

The political economy of the fiscal deficit in nineteenth-century Chile

Roberto Pastén

Abstract

A structural shift in the trend toward higher deficits had emerged by the middle of the 1860s in Chile. For some authors, this was the result of increased spending owing to a fast-growing economy. Another common explanation is the higher spending required to finance and then recover from the war against Spain, which began in 1864. This article provides an alternative explanation for the country's fiscal disarray during that period, suggesting that it was motivated largely by increased political turmoil at the beginning of the second half of the nineteenth century in Chile that ended with the ousting of President Balmaceda in 1891. That period represents a dramatic departure from the calmer and economically buoyant early years of the Republic. Thus, it is suggested that the beginning of President José Joaquín Pérez's rule in 1861 marks both a major political realignment after the birth of the Republic and a structural shift in the trend toward higher deficits. This hypothesis is consistent with the idea that political instability tends to lead to a decoupling of taxes from spending, two elements which would be otherwise aligned as predicted by the tax smoothing theory. This essay is a factual description in support of this hypothesis.

Keyword

Fiscal policy, budget deficits, national budgets, economic history, Chile

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Author

Roberto Pastén is a Third Environment Court judge and adjunct professor at the Economics Institute, Austral University of Chile, Valdivia, Chile. roberto.pasten@uach.cl

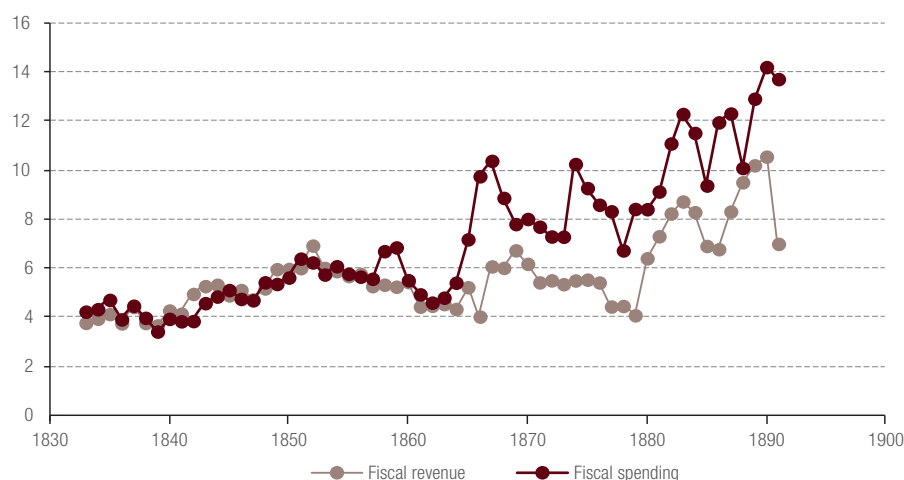
I. Introduction

The patterns of Chile's fiscal spending and fiscal revenues between 1833 and 1891 clearly highlight a change in trend by the middle of the 1860s (see figure 1). Although this change is little documented, some scholars have nevertheless taken note of it (Collier and Sater, 2004; Cortés, Butelmann and Videla, 1981; Humud, 1969). For example, in *A History of Chile, 1808-2002*, Collier and Sater (2004) state:

Prior to the late 1850s, finance ministers had no difficulty in balancing the budget. After 1860, however, spending began to outpace the growth of trade, and it became harder to cover expenditure from “ordinary” (i.e., legislatively authorized) sources. Internal taxation declined as a proportion of the state's revenue; there was a marked reluctance to impose taxes on property or income (internal tax rates actually fell during this period); and even though the state was now making money from some of its own services (e.g., railways), the books could no longer be balanced without recourse to borrowing (Collier and Sater, 2004, p. 76).

Humud (1969) also provides some evidence of a structural shift in fiscal accounts by the beginning of the second half of the nineteenth century in Chile. He points out that in the early days of the Republic, public sector activity was constrained by growth in fiscal revenues. However, by the second half of the nineteenth century, the increase in public activities and the involvement in new areas such as the building of roads and railways put pressure on public expenditures to grow independently of revenues.

