POLICY BRIEF

OECD

Economic Survey of Chile, 2003

Summary

A stable institutional framework in Chile has provided the foundations for growth and confidence of international markets. While a comprehensive social agenda is putting pressure on resources under the recent economic slowdown, the Chilean government should be praised for having maintained a sound fiscal and monetary stance and building on its unique institutional framework based on the freedom of choice. The current challenges are to strengthen the coherence of this development policy agenda with a vision to long-term growth and broader social consensus. Chile is a small open economy, for which international competitiveness is the cornerstone for sustainable growth. The latter is the outcome of the multiple policy synergies discussed above. The first important link is to continue preserving a sound macroeconomic framework avoiding distortions that may produce excessive real exchange rate appreciation, which could hinder the incentives to invest and expand employment in the tradable sector. The deepening of financial intermediation and development of risk capital are needed to support the emergence of new and more innovative firms. A better functioning of the labour market is critical to the development of the enterprise

This Policy Brief presents the assessment and recommendations of the first OECD Economic Survey of Chile, 2003. The Economic and Development Review Committee, which is made up of the 30 member countries and the European Commission, reviewed this Survey. A draft of the Assessment was prepared by the Economics Department as part of the South America Regional programme of the Centre for Co-operation with Non-Members. It was revised following the Committee's discussions, and issued under the responsibility of the Secretary-General.

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sector. In particular increased female labour participation would support the development of light industries and services. Investment in human capital, in particular education and workers' training, is needed to develop products with a higher technological content. The administrative conditions and regulation of product markets should also be improved, notably by reducing administrative barriers to enterprise creation and removing distortions in the tax treatment of cross-border inter-enterprise financial flows. These policy linkages would help increase product variety and intra-industry trade that could contribute to reduce the vulnerabilities associated with an excessive reliance on natural resources and export concentration. In all these areas of reform, Chile is now in a position to emulate and converge towards the more advanced benchmark of OECD countries. ■

Why the Chilean economy is resilient?

In a turbulent region, Chile has emerged as a particularly resilient economy. The Chilean policy framework is characterised by responsible fiscal and monetary policies, a relatively well-developed financial system and modern institutions. Together with a liberal environment for the private sector, this framework has held up well in the face of several strong external shocks over recent years. As a result, Chile has achieved the highest per capita growth in Latin America since the mid-1980s. Confidence of international financial markets in Chile is reflected by the lowest spreads in the region.

Chile has also become a regional benchmark for structural reforms. In particular, it was among the first to implement far-reaching trade and market liberalisation in the mid-1970s. Chile pioneered in the field of competition law and policy. In the early 1980s, Chile was also a precursor in terms of privatisation of pensions, health care and education. The goal of these reforms was to reduce state provision of services, increase efficiency, allow individual choice, while freeing resources to reduce extreme poverty. Liberal reforms continued in the 1990s, with a focus on infrastructure provision and trade liberalisation.

Many of these deep reforms were imposed by the authoritarian regime (1973-89). After the reestablishment of democracy, the legitimacy of the reforms and their uneven social impact was put into question. But the governments in place since 1990 maintained the key features of the market-oriented approach. Notably, they strengthened macroeconomic stability and broadened the liberal institutional environment, while trying to widen access to the benefits of growth. To improve social standards and equity the democratic governments increased public spending on social policies in absolute terms and as a share of total spending. This was financed by the proceeds of growth and tax increases, which partly reversed the tax cuts implemented by the authoritarian government in 1988.

The pursuit of growth with equity is pressing in the context of the significant and persistent social inequalities. In particular, Chile has one of the most uneven distributions of income among emerging market economies. The labour market is characterised by a dualistic structure, with a high share of informality and precarious contracts. Economic development is also split between the modern and dynamic metropolitan area of Santiago and several poor and relatively underdeveloped regions. ■

How to reconcile the growth and equity objectives?

The compromise between the liberal model and the social agenda worked well until 1997 because of the remarkably high economic growth. After 1998 GDP growth slowed down substantially. While there are arguments for a benign interpretation, *i.e.* a cyclical deceleration due to a series of adverse external shocks, the slowdown of growth may be also due to structural factors that lowered the long-run trend rate. Amongst others, they could be related to the exhaustion of the gains achieved from market-oriented reforms and the possible negative impact of increased labour market rigidity on the growth potential of the economy.

