

LIBERTAD Y DESARROLLO

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## FIRST TWO YEARS OF GOVERNMENT: CONSEQUENCES OF ADHERING TO THE PROGRAM

- The fact that the governing sector seems to be satisfied with the changes made is a matter of concern, because they have gone mostly in the wrong direction. Still worse is that they keep going forward with the initiated reforms, despite the lack of support revealed by surveys and criticisms of a large number of experts.
- The changes introduced could be difficult to rectify, since they will be associated to a strong deterioration of fiscal accounts and a stricken economic growth capacity.

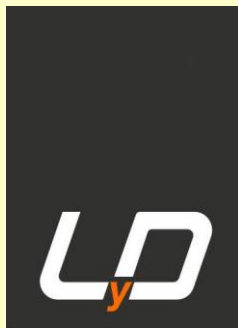
We are halfway of Michelle Bachelet's presidential term, which deserves a review and evaluation of her administration. Everything indicates that she has succeeded to impose a program based on distrust towards the private sector, an increasingly planned economy and overregulated markets. The latter has brought disastrous consequences, although its magnitude is still unpredictable. The strong deceleration of the economic activity, and particularly investment, the prevailing pessimism, the deterioration of public accounts and the sustained citizen disapproval have started to show signs of this adverse impact.

Nevertheless, this scenario does not seem to permeate neither the authority nor the public agenda. In a recent interview, the Minister General Secretariat of Government, Nicolás Eyzaguirre, disqualified those who blame the reforms for the economic deceleration and the drop in the presidential approval, and justifies the deep transformation driven by the current administration, based on alleged threats of social rupture and convergence towards lower growth rates<sup>1</sup>. This diagnosis is questionable, not only in the light of the good economic and social results obtained in the last thirty years, but also because it does not validate the achievements accomplished during these two years in relation to opportunities, mobility and uprooting of poverty.

### **REFORMS MARKED BY ERRONEOUS DIAGNOSIS AND IMPROVISATION**

#### ***Tax Reform***

The current administration started its term –as promised- with an important Tax Reform whose objective was to increase fiscal revenues by 3% of the GDP. With the approved reform (Law No. 20,780 and its insufficient rectification, Law No. 20,899), both the total tax burden –net from



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social security contributions – and the share endured by the companies will be higher than the average of the OECD member countries<sup>2</sup>.

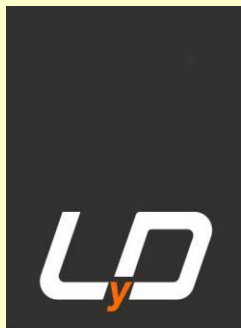
This reform has shown temporary impacts and it will also have permanent effects. The temporary impact concerns the high uncertainty level that started to show more than two years ago, during the presidential campaign, which has been strengthened while confirming the deepness, complexity and contents thereof<sup>3</sup>. But this is not all, since relevant effects will persist on the economy's trend growth while reducing the profitability of the projects and making saving less attractive for the companies, as a result of the significant rate increase and the partial disintegration. It should not be overlooked that, in less than 10 years, the income rate tax, considered the most inefficient and harmful of all taxes<sup>4</sup>, will have increased almost 60%.

### ***Labor Reform***

The Labor Reform, to be dispatched soon, reflects the traditional vision of the left regarding the capital-work relationship. Behind the so-called “modernization of labor relations” underlies the concept of class struggle, in which the improvement of the workers' conditions comes mainly from taking from the employer a greater share of his income through the power of trade unions. In this manner, through the union's full entitlement to negotiate and the prohibition to hire replacement workers during strikes, the trade union becomes the single representative authorized to negotiate contractual improvements, and if it does not reach its objectives, the trade union has the power to produce irreversible damage in the company's situation. This vision of the employer-employee relationship, which can be valid in the context of a closed economy with large monopolistic companies, has a very adverse effect on open and competitive economies, where incomes are usually temporary phenomena. The result will be negative in terms of incentives for workers, employers and the development of new projects. Thus, the Labor Reform will end up being equally or more harmful than the Tax Reform, and also much more difficult to amend.

