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Understanding Chilean Reforms

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4.1 Introduction

Chile's economic performance in the last 20 years has been outstanding and it is the only country in the region that can claim significant progress in reducing income gaps with the developed world. However, in the 1960s and 1970s Chile's per capita GDP growth was way below the average of East Asia, OECD countries, and the world economy. When compared with the other Latin American countries, the Chilean economy grew at about average rates in the 1960s, below average rates in the 1970s and only outperformed them in the 1980s and 1990s.

As Chumacero and Fuentes (2002) point out, Chile was extremely vulnerable to major international crises (the Great Depression, the oil shock crisis, and the debt crisis). Despite this vulnerability, Chile recovered faster than other countries in the region. After the debt crisis, Chile exhibited not only the highest growth rates of the region, but also a level of volatility that is not statistically different from the average of the region. Something happened with Chile, transforming it from an 'average' Latin American country to a dynamic economy that now exhibits accelerated growth rates and decreased volatility.

The market-oriented reforms put in place in the 1970s and 1980s and deepened in the 1990s are prime candidates to explain this transformation. This chapter describes the nature of the process leading to the reforms, with emphasis on the political economy and incentives behind the two main political regimes that undertook them. Our goal is to address questions such as:

- Why did Chile start its reform process fifteen years prior to the Washington Consensus?
- Why were the reforms so profound?
- What role did the political regimes play in implementing the reforms?
- Why were the reforms maintained with the advent of democracy?

The Chilean experience during the implementation and consolidation of the reforms was unique. The early reforms were conducted under an authoritarian government, and, contrary to experiences elsewhere in the region, the return to democracy did not entail reform reversals but brought their consolidation.

We concentrate our analysis on how political institutions affected the processes of implementation and consolidation. We argue that, under the authoritarian regime, the initial conditions and the intertemporal linkage of policies allowed policy-makers to follow something close to a first-best policy. During the 1990s and early 2000s, the prevalence of common views on matters of economic policy between government officials and the opposition reduced 'transaction costs' and permitted the economic reform to continue at a reasonable pace. We will discuss how the electoral system and the constitutional powers of the president and Congress configured a setup that made reform reversal difficult. We also argue that success was a determinant factor in preventing reform reversal in the early 1990s.

We follow the transactional theory to policy decision-making in which public policies are the result of a political transaction game that is conditioned by the functioning of political institutions and historical circumstances (Spiller and Tommasi, 2003). Under this approach the first-best policy is reachable only when conditions favor political cooperation. Spiller and Tommasi (2003) consider six elements that determine how the political game is played. They argue that a Pareto-optimal solution is more likely to be attained:

(1) The smaller the number of key political actors (reducing transaction costs).
(2) If there are strong intertemporal linkages among the political actors (under a repeated game scheme, players have incentives to cooperate).
(3) The easier it is to observe the moves of different players (reducing monitoring cost and increasing cooperation).
(4) When effective enforcement technologies are available.
(5) If the field where the exchange among the political actors takes place facilitates the enforcement of cooperation (depending on the type of legislation available).
(6) The lower are the short-run pay-offs to deviate from non-cooperative solutions.

We also follow Aninat et al. (2004), who argue that the prevalence of common views as opposed to widely divergent proposals can play a significant role, especially in the presence of strong veto players, as is the case in Chile in the post-reform period.

We use these frameworks and evaluate these elements during the military and democratic governments. The rest of the chapter is organized as follows: Section 4.2 describes the situation prior to the first wave of reforms and lists the reforms conducted since then. Section 4.3 analyzes the political economy of the reform process under the military and democratic regimes. It describes their political structure, identifying the key players and how the reform process took place. Section 4.4 provides a closer look at some reforms. Section 4.5 concludes.

4.2 The Chilean economy: a historical description

As Fanelli and Popov (2005) point out, initial conditions are crucial for understanding the timing and shape of reforms. This section briefly describes the historical background that led the Chilean economy to the situation prior to the reforms and presents a brief summary of the reforms themselves.

