

SEPTEMBER 26, 2023

The background of the slide is a dark blue gradient with intricate, light blue wavy lines that create a sense of movement and depth. A solid, medium-blue vertical bar is positioned on the left side of the slide, partially overlapping the text.

MAIN MESSAGES OF THE AUTONOMOUS FISCAL COUNCIL IN CHILE ON THE EXERCISE OF ITS DUTIES AND POWERS

*Presentation before the
Special Joint Budget Committee of Congress*

The Autonomous Fiscal Council notes that in 2023 some fiscal risks it had warned about, such as lower mining activity, a sluggish economic recovery and higher spending pressures have materialized. This trend could potentially persist in 2024. To address these risks, the Ministry of Finance should return to the path of convergence and avoid postponing the remaining fiscal effort until the end of the current administration.

Message

In the course of 2023, some of the fiscal risks that had been warned by the Autonomous Fiscal Council (CFA, known by its Spanish acronym)¹ have materialized. Both the structural fiscal deficit and the effective deficit for 2023 have seen upward revisions. This is mainly due to a deterioration in revenues, alongside higher public spending pressures, which could be mitigated, in part, through reallocations. Additionally, the methodological change proposed by the Budget Office (Dipres, abbreviated in Spanish) to include a prudential adjustment for lithium fiscal revenues in the fiscal rule would result in a higher structural deficit. If the CFA's proposals for such adjustment were also considered, this deficit would increase even more.

In view of this situation, the Council insists on the importance of resuming the fiscal consolidation path initiated in 2022, until reaching values for the Structural Balance (SB) close to zero in 2027, in order to stabilize public debt below the prudent level of 45% of GDP. At the same time, it highlights the need to monitor the risks that could make it difficult to achieve this. To this end, the Council insists that the Ministry of Finance should consider a path that will allow the greater fiscal effort not to be postponed until the end of the current administration. In this sense, the CFA calls on the Executive and Legislative branches to reinforce their commitment to comply with fiscal convergence and to stabilize public debt so that it remains below the prudent level. To contribute to the above, the Council insists that the Ministry of Finance should establish timely SB targets for each year of the current administration, which should be reflected in a new Fiscal Policy Decree. This would facilitate gradualness, predictability, credibility and monitoring of the fiscal convergence process.

In another area, the Council highlights that the fiscal adjustment of 2022 and the limited increase in spending projected for 2023 have contributed to the moderation of inflation and other macroeconomic imbalances, demonstrating the benefits of convergence and the

¹ See Structural Balance Report No. 16 - "Informe de evaluación y monitoreo del cálculo del Balance Estructural y nivel prudente de deuda: estimaciones 2023-2027" (Evaluation and monitoring report on the calculation of the Structural Balance and prudent debt level: estimates 2023-2027) (08.03.2023), available at: <https://www.cfachile.cl/balance-estructural/informes-sobre-balance-estructural/informe-sobre-balance-estructural-n-16-informe-de-evaluacion-y-monitoreo-del>

importance of fiscal sustainability. However, the Council sees that the task is not yet complete and that there are risks to public finances.

The projected fiscal deficit for 2023 is mainly due to lower actual revenues, which are expected to show a significant reduction compared to 2022, due to the fall in both mining revenues (private mining and raw copper from the National Copper Corporation (Codelco, for its acronym in Spanish) and non-mining revenues. In the case of mining revenues, there stand out the effect of higher production costs, while in the case of non-mining revenues, a lower than expected performance of the Income Operation.

On the expenditure side, there have been upward pressures due to the emergency measures packages for climatic phenomena, as well as to higher spending on health and on the financing of the Universal Guaranteed Pension (PGU, known by its acronym in Spanish). In recent months, there has been an increase in spending on social security benefits, attributed to a larger number of beneficiaries and PGU amounts compared to what was allocated for the Solidarity Pillar. According to information provided by the Dipres to the CFA, it is expected that part of the higher expenditure will be moderated by budget reallocations.

The CFA highlights that some of the risks of 2023, such as lower activity and operating margins in mining, a weak economic recovery and greater spending pressures, could be repeated in 2024, which could make it difficult to resume the convergence path and cause the fiscal deterioration to spread over the coming years. This concern is accentuated by the uncertainty surrounding copper and lithium prices.

