

Ministerio de Hacienda



Chile at a Crossroads: Finding its Path to Inclusive Development

Columbia University

July 19, 2022

Mario Marcel | Minister of Finance

Introduction

Chile is undergoing a broad transition in three overlapping dimensions:

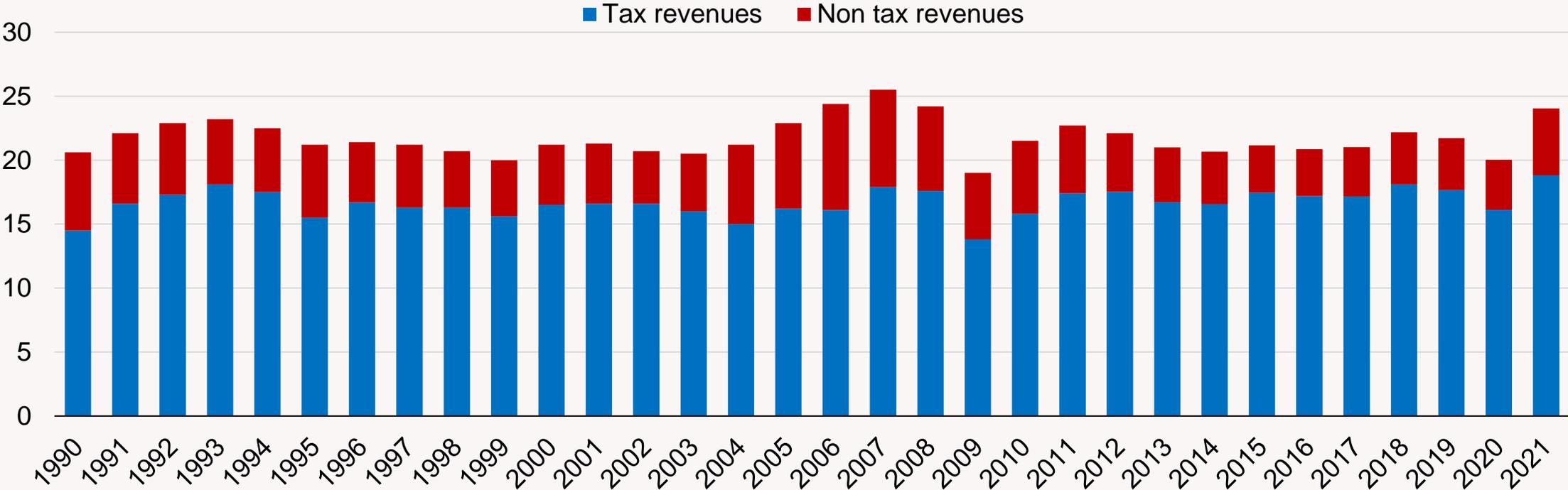
- *Productive transition*: a mining oil-dependent economy, evolving into a green-growth supplier and service hub
- *Political transition*: from a hierarchical, centralized society, to an inclusive society with institutionalized distributed power
- *Economic transition*: regaining equilibria after the Covid-19 crisis and disproportionate policy responses

These features may be present in many other countries, but in Chile they became particularly acute due to fast-growing middle class, enhanced transparency and stagnating productivity

Tax Reform: A New Fiscal Pact

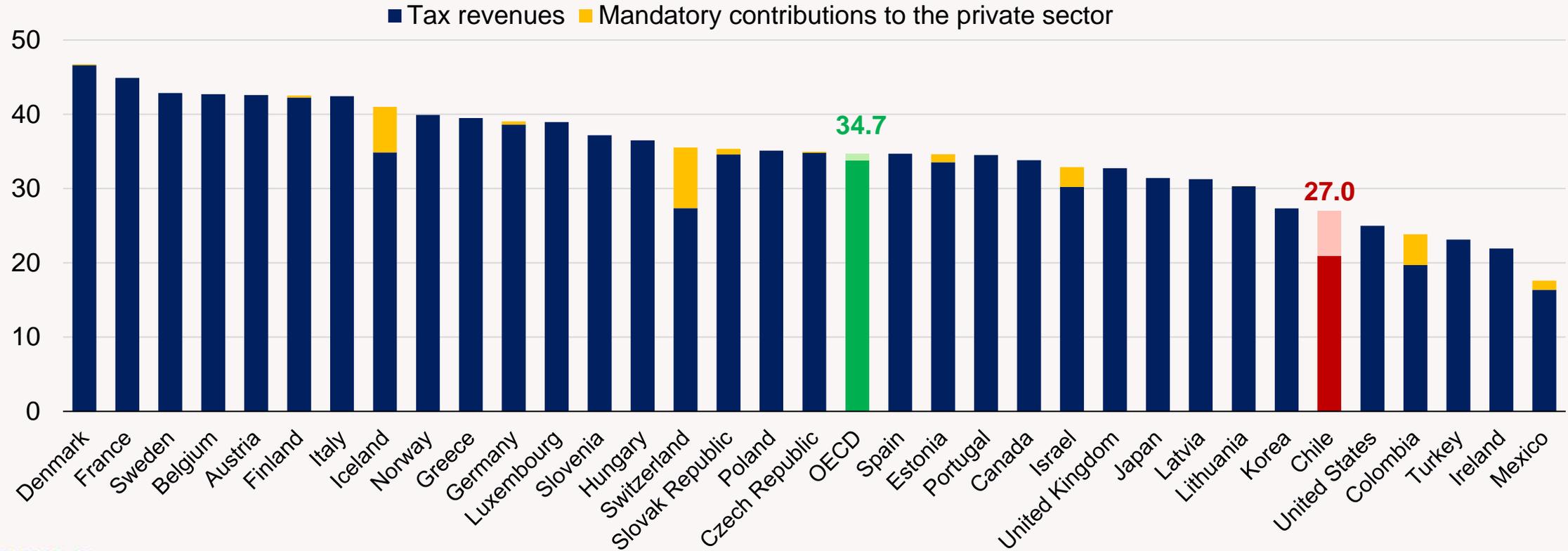
Tax burden in Chile is comparatively low and has changed very little over the last 30 years

Central Government operating income
(GDP %)

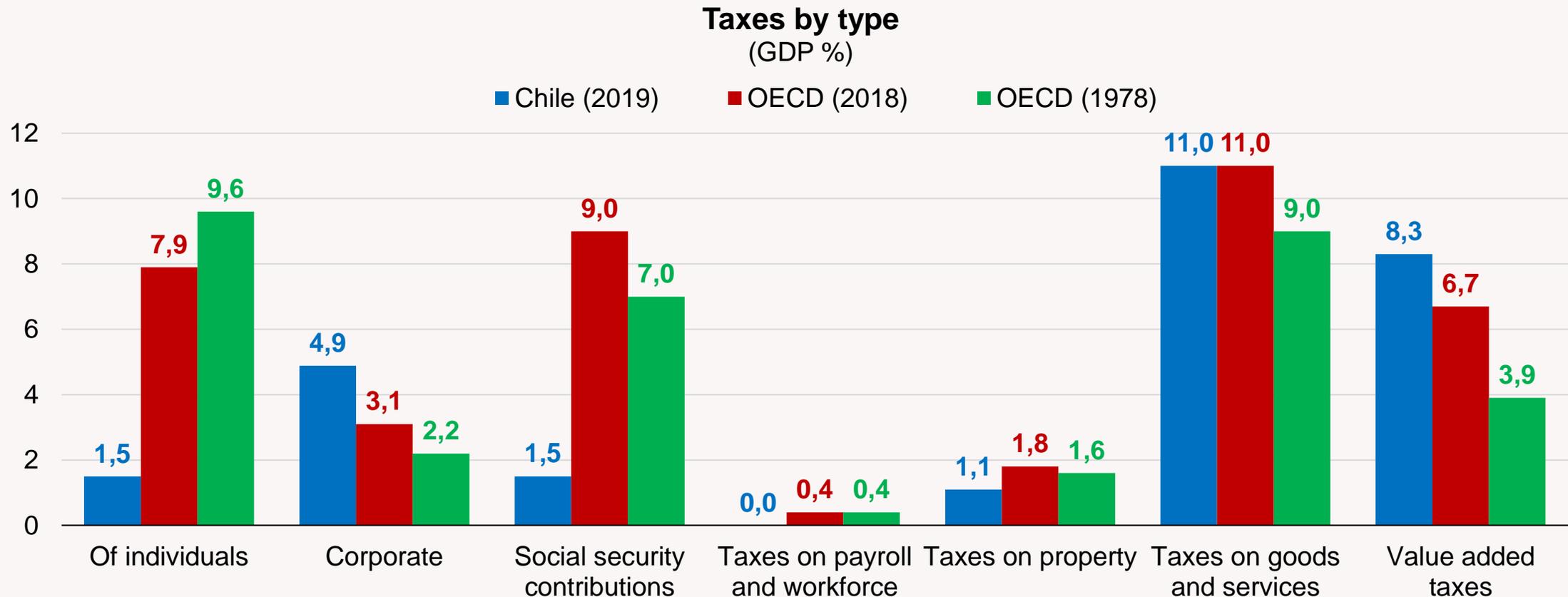


The normalized gap with OECD countries is almost 8 points of GDP

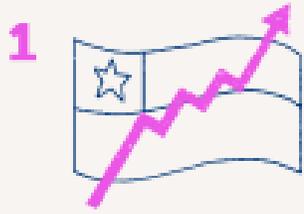
Total tax burden, OECD
(% of GDP, 2019)



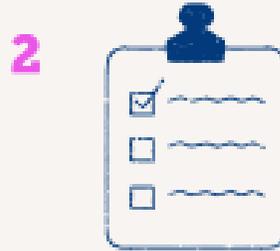
Chile's tax structure is atypical in comparison with OECD countries. There are large gaps on personal income taxes, property tax, and social security contributions.



What do people want from their tax system?



