Chapter 5

Structural change in Chile: From fiscal deficits to surpluses

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This chapter discusses the driving forces behind Chile's strong fiscal performance. It is argued that fiscal rectitude owes much to the progressive concentration of policymaking powers on the executive branch of government, including over sub-national finances. The ban on revenue earmarking is highlighted as a means of rendering fiscal management more flexible. Structural reform since the return to democracy in 1990 was facilitated by a high degree of political cohesiveness. The use of fiscal policy as a demand management instrument is due to the introduction of mechanisms to deal with the impact on the budget of fluctuations in copper prices and the business cycle, an achievement that is underpinned by Chile's low level of public indebtedness.

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Introduction

One of the strengths of the Chilean economy is its fiscal performance. Several indicators are worth pointing out: the public debt-to-GDP ratio fell from 45% in 1990 to 13% in 2004.[1] The budget has been in surplus almost without interruption, averaging 1% of GDP between 1987 and 2004.[2] Exceptionally, a deficit was recorded in 1999-2003 when growth slowed down and the price of copper fell sharply. Measured in cyclically-adjusted terms, a budget surplus was nevertheless posted in the period. At the same time, country risk has been reduced and is now among the lowest among the emerging-market economies. Chile is rated among the top performers in international competitiveness rankings on account of its fiscal policy. This has nevertheless not always been the case. The average budget deficit was 1.9% of GDP between 1950-86, except for just five years of surplus and public indebtedness was on the rise.[3]

The fiscal consolidation effort of the last 18 years has been a key instrument for reducing inflation and ensuring high economic growth. Fiscal policy has ceased to be a cause of macroeconomic imbalance; it has permitted the adoption of a counter-cyclical policy stance, which has brought about greater stability of growth and employment in the face of external shocks. Thanks to the reduction in public indebtedness and the improvement in fiscal performance, the country was able to cope better with the negative effects of the Asian crisis in the late 1990s and, in part, to mitigate these effects. At the same time, fiscal policy has made it possible to set medium-term objectives for social development and public investment which is difficult in situations of fiscal weakness. Not only was social spending not reduced at the time but it has also continued to rise uninterruptedly.[4]

The main focus of this chapter is to identify the factors behind this structural change. The objective is not to provide a detailed historical account of Chile's economic performance but, rather, to underscore the key engines of reform. The analysis also contributes to the study of fiscal outcomes from a comparative cross-country perspective,[5] and is based in part on my personal experience when in charge of the national budget from the return of democracy in 1990 to the end of 1996, and as an active observer thereafter from other parts of government that also involve the use of public resources.

The constitutional and legal framework for fiscal policymaking

A key determinant of fiscal performance is to the way in which policymaking powers are distributed among the various stakeholders and the rules governing the formulation, approval and implementation of the budget. For many decades, it was common in Chile for the Presidents to blame pervasive deficits and fiscal imbalances on the fact that they had no authority over expenditure policy and the public finances in a way they considered appropriate from the point of view of macroeconomic management.

Starting in 1925, legal and constitutional reforms progressively reinforced the authority of the executive branch of government in fiscal policy. The 1925 Constitution adopted a presidential regime, which was strengthened in 1943 during the Juan Antonio Ríos' administration, with the approval of a constitutional reform giving the executive branch stronger prerogatives in public spending. In practice, however, this was not enough. All the subsequent Presidents, Carlos Ibáñez del Campo, Jorge Alessandri and Eduardo Frei Montalva, elected with the support of different political parties, proposed constitutional reforms which would strengthen presidential authority in expenditure matters. Jorge Alessandri, in the constitutional reform law of July 1964, stated that:

"The steadily growing importance of economic and social problems and the consequent pressure exerted by Congress in these matters highlight the need to introduce changes to the 1925 Constitution with a view of protecting the country's fiscal stability. To this end, only the President of the Republic should be able to take the initiative to propose legislation is related to the remuneration of public-sector workers. This was the purpose of the reform of the Constitution in 1943 and during the presidency of Juan Antonio Ríos. Unquestionably, its spirit was also to tackle budgetary problems and that was the view taken by Congress before I took office".

"What has happened since the 1943 amendment has suggested that much more radical changes are needed to remedy the problem. Those inappropriate practices that were previously introduced by Congress under the Budget Law nowadays make their presence felt in all the laws which the executive branch submits for its consideration, especially those of a social, budgetary, financial and tax nature and others, apart from the fact that Congressmen very often propose legislation on these subjects which give rise to even worse outcomes. Each law is the subject of hundreds of provisions which undermine its purpose and other legislation in force, and involve all kinds of matters totally alien to the law itself".

