Brazil: Assessing the Fiscal Policy Stance

HIGHLIGHTS

In recent statements, the Brazilian Central Bank (BCB) highlighted the structural primary balance’s role as the key measure to capture the macroeconomic effects of fiscal policy.

We estimate that the public sector’s trailing four-quarter structural primary surplus was at 1.2% of GDP in 2Q13, virtually flat from 1Q13. We note a recent decrease in the fiscal impulse – defined as the change in the structural fiscal balance – meaning a slower pace of new stimuli via government budget.

Our estimates point to an expansionary fiscal policy stance, as the structural primary balance stands below the long-term equilibrium level (i.e., consistent with a stable public debt over the years). We estimate this equilibrium level at 2.0% of GDP.

The final effect of the fiscal stance on activity may be limited in the short and medium term by the level of resource utilization and projections about fiscal solvency, which may affect the size of fiscal multipliers. Amid an overheated activity and concerns about public debt trends, fiscal expansion may lead to higher inflation expectations and interest rates, which overshadows the initial the fiscal impulse.

ANALYZING THE ACTUAL FISCAL PERFORMANCE IN 2Q13

In recent statements, the Brazilian Central Bank has been stressing on the concept of structural primary budget surplus, highlighting it as the main measure to capture the fiscal policy effects on the economy. The monetary authority has also incorporated this variable in its models to forecast economic activity and inflation. This creates an interesting context to watch the fiscal trends based on structural balance estimates.

According to our calculations, the public sector posted a structural primary surplus\(^1\) (i.e., adjusted for non-recurring transactions, activity and financial cycles) of 1.2% of GDP in the four quarters to 2Q13. The result was virtually flat compared to 1Q13 (1.3%). In end-2012, the structural primary surplus was 1.4%.

The recurring primary surplus\(^2\) (i.e., with adjustments for non-recurring operations) was 1.5% of GDP in the one-year period ending in 2Q13 (compared to 1.6% in 1Q13). The conventional primary surplus (i.e., unadjusted) was 2.0% of GDP in the second quarter (1Q13: 2.0%). Overall, the recent data show little variation in the key measures of fiscal effort (Graph 1).

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\(^1\) The structural primary surplus is the budgetary result (before interest payments) adjusted to the cycles of economic activity (measured by GDP or other disaggregated variables), asset prices and / or raw materials (oil, in the Brazilian case) and non-recurring budgetary transactions (i.e., revenues and expenses of an accounting or temporary nature). For further details, refer to the recommended reading at the end of this report.

\(^2\) The recurring primary surplus is the budget result adjusted for non-recurring operations (i.e., revenues and expenses of an accounting or temporary nature), with no adjustment to economic cycle or assets/commodity prices.
Sequentially, our quarterly seasonally-adjusted estimates suggest a small increase in the "underlying" fiscal performance during the 2Q13. The seasonally adjusted recurring fiscal result rose from 1.2% of GDP in 1Q13 to 1.6% in the April - June period; in the same period, the structural balance rose from 1.1% to 1.3% (Table 1).

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Source: Itaú, BCB

Given the volatility of the budget execution in shorter time-horizons, we should also consider a 6-month (seasonally-adjusted) average of fiscal effort measures. Despite a recent drop in the seasonally-adjusted conventional result in the first half (our own estimate fell to 1.7% of GDP, from 2.4%), the results adjusted for accounting and cyclical factors (i.e., recurrent and structural primary) showed stability, albeit at relatively low levels. These measures of fiscal performance stood between 1.2—1.4% of GDP in 1H13 (Graph 2).
Our calculations point to a slower implementation of new budgetary stimuli in the second quarter. These figures probably reflect a more cautious approach by policymakers, given the lower primary surplus recently, and the constraints imposed by a more challenging global environment. Yet the accommodation of the structural (and recurrent) primary result on relatively low levels signals that the fiscal stance remains expansionary.

