# COMMENTS ON SESSION 3
# FISCAL POLICY AND MACROECONOMIC IMBALANCES IN EMERGING ECONOMIES AND RESOURCE-RICH COUNTRIES

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## Comments on "Fiscal Challenges to a Long-run Sustainable Growth in Brazil" by Ana Teresa Holanda De Albuquerque

The paper by Ana Teresa Albuquerque provides an interesting and thoughtful discussion of challenges for fiscal policy in Brazil today. I agree with most of it. Therefore, my comments will focus on what I believe to be key reasons for the current sub-par performance of the Brazilian economy, and on the appropriate role of fiscal policy in improving it.

First, in my view, the current protracted slowdown in the economy reflects more structural than cyclical factors, in particular a significant loss of competitiveness, reflected in poor performance of manufacturing exports, growing import penetration (despite increased resort to protectionist measures), and an increase in the relative price of non-tradable goods and services, and, relatedly, in the share of services in GDP. The loss of competitiveness is only partly due to nominal exchange rate movements. The overheated labor market, rapid increases in the minimum wage, a continuing rise in the tax burden, and lack of progress in needed structural reforms to boost productivity over the last ten years are the main culprits.

The loss of competitiveness, together with uncertainties on the course of key policies, explains the poor performance of private investment, despite fiscal incentives and a marked reduction in the cost of credit from mid-2011 to mid-2013. Public investment continues to be hampered by structural impediments, despite ongoing government efforts to boost infrastructure spending. Private consumption has been the main engine of growth in domestic demand in recent years, but households are moderating their spending, given their rapidly rising debt burden.

The assessment of the role of fiscal policy in recent years in Brazil is hampered by a proliferation of accounting gimmicks and quasi-fiscal operations, including:

- anticipation of revenues and postponements of payments (including VAT refunds),
- progressive reduction of the coverage of the fiscal target (exclusion of large public enterprises and of a growing share of public investment),
- massive use of public banks for directed lending, financed by below-the-line Treasury loans.

As a result, both the primary balance and the net public debt have lost value as indicators of the fiscal stance (as well as of fiscal sustainability). Fiscal policy is more expansionary than signaled by the recorded modest decline of the primary surplus; and it is less sustainable than suggested by the gradual decline of the net public debt. The gross public debt is still rising and, at just under 60 per cent of GDP, is relatively high for an emerging market country; and fiscal risks are mounting, as underlined by Ana Teresa.

Nevertheless, the significant fiscal stimulus and the substantial monetary easing through mid-2013 have failed so far to produce a sustained recovery of the economy. This supports the view that neither is the appropriate remedy for the underlying causes of the slow growth. How could fiscal policy support sustainable higher growth in Brazil?

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First and foremost by reducing the share, and improving the quality, of current spending. This would require:

- entitlement reforms (in the pensions and, to a lesser extent, the health systems),
- the elimination or at least substantial reduction of the pervasive earmarking requirements,
- reforms of the civil service at all levels of government, and
- reduction of interest and other types of subsidies.

A significant and sustained reduction of current spending would create fiscal space for much needed investments in infrastructure and in the energy sector (either through public works or PPPs); and for reforms in indirect taxation at both the federal and sub-national levels that are essential to improve competitiveness. It would be also important to reverse the unfortunate recent trend to manipulate the fiscal accounts, that has undermined the transparency and credibility of fiscal policy

Fiscal reforms are only a part of the structural reform agenda needed for growth in Brazil, but are a crucial part of it. Unfortunately, the electoral timetable and still relatively benign conditions in financial markets make it unlikely, in my view, that such an agenda will be meaningfully addressed in the near future.

## Comments on "Cyclicality of Fiscal Policy in India" by Atri Mukherjee

*Main comment*

The paper provides an interesting quantitative analysis of the responses of fiscal variables to cyclical fluctuations in output, using alternative statistical and econometric methodologies. But, is it appropriate to call this an exploration of the pro- or counter-cyclicality of fiscal policy?

Traditionally a fiscal policy is characterized as pro-cyclical if the impulse it imparts to the economy tends to aggravate, rather than smooth, the output cycle. From this perspective a positive elasticity of revenues to output is stabilizing, not pro-cyclical. In contrast, a positive elasticity of spending is pro-cyclical. The net impact of the two effects (i.e. whether the overall fiscal stance is pro- or counter-cyclical) depends on the relative size of different revenue and spending categories, and on their respective elasticities.

Therefore, the paper does not really shed light on the cyclicality of the overall fiscal stance, a question of importance in a country like India with historically high deficits and public debt, and currently struggling to return to higher sustainable growth rates.

*Additional comments*

The terminology used in the paper is somewhat at odd with established international standards, and may be confusing for a reader unfamiliar with Indian budgets. Does "revenue expenditure" refer to what is commonly categorized as current expenditures? Are "capital receipts" not really financing items? How do "capital outlays" differ from government investment?

The paper focuses on the Union's budget. Given the federal nature of the country, the sizable shares of the states in expenditure and revenues, and the fact that they run significant (and varying over time) deficits, it would be useful to expand the analysis to the state level, if the relevant data are available.

The three methodologies employed in the paper yield fairly different estimates of the elasticities of various budget categories to the cycle. It would be interesting to include some discussion of possible reasons for such differences.

The estimated tax revenue elasticities are surprisingly high, especially as regards excise taxes. I wonder whether the series have been purged of the effects of discretionary changes. If not, the underlying elasticities may well be lower than the estimated buoyancies.

Is there a risk of reverse causality in the equation relating expenditures to output (methodology 2)?

The paper explains the relatively low cyclical responsiveness of current spending by the inability of the government to cut it during bad times. It would be interesting to test for an asymmetric behavior during good times

The paper also attributes the counter-cyclical character of spending on subsidies to the government's desire to protect the poor. But, how much of these subsidies really go to benefit the lowest income groups?