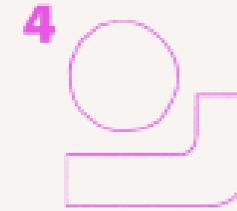
**Progressivity
and tax justice**



**Transparency
and efficiency**



**Commitment to tax
compliance**



Simplicity



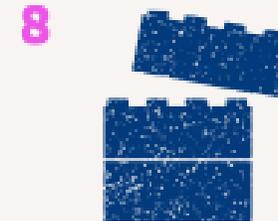
**Education and
taxpayer assistance**



Co-responsibility



**Stability
and certainty**

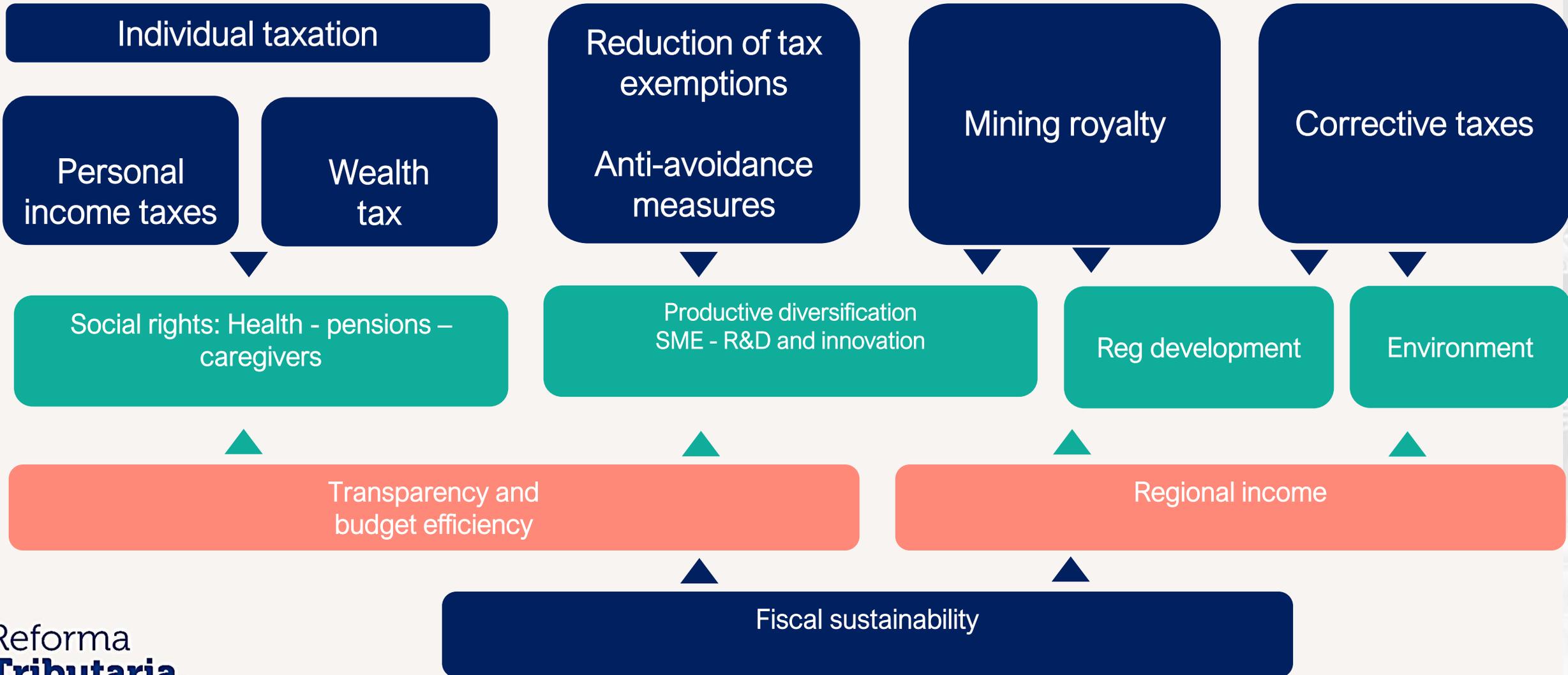


Adaptability

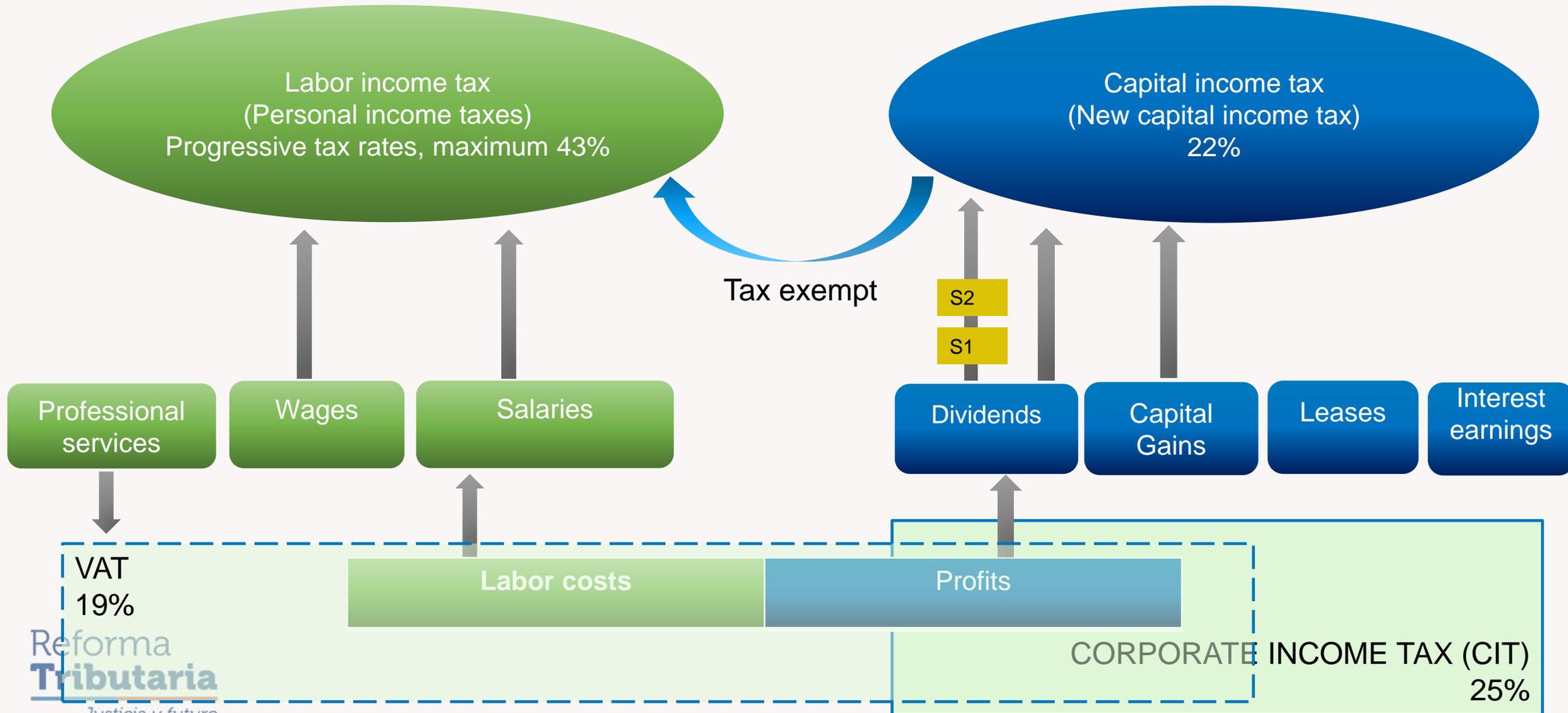
A new fiscal pact: Tax Reform objectives

Tax revenue	<ul style="list-style-type: none">• Increase tax-to-GDP ratio by 4.1 percentage points
Fair Distribution	<ul style="list-style-type: none">• Raise the progressivity of the tax system• Reducing tax loopholes and opportunities for aggressive tax planning
Tax revenue legitimacy	<ul style="list-style-type: none">• Good use of resources• Transparency in the use of resources
Tax Modernization	<ul style="list-style-type: none">• Incorporate global trends in taxation• Taking into account the globalization of taxpayers• Financial development
Efficiency	<ul style="list-style-type: none">• Simplify and reduce compliance costs• Reduce incentives for aggressive tax planning with avoidance purpose

Tax Reform Structure



Restructuring Income Tax



Reforma
Tributaria

Justicia y futuro

Income Tax

- The current semi-integrated tax system becomes a dual tax system
- Corporate income tax (CIT) is reduced from 27% to 25%
- New 2% development rate (DR)
- 22% tax on distributed dividends and capital gains on stock instruments
- Labor income: marginal rates from 0% to 43%
- Deferral of personal taxes subject to a 1.8% tax rate only in companies receiving more than 50% of their income from passive sources

Wealth Tax

1. Applied to less than 0.1% of taxpayers, facilitating audits by the tax authorities
2. Avoids exemptions to prevent taxable base erosion
3. Simple rules for the valuation of assets and liabilities

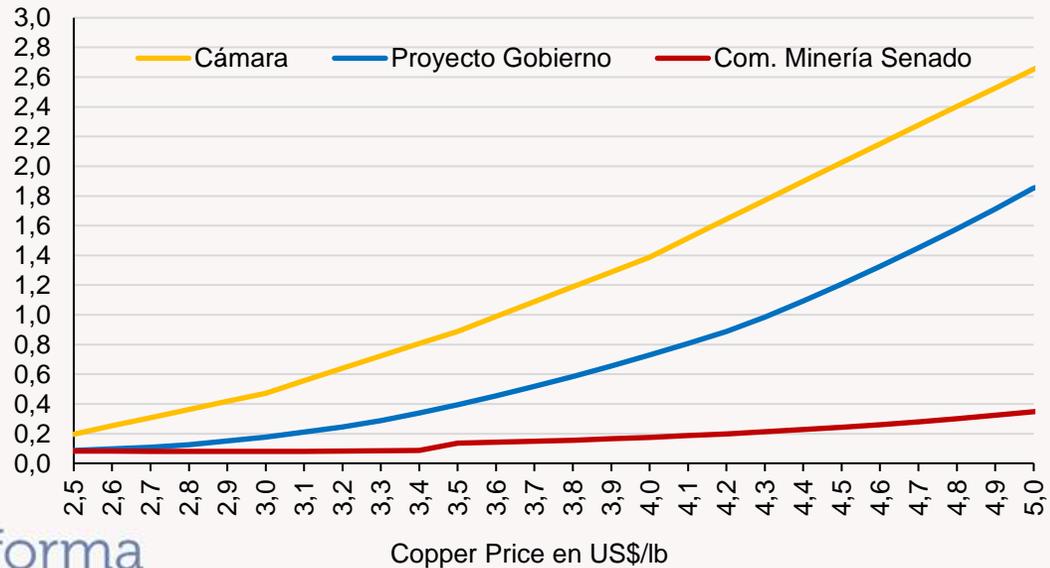
Brackets and tax rates

Bracket (US\$)	Marginal tax rate
0 - 4,9 millions	0%
4,9 – 14,7 millions	1%
More than 14,7 millions	1,8%

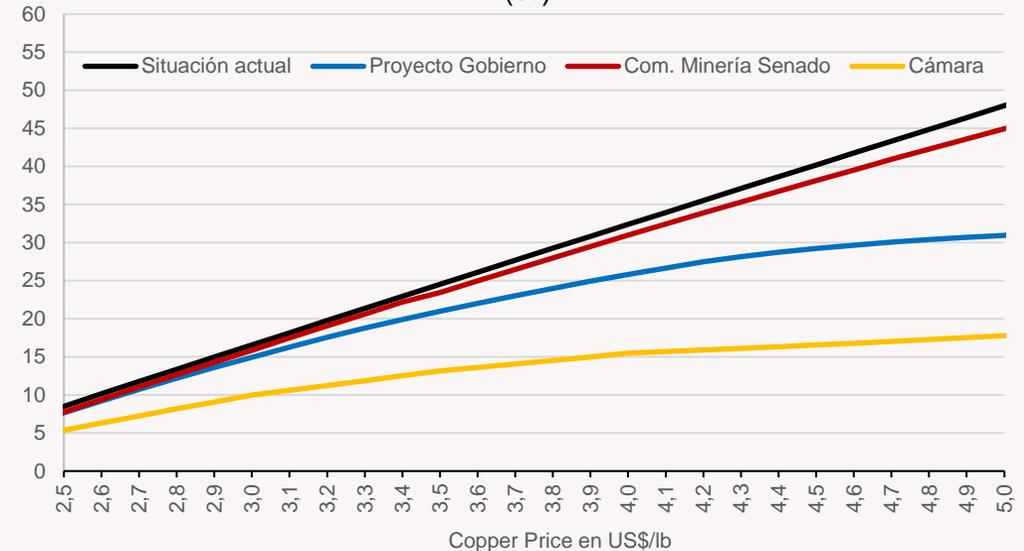
Royalty on mining

1. Taxation of large private copper mining is increased to generate a fairer distribution of economic rent
2. Price risks shared between the private sector and the State
3. Incentives to invest remain
 - Yields greater than 15% per year
 - Similar tax burden than competitors at long-term prices

Increase in tax income, according to different copper Price proposals (% GDP)

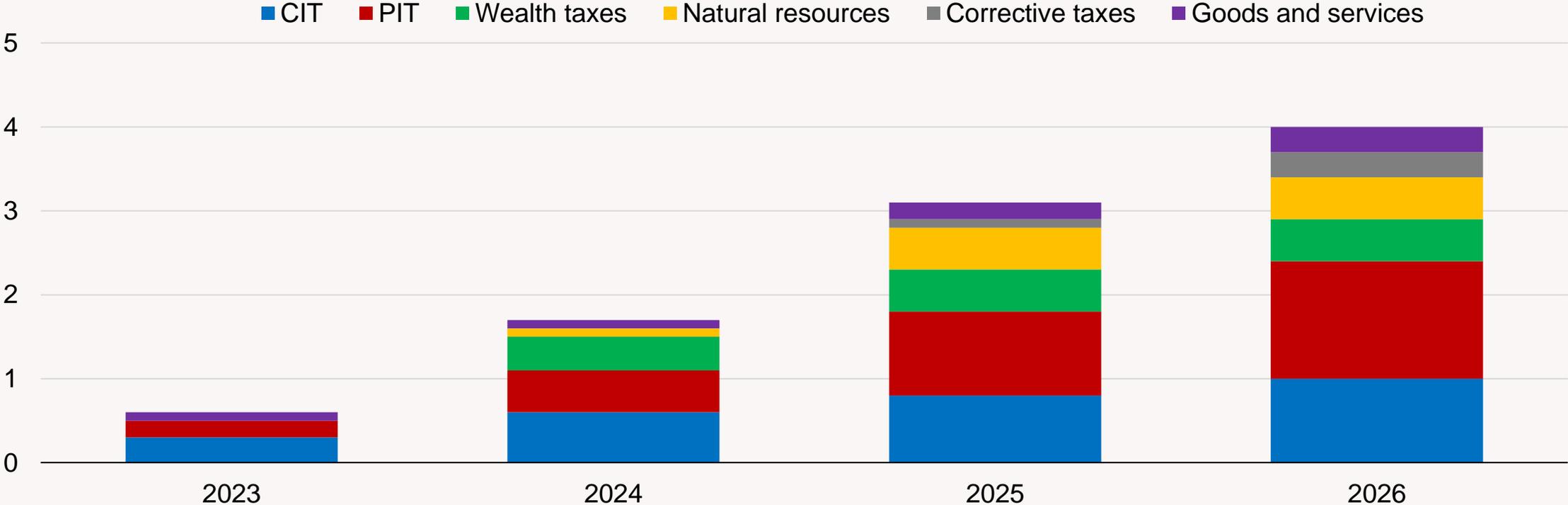


Return over equity (ROE) industry average according to different proposals of copper price (%)



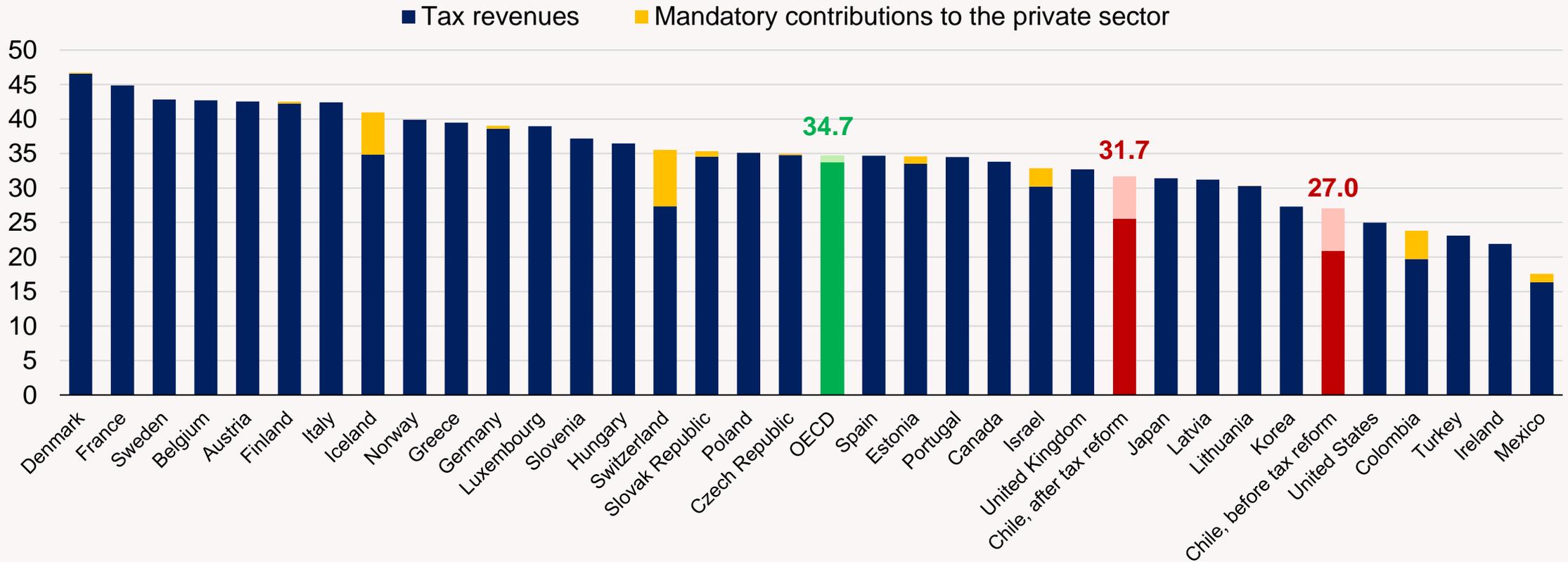
Expected revenue from Tax Reform

Tax reform collection by source
(GDP %)