Figure 1
Chile: fiscal revenue and fiscal spending as a percentage of gross domestic product (GDP), 1833-1891

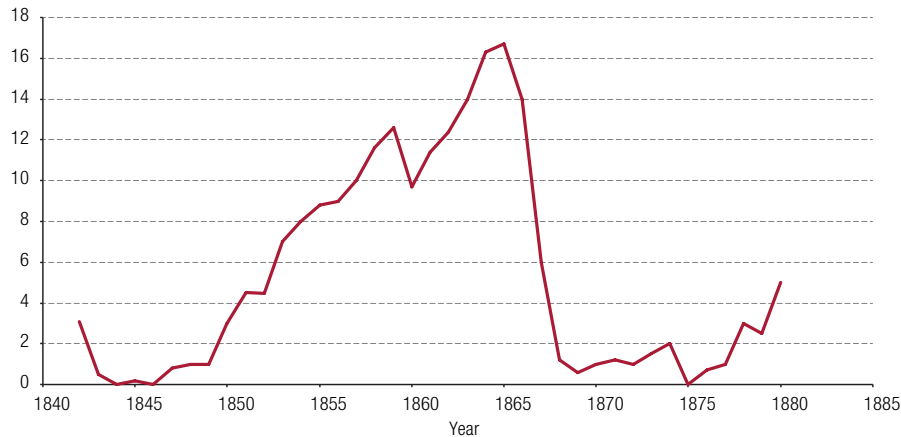


Source: G. Wagner, J. Jofré and R. Lüders, “Economía chilena 1810-1995. Cuentas fiscales”, *Working Paper*, No. 188, Santiago, Catholic University of Chile, 2000.

In order to test the statistical significance of this change in fiscal deficit and to avoid any bias associated with a predetermined structural break, the Bai-Perron test (Bai, 1997; Bai and Perron, 1998 and 2003) is used to endogenously determine when a structural break occurred in the Chilean fiscal deficit series between 1833 and 1891. The results show that the deficit had peaked by the middle of the 1860s, indicating a break in the series by that time (see figure 2).

Figure 2

Chile: fiscal deficit as a percentage of gross domestic product (GDP) (Bai and Perron test of endogenous structural change), 1833-1891



Source: Prepared by the author, on the basis of G. Wagner, J. Jofré and R. Lüders, "Economía chilena 1810-1995. Cuentas fiscales", *Working Paper*, No. 188, Santiago, Catholic University of Chile, 2000.

Given the strong evidence of a structural change in the fiscal deficit during the nineteenth century in Chile, a question immediately arises: which factors led to this sudden change in the fiscal process at the beginning of the 1860s?¹

Several arguments have been put forward to explain this shift. For some authors, the larger deficit stemmed from the increased public spending necessary to keep pace with growth in trade (Cáceres, 2000; Robles-Ortiz, 2010; Cortés, Butelmann and Videla, 1981). However, it is here argued that the evidence only partially supports this point of view, since (as is shown in the following sections) trade had been growing long before 1861, at least since the Chilean forces' defeat of the Peru-Bolivia Confederation in 1839. Moreover, if the turmoil in fiscal policy can be explained only by a growing economy, why was military spending (the second-largest budget item) not increasing at the same pace as the rest of the economy? This is a widely documented fact of Chilean history, which had serious consequences at the beginning of hostilities with neighbouring countries in 1879 (Collier and Sater, 2004).

Another frequent explanation for the increasing deficit is the greater spending necessary to finance and then recover from the war against Spain, which began in 1864 (Corbo and Hernández, 2005). This theory also lacks a strong foundation, since by every account that war was non-conventional and limited. There were no confrontations on Chilean soil and the warring countries engaged in just two naval battles. After two years, the conflict ended with the shelling of the port city of Valparaíso, an event that unquestionably had a temporary effect on domestic production and public spending; however, it is difficult to explain, on these grounds, the 25 years of fiscal disarray that followed the end of the war.

This article postulates a different interpretation of the fiscal problems: they were generated largely by the increased political turmoil in the second half of the nineteenth century, which represented a dramatic departure from the more peaceful and buoyant early years of the Republic. The fact that the early 1860s were a period of major political realignment has been noted by several authors, including Collier (2003), Collier and Sater (2004), Stuvén (1997), Cavieres (2001), Castedo, (2001), and Galdames (1964).

¹ For a general analysis of the Chilean economy during the nineteenth century, see Díaz, Lüders and Wagner (2007).

The hypothesis that political instability is one of the possible causes of fiscal disarray is consistent with the conceptual framework developed by Pastén and Cover (2010, 2011 and 2015) based on the political determinants of tax smoothing and tax tilting, which they believe explain government budget deficits. Under tax smoothing (equivalent to a sustainable and efficient fiscal deficit), in order to minimize the distortionary social cost of taxes, deficits are efficient if they are the result of a policy decision not to vary the tax rate in response to transitory fluctuations in government spending. Tax tilting, conversely, occurs whenever the government has an incentive to discount the social cost of taxes at a higher rate than society discounts them; hence, it delays taxes or advances spending, triggering an upward trend in fiscal deficits. Pastén and Cover's main point is that tax tilting is a positive function of political instability. The transmission mechanism is as follows: an increase in political instability, measured by the probability of losing power, increases the rate at which the government discounts future social costs; so, with tax tilting, a relatively more myopic fiscal government policy produces a trend toward higher fiscal deficits. Moreover, the authors show that the direction of causality is from politics (political instability) to deficits rather than the other way around (Pastén and Cover, 2010 and 2015).

