

## Corbo Commission's Report: Towards a Better Fiscal Policy

**The recommendations on fiscal policy made by the Advisory Committee on Structural Balance Policy are, in general terms, a very helpful contribution to progress in the implementation of a better fiscal policy in Chile. There are also some proposals to strengthen the counter-cyclical nature of the policy which, if applied, generates in our opinion, a bias towards a fiscal policy that is more expansive than advisable.**

In May 2010, the Government convoked an Advisory Committee of Structural Balance Policy, chaired by Vittorio Corbo, with the aim of proposing refinements to the fiscal rule used in Chile since 2001. Although we cannot ignore that this rule has entailed significant improvement in the execution of the fiscal policy, in recent years several questionings have come up, in part due to the sustained increase of the copper price trend and also, in some cases, to several arbitrary changes which in general searched to strengthen the counter-cyclical nature of the rule used, which were leading to a credibility loss.

The Committee delivered a preliminary report in August of last year and a final report recently, which more or less maintains the proposals which had been adopted by the Ministry of Finance for the estimation of the structural balance incorporated in the Budget 2011. The purpose of this analysis is to present the main proposals of the Advisory Committee and some observations concerning the same.

After explaining that the fiscal policy will continue to be governed by trend variables, the report indicates the main problems of the current rule, which can be summarized as follows:

- The continuous changes applied to the rule, especially after the 2009 crisis, weakened its transparency and credibility, and there is also the way in which these changes were informed to the public opinion.
- The counter-cyclical nature of the rule may be insufficient when facing big crisis like the one occurred between 2008 and 2009.

- The problem caused when trend variables, specifically the copper price, increase as sharply as between 2004 and 2008, is that even if the spending level is compatible with the rule, it may not be compatible with the stability of important macro-variables such as the real exchange rate or the aggregate spending level.

The report recommends modifying a first point, which seems very logical, which is to clearly define that the fiscal policy adopted by the country is defined as a Cyclically-Adjusted Balance (CAB) and not as a structural balance. The first one adjusts by the variables which are affected by the cycle (copper price, tax receipts mainly), while the second needs to estimate a permanent fiscal income concept, of great practical complexity, and which no other country in the world uses.

One of the problems derived from the rule during 2009 was that, due to the objective of more expansive fiscal policy, both concepts got mixed up, and changes closer to the concept of permanent income than of cyclic adjustments were introduced. Thus, it is made clear that the spending level should be estimated by the CAB. In short, the CAB concept has always been used, and it is also the most used and the one recommended by the Commission, which leads to reverse some of the adjustments made to the rule in 2009. Accordingly, the Commission also recommends not speaking of structural surplus or deficit, but rather of CAB deviations, since that is what is really being calculated.

The CAB policy actually allows the operation of automatic stabilizers, thus achieving that fiscal spending is neutral to the cycle, that is, acyclic, although it is not sufficiently counter-cyclical in the case of big shocks. In this perspective, the Committee recommended that the CAB goal be a function of the GDP gap, through a scheme where, at the beginning of each government, the authority may define the parameters used to consider the GDP gap, and is also able to choose a simply acyclic policy, where the parameter of the GDP gap adopts a value of zero.

If a parameter different from zero is chosen, it is suggested to maintain three additional criteria in order to safeguard the medium-term fiscal sustainability:

1. The magnitude of the counter-cyclical fiscal space should be around 0.5% of the GDP.
2. Fiscal gap should be used only by higher expenditures or lower transitional taxes.
3. Periodical reviews should be made concerning the medium-term fiscal stability.

The previous statement, although it tries to assume the responsibility for the situation in 2009, leaves out two important arguments. The first one is that, in a scenario of exchange rate flexibility and capital account

liberalization, fiscal policy loses effectiveness in terms of attenuating the contractive cycles, since it reduces the value of the exchange rate, and thus negatively affects the net exports. The second argument is that the macroeconomic vision behind counter-cyclical fiscal rules has a Keynesian bias, since it does not take into account the effects that spending and tax policy may have on the aggregated offer, through its effects on the microeconomic efficiency.

