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CONSEJO FISCAL AUTÓNOMO

REPORT OF THE AUTONOMOUS FISCAL COUNCIL ON THE EXERCISE OF ITS DUTIES AND POWERS

Presentation before the Special Joint Budget Committee of National Congress

Message

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The Budget Office's (Dipres, in Spanish) projection of non-compliance with the 2024 Structural Balance (SB) target (a deficit of 2.3% of GDP, exceeding the target by 0.4 percentage points) and the potential for an even larger deviation, pose a risk to fiscal consolidation and could undermine the credibility of the fiscal rule. This is particularly concerning given that such a deviation would occur in a year without an economic crisis or extraordinary events. In view of this, the CFA reiterates its call for fiscal authorities to adhere to the SB target this year.

As the likelihood of missing the 2024 target stems largely from significant deviations in fiscal revenue estimates, the CFA emphasizes the importance of improving the fiscal authority's accuracy and prudence in future budgets planning. Additionally, it underscores the need for fiscal authorities to exercise their ability to adjust spending in response to lower structural revenues, ensuring compliance with the SB target.

In particular, given the uncertainty surrounding certain fiscal revenues projected for 2025 (such as those anticipated from the Tax Compliance Law) and the potential for deviations in 2024 fiscal revenue estimates to carry forward into 2025, the Council considers it crutial for the Ministry of Finance to have the effective capacity to contain expenditures to ensure compliance with the SB target of -1.1% of GDP for that year, in case such revenues fail to materialize. In this regard, the CFA recalls the importance of aligning permanent expenditures with their sources of financing, both in magnitude and timing, particularly for medium-term budget and projections.

On the other hand, the CFA notes that the medium-term fiscal scenario succeeds in stabilizing gross debt below the prudent level of 45% of GDP, but remains highly constrained, as evidenced in zero fiscal spending slack for the 2026-2029 period. In the medium term, a convergence towards a SB of 0% of GDP would stabilize gross debt, nevertheless, this alone would not be sufficient to rebuild the Economic and Social Stabilization Fund (FEES, known by its acronym in Spanish) or finance new public policies. Therefore, the Council recommends adhering to the SB targets set by the current administration through 2026 and, subsequently continuing the convergence, at a minimum, towards a structural balance of 0% of GDP. This objective should be explicited in the fiscal policy decrees of future administrations. The CFA acknowledges the recent passage of the Tax Compliance Law as a significant step forward in reducing tax evasion and avoidance, thereby creating a source of permanent financing. However, as Dipres' medium-term projections highlight, this progress alone will not resolve the fiscal stress situation if the additional revenue is allocated entirely to expenditures. Thus, the Council reiterates the importance of reaching political agreements on additional sources of permanent financing, including fostering economic growth and achieving permanent efficiency gains in public spending.

Finally, the Council reiterates its warning that the country currently has a significantly reduced fiscal capacity to responde to economic crises compared to the last 15 years (Chile has shifted from a net creditor position of 12.2% of GDP in 2008 to a projected debtor position of 37.5% of GDP in 2024). This highlights the urgent need to stabilize gross debt and rebuild the FEES to a medium-term target between 5% and 7% of GDP, rather than allowing its conitued decline (Dipres estimates that it will fall to just 1.1% of GDP by the end of 2024).

1. The Dipres' projection of non-compliance with the SB target for 2024 and the possibility of an even greater deviation than estimated, poses a risk to fiscal consolidation and could undermine the credibility of the fiscal rule, particularly concernring as it would occur in a year without an economic crisis or extraordinary events that would justify invoking an escape clause. The Dipres projects a SB of -2.3% of GDP for 2024, exceeding the established target of -1.9% of GDP by 0.4 percentage points (pp), equivalent to US$1.17 billion). Since this projection is based on an effective deficit of 2.0% of GDP in 2024[1], there is a risk of further deviation from the target, considering that the accumulated effective deficit as of August already stands at 2.2% of GDP, with the deficit over the past twelve months reaching 3.9% of GDP.