Although Dipres estimates show a stabilization of gross debt as a percentage of GDP in a medium-term horizon (2027), this is a projection that depends on many factors, both external and internal, and is therefore subject to uncertainty. Moreover, it is a factor of concern that the trend towards 2025 will continue to be upward, bringing us ever closer to the prudent level of debt. It is important to emphasize that this level is defined as a debt ceiling and not as a target, so it is reasonable to avoid getting too close to it, in order to avoid having to make abrupt corrections to prevent exceeding it. This poses the challenge of effectively achieving early debt stabilization, without postponing most of the remaining fiscal effort to the end of the current administration's projection horizon.

On the other hand, while the gross debt to GDP ratio would stabilize in 2023 at 38.1%, the net debt would increase by 1.4 percentage points of GDP, which underscores the importance of also monitoring this debt measure, as previously recommended by the CFA.

It is the responsibility of the Executive to monitor the multiple risk factors that could affect the long-term sustainability of public finances. In this regard, the CFA suggests conducting a thorough assessment of the effects they could generate on public debt and

taking the necessary measures to mitigate their impact. Next, the Council highlights the following issues to be monitored²:

1. Persistence of financial risks at international level due to restrictive monetary policies in developed economies and rate cuts in emerging economies. The U.S. Federal Reserve is considering rate hikes, while central banks in emerging countries, such as Chile, are reducing them. This divergence affects financial markets and currency dynamics, with risks for public debt in foreign currency and its capacity to finance long-term projects.

2. Uncertainty in the global macro-financial situation and its possible deterioration could trigger episodes of high volatility, liquidity reduction, and capital outflows in emerging economies. China's economic evolution accentuates this concern, as it could affect the prices of raw materials such as copper and lithium, impacting fiscal revenues from mining and property income.

3. The Council appreciates the policy mix to finance permanent expenditures proposed in the Executive's fiscal pact proposal, but notes certain risks in its implementation. These include the possibility of discrepancies –in terms of amounts or timing– between revenues and spending commitments; lower than expected actual revenues; lower than expected economic impact of pro-growth measures; and the possible lack of political consensus to implement efficiency measures and spending reallocation.

4. The potential fiscal effects of a financial crisis in Social Security Health Institutions (Isapres, for their acronym in Spanish). The Council recommends that the Dipres should conduct and publish a study on the impact on public spending of a massive transfer of affiliates to the National Health Fund (Fonasa, for its acronym in Spanish). In the Council's opinion, a financial crisis of the Isapres, being neither transitory nor totally exogenous to the actions of the Government, could not be considered as a cause for triggering an escape clause. Therefore, should it occur, and imply a higher permanent expenditure for the public sector, it should be addressed with also permanent sources, whether new revenues or spending reallocations.

5. The risks of advancing in fiscal decentralization without effective regulations to ensure aggregate fiscal sustainability. The Council identifies areas for improvement in the fiscal decentralization bill currently being processed, which include, among others, the importance of establishing and monitoring fiscal rules for subnational governments and also aggregated with the Central Government, a strict framework for authorizing regional

² The CFA, in accordance with the provisions of Law No. 21,148, which created it, plays a complementary role in the responsible management of the Central Government's fiscal policy. Through the constant monitoring of the main fiscal variables and the identification of risks that may threaten fiscal sustainability, the Council issues non-binding warnings and recommendations, which seek to contribute to better decision making by the fiscal authority.

government indebtedness, the evaluation of regional revenue projections, incentives to avoid moral hazard, and strengthening the control and accountability of regional public finances. While several of these issues have been addressed by the Executive in recent indications, the CFA will continue to analyze the bill's progress.

6. The drop in Codelco's production and the uncertainty that this generates regarding its contribution to the fiscal coffers in the medium and long term. Delays in projects and the decrease in ore grades are relevant factors for the ability of the state mining company to generate contributions to the Treasury. The Council warns about the possibility that the company's contributions to fiscal revenues may decrease if this trend persists, which would make it necessary to adjust spending or seek alternative financing sources to comply with the structural balance convergence.

7. The uncertainty about lithium fiscal revenues and the risk of committing permanent expenditures against them. The Council values the strengthening of the SB fiscal rule put out for public consultation by the Dipres to incorporate an adjustment to lithium revenues, but warns that it does not consider important methodological suggestions, including covering all fiscal revenues from lithium and extending the time horizon of historical data to calculate the prudential adjustment threshold.