The Chilean economy is relatively small (16 million people in 2005). Since its independence in 1810, its economic record has been mixed. After an initial setback, the income gap with the US closed in the nineteenth century, but, until the 1980s, it continuously deteriorated during the twentieth century, particularly during the import substitution period (between 1940 and 1973).

4.2.1 The import substitution period[1]

After the Great Depression, the internationally prevailing notions about ideal development policies heavily influenced the Chilean elite's economic thinking. In the 1940s, under the Popular Front governments,[2] a new development ideology emerged.[3] It was heavily influenced by the circumstances of the time, the breakdown of trade as a result of the Great Depression and later World War II, and by new beliefs about the role of government,[4] not only for short-term macroeconomic stabilization, but also as an engine of growth.[5] Along with higher inflation rates, the main effects of these policies were:

1. *Growing macroeconomic imbalances.* The economic ideas that prevailed after the Great Depression generated pressures to increase fiscal expenditures destined to finance industrial infrastructure (steel mills, energy supplies, transport facilities, and so on) and social expenditures (education, health, housing, and so on). As a consequence, from the early 1940s governments began to run deficits.[6] In the absence of functioning capital markets and with no access to international loans,[7] they were financed by a central bank that gradually lost its independence.[8] Keynesian ideas and the widespread belief that supply was bound to react to expanding demand heavily influenced macroeconomic thinking. On the other hand, inflation was seen mostly as a 'structural problem' due to low agricultural productivity, monopoly power by industries, and redistributive conflicts. Growing imbalances led to rising inflation rates and chronic foreign exchange crises and massive devaluations. Consumer prices rose on average by 16.6, 34.5, and 23.7 per cent annually during the 1940s, 1950s, and 1960s, respectively. By 1956, successive governments initiated anti-inflationary programs that ended in failure after a few years of transitory success.[9] This process reached a climax in 1971–73 during Salvador Allende's government, when the inflation rate reached over 600 per cent in the last year.
2. *A more active role of government in the economy.* After the Great Depression, the government started taking over activities previously conducted by the private sector. The symbol of the 'entrepreneurial state' was CORFO (created in 1939), a state-owned and managed development corporation commissioned to promote industrialization, either directly (creating new SOEs), or with preferential loans to the private sector that invested in high priority industries. Over time, it took over failed large private firms that the government did not want to close down. In 1970, 64 of the largest firms in the country were either CORFO subsidiaries or other SOEs. Government intervention is attested by the activities in which it was involved.[10] During Allende's government, 500 additional medium- and large-sized firms were either nationalized or taken over by the government.[11] The value added by SOEs, which was negligible in 1940, rose to 14 per cent of GDP in 1965 and 39 per cent in 1973.[12]
3. *Protectionism.* Besides supplying the private sector with the infrastructure for industrial development, the government provided protection to local producers. Protection took many forms, of which import licenses and quotas, differential custom duties, multiple exchange rates, and low and often negative real interest rates were the most important. During Allende's regime, extremely high previous import deposits were added and eventually, the government directly carried out all foreign trade operations. As a result, trade to GDP ratios fell from 29.2 per cent in 1929 to 16.7 per cent in 1970.
4. *The welfare system.* The industrialization process and increased population growth rates early in the twentieth century induced large migrations from the rural sector to the main cities. As migrants could not always find employment, large and evident differences in living standards gave rise to the so-called 'social problem'. The official reaction was to increase government expenditures on education, public housing, health and pensions, as well as the development of a mandatory and onerous social insurance system. Governments yielded to the many demands, more often than not financing them through monetary emission. As inflation rates picked up, governments relied on stop-gap measures, like price controls and subsidies. These new distortions reduced growth rates even further, compounding the social problem. By 1970, 42.5 per cent of central government expenses were already 'social' expenditures, most of them, merit goods. They accounted for 10.5 per cent of GDP. However, social expenditures largely missed the poor and in large part were captured by emerging pressure groups in the middle and upper classes (Arellano, 1985).

