

Budget Law 2014: Criticism with Mistaken Premises

Criticisms from the opposing coalition concerning an alleged fiscal sustainability problem are groundless. The copper boom has come to an end, which rather than creating the need to increase taxes, is a strong call for greater responsibility in terms of future spending promises. The revenue slack condition of the period 2006-2012 is over.

We are already amid the process of discussing the budget bill for 2014, the last of the current Administration, and which shall be executed by the next government. This fact by itself adds a complexity to its elaboration. Furthermore, for the first time the discussion will take place in a presidential and parliamentary election scenario, and the process will last 30 days less than usual due to the legislative pause, and it will finally be approved by parliament members not going for re-election or who may have lost the election. Given these special circumstances, until now the mixed commissions have shown a more expeditious proceeding than in previous years, something that could change after November 17th. The conflicting points of view have been focused on the macro discussion, which we will analyze in depth below.

The first thing is to point out the big contradiction in the substantive discussion set forth by the opposing coalition, which accuses a restrictive fiscal situation for next year, advocating greater expenditure laxity, but at the same time calls the attention to an alleged lack of fiscal discipline due to a fiscal deficit of 1% of the GDP. It is obviously incompatible to deal with both situations. In previous budget discussions this underlying contradiction was also present, but in a more evasive way,

because asking for more spending was always privileged, both at the macro level and in the discussions for each one of the items, putting the discussion of the mid-term fiscal sustainability in the background.

What explains this contradiction between considering that spending is always tight-fisted and siding with a quick return to the structural balance? The answer is in the intention of making the State bigger by means of increasing the tax burden in a quite significant degree.

Additionally, the approach of Robert Barro has been used in the sense that a greater tax burden would not affect growth; on the contrary, it could even benefit it if taxes are not distorting, and if tax receipts are used to favor the economy's productivity. This is theoretically right, but the corporate tax increase, together with taxation on accruals basis, is highly distorting, since it discourages investment and causes serious problems for corporate structures, minority shareholders, pension funds and monthly liquid assets of small businesses, which will face a 25% increase in the Provisional Monthly Payments (PPM, in Spanish). On the other hand, if these funds are mainly used for fee-free higher education and the end of copayment in the private subsidized education, it would not be possible to achieve a productivity increase that would compensate higher taxes, because this type of policy is just a transfer from the Public Treasury and does not improve by itself the quality of education. In fact, productivity would probably drop, since fee-free education reduces the effort of parents and children. In brief, Barro's arguments in tax matters do not apply to the program content proposals of Bachelet's campaign staff.

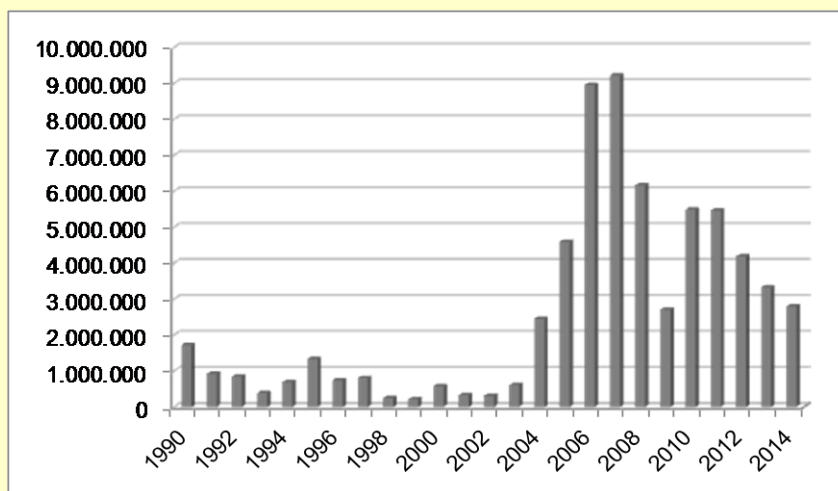
A second criticism refers to mid-term fiscal sustainability. A very important starting point for the analysis of this argument can be found during the previous government. It is a fact that, in spite of the strong spending boost of 2009, the former government ended with a net credit financial position for the central government. However, it was a consequence of that period's spectacular copper boom, which doubled that of the present government in GDP terms. Chart 1 shows mining tax receipts as of 1990 measured in million pesos of 2014.