"The consequences of all these initiatives fall on the President of the Republic, who is responsible for the financial and economic administration of the nation. If the President has sole responsibility for its management, the logical consequence is that Congressmen should not have any right of initiative whatsoever in this matter and that such a right should belong exclusively to the Head of State. In other words, for all these problems, the same principle which inspired the 1925 Constitution concerning the national budget law should prevail. Only thus can anarchy, injustice and privilege in wage policy be avoided in the public or the private sectors, and a budgetary system free of favouritism, a tax system and an investment policy can be established and maintained in accordance with a harmonious development plan for the national economy. It is therefore sought to avoid the bad practice whereby Congress allocates through the budget law funds for specific works, which has been one of the major reasons why it has been impossible to implement public investment programmes as economically and rapidly as possible…”.[6]

Jorge Alessandri did not succeed in securing congressional approval for his constitutional reform, which led Eduardo Frei Montalva to propose soon after taking office in November 1964 that “there is an urgent need to reserve to the executive branch the initiative in all laws which involve expenditure or which have an impact on the economy”. In particular:

“This measure is rooted in the economic reality of our times. There is no doubt that the enormous complexity of the modern economy and the need to plan investment and set targets and priorities demands not only short-term planning but also long-term development, which requires a unified approach to investment and expenditure. To this end, it is essential to ensure that pre-established targets, objectives and priorities are not undermined by contradictory initiatives. Once the economic and social policy objectives have been approved, it is up to the government to implement them, which means that it must be given the exclusive initiative in all legislation which involves expenditure or other measures which may interfere with the implementation of plans or programmes. This is what the law I am presenting to you seeks to achieve when it extends in article 45 the matters of law where the initiative is reserved exclusively to the President of the Republic”.

Almost six years had passed before this constitutional reform was approved in 1970 at the end of Eduardo Frei Montalva’s term in office. On the occasion of the promulgation of the reform, President Frei Montalva stated that “the authority of the executive branch must be reaffirmed with respect to the planning and control of the economy and, to that end, it is necessary to extend the scope of legislation which is of the exclusive initiative of the President of the Republic, to all matters which impact on fiscal expenditure and the system of remuneration and pensions in the private sector. The idea exists already in the current Constitution, under the reform sponsored by President Ríos. It is imperative because the efficient management of the economy, which involves all sectors, requires that this responsibility be based in the executive branch which, by its structure and the technical assistance available to it, is in a position to act with the consistency and continuity that the National Congress

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cannot provide and which are essential in all countries, but especially those like ours which are developing".

The text approved by Congress was the following (Law No. 17 284 of 23 January 1970): "It shall be the exclusive prerogative of the President of the Republic to propose amendments to the Budget Law to alter the country's political or administrative structure; to abolish, reduce or waive taxes or contributions of any kind, interest or penalties, defer or consolidate their payment and grant total or partial tax exemptions; to create new public services or paid employment; to modify the remuneration and other pecuniary benefits of staff in the public administration, both central and local; to fix minimum wages or salaries for workers in the private sector, increase their remuneration on a mandatory basis or alter the rules by which they are determined; to create or modify pension and social security entitlements; and to grant or increase, *ex gratia*, retirement, old-age or survivors' pensions or *ex gratia* pensions. These provisions shall not apply to Congress and services under its authority".

The military government which took power in the midst of a serious fiscal crisis introduced a series of changes to centralise policymaking powers over public revenue and expenditure in the Treasury. These measures were summarised in a new law on the financial administration of the State (Decree Law 1263) which came into force in 1975.[7] This law incorporated all revenue and expenditure in the national budget and abolished practically all earmarking of tax revenue. In 1980, the new Constitution reinforced the provisions of the previous constitutional reforms which had been approved in 1943 and 1970: budgetary and financial management prerogatives were concentrated in the President of the Republic.

To sum up, successive legal and constitutional reforms strengthened the authority of the executive branch of government in fiscal matters leading to the current legal framework enshrined in the 1980 Constitution and in the 1975 Financial Administration Law (as subsequently amended), which underscored and extended presidential authority over fiscal policymaking. According to the constitutional provisions currently in place, it is the exclusive prerogative of the President of the Republic to propose legislation on tax and expenditure matters, including those of a budgetary character.

