



Basic Features of Michelle Bachelet's Tax Proposal

Far from ensuring stability, as their authors claim, Michelle Bachelet's proposal entails a deep modification to the pillars of our current tax system, which has given good results to the country in terms of promoting growth, savings, investment and employment.

As it was already anticipatedⁱ during the complex discussion about the last tax modifications, approved in September 2012 by the Law 20,630, they did not settle the debate at all in relation to the alleged need for major changes to the current tax system. At this point of the discussion it is even reasonable to think that these changes will end up opening the door to more radical reforms.

The recent proposal of candidate Michelle Bachelet falls precisely within this framework of radical reforms, which pretend to quickly and deeply change the bases of our tax system.

Based on the document "*Reforma tributaria: un país más solidario, con sustentabilidad fiscal*"ⁱⁱ (Tax Reform: A More Solidary Country, with Fiscal Sustainability) and some details that have leaked out, we submit a first analysis of the proposal's main features and point out some of the multiple concerns about a reform of this magnitude.

First Proposal

"In order to achieve development, it is necessary to increase the tax burden by 3 points of the GDP through a tax reform, which will additionally improve income distribution".

It is very irresponsible to propose a tax burden increase of three points of the product, if the purpose of this greater collection is not previously and absolutely defined. Until now, we have only heard watchwords – such as "total fee-free higher education" – and no one seems to care if withdrawals of financial resources by individuals and businesses are actually being used to finance socially profitable projects. Furthermore, regarding fiscal discipline, the idea is to use part of the financial resources to eliminate the

structural fiscal deficit of 1% of the GDP left by the current government. We should recall that when Bachelet assumed the administration, fiscal figures registered a 1% structural surplus, which her government left in a 3% deficit in 2009. In other words, fiscal position was deteriorated by four points. The current government has managed to reduce it to a 1% of the GDP, improving the fiscal accounts by two points of the product. Recuperating the fiscal balance can be done gradually by using the funds derived from higher economic growth.

Moreover, it has been suggested that the reform would flatten income distribution, when it is well known that, a priori, redistributive effects of taxes are not evident. In fact, if they end up damaging growth and employment, the real wages will drop without positive changes in the income distribution. What is really evident are its effects on efficiency; therefore, when it comes to collect funds to finance a spending that can actually contribute, and significantly, to improve equity, less distortive taxes should be privileged, and those which adversely affect growth should be avoided. The reform proposed by the candidate does the opposite. We should expect such a wide-ranging tax reform to rely on a detailed study of its growth and wellbeing effects on individuals.

In relation to the impact's magnitude on Chile's current tax burden, it should be made clear that our (net) tax burden is not especially misaligned with that of the OECD countries when they had similar income levels as ours (US\$20,000)ⁱⁱⁱ. Furthermore, if it should be necessary to increase the burden, because there is a specific project, it should be done gradually, by privileging more efficient taxes and not forgetting that economic growth is the best way to increase fiscal revenues, since GDP elasticity of tax revenues (non-mining ones) is significantly higher than 1.

On the other hand, we should recall that our Constitution does allow assessing a priori the purpose of financial resources collected from taxes, so nothing ensures that these funds will not end up financing other deficits, such as the one created by the *Transantiago* public transport system. It is also surprising that there are no previous proposals that favor mechanisms which ensure efficiency and the pertinence of public spending.

Second Proposal

“To increase First Category Tax to 25% and change taxation of business owners and shareholders from cash basis to accrual basis”.

This proposal will impair investment and growth. Literature distinguishes at least two channels by which these distortions are produced: capital cost increase and availability of internal funds.

When financing a project, investors require profitability in harmony with the market and the risk they take, but in a world with corporate income tax, the relevant return on investment is that which is net from all these liabilities; in other words, that which actually “ends in their pockets”. The higher the tax,

the higher the before-tax return required by the market to the projects, so once taxes are applied they will cover the originally required returns. Therefore, if these taxes were raised, corporate capital cost will increase and investments will drop.

