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Development in Chile 1990-2005

Lessons from a Positive Experience

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Abstract

Chile, in the last 15 years, has shown remarkable results in terms of growth, poverty reduction and democratic governance. This paper reviews the structural changes that were behind these positive outcomes, as well as the pending challenges for Chile's development. Also shows that Chile did better in terms of growth than social integration and that this is related to the weak representation and participation of a wide majority in the national debate and decision making process. It also draws conclusions valid for other Latin American countries' development.

Keywords: growth, competitiveness, poverty, inequality, institutions, democratic governance
JEL classification: O1, O11, O12, O15, P5, P54

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1 Introduction

In December 1989, a democratic president was elected in Chile. The 16-year Pinochet dictatorship had been defeated by a national vote. The Concertación had a simple but widely supported strategic vision—democracy and equitable growth. On three accounts the defeated authoritarian regime had shown a very poor outcome: it had interrupted a long democratic tradition; there had been very little growth (3 per cent per cent per year between 1974-89 amounting to 1.5 per cent in per capita terms); and income had become more concentrated resulting in an increase in poverty (amounting to 38.6 per cent of the population in 1990).[1]

During the past 16 years the Concertación government has carried through deep and simultaneous changes in the economic, social and political dimension. Some of the economic reforms, like opening up the economy, were built on changes made by the authoritarian regime. But the Concertación strategy assumed that simultaneous reforms should reinforce each other in promoting democratization and growth with equity. Throughout these 16 years there has been a permanent, coherent and fruitful effort from the government to advance in this strategic direction.

The political scenario in which this reform process took place was a complicated one, because most legal reforms require high majorities in Parliament where the right-wing opposition parties are over-represented (due to the electoral system inherited from Pinochet). Whenever political agreements were reached, they occurred in Congress and always on specific issues, never on a national vision. There never has been an explicit agreement around the vision that involves all social and political stakeholders of Chile. This has implied very lengthy and repetitive discussion, particularly on the ways to finance the reforms. This fact, as will be seen, has retarded and weakened the effects of the reforms particularly in the equity objective.

All in all, the implementation of the Concertación Vision shows positive results. Increasing competitiveness was the way chosen to promote growth. Competitiveness was sought through macroeconomic reforms to stabilize and continue opening the economy, complemented by microeconomic reforms to increase efficiency and productivity. Their outcome has been positive. Chile in the last 20 years has averaged an annual per capita growth rate of 4.2 per cent. According to the IMF database, Chile ranks ninth among the fastest growing economies in this period. The majority of the countries that are ahead of Chile have a much lower income per capita and thus are less affected by convergence.

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[1] All data references in this text that do not have a source can be found in the Monthly Bulletin of the Central Bank of Chile. A compilation of this information, up to year 2000, can be found in Banco Central de Chile (2001).

Chile also experienced a sharp reduction in poverty. According to Mideplan (2004), total poverty decreased from 38.6 per cent in 1990 to 18.8 per cent per cent in 2003; while the incidence of extreme poverty decreased from 12.9 per cent to 4.7 per cent in the same period. Chile had the most rapid decrease in poverty in Latin America and is the only country that has reached the poverty Millennium Development Goal.

Also very important reforms were completed to strengthen democratic governance. The most important, were the constitutional reforms finally approved by Congress in June 2005 which eliminate the most important non-democratic institutions that had been put in place by the Pinochet regime. Before that, important institutional changes were implemented particularly in the economic area. These changes, according to the World Bank, placed Chile among the 15 countries with better institutional quality.[2]

These outcomes place Chile among the more successful developing countries. But Chile also has important current problems. As will be seen, there is still low value added and diversification of exports, low investment in R&D and human capital; insufficient support to small- and medium-sized enterprises (SMEs); problems of coverage in social areas; health, preschool education and pensions; also a very unequal income distribution with a relatively low tax burden; and an electoral system that over represents the minority. This study will analyze the instruments (competitiveness, social reforms and institutional change) used to reach the three pillars of the Chilean development strategy—growth, equity, and democratic governance—as well as the remaining challenges.

2 Growth and competitiveness

2.1 Strong macro fundamentals and open trade

From the very beginning the democratic governments aimed at reducing inflation and continue opening the economy. Reaching strong macro fundamentals was the instrument to promote investment, considered the main restriction to economic growth. Opening the economy was the instrument to turn exports into the engine of growth. Investment and exports were the two main economic pillars of the growth strategy.

During the military regime, tariffs were reduced in a very significant manner. From an average tariff of over 100 per cent they were reduced to a flat one of 15 per cent. Democratic governments continued the unilateral reduction of import duties (to its present level of a flat 6 per cent) and initiated the negotiations of free trade agreements (FTAs) as a complementary way of opening the economy. Chile has now signed FTAs

[2] See Kaufmann et al. The institutions are those related to voice and accountability, political stability, government effectiveness, regulatory quality, rule of law, control of corruption, and economic freedom ranking.

with all American countries (except Cuba), the European Union, China and some other countries in Asia and Oceania. These FTAs cover 65 per cent of the world's population and about 80 per cent of Chilean trade. Additionally, it is presently negotiating trade agreements with Japan and India.

