Report of the Autonomous Fiscal Council on the exercise of its duties and powers

Presentation before the Hon. Joint Budget Committee of the National Congress

SEPTEMBER 27, 2022

1. Message

The Autonomous Fiscal Council values the important progress achieved in 2022 regarding fiscal consolidation.

At the same time, it warns that there are risks that, if materialized, would hinder the continuity of fiscal convergence during the next years, which could cause an additional downgrade in credit rating, persistence of high interest rates and a higher cost of indebtedness for the government, companies, and individuals.

Therefore, the CFA suggests the need to strengthen fiscal consolidation in order to reverse macroeconomic imbalances, mitigate risks and ensure the sustainability of public debt.

i. **Chile made an important fiscal effort in 2020-2021 to face the Covid-19 pandemic, which allowed mitigating its effects on households and companies, but at the same time, generated important macroeconomic imbalances in terms of structural deficit, public debt, inflation, current account deficit and country risk**. Thanks to responsible fiscal policies of previous decades, the country was able to count on savings and low-cost financing to implement extraordinary support measures, which implied a real annual growth in public expenditure of 10.4% in 2020 and 33.4% in 2021. This contributed to the increase in the structural deficit (10.7% of GDP at the end of 2021), an increase in gross debt (36.3% of GDP at the end of 2021), the acceleration of inflation (14.1% year-on-year in August 2022), a deterioration of the current account (-8.5% of GDP in the second quarter of 2022), and to a progressive increase in the sovereign spread (on average, 186 basis points in August 2022).

ii. **Fiscal convergence began in 2022 with the withdrawal of most of the extraordinary measures to address the pandemic. Nevertheless, current macroeconomic imbalances make it essential to strengthen fiscal convergence credibly in the medium term.** According to the Public Finance Report (IFP) for the second quarter of 2022 (IFP2T22), presented by the Budget Office (Dipres), public expenditure is projected to fall by 24.1% in real terms with respect to 2021. At the same time, the structural deficit projected for 2022 would be significantly lower than that observed in 2021 (10.7% of GDP), which would contribute to stabilize gross public debt at around 37% of GDP. While this is an important first step, it is essential to continue on the path of convergence until the structural deficit target set for 2026 (0.3% of GDP) is reached. A possible failure to achieve fiscal consolidation, or a weakened credibility of fiscal consolidation, could deepen the already existing macroeconomic imbalances, leading to an additional credit rating downgrade, persistently high interest rates and higher borrowing costs for the government, companies, and individuals.

iii. **The Council notes that the structural result for 2022 will be better than initially expected, which is essentially explained by extraordinary revenues originated by a higher tax collection of the Income Tax Operation and of the Substitutive Tax on Income Accumulated in the Taxable Profits Fund (ISFUT), and by property income revenues**. The overachievement of the structural deficit target announced by the Ministry of Finance for 2022 reflects adequate risk management, as explained by higher-than-expected tax revenues caused by extraordinary factors. Although the projected structural revenues increased with respect to the original projection for 2022, this increase does not necessarily correspond to permanent revenues, so it is prudent not to consider them as a greater fiscal spending space.

iv. **Overachievement of the 2022 target, together withmaintenanceof the original structural deficit target for 2023, would imply a setback in fiscal convergence next year. In this scenario, it is essential for the Ministry of Finance to ratify resuming the consolidation path from 2024 onwards, in order to reach a structural deficit of 0.3% of GDP in 2026 and thus safeguard fiscal sustainability**. For 2023, the Dipres proposed in the IFP2T22 a structural deficit target of 2.6% of GDP, which would imply an increase of more than 2 percentage points (pp) of GDP with respect to the estimated closing for 2022. According to the results of the CFA's fiscal sustainability model, failure to comply with fiscal consolidation would imply substantial increases in gross debt. Specifically, if the structural deficit were to remain constant at its average value of the last 10 years (i.e., 2% of GDP), gross debt would exceed its prudent level –of 45% of GDP– from 2027 onwards. Therefore, it is imperative that the Ministry of Finance reaffirms the convergence commitment for the following years.

v. **To reaffirm the commitment to fiscal consolidation, the CFA recommends the Ministry of Finance to incorporate annual targets in a new Fiscal Policy Decree for the remainder of its term**. Currently, said Decree only establishes a starting point in 2022 and a finishing point in 2026 for the structural deficit (3.3% and 0.3% of GDP, respectively). In view of a possible reversal of convergence in 2023, having explicit targets for each year is relevant to: (i) ensure gradualness in the process of normalization of public finances; (ii) provide greater predictability to fiscal policy, in a context of high economic and political uncertainty; (iii) contribute to the credibility of the rule; and (iv) facilitate its monitoring.