### ***Education***

The education program has been gradually and totally enforced. In school education, the Law No. 20,845 (“about inclusion”) was approved, which will gradually end with shared financing and decentralized school admission processes. Additionally, it will eliminate public financing for educational institutions constituted as a corporation with commercial purposes, and that do not own the property in which they operate. Although the President has openly celebrated the “fruits” of this initiative, it is good to know that it will take more than 5 years to come into force, so that a long time is needed to actually know the consequences thereof. Anyway, it is foreseeable that in upcoming years all educational institutions will remain cautious regarding innovation and investment decisions and, therefore, the drive and modernization that our school system needs seems distant.



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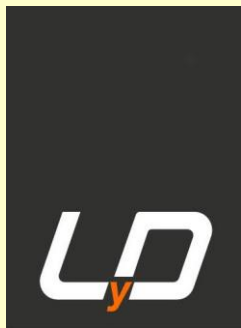
At the beginning of the present year, the government enacted a second bill regarding the Teaching Career, which although it was well received by the public opinion, it fails to introduce effective incentives to attract better professionals to teaching. The reason is that it continues with the logic of fixing the salaries of 93% of the teachers in a centralized way (not only of municipal schools, but also of private-subsidized schools). Despite the fact that new allowances are incorporated based on results of an evaluation, the latter will be incapable of properly measuring the teaching performance since it will be performed under the authority of the Ministry of Education, and at the same time it puts pressure on the Teacher's Association; and this could be impossible to counteract in the future.

Concerning higher education, while waiting for the submission of a bill that definitively modifies the institutional framework and financing system, the government introduced a new item in the Budget Law to finance tuition-free education for students belonging to the first 5 deciles in a certain number of universities. The information so far does not allow to be very optimistic when assessing the impact on the access of lower-income students to the universities involved. The reason is that the estimated number of first-year benefited students in universities of the Council of Rectors (CRUCH) would finally be very similar to the 30 thousands students of the first 5 deciles who were benefited in 2015 with a tuition scholarship in the first year. This means that, instead of being a stimulus for those who did not have access to higher education, tuition-free education is aimed at those who would have entered this educational level one way or another. Anyhow, we will have to wait and see how the government decides to advance given the economical restrictions: if it will favor partial aids and be focalized on the most vulnerable students, or if it will persevere with price-fixing and privileging students of a limited group of institutions to whom their autonomy will be impaired.

### ***Health***

The government has given repeated proof of its incapacity to efficiently advance in their commitment regarding a millionaire investment plan of US\$4 billion to build a new health infrastructure. In this context, the purely ideological decision of our authorities to close the door to the cooperation of the private sector in investment matters is even more incomprehensible; this decision has been materialized in the cancellation of the bidding process (already underway) for the hospitals of Marga–Marga and Quillota–Petorca, in addition to the hospitals of Sótero del Río and Puente Alto. Furthermore, it decided not to call for tender for the hospitals of Curicó, Linares and Chillán.

Likewise, waiting lists do not ease off, and in 2015 the hospital debt largely exceeded the threshold of \$200 billion. Furthermore, the Ministry of Health (MINSAL) has been incapable of materializing their commitment to the millionaire investment plan. In parallel, and instead of trying to improve the quality and timeliness of medical care for the people affiliated to the



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National Health Fund FONASA (close to 80% of our population), the government would be *ad portas* of sending a bill that would reform the system of private health insurers (ISAPRES). The latter require modifications<sup>5</sup>, but they are very far from the proposals suggested to date, which could end up worsening the situation of the insureds of both the ISAPRES and the public sector<sup>6</sup>.

### **Poverty**

The government has worryingly attenuated the urgency of uprooting poverty and has erroneously changed the focus of social policies towards reducing inequality. In a society like ours, which has presented high upward mobility levels (where more than half of the population is considered middle class) and has evidenced an extraordinary uprooting of poverty (it went from 38.6% to 11.7% between 1990 y 2013), the inequality indicator provides very little information, since it does not consider the changes in the social composition of the population.

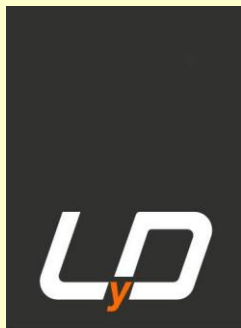
The logic of the focalization instrument was also modified. The new Social Protection Card seeks to exclude higher-income households, neglecting the identification of the most vulnerable ones. Considering that this new instrument uses effective income data from the administrative records, it could encourage informality and promote aids that are not very effective, such as the “Permanent March Bonus” of March 2014, which are far from solving the structural problems of families in poverty conditions.