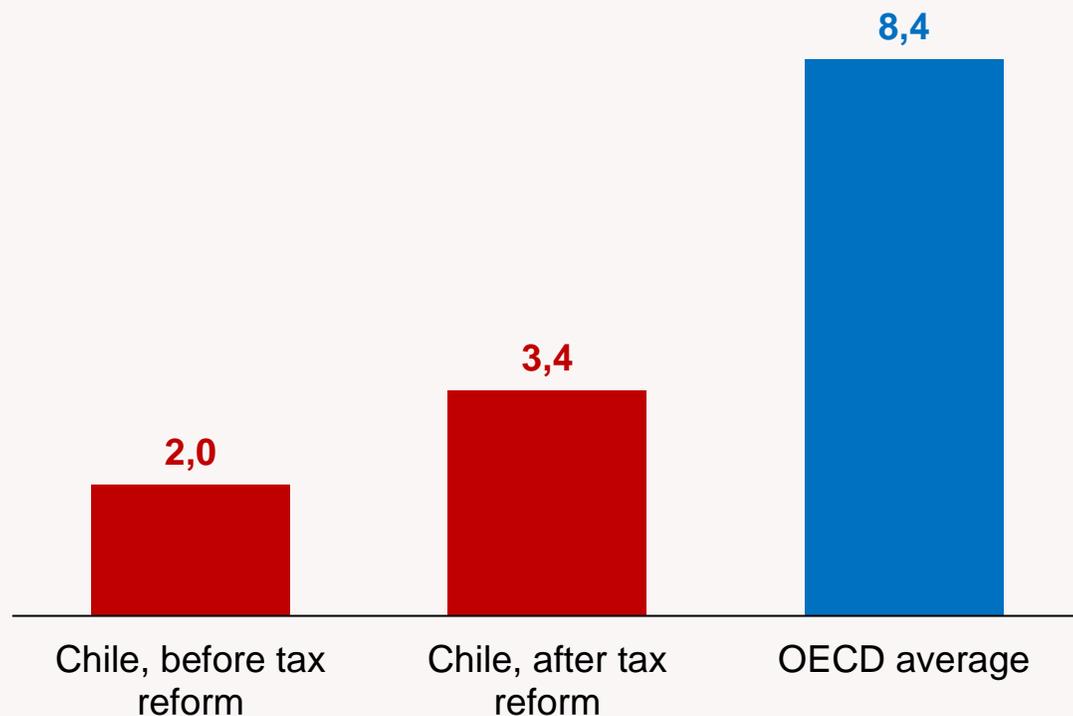
Adjusted tax gap, before and after the tax reform

Total tax burden, OECD countries
(GDP %, 2019)

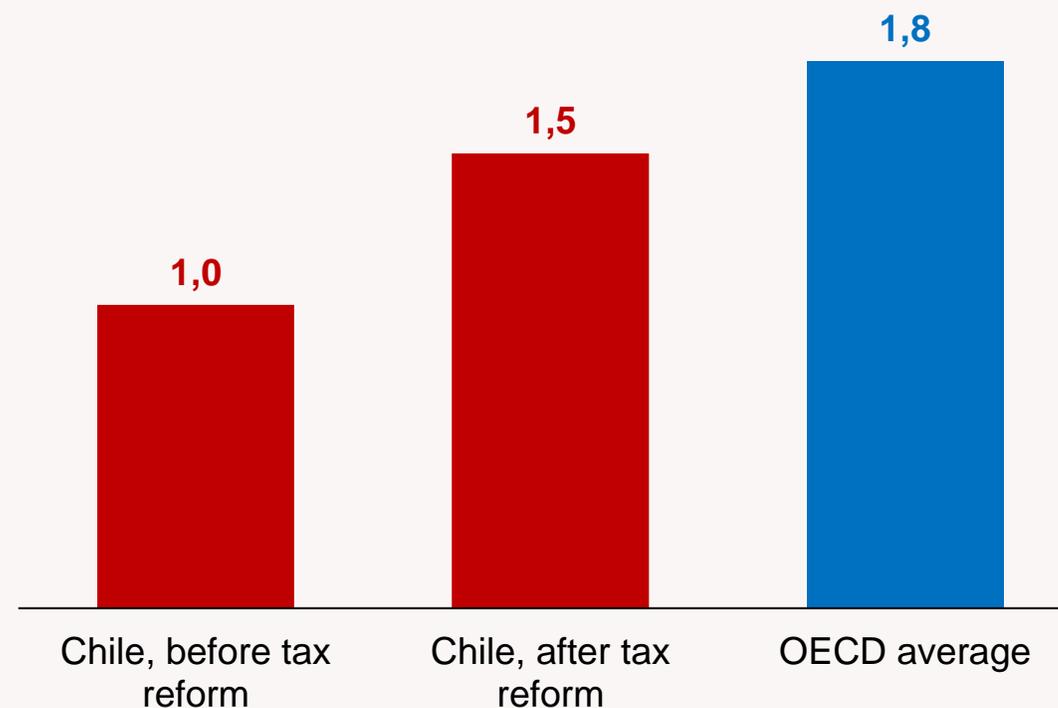


Gap in personal income taxes and property taxes, before and after the tax reform

Personal income taxes, OECD countries
(GDP %, 2020)

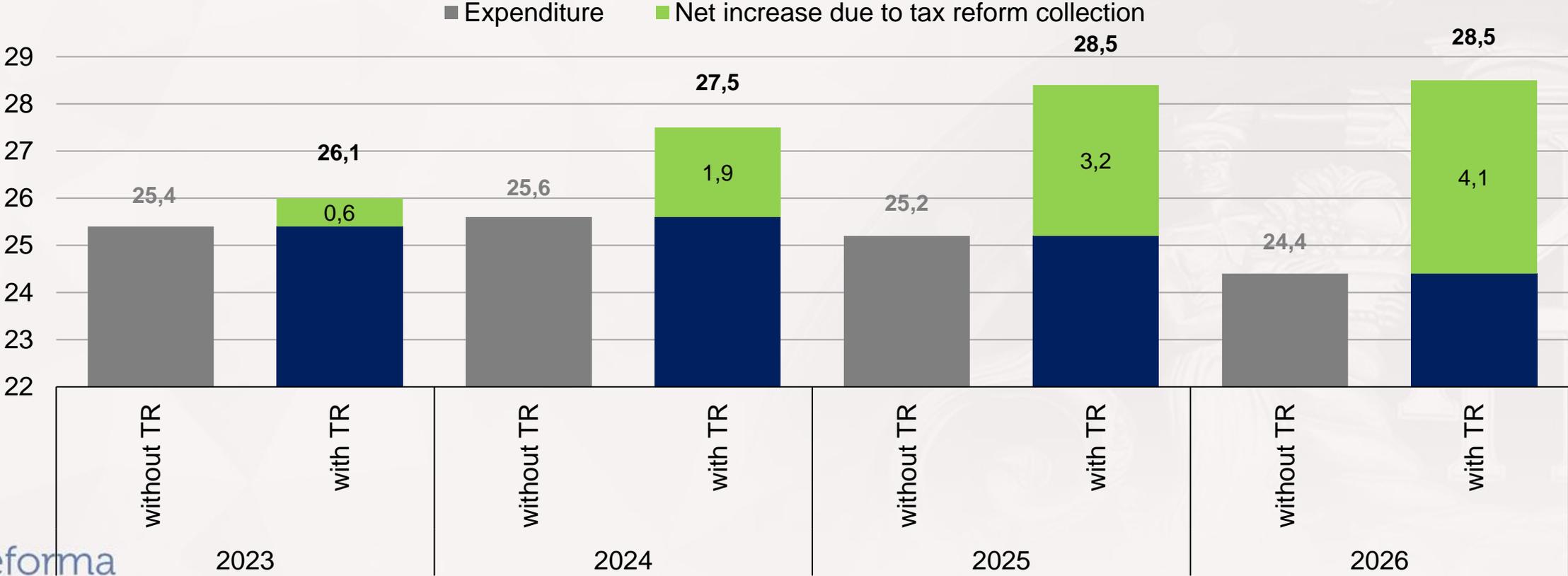


Property taxes, OECD countries
(GDP %, 2020)



Revenues from tax reform will fund approximately 50% of the Government's program. They will be especially important in 2024 and 2025

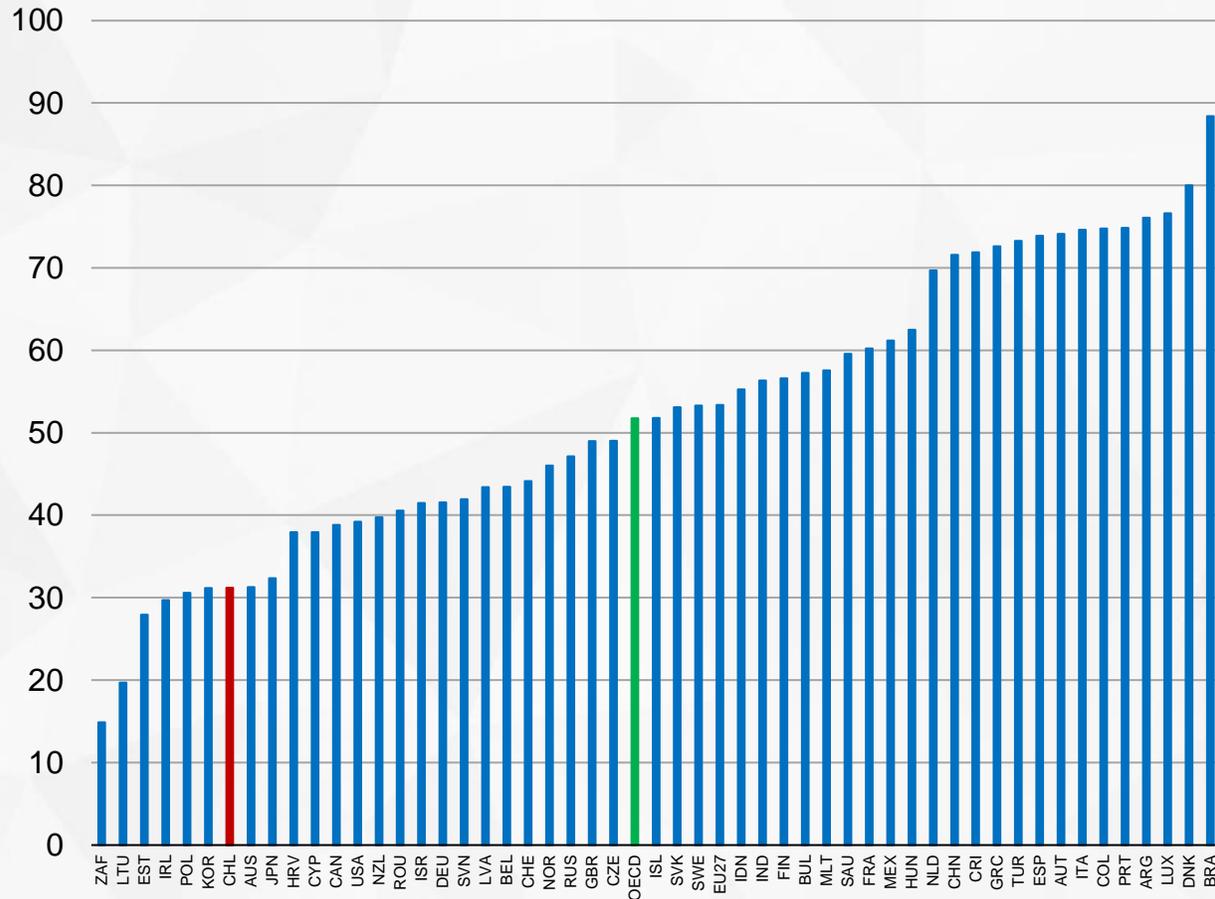
Central government expenditure
(% of GDP)



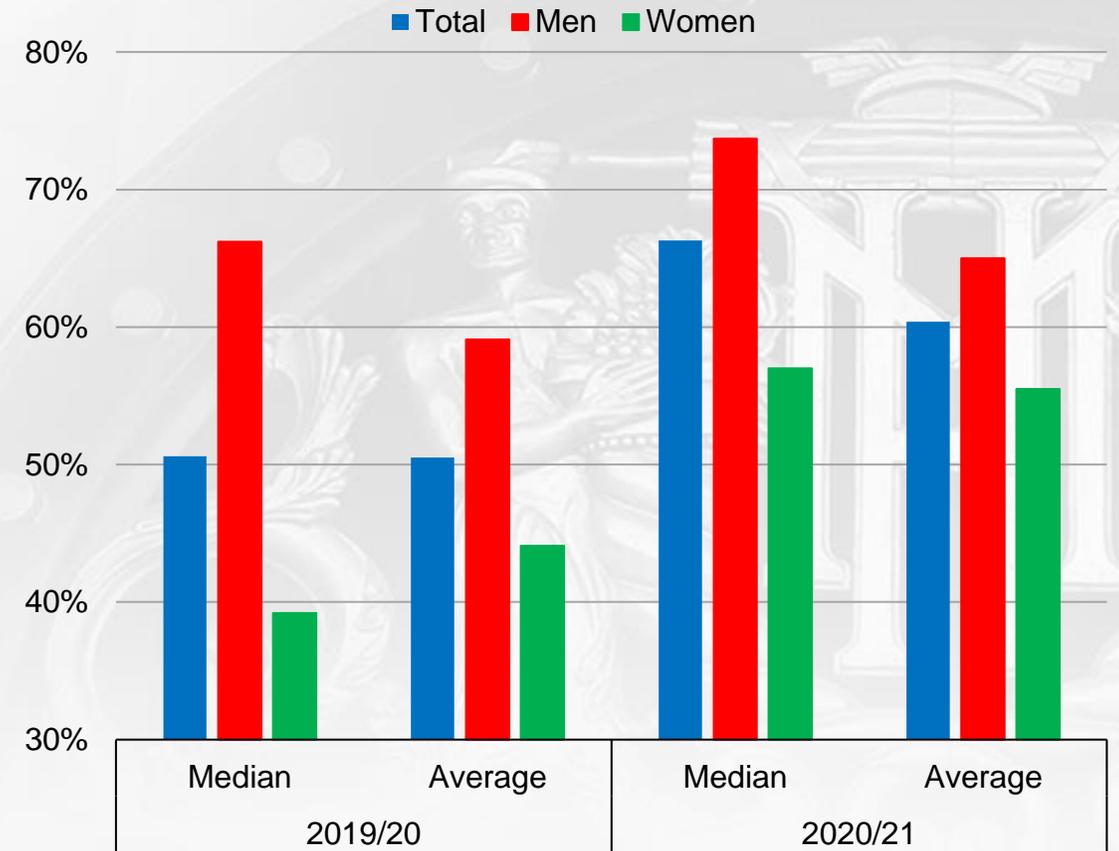
Pension Reform

Pension system: Effective contributions towards the pensions system are low, limiting a higher replacement rate. The contributions' density is considerably low for women.

Gross replacement rate
(at retirement age, 2020)



Chile's contribution density
(# months contributed over # months affiliated to the system)



Note: The green column stands for the OECD average and the red column for Chile. In Chile, figures include the disability insurance and fees paid to AFPs.