The FTAs not only continued to open the economy (the effective tariff after the agreements is below 2 per cent) but also changed the economic features of the country. Chile grew from being a small economy (15 million inhabitants with an income per capita PPP (2005) of U$10,981) into an export producing country where domestic firms could trade on the larger global market with quite advantageous conditions. This feature was an additional source of attraction for foreign direct investment (FDI).

Simultaneously, an effort was made to strengthen fiscal accounts and reduce inflation that was increasing at the time of the democratic transition (yearly inflation at the end of 1989 was 25.6 per cent). Although in 1989 there was a surplus in the fiscal accounts, it was financed by a large sum of non-permanent government revenues that came from privatizations and an unusually high price of copper. Thus, a tax reform was proposed and approved to make compatible fiscal balance with the necessary increase in social expenditure to promote equity.

The Concertación governments have kept a permanent surplus in fiscal accounts with the only exemption of the years of the Asian crisis that had a large effect on the price of copper which in turn has a large impact on government revenues. Because of this, in 2000 a new fiscal rule was established. This implied maintaining a structural surplus of 1 per cent of GNP on the fiscal accounts, which has been strictly kept. The structural surplus calculates the budget considering the revenues that would exist with a tendential rate of growth, which is very significantly affected by the price of copper. Thus when the price of copper is down, the rule enables a deficit. This happened in 2000-03 (where it reached a maximum of 1 per cent of GNP). But when the price of copper is above its tendency it forces a surplus, as we have now (in 2004 fiscal accounts had a surplus of 2.2 per cent of GNP). This insures countercyclical government spending, as well as a tendency towards larger government savings (that in the future could be used to cover deficits in the private pension system). This fiscal innovation is a very attractive tool for all developing countries whose export structure is very intensive in commodities that experience sharp and frequent changes in prices with its consequent cyclical effect on growth and fiscal accounts.

A strict fiscal policy plus an autonomous central bank (since 1990) with inflation targeting (2-4 per cent) drastically decreased inflation to its present and within the target level (1999-2004 averaged 2.6 per cent). At the same time it has been permanently reducing the country's risk, up to its present level (August 2005) of 52 basic points of Chilean sovereign debt over the US treasury bonds, which places Chile among the three lower country risks in emerging markets This creates a very significant difference in the cost of capital relative to other Latin American countries (average 300 basic points) and contributes to explain the larger increase in investment and growth.

2.2 Microeconomic efficiency

In order to increase competitiveness, since the early 1990s an effort has been made to improve microeconomic efficiency in four main policy areas: infrastructure, human capital, productive development (R&D and support to SMEs), and strengthening economic institutions (mostly regulatory and anti-trust). In 2001, with much the same purpose, a 'pro-growth agenda' was agreed between government and business. This agenda was geared towards improving transparency and efficiency in the public sector, overcoming market failures and stimulating private participation in the provision of public goods. Public policies in this area were horizontal, that is the benefits were open to all sectors of the economy. As well as pro-competition, given a market distortion, a first attempt was to stimulate competition and if this was not successful, regulate the market with a framework that emulated competition.

Promoting private investment in infrastructure and public goods, was aimed to improve the global connectivity of the Chilean economy. The private sector was incorporated in the provision of public utilities, as well as, in all kinds of infrastructure. In order to do this, new regulatory bodies were created that enabled the participation of the private sector and/or authorized the privatization of existing infrastructure. Particular emphasis was placed in promoting and/or emulating competition in each sector, as a means of transferring the gains of productivity to consumers and users of public utilities and infrastructure.

In the last decade, 62 projects for over U$7 billion have been granted as concessions to the private sector to build and operate highways, ports, airports, trains, buses, prisons and hospitals. Additionally the privatization of the telecommunication and water and sewage services brought enormous investments with the consequent improvement in efficiency (tariffs) and quality. The electricity sector was already privatized, but there was an important change in its regulatory bodies and very significant amounts of FDI in it. The outcome of these changes is very positive. Chile has a 100 per cent digitalized telecommunication system, it is connected to three international fibre optics networks, and ranks among the first 15 in all transportation and communication variables of the IMD competitiveness report.[3] This is an important achievement considering that in the early 1990s infrastructure was one of the least competitive sectors of the Chilean economy according to the same report.

