group. Thus, an increase in demand can hardly be expected without a government intervention through fiscal and/or social policies. Because of this, an increase in investment will have a positive effect on employment and wages and will also increase the use of existing capital.

In addition, in trying to compare the two types of investment, studies have been developed that show investment in public infrastructure is more important than any private investment, that is, the latter depends on the former. In this regard, Aschauer (1990, 3) mentions that, "investment in public infrastructure is a higher economic priority than private investment. The repayment of GDP growth for one additional dollar of public capital is estimated to be higher than that of private investment by a factor of between two and five."

In other words, public investment not only provides services to the private sector (e.g., airports, roads, transportation systems, among others) or tools that are necessary for the realization of the production process and capital goods of private businesses, it also increases effective demand so that entrepreneurs can increase their profits.

The picture becomes even more encouraging if the time variable is added to the effect that investment has on economic growth with respect to the determinant of profits. As a consequence of the above, Kalecki (1954, 53) explains why real present profits depend on both present and past investments: "If we consider that workers do not save, profits will be a function of current investment as well as of investment in the near past, or roughly, profits follow investment after a certain period."

At this point, the most important thing is to understand this argument from right to left, which means that if profits at a given time (t) depend on the investments at time (t) and (t – 1), we can deduce that investments at time (t) determine profits at time (t) and (t + 1). That is, investments have an intertemporal effect on the economy, where t is the present, t – 1 is the past, and t + 1 is the future.

According to Kalecki, one can only tame the beast to some extent, as there is a level of unemployment (low) that induces a capital/investment strike.

Unlike Keynesian fundamentalists, in the Kaleckian macroeconomic model, income distribution between capital and labor plays a predominant role. Income distribution depends on the degree of monopoly in the market for oligopoly products. Moreover, workers' salaries occupy a very

insignificant place in business profits. For this reason, there is insufficient consumption expenditure to maintain full employment in the labor market.

Again, the investment factor can break this cycle by means of its multiplier effect on other economic variables.

INCOME DISTRIBUTION AND FISCAL POLICY IN ARGENTINA, BRAZIL, AND MEXICO

Latin America countries are well-known for having commodity-export-based economies. With the changing of the trade structure (from import substitution policies to export-oriented industrialization), most Latin American countries have experienced moderate GDP growth during the past two decades. They have, however, failed to enjoy a rise in value-added from participation in international trade and, as there is little beneficial impact on domestic income growth, this has led to the widening inequality between developed and developing countries (Kregel 2019).

The importance of studying income distribution is largely due to its correlation with inequality and how it limits economic growth. In addition, it should be mentioned that unequal income distribution could reduce the drive to invest, thus generating long-term political instability. According to the UN's Economic Commission for Latin America and Caribbean (ECLAC 2019), the significant gains in improving income distribution are linked to two main factors—income growth to the lower-resource deciles thanks to increases in labor income and public transfers under social protection systems—hence the relevance of fiscal policy serving as a redistributive factor not only to reduce inequality, but also to facilitate economic growth. In this regard, Murphy, Schleifer, and Vishny (1989) mention: "In the first stage of the industrialization of a country there must be sufficient wealth (income) available to help industries cover their fixed costs. On the other hand, income must be distributed in a sufficiently broad way to generate strong demand from a wide range of manufactured goods. Therefore, at least at this stage of

development, redistribution can have a positive effect on economic growth when it helps create an economically significant middle class."