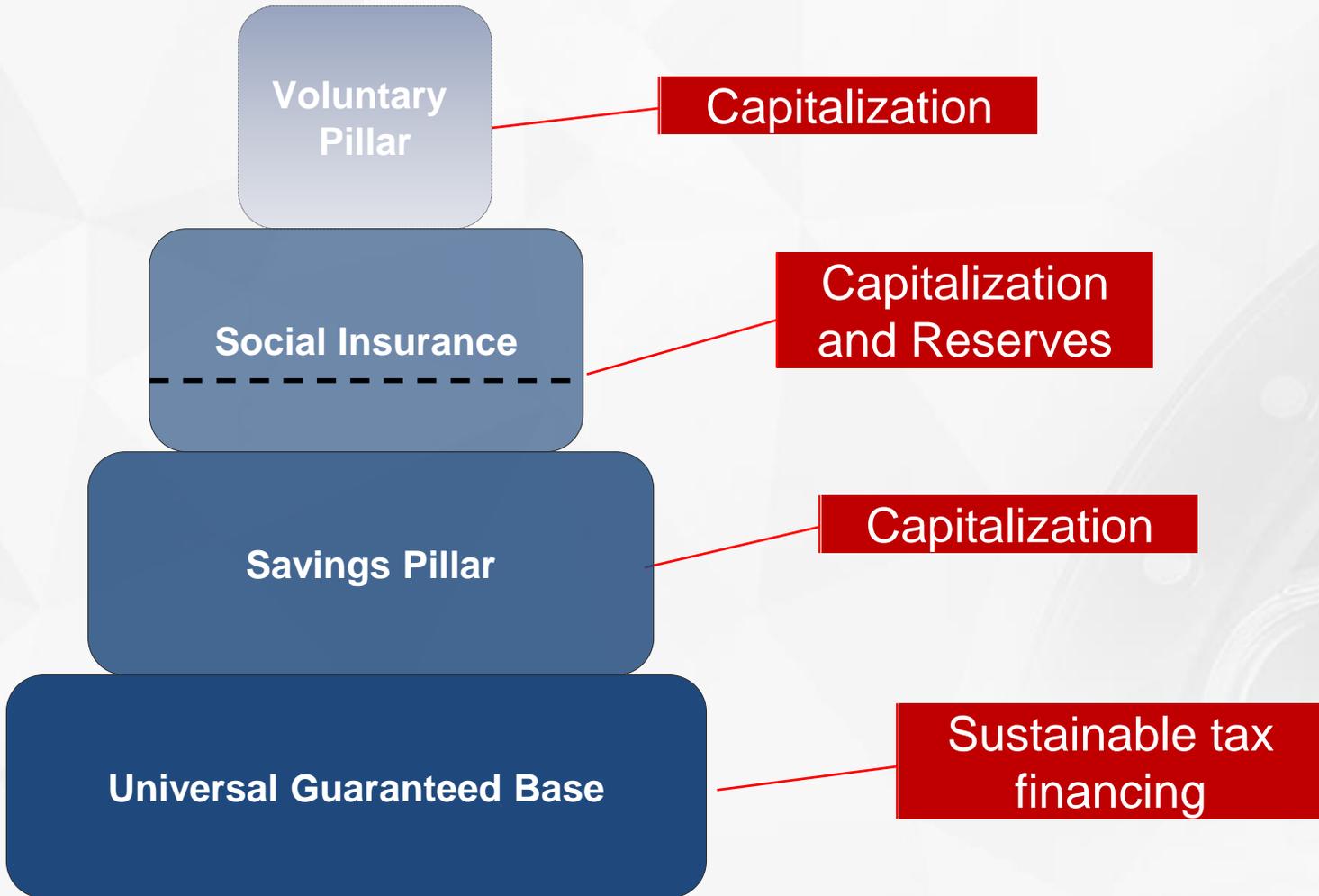
Source: OECD and Chilean Pensions Supervisor.

Pension system

- Goals of pension systems:
 1. To prevent poverty in old age.
 2. To generate a certain continuity of income in the face of various contingencies, including old age.
 3. Be able to cover all the major contingencies that people may face throughout their lives.
- Need systems that are sustainable in terms of their financial structure. You cannot depend on a single mechanism.
 - Individual capitalization: cannot secure the prevention of poverty in old age.
 - Pay-as-you-go system: unsustainable financial imbalances as their population ages.
- Need to combine elements, different building blocks to address these three challenges.
 1. Fiscal support to ensure the prevention of poverty in old age.
 2. Capitalization to ensure accumulation over time, which makes feasible a high rate of replacement.
 3. A solidarity component to secure that different contingencies are appropriately covered.

Government will be presenting a proposal by 3Q 2022.

Pension Reform bill will include a number of mechanisms to rebuild long-term domestic capital markets



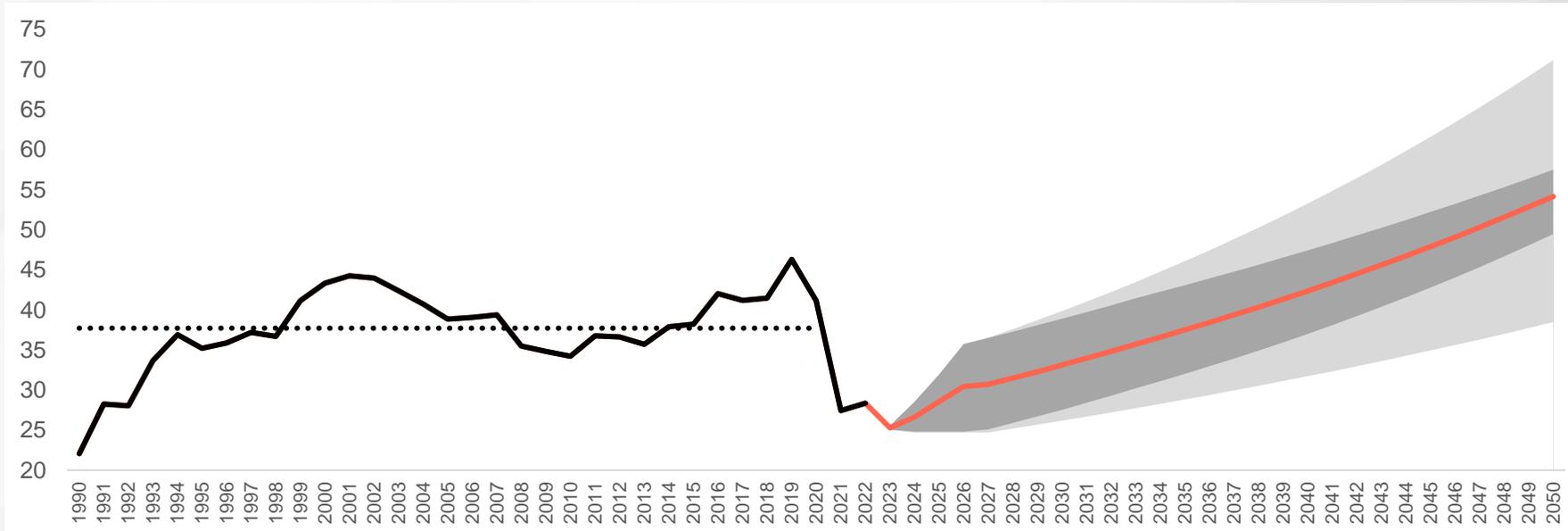
Pension reform is intended to change the architecture of the current system.

It will be supported by

- (i) a universal guaranteed base;
- (ii) a savings pillar via capitalization, with a quotation increase of 6%;
- (iii) social security; and
- (iv) voluntary savings via capitalization.

Pension reform and capital markets

Domestic assets of Pension System
(% GDP)



Note: Simulations assuming different scenarios of increases in pension contributions, growth, domestic investment, decrease in contribution gaps, etc

Source: Ministry of Finance.

The pension system may contribute by:

- Capitalizing workers' contributions
- Reserve accumulation in the social security of defined benefit pillar, from employers' contributions
- Increasing density of contributions
- Reducing under-declaration and raising wage top

Constitutional Process

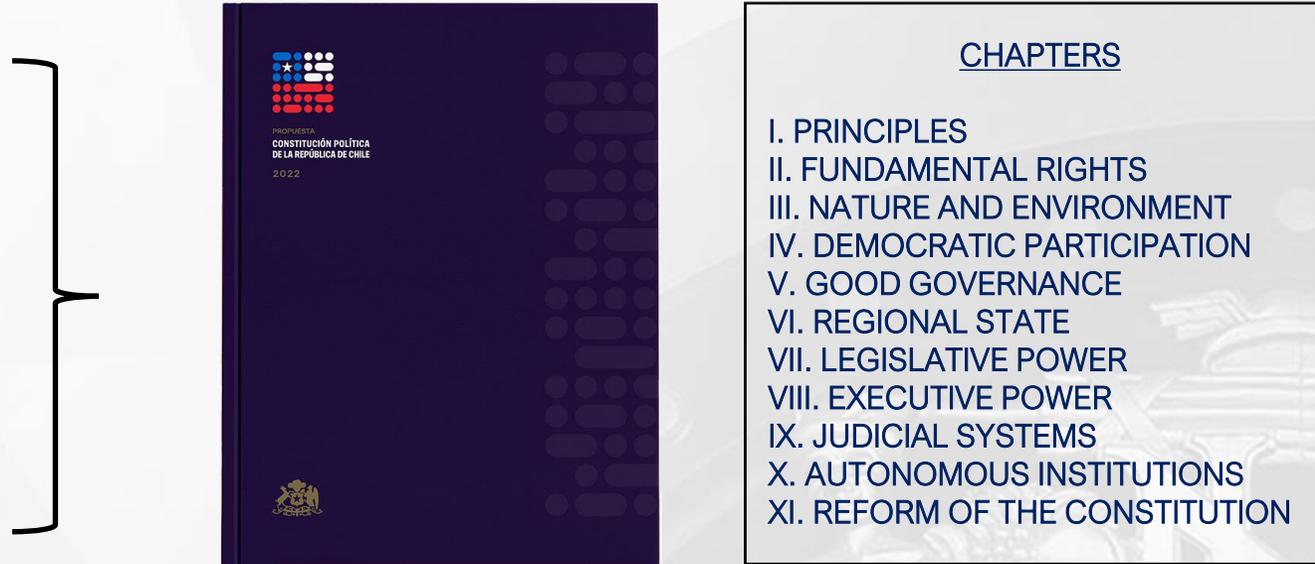
Constitutional Process Calendar

July 4th, 2022:

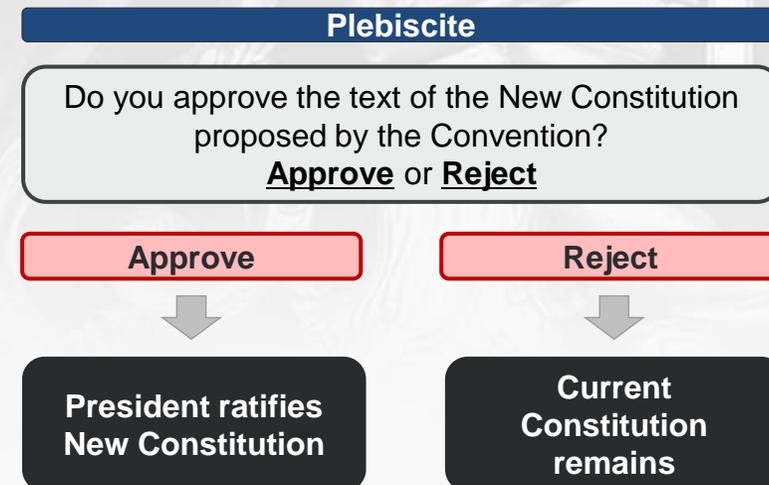
Constitutional Convention delivered the Proposal for a New Constitution.

September 4th, 2022:

Referendum to approve or reject the proposal.



- ✓ Mandatory participation
- ✓ Simple majority



Economic issues in the Proposed New Constitution

- New Constitution guarantees robust social rights and a larger role of the State to secure them.
- Many key issues (social rights, regionalist structure, attributions of the different branches of the State) will depend on the implementation of future legislation.
- Government has called for a gradual implementation of changes that imply higher fiscal costs.
- Fiscal Budget almost identical to the current Constitution.
- Freedom of entrepreneurship, property rights properly acknowledged.
- Central Bank remains autonomous with price stability and normal operation of internal and external payments as mandate.
- Fiscal sustainability and responsibility principles are now recognized at a constitutional level.

V. GOOD GOVERNANCE AND PUBLIC FUNCTION

183^h art.:

*i. “Public finances will be conducted through **fiscal sustainability and responsibility principles**, which will guide the State action in all its institutions and levels.”*

ii. “The State will use its resources in a reasonable, optimal, effective and efficient way in benefit of the people and in accordance with what the Constitution and the laws impose” ()*

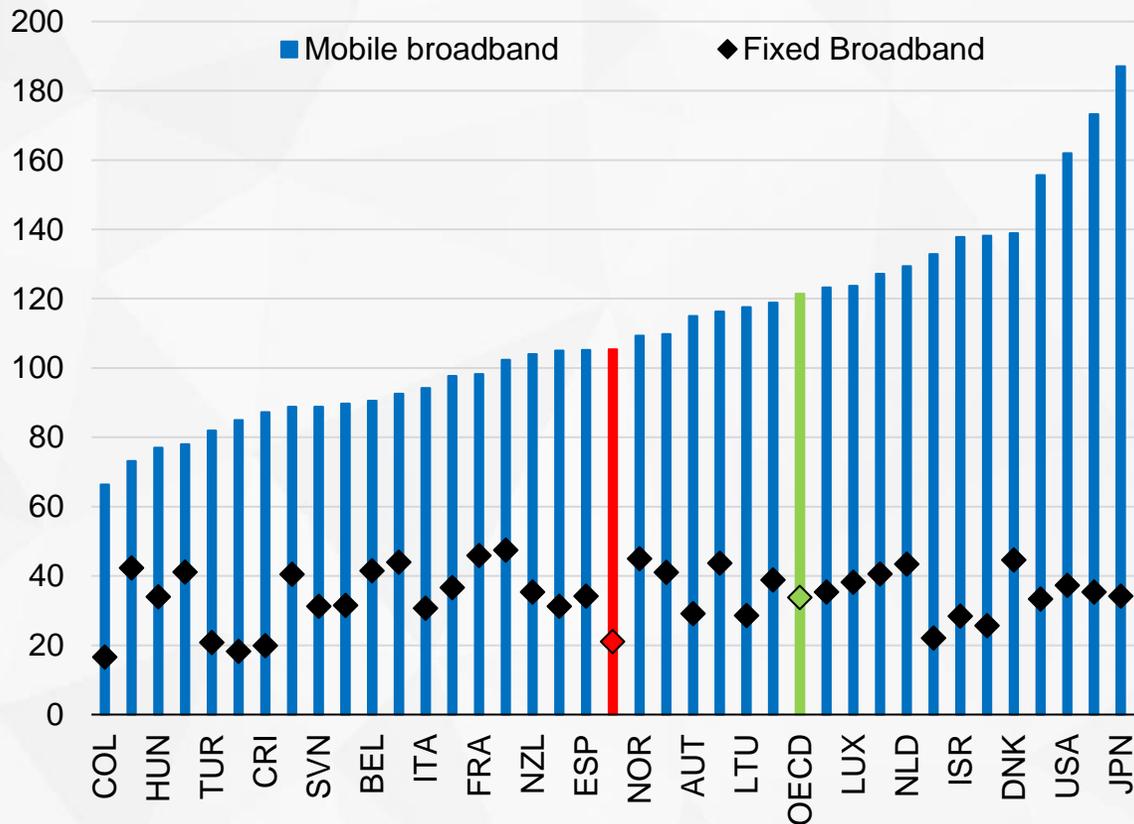
Note: (*) Original version (in Spanish) prevails.