With regard to the budget-making process, the main provisions of current legislation are as follows. The national budget presented by the executive branch to Congress must be approved within 60 days prior to 30 November of each year. The estimation of revenue is the exclusive responsibility of the executive branch. Congress can only reduce the expenditure envelope proposed in the draft budget law and does not have the prerogative to reallocate resources in the draft budget law without the executive branch's agreement. If Congress does not approve the budget law within the constitutional timeframe, the law comes into force as presented by the executive branch. At the same time, the legislation on financial management calls on the Treasury and the Budget Office to take the lead in the drafting, discussion and implementation of the budget. Borrowing must be authorised by the Treasury for all public entities, including corporations, and is banned for the municipalities, unless authorised by law.

In the Chilean tradition, the executive branch has political responsibility for the economic management and administration of the State. This institutional framework has underscored a fairly strong tradition of fiscal discipline where different ministries are subject to the authority that, in practice, Presidents delegate to the Treasury to conduct fiscal policy. This system, which concentrates policymaking powers, makes it possible for the government to set objectives for fiscal policy and not to leave fiscal performance to the mercy of generally independent, and not necessarily mutually consistent, decisions taken by different stakeholders.

Fiscal policy is the most political of economic policies. It requires the capacity to exercise self-discipline in the face of multiple demands and needs, numerous beneficiaries and interest groups, and scarce resources. Only with very good institutions and rules can fiscal policy become an effective instrument of macroeconomic management. In my view, the constitutional and legal reforms that were implemented by successive administrations and emerged with full clarity in the current rules are the main factors explaining the strong fiscal performance of the last 18 years. Comparison with other countries leads to similar conclusions as can be drawn from our history: legislation that encourages the centralisation of, and a strong hierarchical system for, decision-making delivers better fiscal outcomes.[8]

Budget institutions and fiscal performance

Unity and comprehensiveness of the budget

All revenue and expenditure, and all entities except the public enterprises and the municipalities, are included in the budget approved by Congress. Before the 1975 Financial Administration Law, some revenue, borrowing and expenditure items were often treated off-budget. As a result of this practice, there were different *fora* for negotiation and decision-making concerning the total amount of revenue and expenditure, which made it difficult for the fiscal authorities to achieve the desired budgetary outcomes.[9] The counterpart of comprehensiveness is greater flexibility in execution, allowing the reallocation of budgetary funds in line with financial management needs. Revenue and expenditure programmes are approved in the budget law at a fairly aggregate level; that is, there is only one line for payroll, another one for outlays on goods and services, and a few lines for transfers when different programmes are identified.

Strengthening the tax system

A pre-requisite for sound fiscal policy is a tax system that is capable of collecting the resources needed to finance the budgeted expenditure envelope. This requires laws that clearly define the tax bases and allow for efficient tax administration. In this respect, the Chilean tax system has been evolving over time. Collection performance was affected adversely by inflation, which eroded the real value of the tax take, a phenomenon that was mitigated in part by the introduction of indexation in the 1960s. In the current tax regime, in place since 1975, taxes are fully indexed to a unit of account, which is regularly updated based on inflation measured by the CPI for the previous month. This means that the tax take is fully protected against inflation.

In addition, as a result of indexation, tax legislation takes on a permanent character and does not have to be revised for every budget. In fact, budget laws do not include any tax provisions, in addition to the estimates of the tax take that will be generated based on unchanged legislation. This makes it possible to formulate tax policy from a medium- and long-term perspective and not with respect to the financing needs of any particular budget.

There has been a sustained improvement in tax administration over the last 20 years, significantly reducing evasion. The capacity of the Internal Revenue Service was enhanced by giving it greater powers of control and to close loopholes in the tax code, which could facilitate tax evasion and/or avoidance.[10] The quality of tax administration in terms of the probity and dedication of its staff and the increasing use of the new information technologies have made it one of the most modern in the world. With regard to the effects of the tax system on the allocation of resources, although not the subject of this chapter, disincentives and distortions are minimised because of the neutrality of the tax code.

During the last ten years there has been a major change in the structure of tax revenue to accommodate the successive reductions in import tariff to an average of 2% as a result of bilateral free-trade agreements. This has reduced the share of revenue from taxes on foreign trade from 10% to 1.5% of tax collections. Another important development from the macroeconomic point of view has been the prohibition by law of the earmarking of tax revenue for specific expenditure items.[11] Revenue earmarking creates rigidities and prevents the allocation of resources according to changing priorities and macroeconomic objectives. Of course, taxes are created to meet specific needs and, as such, the introduction of new taxes needs to be justified in the legislative process on the basis of the specific use for the funds they raise. However, this is very different from earmarking the revenue of a tax whose base and amount collected will change over time. The earmarking of taxes may also stem from pressures exerted by interest groups; the absence of earmarking therefore prevents transitory legislative victories from translating themselves into permanent measures which are difficult to reverse. The current constitutional provision which prevents revenue earmarking is thus most useful.

