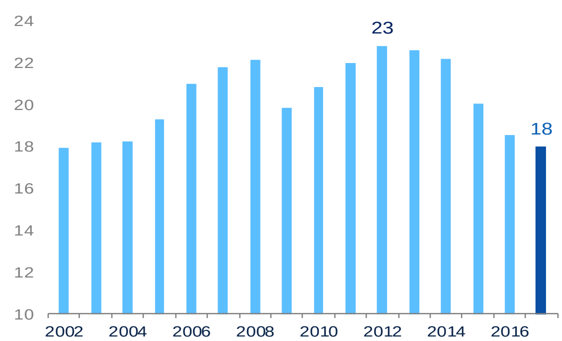
4. Fiscal policy: the major challenge continues to be increasing government revenues

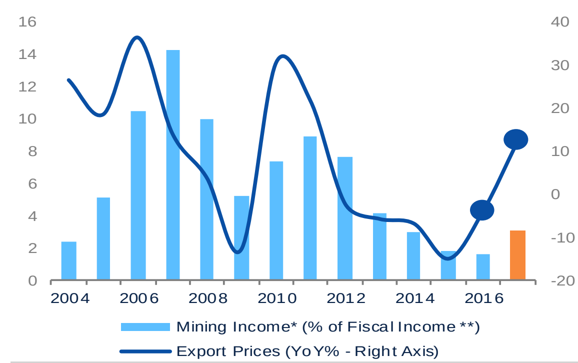
The fiscal deficit increased in 2017 to 3.2% of GDP (2.6% the year before). The increase in the deficit was due mainly to the fall in tax revenues (as a percentage of GDP, see Figure 4.1). This fall was in spite of the improved performance of domestic demand and the improvement in the terms of trade, as a result of which revenues from mining increased (see Figure 4.2), and is related to the measures put in place to make the formal economy more attractive (for example the introduction of the tax regime for micro and small firms and the "fair IGV" (general sales tax)), which have had a negative impact on tax revenues, at least in the short term.

Figure 4.1 Current revenues of the central government (% of GDP)



Source: Central Reserve Bank of Peru and BBVA Research

Figure 4.2 Tax revenues from mining and export prices



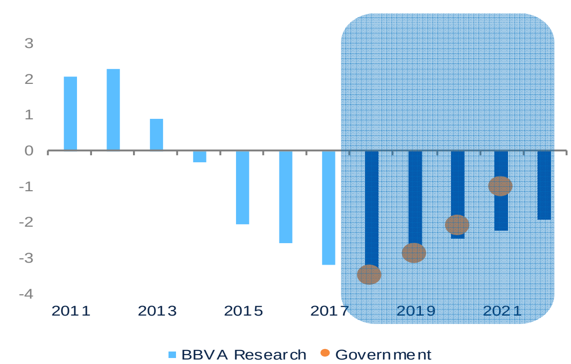
*Corresponds to income tax (3rd category), duty and special tax on mining.** Current revenues of the central government
Source: Central Reserve Bank of Peru, SUNAT (Customs and Tax Administration Authority) and BBVA Research

For 2018 we project that the government deficit will increase temporarily to 3.4% of GDP. This will be the highest level in eighteen years. The increased fiscal deficit that we expect is consistent with the increase there will be in the spending for the reconstruction of the infrastructure damaged by *El Niño Costero* (US$950 million more than the year before), the construction of infrastructure for the 2019 Pan American Games (US$635 million more) and the acceleration of work on the major public infrastructure projects (increase of US$640 million), particularly on the second line of the Lima Metro. This means that non-financial public sector expenditure will increase by nearly 6% in real terms, a more conservative boost than that projected in our previous report for the reasons explained above.

Turning to revenues, we estimate that they will start to recover (as a percentage of GDP) due to the fact that domestic demand will continue to strengthen, metal prices will be higher on average than in the previous year (that of copper in particular), and tax refunds will start to return to normal (having peaked at the beginning of last year and since having stabilised and even started to fall). Moreover, this year there will be no downward effect from the "fair IGV" scheme (its impact having been temporary by its very nature when it was introduced). All these factors will more than offset the additional personal income tax deductions that will start in 2018 and the fact that our projection does not envisage exceptional revenues such as those of last year (execution of the Southern Gas Pipeline operator's bond and tax amnesty for declaration of funds and income from abroad).

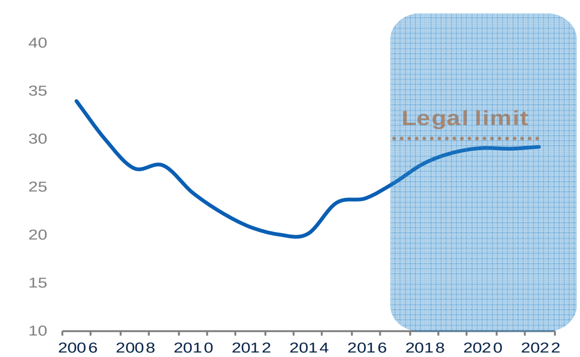
The government has committed to start a process of fiscal consolidation from 2019. Although this commitment will require effort, it seems realistic as long as the increase in the public spending in 2018 will be mainly by way of investment and of a temporary nature (reconstruction of infrastructure, Pan American Games); added to this is the fact that revenues will have ceased to decline as a percentage of GDP and tax refunds are starting to return to normal. This trend towards consolidation of the fiscal accounts has been factored in to our baseline scenario. However, in our scenario the pace of consolidation is less ambitious than the government's. We are more conservative as regards expenditure, allowing a little more flexibility for infrastructure spending, and also for current spending although the adjustment here is less marked); on the revenue side, we assume that the tax measures put in place in 2017 to make it more attractive for firms to enter the formal economy will have only a limited effect on tax revenues. Thus the fiscal deficit will start to narrow from 2019 (see Figure 4.3) and will stand at around 2.0% of GDP towards 2021. It is important to mention that the trend towards consolidation of the fiscal accounts from next year, together with gross public debt which we think will stabilise at around 29% of GDP in the medium term (below the maximum limit of 30% of GDP established in the Fiscal Transparency and Responsibility Act; see Figure 4.4), are essential for maintaining the credibility of the Peruvian State and hence its sovereign credit rating.

Figure 4.3 Fiscal result
(% of GDP)



Source: MEF (Ministry of Economy and Finance) and BBVA Research

Figure 4.4 Gross public debt
(% of GDP)



Source: Central Reserve Bank of Peru and BBVA Research

We do not rule out the possibility of the government's implementing measures (or reinstating some of those it has removed in recent years) to raise the level of tax revenues, which as a percentage of GDP have fallen by five percentage points since 2012. The recovery of revenues will be important for ensuring that the fiscal deficit is reduced and that public investment (a less rigid component of public spending than current expenditure) is not squeezed. It will also be an important contributory factor in ensuring that the country's sovereign credit rating is not revised downwards.

DISCLAIMER

This report has been produced by the Peru Division

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