Currently, the government is trying to promote growth while seeking to improve, rather than overturn the social policy foundations based on a market-oriented approach. Several significant reforms have been passed or are announced in areas including labour markets, regulatory policy, state modernisation and the fight against corruption. These are largely the fruit of a new and constructive dialogue between the government and the private sector (the so-called "Pro-growth Agenda", announced in January 2002). At the same time, the government is pursuing major social reforms, notably in health care and education.

Economic activity has been recovering since late 2002 with GDP growth projected at more than 3 per cent in 2003. While targeting a structural surplus, fiscal policy has been mildly counter-cyclical in the context of a nominal deficit of 0.8 per cent of GDP in 2002. Monetary policy has also been very supportive of domestic demand with base rates at historical lows of 2.75 per cent. In 2003, inflation is projected to remain within the 2-4 per cent target range. Nevertheless, the growth rate is still below trend (estimated by an expert panel at around 4 per cent for 2003-04). ■

Why the coherence of reforms needs to be improved?

Therefore, the financing of major social reforms, notably health care, is rather constrained. With a tax to GDP ratio below 20 per cent and a small public debt, the government sees some room for extending the social safety net through tax increases. In October 2003, the value-added tax was raised by 1 percentage point to finance the health care reform and tariff revenue losses resulting from the free trade agreements with the European Community (EC) and the United States. However, these tax increases have been debated, as the size of the government remains a controversial issue and there is also scope to improve efficiency of social policies.

Against this background, this Survey stresses the need for policy coherence. In revisiting its social agenda for growth, the government should consider the linkages across different policy areas and reforms. There are important synergies in preserving macroeconomic stability, deepening financial markets, addressing the duality in labour markets, investing in human capital, regulating product markets and removing administrative barriers, which in turn will help to enhance Chile's international competitiveness. These policy links are discussed below and underlie the main recommendations of this study. ■

Are macroeconomic policies supporting growth?

In the area of fiscal policy, the different governments in place from the mid-1980s had generated fiscal surpluses. In 2000, an *explicit* structural budget surplus rule of 1 per cent of actual GDP was introduced, allowing the government to pursue a counter-cyclical policy. It permits the fiscal balance to be below the target in recessions but requires surpluses during upswings. The rule introduced a medium term orientation and helped to institutionalise fiscal discipline. Fiscal transparency and accountability have also been improved through the creation of independent panels of experts to determine the key parameters of the budget plan and the progressive move from cash to accrual accounting.

The fiscal rule has a strong merit *per se*, though its design could be somewhat improved. Currently, the structural budget target is measured against actual rather than potential GDP, which would tend to introduce noise into the interpretation of fiscal developments when there are unexpected changes in the business cycle. In addition, the rule is implemented to include mid-year expenditure adjustments to offset revenue surprises that are not clearly linked to the deviation of actual from projected growth and copper prices. This may be disruptive of smooth programme implementation, but has the virtue of reducing the risk of cumulative departures from the target in case, for instance, potential output is poorly estimated. It might be considered whether a multi-year rule, whereby deviations in the structural balance from target are compensated in succeeding budgets rather than within the budget year (as applied, for instance, in Switzerland) would be an improvement. More importantly, an increase of the structural surplus should be considered in the medium-term to cope with future budget pressures related to social contingent liabilities (see below). This would also help to increase the national saving rate. ■

How to better coordinate the key reform areas?

Chile has a fully funded defined-contribution pension system, but because of low coverage and a weak density of contributions, the income replacement rates risk being very low for many. This would place mounting pressure on the minimum-income scheme for retirees, which is financed out of general taxes. Reforms in the labour market to increase the coverage of formal employment and in the pension market to reduce high administrative costs and raise returns so as to encourage greater participation by the self employed are necessary if the funded system is to deliver on its promises. Failing such structural changes and synergies, the Chilean government may have no choice but to re-introduce and fund a basic pillar within the overall pension system.

The Chilean financial system is generally sound: the financial position of banks appears to be strong, and the pension funds have underpinned the development of a large capital market. But the contribution of the financial sector to growth is still limited by weaknesses in the functioning of financial intermediation: the capital market, though large in terms of capitalisation, is illiquid and this limits interest of potential foreign equity investors; credit to small and medium size companies remains restricted and risk capital is extremely scarce. The adequacy of risk-diversification instruments and apparent lack of aggressive competition in both banking and pension sectors are further issues that should be examined. There is no single recipe for strengthening financial intermediation, and the government's approach of progressive review and reform of the regulatory framework to address emerging problems is appropriate, including present reforms to corporate governance and bankruptcy provisions. Chile may have particular interest in assuring a steady inflow of foreign investment to supplement domestic saving, while assuring that financial institutions are robust, and hedging instruments sufficiently available, to avoid undue exposure of the domestic economy to disruptions linked to fluctuation in international capital flows. In this regard, the present very high rates of withholding tax on inter-company transfers should be looked at. At the same time, while most capital account restrictions were removed *de facto* in 2001, their elimination *de jure* could also be envisaged. This would demonstrate the authorities' confidence in the resilience of the existing framework.