Considering the above, and since the tax system for shareholders or capital owners is changed from a cash basis to an accrual basis, in a project where earnings are not immediately withdrawn, the rate increase for the investor is not from 20% to 25%, but from 20% to 35%, depending on the taxable income amount. The reason is that changing to the accrual basis would lead investors to pay taxes when the right on a profit is generated, regardless if it is eventually cashed (effectively distributed) or not. From a practical point of view, this could derive in shareholders or partners to get into debts to pay the corresponding taxes, which could also turn into a pressure to distribute earnings in the companies with the consequent negative effect in terms of investment or reinvestment of these financial resources.

Additionally, the availability of internal funds refers to the earnings obtained by the company, which can be used to finance investment projects. The small and emerging firms are more dependent on this type of internal financing, since they are more risky and face external financing restraints, either from the banks or through the issuance of debts or shares. In this context, a tax on retained earnings reduces the available funds for reinvestment, affecting mainly the PYMES. In order to try to compensate this, in an imperfect and partial way, the “instantaneous depreciation” mechanism is introduced, which allows the company to rebate from its tax base certain fixed assets on which the company invests. The problem is that not all retained earnings are meant to finance fixed assets, there is also the working capital, debt payment, and the inventories that companies (especially growing ones) have to finance and which would be excluded from this measure. The “instantaneous depreciation” is a measure that discriminates in terms of a company’s different reinvestments and tends to benefit businesses that are intensive on capital asset which can instantaneously depreciate. And it usually involves larger companies.

We believe that there is a very old fashioned concept of business underlying this measure, which assumes that a company only buys “machines and sheds”, which can be instantaneously depreciated and that other saving modes in the firm are irrelevant, including financing third companies through the financial market.

The simplest way to appreciate the proposal’s negative effects on savings and investment is using the GDP’s macroeconomic identity. In 2012, the investment – as percentage of the GDP- reached 25%, domestic savings, 21.5% and external savings, 3.5%. If the goal is to increase government spending by 3% of the GDP, and if consumption does not fall (private savings increase), external savings should reach 6.5%, which is

impossible, particularly within a global highly volatile financial situation. Therefore, investment will end up contracting.

Such radical change raises many questions concerning the new system's operation. For example, in relation to the use of instantaneous depreciation when businesses have losses; the proposal is not clear, but we could assume that they will be allowed to carry forward the spending for a specific number of fiscal years so that it is really effective and stimulates investment. The lower this limit of fiscal years, less attractive is the mechanism as a replacement of the FUT (fund of taxable income).

Additionally: How will instantaneous depreciation be related to the owners' Complementary Global Tax or Additional Tax, especially if these personal taxes are paid on accrual basis? Currently, the Income Tax Law, following its 2001 amendment, stipulates that when the accelerated depreciation treatment is applied, the difference resulting in the respective fiscal year between accelerated depreciation and normal depreciation, can only be deducted as spending for the purpose of the First Category Tax, so that for the purpose of the Complementary Global Tax or Additional Tax only the normal depreciation is deducted as spending. This implied to negatively alter one of the foundations of the tax system due to the withdrawn incomes and the neutrality of the tax system, inasmuch as corporate incomes and those of its partners and owners will be determined on different basis when applying the respective taxes.

If these proposals are put into practice, particularly this instantaneous depreciation formula as a "replacement" (incidentally very imperfect) of the FUT, there is no certainty about its viability at the Congress. We should not forget that during Bachelet's administration, former Minister of Finance Andrés Velasco proposed a set of measures in this direction, which was known as "*Chile Invierte*" (Chile Invests). The proposal which transitionally aimed at instantaneously acknowledging as spending 50% of the value of the immobilised asset's physical goods liable to claim an accelerated depreciation, was approved in the Chamber of Deputies, but it was rejected by the Senate, and finally the Executive withdrew it due to the rejection of the same sector who claims to represent the candidate.