Capacity to control borrowing

The counterpart to deficits is borrowing; it is therefore important for fiscal policymakers to have centralised control over the financial operations of public entities. Under the current legal framework, entities that are part of the central government require authorisation by the Treasury to borrow. Relationships with multilateral lending organisations (*e.g.* World Bank, Inter-American Development Bank) is centralised at the Budget Office. Public enterprises, whose budget is not approved by law but by Treasury order, require authorisation from the Treasury to contract loans. The municipalities, which have budgetary autonomy, may not borrow unless authorised to do so by law. The executive branch of government has not proposed any law to authorise municipal borrowing in the last fifteen years.

The 1992 Regional Government Law banned regional government borrowing. The explicit objective of this reform was to encourage the decentralisation of investment without the risk of losing control over public borrowing and the fiscal policy objectives set by the central government. For this reason, while granting increased fiscal powers to the regional governments, including the prerogative to formulate their own budget, special care was taken to ensure that the Treasury's ability to control the overall level of expenditure was not jeopardised. The new role of regional governments involved greater autonomy to allocate resources to different investment projects, but within a centrally determined framework. As a result, the proportion of public investment that is allocated at the regional level increased from 18% in 1992 to almost 50% now.

The legislation which limits borrowing is complemented by strict control on the part of the banking supervision authorities. As new mechanisms for private investment have developed based on concessions, the government has provided guarantees to reduce risk and facilitate private investment. These contingent liabilities cannot be provided without the authorisation of the Treasury. In support of transparency and higher accounting standards, a register of contingent liabilities of the public sector has recently been created setting out the government's commitments under public-private partnership contracts.[12]

Political consensus on the importance of fiscal discipline: The lesson from macro-economic crises

In a democratic environment, there is support for the rule of law to the extent that it is perceived as serving the common interest; instead of that of individual groups. Otherwise, laws end up facing resistance and being amended. There has been general consensus on this matter over the last 15 years, despite some reaction on the part of lawmakers against their lack of power in the budget process. Since the return to democracy, the institutional framework for discussing and approving the budget has been enhanced and the quality and quantity of information available to this end has improved steadily.[13] The legal framework has been maintained and improved through the budget law and amendments to the Financial Administration Law.[14] The rules setting the powers and authority of stakeholders have focused on the macroeconomic objectives of the budget and fiscal policy.[15] This is evidenced by the functioning of the Copper Stabilisation Fund and the fiscal policy rule, discussed below.

Behind this political consensus is the recognition of the importance of fiscal discipline and the high price paid by the country in the past in periods of fiscal imbalance and macroeconomic crisis. At the same time, fiscal discipline has paid off, generating a "fiscal dividend". The reduction of government borrowing, for example, has allowed a firm response to external crises, and lower interest payments have freed up resources to finance social spending.

With the return to democracy in 1990, the main factor behind cohesiveness within the centre-left coalition government was the need to avoid fiscal relaxation and the resurgence of macroeconomic imbalances. The political crisis of 1973 and the economic crisis of 1982-84 were associated with costly macroeconomic disarray, which was very much present in the memory of all stakeholders. In those days, those who might have disagreed with the conduct of fiscal policy or the main elements of the institutional framework for policymaking described above yielded to the consensus to avoid instability. Subsequently, policies gradually proved to be effective, generating dividends that contributed to entrenching the consensus, particularly due to its ability to sustain social spending in the face of external difficulties, to reduce inflation and country risk, and to give the policy framework greater predictability.

Fiscal sustainability: The Copper Stabilisation Fund and the structural budget surplus rule

The Copper Stabilisation Fund was created in 1987 and the structural budget surplus rule in 2001. Both mechanisms sought to anchor fiscal policymaking in a longer-term framework. It is worth examining their impact on fiscal policy.

The Copper Stabilisation Fund

Copper price cycles have traditionally had a strong impact on government revenue in Chile. The share of copper has varied between 5 and 17% of tax collection.[16] To counter the effect of variations in the price of copper, a stabilisation fund was created and has been in operation since 1987.[17] The basic idea is to save resources when the price of copper exceeds its long-term level so as to use these savings when copper prices fall below the long-term trend. The operational rules of the Copper Stabilisation Fund and the trend in assets during the last 15 years are presented in Annex 5.1).

