Public Issues

Nº 964
May 6th, 2010
www.lyd.org ISSN 0717-1528

Reconstruction Financing and Tax Increases

It should be emphasized that a greater reallocation has more important qualities than the option of the proposed measures. Among them we can mention the following: (i) it allows generating more space to achieve the macroeconomic stability; (ii) it does not create distortions for investments (in other words, it does not have collateral effects); (iii) it does not have to face problems associated with evasion (and, therefore, it is more efficient); and (iv) it accelerates the expected and promised revision and improvement of the public spending management.

The Government presented at last the financing law project for reconstruction, including a number of tax increases and some exemptions or concessions that partially mitigate the tax burden increase.

The higher collection, of around US$1,150 millions, derives almost completely from the net effect in the fiscal incomes generated by the amendments proposed for the income tax, while the other modifications fully compensate the lesser fiscal incomes generated from maintaining the stamp duties rate; this last measure was contemplated in the government program of Sebastián Piñera.

Tax amendments

In general terms, the main amendments imply an increase of the first category income tax rate, from the current 17%, to 20% in 2011 and 18.5% in 2012. In a combined and permanent manner, there is a taxation system with an exempted quota of the first category tax payment for the reinvested earnings up to $50 millions approximately for the Small and Medium Businesses which keep a full accounting, businesses with total annual incomes not greater than $1,000 millions and a corporate equity not greater than $110 millions.

The amendment of the so-called mining royalty tax implies a share increase for the mining companies with annual sales greater than the value equivalent to 50,000 metric tons of fine copper. The share increase should be for the next two years, that is, 2010 and 2011, returning to its current level for the corresponding time of the current tax invariability, until 2017. Then, it should enter a system of taxation invariability for 8 more years, subject to the new standards being created, that is, until 2025. In other words, the royalty is increased during these two years in exchange for the new taxation system invariability between the years 2017 and 2025, with the new rate proposed in this project amounting to an average maximum value of 9%.

There is also a provisional increase of real estate taxes; the new surcharge is of 0.275% during 2011 and 2012 and it applies to all properties with a fiscal assessment greater than $96 millions. Therefore, in the case of non-agricultural real estates, the rate increases from the current 1.225% to 1.475%. It should be noted that low-income third age persons shall not pay this new tax.

Moreover, the proposed project increases the tobacco tax, establishes a ceiling of 900 UF [1]per year to the agreed-upon deposits, and limits the benefits of the DFL 2[2] to two housings per natural person and eliminates them for the juridical persons. In relation to tax rebates, it maintains the stamp duties rate at 0.6% on a permanent basis; this tax should increase to 1.2% starting June of the present year, according to the current practice.

Although at a certain moment it was thought to incorporate the accelerated depreciation to this project, it was finally excluded. The fact of not incorporating the accelerated depreciation to this tax package will be highly prejudicial to the reactivation, because the private sector shall invest around US$6,700 millions in rebuilding its own infrastructure which was damaged by the earthquake and, therefore, the accelerated depreciation would have contributed to relieve the financing requirements.

Was it necessary to raise taxes?

The proposed tax amendments have caused various reactions, both conceptual (regarding the actual need of raising taxes) and concerning the chosen measures.

---

[1] Unidad de Fomento. One UF is equal to 21,068.29 Chilean pesos (rate of May 18th, 2010).

[2] DFL 2 refers to housings having less then $140m^2$.

In relation to the first point, the government had declared that a tax rise was necessary to finance the reconstruction program. However, shortly after it recognized that the reason justifying the increase would be the need to maintain a macroeconomic stability in the coming years. Particularly, the government is trying, through the proposed set of measures, to prevent a major effect upon the exchange rate (in the event of a massive currency inflow) and the interest rates (in the presence of an economy that could be overheated in a near future as a result of a greater economic activity due to the reconstruction both at the public and private sector level).

Nevertheless, the taxes put forward could generate a similar macro-effect as well. The businesses, in view of a transitional downturn in the earnings after taxes, would resort to indebtedness to damp their provisional incomes' fall, which would, eventually, cause the same impact on the exchange rate and/or the interest rates. On the other hand, several studies –among them, studies carried out by the economists Rodrigo Cerda and Felipe Larraín- have demonstrated that a factor that weights on the exchange rate is the size of the State in the economy, which is measured through the fiscal spending in relation to the GDP. Nowadays it is around 25%, much higher than the 18% of the first year of the Bachelet Administration, which should have an important effect on the exchange rate.