Investment in human capital was also a very high priority. Since 1990 public expenditure in education has more than tripled, increasing its participation from 2.5 to 4 per cent of GNP. According to UNESCO, Chile's total expenditure in education

3 IMD (2004). This ranked Chile 26th out of 60 countries analyzed.

amounts to 7.3 per cent of GNP which favourably compares to the 5.4 per cent of OECD countries. Simultaneously an important effort was made to increase investment in training of the labour force (it increased over 100 per cent). Although the increase in investment enabled a large improvement in the coverage of these services, it still has a long way to go in terms of quality. For example, Chile is reaching 100 per cent coverage of secondary education, but it is lagging behind in preschool coverage and in quality, it ranks 37 for education systems and 55 in pupil/teacher ratios. Access to training programmes for workers, although increasing at a fast pace, is very limited for SMEs and inexistent for self-employed workers which are precisely the sectors with lower productivity.

The increase in coverage of education was particularly high in universities (more than double) reaching 37.5 per cent of the population, which still compares unfavourably to the 65 per cent figure for developed countries. A good example of the social and economic impact of this progress is that presently 70 per cent of all university students are the first members of their families to reach this educational level; a very significant change that will transform the quality of life for these families and productivity in the country. The total impact of the very large increase in investment in human capital is still to be felt in terms of equitable growth.

From the very beginning the Concertación Government aimed at reaching what was called the second phase of the export model, one more intensive in value added. For this purpose public research funds were created to stimulate R&D in the private sector and to strengthen the link with universities. As well as a programme to support productivity growth and market penetration for SMEs, mostly through stimulating its association. Although existing evaluations of these programmes show very positive results, their size did not enable them to have a very large impact. Their limited funds plus the 'horizontal' criteria (to avoid 'picking the winners') in the definition of public R&D policy attempted against real progress. Moving towards a cluster approach around the existing export sectors, could take the Chilean economy faster to an export structure more intensive in value added. As will be seen, R&D is still a competitive disadvantage for the Chilean economy and SMEs have kept the 75 per cent productivity gap they had with large firms. The final goal of moving into the second phase of export growth was not reached either.

Chile also invested in modernizing economic institutions to increase transparency and efficiency. Since 1990 it has completed a reform of the entire judicial system. It has transformed all regulatory institutions and its legislation, it has created a fair competition tribunal and an independent tax tribunal. It has new legislation and institutions on consumer protection, industrial property rights and international commercial arbitration. It also legislated on corporate governance and venture capital industry. It has improved the legislation on private pension funds and incorporated voluntary savings in it.

The positive impact of these transformations can be appreciated in several international reports. The IMD (2004) *Competitiveness Report* ranks Chile 1st in central bank policies and 2nd in pro-business country and management of public finances, 6th in financial institutions transparency, and 8th in government efficiency. The Economist Intelligence Unit ranks Chile 15th in its offshore environment ranking and says that, ‘Chile outshines its neighbours, luring investment with educated workers and strong IT skills … Chile is the strongest performing Latin American country’. Transparency International ranks Chile 20th (out 145 countries) in its level of corruption.

2.3 Exports and investment the two engines of growth and competitiveness.

The macro and microeconomic reforms were geared towards increasing competitiveness and making exports and investment the two engines of growth. The strategy succeeded on all of these accounts. Competitiveness, as measured by the international reports, has been increasing. The 2005 IMD report places Chile in the 19th place under New Zealand and above Japan. Many studies show that Chile is the best place to do business in Latin America. For example the Kearney offshore location index places Chile 9th in the world and underlines that it ‘offers the best business environment and infrastructure in the region’. The strategy was effective in promoting investment and exports, both variables grew faster than GNP. While investment averaged 22 per cent of GNP in 1987-89, it increased to 32 per cent in the period 1995-98. The cooling effect on Chilean growth brought on by the Asian crisis decreased the investment rate, but it is already increasing its participation in GNP again.

As expected by policymakers in Chile, foreign direct investment was crucial to increase total investment. While before 1990 FDI did not reach 0.7 per cent of GNP, in 1990-91 it more than doubled reaching 1.4 per cent of GNP. In 1997-99 it increased to 7.5 per cent and in 2004 it was 7.1 per cent of GNP. Thus over 60 per cent of the increase in investment is explained by the increase in FDI. Chile is second, after Ireland, in its reception of FDI relative to GNP and it doubles the average of developing countries. It is important to notice that democracy brought a large increase in FDI (more than double), although the legislation that governed foreign investment was the same that under the authoritarian regime. Democracy seems to make a difference for FDI.

Annual exports grew 9.7 per cent in the decade before 1997, while GNP grew 7 per cent per year. In 1998-2003 exports grew 6.3 per cent per year, while GNPs growth was 3.1 per cent. External shocks (in this case the effect of the Asian crisis) have a very large effect in Chile, decreasing exports and terms of trade. The price of exports grew 6.2 per cent annually in the first period and minus 3.6 per cent per year in the second, which explains 1.5 percentage points of reduction in the growth rate. In spite of the fall in terms of trade, exports were permanently an engine for growth and, in 2004, accounted for one third of GNP.

