Comments for paper by Ángel Melguizo, Alejandro Neut, and Christian Daude, "Fiscal Policy in Latin America: Better After All?"

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This paper is an extremely fine effort at analyzing fiscal policy in Latin America during the last two decades. The authors present estimates of cyclical-adjusted primary balances implementing the standardized OECD methodology but including an extension for commodity cycles. Based on these estimates, the paper evaluates the size of automatic stabilizers and the cyclical position of discretionary fiscal policy.

Much has been written about the relation between fiscal policy and the business cycle in the region. Most of the studies document high volatility at which Latin America is exposed, the procyclicality of fiscal policy, the weakness of automatic stabilizers, etc. However, with the exception of Chile, the region has not enough information about what is the fiscal position in the medium term.

In our comments we will briefly examine the methodology used in this paper, trying to contribute to the debate about how this relationship between the cycle and the fiscal policy has to be measured in a context of high volatility, frequent temporary and permanent shocks, procyclical financial access and small automatic stabilizers. Our main comment is that both estimates of the output gap as the tax elasticities, and therefore the result presented as the cyclically-adjusted budget balance must be interpreted with caution as they are very sensitive to the methodology chosen and are subject to some uncertainty.

The cyclically-adjusted budget balance is an indicator that assess fiscal policy stance in the medium term. Under the assumption that real output fluctuates around a trend, it calculates the cyclical effect that the economic activity and the changes in relevant prices have in the budget balance, showing the balance that would result if GDP were at its trend level and if the relevant prices were those of the medium term.

In determining the methodology for calculating the cyclically-adjusted budget balance is imperative to address the following issues in detail, knowing that all options are not always feasible and there are advantages and disadvantages for each of them:

(1) Estimation of potential output, where the most used methodologies are the calculation of a production function and the use a filter to estimate the trend, being the most widely used Hodrick-Prescott filter. The authors use in this paper the estimation of a production function but they very appropriately highlight the uncertainty stemming from this estimation, due to large and simultaneous cyclical, temporary and permanent shocks in several Latin American economies.

(2) Which kind of incomes and expenses are affected by the economic cycle. The authors adjust by the revenue side, the following items: personal income tax, corporate income tax, indirect taxes, social security contributions and commodity revenues. In contrast, by the expenditure side, no item is adjusted assuming that unemployment benefits are absent in many countries in the region. At this point it will be interesting to analyze deeply the relation of the different budget items with respect to the cycle. The OCDE methodology assume that the items named above are the ones that have a cyclical component, but as Latin America does not share all the characteristics with the OECD countries, the budget items that are affected by the cycle could differ from the ones selected by this methodology. One exercise that is interesting to replicate is that of Marcel et al. (2001) where in order to determine the most significant cyclical components of the budget, they perform an analysis of the volatility of the different items, its relation with the cycle and its incidence on the fiscal balance.

(3) In the case of the existence of revenues from the exploitation of natural resources, often affected by international price movements, it is necessary to determine the reference price in the long term. The most common methods are moving average, using long term prices published by international organizations or the use of trend filters such as the Hodrick-Prescott. As it is remarked by the authors, commodity cycles may be as relevant to countercyclical policy as economic cycles, because of the former's significance in total fiscal revenues and because of the high volatility of the international commodity prices.

(4) The selection of the methodology for the estimation of the elasticities, where the most common methods are the ones used by the IMF and the OECD, although there are simpler alternative methods such as OLS estimates, OLS or recursive dynamic, error correction method, etc. The authors use the methodology proposed by the OECD but they add some assumptions that could be discussed. For example, when calculating the elasticity of income tax and social security contributions with respect to the tax base, the marginal and the average tax rates of a representative household for an OECD country are calculated for several points in the earnings distribution: from 0.5 to 3.0 times the average

production worker. By contrast, the authors, arguing the high levels of informality and income inequality in the region, cover an extended income interval from 0.05 to 6; while De Mello and Moccero (2006) used, for Brazil, an interval from 0.5 to 4. Another example could be the assumed elasticity of 1 of the indirect taxes with respect to the output. If, as it is known in the region, the volatility of consumption is higher than the volatility of output, we could assume that the elasticity of the indirect taxes with respect to output could be different than one. Also, another discussion could be if this kind of taxes, or for example, import taxes, should be adjusted directly with respect to another variable different from output, as consumption or imports.

(5) The estimation of the cyclically-adjusted budget balance is usually based, as is the case in this paper, on the primary balance, excluding interest on debt, considering that it does not depend on the decisions of the current fiscal position.

Finally, we would like to make a point regarding the concept of the cyclically-adjusted budget balance and the concept of a structural balance. Following the OECD definition,

> *"the budget balance can be decomposed into a cyclical and a non-cyclical, or structural, component. The decomposition is aimed at separating cyclical influences on the budget balances resulting from the divergence between actual and potential output (the output gap), from those which are non-cyclical. Changes in the latter can be seen as a cause rather than an effect of output fluctuations and may be interpreted as indicative of discretionary policy adjustments. It should be noted, however, that changes in resource revenues -- as a result of oil price changes, for example -- and in interest payments -- as a result of past debt accumulation or changes in interest rates -- are neither cyclical nor purely discretionary. Yet these changes are reflected in the evolution of the structural component of the budget balance".*

As the last part of the definition says, if there is something that is neither cyclical nor purely discretionary, and if we take into account the small size of automatic stabilizers in the region, and other facts as the high volatility, the difficulty in determining the output gap, etc. we can conclude that it is necessary to further continue the work undertaken by the authors in order to find a more accurate methodology capable of assessing the fiscal policy stance in Latin America.