Journal Essays on Economic Policy (ESPE) - Fiscal policy and macroeconomic stabilization in Colombia

Download Keep in mind
In the journal Essays on Economic Policy (ESPE) - we disclose the results and policy proposals that arise from academic research carried out at the *Banco de la República*. When you read us, always keep in mind that the content of our articles, as well as the analyzes and conclusions derived from them, are the sole responsibility of their authors. The material disclosed in our ESPE magazine does not compromise or represent the opinion of *Banco de la República* or that of its Board of Directors.

AUTHORS AND/OR EDITORS Ignacio Lozano-Espitia Arias-Rodríguez, Fernando González-Gómez, Andrés Granger-Castaño, Clark Hamann-Salcedo, Franz Yurany Hernández-Turca Julio-Román, Juan Manuel López-Piñeros, Martha Rosalba Méndez-Vizcaíno, Juan Camilo Rincón-Castro, Hernán Rodríguez-Guzmán, Diego Arturo Zárate-Solano, Héctor M.
In the journal *Essays on Economic Policy (ESPE)* - we disclose the results and policy proposals that arise from academic research carried out at the Banco de la República. When you read us, always keep in mind that the content of our articles, as well as the analyzes and conclusions derived from them, are the sole responsibility of their authors. The material disclosed in our ESPE magazine does not compromise or represent the opinion of Banco de la República or that of its Board of Directors.

Publication Date: Friday, 10 of May 2019

This document analyzes the most important macroeconomic aspects of fiscal policy in Colombia. First, its role in stabilizing the economic cycle in the short term, which is usually investigated by examining the government's stance toward the economy’s expansion and contraction phases.

Other issues related to macroeconomic stabilization are also studied, such as the impact of uncertainty –caused by recurrent changes in taxation– on aggregate demand, as well as the relationship between fiscal and monetary policies. Furthermore, the sustainability of public debt and the fiscal space available in the economy are analyzed as crucial factors for knowing the government’s room for maneuver in the medium and long term. The study’s main findings have important implications for economic policy.

Findings related to macroeconomic stabilization

The first finding regarding the role of fiscal policy in macroeconomic stabilization states that the **stance of the national government toward the economic cycle** continues to be procyclical, as concluded in previous studies. This is despite the enactment of the fiscal rule in 2011, which, by design, should correct this behavior. As a new finding, however, it is determined that the procyclical stance has mainly been the result of tax management, since this situation is not confirmed by changes in expenditure. The government's stance toward the economic cycle represents a great challenge for

future policymakers: to reverse the existing procyclical management, so that fiscal policy can properly conduct aggregate demand.

The second finding related to taxes suggests that, although **recurrent reforms to national taxation** sought resources to address fiscal sustainability, their high frequency seems to generate uncertainty and distrust in the rules of the game, which negatively affects short-term private investment and consumption. On this matter, the National Government and Congress need to recognize this reality and ensure that future adjustments in taxation are oriented toward finding a system that's consistent with the precepts of efficiency and progressivity, and especially, that is stable over time, to avoid continuously changing tax rules.

The document also offers evidence on a matter of interest, especially if the government were to implement countercyclical stances through spending in the future. It is found that, under the current inflation targeting scheme of monetary policy, and the floating exchange rate regime, **the public spending multiplier** is higher, compared to the multiplier found under the exchange rate band regime that operated in the nineties, and to the mini-devaluation regime of the eighties. The higher multiplier implies that, in current conditions, the government would have a greater capacity to alleviate deficiencies or excesses in aggregate demand. This meaning that it would be more effective in reactivating the economy when it enters recessions, or mitigating its growth in boom phases, to moderate inflationary pressure. This finding also means that, since the adoption of the inflation targeting scheme in the late nineties, there has been a better interaction between fiscal and monetary policies, which has been beneficial to the country's macroeconomic management.

> **This article analyzes the most important macroeconomic aspects of fiscal policy in Colombia: its role in short-term economic cycle stability, sustainability of public debt, and the fiscal space available in the economy.**

Findings related to debt sustainability and fiscal space

The aspects related to the sustainability of public debt and the available fiscal space were addressed based on a question that was the central axis of discussion: How close is the country to an eventual fiscal limit? To answer it, two approaches were used: one regarding tax revenue, and another from the side of increased debt. Results don’t vary much across both approaches.

On the tax side, Laffer curves were estimated, which relate government collections to tax rates and suggest that these grow with increases in rates up to a maximum level and then fall, due to the disincentives that taxes generate on labor supply and the desire to invest. Their estimation yields previously unknown evidence. In the case of labor income taxes, the government would have space for greater collection of 3,3% of output. The space for greater burden on capital income is 1,9% of

output.

Thus, the government would have more than 5 points of output as space to increase the burden on production factors in the long term, before adding the eventual space from consumption taxes. The tax burden could be increased not only by reviewing statutory rates, but especially by expanding taxed bases to new taxpayers, reducing or eliminating tax benefits, and through better management of tax administration. Public revenue missions have established the guidelines on how to operate on these fronts.

On the debt side, the so-called natural debt limit for the national government was estimated, understood as the maximum level of sustainable debt under "*adverse income and expenditure scenarios*". It is emphasized that the debt limit is nothing more than an indicative or reference value, which is valuable as a signaling device to the government, to prevent its debt from approaching said level. The results suggest that this natural limit would amount to 50% of GDP, a figure that is not very high, especially considering that currently, the country’s debt level exceeds 45% of GDP, and that it remains sensitive to external shocks.

Even though the current level of debt appears sustainable, and the National Government’s fiscal space would be close to 5 percentage points of output, this space is still quite narrow. It is advisable to reduce debt levels to have more fiscal space, and thus preserve access to financial markets at reasonable costs. Recent decisions to temporarily relax the government deficit implicit in the fiscal rule due to the additional resources required to address Venezuelan immigration could imply, in practice, increases in indebtedness, causing a reduction in said fiscal space.

Lastly, the debt limit was assessed with a more benevolent alternative technique that considers the fiscal situation of countries in the region, among others. The concept known as "fiscal fatigue" suggests that a country could enter this situation when, faced with continuous increases in debt and interest payments, the government's efforts to achieve positive primary balances are undermined. This ensues a state of fatigue that pushes debt to critical levels.

It is found that the country's consolidated public debt limit would be 56% of GDP, and that fiscal space would increase to 7% of GDP, a space that remains narrow, due to the sensitivity of public debt to changes in the internal and external macroeconomic environment. When applying this technique to the national government's debt, the limit is around 52% of GDP, meaning it would have a slightly larger fiscal space than estimated with the natural limit criterion.

Fuente: https://www.banrep.gov.co/en/publications-research/espe/fiscal-policy-macroeconomic-stabilization-colombia