Executive Summary | Report on Structural Fiscal Balance of 2022

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This document includes the executive summary of the Fiscal Advisory Council Report on the Structural Fiscal Balance of 2022.[1]

Executive Summary

In compliance with the Decree 315/021, article 18, the Fiscal Advisory Council (CFA, by its acronym in Spanish) publishes this report after the publication of the annual public finance data for 2022. The CFA is a technical, honorary, and independent body. Its main mandate is "to ensure that the estimates of the Structural Fiscal Balance (RFE, by its acronym in Spanish) are supported by solid and objective academic bases" (Art. 13 of Decree 315/021).

The CFA as reviewer of structural fiscal balance estimation. Based on the review of the fiscal data sent by the Ministry of Economy and Finance (MEF), as well as on the exchange with government authorities, the CFA concluded that the estimation of the structural fiscal balance of the Central Government-BPS (GC-BPS) carried out by MEF complied with the current methodology in place.

Fiscal ratios may require adjustments to account for the upcoming revision of the estimated nominal GDP due to the impact of the draught on the real activity and a lower-than-expected increase in the GDP deflator. Following the procedure defined by the MEF for the disclosure of the monthly results of the public sector, the effective and structural fiscal balance ratios expressed as a percentage of GDP were published using as reference the nominal GDP forecasted by MEF back in June 2022 in the annual "Rendición de Cuentas" Law. Definitive data of the GDP for 2022 might differ from the current official estimation for two reasons: (i) the effect of the drought on the physical volume of Q4.22, and (ii) lower-than-expected increase in GDP deflator due to falling export prices and the real exchange rate appreciation. A lower-than-expected nominal GDP for 2022 could lead to an upward correction of the effective and structural fiscal balance ratios between 0.1 and 0.2 percentage points. According to Central Bank's calendar, definite GDP figures for Q4.22 will be published on March 23, 2023.

The effective fiscal balance of the GC-BPS showed a deficit of 3.0% of GDP, according to data released by the MEF. This represents a decrease of 0.8 percentage points compared to 2021. The decreased was explained mainly by cyclical factors given the fact that GDP grew three percentage

[1] Complete version of the document available in Spanish in this link https://www.gub.uy/ministerio-economia-finanzas/sites/ministerio-economia-finanzas/files/2023-02/2023%2002%2022%20CFA%20Uruguay_Informe%20CFA%20Resultado%20Fiscal%20Estructural%202022.pdf

points above its long-term potential growth rate (estimated at 2.1%). However, in the last quarter of 2022 the effective fiscal deficit increased by 0.8 p.p. of GDP due to transitory innovations (increase in CG investments, transfers, and extraordinary expenses associated to COVID-19), and a cyclical slowdown in the real tax collection. The latter is a factor of concern to be followed in the upcoming months.

The structural fiscal deficit of the GC-BPS was below the effective deficit, standing at 2.4% of GDP. The structural deficit was 0.6 percentage points lower than the effective result since the latter is still affected by the cycle, as well as by extraordinary factors such as COVID-19 Fund. The structural fiscal balance estimation is based on the potential growth estimation of 2.1% and an output gap of -2.4%. Despite high GDP growth in 2022 (around 5%), the economy is still working with slack, meaning that the effective income of the GC-BPS would have been 0.5% of GDP lower than the cyclically adjusted, while the effective expenses of the GC-BPS would have been 0.3% of GDP higher than the structural. Therefore, the cyclical adjustment to the effective fiscal balance in 2022 was estimated at 0.2% of GDP. Finally, the net effect of extraordinary factors caused a one-off increase in the effective fiscal deficit of 0.4% of GDP.

CFA assessment on the fiscal adjustment carried out since 2020. The CFA positively assess the compliance with the three pillars of the fiscal rule for the third year in a row: the targeted structural fiscal balance; the cap on the real expenditure growth of the Central Government below the GDP potential growth; and the debt ceiling. The CFA considers that the new fiscal institutional framework in place, the fulfillment of the fiscal rule in its three pillars, and the decrease of the structural fiscal deficit from -4.6% of GDP in 2019 to -2.4% of GDP in 2022, all might explain the improvement in credit ratings and a historically low sovereign spread. The improvement in credit conditions not only favors public finances and the sustainability of social policies, but also enables the reduction of macroeconomic imbalances making possible the investment grade sustainability.