The background features a light gray geometric pattern of overlapping triangles on the left side. On the right side, there is a large, faded, circular emblem or crest. The crest includes a central figure, possibly a woman holding a cornucopia, and large, stylized letters, likely 'M' and 'H', suggesting a university or institutional logo. The overall color palette is light and professional.

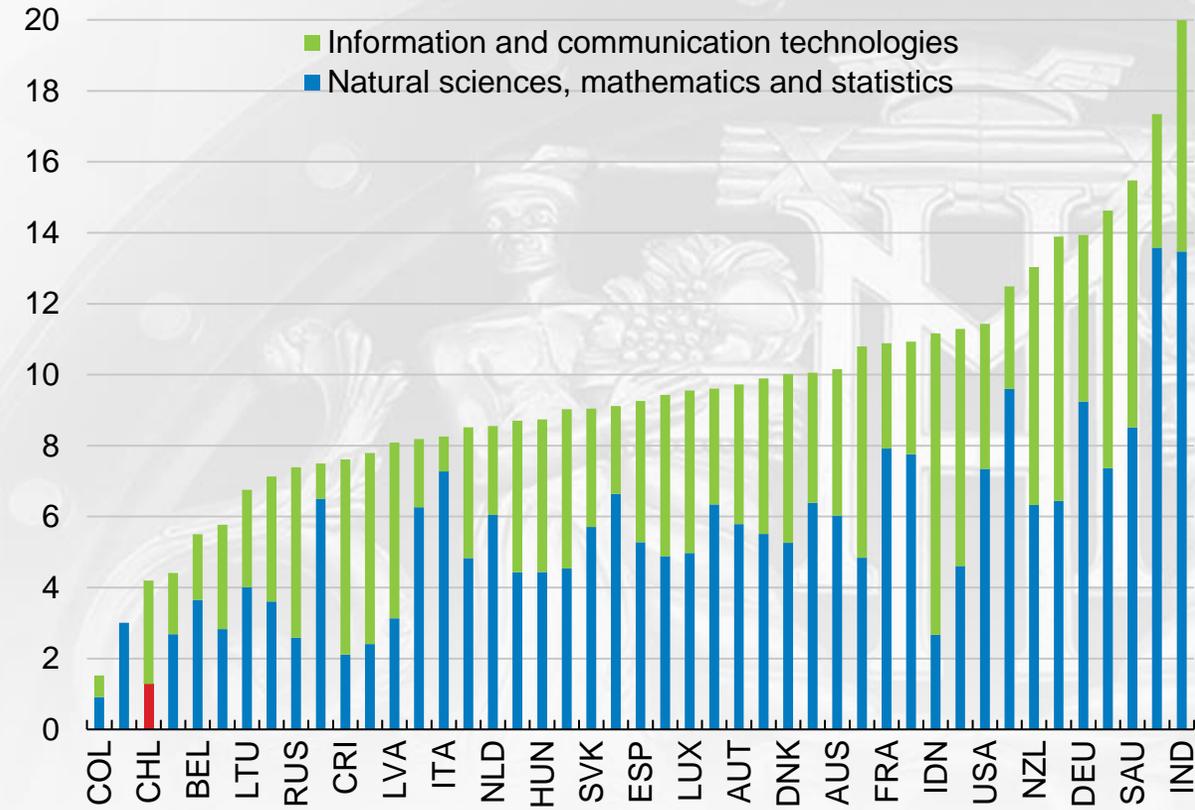
Growth, Productivity and the Green Economy

Improving productivity: There're some gaps to close in terms of digital transformation. Chile lags other countries in fixed broadband subscriptions and digital areas ICT tertiary-educated workers.

Broadband subscriptions
(Subscriptions per 100 inhabitants, Jun-21)



Tertiary graduates by field: IT and STEM
(% of all graduates, 2017 or latest year available)



Chile is committed to confronting Climate Change. The goals are ambitious, but significant changes are already being observed in the energy matrix.

Regulatory Framework

- **Framework Law on Climate Change** : setting goals, institutions and tools.
- **Energy Efficiency Law**: focus on the industrial, mining and transport sectors, in order to reduce emissions by 2% per year.

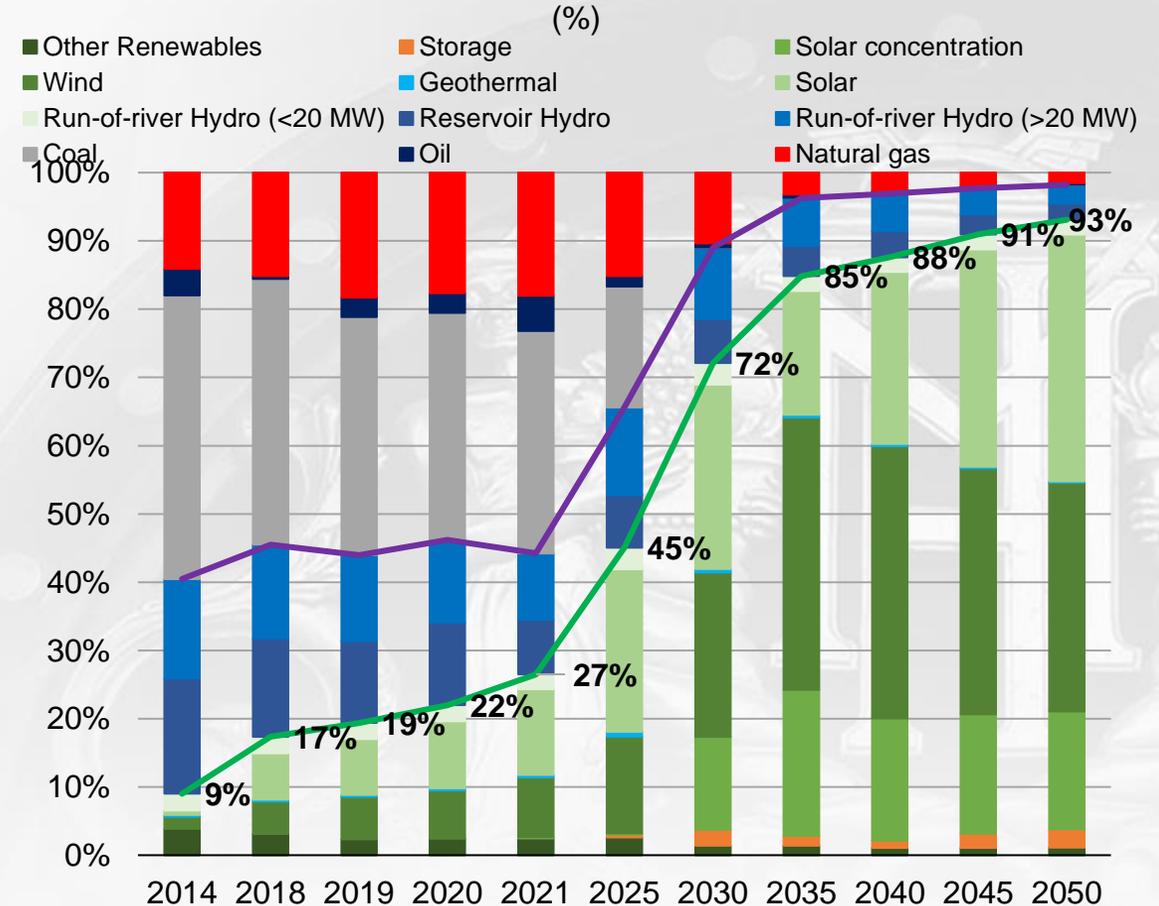
Objectives and Goals

- **NDC 2020.**
- Chile committed to a gross carbon budget of no more than 1,100 MtCO₂eq for the period 2020-2030, reaching a peak in 2050, and a level of 95 MtCO₂eq in 2030.
- Others: reduce at least 25% of carbon emissions by 2030; sustainable management and recovery of 1,100 hectares of native forest by 2030; creation of marine protected areas.
- **Long-Term Climate Strategy, with goals to 2050.**

Public Policies

- **Long-Term Energy Planning**: every five years, in order to foresee long-term scenarios (30 years).
- **Electromobility Law.**
- **National Green Hydrogen Strategy**:
 - (i) Domestic consumption.
 - (ii) Transportation and export.

Energy matrix and NCRE participation



Within the Financial Strategy against Climate Change, the issuance of **Sustainable Linked Bonds** (NDC commitments) was incorporated.

- The financial cost of an instrument like this depends on the achievement of the sustainability goals associated with the instrument → It implies aligning efforts at the country level to meet the goals and avoid a financial penalty.

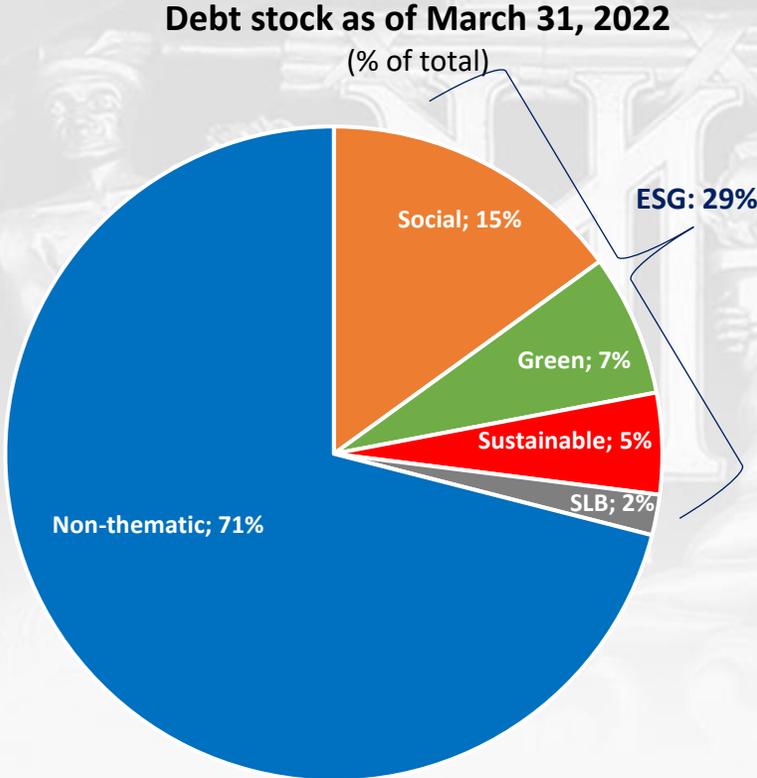
Meanwhile, the Thematic Bonds have made it possible to direct resources to **Green, Social and Sustainable objectives**, that is, to specific projects that meet ESG criteria.

- Today almost 30% of the debt stock meets ESG criteria.
- Certified green sectors are mainly clean transport.
- The social ones are aligned with the UN Sustainable Development Goals.

The Ministry also channels resources to green projects with a local line in the **Green Climate Fund**.

- 5 projects in execution (US\$417 million in financing), one public (CONAF/FAO).

The Ministry will study the "responsible investment" of Sovereign Wealth Funds, being able to incorporate sustainability criteria.



Source: Ministry of Finance.

National Carbon Market: Chile has a "Green Tax" since 2017 and a compensation system will be implemented in 2023.

The role of the Ministry of Finance:

- Anticipate the implementation and opportunity of a new reform (oils, upstream taxes, increase in carbon prices, other instruments, collection recycling, carbon adjustment at the border).
- Coordinate for a correct implementation of a mixed system of carbon price instruments.

Fiscal framework for measuring public spending on climate change: Objective is to measure progress in the implementation of public policies associated with climate change mitigation and adaptation.

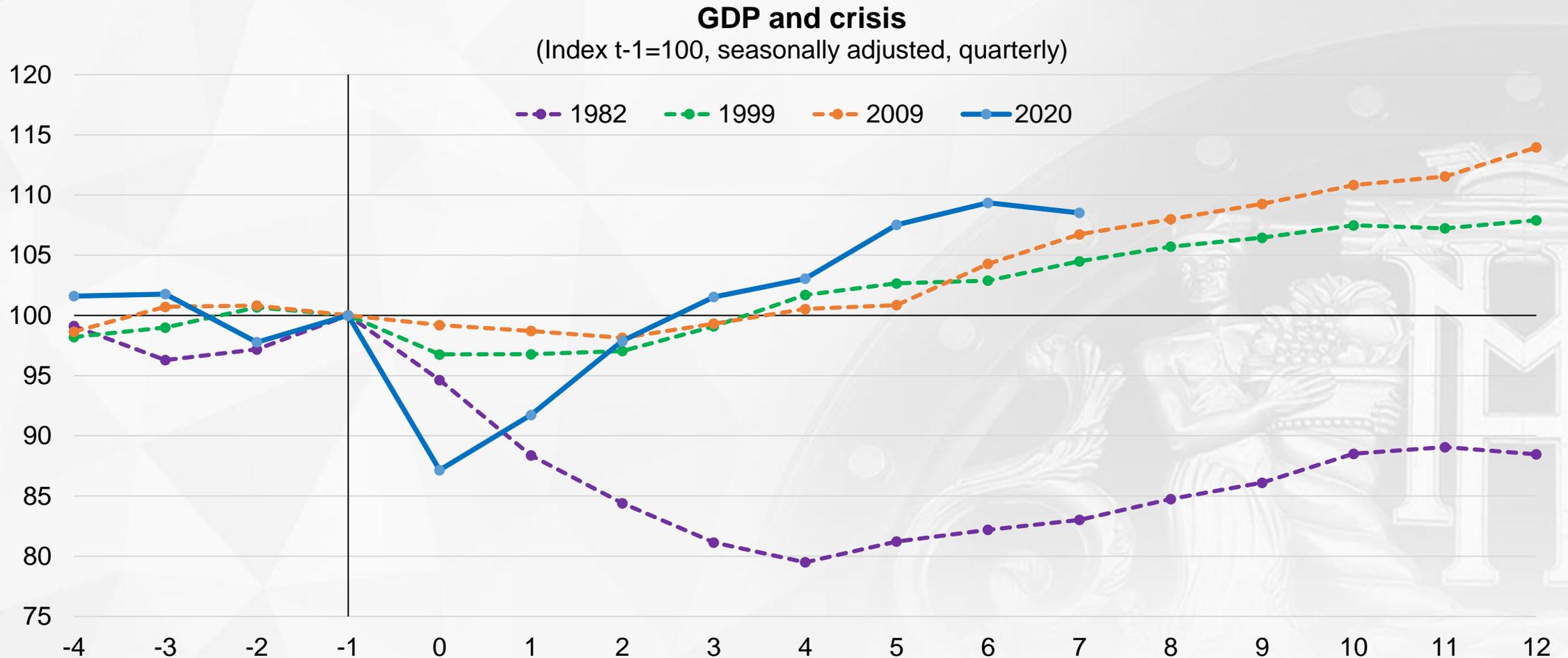
- Work has been done in direct coordination with the Budget Office (DIPRES).
- The result obtained has been the institutionalization of a fiscal framework for the reporting of public spending on climate change in the Budget Law and the Framework Law on Climate Change.
- This project has made it possible to generate elements that facilitate the discussion on climate spending.