Allende's government represents the cusp of previous trends, imposing the highest restrictions on international trade and finance ever experienced. Practically all prices in the economy – including wages, interest rates, and exchange rates – were not only fixed but also micro-managed by government decrees. Most of the large- and medium-sized firms were taken over by the government and managed by it. Rent-seeking reached its peak. Although freedom of expression existed and most democratic institutions were in place, the economy began to resemble a Central European centralized economy. Massive expropriations, dramatic economic failure reflected in runaway inflation and widespread shortages of all kinds of goods, as well as an extremely confrontational political climate, were major sources of social turmoil.

After the military coup of 1973, major economic reforms were enacted to reintroduce free markets and free trade, restore the solvency of public finances, stabilize the economy, and reduce the role of the government. All these reforms began 15 years ahead of the Washington Consensus and were met with widespread skepticism, nationally and abroad.

4.2.2 The reforms of the 1974–89 period

By September 1973, socio-economic conditions had deteriorated to the extent that deep reforms were possible.[13] Relative to the US, Latin America, or any other region except Africa, Chile's GDP per capita had been losing position since the early 1900s and the country had fallen into socio-political chaos.

After an initial period of hesitation and disorganization, the military government adopted a socio-economic reform agenda proposed by a group of liberal economists early in 1975, partly forced by a severe deterioration of the international economic environment.[14] These economists – the so-called 'Chicago Boys' – had similar academic backgrounds and most of them had no active political experience, although their sympathies tended to lie with the center-right.[15]

Principles behind the reforms

The guiding principles for the implementation of a modern market economy in Chile were:

- *Secure property rights*, which had been severely undermined, especially during the Allende regime when many companies in all sectors of the economy and of almost every size were nationalized or put under state management with little or no compensation.
- *A subsidiary role of the state*, which limited state interventions to cases of clear market failures. Exceptions were made on the basis of political considerations, with the preservation of state-owned firms in the mining sector being the most flagrant.
- *Freedom of choice*, reflected in the elimination of trade permits and prohibitions, as well as rationing procedures and price controls, which pervaded every activity by the end of Allende's government.
- *Fiscal consolidation and orthodox management of monetary and foreign exchange policies*, which were a necessary condition for a well functioning market economy and an area in which governments had failed in the past.

- *Systematic reduction of the spaces for public discretion and potential arbitrariness, introducing impersonal rules whenever possible.* Rent-seeking was seen as a major source of inefficiency and corruption, with a significant impact on overall factor productivity and growth.
- *Trade and financial openness*, which would provide the impulse for growth that the limited size of the domestic economy could not provide, as well as creating competition in the local economy.
- *Social policies were focused on poverty reduction, with means testing and expenditure targeting as main instruments.* This approach was in stark contrast with prevailing views in the 1960s and early 1970s that put a very strong emphasis on income redistribution.
- *Institutionalization of the 'rules of the game' in such a way that it would not be easy to change them*, with the purpose of granting stability of those rules under different governments.

Most of these principles can still be recognized in today's economic policies, even though in many cases they are qualified in recognition of the increasing complexities of the policy issues.

The political environment surrounding the initial reforms was unique. After the military coup, political parties were outlawed and political opposition was strongly repressed. However, when the economic crisis of 1982–83 severely weakened the regime, an organized political opposition emerged de facto. This opposition took advantage of the fact that the regime allowed public discussion of the socio-economic management of the country and their criticism of economic policies was publicly circulated. The weakened state of the political parties and the repression of normal political activities did not mean that policy-making processes were simple. There were dissenting views within the armed forces and there was always a nationalistic faction, sharing many of the old views about state intervention and in favor of protection of traditional agriculture against foreign competition, that was trying to block many reforms. The strong backing by Pinochet was essential for their implementation and survival through economic crises. However, the power of Pinochet was limited by his need to preserve the unity of the armed forces.

Chronology of the reforms

The economic reforms between 1973 and 1989 were not continuous. The following reform periods can be distinguished:

1. *Basic Structural reforms.* Between late 1973 and 1981, the structure of the economy was drastically changed:

(a) Prices, interest rates and wages were left to be determined by market forces.[16]
(b) Customs duties, which reached up to 200 per cent, were drastically reduced and non-custom barriers were virtually eliminated.