The Copper Stabilisation Fund prevents expenditure from increasing beyond the level deemed sustainable over the medium term and provides financing to ensure its continuity when prices fall. Before this mechanism came into effect, public expenditure usually rose in boom years in line with the rise in revenue, but it was difficult to reduce it when prices came down, a phenomenon described by Rogelio Arellano and Fausto Hernández in Chapter 6 for the case of oil in Mexico. Currently, the resources accumulated in the Fund are used to retire external debt. To the extent that debt is reduced during booms, spending on debt service can subsequently be reduced in bad times. As a result, markets also have greater confidence in policies, without the fear that the debt dynamics may become unsustainable.[18] Chile is therefore among the few countries in the world that can implement fiscal policy in a counter-cyclical manner, thereby alleviating the magnitude of the natural resource price cycle. In times of crisis, the room for manoeuvre is very limited and thus the government is often unable to implement counter-cyclical policies.

The structural budget surplus rule

In 2001, the mechanism for stabilising fluctuations in the price of copper was complemented by another mechanism to deal with fluctuations in revenue arising from deviations of GDP growth from its long-term trend. A methodology was set up for estimating revenue based on trend GDP growth, so that expenditure can be calculated on the basis of the government's capacity to collect taxes over the medium term, rather than on economic conditions each year. Fiscal policy objectives are therefore set consistent with the budget's structural balance. As a result, not only can fiscal policy be implemented in line with long-term revenue trends, but the introduction of a fiscal policy rule targeting a structural budget surplus of 1% of GDP has allowed for counter-cyclicality.[19]

Where it is possible to have a counter-cyclical fiscal stance, the degree to which it is appropriate to do so will be open to debate. It is certain that in the midst of a crisis there will be a natural tendency to press for the maximum use of counter-cyclical measures. The structural budget surplus rule addresses this challenge and enhances credibility by setting a clear *ex ante* limit on counter-cyclical measures. In recent years, the rule has allowed for fairly significant counter-cyclicality. In 2001 and 2002, the budget balance based on the fiscal rule was between -0.5 and -1.2% of GDP. In both years, the Copper Fund allowed the financing of expenditure equivalent to 1% of GDP.

These stabilisation mechanisms serve an important political purpose. They set priorities and play an educational role by targeting an explicit level for the budget balance. They also imply a political commitment by the authorities to a fiscal objective and hence reduce the need for negotiating the level of the desired budget balance each year. Moreover, they strengthen fiscal discipline by rendering budget outcomes that deviate from the level set by the fiscal rule costlier. These mechanisms contribute to the sharing of political responsibilities and make it easier for policymakers to bear the political burden of not being able to meet social demands in a low-revenue environment and to limit the benefit of spending revenue windfalls in boom years. By setting a formal budget target, the rule reduces discretion, since it can always be argued that the special circumstances of each economic cycle would justify a more expansionary policy. The automatic nature of the rule can overcome difficulties in reaching agreements in situations of change in parliamentary majority and where there is greater political competition. For the same reason, these mechanisms facilitate the implementation of fiscal policy, making it swifter, compared with what would happen if the fiscal measures were fully discretionary.

Such a rule, once it has gained credibility, can send a signal of sustainability to financial markets, generating benefits in terms of access to, and costs of, financing. A discretionary policy, on the other hand, presupposes greater ability by the economic authority to persuade markets that the current policy stance is the most appropriate from the macroeconomic point of view and thus justifiable in terms of the particular characteristics of each business cycle. Because credibility is important, indeed indispensable for sound economic policymaking, this rule enhances the credibility of fiscal policy and macroeconomic policy in general, by making it more effective and reducing adjustment costs. These stabilisation mechanisms have contributed to creating a common ground on what is acceptable and desirable in fiscal policy. These mechanisms not only give medium-term sustainability to fiscal policy, with all the benefits that have been described, but they also extend the planning horizon. It is possible to design and implement medium-term initiatives without the extreme uncertainty of their budgetary sustainability, as was so common in past decades and in countries which have not achieved fiscal sustainability.

It is interesting to note that neither the Copper Stabilisation Fund nor the structural budget surplus rule are set in law. These mechanisms are good policies which the executive branch of government has introduced, whose legitimacy has been justified in practice, and whose specific application has been improved over time. An improvement to gain credibility and strengthen these rules was the initiative put in place in 2002 that the key parameters for estimating the long-term price of copper and trend GDP growth used to set the structural surplus, should be determined by a panel of independent experts. The panel adds credibility and dispels any doubts concerning the discretionality to which this type of mechanism may be exposed.