The income distribution in Latin American countries has been exacerbated by the ending of the commodity export boom. The recent "Social Panorama of Latin America" report (ECLAC 2018) notes that the Gini coefficient averages 0.466 for Latin America as a whole. In the 15 countries with data for 2016 or 2017, it ranges from over 0.5 in Brazil, Colombia, Mexico, and Panama to below 0.4 in Argentina, El Salvador, and Uruguay. It is important to remember that in the 1990s the major concern of all them was to increase their real wages through international trade and globalization. As time went by, world trade grew faster than GDP and the result was not up to expectations. It is important to mention that between 1990 and 2018, the value of export goods and services as a share of GDP increased from 19.336 percent to 30.055 percent (World Bank 2020). How this could have happened? As was mentioned earlier, when the domestic value-added is taken into account, most Latin America countries failed in terms of maximizing profit. All of this took place without any functional finance and monetary policy. At best, economists recognize that insufficient investments in productive factors and insufficient proactive national policies represent an important reason behind subdued productivity growth. China is a notable exception—public investments have doubled there since 1970 but are still far from the levels achieved by advanced economies during their "golden age" (GCR 2019).

To analyze the evolution of current fiscal situation in ABM, it is important to look at the UN's 2030 Agenda for Sustainable Development and the International Monetary Fund's World Economic Outlook (WEO). The Agenda for Sustainable Development mentions that all countries must adopt policies related to fiscal operation, wages, and social protections, and progressively achieve greater equality (UN 2015). This is particularly important in emerging economies such as ABM. In addition, the same phenomenon is highlighted by the 2019 WEO: "Fiscal policy should balance multiple objectives: smoothing demand as needed, protecting the vulnerable, bolstering growth potential with spending that supports structural reforms, and ensuring sustainable public finances over the medium term. If growth weakens relative to the baseline, macroeconomic policies will need to turn more accommodative, depending on country

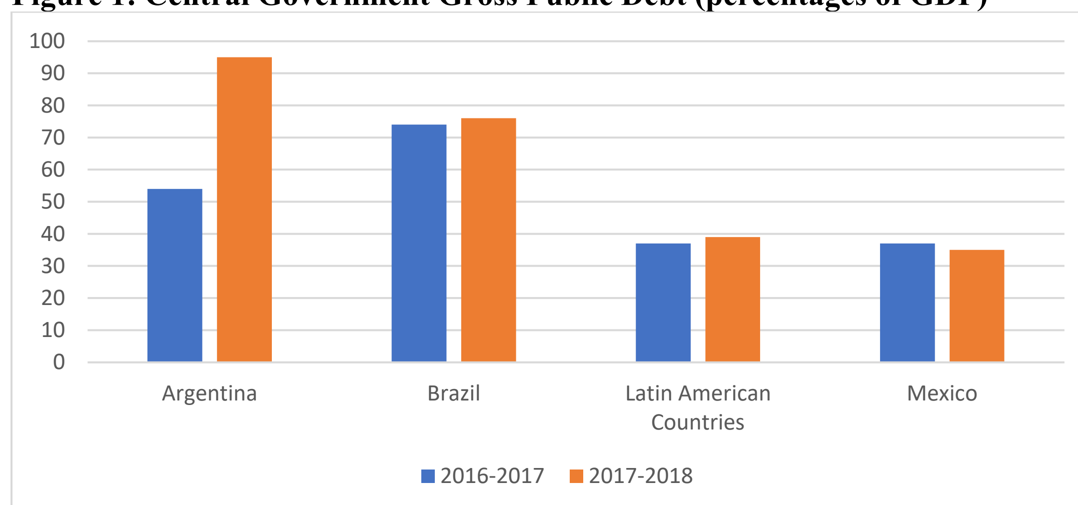
circumstances. Priorities across all economies are to enhance inclusion, strengthen resilience, and address constraints on potential output growth."

However, in the past ABM applied fiscal consolidation[2] in order to reduce deficits or stabilize debts, following research that spending-driven adjustments are more likely to stabilize debt vis-à-vis revenue-driven ones. Nevertheless, for most Latin America countries in general, and specifically for ABM, the benefits of this strategy have been meager. Based on ECLAC (2018, 2019) data, the primary deficit fell on average from 1.9 percent of GDP in 2016 to 1.5 percent of GDP in 2017, while the primary balance improved from a deficit of 0.2 percent of GDP in 2016 to a surplus of 0.1 percent of GDP in 2017. In addition to that, debt accumulation grew, reaching 42.3 percent of GDP in 2018 compared with 39.4 percent the previous year.

