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Is it necessary to raise taxes?

The country's fiscal situation and the impacts on the exchange rate caused by the entry of dollars to Chile in the past and by the financing formula that shall be adopted by the Government, demonstrate categorically that it was not necessary to apply a tax rise in order to finance the reconstruction after the earthquake.

The Government has decided to finance through taxes almost 40% of the total US$8,431 millions that it pretends to spend during the next four years in order to rebuild the country after the earthquake. So far, no information has been revealed to justify the need to turn to this financing source and authorities have simply declared that we must all contribute to this effort, due to the inevitable spending increase.

We believe that it is necessary to provide specific numbers so as to enrich the technical discussion and thus justifying the postulate regarding an eventual tax rise.

In this discussion it is fundamental to understand the current fiscal situation of Chile, because the Government has not been sufficiently clear on this matter. It only has insinuated that the structural deficit is higher than expected, but preliminary figures do not suggest the need to raise taxes. But even if the structural deficit 2010 were relevant, the country's small debt level allows correcting it in several years with no major startle. This is precisely the line of argument for which we shall furnish solid facts.

Chile's solid fiscal position

Let us therefore analyze the fiscal situation, starting by the positive aspects. To December 31st 2009, the gross debt of the Central Government plus the Acceptance Bonds was equivalent to 13.2% of the GDP, an extremely low level according to all standards. For example, as The Economist indicated recently, the debt-*to*-GDP ratio of the developed economies today hits nearly 80% and it is still increasing. But if we add the savings accumulated in the Economic and Social Stabilization Fund (FEES), the Pension Reserve Fund and the financial assets of the Public Treasury, which together represented 10% of the GDP in 2009, we obtain a total net fiscal debt of 3.2% of the GDP, a figure which offers a categorical proof of today's comfortable fiscal position.

The former is enhanced if we add to this net debt the higher price of copper in 2010 in relation to the long term price. In fact, if an increase of 150 cents (US$) per pound is confirmed this year, we shall have under this heading (the current and projected 366 cents less 216 cents (US$) per pound estimated in the Budget Law), an equivalent to 3.6% of the GDP in additional savings which, if we add them to the net debt already inferred of 3.2% of the GDP, we obtain a surprising credit balance of 0.4% of the GDP. Therefore, the level of the Chilean fiscal debt does not present an obstacle to privilege a higher indebtedness versus a tax rise (see Table 1).

Table 1

Current Fiscal Situation: Low debt, accumulated funds and high price of copper 2010

	December 31st 2009 Mills. US$	% GDP
Gross Debt Central Government w/o Acceptance Bond	10,041	
Acceptance Bonds	11,523	
Total Fiscal Debt	21,564	13.2
(-) Total Fiscal Saving *	16,363	-10
Total Net Fiscal Debt	5,204	3.2
Higher copper value 2010 on long term price		-3.6
Balance		-0.4

(*) Economic and Social Stabilization Fund (FEES), Pension Reserve Fund and Financial Assets of the Public Treasury

Source: Self-preparation based on figures from the Ministry of Finance

New sources of spending

On the other hand, we have the negative aspects of the fiscal situation. In the first place, we observe an excessive expansion of the actual public spending in the last years, with increases of 17.8% in 2009 and 6.3%

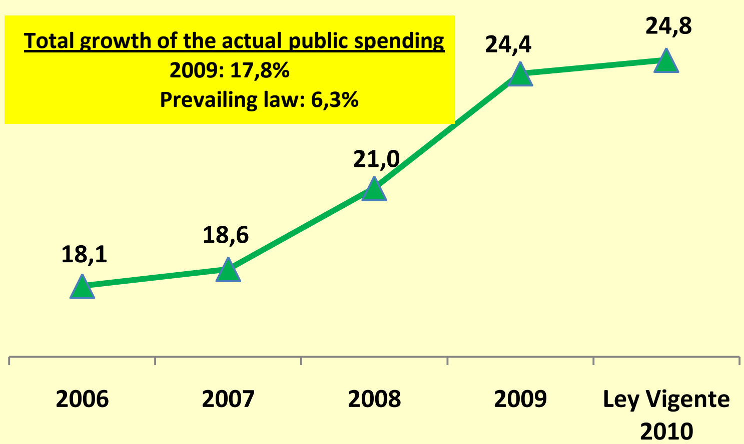
according to the prevailing law 2010, without considering the rebuilding cost. This has resulted in an increase of the public spending-GDO ratio from 21.8% in 2008 to 24.8% in 2010 (see Chart 1).

An additional expansion of this spending level will not be cost-free, with the subsequent impact on the actual exchange rate and the economy competitiveness.

The second negative aspect of the fiscal situation would be a structural deficit level which is not minor and, in fact, for 2010 it should be reaching 2.2% of the GDP, a figure that has not been recognized by the former authorities. But the interesting point of this gap is that it is possible to cut it with no major inconvenient or major difficulties, due precisely to the comfortable situation of Chile's current net debt, which was explained above.