Chile's labour market is highly segmented, with a relatively high prevalence of insecure and informal jobs. This is mainly due to rigidities existing in the current legislation. In particular, severance payments are rather high and rules for dismissal are strict and cumbersome for those with indefinite contracts. Moreover, the minimum wage has increased at a substantially higher rate than the average wage and the typical remuneration of the unskilled since 1997. Enterprises have reacted to these regulations by widespread recourse to outsourcing and informality. To overcome labour market segmentation and unify the present dual labour market, the regulations that govern ordinary indefinite job contracts must be acceptable to employers and employees. Moreover, the maximum severance benefit should be reduced if possible, say to five monthly wages, while at the same time increasing the public support of the unemployed. The government has modified the system of severance payments, by pre-funding part of them in individual workers' accounts and by the creation of a Solidarity Fund. In the future this fund should evolve into fully-fledged unemployment insurance. Judging from OECD experience, an increase in such benefit spending would nevertheless require further measures to enhance the capacity of relevant administrations to implement activation measures, such as job-search assistance and training. Moreover, the minimum wage should evolve in line with other wages, in particular those of the unskilled.

Another characteristic of the Chilean labour market is low participation rate of the young and women. This is due to the existence of a legal framework imposing constraints on working hours and flexible work arrangements. Moreover, employers have a disincentive to hire women because they are obliged to provide child-care. The government is seeking to encourage enterprise bargaining to substitute for regulation, notably with regard to working time. This in combination with extended coverage of child education should improve the female participation rate. An improvement in the functioning of the labour market and increased labour participation would have very positive spillovers not only to the pension and health sectors, but also to the dynamism of the enterprise sector.

Chile has made great progress in the access and coverage of education and health care. It has reached almost universal access in primary education while coverage of secondary schooling has reached 85 per cent of the respective age group. Chile has low repetition rates by Latin American standards. The present universal voucher system in pre-university schooling has allowed for a large increase in coverage, in particular through the creation of subsidised private schools. Those serve more than one third of the school-age population today. Nonetheless, increased coverage has not yet been accompanied by improvements in learning outcomes, as suggested by the results of the OECD Programme for International Student Assessment (PISA+) and national surveys.

Indeed, the voucher system as currently applied is not contributing noticeably to greater equality of opportunity. Stronger social targeting may be needed, combined with more decentralised management at the school level. Moreover, Chile will need to improve the quality and assessment of teaching. Appropriate regulations and incentives will be needed while dealing with the entrenched position of the Teachers' Union. Negotiations in this area are now under way.

In an international comparison, Chile scores favourably in terms of health indicators such as life expectancy and infant mortality rates. This record largely stems from better socio-economic living conditions and a strong improvement in preventive types of care provided by the municipalities. However, diverging health outcomes between socio-economic groups and regions point to insufficient solidarity in the health system. Some malfunctioning of the public and private insurance and care provision needs to be addressed: the public sector is characterised by stagnating productivity of physicians and long waiting lists, while adverse selection problems and excessive supplementary payments for certain treatments are common in the private sector.

The main aim of the currently discussed health reform is to improve access to care under the so-called plan AUGE that provides minimum care guarantees for the entire population. The estimated cost of this plan is over USD 300 million (estimated at around ½ per cent of GDP). Controlling the evolution of costs in this area will be essential. This can be stimulated by granting more autonomy to hospitals and moving to more prospective and performance related types of funding. Other aspects of the reform should limit opportunities for “cream skimming” in private health insurance and strengthen patients’ rights. In order to evaluate the return on additional investment in health care, Chile should develop a system of indicators to monitor improvements over time. Examples in this area include patient feedback measures, rate of childhood vaccination and mortality rates for key diseases. ■

How to improve the regulatory framework?

