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Tax Reform Bill: Main Issues

The business tax increase will especially impair the medium and small businesses (Pymes), by reducing savings and investment, and it will entail potential negative effects on growth in the short and medium term. However, the proposal contains favorable aspects such as individual income tax reduction and tax credit for education expenses.

At last the government sent a tax reform bill for its discussion at the Congress. The Executive's intention is to rely on an approved and forwarded bill by July.

During the initiative's introduction speech, the President emphasized the education reform and the resources that will be required for the different education levels. The changes in education are positive, since improving the quality of education, especially at initial levels, is a key factor to make progress in equal opportunities for all individuals, something that society should guarantee. Additionally, a better education allows improving labor productivity and thus strengthening economic growth.

In spite of the latter, the disclosure of the education bill does not specify whether a tax reform is necessary for this purpose. The government has embarked in spending initiatives beyond the projects under discussion, which emerged towards the end of last year. For example: the annual subsidy to the *Transantiago* transportation system for US$700 millions and the corresponding equivalent expenditure in the regions of the country. The lack of a clearer proposal regarding the projected fiscal spending trajectory prevents concluding that tax reform funds will actually go to education. In other words, money is fungible and the need to level more resources to the Public Treasury may be due to its intention of making greater expenditures not only in the education area.

The bill's submission does neither discuss the effects of the tax reform on wellbeing and economic growth. Furthermore, no alternatives different from tax financing are considered. In fact, most of the expenditures could be financed through a combination of greater efficiency in the use of resources and the creation of an education fund. This fund, in a similar way as in the pension fund, could be established with resources coming from the higher copper price, in relation to its long-term level. If necessary, the discussion should envisage the possibility of privatizing a small part of CODELCO (15%) in order to capitalize this fund, and face permanent expenses using the resulting interest flow. At the end of the day, the social return on investing on education may be higher than that of copper.

Relevant Features of the Tax Reform

As we expected, one of the central points of the bill is the first category tax increase from 17% to 20%, reaffirming once again that temporary tax increases usually end up being permanent. This increase has negative effects on saving and investment as we will analyze later. Moreover, the transversal increase impacting both Pymes and large businesses, has more adverse effects on the first ones since they largely depend on earnings to finance investment and growth, because they do not have access to debt financing in the same favorable conditions as large businesses. The bill does not consider a mechanism extension such as article 14 Quater which allows Pymes to reinvest earnings free from tax for approximately CLP$50 million which would somehow help compensating the adverse effects of this increase. Additionally, it is highly probable that it will be necessary to simplify the access to this system, since today it is used by scarcely 6% of potential beneficiaries. As for the expected collection of US$1,796 million in 2013 and US$1,151 million in 2014, it could be lower if it entails a change of behavior concerning the withdrawals made by the owners.

Furthermore, the application of green taxes is being considered on products whose handling as residue after its service life generates a high social cost; specifically, on tires, oils, lubricants and batteries, light bulbs and certain packing and containers. This modification, although based on the right concept, such as imposing a tax on goods which generate externalities, is not presented within a general scheme to fight damages which has an ordering approach and avoids discretionalities, nor does it take into account the use of fossil fuels for vehicle transportation. Even, a flexibilization of the fuel price stabilization system (SIPCO) has been announced, which would not contribute to mitigate the impact on pollution and congestion. The act of imposing taxes on certain goods with no major explanation may produce an inconvenient dynamics to try to include or exclude specific goods from taxes, if it lacks a general concept that supports it.

With regard to the reduction of the second category and global complementary taxes, it is a positive initiative considering the high marginal rates of individual income tax prevailing in Chile compared with those existing at international level. In the same perspective, especially positive is the possibility of using, as credit against individual income tax, the expenses that families make on enrollment and monthly fees in educational institutions, with a family income ceiling of 66UF, thus recognizing that education is a human capital investment.

It has been stated that the individual income tax reduction, together with the business income tax increase, would reduce the incentives for creating partnerships in order to postpone the payment of taxes. The point is that this incentive is a consequence of the different saving approach concerning individuals and businesses. In fact, it would be more advisable to give the same saving incentive to both and thus, it would not be attractive to create these partnerships.

The proposal also envisages modifying a series of articles with the aim of limiting certain loopholes. However, some of them were originally conceived in the law and therefore cannot be considered as evasion mechanisms. This is the case of excessive withdrawals which allowed corporations (and limited companies) to make withdrawals in the case of losses, postponing the payment of taxes until taxable earnings were generated, which was later eliminated for corporations. The current bill finishes with this possibility for partnerships, compelling the tax payment for excessive withdrawals. The modification seems justified, since certain partnerships indefinitely postpone the payment of taxes while not generating earnings. However, to avoid this bad practice, the tax payment postponement could be limited to a reasonable term in the case of excessive withdrawals.