Other authors have also suggested a link between tax tilting and political instability. Cashin, Haque and Olekalns (1999, p. 14) state that, "Tax tilting could occur, for example, if the current government is unsure of its re-election prospects and therefore favours higher current debt levels than are implied by tax smoothing." For a similar view, see Cerda and Vergara (2008). For empirical evidence on Latin America, see Pastén and Cover (2015), and for evidence on Chile see Pastén and Cover (2010).

A closer look at figure 1 also seems to give some support to the hypothesis of political instability as a determinant of tax tilting. First, according to the graph, at least from 1851, fiscal revenues (as a percentage of gross domestic product (GDP)) start to fall prior to the break point postulated in this paper and before the crisis of 1873, which at first glance seems to be inconsistent with the hypothesis that fiscal disarray starts in the mid-1860s. However, figure 1 also shows clearly that not only taxes but also total spending fell at the beginning of the 1850s and they both continue to decrease for the most part, until the mid-1860s. This is consistent with the hypothesis outlined in this paper that in conditions of political stability, there are no tax tilting effects, and taxes and spending move together in the long run. Moreover, according to figure 1 spending only temporarily outpaces taxes in 1859, most likely due to a small civil war that year, at the end of President Manuel Montt's term of office. That effect was transitory because, while taxes were kept relatively constant, spending increased briefly in order to finance the 1859 civil war, which is typical of tax smoothing but not of tax tilting. Also, after the mid-1860s, the chart shows that spending outpaces taxes dramatically, which is indeed characteristic of tax tilting.

Second, although Chile wrested control of nitrate-rich zones from Peru and Bolivia after the War of the Pacific (1879-1883), increasing the amount of revenues collected, the fiscal deficit problem persisted at least until 1891 (see again figure 1). This strongly supports the hypothesis proposed here, because even the higher revenues collected after the War of the Pacific were not enough to offset the increased fiscal expenditure which, according to this hypothesis, could be explained by the political weakness of a government desperate to bolster support in the run up to the 1891 civil war.

Lastly, starting from the mid-1860s, the higher deficits stemmed mainly from growth in spending; however, it is not clear which spending component fuelled this growth. Although the explanation is beyond the scope of this paper, Humud (1969) may shed some light on this change in composition, which is consistent with the hypothesis proposed here. Humud found that, before 1860, fiscal spending grew at a rate of 5.5% (compared with a 6.2% increase in tax revenues) mainly in order to finance conventional and administrative spending. However, spending then grew by 5.7% between 1860 and 1879, and by 3.4% from 1880 to 1900 (by comparison, revenues grew by 4.8% and 2.8%, respectively). This growth stemmed mainly from a group of emerging components of fiscal expenditure,

chief among them public works —particularly railroad construction— but also justice, education and war efforts. Spending on public works is a sign of patronage as postulated by Rogoff (1990) in his political business cycle models, where he describes the preference of governments for “projects with high immediate visibility.” González (2002) found similar political bias in Mexico, showing that the government manipulated fiscal policy for political purposes prior to all federal elections; infrastructure spending was the policy variable used.

In section II, we will show that, throughout Chile’s nineteenth-century history of politics and public finance, it is a reasonable hypothesis that the trend in fiscal deficits was affected by the political context. A brief, highly stylized description of the political and economic events that shaped the period between 1833 and 1860 is presented here, aiming to show that this was a time of sound fiscal policies and also of political stability. Section III describes the political and economic events of 1861-1891, a period characterized by fiscal crisis and intense and growing political uncertainty that climaxed with the civil war, which ended with the suicide of President José Manuel Balmaceda in 1891. Lastly, section IV concludes.

II. 1833-1860: a time of order and progress

As early as 1818, when Chile declared independence from Spain, two political movements with opposing views on society emerged. On one side, the liberals (*pipiolo*s) most faithfully represented the liberal doctrines of Europe while, on the other, the conservatives (*pelucon*es) were predominantly landowners and represented the country’s Spanish heritage.

Their differing views on how the new Republic should be organized led to constant clashes in the period immediately following independence from Spain. Following the Battle of Lircay (1830), the *pelucon*es prevailed over the *pipiolo*s, implementing a constitution that favoured a strong executive branch, in keeping with the ideas of Minister Diego Portales.