Overall product market restrictions in Chile are comparable to those of other emerging economies in the OECD. The priority now is to improve the regulatory framework by overcoming uncertainty and inefficiencies. The OECD indicators on product market restrictions reveal a certain regulatory and administrative opacity, which is currently being addressed in the “Pro-growth Agenda”. For example, the recent introduction of the administrative “silence is consent” rule is to be welcomed. Other administrative measures are needed to unify access to information on licensing, notifications and set-up of “one-stop shops” for enterprise creation. Administrative transparency at the international level could also be improved by encouraging the convergence of the Chilean regulations with international best practices. Important to note, the government is presently undertaking major reforms of the public sector. These include more transparent procedures for the recruitment of high level officials and public procurement, notably through an increased use of *e*-government.

A main regulatory problem has emerged in the electricity sector, due to ambiguities in the electricity law concerning transmission costs. This is holding up investment in transmission infrastructure, which in turn is deterring investment in new generation facilities. The regulatory framework does also not address well the specific risks associated with a high share of hydropower and the valuation of reserve supply in periods of serious droughts. Solving this issue would become critical under a resumption of growth, as the elasticity of electricity demand to output is typically rather high. Diversification of the power-generation mix should nevertheless take into account the environmental dimensions, notably air pollution which is an important concern in the metropolitan area.

Recent corruption scandals in the financial sector demonstrated the need to improve co-ordination and information among the different regulatory bodies. A stronger coordination of the supervisors of pension funds, banks, and capital market is required due to the small size of the Chilean market and the intertwined relations between the largest banks, pension funds and stock market participants. This process is being considered in the second capital market reform now under discussion and would parallel the experience of some OECD countries. ■

Is the strong dependence on natural resources a problem?

Another area of concern is the low degree of diversification of the economy, which continues to rely heavily on natural resources. Chile has been very successful in developing some product segments in the agro-food sector, but their scope is limited. The free trade agreements with the EC and the United States will provide new export opportunities, in particular in terms of improved market access for more value-added goods. The authorities also foresee a large potential for developing Chile as a regional platform for services, notably finance and technical support. The business community also views a possibility to develop more technologically intensive clusters around the traditional sectors such as mining and fisheries. For these options to materialise the barriers for enterprise creation and development should be reduced. ■

For more information

More information about this Policy Brief can be obtained from Joaquim Oliveira Martins,
tel.: (33) 01 45 24 88 53
e-mail: *joaquim.oliveira@oecd.org*, and
Nanno Mulder, tel.: (33) 01 45 24 95 78
e-mail: *nanno.mulder@oecd.org*

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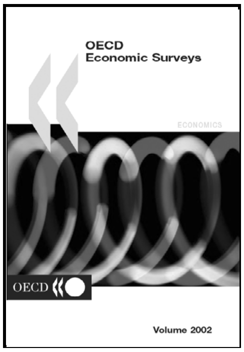

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Public Affairs and Communications Directorate.
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Where to contact us?

FRANCE
OECD Headquarters
2, rue André-Pascal
75775 PARIS Cedex 16
Tel.: (33) 01 45 24 81 81
Fax: (33) 01 45 24 19 50
E-mail: sales@oecd.org
Internet: *www.oecd.org*

GERMANY
OECD BERLIN Centre
Albrechtstrasse 9/10
D-10117 BERLIN
Tel.: (49-30) 2888353
Fax: (49-30) 28883545
E-mail: berlin.contact@oecd.org
Internet: *www.oecd.org/deutschland*

JAPAN
OECD TOKYO Centre
Nippon Press Center Bldg
2-2-1 Uchisaiwaicho,
Chiyoda-ku
TOKYO 100-0011
Tel.: (81-3) 5532 0021
Fax: (81-3) 5532 0036/0035
E-mail: center@oecdtokyo.org
Internet: *www.oecdtokyo.org*

MEXICO
OECD MEXICO Centre
Av. Presidente Mazaryk 526
Colonia: Polanco
C.P. 11560
MEXICO, D.F
Tel.: (00.52.55) 5281 3810
Fax: (00.52.55) 5280 0480
E-mail: mexico.contact@oecd.org
Internet: *www.rtn.net.mx/ocde*

UNITED STATES
OECD WASHINGTON Center
2001 L Street N.W.,
Suite 650
WASHINGTON D.C. 20036-4922
Tel.: (1-202) 785 6323
Fax: (1-202) 785 0350
E-mail: washington.contact@oecd.org
Internet: *www.oecdwash.org*
Toll free: (1-800) 456 6323

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