Economists urge frugal Chile to rethink its fiscal policy

By Gideon Long

SANTIAGO, March 7 (Reuters) - Blessed with the healthiest fiscal surplus in Latin America but grappling with a slowdown in economic growth, the Chilean government is coming under pressure to open its wallet and spend some of its spare cash.

For years, economists have praised Chile's center-left leaders for their fiscal rectitude, applauding their commitment to save most of the country's vast copper profit for harder economic times rather than spending it for short-term gain.

But with the surplus at an historic high and economic growth at a three-year low, some say it is time for a rethink.

They say the government should relax its fiscal policy so it can spend on research and development, plow funds into education and cut corporate taxes to boost the economy -- even if that means eating into the cherished surplus.

"Like any developing country, (Chile) should develop projects that offer greater returns than those you get by simply depositing your fiscal surplus abroad," said Eduardo Orpis, an economist at Chilean consultancy Finanzas Today. "I don't see the problem."

Chile's fiscal surplus in 2006 was a whopping 7.9 percent of gross domestic product (GDP), largely due to high international prices for copper.

Chile is easily the world's leading producer of the red metal, accounting for around a third of global output.

As a percentage of GDP, last year's fiscal surplus was the biggest in the country's economic history. It was also the largest fiscal surplus in Latin America by far, where most countries are running either a deficit or a modest surplus.

The weighted average for the region is a deficit of around 1.0 percent, according to the United Nations' Economic Commission for Latin America and the Caribbean (ECLAC), based in Chile.

In dollar terms, the 2006 surplus was $11.3 billion, much of which will be stashed away in offshore investment funds.

While those funds provide a steady rate of return, some economists say more of the money should be used to rekindle economic growth, which has slowed from over 6 percent in 2004 and 2005 to an estimated 4.2 percent in 2006.

At the heart of the debate is a stringent fiscal rule, introduced in 2000 by the previous government of President Ricardo Lagos, a trained economist.

The counter-cyclical rule, designed to help Chile during an economic downturn, states that the government must produce an annual surplus of 1 percent of GDP, so long as the copper price is at its long term forecast level and the economy is growing at its underlying potential rate.

Increasingly, economists -- particularly those close to the center-right opposition -- say the government should relax the rule to give itself more wiggle room.

"When the rule was created the Chilean government was in the position of being a net debtor ... but today the situation has changed radically," said Tomas Flores, one of 20 economists who published a joint paper late last year urging the government to aim for a balanced budget rather than a one percent surplus.

"There has been a structural change which justifies a modification of the rule," said Flores, based at the right-wing Libertad y Desarrollo think-tank in Santiago.

For Rene Muga, head of Chile's Confederation of Production and Commerce (CPC), it is not simply a question of shaking more money from the piggy-bank, but of spending it wisely.

His organization has submitted a list of 12 proposals to government designed to attract foreign investment, cut specific taxes and reward innovation.

Referring to the 1 percent fiscal surplus threshold, Muga said: "If you lower it, you've got a great deal more money to spend, but you've still got to decide how to spend it."

"The state already has more than $600 million in royalties from mining and yet it hasn't spent it, because there's no clear policy on what to do with it."

For now, the government says it has no plans to alter its fiscal surplus rule, saying the country must continue to set aside money for unforeseen economic shocks in the future.

It argues that the price of copper, which still accounts for over half Chile's export revenues despite attempts to diversify the economy, is unlikely to stay as high as it was in 2006.

The government says it has already budgeted for a sharp increase in public spending this year, and points out that the central bank sees the economy growing by between 5 and 6 percent this year -- a significant recovery from last year even without a change of fiscal policy.