As can be seen in figure 1, Argentina's fiscal situation in term of gross central government public debt is noteworthy in comparison to that of Brazil and Mexico, as debt levels increased by more than 38 percentage points of GDP, with gross public debt growing from 54 percent of GDP in 2017 to 94.5 percent of GDP in 2018. More importantly, Brazil and Argentina have the highest interest on public debt service in the region, 5.6 percent and 3.9 percent of the GDP, respectively. On the other hand, the average of interest payment for the rest of the Latin American countries (including Mexico) is 2.5 percent of the GDP.

[2] Fiscal rules are, in general, associated with fiscal consolidation episodes that are successful in stabilizing debt, though there is no evidence that they influence the size or the intensity of consolidation. Budget balance rules appear to lengthen the duration of consolidations (OECD 2012).

Figure 1: Central Government Gross Public Debt (percentages of GDP)



Source: ECLAC (2019**)**

Another factor we need to bear in mind, which complicates the interest payment on gross public debt, is that most Latin American countries service public debt in their local currency (69 percent) and the US dollar (26 percent). By saying that, the international financial environment is vital for the repayment and interest burden on loans. As Kregel notes concerning Minsky's hypothesis in term of Ponzi units[3] in an international context to the sovereign regarding a Bretton Woods System for developing-country borrowers:

> The basic philosophy behind this approach was that a commitment to a fixed exchange rate was identical to the commitment to pay in a timely fashion included in any financial contract so that devaluation was equivalent to a partial default on debt service to non-resident holders of domestic assets. The system was organized on the presumption that on average, over time, countries applying appropriate monetary and fiscal policies to preserve price stability would have a balanced external position and would always be able eventually to meet their financial commitments in terms of foreign currency at their declared par rate. Bretton Woods was a system organized for a world of more or less similar industrialized countries living in a world where "hedge finance" predominated as the norm with individual countries occasionally falling into speculative mode due to an unforeseen internal. (Kregel 2004)

Under these conditions, Minsky's (1992) theory of Ponzi finance can be used to explain the situation in ABM, where fiscal revenues are insufficient to both meet their payment

[3] The concept of Ponzi units is used to indicate when the cash flows from operations are not sufficient to fulfill either the repayment of principal or the interest due on outstanding debts by theirs cash flows from operations (Minsky 1992)

commitments and to achieve the 2030 Agenda for Sustainable Development. The result is a crisis by increasing the rate of tax revenue or convincing international institutions to increase the existing loan.

On the tax side, fiscal revenue has always been a handicap for Latin American countries. Throughout the past 30 years, tax revenue as a percentage of GDP continued to be their Achilles heel compared to other Organisation for Economic Cooperation and Development (OECD) countries. Tax policy is considered as a tool to boost the economy; in this regard, post-Keynesian and Kaleckian analysis can be used to analyze the plausibility of fiscal policy based on tax incidence. As Sawyer's interpretation of Kalecki noted, in post-Keynesian/Kaleckian tax incidence theory: "Kalecki recognized that the achievement of full employment by redistribution through the tax system was more egalitarian than achieving that objective through budget deficits. But precisely for this reason, 'full employment through taxation' is likely to encounter a much stronger opposition that a 'budget deficit policy.' One cannot, therefore, make any definite choice between the budget deficit and income tax method" (Sawyer 1985).

Of note, since the total revenue percentage of GDP is very low in ABM countries (Mexico from 16.9 percent of GDP in 2017 to 16.4 percent in 2018, and Brazil and Argentina unchanged at 18.1 percent of GDP for the same period). As part of a broader strategy, Latin American countries in general, and specifically ABM, have increased "corrective" taxes on products such as tobacco and other products considered unhealthy in order to support the 2030 Agenda for Sustainable Development. The main objective of this policy is to: "(i) discourage and reduce the consumption of products that are harmful to health; (ii) decrease the fiscal cost associated with programmes to deal with non-communicable diseases; and (iii) make use of the tax revenues obtained from their application to finance public policies that are consistent with sustainable development" (ECLAC 2019).