The poverty measurement also suffered a relevant modification. Although there was a certain consensus about the need to update indicators, the historical methodology did not correspond to the same one provided in 2011. With the replacement in the series, the increase of the poverty rate in 2009 “disappeared”. Moreover, it incorporated a multidimensional poverty rate not defined by income level, thus identifying people with incomes up to CLP\$8 million as “priority” households of the social policy, a clear nonsense when the purpose is to help the most vulnerable.

### **Security**

The Executive insists in denying the reality marked by poor management in delinquency control and an increasing perception of insecurity among the citizens. Data in relation to the rejection of delinquency management are conclusive: 92% disapproves the government’s management in the matter (Adimark survey, February 2015), while 85% of the interviewees in the survey Plaza Pública CADEM considers that delinquency has increased, and for 88%, it expresses itself in a more violent way.

The government’s response to this general perception has been reduced to introducing the so-called Anti-Delinquency Short Law, a set of regulations aimed at optimizing crime prevention and control and at modifying the punishment system. This legislative package contains positive aspects, but does not deal with the most relevant issues regarding the crime pursuing task, such



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as: the correct implementation of the PACIC system (police platform for an integrated criminal analysis), work coordination improvement among all actors involved in the prevention, control, punishment and rehabilitation of crimes, and continuity in the implementation of policies and programs based on evidence.

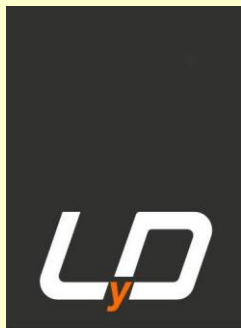
### ***Energy***

The Energy Agenda kicked off a series of changes. Although we appreciate the fact that this sector has shown more dynamism, the intense legislative activity has persistently promoted a greater role of the State. That is how the National Petroleum Company (ENAP) was authorized to enter the market of electric power generation, and the State was given a leadership role in the bidding and awarding processes, and in the modification of the supply contracts for electricity distribution companies. Other bills seek to increase the powers of the State in energy planning and the extension of the transmission system, and in a possible rate fixing process in the gas market. In addition, the powers of the National Energy Commission (CNE) on various matters have been continuously increased. The consequences thereof will only be evident as time goes by, but they certainly entail risks for the efficient development of the energy sector, which will have an influence on energy rates in the long-term.

### ***Politics***

In the frame of the Probity and Transparency Agenda, the government launched a set of 35 measures –both administrative and legislative- with the aim of repairing the regulation voids in matters concerning political-electoral financing and reversing the atmosphere of distrust and rejection caused by an increasing perception of corruption. However, the Executive’s main mistake has been to impregnate the legislation with exulting and revisionist voices, which, ignoring the standards of consolidated democracies, have imposed an excessively intense regulation referring to spending limits and prohibition of financing sources that will put at risk the system’s competitiveness; candidates currently holding the position (incumbents) will be favored in detriment of new actors (challenging), who will have difficulties to carry out their campaigns and transmit their political message.

Furthermore, this new financing regulation destabilizes the mixed financing system, practically eliminating private (citizen) financing, and political parties will turn into bodies that are excessively dependent on public resources, with the respective damage in terms of financial and operational autonomy. In addition to this, political parties will become legal entities at public law, with the corresponding implications in terms of constraining their internal life, and the risk of dissociating them even further from their natural environment, which is the civil society.



