

BOX 3.3 Chile's Fiscal Rule—An Example of Success¹

Political pressures that underlie procyclicality of fiscal policy can be partly mitigated by the design of mechanisms (such as fiscal rules or stabilization funds) that are supported by technically sound and credible institutions (such as fiscal councils) (World Bank, 2013c). Chile presents an example of a well-designed mechanism in an enabling institutional environment.

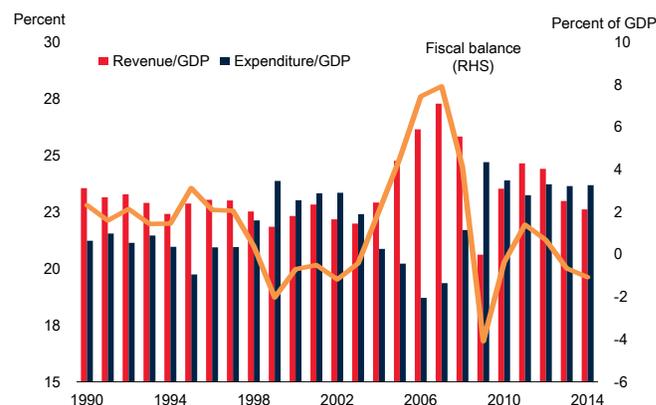
Chile is the world's largest exporter of copper. It has experienced significant macroeconomic volatility for much of its history due to terms-of-trade shocks associated with fluctuations in global copper prices. In 2001, Chile adopted a fiscal regime that was designed to break this pattern. The regime was based on a target for the structurally-adjusted fiscal balance, which adjusted the overall balance for the output gap and commodity prices. Importantly, the determination of both the output gap and the medium-term price of copper is entrusted to two expert panels, comprising representatives from both the private sector and academia, which serve the crucial role of providing unbiased projections of these key variables (Frankel, 2011). The role of the government is limited to adjusting expenditures to meet the structural balance target. The Fiscal Responsibility Law that Chile enacted in 2006 provides an institutional framework that strengthens the link between the fiscal rule, government savings, and two sovereign wealth funds—the Pension Reserve Fund and the Economic and Social Stabilization Fund (Schmidt-Hebbel, 2012a; 2012b). The law also facilitates greater transparency and disclosure in the conduct of fiscal policy.

The introduction of the fiscal regime coincided with a global copper boom, which led to steadily increasing fiscal surpluses, peaking at 7.4 percent of GDP on the eve of the global crisis (Figure B3.3.1). By the end of 2007, the government debt-to-GDP ratio had fallen to single digits. As surpluses rose, the council of technical experts stood firm against political pressures to assume that copper prices would remain permanently high and to maintain higher spending levels. Copper prices fell sharply during the Great Recession. The significant fiscal space built up over the preceding years allowed Chile to implement a stimulus package amounting to 2.9 percent of GDP. It included increases in public investment; temporary reductions in a range of taxes; and subsidies for housing, transportation, and low-income households (IMF, 2009). In part because of this fiscal stimulus, growth resumed the following year. While the recovery of the global economy was also accompanied by a rebound in copper prices, they did not return to pre-crisis levels.

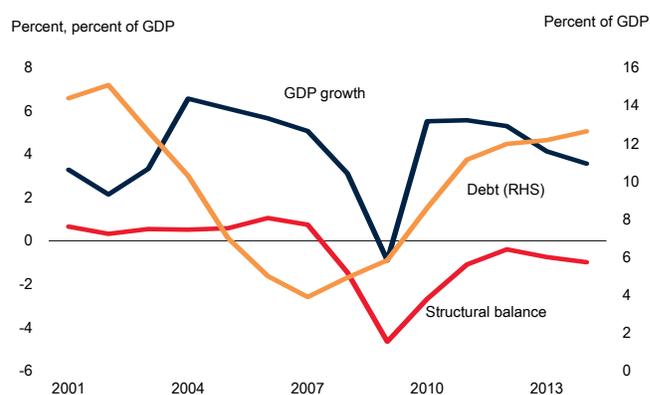
Chile's fiscal rule and its use of fiscal policy during the crisis illustrate an important limitation of the rule. Chile's rule specifically calls for a zero structural balance, and thus does not

FIGURE B3.3.1 Chile's fiscal indicators and economic performance

A. Fiscal balance, 1990-2014



B. Structural fiscal balance, government debt, and growth 2001-14



Source: World Bank estimates.

Notes: Fiscal and structural balance data are from the database described in Annex 3B. GDP data are from the World Development Indicators.

allow the implementation of countercyclical fiscal stimulus. The stimulus of 2009 was only implemented with a change in the rule after much deliberation by country authorities. Escape clauses in fiscal rules that accommodate such circumstances can thus provide valuable flexibility in dealing with low probability events and are included in recent fiscal rules (Schaechter et al., 2012).

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