This results shows that Chile successfully identified engines for rapid growth, as well as instruments to promote exports and investment, but there are a few clouds on the horizon that need to be dealt with. As seen, Chile's growth is very sensitive to international cycles and this is so because its structure of exports is still too concentrated on commodities that experience sharp changes in terms of trade. Up till now Chile still shows little value added in its main exports; this is due to a relatively low investment in R&D and to the need for further progress in labour productivity

2.4 Pending challenges in Chile's growth strategy

Chile has suffered a kind of 'Dutch disease'. The very large and simultaneous growth in exports and FDI appreciated the real exchange rate. Between 1990 and 1998 the Chilean peso permanently revalued accumulating a change of 45 per cent. After the Asian crisis, with its negative impact on exports and terms of trade, the peso devalued, but this process was reversed in 2002, as soon as the price of copper started increasing again. Mining exports represent 40 per cent of total exports in Chile and when the price of copper is very high, as in 2004-05, they come up to about 50 per cent.

Although non-traditional exports have grown, still the structure of exports is dominated by low value added exports. If the World's Bank definition of 'dominated exports' is considered,[4] Chile, relative to Latin America, has kept a high participation of exports that do not induce technological change. Landerretche et al. (2004) show that dominated exports accounted for a large amount of total exports between 1986-2001 (from 93 per cent they decreased to 89 per cent); while in Latin America and the Caribbean in the same period they decreased from 82 to 55 per cent.

This is partially due and also explains why R&D remains at very low levels in Chile. R&D represents 0.6 per cent of GNP, while in the OECD countries it is 2.6 per cent. The way this investment is financed also differs drastically—in Chile it is 80 per cent public, in OECD countries is 80 per cent private. In other words the private sector in Chile is making a very marginal effort to incorporate more value added into exports. This is probably related to the uncertainty that generates the permanent changes in the real value of the exchange rate and its tendency towards appreciation, making more secure and less expensive the export of raw materials.

There is already an agreed way of increasing investment in R&D in Chile. Parliament has approved a royalty to the extraction of copper and its entire proceeds will go to finance 'innovation for competitiveness'. Its amount should at least double the present level of investment and help overcome the most important missing link in the country's

[4] 'Dominated' are those exports where innovation is induced by the companies that provide capital goods. Thus its growth does not induce technological development in the domestic economy and the incorporation of value added into exports. Commodities lose terms of trade relative to goods and services intensive in value added. See Bell and Pavitt (1992).

growth strategy. This structure of exports, in turn, has a large social impact through the labour market. Although employment, as will be seen, is the most important explanatory variable in reducing poverty; exports made no contribution in this respect. As a matter of fact, total employment in tradable goods plus construction (this latter sector grew very significantly in the first decade) remained practically constant in about 2 million employees between 1990 and 2003; while employment in non-tradable goods permanently increased from 2.5 million to 3.4 million employees. A large proportion of this latter employment was in low quality/productivity jobs in the informal sector, SMEs or the personal service sector; which contributed to deteriorate income distribution and did not promote competitiveness in the economy as a whole.

Although the unemployment rate in general was not very high (it increased to 10-11 per cent around the year 2000); the participation rate of 57 per cent (42 per cent for women) is the lowest in Latin America. Labour participation is particularly low among poor families and is very elastic to growth in employment opportunities (it increased in the first half of the 1990s). The dependency ratio is 4.7 for the poorest 20 per cent and 2.6 for the wealthiest 20 per cent. Thus if more employment would be generated in the export sector, more members of poor families would look and find a job making an important addition to family income. The same is true if a largest effort is made to support the modernization of SMEs and thus increase the quality of the jobs they generate. Exports with more value added and/or more competitive SMEs would also reduce the depth and duration of external shocks and, through that, increase the average growth rate of the economy. New high quality jobs could be crucial to reduce the incidence of poverty and to move towards a more equitable distribution of income. Real support to SMEs is a pending challenge for equitable growth.

3 Reduction of poverty and inequality

High growth enabled Chile to close in 30 per cent its per capita gap with developed countries and to significantly reduce the incidence of poverty and even more of extreme poverty. But, during 1990-2003, there was no change in a very regressive income distribution structure. In this period the Gini coefficient fluctuated between 0.58 and 0.57 and the relationship between the income level of the wealthiest and poorest 20 per cent of the population was 14 in 1990 and 14.3 in 2003.[5]

Chile and Brazil were the two Latin American countries with better results in terms of poverty reduction, but their relationship to economic growth is very different. Brazil reduced its incidence of poverty from 41.4 in 1990 to 29.9 in 2001, but it did not grow (per capita GNP grew 0 per cent in the 1990s and 0.1 per cent in 2000-03); while Chile grew quite substantially (4.1 per cent per capita per year in the 1990s and 2.1 per cent in

[5] All information on poverty and income distribution comes from the CASEN survey published by Mideplan (2004).

