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Medium-term Fiscal Situation: Redirecting the Focus

In today's tax discussion, the opposition has put the attention on an alleged lack of fiscal discipline and on the fact that the expenditure margin for the years to come would be smaller than the one left by former governments. However, the government complied with its structural deficit goal of 1% of the GDP two years ahead of schedule, and the fiscal margin available for the next three years is very similar to the last year of Ricardo Lagos' government and greater than that of Michelle Bachelet.

After two years of budget discussions where pressures had always been put on the expenditure increase, this year the focus has shifted to a discourse of greater fiscal discipline and the inconvenience for the country of having a structural deficit of 1% of the GDP. The first thing that calls our attention is that since the very first months of the present government, it was announced that the presidential term would end with a structural deficit of 1% of the GDP, and this target received no questioning from the opposition since then. Criticism regarding an alleged lack of fiscal discipline arise today, once this goal was practically achieved in 2011 already (structural deficit of 1.1% of the GDP) and it should be maintained at -1% between 2012 and 2014.

Table 1 shows the structural result estimates made in 2010, 2011 and 2012, demonstrating that we have actually verified an improvement of the fiscal situation, and not the opposite.

In fact, we observe that the structural result estimates have shown a downward trend and that the goal was achieved two years ahead of the initial schedule. It is true that this improvement is mainly explained by a higher trend copper price, but the relevant point is that part of this improvement has been used to reduce structural deficits. Admittedly, when the 1% deficit goal was set for 2014, the trend copper price was at US$2.13/pound and today it is at US$3.06, which makes us believe that the effort could have been greater, but the copper production costs have increased to a very similar extent (see chart 1), so the surpluses have not significantly increased.

Table 1

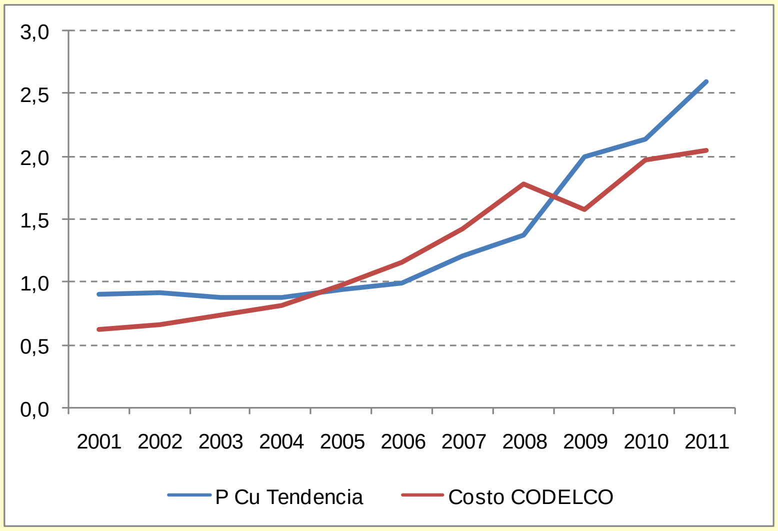
STRUCTURAL FISCAL DEFICIT (% OF THE GDP)

	2010	2011	2012	2013	**Average**
IFP October 2010	-2.3	-1.8	-1.5	-1.3	**-1.7**
IFP October 2011	-2.0	-1.6	-1.5	-1.3	**-1.6**
IFP October 2012	-2.0	-1.1	-1.0	-1.0	**-1.3**

Source: Public Finances Report (IFP, in Spanish) 2012.

Chart 1

TREND COPPER PRICE AND CODELCO'S UNIT PRICE (US$/POUND)



Source: DIPRES, Cochilco

Recovering the structural balance is no doubt a desirable objective, especially considering that the external deficit estimates for Chile are increasing, and it should reach 4.4% of the GDP in 2013.[i] Opposing parliament members have expressed their concern on this matter. However, the basic problem of this external deficit is an expenditure excess from the private sector, accounting for 85%. Therefore, the right way of facing it from the fiscal perspective is moderating the growth rate of public expenditure, since this aspect is more relevant than the extent of fiscal deficit.

