Box 2. Chile's economic reform programme

Chile's GDP per capita is close to USD19,000 PPP, the highest in Latin America, but recent social movements in the country reveal unmet demands in education, healthcare and policy. To face these issues, the current administration headed by Michelle Bachelet has proposed a tax reform which seeks to raise revenues by 3% of GDP. Concurrently, the first bills to conduct a reform of the education system have been submitted to Congress. In addition to the latter, to support growth and tackle the sluggish productivity of recent years[1] (Magendzo and Villena, 2012), agendas were also launched to improve competitiveness, reduce energy costs and strengthen workers' bargaining ability, and which will become future bills.

Tax reform: A commitment to redistribution and higher revenues, but uncertainties remain over the impact on savings and investment

The goal of the tax reform is to permanently increase revenues by an amount equivalent to 3% of GDP, to finance higher public savings (converging toward a structural balance of 0% of GDP in 2018), education reform and higher healthcare spending. Furthermore, policymakers are considering making the tax system more progressive, to help reduce inequality. Chile has the OECD's highest level of income inequality[2,] and recent studies have revealed that the tax system would appear to be regressive[3].

Chile's current tax system is integrated, that is, taxes paid by companies serve as a credit toward the taxes paid by their owners or shareholders. Income from capital and labour is subject to the personal tax called "Global complementario", which has a rising marginal rate from 0 to 40%. Non-distributed after-tax profits are recorded in the Taxable Profits Fund (Fondo de Utilidades Tributarias / FUT), and may be reinvested in the company. There is no limit on the number of years profits may remain in the FUT before being distributed (when they are subject to individual income tax), nor by a minimum amount that must be withdrawn each year. According to Ministry of Treasury estimates, there are USD250bn in company FUTs.

In essence, the original bill submitted to Congress included a rise in the corporate tax rate from 20% to 25%, and the payment of taxes on an accrual basis (attributable income) instead of on a cash basis (received income). This would lead to the elimination of the FUT, which was introduced as an incentive to reinvest company profits in the mid-1980s. The top marginal individual income tax rate would also be reduced from 40% to 35%. That said, this would end up taking the tax rate for the owners of companies with the highest incomes to 35%, after having enjoyed effective tax rates of close to 20% (Table 1, second column). The main concerns included the negative impact this might have on savings, investment and, consequently, on long-term growth. On another note, there were concerns over the effects on the real estate and construction sectors, and over the reduced support for SMEs. As a compensatory way of supporting investment, the bill included an instant depreciation benefit, but only for physical investments. Also questioned was the impact the reform would have on the wine and beer industry and on the financial markets, as time deposits were markedly favoured over other instruments.

3: Magendzo, Igal and Marcelo Villena (2012). "Evolution of Total Factor Productivity in Chile," Technical Report, Adolfo Ibáñez University, March.
4: OECD (2014), Society at a Glance 2014: OECD Social Indicators, OECD Publishing.
5: See Fairfield, Tasha and Michel Jorratt (2014). "Top Income Shares, Business Profits, and Effective Tax Rates in Contemporary Chile." ICTD Working Paper 17. See also Agostini, Claudio (2012). "An Efficient and Equitable Reform of Income Tax in Chile," in the book "Criteria for Tax Reform," CEP-Cieplan.

All in all, since the end of 2013, the Chilean economy has seen a marked slowdown, a considerable drop in investment and a significant fall in business expectations. While we acknowledge that external factors are central to explaining this dynamic, the role played by the uncertainty generated by the debate on the tax reform was also clearly important.

Within this context, on 8 July, the government and the opposition signed a Protocol of Agreement (summarised in column three of Table 1), which seeks to mitigate the negative impacts of the reform on savings and SMEs, without changing the revenue target of 3% of GDP nor the above-mentioned destination of the resources. The main changes include: (1) the attributable income system for corporate taxes with a rate of 25% becomes optional, and a partially-integrated system with a business tax rate of 27% is added, with the option to use 65% of the tax paid by the corporation as a credit toward individual income; (2) a series of new measures which favour SMEs and the reinvestment of profits; (3) the measures that affect the real estate market are reduced, but not eliminated.