Although, to date, Dipres has proposed a net expenditure adjustment of US$772 million (0.24 pp of GDP)[2], an additional effort of at least the magnitude of the projected deviation, or pottentially greater, will be necessary to meet this year's SB target if fiscal revenue projections fall short. Assuming that the tax revenue projections of the Public Finance Report (IFP, known by its acronym in Spanish) for the third quarter of 2024 (IFP3T24) are achieved and that the full adjustment is applied to expenditures, this would require a real year-on-year contraction in spending of 4.3% during the last four months of the year. Achieving such a contraction presents a significant challenge given that spending through August, has already recorded a 5.9% expansion. Moreover, any adjustment in the last months of the year would need to account for the strong seasonal pattern of high budget execution typically observed during this period, requiring an even more substancial effort.

The CFA considers that the expected deviation from the 2024 SB target is concerning for two key reasons. First, it undermines fiscal convergence and increases net debt. Second, it sends an unfavorable signal regarding the government's commitment to achieve fiscal targets, especially for 2025, when the target will be more ambitious (a structural deficit of 1.1% of GDP) and spending pressures may intensify in an election year. In this respect, it should be noted that CFA simulations indicate that persistent deviations of 0.4% of GDP are not harmless for public finances sustainability, since they would result in a rising gross debt trajectory, potentially exceeding the prudent level by 2030. More significant deviations, such as maintaining a structural deficit of 2.3% of GDP, would imply exceeding the prudent debt level as early as 2026.

It should be noted that, if at the close of the fiscal year, there is a deviation from the SB target, the recent amendments introduced to Law No. 20,128 on Fiscal Responsibility[3], require the Ministry of Finance to outline the corrective measures needed to restore fiscal

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[1] In the SB methodology, the difference between structural and effective deficits is given by the cyclical adjustment, which the Dipres estimated at 0.3% of GDP in its latest quarterly report (IFP3T24).

[2] The US$772 million correspond to the difference between the public spending projections in the Public Finance Report for the third quarter of 2024 (IFP3T24) and the original one in the 2024 Budget Law, valued at the expected exchange rate of the IFP3T24. For its part, the 0.24 pp of GDP was constructed using said difference in pesos divided by the nominal GDP of 2024 of the IFP3T24.

[3] Due to the publication of Law No. 21,683, which promotes responsibility and transparency in financial management by the State.

sustainability. These measures must be detailed in the IFP immediately following the fiscal year's close and reported to the Finance Committees of both chambers of National Congress, as well as to the CFA. The Council, in turn, shall have thirty days from the publication of this report to provide its opinion on the proposed corrective actions.

Recommendations:

Compliance with the fiscal target: The CFA reiterates to the Ministry of Finance the importance of explaining and specifying the fiscal efforts needed to meet the SB target of -1.9% of GDP in 2024. Specifically, expenditures should be adjusted to align with lower structural revenues, with a stronger emphasis on reducing current spending than capital spending.

2. The deviation in the Dipres' fiscal revenue estimates for 2024 underscores the need to improve the accuracy and prudence of future budgets, as well as the fiscal authority's ability to adjust spending in response to lower structural revenues to ensure compliance with the fiscal rule. To meet the fiscal revenue projections in the IFP3T24, a 26% growth in fiscal revenues during the last four months of the year is required. This includes the expected collection of 0.21% of GDP from the recently approved capital repatriation under Law No. 21,713 that "Dictates rules to ensure compliance with tax obligations within the Pact for Economic Growth, Social Progress and Fiscal Responsibility" (Tax Compliance Law or TCL)[4]. Excluding this capital repatriation revenues, the remaining fiscal revenues would need to grow by 22.9%, equivalent to 8.6% of GDP (US$28,558 million). Achieving this would require a significant reversal of the 4.4% year-on-year contraction observed between January and August[5]. As noted above, should these revenues fail to materialize, an additional expenditure adjustment would be necessary to meet the SB target.

This situation emphasizes the importance of having accurate and prudent revenue estimates, in order to minimize the need for mid-year spending adjustments in response to lower structural revenues to meet the SB target. In addition, if such deviations materialize, it is crucial that the fiscal authority is equipped with the ability to make timely adjustments to spending through budget management instruments.

Recommendations:

Enhance and increase transparency of the fiscal revenue projection methodology: The CFA reiterates its recommendation that Dipres improve the accuracy and transparency of fiscal revenue estimates. To achieve this, it suggests setting up a joint working group to enhance its projection models.