Green Taxonomy: Seeks to identify environmentally sustainable economic activities, which are the key to mobilizing investment.

- The Preparatory Committee for the development of the environmentally sustainable economic activities will work during 2022 to lay the foundations for its preparation.
- Members: Ministry of Finance, Ministry of Environment, Central Bank of Chile, Financial Markets Council and Pension Superintendency.

The economic environment

Chile recovered from the Covid-19 crisis faster than in previous episodes

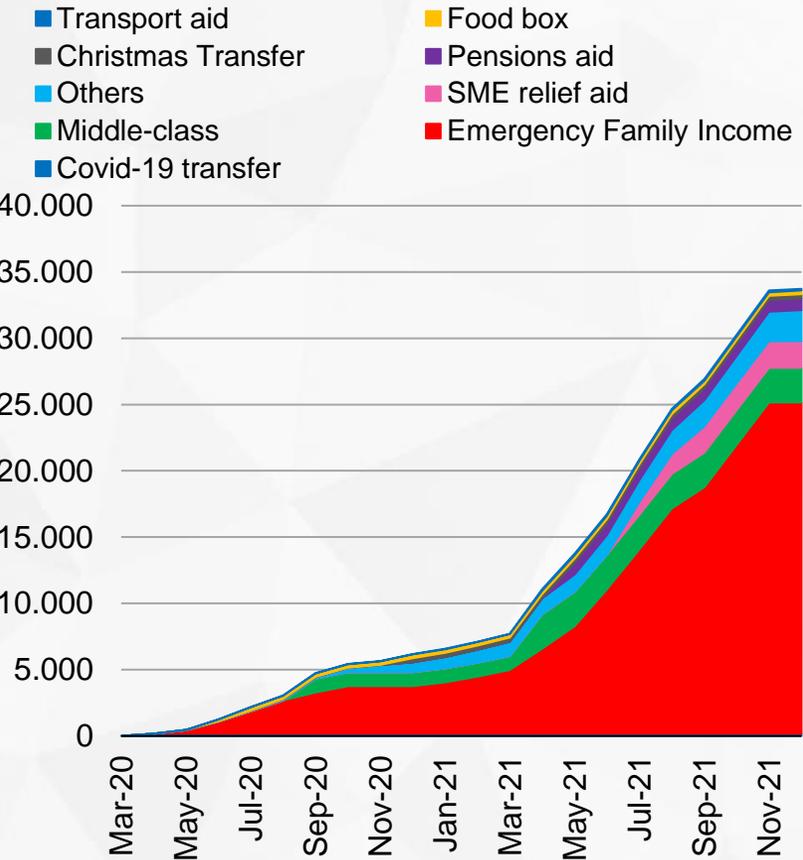


Note: T=0 in periods 1981.Q4, 1998.Q4, 2008.Q4, 2020.Q2 Official seasonally adjusted spliced series for all periods except 1982-83. For that period, the series contained in the volume “Economic and Social Indicators 1960-1988” was seasonally adjusted.

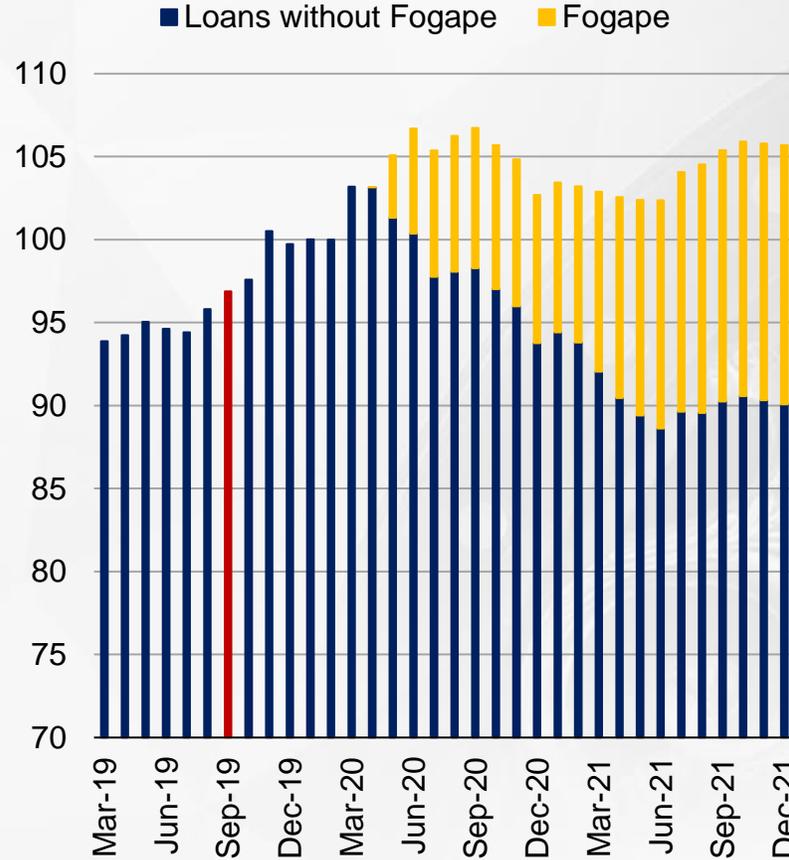
Source: Central Bank of Chile.

Fiscal transfers, accommodative monetary policy, and pension fund withdrawals largely explain a consumption-led recovery

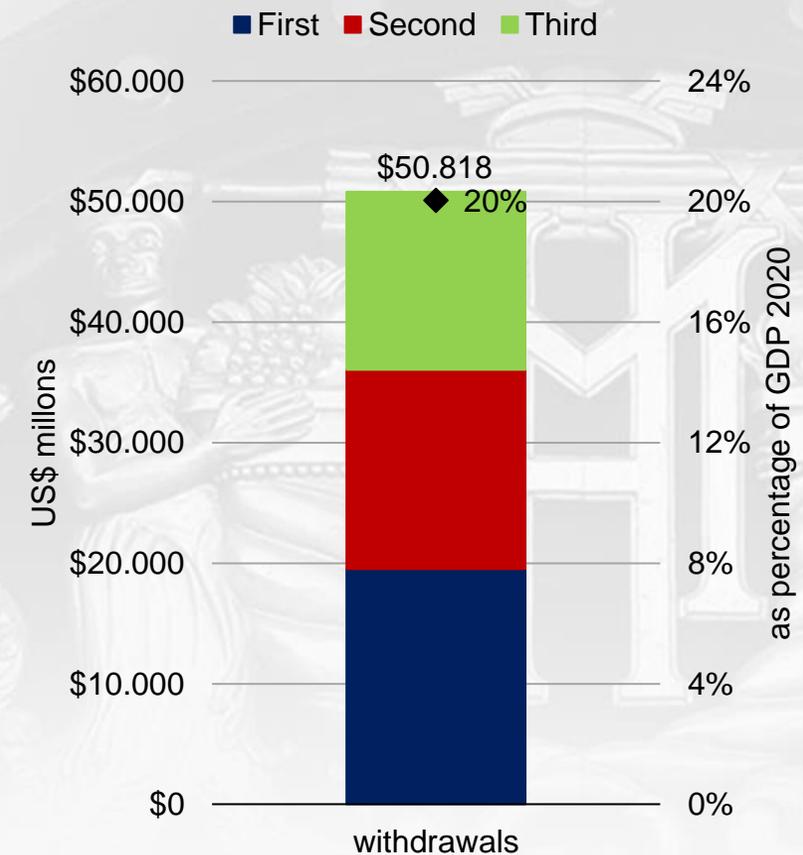
Covid-19 Fiscal Measures
(US \$ million)



Real commercial loans balance
(index, Feb-20=100)



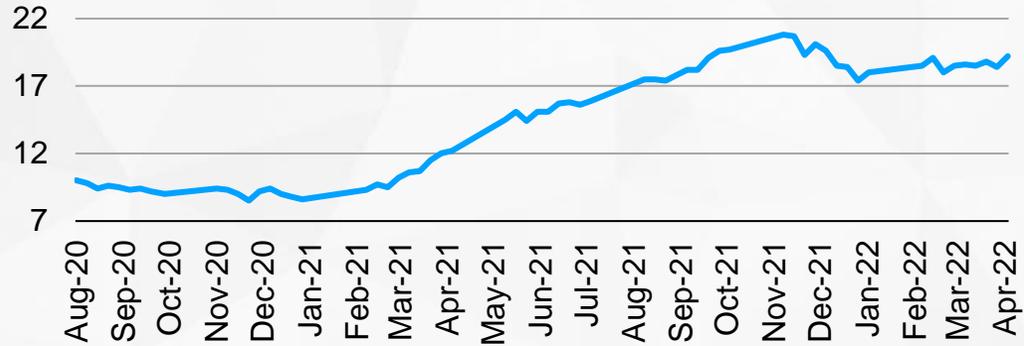
Pension funds withdrawals
(US\$ millions and % as GDP 2020)



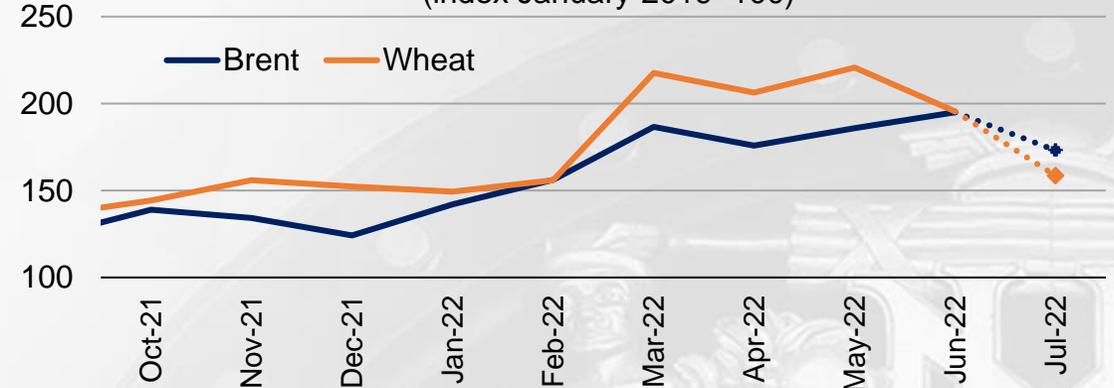
Note: The amounts are in dollars, considering an exchange rate of 800 pesos per dollar. The amounts were updated as of March 25, 2022, the latest report reported by the Pensions Supervisor.
Source: Central Bank of Chile, Pensions Supervisor, and Ministry of Finance.

Four drivers of Inflation: post-pandemic bottlenecks, high private consumption, increase in commodity prices, and exchange rate depreciation

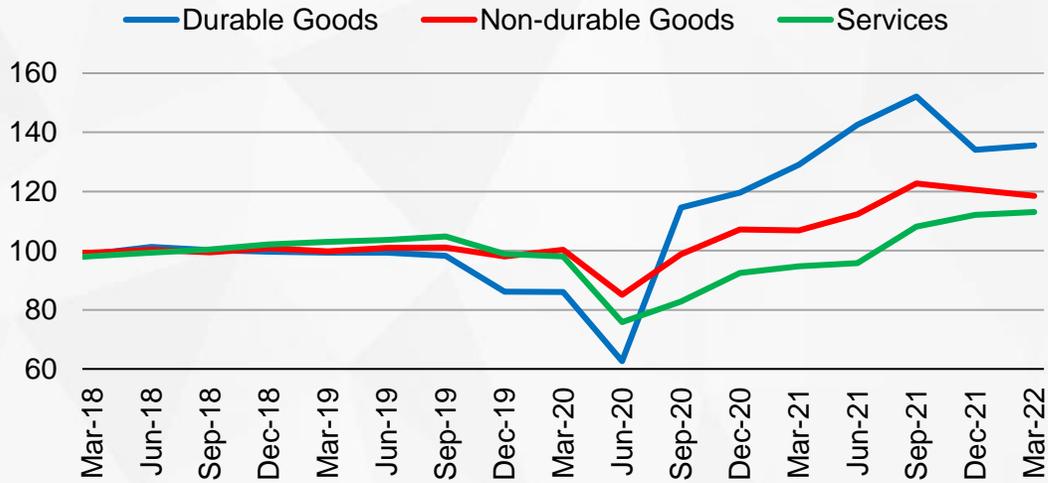
US: Foreign supplier delays
(Days)



Commodity prices
(index January-2019=100)