With this extraordinary revenue boom, and despite an average spending growth of 10.5% real between 2006 and 2009, an improvement of the net financial position was achieved until 2008, and then changed back in 2009. In the last four years we see a situation of relative stability in spite of the decreasing mining

revenues. Chart 2 shows the central government's net financial position.

Chart 1

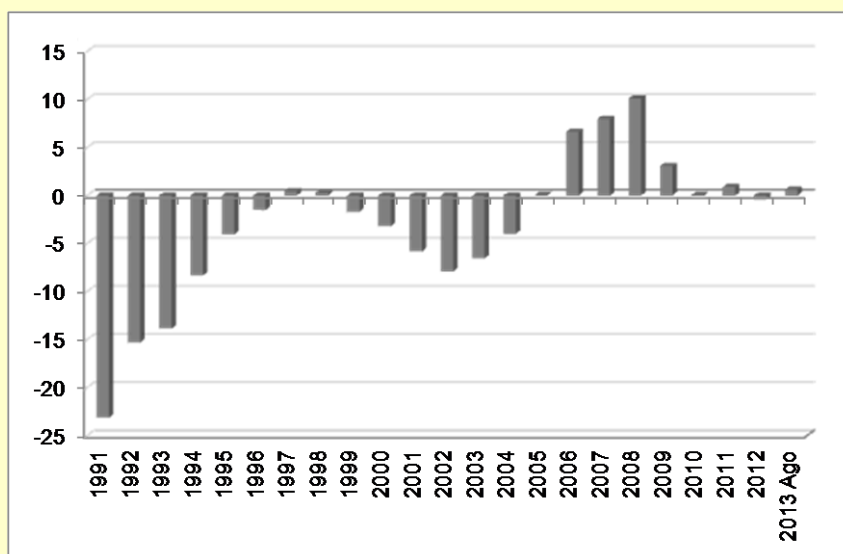
GOVERNMENT REVENUES FROM THE PRIVATE MINING SECTOR AND CODELCO (CLP\$ MILLIONS OF 2014)



Source: Budget Office (DIPRES)

Chart 2

CENTRAL GOVERNMENT'S NET FINANCIAL POSITION (% OF THE GDP)



Source: Budget Office (DIPRES)

It is evident that the Chilean fiscal position is still very solid, and impairment is explained by two reasons: the first is the strong fiscal boost of 2009 and the second is the reversion of a temporary boom in the mining revenues. Chile is still one of the countries with best fiscal position in the world, as the next chart shows for a group of countries: (see Chart 3)

Chart 3



Source: IMF

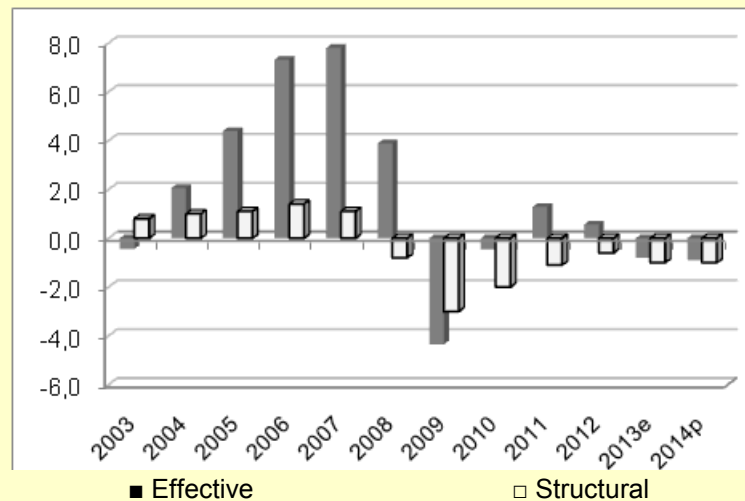
Therefore, it is evident that criticism about an alleged fiscal sustainability problem has no support. Nevertheless, the numbers estimated for 2014 allow deducing that the copper boom is coming to an end which, rather than causing the need to increase taxes, is a