[4] There is even some uncertainty as to whether this total can be reached, since there are only a few months left in the year to profit from this benefit. It should be noted that on October 24, 2024, the Minister of Finance announced that he will submit a bill to extend the deadline for the capital repatriation benefit.

[5] August is the last fiscal statistics data published as of the date of this report. Chapter II of the CFA's report addresses the possibility of a deviation of the income projected by the Dipres with respect to a theoretical level given by the elasticities of income to GDP and the Ministry of Finance's projections of economic activity.

Ex-post analysis of fiscal revenue estimates: The CFA recommends that Dipres conduct and publish, on an annual basis, an ex-post analysis explaining the deviations in its revenue estimates for each source. This practice would contribute to a continuous improvement in projections, reduce the risk of overestimation, and strengthen accountability standards. While Dipres currently conducts ex post evaluation for tax revenues, the Council suggests extending this practice to cover all revenues.

3. Given the uncertainty sorrounding fiscal revenues projected for 2025, it is essential that the Ministry of Finance has the effective capacity to contain expenditures to ensure compliance with the SB target of -1.1% of GDP, if these revenues fail to materialize. For 2025, Dipres projects real revenue growth of 8.5% compared to the projections for 2024. A significant portion of this increase (1.6 pp) relies on revenues from the TCL, which, according to the Dipres financial report, is expected to generate 0.37% of GDP in 2025[6]. Additionally, private mining revenues (2.9 pp) and revenues from other taxpayers excluding TCL (3.3 pp) are substancial contributors to the projected growth.

On this matter and considering the potential deviations in fiscal revenue estimates in 2024 that could result in overestimates for 2025, as well as the uncertainty associated with implementing a new regulation[7], the CFA has emphasized in previous reports the importance of aligning permanent expenditures with their sources of financing. This alignment must consider not only the magnitude, but also the timing of revenues in medium-term budget years and projections. In other words, expenditures should be committed based on actual revenue collections, rather than projected revenue collections.

Furthermore, it is crucial that the Ministry of Finance maintains an effective capacity, through budget management instruments, to contain expenditures in 2025 if the projected structural revenues are not realized. This is critical to ensure compliance with the SB target.

Recommendations:

Aligment of revenues and expenditures: The CFA recalls its recommendation to ensure a proper match between permanent expenditures and their sources of funding. This aligment should account for magnitude and timing in medium-term budget years and projections.

Establishment of concrete procedures for expenditure containment: Considering the uncertainty surrounding projected revenues, the CFA recommends implementing preventive measures to ensure expenditures can be adjusted as needed to meet the SB target.

Transparency and monitoring of tax revenue deviations: The CFA suggests that Dipres report on any revenue deviations from the estimates included in the 2025 Budget Law. This

[6] When fully operatoing, a revenue collection of 1.47% of GDP is expected due to the TCL. See "Informe Financiero del Proyecto de Cumplimiento Tributario" (Financial Report of the Tax Compliance Bill), Dipres, 2024. Available here.

[7] The International Monetary Fund (IMF), based on international experience, suggests that it is unusual to achieve collections above 0.5% of GDP by tax administration measures. IMF Country Report No. 23/37 – Chile Selected Issues, January 2023. Available here.

analysis should be incorporated into the quarterly IFP to enable timely adjustments to public spending if necessary for achieving the SB target.

4. Dipres' medium-term fiscal scenario foresees the stabilization of gross debt below the prudent level of 45% of GDP but highlights the tight fiscal constraints, as reflected in the absense of fiscal spending slack for the 2026-2029 period. Addressing this situation requires a broad political consensus on measures to strengthen fiscal sustainability. The Council acknowledges that the Ministry of Finance has adopted its proposal, outlined in its April report to Congress, to converge toward a balanced SB (0% of GDP) in the medium term[8]. Achieving this goal would allow stabilizing gross debt below the prudent level of 45% of GDP within the financial programming horizon (2026-2029). However, the CFA notes that reaching this objectives requires a very important effort, as reflected in the projected lack of fiscal expenditures slack during this period, even with the expected collection under the Tax Compliance Law. Moreover, CFA's simulations indicate that while maintaining a 0% SB in the medium and long term would stabilize gross debt below the prudent level, it would be insufficient to rebuild the FEES or finance new public policies beyond the already committed spending, unless additional permanent revenues are obtained.