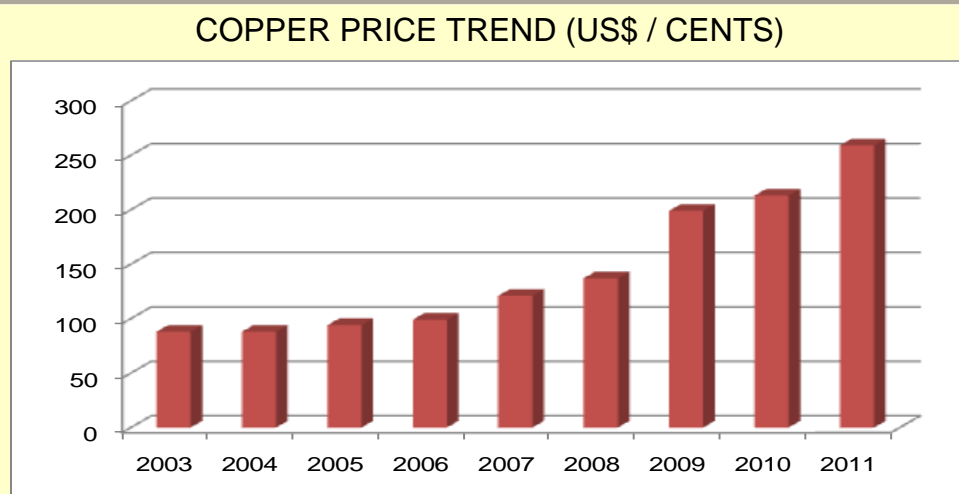
It is possible to have situations where spending reduction ends up being more revitalizing than the increase itself, as shown by the Chilean experience between 1985 and 1989, because lower spending comes along with productivity reforms. Finally, the policies of aggregate offer, and not demand, are the ones that generate economic development.

If the above mentioned is ignored, there is the risk of a fiscal impairment trend in the medium-term, since normally the positive shocks are considered permanent, which entails spending increases, and the contractive shocks are assumed transitional, which also generates a spending expansive bias. It must not be forgotten that a crucial starting point in a CAB policy is being able to distinguish the shocks' nature, which is a lot more complex than what we think.

The underlying central idea is that the effects of fiscal policy should not be maximized during the cycles, and to keep the discretion rule that, in trend terms, it is negative for public spending to grow above the GDP, as it definitely occurred during the period 2004-2009.

The Committee also referred to significant changes in the key parameters (the long-term copper price), recommending that the government studies an income partial adjustment mechanism, and then the Fiscal Council<sup>1</sup> gives his opinion on the adopted adjustment policy. This is a very relevant factor, considering the recent behavior of the copper price trend, shown in the next Chart. It is difficult for the fiscal policy to be acyclic when one of the parameters registers such a strongly expansive trend.

Chart 1



Source: DIPRES (Budget Office)

The existence of escape clauses, when facing unforeseen situations such as natural disasters, wars or strong external shocks are also analyzed. The Committee recommends the existence of these clauses, which must be exclusively summoned by the Executive Power, and then the Fiscal Council must deliver a report to the Congress regarding its application validity. Once a clause is summoned, a program must be established to recover the CAB in a period not exceeding three years. The Council would also express its opinion about this program.

We believe that the existence of escape clauses is redundant with the establishment of a CAB target adjusted by the GDP gap and, therefore, we should choose one of the two mechanisms, being the latter the best one, since it is less arbitrary. Once more, we insist on the idea of not biasing fiscal policy towards an excessive spending growth, because, from the political point of view, good justifications to increase spending will always exist, and the opposite occurs when it is necessary to reduce its growth rate.

With regard to the adjustments derived from errors in the parameters' estimation, the Committee correctly recommends that the authority makes parameters' corrections public, together with a legal requirement to maintain the goal's achievement after the parameters' corrections.

On the other hand, the Committee recommends maintaining the CAB goal at the level of the consolidated central government, since fiscal policy is executed on the base of that level. The Committee also suggests integrating the extra-budgetary level to the fiscal budget, something that could be accomplished if the Copper Reserve Law is eliminated.