(c) Fiscal and monetary responsibilities, which had been exceptionally weak for several decades, were restored and the tax system reformed, including the introduction of a VAT.
(d) The foreign investment code was changed to make it attractive to investors. The exchange rate system was significantly liberalized.
(e) Except for the traditional SOEs, over 500 large- and medium-sized firms managed by the government were privatized.
(f) Labor market regulations were changed. Collective bargaining was limited to the firm level, and firms could dismiss workers and negotiate wages.
(g) Social security legislation was 'revolutionized' by the replacement of a pay-as-you-go system with a fully funded system based on individual retirement accounts privately managed.
(h) Competition regulation was introduced.
(i) Public utilities were regulated in a market-friendly manner.

2. *The 'debt crisis' and reform reversals.* During 1982 and 1983, the country experienced a deep economic and financial recession, which had political consequences. Discontent and social unrest were expressed in large public demonstrations, organized by union leaders with the backing of the political opposition. This led the military regime to some partial reform reversals. The tipping point was the realization by the government that traditional supporters among farmers, small business owners in commerce and transportation were leaning against it. Yielding to pressures from unions and the entrepreneurial leadership, custom duties were raised from a uniform 10 per cent to 35 per cent and loans were granted with preferential interest rates. As a consequence of the bankruptcy of a relatively high proportion of commercial banks, the government 'intervened' in them, replacing their boards of directors and managers by public sector appointed teams. It also instructed the latter to declare the bankruptcy of the holding companies that were not in a position to serve their loans regularly. As a result, the management of many large firms, among them a good number of those which had been privatized by the military regime a few years before were again indirectly managed by the government. This was made possible because capital shares of those holdings were used as collateral for commercial bank loans.[17]

3. *Policy reforms.* Between 1985 and 1989, once the economy had recovered from the recession and the government had regained some of its political power, the regime went back to its pre-recession track. The cabinet was changed and a new generation of economists took over. Custom duties were reduced to a uniform 15 per cent. Firms that had fallen under public sector management were re-privatized. Most of the large, traditional SOEs were also privatized, spreading share ownership as widely as possible. Most significantly, important policy changes intended to increase savings and exports were implemented.

(a) The main instrument used to increase private savings was a reduction in government taxes, made possible by lower government expenditures, which included the granting of special tax incentives on savings.
(b) The export promotion tool was the maintenance of a high real exchange rate, made possible by an aggressive foreign debt repayment policy, which also increased savings.

Compared with the pre-recession period, in which structural changes clearly dominated economic policy-making and an effort was made to maintain a 'neutral' economic policy stance, the post-recession period was characterized by an active role of the government intended to increase exports and savings.[18]

4.2.3 Reforms after the return of democracy

After the defeat of Pinochet in the October 1988 referendum, it was clear that a transition towards democracy had started and, in all likelihood, the new president would come from the ranks of the political opposition.

Early stage

When elected, the first democratic government did not have an agenda for structural reforms. Its first priority was to secure a stable macroeconomic environment and to build the necessary support to pass through Congress a tax increase to roll back part of the tax cuts introduced in the late 1980s. The latter was essential to get the social programs of the new government in place. The only exception had to do with reforms of the labor codes, which were bound to appear as a key issue in any social dialogue initiative (a priority of the new government). The social dialogue was a forum for negotiation between labor and business leaders to revise the labor code while maintaining key provisions intact.[19]

Despite the fact that the government did not have an explicit reform agenda, it took advantage of specific circumstances to introduce reforms in several areas:

- *International trade.* There was a unilateral reduction of import duties from a uniform tariff of 15 per cent to 11 per cent. An agenda to negotiate an FTA with the US was placed, taking advantage of an invitation from President Bush (senior) to create a Free Trade Area of the Americas.
- *Regulation of capital flows.* Changes were in different, and sometimes opposite, directions. On the one hand, the Central Bank lifted restrictions on capital movements, gradually allowing private companies to issue bonds and stocks in international markets. On the other hand, a controversial reserve requirement to foreign loans (linked to the duration of the loan) was introduced.
- *Capital markets reform.* When the government took power it was clear that a reform of domestic financial and capital markets was needed to

adapt them to the emerging reality of huge long-term savings accumulated in the pension system.