In addition, the Council's simulations suggest that various macrofiscal risks, such as an economic crisis or unmet fiscal revenue projections, could lead to gross debt exceeding the prudent threshold.

In view of this situation, the CFA reiterates the importance of achieving and strenghthening a broad political consensus, involving both the Executive and Legislative branches, to address the current fiscal stress. In this regard, the Council underscores that the political agreement that enabled the passage of Law No. 21,683, which promotes accountability and transparency in the financial management of the State, published on August 14, 2024, as well as the passage of the Tax Compliance Law, are significant steps forward. In this context, the CFA urges that the focus on fiscal sustainability remain central during the consideration and analysis of all bills with fiscal impact.

Recommendations:

Adhere to the current administration's SB targets and continue converging toward a structural balance (0% of GDP): To stabilize gross debt below its prudent level of 45% of GDP, is essential to follow a trajectory that achieves a balanced SB. This requires meeting the fiscal targets set by the current administration but also needs to continue in the subsequent´s, as should be reflected in their fiscal policy decrees. However, rebuilding the FEES will require transitioning toward fiscal surpluses in the medium term.

Strengthen and broaden political consensus for fiscal sustainability: The CFA restates its recommendation to the Executive and Legislative branches to design and agree on a consensus on a comprehensive agenda of measures to enhance fiscal sustainability. This should include initiatives to increase permanent fiscal revenues, adjust expenditure

[8] This should be reaffirmed in any case in the decree that sets the bases for the fiscal policy of the next administration.

trajectories and rebuild fiscal buffers such as the FEES. Additionally, the focus on fiscal sustainability should remain a priority during the evaluation and passage of bills with significant fiscal impact.

5. The passage of the Tax Compliance Law represents significant progress in reducing tax evasion and avoidance, providing a permanent source of financing. However, as evidenced by Dipres' medium-term projections, this progress is insufficient to solve the fiscal stress, especially as the increased revenues are allocated to already committed expenditures. Therefore, the CFA reiterates the importance of reaching similar agreements on additional sources of permanent financing, including fostering economic growth and achieving permanent efficiency in public spending. Given that Dipres projects that fiscal stress will persist in the medium term, and that the Minister of Finance has indicated that there will be no further tax proposals generating new fiscal revenues during this administration -a commitment embodied in a protocol signed with the National Congress[9]- it is essential to intesify efforts in the other two areas identified by the CFA: promoting economic growth and ensuring permanent efficiency gains in public spending[10].

Furthermore, there is a possibility that some projected fiscal revenues -such as those coming from the TCL, the agreement between the National Copper Corporation of Chile (Codelco, known by its Spanish acronym) and Sociedad Química y Minera de Chile (SQM, known by its acronym) for lithium exploitation and the mining royalty- may not materialize as anticipated in terms of amounts or timing. This highlights the critical need to strengthen alternative sources of permanent funding.

Recent studies indicate that a one percentage point increase in economic growth raises structural fiscal revenues by 0.24% of GDP and fiscal slack by 0.16 pp of annual GDP[11]. In this regard, CFA simulation exercises show that gross debt would stabilize below the prudent level with a SB of 0% of GDP and long-term GDP growth of 1.9%[12]. However, if the economy grows at a slower pace, such as the 1.3% average trend GDP growth estimated by the Central Bank (BCCh, known by its acronym in Spanish) for 2025-2054, convergence to a balanced SB would be insufficient to keep debt below the prudent level. Therefore, achieving a political consensus on concrete measures to substantially boost long-term economic growth is essential.

At the same time, the CFA emphasizes that pursuing efficiency gains in public spending should be a permanent task, aimed at creating considerable fiscal space through resource reallocations. Achieving this objective requires specific, targeted actions which depend on broad political support for their implemention. According to the OECD, observed countries

[9] Protocol of agreement on tax compliance project. Available here.