After the Battle of Lircay, Diego Portales emerged as a kind of Chilean Alexander Hamilton.² In the joint posts of Minister of the Interior, Foreign Relations, and War, he designed and supported a centralist and presidential constitution. The Constitution of 1833 remained in effect for almost 100 years (until 1925), albeit with some modifications. It vested the president with two consecutive five-year terms that resulted, for example, in only four presidents being elected over a period of 40 years. The president controlled the cabinet, judiciary, public administration and armed forces, and also enjoyed emergency powers such as the authority to declare a state of siege in any part of the territory while the parliament was in recess. With these emergency powers, the president could suspend any constitutional guarantees in the affected territory. Also, because the Constitution of 1833 was strongly centralist, no federalist assemblies were allowed, provincial heads were appointed by the president, and the president had veto power over elected municipal councils.

The principal characteristics of this period (1833-1860) were the organization of a State of notable stability, efficacy and endurance; in addition, it was a period of sustained economic progress. Another feature was the electoral intervention that in practice allowed any government to elect the Congress and the presidential successor. The electorate was small (only owners of a certain amount of property were allowed to elect representatives) and military officers were able to influence the votes of their soldiers by retaining their electoral registration certificates until election day (Collier and Sater, 2004). Nevertheless, there was some opposition, mostly from deputies (representatives) who never held a majority in parliament. Conservative rule was more religious than secular and went

² The similarities between the two men are remarkable. Each could have easily become president but neither sought the post. They both advocated a strong and centralized government and died tragically in their 40s.

unchallenged during the first half of the nineteenth century. At least until the 1850s, there was no significant political resistance.³

The point of consensus between liberals and conservatives was a high regard for social order, which Minister Portales expressed eloquently when he said that: “The Republic should be a strong and centralized government that led citizens along the path of order and virtues.”⁴ Herein lies the justification for strict control over the press, the reshaping of the army and harsh public policies. In Portales’s view, order consisted primarily of public order and its ultimate goal was social order. He also believed in a union between the State and the (Catholic) Church as another precondition for social order.

For the liberals (who were more secular than confessional), the state of affairs imposed by the conservative regime was acceptable if the alternative was the anarchy that marked the early years of the Republic. Andrés Bello and other notable liberals were supportive of the conservative governments’ authoritarian rule. Any perceived opposition was quickly suppressed by the political class. For example, *El Progreso* (Santiago’s first daily newspaper) stated that: “In Chile [...] there is no national will to express, because there are no parties with conflicting points of view, or vital issues dividing society.”⁵

Regarding the prevailing consensus and the self-imposed limits on dissent, Collier and Sater (2004, p. 104) said that “liberalism as a coherent political force came close in these years [1833-1850] to being killed by kindness.”

1. A time of economic progress

After Chile’s independence from Spain in 1818, the Spanish monopoly ended and the flow of trade turned mostly to the United Kingdom and, to a lesser extent, France and Germany. The new trade pattern resulted in the installation of branches of British companies in Chile’s principal cities and ports. Nevertheless, it was the programme of economic reforms implemented by Portales’s Treasury Minister, Manuel Rengifo, that consolidated a development path based on openness to world trade by 1830.

The aim of Rengifo (who served as Minister of Finance from 1830 to 1835 and again from 1841 to 1844) was to balance the fiscal accounts. This was achieved in 1839 thanks to rising customs revenues.

From an economic standpoint, Rengifo’s policies were more neo-classical than neo-mercantilist. He favoured the expansion of trade. In 1834 commercial legislation reinforced the downward trend in the tariffs on imports in place since independence. The average tariff was 25% (Sutter and Sunkel, 1982).⁶

The reforms implemented by Minister Rengifo were consistent with an economy open to global trade and led to a spectacular increase in fiscal revenues. He eliminated most export duties, with the exception of a 4% duty on wheat and a 6% duty on minerals. However, the greatest stimulus to international trade was a measure that had been attempted by every government since 1813: public or bonded warehouse (*almacén fiscal*). Under this initiative, trading companies were allowed to store merchandise in the port of Valparaíso at low cost and then trade these goods when market conditions

³ In 7 of the 11 congressional elections held between 1833 and 1864, the opposition either abstained or scarcely bothered to run. It focused its efforts on the Chamber of Representatives, but only after 1860 were a handful of deputies elected (Collier, 2003).

⁴ Ernesto de la Cruz (editor), *Epistolario de don Diego Portales* (Santiago, Ediciones de la Biblioteca Nacional, 1936), p. 177; cited in Stuenkel, 1997, pp. 269-270.

⁵ *El Progreso*, 10 June 1844; cited by Stuenkel (1997, p. 280).

⁶ Nonetheless, several studies show very different treatments behind the average tariff (Cortés, Butelmann and Videla, 1981; Díaz and Wagner, 2004).

were favourable. In 1833, the time allowed for storage was increased from three to six years. At that point, Valparaiso became one of the most important ports in the South Pacific (second only to Callao in Peru) and the dominant port for ships rounding Cape Horn. Chile's victory over Peru and Bolivia in the war with the Peru-Bolivia Confederation (1836-1839) consolidated Valparaiso's position as the predominant port south of California. This period defines the expansion of foreign trade in Chile. By 1840, foreign trade tripled that of 1810 (Sutter and Sunkel, 1982).

