

## Economic Growth: The Best Tax Revenue Source

**During the first two quarters of this year, the situation of the Central Government presented an evident improvement, with a surplus equivalent to 2.3% of the GDP. This was a result of a significant income growth, mainly due to a higher copper price and a more dynamic activity level. These two elements contribute more than the tax increases approved last year as part of the reconstruction program.**

The Budget Office (DIPRES, in Spanish) has recently circulated the fiscal execution of the first two quarters of the year, which evidences a very comfortable situation, with a surplus of US\$5,700 million, equivalent to 2.3% of the GDP. This result is due to a 14.2% real increase of the fiscal revenues in relation to the first two quarters of 2010, and a spending drop of 0.8% real.

The total revenues of this period are equal to 54.4% of the amount estimated for the whole year, which reflects that the tax revenue has been higher than expected. Instead, the total spending is equal to only 42.1% of the year's budget, which shows

sluggishness in the execution, regardless of the fact that normally the execution of the second semester is higher than that of the first one. Nevertheless, it is interesting to note that, although the spending execution accounted for 50% of the budget, there was still a surplus (see Table 1).

The figures' breakdown shows that the private mining contribution stands out in the revenue increase, with 33.8% real growth, while the contributions of CODELCO increase 9.4% real. We can also highlight the increase of the grants item, 162% real, due mainly to the changes introduced to finance the reconstruction. However, this item is not very significant, even considering the total, and it is far behind the budgeted amount.

The favorable evolution of the fiscal revenues, which are better than the estimated ones, is derived from three factors: economic activity growth, higher copper price, and increases of the business income tax (first category tax), mining royalty, tobacco, fuel and stamps taxes; however, we should also keep in mind that article 14 of the Income Law was extended as part of the reconstruction pack, thus reducing the first category tax of the smaller businesses.

Table 1

GOVERNMENT FINANCIAL STATEMENT, 2011.  
 CENTRAL GOVERNMENT TOTAL (FIRST TWO QUARTERS)

|  | Million CLP\$     | GDP %       | Var. 2011/10 Real % | Progress % on Budget |
|--|-------------------|-------------|---------------------|----------------------|
| <b>CURRENT REVENUES</b>                    | <b>14,059,819</b> | <b>12.0</b> | <b>14.2</b>         | <b>54.4</b>          |
| Net tax revenues                           | 10,759,633        | 9.2         | 16.3                | 54.5                 |
| <i>Tax on private mining</i>               | 1,441,875         | 1.2         | 33.8                | 78.9                 |
| <i>Tax on other taxpayers</i>              | 9,317,758         | 8.0         | 14.0                | 52.0                 |
| Copper, Gross                              | 1,617,049         | 1.4         | 9.4                 | 57.1                 |
| Social contributions                       | 794,283           | 0.7         | 5.1                 | 51.0                 |
| Grants                                     | 49,700            | 0.0         | 161.8               | 26.1                 |
| Property income                            | 250,530           | 0.2         | (3.6)               | 52.5                 |
| Operating earnings                         | 299,378           | 0.3         | 8.1                 | 57.3                 |
| Other revenues                             | 289,246           | 0.2         | 7.8                 | 58.8                 |
| <b>CURRENT EXPENSES</b>                    | <b>9,575,944</b>  | <b>8.2</b>  | <b>1.3</b>          | <b>44.3</b>          |
| Personnel                                  | 2,400,808         | 2.1         | 1.3                 | 51.8                 |
| Consumer and production goods and services | 1,106,940         | 0.9         | 16.2                | 41.6                 |
| 321,313                                    | 0.3               | 21.6        | 44.4                |                      |
| Interests                                  | 3,281,212         | 2.8         | (4.7)               | 38.0                 |
| Subsidies and grants                       | 2,452,837         | 2.1         | 1.6                 | 49.0                 |
| Social security benefits                   | 12,835            | 0.0         | 62.5                |                      |
| Others                                     |                   |             |                     |                      |
| <b>GROSS OPERATING INCOME</b>              | <b>4,483,875</b>  | <b>3.8</b>  | <b>56.9</b>         | <b>100.7</b>         |
| NET ACQUISITION OF NON FINANCIAL ASSETS    | 1,752,017         | 1.5         | (11.2)              | 33.3                 |
| Sale of tangible assets                    | 8,833             | 0.0         | 17.6                | 32.1                 |
| Investment                                 | 816,057           | 0.7         | (18.4)              | 27.6                 |
| Capital transfers                          | 944,794           | 0.8         | (3.6)               | 40.5                 |
| <b>TOTAL REVENUES</b>                      | <b>14,068,653</b> | <b>12.0</b> | <b>14.2</b>         | <b>54.4</b>          |
| <b>TOTAL EXPENSES</b>                      | <b>11,336,794</b> | <b>9.7</b>  | <b>(0.8)</b>        | <b>42.1</b>          |
| <b>NET LENDING/NET BORROWING</b>           | <b>2,731,859</b>  | <b>2.3</b>  |                     |                      |