[10] For a more extensive review on economic growth and permanent efficiency gains in public spending, see the CFA's Report to Congress of April 2024, available here.

[11] See "Informe del Comité de Expertos sobre Espacio Fiscal y Crecimiento Tendencial" (Report of the Committee of Experts on Fiscal Space and Trend Growth), published in November 2023. Available here.

[12] Growth of 1.9% is assumed in the long term in line with OECD estimates for Chile.

conducting spending reviews have improved public spending efficiency by 0.1% of GDP[13]. Similarly, the Inter-American Development Bank (IDB) in 2018, using a different methodology, estimated Chile's technical inefficiency in public spending at 1.8% of GDP.

Recommendations:

Measures to boost economic growth: The CFA repeats its call to the Executive and Legislative branches to reach agreements and implement measures aimed at increasing trend economic growth, for which, in addition to ongoing efforts, it is essential to evaluate and consider further proposals from experts and specialized organizations in areas such as competition, innovation and human capital development.

Ambitious plan for permanent efficiency in public spending: The CFA reiterates its recommendation for the Ministry of Finance to develop a comprehensive plan with specific, realistic, yet substancial annual targets for efficiency gains. This plan should include mechanisms for annual accountability to ensure credibility, transparency and effectiveness in achieving these goals. The Council reiterates that implementing such efficiency measures will require robust political support[14].

6. **The country currently has a reduced fiscal capacity to address economic crises compared to the past 15 years, highlighting the urgency of stabilizing gross debt and rebuilding the FEES**. The deterioration in fiscal indicators is not solely a result of recent events, such as the Covid-19 pandemic, but reflects a trend that began with the 2008-2009 global financial crisis. Among other factors, this trend has contributed to two credit rating downgrades by each major agency since 2016. Consequently, the CFA insists on the critical importance of stabilizing gross debt and rebuilding the FEES to strengthen fiscal sustainability and enhance the country's capacity to respond to future economic crises.

The sustained increase in net debt reveals a concerning trend: due to reliance on Public Treasury (PT) assets and gross debt as financing sources, Chile has shifted from a net creditor position of 12.2% of GDP in 2008 to an estimated debtor position of 37.5% in 2024, according to the latest Dipres' IFP projections. Continuing this trajectory is fiscally unsustainable, prompting the CFA to reiterate the importance of stabilizing net debt. While the IFP3T24 projections suggest that gross debt could stabilize in the medium term below the prudent level of 45% of GDP, they also indicate ongoing use of PT assets as a source of financing. This highlights the persistent fiscal stress and underscores the need for a broader approach of analysis that considers both net a gross debt to fully understand the country's fiscal position.

Therefore, the CFA insists that, alongside stabilizing gross debt, rebuilding the FEES is critical to be prepared for future crises. In this sense, it recalls the International Monetary Fund's (IMF) recommendation to increase and maintain the FEES at a level between 5% and 7% of

[13] OECD, Selective Spending Reviews in Chile: Action Plan, as of December 1, 2023.

[14] Additional proposals regarding fiscal efficiency and spending transparency are presented in the "Informe final de la Comisión Asesora Ministerial para Mejorar la Transparencia, Calidad, y el Impacto del Gasto Público" (Final Report of the Ministerial Advisory Commission to Improve the Transparency, Quality, and Impact of Public Spending), available here.

GDP in the medium term[15]. This contrasts sharply with current projections, which indicate a reduction in the FEES from 1.9% of GDP in 2023 to 1.1% of GDP in 2024[16]. In addition, the Council highlights the recent amendment to the Fiscal Responsibility Law[17] which reaffirms the FEES's primary purpose: to ensure public finances stability and the continuity of public goods and services delivery in response to abrupt economic changes and extraordinary events. This underscores its role as a vital fiscal buffer to face crisis situations.

The Council further observes that the increase in debt stems not only from fiscal deficits, but also from additional financing needs that are accounted for "below the line" because they do not correspond to expenditures. These other capital requirements have averaged 1.4% of GDP per year over the last 16 years[18], but rose 2.4% of GDP in 2023. According to CFA's simulation exercises, if these capital requirements persist at the 2023 level, gross debt would exceed the prudent level in 2028. To ensure comprehensive and sustainable management of public finances, the CFA emphasizes the need for greater transparency, monitoring and control of all financial liabilities and assets of the Public Treasury. Additionally, the Council highlights the importance of clarifying and systematizing the criteria used to classify transactions as either investment or disinvestment ("below the line") or income or expenditure ("above the line"). This distinction is relevant to ensure that fiscal accounting and the SB indicator to accurately reflect fiscal risks.