On the other hand, there is also considerable doubt regarding how this tax system is related to AFP funds (private pension system), because through them practically all Chileans own a fraction of the country's large companies and, therefore, strictly speaking, they should pay taxes for their fraction immediately in the same fiscal year generating the earnings of the companies in which they indirectly participate. Even if this problem were solved, raising the First Category Tax from 20 to 35% would adversely affect AFP contributors, since they would not be able to use their First Category Tax credits associated to the dividends that these companies regularly pay and which are reinvested.

Third Proposal

“To reduce the maximum marginal rate of personal taxes from 40% to 35%”.

This is a positive factor, which is in line with many other countries, including Chile, which have historically presented extremely high rates in individual taxes (Chart 1). However, together with the instantaneous depreciation, it does not succeed to compensate the disincentive to investment, in the context of the new accrual basis for individuals.

In Chile, marginal rates of individual taxes have constantly decreased, while brackets to which these rates are applied to have extended over time. Thus, while in the mid 70s incomes higher than 80 UTM had to bear a 60% marginal burden, already in 2001 the maximum marginal rate reached 40% and it was applied only to incomes exceeding 150 UTM (Chart 2).

In the end, progressive income tax is a tax on human capital, which is not yet a very common factor in our country and, therefore, its offer is rather elastic. We should advance towards a system with flatter rates that stimulates work and investment on human capital, instead of aiming at reducing the available income of individuals who have higher incomes, and incentivize more people to obtain higher incomes.

Once again we should point out the concern regarding the viability of this measure at the Congress. Something similar occurred with the proposal of President Sebastián Piñera in 2012, which did not see the light due to the strong opposition of candidate Bachelet's own partisans, and finally the marginal rate for the top income bracket was kept at 40%. If there were a similar rejection at the Congress to the candidate's proposal in the context of a system which seeks to pay personal taxes on an accrual basis, the consequences would be highly regrettable for the economy.

Fourth Proposal

“To annul the Foreign Investment Statute D.L. 600 for new investment projects”

The D.L. 600 is an instrument which is still attractive for investors; therefore there is no reason to eliminate it^{iv}, especially within a context that seeks to alter the foundations of the Chilean tax system. The candidate's document states that eliminating the D.L. 600 “means to ratify the institutional stability of Chile for foreign investments”. The latter, in the frame of the deep tax reform she is proposing, is a contradiction and it ends up sending an instability signal which is of course not desirable. Between 1974 and 2011, more than US\$80 billions have been materialized through the D.L. 600, which represent 56.5% of the total gross foreign capital entering Chile. Just in the period 2008-2011, more than US\$17 billions entered the country under this modality; therefore, it seems quite unreasonable to question its applicability.