strong call for greater responsibility in terms of future spending promises, because the revenue slack condition of the period 2006-2012 is over. To keep this privileged fiscal position in the world requires a moderate spending growth rate, according to the mid-term estimations of the DIPRES (Budget Office).

Additionally, if we incorporate the flow analysis to the fiscal assets and liabilities, the criticism regarding lack of fiscal responsibility has still less support, since during the former government a significant impairment was produced in the central government's budget balance, both structural and effective, as shown in Chart 4.

Chart 4

CENTRAL GOVERNMENT'S EFFECTIVE AND STRUCTURAL BUDGET BALANCE (% OF THE GDP)



Source: DIPRES

Bachelet's government received a structural deficit of 1% of the GDP in 2005 and ended with a structural deficit of 3% of the GDP in 2009, that is, an impairment of 4.1 points of the GDP. This is not explained by the external crisis, as is usually said, because between 2005 and 2008, despite an extraordinary copper boom, the structural budget balance decreased 1.9 points of the GDP, which is compared to an improvement of 2 points of the GDP in this government, with an earthquake and a less significant copper boom in between. Actually, the main reason explaining this situation is the former government's highly expansive fiscal policy, which although it was comfortably

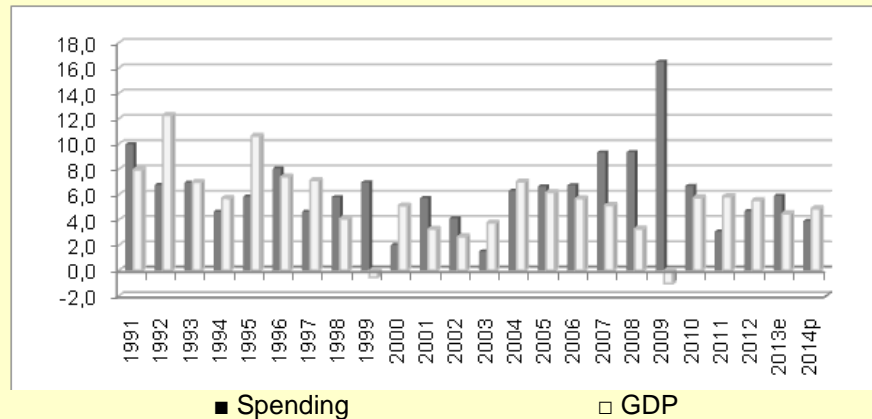
financed until 2008, its financing was based mainly on a commodity boom.

Chart 5 shows the behavior of fiscal spending in the last two decades compared with the GDP growth. The previous government was the most expansive, far above the behavior of the previous administrations. The consequences of this fiscal expansiveness go far beyond the impairment of the structural budget balance. During that period, a significant shift was made in the way of understanding the social policy in Chile, leaving aside the concept of Subsidiary State in order to advance towards a Welfare State.