In addition to opening up its economy, Chile was developing its focus on natural resources. In 1832, Juan Godoy discovered Chañarcillo, a silver mine that became the most spectacular mining discovery of the first half of the nineteenth century. Silver and subsequent copper mines helped increase the population of Chile's Norte Chico region (a mining zone) and simultaneously created a new market for agricultural products from the southern part of the country. Nevertheless, fiscal revenues from natural resources never surpassed 10% of total revenues. Until the end of the War of the Pacific in 1883, customs duties and taxes rather than taxes on natural resources remained the largest component of total revenues.

The spectacular expansion of trade that began in 1833 allowed for the systematization of the tax system along with the simplification of customs rules and regulations and administrative organization. These conditions had a strong impact, resulting in increased revenue collection. Chile was able to pay back the loans incurred during colonial times and, furthermore, to generate large budget surpluses. Every conservative government from that of President José Joaquín Prieto in the early 1830s to that of President Manuel Montt in the early 1860s maintained the strict policy of keeping up with public debt payments. Chile's creditworthiness under conservative rule was admirable (Edwards, 1932; Galdames, 1964; Collier and Sater, 2004).

2. An emerging crisis

As the memory of anarchy faded in Chile and foreign ideas arising from the events surrounding the French Revolution in 1848 gained ground among the liberals, the conservative regime began to face challenges (Stuven, 1997). Collier and Sater (2004, p. 104) accurately describe the incipient signs of a political realignment by the mid-nineteenth century:

It was unlikely that the Conservative settlement would survive indefinitely without alteration. In the middle years of the century a fierce and at times bloody battle was waged between the upholders of its initial authoritarian style and those who favored a more liberal and tolerant approach to the government.

The liberals used their constitutional authority for the first time in 1850, to delay the passing of the annual tax law in order to apply political pressure (this practice intensified in the early 1860s and was an important factor in the fall of President Balmaceda in the conflict of 1891).

The first significant uprising in republican history occurred on 20 April 1851. Government forces quashed the rebellion and those members of the army who led the revolt died in the confrontation. Later that year Manuel Montt became president (1851-1861). A hallmark of his government was its focus on material progress, with the construction of roads and railways, the opening up of new territories, the broadening of the frontier and other efforts. According to Collier and Sater (2004, p. 110):

Montt himself may have seen his emphasis on "material interest" as a means of distracting Chileans' minds from political concerns.

Although President Montt did not swerve from this path of progress for almost his entire administration, by the end of his rule, there were signs of a profound change in Chilean politics. These events would reshape the political scenario in the years to come and put an end to the period of peace, order and progress imposed by the conservative governments.

These political changes emerged because of a minor event in the late 1850s triggered by a conflict between the Catholic Church and the judiciary. In that instance, President Montt (in an unusual move given his conservative outlook) decided to support the judiciary because of his desire to uphold presidential power. As a result, for the first time in Chilean history, a crack appeared in the Conservative Party.

During the near-decade of President Montt's rule, ideas of enlightened modernity and European liberalism were slowly absorbed by part of the political class. According to Domingo Santa María (a future liberal president, himself at odds with the Church) there were contradictions within the conservative settlement. Stuvén (1997) argued that the political laziness of the time could be explained by presidential authoritarianism along with President Montt's excessive kindness toward the Church.

However, the very notion of a confessional, conservative conglomerate was contrary to the idea of a strong presidential system. All of Chilean society was involved in the clash between the government and the Catholic Church. Starting from a minor conflict with the Church, the debate spread to other areas that had been previously overlooked by the public, including Catholic education and freedom of religion. The result was a bitter division of the president's party into secular and confessional conservatives.

A strong new political force emerged from the ongoing conflict: a mix of liberals and conservatives unhappy with the president's pro-clerical policies. At the end of President Montt's term, a new (and bloodier) uprising against the government was suppressed. However, the period of conservative supremacy that had provided the country with stability (particularly fiscal stability) and economic progress had ended.

III. 1861-1891: a time of political turmoil

1. The turning point

Several authors have identified different structural changes in the republican period between 1833 and 1891. For some, 1876 was a major turning point, as a year in which the country experienced one of its deepest economic depressions. For others, the tide changed in 1879, when the War of the Pacific broke out. For still others (including this author), the most significant change in the nineteenth century in Chile occurred in the early 1860s, with the political realignment of the Conservative Party mentioned above. According to Collier and Sater (2004, p. 116):

The events of 1861 mark an important dividing line in Chilean political history. Later generations were to reflect more generously on Montt and Varas [President Montt's Minister of the Interior], but the political class as a whole viewed their departure from office with undisguised relief. The new president's style was very different. His tolerance may have stemmed, as was said at the time, from supreme indifference. José Manuel Balmaceda described him as "drunk on indolence." Yet these qualities were precisely those needed to induce a mood of calm after the agitations of the previous decade. Admirers of strong government have often presented this elderly patrician in a poor light. In fact he deserves as much credit as any nineteenth-century president for consolidating the national "idiosyncrasy" of civilized politics.