Chart 1

MAXIMUM MARGINAL RATE OF INDIVIDUAL INCOME TAXES

País	Tasa	País	Tasa	País	Tasa
Suecia	56,6%	Tailandia	37,0%	Armenia	20,0%
Dinamarca	55,4%	Argentina	35,0%	Egipto	20,0%
Holanda	52,0%	Ecuador	35,0%	Guernsey	20,0%
Austria	50,0%	Jamaica	35,0%	Isle Of Man	20,0%
Bélgica	50,0%	Corea del Sur	35,0%	Jersey	20,0%
Japón	50,0%	Malta	35,0%	Pakistan	20,0%
Reino Unido	50,0%	Sri Lanka	35,0%	Singapur	20,0%
Finlandia	49,6%	Turquia	35,0%	Eslovaquia	19,0%
Noruega	47,8%	EE.UU	35,0%	Rumania	16,0%
Irlandia	47,0%	Vietnam	35,0%	Costa Rica	15,0%
Islandia	46,3%	Venezuela	34,0%	Republica Checa	15,0%
Portugal	45,9%	Colombia	33,0%	Hong Kong	15,0%
Australia	45,0%	Nueva Zelandia	33,0%	Lituania	15,0%
China	45,0%	Hungría	32,0%	Serbia	15,0%
Alemania	45,0%	Filipinas	32,0%	Ucrania	15,0%
Grecia	45,0%	Polonia	32,0%	Rusia	13,0%
Israel	45,0%	Guatemala	31,0%	Bulgaria	10,0%
Italia	43,0%	Chipre	30,0%	Kazakhstan	10,0%
España	43,0%	India	30,0%	Paraguay	10,0%
Papua Nueva Guinea	42,0%	Indonesia	30,0%	Bahamas	0,0%
Francia	41,0%	México	30,0%	Bahrain	0,0%
Eslovenia	41,0%	Perú	30,0%	Bermuda	0,0%
Chile	40,0%	Canadá	29,0%	Islas Caimán	0,0%
Croacia	40,0%	Brazil	27,5%	Kuwait	0,0%
Gibraltar	40,0%	Latvia	26,0%	Oman	0,0%
Sudáfrica	40,0%	Malasia	26,0%	Qatar	0,0%
Suiza	40,0%	Panamá	25,0%	Arabia Saudita	0,0%
Taiwan	40,0%	Uruguay	25,0%	Emiratos Arabes Unidos	0,0%
Luxemburgo	39,0%	Estonia	21,0%	Promedio Simple	29,4%

Source: KPMG's Individual Income Tax and Social Security Rate Survey 2010.

Chart 2

MAXIMUM MARGINAL RATE OF INDIVIDUAL INCOME TAXES AND BRACKETS

	Article 43 original DL 824 1974			Law 18,985 of 1990			Law 19,247 of 1993 transitional until 12/31/94		
	From	To	Marginal rate	From	To	Marginal rate	From	To	Marginal rate
Bracket 1	0	2	3.5%	0	10	0%	0	10	0%
Bracket 2	2	5	10%	10	30	5%	10	30	5%
Bracket 3	5	10	15%	30	50	15%	30	50	13%

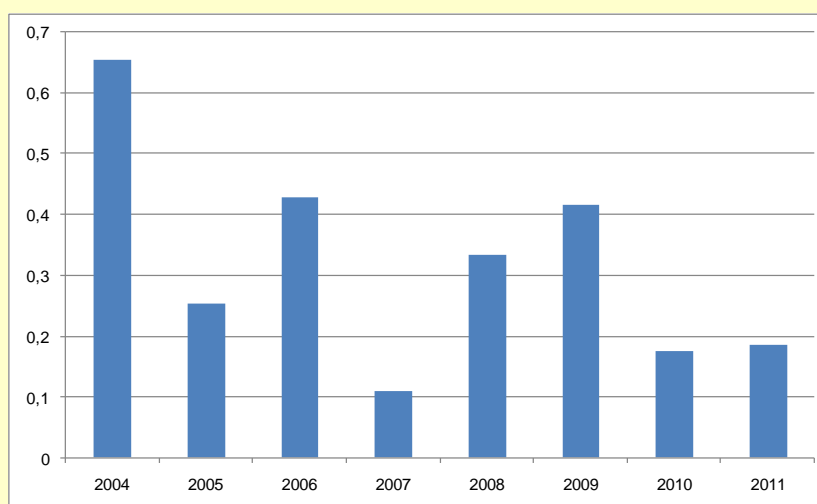
Bracket 4	10	15	20%	50	70	25%	50	70	23%
Bracket 5	15	20	30%	70	100	35%	70	90	33%
Bracket 6	20	40	40%	100	-	50%	90	100	35%
Bracket 7	40	80	50%				100	120	45%
Bracket 8	80	-	60%				120	-	48%

	Law 19,247 of 1993			Law 19,753 of 2001			Law 20,630 of 2012		
	From	To	Marginal rate	From	To	Marginal rate	From	To	Marginal rate
Bracket 1	0	10	0%	0	13.5	0%	0	13.5	0%
Bracket 2	10	30	5%	13.5	30	5%	13.5	30	4%
Bracket 3	30	50	10%	30	50	10%	30	50	8%
Bracket 4	50	70	15%	50	70	15%	50	70	14%
Bracket 5	70	90	25%	70	90	25%	70	90	23%
Bracket 6	90	120	35%	90	120	32%	90	120	30%
Bracket 7	120	-	45%	120	150	37%	120	150	36%
Bracket 8				150	-	40%	150	-	40%

Source: LyD based on corresponding laws.