It is worth noting that our structural primary surplus calculation takes into account (the average of) two different methodologies: the aggregate method (proposed by the IMF, International Monetary Fund, based on GDP cycles) and the disaggregated method (proposed by the ECB, European Central Bank, based on cycles of subcomponents of economic activity).

The relative stability in the structural fiscal result in 2Q13 derives from small movements (i.e., 0.1% of GDP) in opposite directions in the estimates obtained under each methodology. The calculations point to stability in the fiscal stance and in the cyclical effect of automatic stabilizers as well as nonrecurring operations on the observed fiscal performance.

On one hand, the GDP acceleration in the first half (especially in 2Q13) leads us to associate a larger portion of the conventional primary result with cyclical factors, when we run the aggregate methodology (IMF). This reduces the structural primary result. On the other hand, an important change in the composition of economic activity is already being captured by the disaggregated methodology (ECB): the loss of momentum in consumer spending and labor market. The latter cause our estimates (under the disaggregated method) to indicate less support from the economic cycle for the generation of fiscal results. And this helps raise the structural primary result.

It is important to note that tax collection is quite sensitive to retail sales and the wage bill. In general, tax revenue is asymmetrically more influenced by domestic absorption than by external demand\(^3\), as taxation levied on exports is usually lower.

\(^3\) For details on our estimates of structural fiscal result under both methodologies, as well as estimates of relevant cycles for economic activity, refer to the Appendix.
THE FISCAL IMPULSE AND ITS COMPOSITION

Over the one-year period ended in 2Q13, the fiscal impulse via general government budget (i.e., federal, state and municipality governments, excluding state-owned companies) amounted to 0.4% of GDP. We define fiscal impulse as the change in the structural primary surplus over one year: a positive (negative) impulse is defined as expansionary (contractionary).

In 2012, the fiscal impulse promoted by the general government was +0.5% of GDP (Graph 3-A). The impulse in 2013 (up to Q2) results from a less fast spending growth (+0.6% in the one-year period ended in 2Q13, from +0.8% of GDP in 2012) and a slower growth in structural revenues (impulse of -0.2% of GDP in 2Q13, compared to -0.3% in 2012).

When we watch the fiscal stimulus by public sector entity (Graph 3-B), we note an expansion by the central government (via spending) and some neutrality on the part of regional governments.
Graph 4 depicts National Treasury (unadjusted) spending data from January to June. It breaks down into categories the federal fiscal impulse via spending. The variation of central government spending was 0.6% of GDP in the 1H13, largely reflecting the acceleration in transfers (+0.5 pp) and a strong growth in healthcare and education expenditures (+0.3 pp). These are partially offset by a reduction in federal investment and subsidies. Thus, one can conclude that the impulse via public spending continues to generate little incentives for gross fixed capital formation.

UNDERSTANDING THE NEUTRALITY OF FISCAL IMPULSE VIA REVENUE

Graph 3-B indicates that, during the last four quarters, general government revenues accounted for a small fiscal contraction of 0.2% of GDP. However, the interpretation and analysis of the structural fiscal result must take into account a confidence interval around the estimates, due to difficulties in measuring key variables that serve as input for calculation of the structural budget balance (e.g., trend values of the tax bases).
Thus, we view the slightly contractive impulse via revenue (0.2% of GDP) as close to a neutrality region (i.e., of null impulse). In other words, our calculations show the (annual) variation of structural government revenues (both tax and non-tax collection) is nearing a zone of neutrality in terms of fiscal impulse.

Despite hefty tax cuts announced and implemented by the federal government lately, there are other revenues (such as tax receipts from state governments, and non-tax revenues from the central government) whose increase is not explained by cyclical (or accounting) factors. Altogether, these other revenues have offset the budgetary expansion via tax exemptions. As an upshot, the numbers suggest some accommodation of the general government’s fiscal stance on the revenue side.

This result may seem counter-intuitive at first, when taking into consideration all the tax cuts recently announced by the federal government. But the figures reflect important aspects:

1) BELOW-TREND GDP: Our output gap estimates show the Brazilian economy operating below its long-term trend, which especially influence the estimates under the aggregate method. All else equal, idleness in resource utilization means that a given level of budgetary stimulus generates a lower fiscal impulse, or a relatively less expansionary fiscal stance.