2000-03).[6] Although Brazilian and Chilean outcomes are quite impressive, Attanassio and Székely (2001) show that about 85 per cent of the poverty reduction in Chile is due to economic growth, while in Brazil 70 per cent of the decrease can be explained by income distribution.

In Chile poverty was mostly reduced because of productivity growth (5 per cent per year between 1990 and 2000), which was transferred to higher wages. The minimum wage, that receives a large proportion of the poor, increased 70.1 per cent in real terms between 1990 and 2004. As average productivity and wages increased at the same pace, the functional distribution of income did not change. But higher wages increased 20 per cent more than the lower ones, this differential in the growth of wages is an important explanation for the regressive personal income distribution.

Throughout this period, the ratio between reduction of poverty and growth of GNP constantly varied. It went from 3.9 percentage points of growth for one percentage point reduction of poverty in the period of faster growth (1996-98), to 1.8 in the period of lower growth but higher expenditure on targeted employment programmes. This is a good example of the potential effect of public transfers on income distribution and reduction of poverty, if they have a significant amount of resources. With redistribution Chile could have done better in reducing poverty. If it would have had permanently the growth/reduction of poverty ratio of 1999-2000 it would have eliminated extreme poverty and almost all the rest of poverty as well.

3.1 Inequality and the labour market

High inequality in Chile, and its permanence through time, is mostly a reflection of what happens in the labour market. The poorest 20 per cent have very precarious jobs: low productivity and, mostly, informal (53 per cent of the employed have a permanent job and 40.3 per cent do not have a labour contract). They also have higher unemployment rates (they represent 41.6 per cent of all the unemployed) and higher dependency ratios (twice as large as the average).

One of the largest problems, in terms of inequality, is the permanence of informal unemployment.[7] This was 36.9 per cent of total employment in 1990 and 37.6 per cent in 2000. Informal jobs have only 25 per cent of the average productivity of the formal ones and thus pay much less. The incidence of poverty among their workers is 26 per cent, while in formal jobs is 8.5 per cent, also informal workers are less educated (8.6 versus 12.2 years in formal employees). Only 50 per cent of informal workers have a formal contract (and thus access to social benefits) while 86.5 per cent of formal workers have such a contract.

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6 Data on poverty in Latin America comes from ECLAC (2005).

7 Informal unemployment is understood as ILO does: workers in firms with 5 or less employees and self employed workers that are not professional, technicians or provide domestic services.

The permanence of low productivity and informal jobs partially explains why although low-income workers increased employment in the decade 1990-2000 at a faster speed than high income workers (2.6 per cent versus 1.7 per cent per annum); their per capita family income increased less (4.4 per cent versus 5.4 per cent per year). Their productivity and wages grow at a lower pace (3.3 per cent versus 4.7 per cent per year) and 61.5 per cent of all the high quality jobs created in the decade were captured by workers of high income families.[8] Although income from labour increased rapidly, its distribution became more unequal. Thus the labour market in this period was a source of inequality and, at the same time, because of its dynamism, the main explanation for the reduction of poverty.

Precarious employment is the source of poverty and inequality in Chile. The government tried to support productivity growth in SMEs but with very limited funds (in the years 2002-04 these programmes added an amount of U$25 million per annum) and had little impact. Increasing productive employment for the poor is the most effective tool to overcome poverty and reduce inequalities, as well as coherent with growth. This poses two challenges. The first is increasing productivity (training) of the poor, the second, more important in the short run, is increasing the productivity of the working place. In other words increase the access to capital for SMEs, where the majority of the poor work.

3.2 Social reforms in Chile, income distribution and tax burden

During the Concertación government, Chile significantly increased its level of social expenditure and reformed its policies. Between 1990-2005 social investment more than doubled in real terms, its priority was reflected in its increased participation in GNP from 12.9 to 16.4 per cent, as well as from 60 to 72 per cent in government expenditure. This increase in the volume of social expenditure had an important distributive impact, particularly in the period of greater unemployment, where special employment programmes for the poor were implemented. The portion of social expenditure that can be distributed among income groups implied that income of poor families increased by 17 per cent between 1990-96, by 46 per cent in 1998-2000 and by 30 per cent throughout the period.[9] Its redistributive effect can be appreciated by comparing the relationship between the average income of the wealthiest and the poorest 20 per cent of the population. This, as mentioned, was 14.3 in 2003 for autonomous income (return to labour and capital), but it decreases to 7.6 when social expenditure is incorporated and total income is considered. Thus social expenditure has an important equalizing effect in Chile and has compensated the inequities created in the labour market, maintaining a stable income distribution.

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8 For a more detailed analysis see Infante and Sunkel (2205).

9 See Mideplan (2004). It is important to notice that there is no international convention on how to compute government social expenditure in household surveys but their inclusion, as can be seen for the case of Chile, can make a large difference in terms of income distribution and the incidence of poverty.