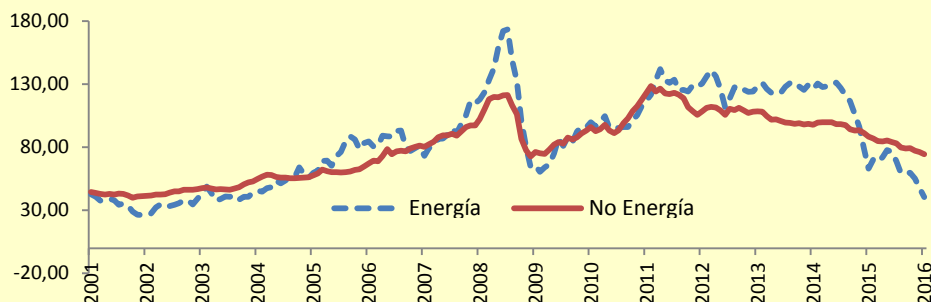
## EFFECTS THAT ARE BECOMING EVIDENT

### *Macro Results*

The Executive has insisted that the deceleration is a phenomenon that responds mainly to external factors that are affecting all emerging economies and, especially, the exporters of raw materials<sup>7</sup>. However, and beyond the relative deterioration of adverse conditions, giving them too much relevance does not resist a more rigorous data analysis. First, we should observe the performance and perspectives of relatively comparable economies, such as the member countries of the Pacific Alliance -Peru, Colombia, Mexico-, especially after the end of the super-cycle of commodities. While non-energy commodities –copper among them- started to fall at the end of 2010, energy – particularly oil- remained at historically high levels until mid-2014.

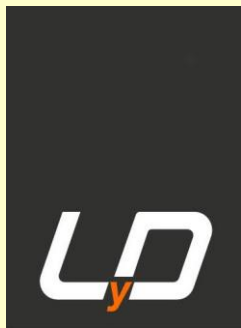
### NON-ENERGY COMMODITIES START TO DROP IN 2011, ENERGY ONLY IN 2014

Chart 1: Commodities' Nominal Price Index in US\$, 2010=100



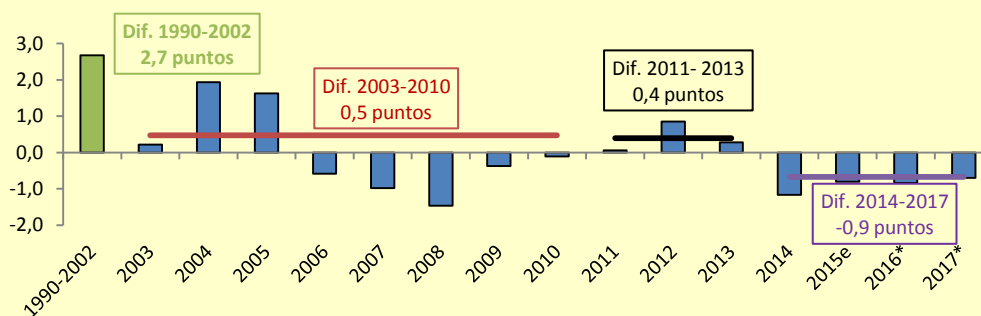
Source: World Data Bank 2016

In general, Chile has grown at a higher rate than the other members of the Pacific Alliance, even during the period when copper –and other non-energy commodities- had already started to collapse, but hydrocarbons –a relevant export for Mexico and Colombia- still remained high and stable. Our worst performance in relation to the Alliance is emphasized only in 2014, which can be partly due to mining investment lags that kept high activity levels. Nevertheless, since 2014, the price of hydrocarbons has collapsed, which should have mitigated the possible and expectable relative drop, because according to recent IMF documents, Chile could be –together with India- one of the potentially most favored countries by the oil price drop; on the contrary, Mexico and Colombia could be specially impaired. Therefore, it is reasonable to believe that local deterioration is mainly due to internal factors.



Another way of evaluating our performance, beyond regional comparisons, is to directly test if the deceleration is due to external or domestic factors, which is exactly what the Central Bank of Chile did in June 2015<sup>8</sup>. Specifically, the BCCh addresses the confidence-investment relationship through macro data and data at the level of individual companies. At the aggregate level, the Bank studies how the global cycle and domestic macro variables –confidence and uncertainty- contribute to the cyclic component of investments in Chile, using alternative specifications (controlling by the global cycle of copper mining investment), and the results are quite eloquent. During the decrease of total investments in 2009-2010, the external cycle explained between 64% and 83% of the investment drop and the change in the confidence component, which actually moderated the fall; between 3% and 4% of this drop was due to the external cycle, while between 23% and 87% was derived from a decrease in confidence.