2) HIGHER NON-TAX FEDERAL REVENUES: The increase in structural revenues at federal level derives mainly from non-tax revenues, according to estimates from the disaggregated model. Under this methodology, we calculate that the federal government generated an expansionary impulse via taxes worth 0.15% of GDP in a year. The increase in central government’s total structural revenue (0.1% of GDP) follows a yearly lift of 0.25% of GDP in non-tax revenues (e.g., especially fares directly collected by government agencies). Such data is consistent with a search for extraordinary sources of income, amid a cyclical downturn in tax collection and effects of tax cuts.

3) TIGHTENING VIA STATES TAXES: We estimate an increase in states’ structural revenue, driven by higher ICMS (sales tax) revenues. This tax may have been used as a tool to offset the adverse impact of a cyclical downturn in federal transfers.

It is important to bear in mind that the structural primary surplus is the fiscal result adjusted by activity cycles, asset price cycles and non-recurring transactions. Fluctuations in public revenues not explained by these factors are, by definition, structural. With this in mind, one should not confuse the fiscal impulse with the direct effect of budgetary variables on economic activity. This effect, transmitted via fiscal multipliers, will depend on the economic environment (e.g., idleness in the economy) and the instruments used (i.e., taxes and spending classes).

FISCAL STANCE BY FEDERATIVE ENTITIES

The fiscal stance, as determined by the level of structural primary surplus, remains expansionary in both public sector divisions (Graph 5). According to our calculations, the central government posts a structural primary surplus of 0.9% of GDP (2012: 1.1%; 2011:

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4 Some examples of non-tax revenue: fares of public services (e.g., issuance of passports), penalties charges by sector authorities (e.g., regulating agencies).
The structural primary surplus of regional governments stands at 0.5% of GDP in the four quarters to 2Q13 (2012: 0.4%; 2011: 0, 4%).

These numbers show a positive fiscal impulse (i.e., expansionary) by the central government, which contrasts with a more neutral approach by regional governments, when it comes to the implementation of new fiscal stimuli. The data also confirm a choice of economic policy at federal level to keep a certain degree of budgetary expansion. The list of policies include encouraging higher spending and borrowing by states and municipalities.

"TRANSVERSALITY CONDITION" AND THE FISCAL STANCE THRESHOLD

We understand that the fiscal stance is determined, in absolute terms, by the level of the structural primary surplus. But is the primary result level that tells an expansionary stance from a contractionary policy bias?

In long-term equilibrium, the so-called "transversality condition" shall prevail. Applied to the fiscal situation, this condition essentially imposes a constraint on government indebtedness, which may not rise indefinitely or unlimitedly in the long term. Thus, the equilibrium level of primary surplus is the level that is consistent with flat indebtedness in the long-term, in light of other long-term macroeconomic conditions.

Analogous to the role of equilibrium interest rate for monetary policy – which establishes the boundary between an expansionary policy (i.e., with rate below the threshold) or contractionary policy (i.e., with rate above the threshold) – the fiscal stance is expansionary if the structural primary surplus is below the level ensuring long-run debt sustainability. Alternatively, it is contractionary if the structural balance is above the long-term equilibrium level.

It is worth mentioning once again that the final effect of fiscal policy on aggregate demand will depend not only on the level of the structural fiscal balance, but also the budget instruments.
in use (i.e., tax and expenditure classes) and the economic conditions (i.e., the activity cycle, fiscal solvency perceptions). As shown by Spilimbergo et al. (2009), the environment and the instruments significantly affect fiscal multipliers, which may vary over time. In situations of supply-side constraints and concerns about the public debt outlook, fiscal expansion should lead to higher inflation expectations interest rates. Those may more than offset the initial fiscal impulse.

