



The Fiscal Rule in Chile

A Teaching Case Study (Mock Up)

This case study highlights the relationship between research and fiscal policy at different levels. One of these levels has to do with theoretical-academic research at the international level (IMF & OECD) and its power to influence policy; another has to do with media analysis and pressure for policy change; a third type is government commissioned studies. We want you to place yourself in the new Chilean government in the year 2000 working on the fiscal rule. You are facing critical challenges about how to respond to the recession and regarding the nature of the fiscal rule policy. Your task is to suggest how they should respond.

Teaching Purpose: To explore the relationship between research and policy-making, and consider ways that, in the Chilean context, the new government can draw on research to guide its policy choice.

The story so far...

In 2000, the new Chilean government emphasized - as had the previous two ones - the importance of fiscal sustainability for development purposes. What was new, however, was that this particular government applied a policy innovation supported by international research: the fiscal rule. This rule requires the Central Government - by law - to post a structural (cyclically adjusted) surplus equivalent to 1% of GDP every fiscal year. The objective is that under a well designed policy, actual deficits will cancel out with actual surpluses over the long run. The fiscal rule is based on a methodology drawn from the IMF. The model drew on data from the Central Bank and economic surveys. In Chile, the key concerns are to estimate the potential output and the long term price of copper which have a significant impact on the government's budget.

In the case of Chile, a developing economy, the use of a fiscal rule has been positively assessed in international financial markets. Thus Chile's fiscal policy has increased the confidence of international financial markets, giving the country the lowest sovereign spread in the region and one of the lowest among all emerging market economies. The benefits of this reduced financing cost also accrue to private investment, and hence the economic authorities believe that this broader effect of fiscal consolidation on financing costs and aggregate demand is deemed more significant than that of a temporary fiscal expansion.

But in 2001, due to slow recovery of the economy, there were increasing demands in favour of additional fiscal action from different sectors of society (media, political, academic). First, was the argument regarding the significance and impact of the fiscal rule – the government should increase fiscal expenditure due to undesirable slow economic recovery. Second, was a more general argument that potential GDP is not estimated well by the government and thus there is more space for fiscal expenditure than the government acknowledges.

The Challenge ...

You believe the fiscal rule is critical to Chile's development strategy. But, there is increasing public and media pressure to respond to the current crisis as well as to loosen fiscal policy more generally.

Your challenge, as member of the Ministry of Finance, is to consider how to respond. You need to try to: (i) Ensure legitimacy for the fiscal rule. (ii) Respond to the criticism caused by the current economic troubles. Discuss...

What happened next?

In 2002, the government set up an independent panel of experts to estimate potential output and to estimate long term price of copper for the next years (2002-2007). The government used this independent research (by a method of averaging the different results of the different experts) to establish the structural budget for 2003. It also committed to use this approach in subsequent years. It also supported the experts' emphasis on the transparency of the approach which was seen as crucial for assuring the effectiveness of the fiscal rule.

In order to respond to the current economic slowdown and higher unemployment rate, the government changed the composition of public spending to accelerate labor-intensive public investment projects and implement a program of employment subsidies. This shows that a fiscal rule can still leave space to act 'discretionally' and effectively by accommodating policies to work as a countervailing force against economic cycles.

The transparency and credibility of the process (with the use of well-known economists) and the fact the government followed their findings led to a reduction of calls for further public expenditure. The fiscal rule became legitimated in the eyes of the relevant actors.

For more information, see the GDN case study:

http://www.gdnet.org/rapnet/research/studies/case_studies/Case_Study_39_Full.html

Questions

- How could you use research to help legitimize the fiscal rule?
- What could be done to respond to the economic slow down?
- What are the lessons for bridging research and policy?