CFA assessments on macroeconomic risks. First, real revenues and current expenditures (before investment) growth was close to GDP potential growth in 2022 (estimated at 2.1%), meaning that any additional cyclical improvement would tend to generate a reduction in the effective fiscal deficit without improvements in the structural fiscal deficit. The reversal of spending of the COVID-19 Fund scheduled for 2023 should not be interpreted as structural fiscal space, since it is an extraordinary component.

Second, in a global context of falling inflation, disinflationary surprises with respect to what was contemplated in the baseline scenario could lead to higher-than-expected variations in real public spending, unless this moderation is also reflected in some nominal items.

Third, a correction of the exchange rate misalignment (as estimated in the Central Bank Monetary Policy Reports) could increase the debt to GDP ratio, even without necessarily breaching the third pillar of the fiscal rule, as showed in the risk analysis presented by MEF back in June 2022 in the "Rendición de Cuentas" Law.

CFA assessments on policy decisions. The CFA warns about risks of possible reversal of the structural fiscal improvement process given Government's announcements of permanent tax reductions of the Personal Income Tax (IRPF) and the Social Security Assistance Tax (IASS).

On the side of structural revenues, there is no evidence of improvement in potential growth. The CFA considers that any fiscal impulse, regardless of its destination and magnitude, will have direct impacts on the structural fiscal position, unless it is offset by structural savings in expenditure items. As of the date of this report, the CFA has not had access to data regarding the planned tax cut design, regarding size, composition, or sources of financing. The CFA suggests that the MEF makes public this analysis. This would allow the CFA, credit risk agencies and the market, to make their own assessments on the impact of these tax cuts on the structural fiscal balance and in fiscal sustainability. This should be analyzed regardless of the impact in terms of income distribution or resource allocation, considerations that exceed the CFA mandate.

On the other hand, an expansion of the most discretionary items of public spending (investment and non-personal spending) above the potential GDP growth rate, as happened in 2022, could put under stress the compliance with the second pillar of the fiscal rule, given the rigidity of the rest of the expenditures of the GC-BPS and the disinflation risks mentioned above.

The reduction of the fiscal slack and, therefore, of the room for maneuver of fiscal policy in a context of stable potential growth, requires the adoption of a criterion of greater prudence when evaluating economic policy measures with a permanent upward impact on spending and/or a decrease in revenues. Any permanent (structural) fiscal expansion supported by a (transitory) cyclical improvement, could drive a deterioration of the structural fiscal balance position and generate procyclical biases in fiscal policy as well. This document includes a box (pages 19 to 22) aimed to highlight the importance of the structural approach as a guide for fiscal policy.

With a low fiscal slack, eventual deviations from the path improving the structural fiscal balance would also mean less room to react (countercyclically) to some exogenous negative shocks that may arise, such as drastic changes in the international scenario, the drought, or any other extraordinary shocks.

CFA recommendations. The CFA suggests that in the future, the MEF update its reference nominal GDP estimation after the annual closing of the public finances in February of each year. This is relevant for the purpose of delimiting any implicit biases in GDP estimation dragged from the "Rendición de Cuentas" Law assumptions (June).

The CFA restates the importance of the publication of the elasticities of fiscal revenues and expenditures to GDP used for the cyclical adjustment of the fiscal balance. This is relevant for two reasons: (i) it allows the replication of the structural fiscal balance estimation by third parties, and therefore favors transparency of the fiscal framework, and (ii) it allows the CFA and the market to analyze and further understand the evolution of the different components of the fiscal income and the fiscal expenditure in structural terms.

Regarding the correction for the extraordinary factors in the structural fiscal balance, the CFA insists on the importance of defining ex-ante criteria in an explicit and pre-announced manner for the treatment of extraordinary income or expenses that arise as transitory and may eventually adopt a permanent nature ex-post. In this sense, the COVID-19 Fund has been an example of a transitory legal tool that should serve as a guide for other policies that arise in response to a transitory event.

The CFA highlights the need to continue deepening the methodological approach of the structural fiscal balance to strengthen and to complement the current methodological framework: (i) the estimation of the elasticities of revenues and expenditure to GDP in different time horizons, (ii) stochastic and deterministic models of debt sustainability and prudent level of debt, and (iii) complementary approaches for potential GDP and output gap estimations.

Finally, in its role as observer, the CFA reiterates the need to publish the historical series of the production function inputs used for potential GDP growth estimation by the next call to the Expert's Committee, instance foreseen for April 2023.