vi. **In addition, the Council emphasizes that the Structural Balance targets should not only be established ex-ante, in budget planning, but should also be met ex-post. This would make it possible to achieveeffective consolidation and strengthen the credibility of the fiscal rule**. In the last 15 years, there have been difficulties in meeting the targets and even significant deviations in certain years, due to negative shocks to the economy that led to the activation of *de facto* escape clauses. In this regard, it is essential that the Ministry of Finance carry out periodic accountability in order to monitor compliance with these goals and, if necessary, to take timely corrective actions.

vii. **The CFA appreciates that the Fiscal Policy Decree of the current administration incorporates a dual rule, i.e., a trajectory of Structural Balance targets consistent with gross debt not exceeding a prudent level of 45% of GDP. At the same time, the Council notes that gross debt projections for 2022-2026 are below the prudent level set by the fiscal authority**. The dual rule is a significant step towards strengthening the institutional framework for fiscal policy in the country, as the debt anchor is directly linked to fiscal sustainability and is easy to communicate and evaluate. The estimated gross debt for 2022-2026, while increasing, would not exceed the prudent level set by the authority. Indeed, the CFA's fiscal sustainability model shows a gross debt trajectory from 36.5% of GDP in 2022 to 41.5% of GDP in 2026 in the baseline scenario.

viii. **Although in the CFA's baseline scenario –which is assumed to be the most likely– the prudent debt level is not exceeded, there are relevant risk scenarios where the probabilities of insolvency for public finances are no longer low**. These risks are associated with: (i) convergence paths for the Structural Balance with persistent and high deficits, such as those that have been observed, on average, during the last 10 years; (ii) committing permanent expenditures without having equally permanent revenues to finance them; (iii) a slowdown in the trend growth of the economy; and (iv) more adverse external conditions, such as a higher-than-expected drop in copper price.

ix. **The Council positively evaluates that the dual rule be institutionalized in the Fiscal Responsibility Law, as well as that explicit escape clauses and post-application correction mechanisms be regulated, and therefore calls for its legislative processing to be prioritized**. These and other previous recommendations of the CFA on the strengthening of the Chilean fiscal institutional framework have been recently presented by the Government as indications to the bill that modifies Law No. 20,128 on Fiscal Responsibility, which is in its second legislative process.

x. **The CFA highlights as a basic guideline of fiscal responsibility that permanent expenditures should be financed with permanent revenues, and therefore recommends the Ministry of Finance to study in depth options for generating revenues from: (i) new tax revenues; (ii) reallocations and/or greater efficiency in public expenditure; and (iii) higher trend growth**. This is particularly important to meet the fiscal convergence challenge, in an adverse economic context such as the current one, with high expenditure pressures and various risk scenarios for fiscal sustainability.

xi. **In the particular case of the tax reform bill currently in process, which plans to collect revenues for 3.6% of GDP per year, the Council warns of the risks that would result from committing expenditures against it before its materialization**. Indeed, if total spending were committed, but revenue turns out to be less than expected, this would generate growing debt dynamics in the long term. For example, according to the CFA's fiscal sustainability model, if annual revenues were 80% of expected revenues and the corresponding expenditure is not adjusted, gross debt would exceed the prudent level as of 2030.

xii. **The Council stresses the importance of transparency, efficiency, and evaluation of public expenditure for fiscal sustainability, especially after the sharp increase in spending in 2020-2021 as a result of the health crisis**. In this regard, the CFA suggests deepening efforts to achieve greater efficiency and transparency in fiscal spending, seeking substantive reallocation spaces, which should be based on the evaluations carried out by the Dipres and other agencies, and be supported by the search for broad consensus from a technical and political point of view.

xiii. **The CFA also highlights the importance of long-term economic growth for fiscal sustainability**. The Non-Mining Trend GDP growth rate has been progressively decreasing (on average, this was 5.2% in 2003-2009, 3.4% in 2010-2019, and 2.4% in 2020-2021). In this sense, simulation exercises carried out by the Council allow concluding that, in the next 20 years, one point of higher annual Trend GDP growth would allow, with respect to the base scenario: (i) reducing gross debt by around 3.5 pp of GDP; (ii) increasing primary expenditure by approximately 14%; and (iii) reducing interest payment expenses by 0.2 pp of GDP.

xiv. **Finally, the Council insists on the importance of fiscal sustainability for citizens and on generating broad consensus to achieve it**. Empirical evidence shows that fiscal sustainability has a positive impact on a series of economic aspects, which translate into direct improvements in the population's welfare, such as: (i) more stable growth of the economy, employment, and wages; (ii) better borrowing conditions; (iii) higher level and protection of social expenditure; (iv) low and stable inflation; and (v) better fiscal policy responsiveness to unforeseen shocks.