- *Privatization.* The political coalition supporting the government had been very critical of privatizations made during the military regime. The very special nature of the political transition in Chile forced a tacit understanding not to reopen previous privatization processes, but nobody was expecting the new government actually to privatize state companies. The decision to sell a majority fraction of the last major hydroelectric power generator in the hands of the state was a major shift in the *Concertación*. The privatization was conducted in such a way as to strengthen competition in the electric sector.
- *The start of concessions of public works.* An aggressive program to give concessions of public infrastructure to the private sector took off in full in the second half of the 1990s, and totally revamped the Chilean infrastructure in less than a decade.

Second-generation reforms

The second government of the *Concertación* led by Eduardo Frei started in 1994 with a broad program and little sense of actual priorities. As the government consolidated the internal decision-making process, a clearer agenda began to emerge, with an emphasis on what would later be classified as 'second-generation' reforms:

- *Expanding the role of the private sector.* The main pillar of this program was the highway concessions program that had started in the previous administration and allowed the accumulation of expertise leading to a revision of the law (Marcel, 2000, 2002). The other privatizations were: operation of ports,[20] and the water and sewage utilities.[21]
- *Educational reform.* Even though Chile enjoyed better education indicators than most of the region, they were still quite low when compared to developed countries or emerging market economies in Asia (Fuentes and Mies, 2005). The government decided to push ahead with an ambitious (and expensive) educational reform including major changes in two areas: the number of hours of classroom work in primary and secondary education, and a major revision of the curriculum. The results of this reform have not been as expected as educational attainment tests have shown no major improvements.[22] During President Lagos's administration secondary school education was made mandatory, with the goal to reach universal coverage.[23]
- *The penal system reform.* This involved a major change in the way penal justice was administered. Instead of a judge conducting the investigation and sentencing in a written process, the new system involved separating the investigation process from the judging and sentencing in an oral process. A public prosecution service had to be created from scratch, to take care of the investigation process, and another to provide public defenders for those who could not afford private lawyers.[24]
- *Macroeconomic policy reform.* The fiscal policy processes (examined in detail below), starting with the Central Bank Independence Law of 1989 (at the end of the military government), resulted in continuous budget surpluses for more than a decade, leading to a substantial reduction in public sector debt. This outcome would have been unlikely in an environment with a weaker Ministry of Finance, or stronger powers of Congress in fiscal matters. The last stage in this process was the introduction in 2001 of the Structural Balance Rule for the Central Government. An efficient management of monetary policy by the Central Bank of Chile has complemented the fiscal policy.

4.3 The political economy of the reforms

In this section we discuss the political economy of the reforms implemented in the 1970s through the 1980s and 1990s. Prior to that, we briefly describe the political system existing before the 1973 military coup. We also discuss how the military government modified the rules of the political game for the democratic government that followed.

4.3.1 Before 1973

The political system in place was based on a presidential system, while political parties in Congress were elected on a proportional basis. Since the number of deputies varied from one district to the other roughly in proportion to the size of the electoral registry, this led to a very fragmented congressional representation.

The party system was consolidated in the first half of the nineteenth century, within a competitive environment among atomized parties. At the same time, this was the most unstable period of Chilean political history, with several military coups taking place (Scully, 1995). The consolidation of the party system was reflected in the parliamentary elections of 1932 where 27 parties competed and 19 obtained representation. During most of the post-war period, governments did not have a majority in Congress and had limited powers to rein in political pressures and to pass corrective legislation.

Political alliances were needed to govern. Over the twentieth century the parties grouped in three loose – and shifting – coalitions (right, center, and left). As a result, absolute majority was difficult to attain.[25] With opposition from two fronts, governments could not set their agendas. One of the most extreme cases was the presidential election of Salvador Allende in 1970, who won with 36.6 per cent of the votes.