We may apply this reasoning to the Brazilian economy, in light of our estimates for the public sector's structural fiscal result. Our number points to a structural primary balance of 1.2% of GDP, clearly below our estimate of equilibrium primary surplus – around 2.0% of GDP. We estimate that, with trend GDP at 2.7% p.a. and real interest rate between 3.0 - 3.75% p.a. by 2020, an average primary balance of 2.0% of GDP would maintain the net debt-GDP ratio around 35% until the end of the decade.

Thus, the conclusion is that the fiscal stance remained expansionary until the first half of the year. At best, the fiscal policy could be considered neutral if we only took into account the estimates of the structural result under the IMF’s aggregate methodology (see Appendix). But this methodology ignores the important composition effect of growth on tax collection.

Our models point to a slower decrease in the structural primary surplus. This result implies a falling fiscal impulse, and may be understood as a slower pace of implementation of new budgetary stimuli. In parallel with monetary policy, the fiscal situation in Brazil is, at the moment, comparable to a hypothetical case where interest rate, already below the neutral level, starts to fall more slowly (i.e., in smaller steps in each policy meeting).

CONCLUSION

Our structural primary balance estimates points to a more cautious adoption of new fiscal stimuli in 2Q13. In absolute terms, however, the fiscal policy remains expansionary.

The effective fiscal effort of the public sector is now around 1.2% of GDP. Looking forward, we believe that the implementation of new budget stimuli will continue to slow, with the structural primary balance probably stabilizing around 1% of GDP until the end of 2014. These numbers are consistent with our forecast of conventional primary surplus at 1.1% of GDP next year (for 2013, we expect 1.7%).

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APPENDIX - STRUCTURAL PRIMARY SURPLUS, BY METHODOLOGY

We observe a significant difference in the level of structural primary surplus results under the two methods that we use (i.e., the IMF-approach, which makes adjustments based on GDP cycles, and the ECB-approach, with adjustments on cycles of economic activity subcomponents).

The recent variations in the structural result estimates (i.e., the fiscal impulse) fell under both methodologies. In the aggregate method (IMF), the structural balance fell 0.1pp to 1.8% of GDP; in the disaggregated method, it increased by 0.1 pp to 0.7% of GDP (Graph 6).

This difference in the dynamics of the recent results by methodology reflects the acceleration of GDP and the less sluggish activity cycle (i.e., output gap less closed) in 2Q13 (Graph 7-A). The GDP cycle directly affects the structural result estimate under the aggregate method.

The less favorable composition of activity for tax collection, given the slowing pace (and dwindling cycle) of consumption and wages also influenced the final result (Graph 7-B). The variables most directly related to domestic demand affect the cyclical tax collection more intensely, thus having a significant effect on structural fiscal result estimates under the disaggregated method.
Both methodologies (disaggregated and aggregated) present methodological challenges that can be mitigated by using the average of the series – from which we compute the final result in our structural fiscal balance series. In the IMF methodology, the cycle adjustment is made only on the fluctuations of GDP, not taking into account the cycles of the disaggregated components and the composition effect, which may be very relevant for the determination of the primary surplus. Despite the fact that the ECB methodology deals with this effect, the cycle adjustment of the disaggregated subcomponents of economic activity is difficult to measure. Thus, the combination of the two methodologies provides more robust results.
**Bibliography:**


- Past Publications on our Structural Surplus Methodology:

* WORKING PAPER #6 - Brazil’s Structural Fiscal Balance (April/2012): The paper provides the basis of our proposal to adopt a fiscal regime based on structural fiscal balance targets.


* MACRO VISION - Making the case for structural fiscal targets in Brazil (April 2012): Summarizes structural result methodology; discusses the topic from the point of view of fiscal policy formulation.


* MACRO VISION - Brazil – Structural Primary Surplus: What Happened in 2012? (May 2013): Updates the structural result series until the end of 2012; presents methodological changes in our estimates.


* MACRO VISION - Brazil: Structural Primary Balance Drops in 1Q13 (June 2013): Updates the structural result series until 1Q13.


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