Chart 3

INVESTMENT WITHIN DECREE LAW 600 AS EFFECT OF DIRECT FOREIGN INVESTMENT (%)



Source: LyD based on Banco Central and Foreign Investment Committee.

Foreign investments are a key factor for Chile's economic growth; consequently, a good public policy should focus on incentivizing them, especially considering that the level of domestic savings is far from being sufficient to undertake all the projects the country requires. Compared legislation of other countries, particularly OECD members, reveal the existence of juridical instruments similar to the foreign investment agreement stipulated by the D.L. 600; in fact, South Korea, Hungary and Portugal have contractual procedures similar to those in Chile today.

Conclusions

In 2012, the investment as percentage of the GDP reached 25%, domestic savings, 21.5% and external savings, 3.5%. It could be a serious mistake to implement a reform which is not compatible with savings and investment, when we are still far from reaching the goal of investing 28% of the GDP; a figure needed to sustain the long-term higher growth which cannot be financed with external savings –current account deficit.

It should be highlighted that this proposal adversely affects small and medium businesses (PYMES). Contrary to what has been argued, and although sometimes the owners' marginal rates can be less than the First Category Tax – many times increased-, and therefore the partner receives a check for the difference in his personal tax reimbursement, which he could eventually reinvest in the business, this is equivalent to believing that a fraction of the profit is withdrawn to use the credit on personal income, receive the same reimbursement and then reinvest it; hereby, available flows are being reduced, which are always necessary as working capital in small businesses, and it is worth insisting that instantaneous depreciation, the offered bargaining chip, is not considering this at all.

Far from "buying social peace" and ensuring stability, as their authors claim, this proposal simply disrupts our current tax system. We are dealing with a deep modification to the bases or pillars of the current tax system which, by the way, has given very good results to the country in terms of promoting growth, savings, investment and employment; it has taken many years to strengthen it and of course it is subject to improvements. The implementation of this new system, as gradual as it might be, will be a highly complex matter and it will have to cope with a series of situations that in the long run will end up in a listing of exceptions that are contrary to the simplification of our procedure.

In brief...

- The proposal of Michelle Bachelet's campaign staff is a radical, dangerous and improvised change to the Chilean tax system.
- Increasing the tax burden by 3% of the product is irresponsible if public projects that are going to be financed are not known.
- Changing the current tax system from a cash basis to an accrual basis, on the side of company owners or partners, entails highly negative implications for savings and investment.
- The elimination of the D.L. 600 in no way ratifies Chile's institutional stability, quite the opposite, especially when these other changes to the system are being proposed.

ⁱ *Situación fiscal de mediano plazo: ¿Para qué una reforma tributaria?* Libertad & Desarrollo. Public Issues Nº 1,057, April 13th, 2012.

ⁱⁱ <http://michellebachelet.cl/>

ⁱⁱⁱ International Evidence on Tax Revenues and Analysis of the Proposals. Libertad & Desarrollo. Public Issues Nº 1,112, May 31st, 2013.

^{iv} It should be recalled that on May 2011, the D.L. 600 Modernization Commission delivered the final report to the Ministry of Economy; it was prepared by a panel of experts invited by the government to study possible changes to the D.L. 600. Most of the members who subscribed the document were convinced of the benefits and necessity of the existence of a Foreign Investment Statute in our country, because it is a clear sign of the country's commitment to foreign investment, and it is a mechanism that grants security and certainty to this type of investments, notwithstanding the fact that it requires improvements and changes to make the Statute consistent with the current economic situation, all of which were detailed in the Commission's report.