Thus, in general, the announced measures do not prevent a macroeconomic instability and, in particular, they are questionable decisions from the point of view of the economic efficiency. This statement deserves a brief review of the possible consequences of each one of these measures, and later on we shall conclude with our idea of a more reasonable measure in terms of respecting the medium and long term stabilities.

Effects of the tax amendment

With regard to the transitional increase of the **First Category Tax,** it should be noted that smaller businesses are the ones that are going to perceive the impact of this measure more strongly. In fact, for the bigger enterprises it is easier to minimize the effect of higher tax rates, because they can rely on indebtedness to finance their investment decisions (thus reducing their taxable base), while for the medium businesses this task will be more difficult to accomplish, as they shall finance themselves with savings or capital increases, due to the fact that they have more obstacles to obtain financing via debt.

Therefore, the problem is not only the impact of tax increases on investments, but rather who really pays for this impairment. The answer can be found in the study of today's Ministry of Finance[3], where he, based on microeconomic data, provides evidence on the impact of corporate tax over investments. Using data about Chile, he demonstrates that a 10% increase of the corporate tax rate reduces investment as a fraction of capital stock between 0.2% and 1% under different econometric specifications. The work also demonstrates that this impact differs depending on the size of the company: in small and medium businesses the effect is much stronger and highly significant, because the investment as a fraction of the capital stock declines between 0.5% and 1.6%. Instead, in the big enterprises the impact is not very significant. Thus, the proposal shows a regression depending on the size of the businesses.

Although it has been tried to mitigate this effect with the new tax exemption for the small and medium businesses (PYME) having a full accounting, the details of this proposal set serious doubts on their applicability. It seems easier to extend the benefits of the income law's article 14 bis to somewhat greater business, without limiting the deferred taxes to a fixed amount.

In relation to the **Royalty**, this measure should have a good reception in the mining industry as it rewards those who apply this tax amendment by extending the invariability for eight additional years, but at a higher rate than the present one. In other words, the fact of making a new deal of tax invariability until 2025, shall depend upon the expectations with regard to future tax rises in this sector. As a sort of self-fulfilling prophecy, the permanent threats of tax increases to this productive sector end up promoting successive tax invariability regulations which all things considered, are no such thing.

As for the increase of **real estate taxes**, we have already mentioned that it is a tax to the patrimony, which does not consider the real cash position of the people concerned. It is not true that the owners of the more valuable real estates have higher incomes, especially when we

---

[3] Rodrigo Cerda & Felipe Larraín, 2005. "Inversión Privada e Impuestos Corporativos: Evidencia para Chile". Latin American Journal of Economics, Institute of Economy. Pontificia Universidad Católica de Chile, Vol. 42(126), pages 257-281.

talk about elderly and retired persons. It is for this reason that the real estate tax amendment shall not apply to elderly people (women over 60 and men over 65 years old) having a precarious economic situation. But, as it is stated in the project, it shall be the taxpayer who shall furnish proof of his/her economic situation before the Tax Administration (*Servicio de Impuestos Internos,* SII), when the reasonable thing to do is that the SII demonstrates who has to pay.

Among the planned tax amendments, it is important to make reference to the **agreed-upon deposits**. These deposits are an extra money contribution which the worker does in mutual agreement with his/her employer. So far, these deposits have no ceiling and represent a saving alternative which puts off or defers, but in no case eliminates, the tax payment until the withdrawal of the savings during retirement.