A second relevant change is the new way of addressing partnerships' refused expenses; currently they are considered withdrawals from the owners. In this manner, they would receive the same treatment as corporations today, where a 35% rate is applied on refused expenses. This measure aims at punishing more severely the allocation of management's personal expenses to the partnership, which is a quite extended practice. Nevertheless, this would raise the tax performance for small businesses which, out of ignorance and little advice, normally end up with refused expenses. Currently, they only trigger the payment of the owner's global complementary tax, which probably has a low margin rate; but the new regulation would imply a 35% payment, which can end being too onerous for Pymes.

Regarding the collection derived from the modifications on excessive withdrawals and refused expenses accounting for US$800 million according to regulation, is it necessary to set forth that the behavior changes derived from the new legislation alter these amounts.

A positive proposal is the inclusion of pollution standards for passenger transport companies, which currently are not subject to this regulation, and the inclusion of pollution standards for companies of all lines of businesses subject to presumptive income with sales lower than UTM 1,000 per year. In the context of the amendments to the current tax system, it is possible to revise the limits for applying this standard, considering that accounting work is increasingly less onerous.

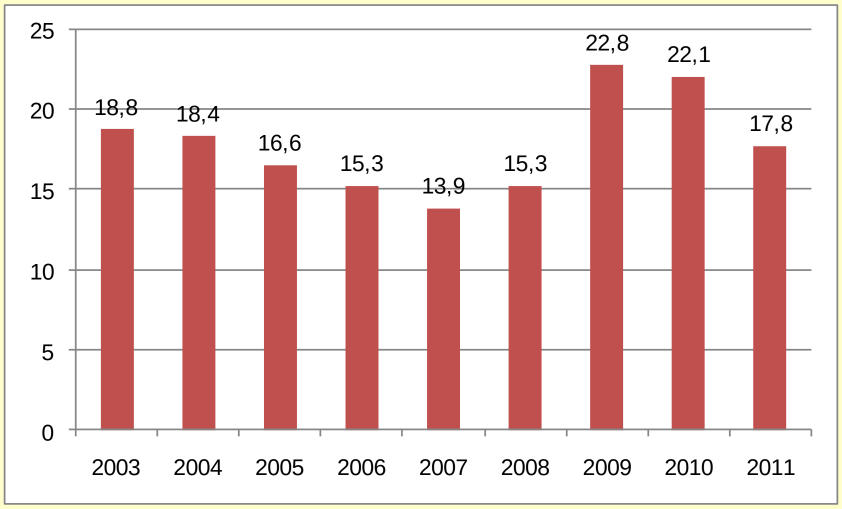
Finally, the gradual reduction of tariffs and the abatement of stamp duties do entail benefits for individuals and Pymes, although they represent a considerable reduction in the collection of approximately US$900 million according to regulation, thus making us doubt if it is the best tax to reduce today, and also considering that it eliminates an item in future commercial negotiations. Although the existing tariffs are already low, taking them to zero eliminates the distortion they generate in consumption and production.

Growth Challenge and Tax Reform

Recently, private savings have descended and the investment rate has kept lower than the 28% goal envisaged by the government program (see Charts 1 and 2). In relation to private savings, almost 70% corresponds to companies' retained earnings. The tax reform bill will adversely affect private savings. The reduction of the individual income tax rate and the increase of the companies' rate is an incentive in the margin for greater withdrawals and consumption. This is particularly important for Pymes, since retained earnings are their main financing source for investment, due to their debt financing restrictions or limitations for issuing shares. In short, the 20% increase of the business income tax will reduce savings, investment and employment of Pymes since they will have less financing resources.

Chart 1

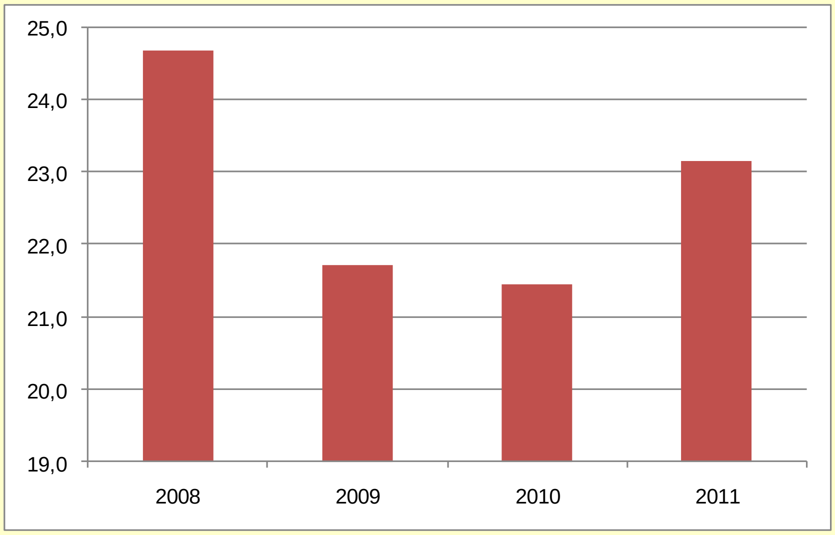
PRIVATE SAVINGS (GDP %)