As these authors point out, President José Joaquín Pérez's rule (1861-1871) was anathema to believers in the strong governments that had characterized the early years of the Republic. His first term marks both the greatest political realignment since the birth of the Republic and a structural shift in the trend toward higher deficits (see figure 1).

During his tenure, President Pérez ruled mostly against the backdrop of the Liberal-Conservative Fusion. The departure from previous authoritarian regimes was evident in a number of proposed reforms to the Constitution of 1833 (some 34 articles of the Constitution were amendable in principle). Under the Constitution of 1833 only the next legislature could amend the Constitution, and as a result the elections of 1870 were hotly contested. The programme of reforms included electoral freedom, an expansion of individual liberties and an overall reduction of the president's power. Nevertheless, the new Congress only adopted one (albeit historically significant) amendment: the prohibition of consecutive presidential terms, putting an end to the periods of decade-long rule by one president. This was the first amendment to the Constitution in 38 years.

The following president, Federico Errázuriz —in office from 1871 to 1876— took office in September. Like his predecessor, he began his term with support from the Liberal-Conservative Fusion; however, by the time he left office he had the support of the liberal coalition only. After that, presidential power shifted to the Liberal Party until Balmaceda's deposition in 1891.

President Errázuriz's term was marked by a much fiercer political struggle than any previous administration. At the beginning of his term, the conservative members of his government disagreed with public education's prevailing tendency to afford great importance to the natural sciences; they regarded this as "contrary to religious belief and injurious to private morality" (Galdames, 1964). This conflict over theological issues prompted President Errázuriz to remove conservatives from his government. Thus, for the first time, conservatives became part of the opposition and began trying to broaden the electoral base to include formerly excluded Chileans (mostly Catholics), in an effort to diminish the president's power. The electoral system was reformed to grant minority parties representation based on their number of qualified electors.

Meanwhile, 1870 ushered in a long period of declining export commodity prices, which affected mainly the wheat sector as crops became more productive and means of transportation for competitors more readily available in foreign markets (eliminating the advantageous position of Chile's food export sector during the gold rush in California and Australia). Additionally, copper production decreased after 1872 and the price of silver fell at the same time. These events caused the deepest economic crisis experienced thus far by the new Republic and had some lasting effects on the economy. The development of the banking system around 1870 made it possible to monetize the economy (replacing the mandatory gold convertibility system with the use of paper notes). However, the inconvertibility of paper notes into gold resulted in the devaluation of the Chilean peso and increased its volatility, which also had political repercussions.⁷ Moreover, there is some evidence that inconvertibility was implemented in order to save some banks as well as to support the government (Millar, 1994).

By 1876 the global price of copper had fallen by 20% and Chile's exports of this metal had declined by 16%. Silver exports were one third of the level seen in 1874. Severe weather in 1877 washed away roads and railroads and destroyed livestock and crops, causing wheat and flour exports to drop. About 300,000 workers lost their jobs, many businesses went bankrupt and food prices increased (Collier and Sater, 2004).

This economic downturn drastically reduced fiscal revenue collection. To remedy this, President Aníbal Pinto (1876-1881) added a 10% surcharge to prevailing tariffs. He also implemented unpopular measures such as laying off public employees, beaching naval vessels and discharging numerous army and navy units. The political crisis (the worst since independence) revealed an incipient social crisis.

In 1878, Congress passed a law modifying the tariff code. From that point on, a 35% tax was levied on luxury items and goods that competed with domestic products, while the tax applied to capital goods was just 15%. Other goods were subject to a 25% tax or a specific value-based tax.

⁷ The dispute between *papeleros* (who supported inconvertibility) and *oreros* (who advocated for convertibility to gold) became part of the political struggle for most of the Parliamentary Republic (1891-1925).

There were also proposals to tax gifts and estate inheritances as well as income and investments, but these measures were ultimately rejected.

By 1870 deposits of sodium nitrate had been discovered in the Peruvian desert province of Tarapacá. The Bolivian silver mines in Caracoles were worked almost entirely by Chileans whose status on foreign soil, mainly in Bolivia, sparked an international crisis that led to the war between Chile and the allied forces of Peru and Bolivia in 1879. The War of the Pacific was to be the most traumatic experience for Chile since independence.