The agreed-upon deposits have been designed with the purpose of allowing people to “average” the income obtained throughout their working life, thus generating a better provisional planning and more balanced taxation throughout their lives. These deposits are, by definition, sporadic –typically associated to productivity bonus- which differentiates them substantially from the voluntary social security saving that represents a systematic saving effort. In the first case, it concerns a capital which is not available until retirement; at that moment it is used in a deferred manner in the form of a pension. On the other side, and in opposition to what many people believe, the agreed-upon deposits cannot be withdrawn as free-disposal tax-exempt surplus, as is the case with the voluntary contributions.[4]

Therefore, this measure apparently does not consider the following: (i) it affects saving, because it eliminates part of the advantages of a tool that allows deferring taxes in exchange of a greater illiquidity; (ii) if restrains a saving alternative that guarantees tax payment to the public treasury, because the AFP (Pension Fund Association) retains a percentage at the moment of withdrawal (there is no evasion); (iii) it fosters other saving alternatives that search to reduce taxes, such as the use of investment companies; (iv) it directly affects the dependant employees, producing an asymmetry with regard to the self-employed worker; and (v) it achieves a low collection.

[4] These contributions are tax-exempted for a maximum of 800 UTM (1 UTM = 36,899 Chilean pesos, May 2010) if they are withdrawn once, or a maximum of 1,200 UTM if they are withdrawn in at least 6 years.

In relation to the former, it should be mentioned that, if this measure is approved, it will affect a delimited universe of individuals (those who make annual deposits over 900 UF) who, according to the market estimations, do not exceed 1,700 persons in the whole industry. The low coverage and the possibilities of searching for alternative saving mechanisms raises some serious doubts as to the real efficacy of the public treasury being able to collect significant amounts in this way, a situation which necessarily leads us to question the explanation for this measure.

Nevertheless, if this idea persists, it would be more reasonable to think of a system that imposes a savings ceiling, subject to the benefits of the agreed-upon deposit, of a higher amount and for a longer term. In particular, the ceiling of 900 UF seems very restrictive if you consider that a contribution of 200 UF generates approximately 1 additional UF of pension; in other words, it is a ceiling which limits the capacity of increasing the pension to 3 additional UF. On the other side, considering that the possibilities of generating savings are sporadic and that they do not necessarily repeat year after year, it would be convenient to bear in mind a ceiling with a total amount established as a mobile average of, for example, five years. It would be still better if this ceiling could envisage a maximum amount subject to the tax benefit throughout the working life of the contributor, which would generate more incentives to raise the replacement rate in the retirement period of every contributor.

In brief, the announced measures do not seem very auspicious as they generate distortions and impair the economic growth. In fact, it is well known that any tax raise necessarily hinder the economic reactivation, because it affects the investment decisions, even if they are introduced as transitional ones. We should not forget that at the beginning of 1990, the government established a transitional income tax increase, but then in 1993 it was set as permanent.

This tax raise is particularly relevant in the current scenario, with an annual average total factor productivity fall of -1.6% during the last four years. If investment is held back (which affects capital stock) it shall have an even more pernicious effect on the factor productivity. In turn, the tax raise affects people directly; after all they are the ones who pay the taxes and, moreover, they are hit directly by the lesser employment opportunities and stability caused by the slowing down of the economic growth.

Alternatives to keep the macroeconomic stability

It is understandable that the public treasury is worried about the macroeconomic stabilities lately, due to the fact that an important spending is expected, both from the public and private sector, as a consequence of the country's reconstruction after the earthquake and tsunami of last February. However, the need to delimit this excessive spending may be forged in different forms, and one of them is the tax raise, which we have already defined as not very sensible.

The expense reallocation seems still to be the best option in the current national scenario. As we have already stated, the fiscal spending increased during the last administration from around 18% to 25% of the GDP. Therefore, it is unavoidable for the present government to consider the possibility of reducing spending to more delimited levels and according to a State size that does not interfere with private undertaking. Thus, it will be necessary to identify the expenses that are committed on a permanent basis (where there is little to do) versus the stopgap expenses which are subject to revision. The public treasury has already committed spending reallocations for US$730 million per year (which represents barely 1.6% of the total government's budget for this year), an amount considered low for the first year of its administration, but definitely insufficient in relation to what should be expected for the coming years.

It is important to highlight that a greater reallocation has important advantages which make it a better option than the proposed measures. Among them we can mention the following: (i) it allows generating more space to achieve the macroeconomic stability; (ii) it does not create distortions for investments (in other words, it does not have collateral effects); (iii) it does not have to face problems associated with evasion (and, therefore, is more efficient); and (iv) it accelerates the expected and promised revision and improvement of the public spending management.