8. Definitions regarding fiscal institutions in the constitutional process and their impact on fiscal sustainability. The Council analyzed the preliminary draft of the new Constitution prepared by the Expert Commission and made recommendations to strengthen its fiscal aspects. Among them, it suggested including the principles of fiscal responsibility and sustainability in the Constitution, strengthening the exclusive presidential initiative on spending, improving certain budget management rules, ensuring subnational fiscal sustainability, controlling spending pressures that may arise from courts of justice, and improving information and technical support for public policies and finances. The definitions that are finally adopted in these areas will have an impact on how robust fiscal institutionality will be in the future.

9. The increase in public indebtedness in ways not accounted in the Central Government's gross debt. In the context of the dual rule that considers a prudent level of debt, it is crucial to enhance greater transparency in all forms of public indebtedness, some of which do not appear in gross debt calculations and, therefore, fall outside the scope of the rule. These encompass debts owed to suppliers, contingent liabilities, and obligations of public entities. This information is necessary to assess their scale and risk for compliance with the fiscal rule. In addition, it is suggested that the Dipres improve transparency on "other capital requirements" and their projections, due to their impact on public debt.

10. Risk of decreased confidence in the proper use of public resources and its impact on tax collection. The responsible and transparent use of public resources reinforces citizens'

compliance with their fiscal obligations. Therefore, it is important to prevent, correct and sanction any irregularities that may be detected in the "agreements case". Likewise, it is important to improve fiscal projections and reduce uncertainty regarding them.

To analyze the sustainability of public finances, the CFA constructed a long-term projection of public debt for a baseline scenario³. This entails a deterioration of the SB in 2023; a continuation of fiscal convergence for the period 2024-2026, in line with the Fiscal Policy Decree No. 755 of the Ministry of Finance of 2022 and with what was proposed by the Dipres in the Public Finance Report for the second quarter of 2023 (IFP2Q23) until 2026, and a balance in structural equilibrium from 2027 onwards, the latter in contrast to the structural deficit of 0.3% of GDP assumed by the Dipres in its IFP2Q23. It is important to note that on this occasion the more demanding assumption for the SB in the long run (balance instead of deficit), is relevant to stabilize gross debt below its prudent level. In particular, a structural deficit of 0.3% of GDP in the long run would exceed the prudent level of debt, while with a balanced balance this would not occur.

To gauge the effect on public finances of different risk scenarios, the Council also presents in this report long-term public debt projections under two alternative scenarios. In both, the prudent level of debt would be exceeded and interest expenditures would reach historically high levels, taking away space for public policy priorities. The scenarios are associated with the following risks: (1) an economic crisis that triggers an escape clause, without an adequate correction and subsequent fiscal convergence mechanism⁴; (2) permanently committing all or part of the expenditures foreseen in the Executive's fiscal pact proposal, but with a lower effective permanent revenue collection.

Finally, in light of the existing fiscal challenges, the Council has considered it pertinent to reflect on its institutional strengthening in order to contribute to address them. In this regard, the Council considers that the development and strengthening of fiscal institutions in Chile has been a constant and necessary process, which must continue. Furthermore, it is noted that the fiscal context has undergone significant shifts since the creation of the CFA in 2019 until today. To illustrate this point, it suffices to consider that between 2018 and 2022 the gross debt of the Central Government grew from 25.8% to 38% of GDP, while the assets of the Public Treasury fell from 10.1% to 6.1% of GDP. At the same time, while the CFA has specific tasks outlined in the law that it has fulfilled, its capacity has not been enough to meet all the emerging challenges arising from its broad mandate to contribute to the responsible management of the Central Government's fiscal policy. Therefore, the Council considers that progress can be made in: (i) recognizing greater hourly dedication of its members; (ii) increasing the technical team of the CFA in terms of current and possible

³ That is, a scenario of projections that are based on the current SB methodology and that do not address economic risk events.

⁴ In Chile's Country Report, the International Monetary Fund (IMF) mentioned that the Chilean economy remains exposed to elevated external risks related to a possible abrupt global slowdown and significantly tighter global financial conditions, which could result in lower and more volatile commodity prices.

new tasks that may arise, applying the criterion that any new task must be accompanied by having the necessary personnel; (iii) having adequate and timely access to the information required to carry out its analyses; and (iv) advancing towards greater operational autonomy of the CFA. For this reflection on how to strengthen the CFA, the Council considers it relevant to obtain feedback from the main users of its analyses.

PRESENTATION BEFORE THE SPECIAL JOINT BUDGET COMMITTEE OF NATIONAL CONGRESS

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