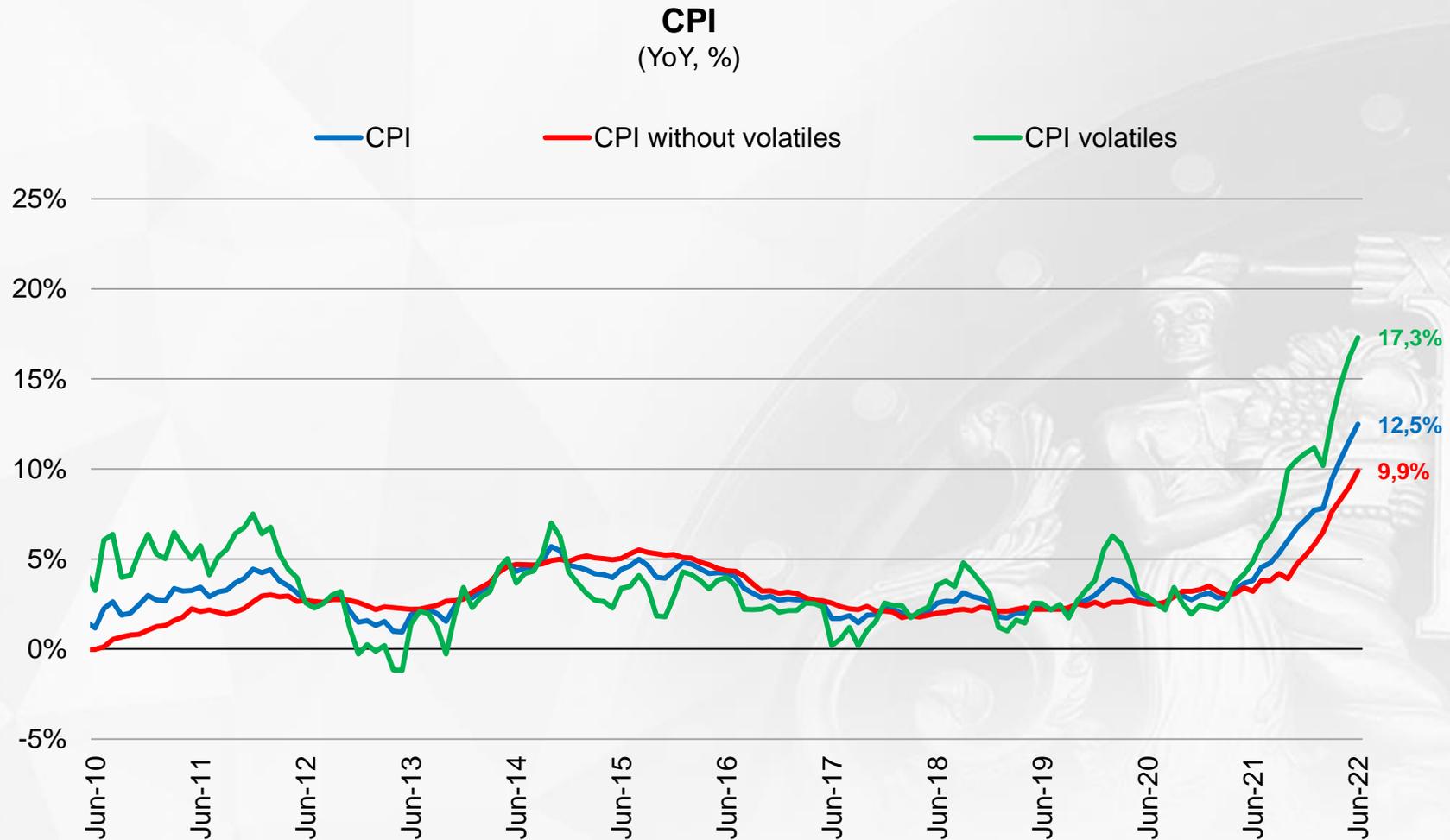
Private consumption
(Index, 2018=100, sa)



Exchange Rate
(pesos per dollar)

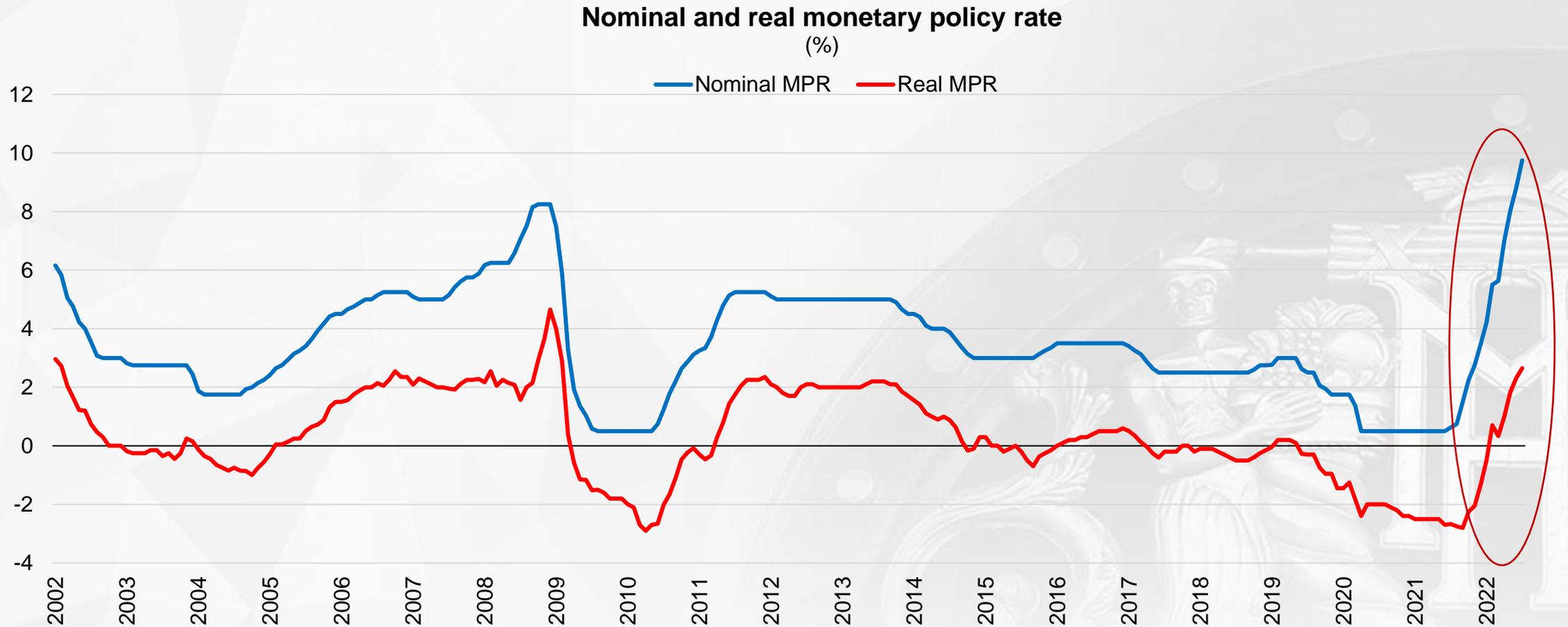


Inflation stands well above the policy target. Currently, inflationary pressures are driven primarily by food and energy prices.



Source: INE and Central Bank of Chile.

The monetary policy adjustment began in 2021. The Central bank responded on time, rapidly increasing the Monetary Policy Rate (MPR).

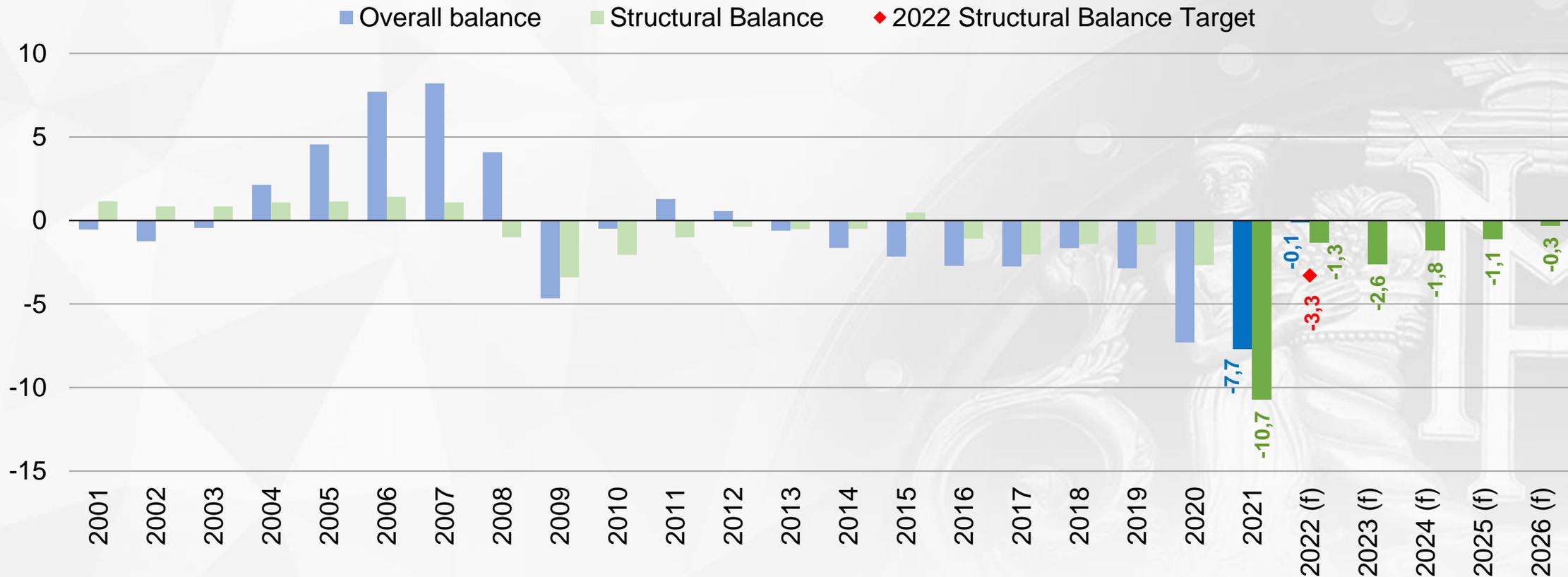


Note: The nominal MPR series shows the average of the month. For July 2022, the nominal MPR is the rate decided in the last Central Bank monetary policy meeting (9.75%). The real MPR measure considers 11-months-ahead inflation expectations from the Economic Expectations Survey (EES).

Source: Central Bank of Chile.

After a historically high deficit caused by the Covid-19 crisis, fiscal accounts have undergone substantial consolidation in 2022, which should continue until 2026

Central Government Fiscal Balance
(% GDP)

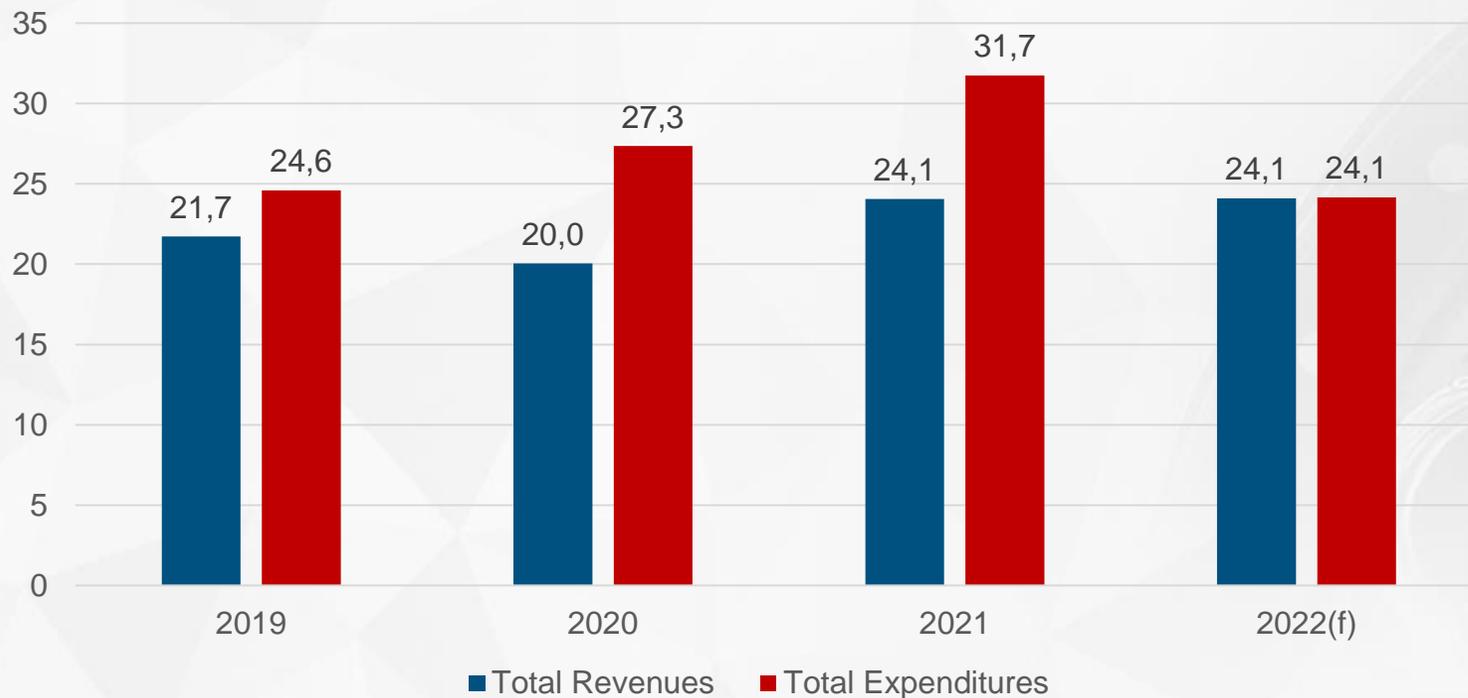


Note: (f): forecasts. Between 2022 and 2026, green bars show the 2Q22 Public Finance Report projections. The fiscal policy decree establishes a structural balance target of -3.3% of GDP for 2022 and -0.3% of GDP for 2026.

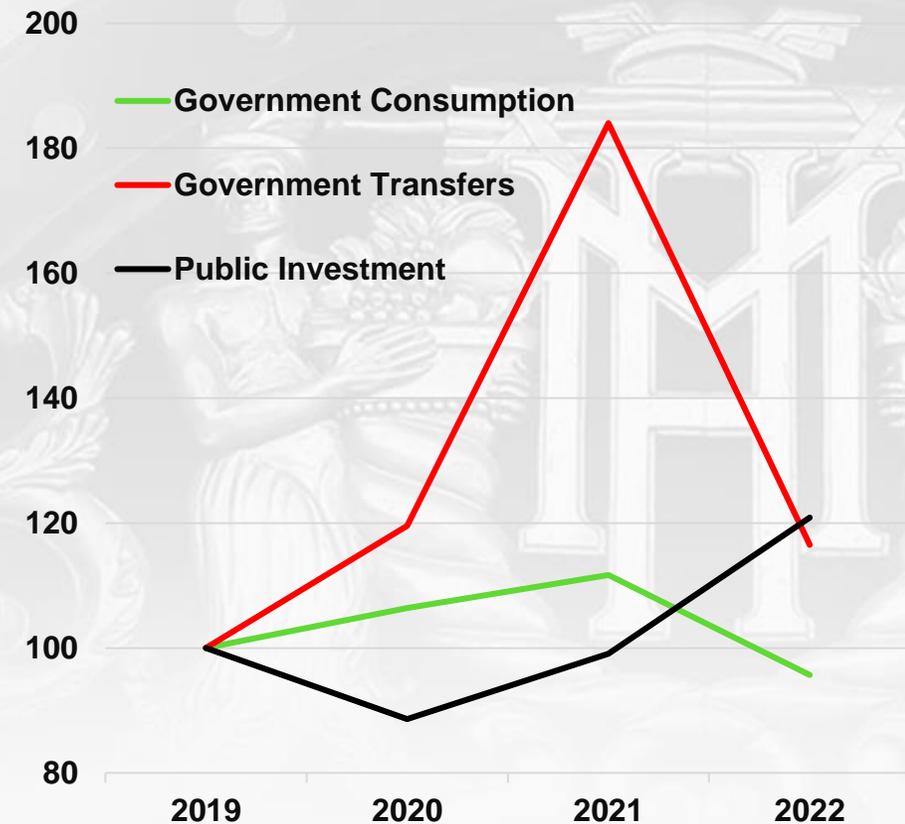
Source: Budget Office (Dipres).