Market discipline and monetary policy autonomy

A complementary factor which contributes to fiscal discipline is provided by the financial markets and monetary policy. The autonomy of the Central Bank of Chile since 1989 means that the monetary authorities are formally independent of the fiscal authorities and can therefore evaluate the macroeconomic effect of fiscal stance. If the monetary authorities consider it more expansionary than desirable from the point of view of price stability, they can raise interest rates, generating a cost for fiscal policy. A similar role is played by the financial markets when they evaluate the sustainability of fiscal policy, which affects country risk and, thus, the cost of finance.

The autonomy of monetary authorities and the role of financial markets are new elements reinforcing fiscal discipline but, based on Chile’s experience, they have not been the decisive factors. They have consolidated the achievements on the fiscal area: the autonomy of monetary policy and the role of financial markets cannot lead to a structural change from bad to good fiscal policy, but once the change has taken place, they reinforce and consolidate it.

Conclusion

There has been a growing recognition of the role of institution in economic analysis. The improvement in macroeconomic performance in Chile, and in particular the dramatic change in fiscal policy, is a clear example of the importance of institutional change, resulting in a sustained move from chronic deficits to structural surpluses. This move has allowed the country to reap a fiscal dividend, leading to greater stability and higher growth. It has also been reflected in better quality of the services financed by the State. Parallel to the good macroeconomic performance, it has been possible to achieve a more redistributive fiscal policy. Many challenges remain, but there is no doubt that fiscal discipline makes it possible to concentrate efforts and energies to improve the quality of public services.

Comments

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The development challenge and policy complementarities

Pablo Arellano's chapter describes a remarkable achievement in terms of fiscal discipline and consolidation and discusses how these institutions have contributed to the stability of the Chilean economy. Nonetheless, the overall good performance and the functioning market institutions should not overshadow the fact that Chile still faces the challenge of finding a sustained and equitable development path. Notably, social demands will be pressing in many areas and these pressures may be exacerbated by a relatively unequal society.

Much in the same way that convergence in income levels requires sustained and coordinated reforms supporting the growth potential of the economy, a sustainable structural fiscal surplus must be the result of appropriate macro-structural complementarities, in particular between fiscal and social policies. Indeed, liberal policy packages require strong internal coherence. In my comments, I would like to highlight three key interactions between fiscal and social policy areas.

The pension reform may not prevent future social contingent liabilities

A first example of policy complementarities is the pension system. While Chile has implemented a major reform of the pension system, a dual labour market may create contingent liabilities hindering the structural fiscal position. As discussed in OECD (2003b), the fully-funded pension system in Chile may not be immune to the problem of ageing because of the significant informality and low density of contributions (in part due to the large share of agricultural employment and seasonal activities).

Without major changes in labour market conditions enhancing business incentives to hire formal labour, improved co-ordination between health care and pension policies, better functioning of the pension market, as well as a more diversified economic structure, old-age assistance benefits may end up creating again a burden on fiscal accounts. If these policy synergies do not materialise, the Chilean government may be obliged to redesign the basic pillar in terms of its size and financing sources.

Moreover, to reduce the spending pressures associated with old-age poverty, Chile needs to further develop the segments of its financial markets, such as annuity markets, that adequately ensure longevity risks (as an aside, this issue also applies to most OECD countries).

Health care may also create structural expenditure pressures

Another area requiring careful reform design is the health sector. Major reforms are under way, such as the AUGE Plan, which will increase the participation of the public sector in the provision of health services. This is desirable to tackle inequality and inefficiencies in the present system, but cost containment in this area will be essential.

Health expenditures have a natural tendency to increase with income per capita. While the magnitude of this income elasticity is still subject to much debate, the evidence available to date would suggest at least a unitary value. This implies that no reduction in the relative share of health expenditures to GDP can be expected from fast economic growth. In addition, technological improvements often reduce the unit costs of treatments but stimulate coverage and increase overall demand, so that technical progress is another important source of cost pressures.[1] Population ageing will also be an important driver of expenditures, as the country is facing a rapid demographic transition.

Insofar as universal health coverage may create perverse incentives for low participation and informality in the lower income groups, the interactions of health reforms with the labour market and the pension system should be carefully analysed.

With an increase of the elderly segment of the population, the demand for long-term care is likely to rise rapidly. Currently, most of old-age long-term care is provided informally, within family networks. Nevertheless, if Chile aims at increasing significantly the participation of women and young people in the

1. For a discussion of the main drivers of health expenditures in OECD countries see Jacobzone (2000) and Jacobzone *et al.* (2003).

labour market, the availability of such informal services is likely to decline in the future. This is another policy interaction that requires attention.