The changes agreed to in the Protocol are on the right track, but questionable elements still remain. The effects on the real estate market and on savings are mitigated, and greater benefits provided to SMEs, but the adverse impact on investment would be maintained. For example, under the new semi-integrated regime, the final tax rate would come in above 40%, which is high in international terms. Furthermore, there is some uncertainty over the ability to collect 3% of GDP, which could imply a sacrifice in public savings, in spending associated with education reform and/or a new tax adjustment in the future. Additionally, there are the concerns over the rises in the tax on alcoholic beverages and on imported diesel vehicles, which could violate the country's double taxation agreements.

Education reform: Doubts over whether the focus on raising quality is sufficient

There are currently three bills before Congress which constitute the first part of the Education reform, notably the bill that introduces changes to school education.

There are three major types of schools in Chile: municipal (public and local government), subsidised private (run by for-profit or non-profit corporations, which receive a government subsidy but also often collect a co-payment from the parents), and paid private. Since a few years ago, subsidised private schools have attracted the highest number of students, accounting for close to 50% of enrolments. Eighty percent of these schools have admittance requirements for students, such as selection tests and parent interviews.

The bill mainly targets subsidised private schools, and seeks to modify their operations in three aspects: (1) elimination of required monthly co-payment from parents, with the goal that the operations of all these schools be 100% subsidised by the state within 10 years, and that they be free for families; (2) elimination of the for-profit category, requiring all corporations to become non-profit entities within a maximum period of two years, and with a maximum 12-year period for the state to become owner of the properties; and (3) elimination of the selection criteria, whether tests, parent interviews or other, introducing a random assignment of places in the event of excess demand.

The education reform has the potential to increase human capital in the long term and, consequently, Chile's productivity and investment appeal. That said, the main criticism is that the proposals put forward do not necessarily imply a rise in the quality of education, but rather focus mainly on the ownership of the means of education. However, this bill has not yet been debated in Congress, and thus may be amended, as was the tax reform. Furthermore, in accordance with the commitments of the government's programme, there are still issues outstanding, such as the strengthening of public education and the changes to higher education.

Energy and competitiveness agendas point in the right direction, but remain to be specified, together with the labour reform

Some of the challenges in Chile's energy sector are the high costs of generation, the scarce competition, the low diversification of energy sources, the high reliance on international markets and the problems with connectivity. The Energy Agenda deals with these problems with a proposal based on seven pillars, which features measures such as the strengthening of the state oil company (ENAP), a higher share of LNG in the power grid, decentralised development of non-conventional renewable energies, a greater role of the state in matters of energy efficiency education, development of a regulatory framework for connectivity, increasing energy infrastructure and the creation of agencies for civic participation.

With respect to the Competitiveness Agenda, a number of sectors have found it valuable. In particular, it covers aspects such as increasing joint public-private action, intensifying support for SMEs through state funds, encouraging the generation of clusters, proposing the creation of a large-scale port together with an improvement in the operational logistics of the country's current ports, and establishes a commitment by the state to protect free competition, among other factors.

The main concern over both agendas is that, for the time being, the measures have only been announced, and the details of the bills that will implement them are yet to be known. In more specific terms, the Energy Agenda has been criticised for failing to make a statement on nuclear energy, for the greater role it would give to LNG, a fossil fuel that is not cheap and maintains foreign reliance, and regarding ENAP's administrative and financial capability to adopt its proposed new role. The Competitiveness Agenda has been criticised for the potential discrimination that a clusters policy might imply, and for the more political than technical position of the Committee of Ministers, who would earmark the state funds for the proposed initiatives.

