Chile case study:

The application of a fiscal rule in the copper sector

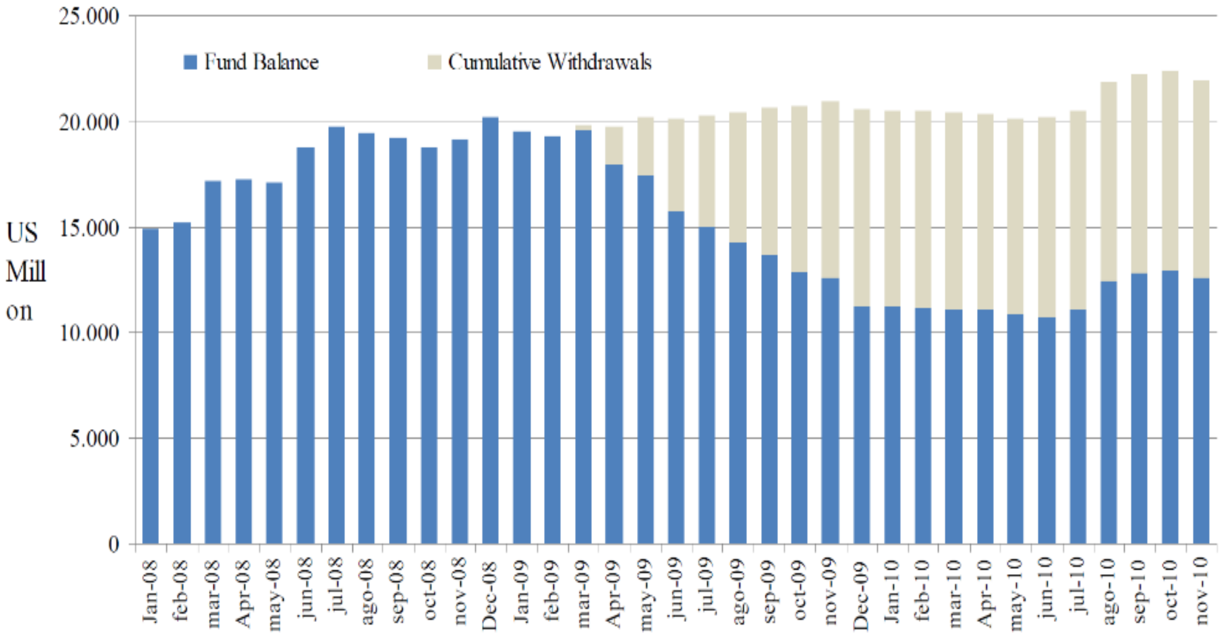
Overview

Chile is the leading producer of copper globally with the related industry accounting for half of its foreign exchange earnings and about 16% of Chile's revenue and hence sensitive to global resource related shocks. Chile regrettably endured a protracted period of military dictatorship from 1978, culminating in a fledgling democracy in the late 1990s which inherited hyperinflation, a bankrupt government, a failed banking system, dwindling FDI and very poor approval ratings from the population. In the early 2000s, in response to concerns about the overly discretionary national and subnational budgetary process, **Chile voluntarily introduced a fiscal rule** that stipulated (1) a structural surplus budget target must be set and (2) the government may run a tightly managed structural budget deficit.

The fiscal rule originally set a budget target of a surplus of 1% of GDP and sought to achieve three objectives, namely (i) recapitalize the central bank, after bailing out the private banking system in the 1980s; (ii) fund some pension-related and other liabilities; and (iii) service net external dollar debt. In 2006 to bolster the management of public finances, **Chile enshrined its fiscal rule in the Fiscal Responsibility Act**. Amongst other institutional reforms, the Economic and Social Stabilization Fund (the 'Fund') replaced the pre-existing SWF, and sought to protect the economy from price shocks with counter cyclical savings made in times of high commodity prices. A key element of the seemingly rigid fiscal rule, that gave flexibility to the government to deal with unanticipated shocks, was the allowance for a budget deficit, but under strict conditions related to long run output and medium term commodity prices.

Operationalisation of the fiscal rule involved **independent oversight** by two panels of experts from mining companies, the financial sector, research centres, and universities who monitor the output and commodity price movements. Each panel had the responsibility to bi-annually make the judgments regarding the output gap and the medium term equilibrium price of copper, respectively. The government then transparently converted these judgements, combined the tax and spending parameters, into the estimated structural budget balance.

Figure 1: The Economic and Social Stabilization Fund - a stabilization fund that stabilizes



Source: Velasco, 2011

Saving in good times to afford a counter-cyclical approach

From 2006 to 2008, the combination of **high copper prices** and **adherence to the statutory fiscal rule**[1] enabled the Government to accumulate large surpluses in the Fund – reported to be USD 13 billion (Velasco, 2011). The fiscal rule was strictly followed, even in some periods when the Minister of Finance was under great political pressure to increase expenditure. However in 2009 when commodity prices and related revenues started falling, the accumulated balances in the Fund facilitated large stimulus injections into the economy ("Cumulative Withdrawals" in Figure 1)[2], - without threatening its debt stability or its global bond ratings - when the effects of the global financial crisis peaked and the copper prices plummeted[3].

Questions for discussion:

Based on the information provided in the case study above, consider the following:

1. What are the relative benefits of enshrining the fiscal rule in strong institutional frameworks compared to more discretionary approaches, especially in times of revenue windfalls?
2. What are the challenges of implementing rigid fiscal rules, especially in low income countries, and what can be done to overcome some of the barriers?

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[1] The fiscal rule during that period stipulated that between 0.2-0.5% of GDP would be deposited into the pension fund, a discretionary 0.5% of GDP would be used to recapitalise the central bank (for up to five years) and the balance of any surplus above 1% would be accumulated in the Economic and Social Stabilization Fund

[2] Velasco, A. (2011), *Fiscal Policy in an Emerging Market Economy*. Harvard, March 2011.

[3] Frankel, J. (2011), *A Solution to Fiscal Procyclicality: the Structural Budget Institutions Pioneered by Chile*, Journal Economía Chilena (The Chilean Economy), Central Bank of Chile, vol. 14(2), pages 39-78, August 2011.