Chart 1

Fiscal Situation: Total Public spending as % of GDP



Source: Self-preparation based on figures from the Ministry of Finance

How to cut the gap

In order to obtain this conclusion, there are two possible scenarios that differ basically in the growth rhythm of the actual spending after 2010: Alternative A is a 4.0% increase and Alternative B is a 4.5% increase. In any case, none of them is particularly restrictive, especially if you consider the high level of the base spending. The assumption of actual growth of the GDP and the structural incomes is an identical 6% in both cases.

The results are the following; in Alternative A, the structural deficit gap is cut in 2015 and it implies a debt increase of 6.4%, a number which, if added to the balance of -0.4% already obtained, gives a resulting net fiscal debt of 6.0% of the GDP. With Alternative B, which represents a more relaxed alternative, the gap is cut in 2017 and it leads to a debt rise of 8.2% of the GDP, a number that, when compensated with the -0.4% already known, gives a resulting net fiscal debt of 7.8% (see Table 2). The preceding results, which by itself represent an extremely comfortable scenario, are on the assumption that the price of copper will not be that high after 2010.

In view of this exercise, where the small debt of the country allows neutralizing the structural deficit in several years with no major inconvenient, it is clearly demonstrated that it is absolutely unnecessary to raise taxes in order to finance the Government program.

Table 2
Fiscal Situation: Structural Deficit 2010 of 2.2 % of GDP
How to cut the gap?

Starting point	Real growth Assumed	Assumed GDP growth and structural incomes	Cutting year of the gap	Net fiscal debt Output (as % of GDP)*
Deficit 2010:	Alt. A = 4.0%	6.00%	2015	-0.4% + 6.4% = 6.0%
2,2% GDP	Alt. B = 4.5%	6.00%	2017	-0.4% +8.2% = 7.8%

(*) Assumes that the price of copper does not remain high after 2010.

Source: Self-preparation based on figures from the Ministry of Finance

Impact on the exchange rate

Another argument of the authority for justifying the technical convenience of raising taxes is the possible impact, on the exchange rate, of selling off a substantial part of the FEES's funds. Along these lines, the Government has declared that it is impossible to obtain the perfect trilogy: low interest rates, high exchange rate and not appealing to taxes.

This argumentation is again mistaken, for at least three reasons:

First: the earthquake of February 27th destroyed 3% of Chile's fixed assets, which reduced the potential product, that is to say, we are poorer. This alone should put pressure on raising the exchange rate.

Second: the actual exchange rate falls when the spending level in the economy increases. When choosing a reallocation of fiscal spending of barely 1.6% of the Budget and a tax rise, the Government is deciding in favour of a financing mix that weakens the exchange rate.

Third: the impact of selling dollars from the FEES last year did not generate significant distortions in this key price of the economy, at least if you consider a moderate term. Initially, there will always be an overshooting in the markets, but it dissipates alone shortly after.

Table 3
Exchange rates for selected countries
(Selected Currency / US$)

	Peso Chile	Dollar Canada	Dollar Australia	Real Brazil
2008 Trim IV (a)	639.74	1.209	1.491	2.275
2009 Trim I	607.31	1.244	1.508	2.315
Trim II	567.33	1.168	1.32	2.081
Trim III	545.46	1.099	1.202	1.868
Trim IV (b)	518.35	1.057	1,101	1.739
Var. % (b/a)	-19.0%	-12.6% (d)	-26,2% (e)	-23.6% (f)
		Average (d,e,f):	-20.8%	

Source: Self-preparation based on figures from the Ministry of Finance

A negative aspect of the Chilean fiscal situation would be a structural deficit level that in 2010 should be reaching 2.2% of the GDP, a number not recognized by the former authorities. But it is possible to close this gap with no major inconvenient and without raising taxes, due to the comfortable situation of Chile's current net debt.

Specifically, US$8.000 millions were sold off in Chile last year and the exchange rate had even a lesser impact than the average one showed in the same period by currencies of exporting economies of raw materials, such as those from Canada, Australia, Brazil, and Chile.

The estimation of the Chilean peso, between the fourth semester of 2008 and the same period of 2009, was of 19%, with a dollar value that dropped from 640 to 518 Chilean pesos, that is, 122 Chilean pesos. In the case of the currencies of the countries mentioned above, the average estimation was 20.8%, almost two points higher than the Chilean one (see Table 3).

Conclusion

The Government has tried to justify a tax rise with several arguments which embrace from a deteriorated fiscal situation inherited from the former administration to the assumed inconvenient effects of other financing sources.

The facts that we have mentioned regarding the fiscal situation of the country, and the impact on the exchange rate caused by the entry of dollars to Chile in the past and the effect of the financing formula chosen by the Government, demonstrate, with no doubt whatsoever, that it was unnecessary to appeal to a tax rise in order to finance the rebuilding after the earthquake.

It would have been perfectly possible to appeal to the external indebtedness and the limited use of the FEES's resources. It was also possible to appeal to the internal indebtedness, without having more negative effects on the Chilean economy than those caused by the future tax rise.

The economic authorities own an explanation to the country regarding its decision to propose a tax rise, because numbers indicate, clearly enough, that it is unnecessary.