Spending in education: from coverage to quality

Progress has been made in increasing access, coverage and reducing repetition rates. These reforms in the education system were supported, among others, by the use of education vouchers; the full-day school (*jornada completa*); the increase in the age of compulsory education from 8 to 12 years; and targeted programmes for low performing students and schools, and improving quality.

Despite all these efforts, the quality is still low, as shown by the results of the OECD/PISA+ exercise (OECD, 2003b, Chapter V). As the development of the Chilean economy requires a large and continued investment in human capital formation, the quality of public spending in this area is essential to ensure a sustainable policy path.

To sum-up, while Chile's macroeconomic policies are praiseworthy, especially in a region marked by recent turbulence and instability, there are structural factors to be addressed in order to reinforce a lasting commitment towards fiscal stability. In particular, despite a relatively low tax-to-GDP ratio, the size of the state is a controversial issue, so more focus on the quality of social spending may be required. Policy complementarities are often viewed as a political constraint, but could on the contrary become a source of benefits by reinforcing the returns from the Chilean liberal model.

Notes

1. The net debt fell even more markedly from 30% of GDP in 1990 to -0.3% of GDP in 1998, reaching 4% of GDP in 2004. The public debt statistics are available at www.dipres.cl.

2. The central government budget includes all public entities except corporations and the municipalities. The budget balance is measured on a cash basis. More information on public finance statistics is available at www.dipres.cl.

3. This refers to the Treasury deficit, see Central Bank of Chile (2002), French-Davis (1973) and Wagner, Jofré and Lüders (2000).

4. For more information on social policy and its relationship with fiscal policy, see Arellano (2005).

5. See Persson and Tabellini (1999) for a survey of the literature.

6. In the reform it is proposed "… that the President should have the exclusive prerogative to impose taxes of any class or nature, abolish, reduce, set exemptions or amend any form of existing taxes, indicate as appropriate their distribution between the provinces or municipalities and determine their form, proportionality or progression, contract loans, or engage in any other class of transactions which might compromise the creditworthiness or financial responsibility of the State, semi-fiscal entities, autonomous provincial or municipal enterprises and cancel, reduce or modify bonds, interest or other financial charges of any kind, established in favour of the Treasury or any other of the aforementioned organisations or entities; to create new public services or paid employment, whether fiscal, semi-fiscal, autonomous, in provincial or municipal enterprises, to grant *ex gratia* pensions, and in general, any law which implies expenditure by the Treasury. The President will also have exclusive initiative concerning laws on social security or which have an impact thereon, both in the public and the private sectors, and those which set or increase wages, salaries, gratuities or emoluments, remuneration or loans of any kind to employees in service or pensioners in the private sector. The National Congress may only accept, reduce or reject services, employment, emoluments, loans, benefits, expenditure, increases and other initiatives proposed to which the two previous paragraphs refer".

7. This law replaced Decree Law DFL 47 of 1959.

8. "Comparisons between countries suggest that … centralisation of budgetary authority in the prime minister or the minister of finance … restrictions in the possibility of amending expenditure … seem to produce greater fiscal discipline" (Persson and Tabellini, 1999, p. 62). A recent study for OECD countries (OECD, 2003a), concludes that the character of fiscal policy is influenced by the institutional framework which regulates it and that it tends to be pro-cyclical in situations where decision-making is fragmented. It is noteworthy that, despite the rules governing the drafting and approval of budgets, only in the last 15 years has its importance been recognised in studies on the subject. Up to the late 1980s, comparative studies of budgetary practices did not exist even in the member-countries of the European Union.

9. Until 1975, the budget of the autonomous and decentralised agencies were approved by decree generally during the budget period, making overall control of public spending difficult.

10. For a review of initiatives to combat evasion during 1990-2005 see http://www.sii.cl/aprenda_sobre_impuestos/estudios/adminis_tributaria.htm

11. The only exception is the copper revenue that is earmarked for the armed forces. There is a growing consensus towards phasing out this exception.

12. For an estimate of these liabilities at the end of 2003 see http://www.dipres.cl/presupuesto/documentos/Informe_Finanzas_Publicas_2004.html.

13. See IMF (2003) for more information on fiscal transparency.

14. Law 19 908 of October 2003, for example, extends the borrowing control provisions to swaps. Law 19 896 of September 2003 establishes regular reporting requirements.

15. See the positive evaluation of an OECD mission requested by the authorities to examine budgetary practices (OECD, 2004).

16. On the importance of copper see Meller (2002).

17. In 1981, under Decree Law No. 3 653, a copper reference price mechanism was established to allocate revenue above the reference level to debt payments.