It is not possible, in this short review, to analyze the important changes that took place in each social policy. The most important effort, from 1990 onwards, was on the educational sector and geared towards improving equitable access and quality to all levels of education. Education is the most important factor behind inequality in Chile, explaining between 9 and 40 per cent of it, depending on sample, definition of income, method, year, and cohort used. No other factors such as region, gender, occupation explain as much as education (Palma 2005). The reforms underway should, in the long run, affect both growth and distribution but it is too early to find quantitative results. Evaluations of these programmes show that progress is under way, although there still is ample room for greater quality in education, as well as to increase coverage at the preschool level (which has a large distributive effect).

In 2000 an unemployment insurance scheme was created. This system had some solidarity, although benefits are related to private financing, like the private pension system which the Concertación government inherited and have not changed in a substantial manner. The unemployment insurance does not cover workers with unstable or informal employments, which constitute the majority of the jobs of the poor. Also a health reform project has been implemented since 2002. The original project had a solidarity component incorporated, but was not approved by Congress.

The pension system is the most important pending social reform to increase equity. The system is based on individual private accounts and thus reproduces the existing inequities in the labour market and excludes workers with no labour contract. Coverage of the system increased from 57 to 61 per cent between 1991 and 2003 (still lower than the 62 per cent the old system had, but the highest in Latin America). The unprotected workers are mostly poor, mainly women and with no or few qualifications. Besides that, the return for savings is higher for higher income workers (between 1981 and 2003 it was 8.3 per cent per year for non-poor families and 6.4 per cent for the poor ones). In addition, monthly savings have not been deposited (by the employer) for an important number of, especially low-income, workers. All these implies that if the system were to continue as it is, about 50 per cent of the labour force (the poorest) will depend on the state for their pensions. The present level of public pensions does not insure that these people will be above the poverty line. Solving this situation, depends on the availability of public funds, specially because the annual deficit of the private system between 1999-2003 amounted to 5.9 per cent of GNP that was also covered by public savings.[10]

Thus equitable growth in Chile depends very strongly on furthering social reforms and policies. As seen, all social policies have well functioning and correctly targeted programmes whose benefits could increase with additional resources. Also the government has reallocated resources in favour of these programmes, as well as increased their efficiency; further efforts along this line although positive will have

[10] For a more detailed analysis of these figures, see Arenas de Mesa (2005).

marginal effects. Greater coverage and/or quality of social programmes require larger funding. In all of these areas increasing solidarity towards poor families exclusively depends on the availability of public funding. Engel et al. (1997) show that the structure of the tax system is quite indifferent from a distributive point of view—what counts is the level and targeting of public expenditure. The Gini coefficient could be reduced by 5 percentage points with an increase in the level of taxes (keeping the present structure of expenditure), even if the structure of the tax system turns more regressive. What really counts is government social expenditure.

The discussion on the level of taxes has been a permanent issue throughout the Concertación government. Three tax reforms have been approved after a prolonged and difficult discussion in Congress, but the tax burden has slightly decreased. The tax burden was 18.06 per cent of GNP in 1993 and 16.29 per cent ten years later (2003). Although all tax reforms were geared to increase taxes (mostly value added tax) and/or reduce evasion; the trade agreements that Chile signed plus the unilateral reduction of tariffs implied a permanent decrease in the tax burden. Between 1993 and 2003 foreign duties decreased its contribution to total taxes from 2.3 per cent of GNP to 0.75 per cent, about the same amount in which the tax burden decreased. In 2005 the net tax burden has increased to 17.9 per cent of GNP (because of reduction in tax evasion), lower than in developed countries (G7 is 26.3 per cent and other OECD are 29.5 per cent of GNP). The fact that there has not been an explicit agreement on the tax burden in Chile has turned this discussion in a permanently unresolved political issue.

Whichever course of action is taken to reach a more equitable distribution of income, the underlying discussion in Chile will be the same one: the tax burden. Given that the electoral system in Chile forces an equal representation in Parliament for the opposition, it seems unlikely that the political composition of Parliament will change creating new conditions for an agreement on a larger tax burden. An important way out of this dilemma could be to incorporate new actors into the political dialogue. Until now social actors—with the exemption of the business community—have had a very weak voice in this discussion and thus all interests have not been adequately represented. A national dialogue, on such a crucial strategic issue, is advisable to reach an agreement that is clearly necessary to advance in equity and also to end a discussion that introduces economic instability. Greater participation of social actors interested in promoting equity should strengthen the political viability of a permanent agreement on the tax burden that increases financing of social policies.