The proportional system encouraged competition between parties, increased the transactions costs required to govern, increased the number of negotiating agents, and reduced the retaliatory powers of the executive branch. Naturally, center parties – first the Radical Party and, starting in the 1960s, the Christian Democrats – tried to arbitrate opportunities between the right and the left, making short-term agreements to approve certain laws.

On the other hand, policy-making institutions were weak. The Ministry of Finance had limited control on public finances, while Congress had almost unlimited powers to legislate benefits for key constituencies (pension benefits being a prominent instrument). Finally, monetary policies were subordinated to fiscal financial requirements.

4.3.2 1974–89

Why was Chile able to carry out such drastic, far-reaching, and successful reforms? The simple – but wrong – answer is that Chile was under a military government. Dictatorships in other developing countries provide countless counter-examples.[26] Either they did not try to improve the existing institutions or if they did, they failed.

While the critical economic situation faced in 1973 played a role in the type of policies considered, other countries in the region had been in similar circumstances and were not able to find a way out of their problems.

What happened in Chile is a fortunate conjunction of a number of factors that contributed to the positive outcome of an extremely ambitious reform project. Fewer actors and a concentration of power in the hands of the president resulted in less frequent political transactions, facilitating the implementation of effective economic policies. The following are some of the factors that contributed to reform:

(1) The deep socio-political and economic crisis of 1971–73, which was the culmination of about 15 years during which the country experienced a wide variety of regimes – from conservative to a mild reform and finally to a full-blown socialist government – that did not produce the desired results. The climate was propitious for the introduction of deep market-oriented reforms, since most citizens were willing to postpone their short-term private interests in favor of a reform that promised prosperous medium- and long-run prospects.

(2) A strategically competent military leadership. Contrary to what happened elsewhere, the military was not as involved in civil matters after 1930. Although they were aware that the experiments of the previous decades had failed, they had no expertise in economic matters and were willing to take the advice of professional economists. They also believed that a viable democracy required a rapidly growing economy. To achieve that end they were willing to withstand the initial political cost of the structural changes.

(3) The existence of a relatively large group of internationally trained economists who shared a common view – liberal, in the European sense of the word – of what a successful economy should look like. The largest group of these economists had followed graduate studies at the University of Chicago, but many others had studied at other top economic institutions in the US and Europe.

(4) A large cadre of business graduates who had been influenced by the ideas of those economists and who understood the workings of such an economy.

(5) The ability to conduct several reforms in a big-bang way. The importance of policy complementarities (that is, how some policies require others to enhance economic growth and to avoid reform reversals) has been recognized in the literature.[27] This was reinforced by macroeconomic stability, a priority objective of all Chilean governments since 1973.[28]

(6) The way the military government was organized and managed its affairs. The military Junta, formed by the chief commanders of the army, navy, air force, and police, had advisers on different economic matters. Although the first finance minister was a member of the armed forces, the Junta soon realized that it lacked a coherent plan to effectively conduct economic policy. The availability of *'El Ladrillo'*, a blueprint for an economic plan for the government following Allende's regime, and the strikingly different policies it proposed, helps us to understand the path taken. After 1974, the military government delegated the definition and management of economic matters almost exclusively to professional economists. This may be one of the reasons why the government allowed some debate on economic – as opposed to political – matters. At the beginning, the members of the military Junta shared power and Pinochet's control of the army was limited. Several key projects, such as pension reform, for instance, were blocked by the Chief Commander of the Air Force, General Leigh, who was the most prominent supporter of the nationalist forces. By the end of the 1970s, Leigh had been dismissed and Pinochet had consolidated his power over the army. At the same time a constitution had been drafted and enacted, setting a clear path for a transfer of power to civilians in the long run. This also allowed the unblocking of the pension reform.

The structure of the government was simple. The president of the Junta and later president of the country, General Pinochet, exercised executive power, while the Junta was the legislative body. Under such a setting, political transactions to decide economic policies took place among a small group of actors. The most important transactions were of an inter-temporal nature. In general, reforms are expected to have important effects in the long run, while the pay-off tends to be small in the short run. The military government – given the initial support it enjoyed – thought it would have enough time to receive the benefits of the reforms. After the approval of the new constitution in the plebiscite of 1980, the government knew that it would remain in power for a long period of time.[29] Furthermore, as the economy had experienced rapid growth after both the 1975 and 1982 crises, the government stressed the idea that the reforms underlay the economic success.