Now, the opposing coalition's campaign speaks of installing a social State of guaranteed rights, whose fiscal cost is impossible to afford in a normal mining revenue situation. It is not only impossible to finance, but this scheme has also shown great weaknesses in European countries, and not only in those undergoing the crisis. This fiscal policy scheme affects individual responsibility and damages the incentives; therefore, it is a significant obstacle for development. We could even think that the end of the "super cycle of copper" can turn out positive if it prevents Chile from advancing in schemes that are resoundingly failing in the developed world.¹

Chart 5

GROWTH OF PUBLIC SPENDING AND THE GDP



Source: DIPRES

In relation to the mid-term fiscal slacks, the DIPRES has provided two scenarios: one that keeps the structural deficit of 1% of the GDP, producing a spending slack of US\$9.571 billions for the period 2015-

2017; and a second one that reduces the structural deficit to 0.25% of the GDP in 2017, which results in a slack of US\$4.727 billions for that period. In its last budget, the previous government estimated a slack of US\$7.361 billions for the period 2010-2013. However, this figure was badly calculated for two reasons: the first, pointed out by the Corbo Commission, was that the estimate used a GDP gap different from the one derived from the estimates of the trend GDP Committee, and the second is that it did not consider any wage adjustment estimate for the public sector, which was very high in real terms (6%). With these two adjustments, the slack is practically reduced to zero. In short, it seems evident that the opposing campaign staff, led by the Budget Director of the former administration, has not the best credentials to criticize an alleged lack of fiscal responsibility in the current government.

A further criticized issue is the unrestricted amount of funds that the current government will leave to the next, accounting for US\$600 millions, which are estimated insufficient. Obviously, the insufficiency depends on the new programs that could be implemented during the first months of the new government, and since most of the bills need some time for their study and parliamentary approval, the amount seems enough. Even the negative March bonus that has been announced as permanent has a cost close to US\$200 millions. Thus, there would be resources left to start other programs, in addition to a budget flexibility to reallocate funds, like the two spending adjustments implemented during this government, in 2010 and 2011, for approximately US\$750 millions each. The criticism to the unrestricted amount of funds has another purpose, which is to insist on the point of insufficient financial resources to justify the need of a tax reform.

A last significant point in the criticism concerning the budget bill refers to the spending growth rate estimated for 2014, which would be considered insufficient in a deceleration scenario. This argument contains a double weakness, because it uses the wrong spending growth rate, of 2.1% real. This figure is obtained from comparing the 2013 Law with the 2014 bill, and since it seems to be a slight sub-execution this year, it is not the relevant rate to analyze the macroeconomic effect of the fiscal policy. The right figure for this analysis should be 3.9%. The program content manager of the opposing campaign staff and former Budget Director, Alberto Arenas, declares that the fiscal policy is not playing its counter-cyclical role. But it should be explained that the structural fiscal policy does not have a counter-cyclical objective, but a neutral one. Furthermore, a

counter-cyclical role would neither be justified in case it were an objective, because the estimated scenario points out that the GDP growth rate should rise to 4.9%, which is higher than the trend growth. This confusing set of arguments provided by Arenas just shows his clearly expansive bias in fiscal spending matters.

Conclusions

The budget bill for 2014 fulfills the fiscal policy objectives set forth by the current government at the beginning of its term of office: to end with a structural deficit of 1% of the GDP and achieve a fiscal spending average lower than the average growth of the GDP. The reason for the latter was to revert, at least partially, the big fiscal boost of 2008-2009, so as to favor the competitiveness of the economy through a higher real exchange rate.

The figures estimated for 2014 are quite evident to show the end of the so-called “super cycle of copper”, considering that the structural government revenues from the mining sector should drop 13% real in relation to the estimates for the present year. This explains why the expenditure grows below the trend GDP, 3.9% real versus 4.8% of the GDP.

In this future, less generous revenue scenario it does not seem reasonable to announce significant tax increases that will probably adversely affect growth; instead, spending promises should be moderated, especially because it seems inadequate to advance towards social policy schemes that are failing in the developed world.

In brief...

- The opposing coalition pretends to install a social State of guaranteed rights, whose fiscal cost is impossible to afford in a normal situation of mining revenues.
- The previous government was the most expansive in fiscal spending matters in the last decades.

ⁱ In his first speech, the new Dutch king summoned to end with the “happiness machine” referring to the Welfare State, and shift to a participation society, mentioning the necessary individual responsibility.