Source: DIPRES (Budget Office)

Between the first two quarters of 2010 and the same period of this year, the tax revenue increased by US\$3,167 million<sup>1</sup>. It is interesting to identify the effect of each factor already mentioned in relation to the revenue increase. The higher copper price and the royalty increase account for US\$1,000 million. Tax increases (excluding mining) generate around US\$900 million, from which US\$250 million come from tobacco and stamps. So we have that economic growth accounts for approximately US\$1,300 million. We also have to add an extra US\$80 million corresponding to higher social contributions. These figures confirm the idea that a greater economic activity is the main source of the tax revenue increase. The 8% economic growth in the first quarter of this year generated more taxes than the rate increases specified as part of the reconstruction pack. This is a very important factor, especially in the current scenario where increasing taxes in order to finance social policies is once more a subject of discussion. If public policies strengthen their impact on the economy's productivity increase, it is needless to increase taxes in order to finance new social projects.

Concerning expenses, we observe a 1.3% real increase in current expenses. This limited expansion rate is mainly explained by a drop of 4% real in the subsidies and grants item, since this year the welfare bonus for low income families was not allocated and the Transantiago transport system received fewer subsidies. We also observe a very slow execution in the capital expenses (they fall 11% real) which, from the macroeconomic point of view, can be considered positive, but it generates questionings on the government's capacity to execute the investment plans. This is also consistent with the critics coming mainly from the Chilean Chamber of Construction concerning the slowness of the concession's program. Nevertheless, if the government finally executes the plans according to the estimations, a slower execution in the first two quarters and a more active one in the second one is positive from the point of view of the macroeconomic stability, since private spending should register the inverse evolution: higher spending in the first two quarters and a moderate one in the third and fourth ones. The countercyclical nature of fiscal spending contributes to mitigate the inflationary and exchange pressures.

Concerning the government's net debtor position in the analyzed period, Table 2 summarizes the assets and liabilities by last June.

In the first place, we can see that a great solidity is maintained in the debtor position of the Chilean public treasury, with a net debt equivalent to 2.4% of the GDP. The difference with the situation of the developed countries is abysmal. The external debt descended slightly in relation to December, while there was an increase in the debt in pesos, which was higher than the increase of the external assets; therefore, the net debt increased somewhat less than US\$2,000 million.

Additionally, the DIPRES recently delivered the Evaluation of the Public Sector Financial Management and the Planning Updating for this year.

Table 2

CENTRAL GOVERNMENT: ASSETS AND LIABILITIES (US\$ MILLIONS)

|   | December 2010 | June 2011     |
|---|---------------|---------------|
| External Debt                                 | 4,095         | 4,041         |
| Internal Debt                                 | 16,262        | 19,468        |
| <b>Total Debt</b>                             | <b>20,358</b> | <b>23,509</b> |
| FEES (Economic and Social Stabilization Fund) | 12,720        | 13,271        |
| FRP (Pension Reserve Fund)                    | 3,837         | 4,444         |
| <b>Total Assets</b>                           | <b>16,557</b> | <b>17,715</b> |
| <b>Net</b>                                    | <b>-3,801</b> | <b>-5,794</b> |
| % of the GDP                                  | -1.7%         | -2.4%         |

Source: DIPRES

It is interesting to remember that 2010 ended with a fiscal deficit of 0.4% of the GDP, and 2% in structural terms. Both figures are better than those of 2009, -4.5% and -3% respectively. For this year, DIPRES' estimations also improve significantly in relation to what was budgeted in September. The highest estimated revenues add up to US\$4,400 million approximately, due to the high copper price and the greater economic activity, which is partly offset by an expected lower exchange rate that negatively affects the external revenues. According to DIPRES, the greater economic activity should generate this year an additional income tax receipt of more than US\$1 billion, so the economic growth is much more "profitable" in terms of fiscal revenues than the tax rate increases. In this case, this amount corresponds to higher cyclical, non-structural incomes, but if we are

able to boost the trend growth, the structural incomes should increase as well.