In order to shed light on the foregoing, we should discuss the leading subject behind the opposition's criticism concerning an alleged lack of fiscal discipline. In the end, they are not aiming at moderating the growth rate of fiscal expenditure but, along with the fiscal sustainability thesis, they are setting forth the need to significantly increase social expenditure in order to reduce inequality. The underlying idea of this discussion is the need for a new tax reform, because the recently approved reform would be inadequate to solve social demands.

Going into more detail, the proposal points at increasing capital gains taxation, either through a higher First Category rate or through the elimination of the Chilean integrated tax system (elimination of the undistributed tax retained earning, *Fondo de Utilidad Tributario*, FUT). However, both tax increases affect savings of the private sector mainly, and thus the external deficit problem is widened instead of being attenuated. It should not be forgotten that the main purpose of the tax integration at businesses' and people's level is to fix expenditure taxes in order to stimulate saving. If tax integration is eliminated, private saving decreases, not in exchange for higher fiscal savings, but instead for higher expenditure, so the net gain entails an impairment of the current account.

The conclusion is quite clear: it is not consistent to set out that there is a fiscal sustainability problem and then solve it by widening the external deficit situation through a transfer of funds from the private to the public sector.

Does this mean that it is not possible to fulfill social demands through a greater provision of public assets? If we only propose tax increases to finance them, this greater provision of public assets will entail less economic growth. A better alternative is to increase the availability of public funds by improving efficiency. In Public Issues Nr 1,082[ii] we showed a pretty simple calculation which illustrates that there are efficiency spaces available: "*In 2013, fiscal expenditure will amount to approximately US$63 billions. If we consider that social expenditure (education, health, housing and social protection) represents 65% of this figure, and if we consider as a simple average that this social expenditure amount is distributed among 60% of the country's lowest incomes, this social expenditure would be equivalent to a monthly salary of CLP$670 thousand for a family of four members".* We are not thereby suggesting that we should close the ministries and distribute the funds, but the problem does not seem to be a funds shortage in social matters, but mainly an efficiency problem.

The current government has made efforts in this area, both in terms of introducing greater incentives to the quality of services and the programs' evaluation. The Public Finances Report (IFP) shows the results of 19 programs assessed in 2012, from which 12 have inadequate performance or non-demonstrated results. Thus, a significant transfer of funds should be made from these programs to new ones, or well-evaluated programs that seek to be increased. However, this process does not occur on a very relevant scale, generally as a result of the political costs derived from eliminating programs, in addition to the fact that in the budget discussions at the Congress what prevails is to obtain greater funds rather than analyzing the efficiency of their use. We have already reaffirmed this point before: it is highly necessary to take steps towards a budget discussion which emphasizes the quality of expenditure instead of the amounts.

Another aspect which has been questioned by the opposition in the current budget discussion refers to the medium-term fiscal margins. It has been said that this government is going to leave a very limited space for expenditure growth to the next administration, compared with the previous governments' figures. The underlying idea of this criticism is the same we indicated at the beginning: the purpose is to demonstrate the need for a new tax reform. As we will see further on, this statement is incorrect, since margins estimated in the current IFP are vey similar to those calculated in the last year of the previous governments, corrected in the case of 2009 due to certain estimates' problems detected by the Corbo Commission.[iii]

We must first define the concept of fiscal margin used in these estimates. Fiscal margin is the difference between the expenditure level that is consistent with the structural goal and the expenditure level already committed by approved laws, with their corresponding adjustments.

The Fiscal Responsibility Law stipulates that the Central Government's expenditure level should correspond to the difference between structural revenues and the defined structural surplus' goal. In other words, if the goal is a structural balance (which is the goal defined in 2008), the allowed expenditures correspond to the structural revenues. In the current IFP's calculation, two scenarios are considered: the first, with a 1% structural deficit, and the second, assuming that the deficit goal is reduced by 0.25 percentage points per year as of 2015. In the following tables, the first scenario is used.

The calculation of the structural deficit is obtained from the CAB methodology (cyclically-adjusted budget balance), which considers the following basic inputs: trend copper price, the gap between trend GDP and actual GDP and the trend GDP growth, data obtained from an independent panel of experts. The calculation made this year also takes into account all the methodological recommendations agreed by the Corbo Commission.