2. War and fiscal policy

As mentioned earlier, from the early years of independence until the crisis of the mid-1870s, the government's budget was supported mostly by customs duties. However, the economic crisis halved these revenues. As a result, the main components of government revenue became *estanco* (trade licences), *alcabala* (transfer tax) and land tax (which had been proposed some years before by Rengifo). Nevertheless, just as these taxes were not enough to fund the fiscal budget during the economic crisis, they were unable to fund the war effort.

In 1879, under pressure owing to the international crisis, Congress passed the *mobiliaria* (income tax) that had been rejected the previous year. The government also tried to borrow money, but the country's banks were unable to help, given the precarious situation of the banking system after the crisis of 1876. As a last resort, the government turned to printing paper notes that the public was forced to accept. Since printing money inevitably leads to inflation, something had to be done to prevent the government from relying indefinitely on this measure.

This problem was solved by Chile's occupation of the resource-rich territories originally held by Peru and Bolivia at the beginning of the conflict. A new export tax was imposed in September 1879 (US\$ 1.60 per quintal of nitrates), providing a sufficient flow of fiscal revenues to finance the government's budget.

Although the Chilean government had the option of taxing nitrate production, the mines were still legally owned by the Peruvian government. This problem was solved by restoring the nitrate mines to their original owners, mostly British companies (who had previously been granted ownership by the Peruvian government). This policy enabled private entrepreneurs to take control of what became the main source of tax revenue during the next 50 years.

3. The deepening political crisis

The ongoing war did not stop the deterioration of the political situation in Chile (for example, in 1881 a group of deputies attempted to cut off funds for the war effort as a means of pressuring President Pinto into reshuffling his cabinet). This crisis was effectively ended by the significant revenues that began pouring in at the end of President Aníbal Pinto's tenure and enabled several municipalities to undertake improvements. Meanwhile, the government itself embarked on a highway construction programme and completed a number of railroad lines.

The next President, Domingo Santa María (1881-1886), also a liberal, was faced with a Congress that was seeking to undermine the presidential system by eliminating the President's veto power over the cabinet and promoting elections free of intervention. Since the President wished to maintain the prerogatives of his office, the relationship between the two branches of government was quite antagonistic. The President was also eager to reduce the powerful role of the Catholic Church in Chilean society. During his mandate, and amid a crisis over the right to appoint the archbishop of Santiago, he broke off relations with the Holy See.

After these events, laws concerning civil marriage and civil registry were passed. Secular cemeteries were created and, following protests from the clergy, a decree prohibiting private cemeteries was issued. “So great was the opposition made by the clergy that the country seemed on the verge of a revolution” (Galdames, 1964).

During this time of struggle between the president and the Church, the liberals (the President’s party) fought to restrict presidential power. A reform extended suffrage to every literate male (women were still not allowed to vote) over 25 years old. This reform was intended to reduce the President’s electoral influence, which had been quite strong since the conservative settlement. The Congressional elections of 1885 (the new Congress had the right to elect the next president) were the most violent in the country’s history (Collier and Sater, 2004).

When President José Manuel Balmaceda (a member of the Liberal Party) was inaugurated on 18 September 1886, the political environment had become highly polarized between those who supported the presidential system and its opponents. President Balmaceda conceived the idea of using the substantial revenues generated by nitrate produced in the new territories to finance an ambitious public works plan (the public works ministry was created in 1887 and by 1890 it accounted for one third of the fiscal budget).

This public works plan (unprecedented in Chile) could arguably be considered a way to uphold presidential power and undermine opposition. In fact, in the dangerous political climate of the time, Balmaceda’s public works projects were seen by the political opposition as a means of expanding presidential patronage.

This was clear to Valentín Letelier, one of the most prominent liberals of the time. In 1891, he presented a lecture on “Tyranny and the revolution” at the University of Chile’s School of Law, with the stated objective of “studying the dangerous politics of despotism and abuse by all parts of our administrative machine with which the government corrupts until it becomes the most horrible rot in the annals of the Republic.” He continued:

The exorbitant enrichment of the treasury, wrongly obtained through the increase in private wealth, transformed the executive into the strongest political power since O’Higgins.⁸

Never before has there been in Chile such large a number of employees, contractors, workers, engineers, architects and others whose subsistence and fortune depend directly and exclusively on the government.

The Ministry of Public Works determines the fate of hundreds of suppliers of wood, lime, brick, building stone, iron and other materials. And the construction of bridges, roads, railways, telegraph lines, schools, churches and prisons is linked so closely to the government that the most influential citizens of every province believe they are in debt to the President of the Republic for the works carried out thanks to his generosity and good grace (Cavieres, 2001).