18. OECD (2004) argues that, for several of the OECD countries, fiscal policy became more pro-cyclical in the 1980s and 1990s due to the fact that the accumulation of public debt prevented the application of expansionary in cyclical downturns.

19. For a description of the structural budget surplus rule see Marcel *et al.* (2001), Marcel and Tokman (2002) and Ministry of Finance (2001).

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Annex 5.1

The Copper Stabilisation Fund

The Copper Stabilisation Fund was established in 1987 following a crisis in the first half of the decade. It was an old idea which had never been implemented formally. The justification for a stabilisation fund is that the price of copper fluctuates enormously and fiscal revenue from the profits of CODELCO, the state enterprise which produces and exports copper, represents some 5% of current government revenue and the bulk of its foreign currency earnings.

The system operates as follows. A reference price is fixed in advance for each year taking into account the estimated medium-term trends or the most stable price. In the 1990s, the reference price was fixed by the Ministry of Finance. From 2001, and to make it independent from the fiscal authorities, an expert committee was set up to recommend the reference price to be used in the budget (Table 5.A1.1). If the actual price in a given year exceeds the reference price by up to 4 cents of US dollar, the corresponding revenue windfall is used freely. For the next 6 cents, 50% of the surplus revenue must be saved. If the gap between the actual and reference prices is above US$ 0.1, these resources are saved into the Copper Fund. If the actual price is below the reference price, the rules apply symmetrically: for the first 4 cents, the authorities are not allowed to access the fund, for the following 6 cents, up to 50% of the revenue shortfall may be transferred from the Fund, and above 10%, the Treasury may fully compensate the revenue shortfall through transfers from the Fund. The calculations are made quarterly, taking into account actual CODELCO sales and export prices. The funds are held in an account with the central bank, which is responsible for the financial management of these resources.

There is enough flexibility in the use of funds. There was concern at the return to democracy about fiscal irresponsibility, leading the democratically-elected government to disburse all the resources at the end of 1989 to repay public debt. In 1990, as a result of the geopolitical tension in the Gulf and the sharp rise in oil prices, part of the Copper Fund assets was used to create an Oil Stabilisation Fund, with the obligation to return the resources to the Copper Fund when international oil prices fell. To a large extent this was done. In subsequent years, public debt was reduced. Not only did new borrowing decline considerably but foreign debt was also repaid early. Throughout the period, no resort was made to domestic borrowing. Given the conditions of those loans, early repayment was a good financial investment. Public debt fell from 47.2% of GDP in 1990 to 14.2% of GDP in 2000. The external public debt fell from US$ 12.25 billion 1989 to US$ 5.3 billion at the end of 2000.

It is worth emphasising that the copper price stabilisation mechanism is not set in law. Naturally, it is included annually in the Budget Law and Congress is provided with a report of the financial performance of the Fund. In general, it has been given a low profile and the Budget Law only notes the resources that may be expended. Since 2002 the reference prices have been fixed by a committee of experts whose reports can be seen at www.dipres.cl.

Table 5.A1.1. **Copper prices and Stabilisation Fund operations, 1987-2004**

	Copper price (in US$ per pound)		Copper Fund balance (in US$ million)			
	Reference	Actual	Revenue	Disburse-ments	Net revenue	Balance
1987	61.5	81.1	26.3	0.0	26.3	26.3
1988	71.0	117.9	496.0	439.5	56.5	82.8
1989	75.0	129.1	1203.0	1260.1	-57.1	25.7
1990	79.0	120.9	785.1	256.2	528.9	554.6
1991	82.0	106.1	289.7	200.0	89.7	644.3
1992	93.0	103.6	134.6	0.0	134.6	778.9
1993	96.0	86.7	9.8	39.0	-29.2	749.8
1994	96.0	104.9	46.5	101.4	-54.9	701.5
1995	96.0	133.2	664.3	0.0	664.3	1365.7
1996	96.0	103.9	324.4	7.3	317.1	1682.8
1997	96.0	103.2	117.6	0.0	117.6	1800.5
1998	96.0	75.0	3.8	273.5	-269.7	1530.7
1999	92.0	71.4	63.4	516.0	-452.6	1078.2
2000	92.0	82.3	0.0	404.8	-404.8	673.4
2001	92.0	71.6	250.0	302.3	-52.3	621.1
2002	90.0	70.6	138.9	483.0	-344.1	277.0
2003	88.0	80.7	0.0	202.5	-202.5	74.6
2004	88.0	130.0	..	..	..	207.8

Source: Budget Office and Central Bank of Chile.

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