4 Institutions for good democratic governance

Chile made a successful effort to implement reforms that produced simultaneous economic, social and political changes. Unlike the rest of Latin America, with this reforms Chile grew steadily at a much higher rate than in the past and also reduced poverty. Corbo et al. (2005), based on a cross-sectional econometric model, show that

Chile’s better performance is explained by the reforms that lead to stronger macro fundamentals and, most importantly, better institutions. The study proves that if all Latin American countries would have had the post-reform institutions that Chile has, their average rate of growth of GNP per capita would have been 1.6 per cent higher per year, and Chile grew 2.4 per cent more than the rest. Now if quality of institutions would have been similar to the ones of Finland, growth per capita would have been 2.3 per cent higher. Building and strengthening economic institutions explains more than half of the difference in Chile’s growth vis-à-vis the rest of Latin America.

Institution building is also related to the reduction of poverty. The three countries with lower incidence of poverty in Latin America (Uruguay, Chile and Costa Rica) are also the three with stronger institutions (according to Kaufmann et al. 2003). Brazil is 4th in poverty and 5th in institutions. The two most successful countries in reducing poverty in Latin America, followed different strategies during the 1990s, but both had in common institutional reforms. Chile placed its emphasis in financial and economic institutions with a positive response in terms of economic growth. Brazil emphasized reform in income transfers with a positive outcome in terms of income distribution. Both routes had a positive effect on poverty.

The relationship between equitable growth and institutions is also present in Rodrik’s (1999) findings that show that Latin American countries recuperate growth, after external shocks, at a lower pace than the rest of the world because of their weak institutions. Particularly, because of the inability of these institutions to deal with the distributional impacts that external shocks generate. This inability generates political and economic instability prolonging the effect of the shocks.

When it comes to political institutions, there still is a discussion in Chile about its transition to democracy. Some argue that it was completed at the beginning of the 1990s when Chile proved it could live under democratic rules and deal with the human rights problems that took place under the Pinochet regime. Others argue that it just concluded with the approval (June 2005) of the amendments to the Constitution that eliminated the non-democratic institutions inherited from the Pinochet regime. Finally there are some who say that there is still one pending issue, the electoral system, which although taken out of the Constitution is still undemocratic. What is clear is that Chile has been able to deal with its problems under democratic rule and improve the quality of its institutions in a democratic manner.

It is also clear that institutions could still be perfected from a democratic point of view. The real test for democracy is the way it is perceived by the population and its degree of democratic participation. In Chile support to democracy has grown from 54 per cent in 1996 to 57 per cent in 2004, in the same period in Latin America it decreased from 61 to

53 per cent of the population.[11] But, one half of those that support democracy believe that it has big problems and that the worst problem is poverty and inequality. Most people (70 per cent in Chile) also believe that governments are run for and by the wealthy and powerful. Also 41 per cent of the population does not participate in democratic elections and only 53 per cent of the people with the right to vote feel it is important to do it. Democracy still needs to be strengthened.

Democracy and equitable growth are strongly related. García (2003) shows a positive correlation between income distribution and support to democracy in Latin America, the stronger inequality the least satisfaction with democracy. There is also a relationship between the economic cycle and support to democracy. In Chile, 1997 was the last year of a prolonged period of growth: democracy support was at its peak (61 per cent) as it also was satisfaction with it (37 per cent); the opposite took place on 2001 (lowest point of the cycle and where democracy had 45 per cent of support and 23 per cent of satisfaction). Reduction of poverty also had a positive effect on the political arena; Chile (as well as Brazil, Uruguay and Costa Rica have) strongly supported democratic government. The Chilean president, although completing his mandate, is among the most approved in Latin America (65 per cent).

Confidence in institutions is also related to inequity. Equal rights or access is the most important variable (47 per cent) to define the level of confidence in an institution, the second reason (28 per cent) is that they fulfil promises. Prevailing inequality in Chile reduced confidence in the market economy, 36 per cent of the population (the highest in Latin America) express satisfaction with the market economy, while 51 per cent are unsatisfied. Lack of confidence also affects other institutions, governments, the judicial system, Congress, and political parties (in that order) were conceived as the least reliable institutions because they are perceived as unequal in ensuring rights and opportunities (their level of confidence varied between 14 and 25 per cent).

The lack of support to democracy and confidence in institutions, as a result of prevailing inequality, in turn, can have an economic impact. The last report of Business Monitor International,[12] that evaluates country risk, places Chile at number 20 out of 127 countries analyzed. But while Chile is number 7 in present political stability; it comes down to 27 in future political stability.

Surprisingly enough, dealing with the weakness of institutions related to distributional issues was not an important aspect, or was definitely not present, on the reform package of the 1990s in most countries in Latin America. In Chile there were three frustrated

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11 Information on democracy and social support comes from ‘Latinbarometro 2004, Una década de mediciones’, Corporación Latinbarómetro, Santiago Chile, 13 August 2004. See wwww.latinbarometro.org.