The government has also considered putting through a labour reform, which centres around strengthening trade union activity and collective bargaining, measures that seek to increase worker protection but at the cost of making the labour market even more inflexible, and with potential negative effects on long-term unemployment.

Conclusion: Reforms with the potential to drive the long term, but yet to be fully defined

There may be questions over the short-term effects of the tax reform, particularly because its debate had a negative impact on expectations in the midst of an economic slowdown scenario. However, these negative effects are mitigated by the positive impact education reform could have, were it well-designed and implemented. This is why it is so important to follow the debate closely, and inform readers as to whether or not the end result will result in higher-quality education.

For their part, the energy and competitiveness agendas arose to deal with problems that have reduced the country's growth over the last years, such as higher energy costs and some difficulties smaller companies have when it comes to raising investment in their businesses. An appropriate approach to these problems would imply a vital boost to long-term growth.

Table B.2.1
Main aspects of tax reform in Chile

Measures	Current tax situation	Bill in the Chamber of Deputies (March 2014)	Agreement Protocol (July 2014)
Tax regime	Integrated (received income)	Integrated (attributed income)	Two options: I. integrated (attributed income) II. semi-integrated, 65% of the corporate tax is used as a credit toward individual tax (received income).
Company tax rate	20%	25%	I. 25% II. 27%
Taxable income for individual tax	Received income Non-distributed income goes to FUT	Attributable income Elimination of FUT Cumulative historical FUT is maintained	I. Attributed income II. Received income FUT is eliminated in both cases, but cumulative historical FUT is maintained
Top marginal individual income tax rate	40%	35%	35%
SME aid	Diverse sections of the income law which enabled companies to not pay taxes	Mainly a regime for SMEs, which allowed them to use simplified accounting, together with instant depreciation of physical assets	Original project is amended to include the options to not pay tax on a percentage of reinvested profits, not pay corporate tax below a certain level of sales, and defer VAT payments for up to two months.
Sin taxes	Rate of 15 or 27% for alcoholic beverages Rate of 13% for non-alcoholic beverages Tax on cigarettes by amount and ad valorem	Rate of 18%, +0.5% per degree of alcohol in alcoholic beverages Rate increase to 18% for high-sugar non-alcoholic beverages Increased cigarette tax rate at specific component	Fixed rate of 22.5% on wine and beer, and 18% +0.5% per degree for all other alcoholic beverages 18% for high-sugar non-alcoholic beverages and 10% for the rest Higher cigarette tax at specific component and reduction at ad valorem component
Real estate sector	Credit of 65% on Construction VAT for homes valued at less than UF[4]4,500(approx. USD200,000), with a limit of UF225(approx. USD10,000) Exemption of VAT intermediate stages prior to final consumer sale Exemption of tax payment on capital gains	Credit of 65% on Construction VAT limited to homes valued at less than UF2,000(approx. USD87,500), with a limit of UF100(approx. USD4,400) VAT on frequent home sales (more than one per year) Capital gains tax on homes sales by individuals owning more than one property.	Credit of 65% on Construction VAT limited to homes valued at less than UF2,000(approx. USD87,500), with a limit of UF225(approx. USD10,000) VAT on frequent home sales (more than one per year) except for foreclosures Capital gains tax on incomes of more than UF8,000(approx. USD350,000), regardless of how many homes owner possesses.
Tax on financial operations	Top annual rate of 0.4%	Top annual rate of 0.8%	Top annual rate of 0.8%, keeps current rate for mortgages
Capital gains tax	Received income Exemption for stocks with "stock exchange presence" and other instruments Exemption of tax on interest income from time deposits	Attributed income Exemption for stocks with "stock exchange presence" Broadening of tax exemption on interest income from time deposits	Received income Exemption for stocks with "stock exchange presence" Broadening of tax exemption on interest income from time deposits and similar instruments

Source: BBVA Research

4: UF accounts for “Unidad de Fomento”, an inflation index currency.

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