Finally, the CFA recalls that the rising share of debt interest in public spending constrains the resources available for budgetary priorities. Interest payments have more than doubled in the past decade, increasing from 1.9% of total spending in 2013 to 4.2% in 2023. According to Dipres forecasts, this figure is expected to reach 4.9% in 2024 and 5.4% in 2029[19]. This growing fiscal stress heightens the risk of debt maturities being renegotiated under less favorable conditions, such as higher interest rates, potentially creating a cycle of increasing and more expensive debt. This dynamic would further raise interest payments and reduce the fiscal space for other expenditures. Moreover, CFA´s simulation exercises indicate that a permanent increase of, for example, 33 basis points in the sovereign spread[20], could lead to an unsustainable debt trajectory unless fiscal adjustments are implemented.

[15] Prior to the last two crises, the FEES reached 7.7% and 4.7% of GDP in 2007 and 2019, respectively.

[16] If an additional US$1.2 billion is withdrawn from the FEES, as approved in the 2024 Budget Law, it could drop to 0.7% of GDP by the end of the year.

[17] Introduced by Law No. 21,683, which promotes responsibility and transparency in the financial management of the State.

[18] These correspond to transactions of financial assets other than the PT and financial liabilities other than gross debt, which affect the financing needs of the Central Government, such as recognition bonds, purchase of State-Guaranteed Loans (sucha as CAE, known by its Spanish acronym, for students' loans), capitalization of public companies, among others.

[19] As a reference, interest expenditure is slightly higher than the expenditure of the Ministry of the Interior (4.1% and 3.8% of total expenditure in 2023 and 2024, respectively) and close to that of the Ministry of Housing and Urban Development (4.4% and 4.7% in 2023 and 2024, respectively). The reference figures for 2024 of Ministries correspond to those of the Budget Law approved for that year.

[20] A permanent increase in sovereign risk can be related to a loss of market confidence in the soundness of public finances. As an illustrative case, the CFA simulated the effect of a 33 basis points increase in sovereign risk, which is the average difference between the EMBI of Chile and Peru over the last four years.

Recommendations:

Stabilization of gross debt: The CFA urges the government to strictly adhere to the SB targets in order to stabilize gross debt as a percentage of GDP.

Rebuilding of the FEES: The CFA reiterates its recommendation to the Ministry of Finance to present a plan for the gradual rebuilding of the FEES through fiscal surpluses and the transformation of illiquid assets into liquid PT assets, aiming to achieve and maintain a level between 5% and 7% of GDP in the medium term.

Avoid withdrawals from the FEES in the absence of extraordinary circumstances: The CFA recommends that the Executive and Legislative branches refrain from repeating the exceptional authorization granted in the 2024 Budget Law to use this fund in a year without abrupt changes in the economic cycle or extraordinary events.

Systematization and comprehensive publication of fiscal liabilities and assets: The CFA reiterates its recommendation to the Ministry of Finance to systematize and comprehensively publish all fiscal assets and liabilities. This is essential for accurately assessing fiscal sustainability, as their dynamics may not be fully reflected in the SB and gross debt indicators.

Greater transparency and monitoring of other capital requirements: The CFA insists on its recommendation for Dipres to improve transparency and publish detailed information on all transactions that require financing, but do not constitute “above the line” expenditures. This would enable better monitoring and control of their impact on net debt.

Systematization and publication of criteria for classifying transactions: The Council recommends that Dipres systematize and publish the criteria used to classify transactions as investment or disinvestments (“below the line”) versus income or expenditures (“above the line”). This should be reviewed in line with international best practices, to ensure that fiscal accounting and the SB indicator adequately reflect the fiscal situation.

PRESENTATION BEFORE THE SPECIAL JOINT BUDGET COMMITTEE OF NACIONAL CONGRESS

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