**CHILE GREW FASTER THAN THE PACIFIC ALLIANCE PARTNERS UNTIL 2014**  
**Chart 2: Growth Rate Difference Chile v/s Pacific Alliance, Average Weighted by GDP PPP**

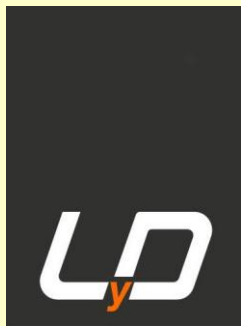


Source: L&D based on BCCh, IMF and CONSENSUS Forecast, \* CONSENSUS estimate.

In relation to the micro approach, using a panel of 51 firms which report their balance sheets to the Superintendencia de Securities and Insurance (SVS), and data from each company of the Monthly Index of Business Confidence (IMCE), the BCCh obtains results that are consistent with the macro evidence: a decline in confidence implies an investment decrease of around 8%, quantitatively similar to the cyclic drop of investment in 2014.

**Fiscal Accounts**

The conjunction of strong economic deceleration, lower copper price and strong increase in public spending commitments, has entailed a quite significant impairment of fiscal accounts, reflected on the increase of the indebtedness level. During the period of 2014-2016, the sum of each year’s fiscal deficit in US\$ adds to US\$16 billion, despite the Tax Reform. This impairment of public accounts is making it evident that without economic growth it is impossible to give the population more and better social benefits, and this is precisely what has imposed some realism degree in the government’s maximalist program.



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### ***Social Effects***

The loss of both priority and focus in social policies are beginning to affect lower-income households. Although when using the official numbers of the updated methodology, the poverty rate decreases (from 22.2% to 14.4% between 2011 and 2013) and inequality remains the same (the Gini coefficient went from 0.492 to 0.491 in the same period), based on an estimate with the last EOD Survey (Employment and Unemployment in Great Santiago), we observe that poverty reduction has stagnated and that the updated poverty rate has gone from 6.6% to 6.8% between March 2014 and September 2015<sup>9</sup>.

### **CONCLUSIONS**

The fact that the governing sector seems to be satisfied with the changes made is a matter of concern, because they have gone mostly in the wrong direction. Still worse is that they keep going forward with the initiated reforms, despite the lack of support revealed by surveys and criticisms of a large number of experts. And now, a constitutional process is bound to begin, which could end up modifying fundamental aspects in the country's socioeconomic development. There are still two more government years ahead and the changes introduced could be difficult to rectify, since they will be associated to a strong deterioration of fiscal accounts and a stricken economic growth capacity. Bad news for the person that will take the baton in March 2018.

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<sup>1</sup> Capital Magazine, "Eyzaguirre reformado", Edition No. 415, March 2016.

<sup>2</sup> Public Issues No. 1,166: "New Tax Reform Bill: Not as Bad but Still Damaging". LyD, July 2014.

<sup>3</sup> In a climate of uncertainty and given the irreversibility nature of investment, the optimal decision, in many cases, is to postpone it until more information is available (Bernanke 1983). Baker, Bloom and Davis (2013) find that when applying uncertainty about fiscal, monetary and regulatory policies, investment is usually reduced.

<sup>4</sup> Tax and Economic Growth, Economics Department, Working Paper No. 620, OECD.

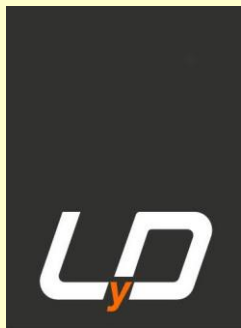
<sup>5</sup> Particularly, measures aimed at improving the mobility and information of their affiliates, in addition to a price adjustment mechanism that allows to objectively incorporate the increasing health costs.

<sup>6</sup> Details in <http://lyd.org/wp-content/uploads/2015/07/TP-1179-COMISI%C3%93N-ASESORA-SALUD-RC-CC-LL1.pdf>

<sup>7</sup> Among the mentioned factors are the drop in trade terms, higher credit spreads, rumors about a possible interest rate increase in the USA, with the consequent capital flows towards the developed world, among others.

<sup>8</sup> Confidence, Uncertainty and Investment in Chile: Macro and Micro Evidence of the IMCE Survey, Draft Quoted in the IPoM of June 2015, Elias Albagli and Emiliano Lutinni.





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<sup>9</sup> Public Issues No. 1,235. *"Se estanca la reducción de la pobreza"*. LyD, December 2015.