Tax increases in Chile equivalent to 3% of GDP: undesirable consequences

The newly elected Chilean government has been moving forward with a substantial tax raise equivalent to 3% of GDP, increasing corporate tax rates to 25% from 20%, decreasing maximum individual tax rates from 40% to 35% and changing the integrated tax cash based system to an accrued based one. Moreover, a tax rule that historically allowed individuals to postpone higher marginal taxes under this integrated tax system, conditioned on the non-distribution of profits from corporations to promote reinvestment, is being revoked. The amount of these postponed individual taxable profits (FUT) is close to Chilean GDP, or US$ 280 billion, and its change will certainly imply less taxpayer freedom to determine the opportunity to pay for higher marginal individual taxes – that is, the option to postpone individual marginal taxes until resources are needed out of the company will no longer be available -. The impact on national savings and investment – private and public, where the former is theoretically replaced by the last one - is less clear cut than redistributive reallocations of income from rich to poor.

As of today, government expenditures approximate 23% of GDP (1% of GDP budget deficit), mainly financed out of taxes and dividends from state owned 1.6 million ton copper producer Codelco. The objective would be to increase expenditures on the educational sector, already the biggest beneficiary (21%) in central government budgets and gradually procure gratuitous higher education – not redistributive at all - with a bias towards state controlled providers, while regrettably signaling less freedom of choice in existing voucher educational programs that have displaced public schools.

In summary, income redistribution associated with less freedom in the use of taxable investment resources and less choice – with a state oriented policy bias - in the educational camp. Indeed, not a reassuring cohesive policy, with objectives over improving human capital that might be shared by many but with means that might be in the end damaging to the whole. The government insists workers and small and medium firms will not be affected by these tax increases, but if the biggest ones and their shareholders are so affected, there will surely be indirect effects on them, because they are part of the same economic system that will react to them trying to recover what is lost. If less liquidity and equity is available at the higher end, less liquidity and equity will inevitably be available at the lower end. Furthermore, it does not help to reach a consensus the associated sound tone of the proposed changes, perhaps as important as tax rates themselves, for the message it conveys for other incoming potential reforms.

The US$ 280 billion FUT case and its financial stability consequence: A former Secretary of the Treasury of the same governing political coalition, Mr. Velasco, has recommended charging an interest rate over FUT´s cumulative amount instead of eliminating it as a mechanism, while collecting equivalent amounts of resources. As such, each 1% interest rate would approximately collect 1% of GDP and would partially anticipate these higher individual taxes (today, 20% additional individual taxes) on a financial basis.

Besides the negative impact on private investment due to all these tax increases, FUT obsolescence might lead to a weakening capital structure. A priori, there exists a reasonable worry that resources

might no longer have the incentive to remain in corporate firms as strongly as of today if this FUT mechanism is ended. Other policies could compensate for its absence, but their significance is to be proved rather than assuming it is already proven. It is the case that non financial firms in Chile, taking as a proxy IPSA and DOW JONES listed non financial firms, have consistently been more capitalized than American ones. One important explanation – and not necessarily exclusive - could clearly be born out of this tax incentive policy that facilitates in-house financing and enables less dependence on banks and capital markets. To understand its impact, it is worth reminding that FUT policy is based on the stock of cumulative taxable resources rather than annual profits only, consequently associated with a long term investment horizon perspective, an essential element the current proposal regrettably misses.

On average, **non financial Chilean firms have shown 22% more equity to assets than American ones –** data since 2000 onwards -. When shocks do happen, those "tax resources" in the form of equity clearly help to absorb them relative to the case where those resources have either been collected by central government taxes or put elsewhere given non-incentives to remain where they were. It is a sort of trade off between higher marginal taxes today, releasing less resources from a private point of view, and lower taxes and bigger reinvested resources in-house. As the tax structure has been until today, a bigger capitalization rate was promoted and, in fact, was achieved. The resilience of Chilean firms, in a 3 decade period, should not be taken as a coincidence, and certainly not as a given fact.

Financial Leverage (Assets to Equity): IPSA more capitalized than DOW
Non financial firms; book values
Source: Bloomberg

	2000	2005	2010	2013	Average 2000 to 2013	Inverse Ratio
IPSA	2.79	2.32	2.50	2.48	***2.47***	***40.4%***
DOW	2.87	2.70	3.50	3.22	***3.02***	***33.2%***
IPSA / DOW	97%	86%	71%	77%	***82%***	***1.22***

Opposing this case is the commercial bank capital structure: Chilean banks are less capitalized than American ones. In some sense, domestic banks have benefitted from this reinforced equity position on non financial firms, and perhaps sacrificed own prudent equity levels because they were indirectly supported by its more capitalized client base. Tax incentives have proven not enough to capitalize banks and overturn powerful incentives to have less equity due to Central Bank guarantees – implicit and explicit - and other quasi equity instruments, such as subordinated debt.

Financial Leverage (Equity to Assets): Chilean banks less capitalized than US´s
Commercial banks; book values; US$ billion
Sources: US Federal Reserve, SBIF (Chile) as of March and February 2014, respectively

	Assets	Equity	Equity / Assets	US / Chile
US	14,355	1,587	***11.1%***	***1.38***
Chile	292.2	23.4	***8.0%***	

At present time, **US commercial banks have 38% more equity to assets than Chilean ones** and are operating under a Federal Reserve and US Treasury policy that has gradually become more equity demanding and will take their equity to assets ratio even higher than today´s figures.

In other words, not only private investment and savings are negatively affected, with an unknown compensation from the public sector, but the ability of the system to face shocks is being weakened.

It is naive to expect some depreciation mechanism in small firms to compensate for this structural change in tax rates and transition from cash to an accrued tax basis. The impact in big firms and their shareholders is considerable and it changes the way to conduct businesses in a very profound way and on a long term basis. It weakens the corporate equity structure and remains to be seen if those resources now under central government administration really improve human capital. Interestingly enough, even though the key reason to intend this structural change is related to human capital improvements, there is no proposal to correct its quantitative aspect via tax reliefs and expenditures to increase birth rates. It is the case that rapidly declining natural growth rates in our population, now under 1% per year, will be a big development liability and a dragging feature for pensions and health needs of the elders. By now, the 0 to 4 years cohort is already smaller by 230.000 members relative to the mid 1990´s historically largest cohort population of almost 1.5 million – incidentally, 230 primary schools would no longer be needed, assuming 1.000 student bodies -. By contrast, population over 65 years old has gone from 0.9 to 1.8 million in the same period and their human capital goes unnoticed.

The steps being taken are too important for the country´s future not to warrant a much deserved deliberative pause, along with data. A serious country cannot afford taking these steps almost blindly.

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