Last Governments' Fiscal Margins

Tables 2, 3 and 4 show the margins calculated in the last government year of Ricardo Lagos (October 2005, Budget Law 2006), last year of Michelle Bachelet (October 2009, Budget Law 2010) and third year of Sebastián Piñera's government (October 2012, Budget Law 2013).

Table 2

GOVERNMENT OF RICARDO LAGOS: FISCAL MARGINS
(CLP$ BILLIONS 2006)

	2006	**2007**	**2008**	**2009**
Assumptions				
Actual GDP var.	5.5	5.7	5.8	5.9
Trend GDP var.	5.0	5.3	5.6	5.8
Domestic demand var.	6.1	5.9	5.7	5.8
Trend copper price	0.99	0.99	0.99	0.99
Structural balance (% of the GDP)	1.0	1.0	1.0	1.0
Structural revenues	14,509	14,615	15,433	16,000
Expenditures consistent with goal	13,867	13.937	14,715	15,240
Committed expenditures	13,867	13.532	13,600	13,652
Margin of expenditures	0	405	1,115	1,588
Margin of expenditures (US$ millions)	0	750	2,065	2,941
Margin of expenditures (% of the GDP)	**0.0**	**0.5**	**1.2**	**1.6**

Source: IFP October 2005

Table 3

GOVERNMENT OF MICHELLE BACHELET: FISCAL MARGINS
(CLP$ BILLIONS 2010)

	2010	**2011**	**2012**	**2013**
Assumptions				
Actual GDP var.	5.0	5.3	5.0	5.0
Trend GDP var.	4.2	4.3	4.4	4.5
Domestic demand var.	6.9	6.4	5.1	4.9
Trend copper price	2.13	2.13	2.13	2.13
Structural balance (% of the GDP)	0.0	0.0	0.0	0.0
Structural revenues	23,381	23,854	24,608	25,508
Expenditures consistent with goal	23,381	23,854	24,608	25,508
Committed expenditures	23,381	23,397	23,360	23,091
Margin of expenditures	0	457	1,248	2,417
Margin of expenditures (US$ millions)	0	816	2,229	4,316
Margin of expenditures (% of the GDP)	**0.0**	**0.5**	**1.2**	**2.2**

Source: IFP October 2009

Nevertheless, the Corbo Commission's Report suggests that the fiscal margins estimated by the Budget Office on that year presented calculation errors, being the main one the use of a GDP gap that did not correspond to the one obtained from the estimates made by the panel of experts that year. The Corbo Commission's Report indicates the following:

"*A different-natured modification should be mentioned. During the preparation of the Budget Law for 2010, a product gap was used in the assumptions for computing the structural balance, which did not consider the potential GDP updating for 2009, determined by an expert panel on August of that year; instead, it applied the growth rate of that variable, derived from the estimates of the said panel of experts for 2010. This meant to overestimate the level of the potential GDP and then, to underestimate the structural deficit planned for 2010, which although it allowed having a more counter-cyclical policy, it introduced an arbitrary change which raised doubts on the applied methodology".*

The relevance of this point lies in the fact that using a greater GDP gap results in higher trend income estimates (in terms of levels), and thus in greater margins. The IFP review of that year does not mention the fact that a GDP gap different from the one estimated by the panel of experts was used, and it only indicates that the trend GDP growth rates computed by this panel were used. This point was neither mentioned in the report prepared by Andrés Velasco and Alberto Arenas on the Corbo Commission's conclusions in September 2010.[iv] Correcting this error significantly reduces the mentioned gaps by 0.6% of the GDP for the period 2010-2013. Other corrections set forth by the Commission also reduce the margins estimated by that government, although in a lesser degree, close to 0.2% of the GDP per year.