12 See www.businessmonitor.com.

efforts to create a tripartite dialogue institution that could deal with the egalitarian development agenda, none of them survive now. There also were partial reforms in the labour code, social security and the tax system, all crucial from a distributional point of view. Building or strengthening institutions able to deal with distributional issues is an ongoing challenge in Chile and Latin America.

As mentioned to advance in equality, it is particularly important to reach a widespread agreement on the tax burden. A good starting point, already used in the last tax reform, is to continue reducing tax evasion which could simultaneously increase government revenues and allow for rationalizing the system including tax cuts. The possibility of a further reduction in tax evasion is proven by the fact that the wealthiest 10 per cent of Chileans get 41.2 per cent of total income and their marginal income tax rate is 40 per cent but the total revenue of this tax is only 4.1 per cent of GNP. If the wealthiest 10 per cent were to pay 40 per cent of their marginal income and the economy would continue to grow at 6 per cent a year; the additional amount of income-tax collected in four years would enable a doubling of income by the poorest 40 per cent eliminating poverty in Chile.

5 Conclusion: a national strategic vision on the equity agenda

Chile has followed a well defined and successful development strategy for a prolonged period of time. It has done better than any other time in its history, better than all other Latin American countries and has partially closed the gap with developed countries. Although there was progress in all three main goals of the strategy, it lagged behind in the equity objectives. Remaining inequality, in turn, has weakened the confidence in democratic institutions. Strong institutions, on the other hand, are a good part of the explanation of why Chile did so well.

Many of the changes that Chile made during the last 16 years provide a positive experience for other Latin American countries. This is the case of the successful and innovative fiscal rule that reduces the depth of the cycle in countries where commodity exports play an important role. Another important lesson has been the priority given to social reform, in terms of the allocation of public funds and the reduction of tax evasion as a means of financing these reforms. Microeconomic changes, in the areas of regulation, transparency and public efficiency have also proven important to promote competitiveness. A crucial tool for the competitive objective has been the private concession of public infrastructures that increased total investment in this area. Chile has several good practices to show to other Latin American countries.

Although Chile's development outcome has been positive, the challenge to progress simultaneously on growth, distribution and democratization remains valid. These objectives seem highly probable to combine, according to econometric evidence. Cornia (2005) shows that high inequality (Gini coefficient over 0.45) limits economic growth.

Thus, redistribution should foster growth, especially if it is done through investment in increasing productivity of the poor. Marshall (2004) shows that closing productivity gaps with developed countries would enable Chile to increase its average rate of growth by 2 per cent. Greater equity on the other hand will strengthen trust in democratic institutions which, in turn, also strengthens growth perspectives making possible the realization of a virtuous circle between growth, distribution and democratization.

After 16 years the strategic vision raised by the Concertación government, has proven to be realistic and it has been adopted by all political parties; undoubtedly a very important political success of the governmental coalition. The presidential campaign that has recently taken place (elections in December 2005) has assigned first priority to equity and distribution. But, recent experience shows that political agreements in an electoral period do not necessarily imply that opposition parties will later support governmental actions to implement them. This is particularly true for the most controversial instruments, such as the tax and labour reform, where the opposition has voted against them or forced a political agreement that minimizes their effects. The fact that electoral agreements are implicit (there is no explicit commitment on specific actions to be implemented) and do not involve social partners; weakens its national representation and its possibilities of realization.

The road to progress in equity and redistribution is well known in Chile. Inequality is mostly explained by the precarious working conditions of the poor: unemployment, underemployment, informal employment and low investment in human capital. Thus, redistribution can be done directly through an increase in existing social programmes (that are efficient and well targeted) or indirectly through increasing productivity of poor workers at a faster pace than average (which requires training, support to SMEs, and compliance with labour standards). More public resources are required to finance the road to equitable growth.

Increasing the tax burden has been the major difficulty and the crucial stepping stone towards greater equality. The fact that it has not been done has reduced the pace of progress towards equality, and also has permanently kept in the political agenda a source of conflict and economic instability. These political difficulties remain present and will probably continue in the future because political actors have divergent interests ones a Government-opposition relationship is established.

Given the widespread political support to Concertación's strategic vision and its positive but incomplete outcome, it is necessary to create an explicit national agreement that involves political and social actors on an equity agenda. That is, on the content and priority of the social reforms to be implemented, the accountability procedures and the required tax burden to ensure their implementation. This strategic agreement should also strengthen the voice of the social partners that benefit from redistribution and democratization and that, until now, have had little presence in decision making. The social partners would provide more stable conditions for the implementation of the equity agenda. Creating an institution that involves all stakeholders and agrees on a socioeconomic agenda has been crucial in most countries that have combined growth and distribution as well as greater social participation in the democratic process.[13]

A formal social pact that explicitly agrees on a strategic vision, its priorities, expected outcomes and financing sources, is an important missing link in Chile's successful development strategy.

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[13] See IDEA, World Bank and ECLAC (2005).

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