Source: Banco Central de Chile

Chart 2

INVESTMENT (GFCF, GDP % AT GOING PRICES)



Source: Banco Central de Chile

Another way of appreciating the saving's drop is to resort to the identities of macroeconomics. A greater collection allows financing a public spending increase, but private consumption also increases, since individuals' available income increases due to the rate decrease affecting them. Therefore, in the medium term, the GDP identity equal to the aggregate demand would require a decrease in the investment and/or an increase in net exports. That is, an increase in the current account deficit or external saving to compensate the domestic savings' drop.

The higher public expenditure on education, and the incentive for a greater private spending, due to the tax abatement associated to the spending on education, should increase labor productivity if quality of education improves, and thus, human capital.

In brief, the impact that tax reform and higher spending on education may have on growth is ambiguous. On the one hand, private savings and investment of Pymes is reduced, entailing an investment rate lower than the projected one, due to the limitations in external savings. On the other hand, it would enable a labor productivity increase since it improves the quality of education, but this is possible only in the long-run[1], and probably without a tax burden increase as the proposed one. Additionally, the total factor productivity could increase due to the companies' cost reduction derived from the stamp duties abatement, the exemption from software tax and the elimination of import tariffs which would positively impact the energy costs, when the LNG price drops.

Table 1 simulates the investment rate, employment growth and Total Factor Productivity (TFP) to attain 5% sustainable growth and thus reach a developed country GDP threshold per capita in 8 years[2].

Table 1

CONTRIBUTION TO GROWTH

GDP Annual Growth	Investment Rate/GDP	Growth Employment %	Growth TPF %
5.0	28%	2%	1.3%
5.2	28%	2%	1.5%
5.7	28%	2%	2.0%
6.0	28%	2%	2.3%
4.4	23%	2%	1.5%
6.0	34%	2%	1.3%

Source: Prepared by L&D.
*Assumes depreciation of 5% annual, capital/product ratio (K/Y=2.5).
Capital Participation: 0.4, Labor: 0.6.
Solow TPF is considered, that is, it includes all product increase not resulting from the accumulation of work or capital. In other words, we did not consider correction by factors' utilization degree and work quality.

Several conclusions can be derived from this exercise. First, it is quite difficult to keep a 6% growth rate as the government program set out. In fact, considering a 28% investment rate, and employment growing at 2%, we would require a significant increase in the quality of education to achieve productivity improvements of 2.3%, which is impossible to attain in the short-term. Additionally, it is quite improbable that economy grows at 6% in the long-term due to the convergence process.

A more moderate and realistic productivity growth of 1.3% would lead us to a 5% growth. Alternatively, in order to grow at 6% with this increase, we would require a 34% investment rate.

In the second place, in order to achieve 28% investment rates, private savings should increase by 4 percentage points to reach 22%; public savings of 3% of the GDP and external savings of 3% also. If the investment rate cannot be increased due to the adverse effects of the tax reform, and productivity grows at 1.5%, then the DGP growth rate would attain only 4.4%.

Conclusion

Although a greater expenditure on education is reasonable insofar it allows improving its quality, it is not clear if a higher tax collection is necessary for this purpose, due to the increase rate of other prospective expenses. The fungible nature of resources does not guarantee that they are going to be used in education matters. The proposal contains favorable aspects such as individual income tax reduction and tax credit for education expenses. However, the business tax increase would adversely affect Pymes, reducing savings and investments, and also with potential negative effects on growth in the short and medium term. In the long-run, if quality of education is improved associated to a spending increase, we should expect an increase in labor productivity and economic activity.

In brief…
CONCERNING THE TAX REFORM BILL: • It is not clear that greater tax collection is required to improve the quality of education. • The impact that tax reform and higher spending on education may have on growth is ambiguous. On the one hand, private savings and Pymes' investment is reduced, which entail an investment rate lower than the expected one and, on the other hand, they allow a labor productivity increase, which could improve the quality of education but only in the long-run. • The reduction of the individual income tax and the tax credit for education expenses is favorable. • The business tax increase would adversely affect Pymes, reducing savings and investments, and with potential negative effects on growth in the short and medium term.

[1] As a matter of fact, before 10 years it is difficult to see any effects of better quality education on labor productivity.

[2] US$23,000 at purchasing power parity, which corresponds today to Portugal. It assumes a 1% growth in the population.