Table 4

GOVERNMENT OF SEBASTIÁN PIÑERA: FISCAL MARGINS
(CLP$ BILLIONS 2013)

	2013	2014	2015	2016
Assumptions				
Actual GDP var.	4.8	5.1	5.1	5.2
Trend GDP var.	5.0	5.0	5.1	5.1
Domestic demand var.	5.5	5.9	6.1	6.1
Trend copper price	3.02	3.02	3.02	3.02
Structural balance (% of the GDP)	-1.0	-1.0	-1.0	-1.0
Structural revenues	29,205	30,214	31,757	33,076
Expenditures consistent with goal	30,632	31,650	33,256	34,347
Committed expenditures	30,632	31,178	31,710	32,369
Margin of expenditures	0	472	1,546	1,977
Margin of expenditures (US$ millions)	0	952	3,117	4,585
Margin of expenditures (% of the GDP)	**0.0**	**0.3**	**1.0**	**1.5**

Source: IFP October 2012

We can see that the margins left by this government are actually not significantly different from those of the two former governments, once the corrections shown in the paragraph above are made. Furthermore, this year the calculation considered as committed expenditures for the period a real wage adjustment for public employees similar to the historical average, while calculations in tables 1 and 2 assume a steady level of real wages. This means that the calculation for the period 2013-2016 is more realistic than the previous ones. This point is especially relevant when comparing margins with those of the former government, since by the end of 2009, after the calculation of these margins, the wage adjustment for public employees was very high, 6.4% real, which according to estimates from the Ministry of Finance in the last Public Finance Statement reduces the margin for the period 2010-2013 by approximately US$3 billions. This, in addition to the mentioned corrections, leaves it practically at zero. Since the adjustment for public employees is always made after the budget discussion, it seems much more reasonable to use the assumption of the last calculation, which instead of considering a steady level of real wages assumes a real wage growth rate close to the historical average.

Conclusions

In the current budget discussion, the opposition’s criticism has had a different focus than that of past budgets, pointing rather at an alleged lack of fiscal discipline and on the fact that the expenditure margin for the years to come would be smaller than the one left by former governments. As it was shown above, this criticism is not based on very solid grounds. First, the government complies with its structural deficit goal of 1% of the GDP two years ahead of schedule, and second, the fiscal margin available for the next three years is very similar to that of the last year of the Ricardo Lagos' government and greater than that of Michelle Bachelet's government, the latter being corrected according to the calculation recommendations by the Corbo Commission.

Finally, the idea underlying these criticisms is an attempt to prove that a new tax reform is needed. However, we do not believe that the reasons for justifying it are the right ones. First, because the tax reform would not contribute to reduce the economy's external deficit, but on the contrary, it could worsen it, since it would probably be based on higher capital gains taxation and this would discourage private savings. Second, figures show that the problem does not seem to be a funds shortage in social matters, but mainly a quality and efficiency issue concerning this expenditure. Consequently, it seems highly necessary to redirect the focus towards a budget discussion which, instead of referring to the amount of funds, assesses the quality and efficiency of the programs being developed.

In brief…

KEY FACTORS FOR THIS BUDGET DISCUSSION:

- Regarding the criticism concerning fiscal responsibility: the **Government complied with its goal of structural deficit of 1% of the GDP two years ahead of schedule**, by reporting a structural deficit of 1.1 of the GDP in 2011. It should maintain at -1.1% between 2012 and 2014.

- Concerning the statements on large budget "margins" left by the governments of the *Concertación*: **the margins that Piñera's government will leave to the next administration will be very similar to those left by the governments of Lagos and Bachelet**.

- **In relation to the idea that a new tax reform is necessary: first, it would not contribute to reduce the economy's external deficit, on the contrary, it could widen it**, since it would probably consist in higher capital gains taxation and this would discourage private savings. Second, figures do not seem to evidence a funds shortage in social expenditure matters; the problem would lie rather on the quality and efficiency of this expenditure.

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[i] Monetary Policy Report (IPoM) of The Central Bank of Chile, September 2012.

[ii] *"Ley de Presupuestos 2013: Críticas con escaso fundamento"*.

[iii] It is also important to point out that this Commission was formed by representatives coming from different sectors, of great professional and academic prestige: Vittorio Corbo, Ricardo Caballero, Mario Marcel, Francisco Rosende, Klaus Schmidt-Hebbel, Rodrigo Vergara and Joaquín Vial.

[iv] "*Balance structural en Chile: 2006-2010*".