



# Economic Observatory

June 23, 2009

## Fiscal policy rule: ex - ante or ex – post assessment?

Soledad Hormazábal  
[shormazabal@bbvaprovida.cl](mailto:shormazabal@bbvaprovida.cl)

- The decline in activity has had an impact on public revenue, causing a rise in the projected fiscal deficit. We expect a deficit of 4.2% of GDP in 2009.
- The actual drop in revenue has gone beyond the parameters used to calculate the structural budget, so although expenditure has remained in line with the ex – ante prediction, this will lead to an effective structural deficit (ex - post) of -0.4% during 2009.
- The correct assessment of the fulfilment of the fiscal rule is based on the calculation of predicted expenditure (ex – ante), as statistical models (simple or complex) will never be accurate enough to prevent forecasting errors, and will require making continual adjustments to revenue and expenses throughout the year.
- For the year 2010 we recommend extending the target of the balanced Structural Fiscal Budget in order to avoid a fiscal contraction which could hold back recovery.

On January 5, the dramatic downturn in economic conditions led the government to announce a stimulus package of US\$4,000 million, equivalent to 2.8% of the 2009 GDP forecast at the time. On that occasion, the government corrected its tax projections, and predicted that 2009 would close with a deficit of 2.9% instead of the surplus previously expected; they also announced a temporary reduction in the target for structural surplus of 0.5% of GDP to 0% of annual GDP. More recently, the government once again modified its public finance estimates for 2009 in order to adjust its calculation of the revenue given the new economic situation. Tax revenue is now predicted to be 24.3% lower than contemplated in the Budget Act, while public expenditure will rise by 14.5% in real terms instead of the 5.7% –also in real terms– established in the act. With these estimates the government expects an effective deficit of 4.1% of the GDP for the current year.

**Table 1: Macroeconomic assumptions from the Ministry of the Treasury**

|                                | Budgetary | January 2009 | June 2009    |
|--------------------------------|-----------|--------------|--------------|
|                                | law 2009  |              |              |
| <b>GDP</b>                     |           |              |              |
| Real variation rate            | 4,00%     | 2%-3%        | -0.75%-0.25% |
| Growth in trend GDP            | 4,90%     | 4,90%        | 4,90%        |
| <b>Domestic demand</b>         |           |              |              |
| Real variation rate            | 4,30%     | 4,30%        | -4,00%       |
| <b>CPI</b>                     |           |              |              |
| December to December variation | 6,20%     | 5,20%        | 2,30%        |
| <b>\$/US\$ exchange rate</b>   |           |              |              |
| In 2009 \$                     | 538       | 538          | 580          |
| <b>Copper price Us\$/lb</b>    |           |              |              |
| Long-term                      | 290       |              | 192          |
| BML                            | 199       | 199          | 199          |

Source: Budget Department

Our own estimates point to a fiscal deficit of -4.2% of GDP in 2009 , slightly higher than the one recently reported by the Ministry of Finance, most likely because of differences in the economic growth projections for 2009.

There has been a recent debate regarding the fulfilment of the Fiscal Policy Rule, which was adjusted in order to achieve a balanced fiscal structural result for 2009, as the effective “structural revenue” will be lower than calculated when the budget was drawn up. This is because the decline in revenue has been greater than what results from directly applying the elasticity of income to the effective fall in GDP. This is the reason we estimate that although total government spending will be consistent with the amounts planned, there will be a structural deficit of 0.4% by year end.

Those who criticise the government for failing to fulfil the Fiscal Policy Rule are saying that it should be used both to define the level of spending during the budgetary process (ex – ante), and to assess its fulfilment at the end of the year (ex - post). We, on the other hand, maintain that this rule defines an ex – ante spending limit which would not be subject to subsequent changes if in fact the original assumptions (growth, elasticities, etc.) are not fulfilled.

This is an important point, as what is at stake is whether fiscal expenditure should be adjusted within the year as conditions change, or whether current spending should be maintained and a greater structural deficit assumed ex - post. This is a legitimate debate which has not yet been addressed in Chile. Although it is true that there have been significant ex – post deviations in the past, they have never been as noticeable as at the current time. There is no obvious answer, and to find one we must assess the objective of the establishment of the Fiscal Policy Rule.

The Fiscal Policy Rule aims to give a medium-term outlook to public finances by providing a buffer for positive and negative shocks. This is done by projecting the structural fiscal revenue and eliminating any changes in revenue produced by the economic cycle. This revenue is used to determine the level of expenditure compatible with the rule, thereby providing stability for aggregate fiscal expenditure and for private sector policies, programmes and projects.

From this point of view, the fiscal rule makes perfect sense only when it is applied ex - ante, that is to say, to define the maximum spending limit in the budgetary year. Otherwise this would require continual adjustments throughout the year as new factors emerge, most of which arrive with a substantial time lag which makes it impractical to incorporate them. In years of major deviation from the trend, calculation errors may well be far greater, which adds the problem that requiring ex – post fulfilment could go against the very aims of the economic policy.

## Public expenditure in 2010

If the structural parameters sustaining the projection of structural fiscal revenue are maintained, and assuming the long-term price of copper stays at \$1.99 USD lb and the trend growth rate at 4.9%, we will have a situation where the lower structural revenue basis deriving from the fall in GDP in 2009 will lead to a lower structural revenue for 2010. This will mean that with a targeted structural surplus of 0.5% of the GDP, the government’s nominal expenditure could only grow 3.9%. Although we expect low inflation for the next year, we believe that this figure would be too low to sustain a solid economic recovery. However, if the (temporary) 2009 target is maintained (structural fiscal balance), this would permit an expansion of nominal expenditure by 6.1% in 2010, a modest figure in comparison with recent years, but consistent with maintaining the proportion of public expenditure with regard to the GDP.

**Tabla 2: Proyección Fiscal (% del PIB)**

|   | 2009  |
|---|-------|
| <b>Total Ingresos</b>                   | 19.3% |
| <b>Total Gastos</b>                     | 23.6% |
| <b>Superávit Primario</b>               | -4.1% |
| <b>PRÉSTAMO NETO/ENDEUDAMIENTO NETO</b> | -4.2% |

Fuente: BBVA