In relation to the expenditures, the Budget Law for 2011 considered an amount of US\$53,381 million. We have to deduce from this amount a spending adjustment of US\$750 million, implemented in the second quarter. But we also have to add US\$180 million, corresponding to the permanent effect on the revenues generated by the mining royalty increase, and which are available for this year's spending. Taking other minor adjustments into account, DIPRES estimates a public spending real increase of 4.6% for this year. Since in the first two quarters spending fell 0.8% real, in the second semester the fiscal spending should grow close to 10% real, in order to achieve the estimated growth; this seems unlikely, but not impossible. This fiscal expansion for the July-December period should keep a high dynamism of internal spending, in spite of a potential deceleration in the private sector.

As a result of the income and spending estimations, this year should end with an effective surplus of 1.3% of the GDP<sup>ii</sup>, which in structural terms corresponds to a deficit of 1.6% of the DGP, less than the one estimated in September, of 1.8%. The reduction is mainly explained by less spending. This gap between the effective and the structural result means that the Public Treasury should make inputs to the Economic and Social Stabilization Fund (FEES) this year. Last June, this Fund already received US\$442 million.

The government kept its goal of converging to a structural deficit of 1% of the GDP in 2014, which brings up the question as to how to accommodate the new spending on education, which is likely to be approved, and the higher spending resulting from the coverage extension of the pensioners' 7% and the post-natal maternity leave. It is interesting to note that the mentioned convergence is calculated with a copper trend price of US\$2.59/pound. As this price increases (as it seems likely), the trend revenues increase and a higher spending level which fulfils the convergence criteria is feasible.

For every 10 cents that the trend copper price increases (assuming that there is no cost upward effect), the revenues derived from copper increase by approximately US\$400 million per year. If, for example, the trend copper price increases from US\$2.59 to US\$2.80 (which does not seem very optimistic), there is room for a higher annual spending of around US\$800 million, which confirms that it is currently not necessary to put forth a tax reform.<sup>iii</sup> We also have to

mention that revenues coming from the mining industry are highly dependent on the energy cost; the lower it is, the higher the amount obtained by the government as mining activity revenue, private and public. In this perspective, the energy cost reduction may end up being a way to finance improvements in education, through its tax impact.

### Conclusions

During the first two quarters of this year, the situation of the Central Government presented an evident improvement, with a surplus equivalent to 2.3% of the GDP. This was a result of a significant income growth, mainly due to a higher copper price and a more dynamic activity level. These two elements contribute more than the tax increases approved last year as part of the reconstruction program. In opposition to this, the spending execution has been very slow, and although this can be positive from the point of view of the macroeconomic stability, it means that in the second semester, spending must grow around 10% real, which is an important challenge in management terms.

On the other hand, the structural situation estimated for this year presents a slight improvement due to the spending adjustment of US\$750 million announced in March. It is important to point out that, even if the government maintains its target of 1% structural deficit in 2014, there is room to accommodate additional projects of education spending, as a result of a potential increase in the copper trend price. If it increases to US\$2.80, there should be an additional increase of nearly US\$800 million. The key issue is that these resources are “invested” and not “spent” on education, so as not to threaten the future fiscal sustainability in a less prosperous copper scenario, as a consequence of lower prices and/or lower ore content.

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<sup>i</sup> Measured in dollars of this year.

<sup>ii</sup> In September, an effective deficit of 0.8% of the GDP had been estimated.

<sup>iii</sup> The effective figure is somewhat less, since according to the recommendations of the Corbo Commission, the transitory tax increases enacted last year must be considered as permanent in the structural result calculation.