Government is contribution to macro stability by substantial fiscal consolidation. 24% cut in real expenditures and better performance of revenues from yearly tax submissions in 2022. The process will extend to 2026, with annual structural targets

Central Government Total Revenues and Expenditures
(% GDP)



Government Expenditure
(index, 2019=100, constant prices)



The fiscal policy framework includes an anchor for the prudent level of debt over the medium term of 45% of GDP.

Central Government gross debt
(% of estimated GDP each year)

--- PFR 1Q22 — PFR 2Q22

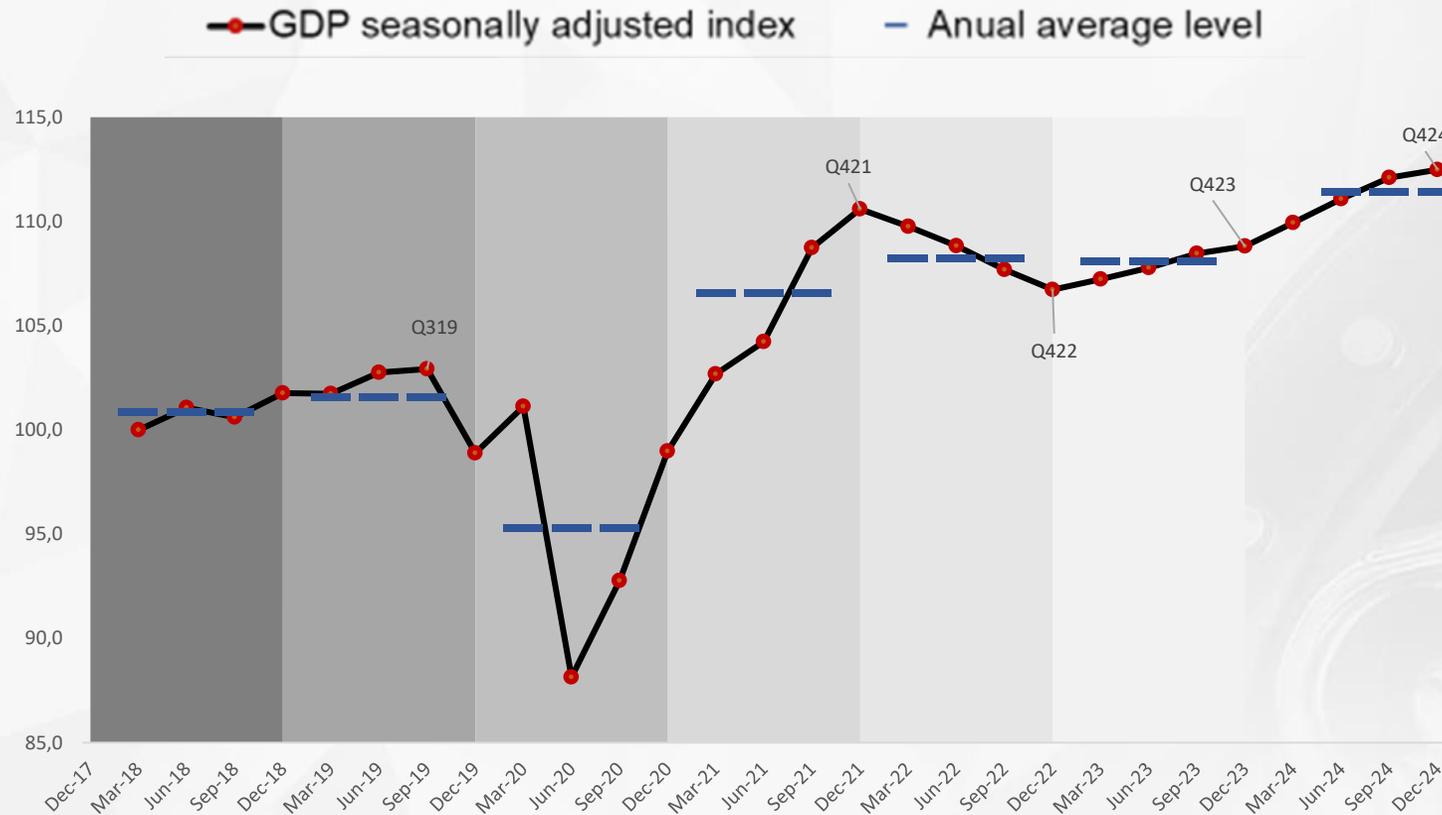


Note: (f): forecasts. PFR: Public Finance Report.

Source: Budget Office (Dipres).

After cooling off in 2022, economic activity will begin to recover across 2023 and 2024

GDP
(Index Q1 2018=100, seasonally adjusted)



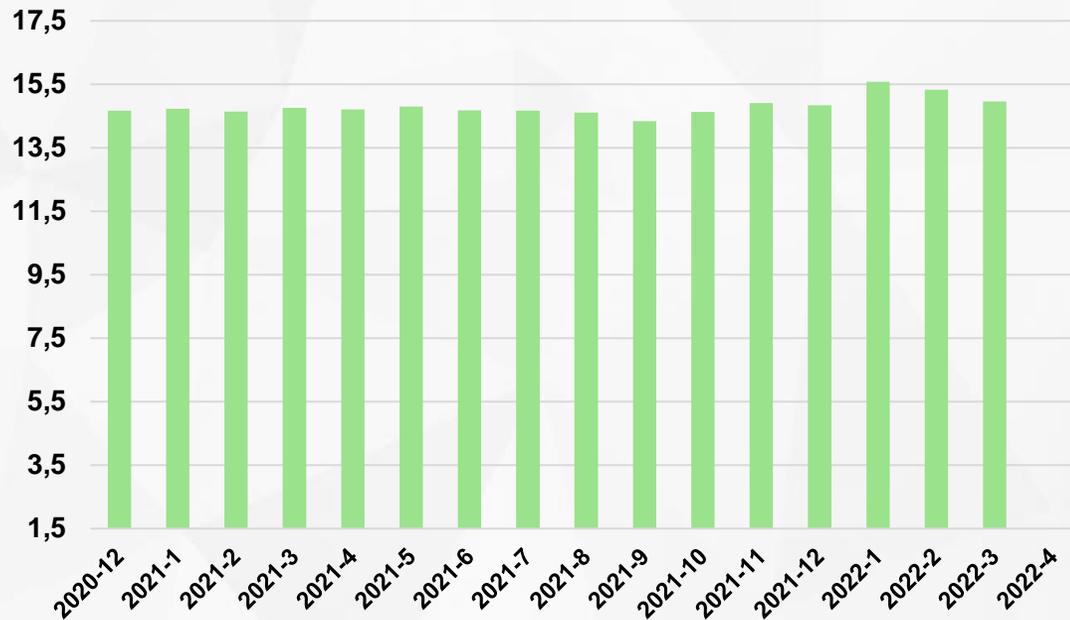
Q2 2022 Public Finance Report forecasts

	2022	2023	2024
GDP (YoY % change)	1.6	-0.1	3.1
Non-mining GDP (YoY % change)	2.3	-1.4	3.0
Domestic demand (YoY % change)	1.3	-4.0	3.2
CPI (YoY % change, average)	11.1	5.4	3.0
Exchange rate (\$/US\$, average, nominal)	854	836	810
Copper price (US\$/lb, average, BML)	419	392	387
Oil price, WTI (US\$/bbl)	102	87	75

Source: Central Bank of Chile and Ministry of Finance.

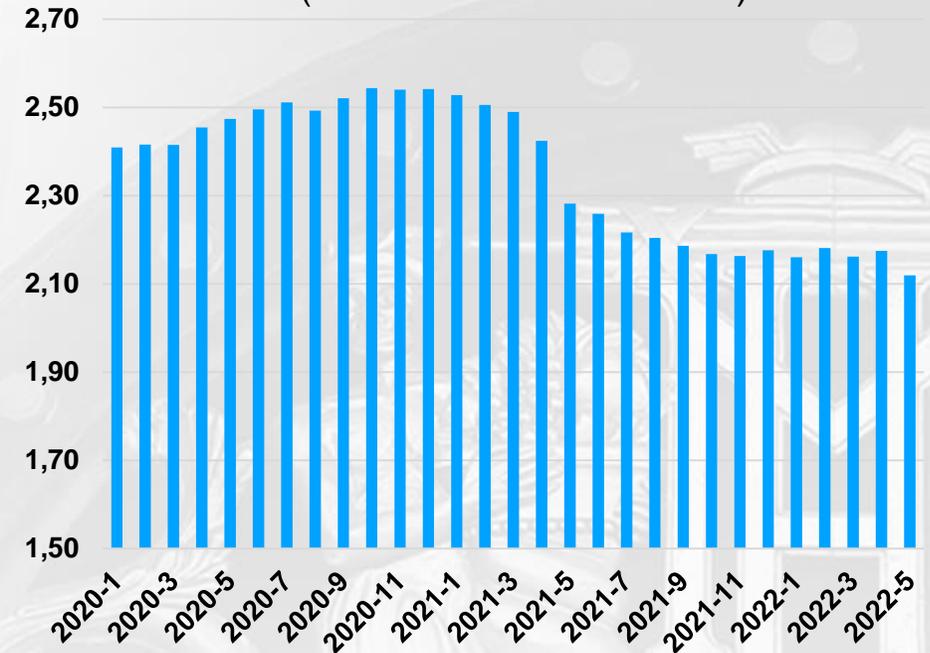
Financial stability: solvency and provisions of the banking system

Solvency: Capital Adequacy Ratio
(Effective equity / Risk-weighted assets, %)



- The Capital Adequacy Ratio, according to Basel III, is estimated at 14.96% of the Risk-Weighted Assets in March (regulatory requirement of 8.625%)
- Bank capital —measured by the effective equity—amounts to more than US\$ 42 billion, equivalent to 14% of GDP. Assets managed by banks in the last twelve months represent US\$ 443 billion (149% of GDP).

Bank provisions
(Provisions/Loans index %)



The reduction of credit in the last year has determined a decrease in the provisions index in Chile, already considerably lower than its Latin American peers. However, a recovery is anticipated, as liquidity in the system decreases and defaults eventually increase.

Financial stability: exposure to FX risk

Banks

- Banks maintain an active management of their foreign exchange position, generally staying hedge, which mitigates currency risks

Insurance companies

- Insurers have sources of liquidity (via debt or sale/collateralization of liquid assets) to meet the additional demands generated by potential increases in the exchange rate.

Corporate

- The level of corporate exchange mismatch has remained negative —net asset position in dollars.
- Higher external bond issuance comes from companies whose functional currency is the dollar

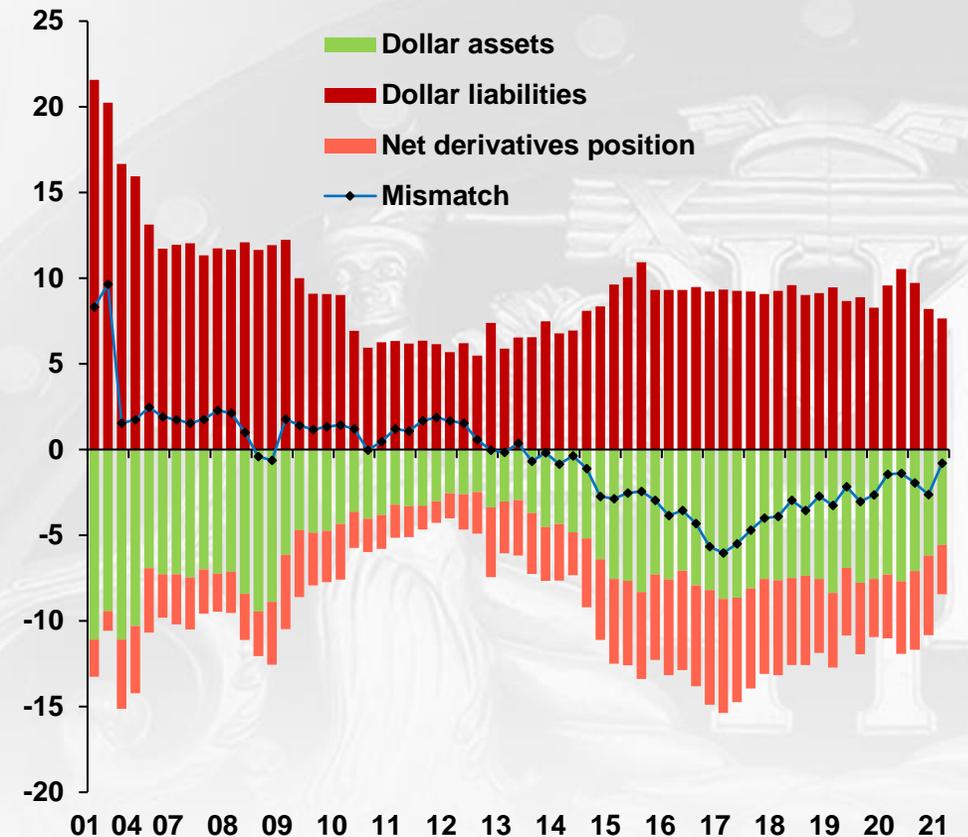
Households

- Households do not hold USD liabilities

Government

- Government is regularly in FX surplus due to the importance of copper revenues

CORPORATE CURRENCY MISMATCH (*) (percent of total assets, pesos)



Mismatch refers to dollar liabilities minus dollar assets, minus net derivatives position, as percent of total assets.

Source: Central Bank of Chile and CMF

Closing Remarks

As suggested by attitudes towards the Constitutional Referendum, even after three years from the social crisis, a large majority of the population wish for an institutionalized, ordered and effective change

Chile will continue being an open, market-based economy, and its future development will depend crucially on successfully completing the institutional, productive and economic transitions

The reform agenda responding to people's expectations is moving ahead, step by step

Economic policy should be an enabler of change, securing the sustainability of structural reforms. This should translate into well-functioning markets, economic stability and fiscal discipline

Many challenges lay ahead. Common purpose, dialogue and trust will be essential to face them



Chile at a Crossroads: Finding its Path to Inclusive Development

Columbia University

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