President Balmaceda also allocated an unprecedented amount of resources to the modernization of the army and the navy. The traditional explanation for this is the threat presented by Chile’s neighbouring countries. However, it seems more plausible that the President was trying to win the loyalty of both entities of the armed forces in the event that the ongoing political conflict led to violence. This seems particularly reasonable given the increased presence of members of the army in high-level government posts and the incentives given to members of the navy who showed support for the government.⁹

⁸ Bernardo O’Higgins was Chile’s independence hero.

⁹ Two years of wages for all crewmembers of a warship who renounced actions against the executive and a 25% wage increase for members of the navy who did not participate in the uprising (*Boletín de leyes y decretos de la dictadura 1891*).

In November 1889, Balmaceda lost his majority in both houses of Congress and his popularity plummeted. The opposition enjoyed broad support among politicians, the media and businessmen. Furthermore, a wave of strikes (the first in the country's republican history) paralysed almost every city in the nation and was followed by heavy, unprecedented repression. These events persuaded a large portion of the lower class to join the opposition.

President Balmaceda was determined to preserve his presidential powers while Congress and the opposition parties (including Balmaceda's own Liberal Party) were determined to ensure that their parliamentary ideas and electoral freedoms prevailed. When Congress adjourned at the end of October, it had failed to approve the fiscal budget for 1891. In response, President Balmaceda decided to maintain the essential fiscal accounts approved for the previous year (an unconstitutional act). In January 1891 the majority of both houses approved a motion to depose President Balmaceda and assigned the navy the task of restoring the Constitution. As most elements of the army decided to support the President, a civil war broke out, and ended in August 1891 with the victory of the congressional forces.

Balmaceda refused to go into exile, instead taking refuge in the Argentine embassy. He committed suicide three weeks after his defeat, on the morning of 19 September, the day after his presidential term expired. As table 1 shows, by the end of President Balmaceda's rule, the fiscal deficit was close to 7% of GDP, the highest level of the nineteenth century and the fourth highest in Chile's history.

Table 1
Chile: the fiscal budget during presidential terms of office, 1833-1891
(Percentages of GDP)

President	Term of office	Average fiscal revenues	Average fiscal spending	Average fiscal balance	End-of-term deficit
Joaquín Prieto	1831-1841	4.0	4.1	-0.1	-0.3
Manuel Bulnes	1841-1851	5.4	5.1	0.3	0.4
Manuel Montt	1851-1861	5.6	6.0	-0.3	0.5
José Joaquín Pérez	1861-1871	5.3	7.5	-2.2	2.3
Federico Errázuriz	1871-1876	5.4	8.6	-3.1	3.2
Aníbal Pinto	1876-1881	5.4	8.3	-2.9	1.8
Domingo Santa María	1881-1886	7.8	11.3	-3.5	5.2
José Manuel Balmaceda	1886-1891	9.1	12.7	-3.5	6.7

Source: G. Wagner, J. Jofré and R. Lüders, "Economía chilena 1810-1995. Cuentas fiscales", *Documento de Trabajo*, No. 188, Santiago, Catholic University of Chile, 2000.

Note: GDP: Gross domestic product.

IV. Concluding remarks

The period from 1833 to 1861 can be characterized by: (i) a highly stable presidential system (only three presidents ruled the country, each for 10 years); (ii) the supremacy of one party (the conservatives) with an almost non-existent opposition (the liberals); (iii) economic progress; (iv) high regard for a Constitution that was both presidential and centralist, and (v) cohesion around the figure of the president. These characteristics indicate an environment of political calm. This was also a period of sound fiscal policies.

Political unrest erupted after 1861. The hegemony of the conservative regime was challenged, coalitions supporting the president became destabilized and the presidency entered into ongoing conflict with the Congress. Finally, civil war destroyed democracy in Chile (1891). During this same period, the fiscal deficit steadily increased.

The events of 1861-1891 seem to provide evidence that in periods of political turmoil, the fiscal deficit rises and as a result, can become unsustainable or at least suboptimal. At the same time, with political stability, there is no incentive to distort fiscal policy and therefore the officeholder plausibly follows an optimal fiscal policy.

Another fact apparent from this brief review of Chilean history and which is consistent with several types of political budget cycle (PBC) models is the attitude toward investment in public works during times of crisis (governments of Pinto, Santa María and, notably, Balmaceda). In his PBC model, Rogoff (1990) describes the preference of governments for “projects with high immediate visibility.” González (2002, p. 220) found similar political bias in Mexico. She states:

The findings presented in this paper have several interesting implications. First, the analysis shows that the Mexican government has, indeed, manipulated fiscal policy for political purposes prior to all federal elections; the policy variable used seems to be infrastructure spending. Some evidence suggests that a public investment boom starts relatively early in the political term (at least six quarters previous to the election), continues until at least the last quarter prior to the ballot, and then diminishes as the election quarter is reached.

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