The basic philosophy behind this approach is that government could have additional financial resources by expanding taxation beyond traditional tax policy in order to reduce the consumption of some products that are detrimental to social well-being. Nevertheless, these taxes are not a significant portion of the overall tax take. For example, in 2016, the "selective tax on tobacco"

reached 0.19 percent of GDP in Mexico, 0.52 percent in Argentina, and 0.09 percent in Brazil. The taxation of alcohol followed the same trend over the same period.

As we can see, added to the already-weak fiscal revenue in ABM, taxation policy did not provide sufficient resources to finance social programs. Also, the 2019 ECLAC report, "Fiscal Panorama of Latin America and the Caribbean," noted that during the previous decades "tax evasion and avoidance" of all types in Latin America reached 6.3 percent of GDP, or US$335 billion, in 2017. As an aside, anyone familiar with the political economy of ABM might be skeptical regarding the possibilities of a short-run solution to tax evasion. The situation in Mexico is particularly noteworthy, given their levels of informal employment. According to INEGI (2019), informal employment accounted for an estimated 56.9 percent of Mexico's total employment in 2019Q1, representing 30.8 million people who carry out their economic activities outside of any regulatory framework and without healthcare coverage and other social protections, which makes it hard to calculate the average household income.

CONCLUSION

As mentioned throughout this paper, after nearly a decade of fiscal consolidation in ABM, a number of weaknesses remain, making it difficult to achieve the goals set forth in the 2030 Agenda for Sustainable Development. First, "corrective and selective tax policies" have had a smaller impact than anticipated on the overall tax burden. Second, both the foreign currency debt as a proportion of the total public debt and the rise in interest payments had a negative effect on their GDP. Third, in the vast majority of Latin American countries, specifically in ABM, fiscal policies are designed to preserve price stability, not boost the economy, and they did not boost the fiscal consolidation process. At best, ECLAC 2019 recognized that the fiscal consolidation efforts shrunk the growth contribution of public expenditure, slowing down the pace of inequality reduction.

This paper also notes, with deep concern, the fact that fiscal policy applied in ABM does not take into account the increase in the middle class's consumption capacity through mechanisms that foster real wage increases and the expansion of purchasing power for the fiscal space. By taxing the middle class at a higher rate it becomes more vulnerable, making it more difficult for the government to finance social programs; evidence has shown in countries where the middle class is strong, entrepreneurship activities tend to have a positive impact on GDP growth (Van Stel, Carree, and Thurik 2005).

This raises a crucial point: in the era of new multilateralism and global production chains, what would be the main element for fiscal policies in terms of public expenditures for ABM when considering that each of these countries has specific characteristics, but at the same time they have a common denominator: *income inequality.*

Answering this question in the multilateralism era is more difficult than it might have been in the import substitution model period. We now need to take into account the concept of both the short and long run.

On the political side, policymakers have little room for maneuver in the short run to fulfill their election promises, so often their decisions are detrimental to the overall economy and benefit only specific social groups.

On the economy side, ABM are countries with export-led growth. For this reason, fiscal policy should be fine-tuned in terms of promoting productivity, aiming for a higher domestic value-added in order to increase real wages. However, the lack of competitiveness still represents the same underlying economic reality in ABM. According to the Global Competitiveness Report (2019), Mexico, ranked at number 48, is ranked highest among the three. Beyond the readily visible productivity and competitiveness aspects as a key determinant of investment, this report is also a result of fiscal responsibility, where the public virtue plays a crucial role in government policy intervention. Hence, fiscal policy should focus on social protection strategies through labor markets, the financial system, and macroeconomic stability in order to achieve greater equality.

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