It also suggests changes in relation to the fiscal results variable on which the goal is applied. Currently, the CAB goal is applied on the public sector's global balance. The Commission recommended, also correctly in our opinion, to apply the fiscal rule on the primary fiscal balance, because when the interests are not considered, the effects of previous operations are isolated on the current year's balance. Moreover, this indicator is far less exposed to the variations of the interest rates and the exchange rate, variables that are beyond the control of the fiscal authority. Finally, when using the primary balance, the pro-cyclic bias derived from the accumulation and drawdown of financial assets is eliminated. Obviously, using a primary balance goal requires to review the quantitative goal, so as to make it consistent with a net debt/GDP ratio which is sustainable over time. The Committee recommends making this important policy change in a gradual form.

The Committee does not state an opinion regarding an explicit CAB goal, but gives several criteria which must be considered in its definition, mainly referred to contingent liabilities (concessions, state guarantees, pension liabilities and assets of the Banco Central, among the most important). This point adds up a very important factor on assets, derived from the expected drop of the CODELCO mines ore grades. The Commission suggests the Budget Office to further develop the analysis of these factors, which seems a key factor in the current situation because, based on a copper price trend which has significantly increased, the Public Treasury has acquired permanent spending commitments. In a long-term analysis (30 years), the country could be committed to a type of Welfare State which, together with the population's aging, could lead us to a similar situation as the one experienced today by the so-called PIGS (Portugal, Italy, Greece and Spain).

The Committee also makes several methodological recommendations on the CAB calculation, which in general seem reasonable, and whose analysis goes slightly beyond the approach of this article. A suggestion is included to improve the estimation of the long-term copper price which seems relevant, although we may state beforehand that this is the main problem of the Chilean fiscal policy, since in the end spending greatly depends on a highly volatile variable, which is very difficult to predict. For the estimation of this price, it could be useful for the Public Treasury to take as reference a calculation of the actual value of the incomes derived from copper, so as to achieve perpetuity, and then verify if the copper price obtained by the Expert Committee is consistent with the perpetuity value. The Commission made some recommendations along these lines.

It also recommended modifying the way of estimating the long-term price of molybdenum, which is currently made on the basis of a four-year historic average, moving towards a scheme more similar to that of the copper price.

The effect of the previous proposals is summarized in Table 1.

Table 1

ESTIMATIONS OF CYCLICALLY-ADJUSTED BALANCE 2001-2010 (GDP %)										
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Structural Balance according to current methodology for each year	1.0	0.6	0.7	1.0	1.0	1.0	0.4	-0.4	-1.2	-2.1
Structural Balance according to proposed methodology	1.1	0.8	0.8	1.0	1.0	1.1	0.5	-0.6	-2.9	-2.0

Source: Fiscal Committee Final Report

As for the institutional framework, the Committee recommends the creation of a permanent Fiscal Council, which serves as a State's autonomous body in the technical evaluation of the fiscal policy and its implementation, giving public account to the Congress. Although the idea is attractive and has theoretical justification, in practice the benefit is not so evident, and additionally the operation costs of a council of this type should also be considered. The key factor is the independence degree with which these councils operate, and to what degree their analysis can be different from the one performed inside the Ministry of Finance itself. It is interesting to note that these councils exist in several countries, and the occurrence of complex fiscal situations has not been able to be prevented. We believe that this item of the proposal must be carefully evaluated.

Finally, the Committee made several proposals concerning transparency matters, which are not only positive but also very necessary.

### Conclusions

The recommendations on fiscal policy made by the Advisory Committee on Structural Balance Policy are, in general terms, a very helpful contribution to progress in the implementation of a better fiscal policy in Chile. Several of them have already been adopted by the Government in the elaboration of the Budget Law 2011 and, therefore, they can be considered completely valid.

There are also some proposals to strengthen the counter-cyclical nature of the policy which, if applied, generates in our opinion a bias towards a fiscal policy that is more expansive than advisable, mainly due to the difficulties to actually recognize the shock's nature. It would also be desirable that the analysis includes the fact that fiscal policy generates not only macroeconomic impacts (which can be even over-dimensioned in a context

of exchange rate flexibility), but also microeconomic ones through the effects of spending and tax policy on the efficiency of economy.

Finally, fiscal reforms that are currently being implemented in Europe are mainly pointing at improving the composition of spending rather than its level, in view of the pressing need to reduce it, even though it faces serious crisis situations. It should be avoided at all costs to fall into a similar scenario in the long term.

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<sup>i</sup> We will later analyze the proposal of creating a Fiscal Council.