Among other things, the constitution fixed the presidential term of Pinochet and it established that after eight years of that presidency, the Junta would nominate a presidential candidate for another six-year term, to be approved in a plebiscite. If the name was not approved – as happened – one year later, Pinochet was to call open elections, which he did in 1989. Part of the political uncertainty was eliminated when the constitution was approved, since Pinochet and the population knew that he would remain in power for at least nine more years.

Criticism and political unrest followed the debt crisis of 1982–83, but with a monolithic government and a set path for the transfer of power, the government was able to weather the storm. Transitory political and economic concessions were made but there was very little room for maneuver, since the country had become critically dependent on the financial support of the IMF and the World Bank. The so-called Structural Adjustment Loans (SAL) became a source of much needed foreign financing and an instrument to support economic reforms at a moment in which the government's political and economic teams were inclined to undo some of them.

In terms of political transactions, the implementation of the reforms was not necessarily efficient, but it was effective. The military regime used a number of instruments adapted from their own institutions. A coordinator, with the rank of minister, would receive the reform proposals, approve or reject them, and decide when to send them to 'Congress' (the Junta).[30] This office was (and still is) housed at the Moneda, the presidential palace, and had easy access to the president. In addition, every year, the ministries prepared a list of the main reforms that they wanted to have approved. After a reform was analyzed, modified, and approved by the minister, the ministry adopted it as its own. Each minister was evaluated on a yearly basis in large part on how effective he was on implementing such programs.

(7) A strong technocracy that provided good enforcement. The military government replaced the existing bureaucracy with a strong technocracy, which had a clear focus. They were housed mainly at ODEPLAN (the planning office), the budget office at the Ministry of Finance and the Central Bank. Special teams were assembled in key areas of reform, such as pensions, comprising economists and lawyers from the different institutions involved. In most cases these teams were recruited by the leader of the economic reform in the government, Sergio de Castro and later on, Hernán Büchi (ministers of finance) and Miguel Kast (ODEPLAN). The technocrats behind the reforms made special efforts to avoid rent-seeking behavior and activities. Examples of this principle were the pricing of all public utilities at marginal cost of production as well as uniform import tariffs for all goods. Pinochet was very supportive of this, as he disliked a dynastic type of society, where family name was an important asset that perpetuated economic and political power.

The economic reform process was far from even and linear. Reforms of the institutions came in waves, as political and economic conditions permitted. It was not uncommon for economic measures approved by the government to be reversed as the result of political pressures. In fact, the military regime was relatively sensitive to public opinion and gradually allowed more public discussion of economic matters. The best known and most significant reversals took place during the debt crisis (approximately a year and a half after the constitutional referendum). Management of commercial banks handling a high proportion of the financial assets and liabilities of the country was transferred to the public sector (due to the financial crisis) and later custom duties were raised. Those were only tactical moves, since as soon as conditions permitted the banks were re-privatized and custom duties were again lowered.

The electoral reform put in place during the military government has been crucial. By the end of the 1980s there was a clear sense of economic success and the military felt that economic reforms and the constitution were their main legacy. The existing political structure, inherited from the military government, is strongly presidential and has a binominal system for electing the members of parliament, replacing the proportional system. As a result of this and the conditions prevailing at the time, two large coalitions were formed, one center-right and the other center-left.

Given the new electoral system, negotiation within the coalitions for the definition of the ballots is the key factor to get elected, so that the power of the party leaders over members of Congress has been enhanced. This reduces the number of players and gives strong retaliatory powers to party leaders. The constitution also allowed the president to designate two senators directly and four indirectly, out of a total of 48 senators. Pinochet nominated the first group of designated senators, independently of the result of the 1988 plebiscite. This structure gave the military a de facto veto power that was used to block political reform until Pinochet became discredited by corruption scandals, after his temporary imprisonment in London. This meant that veto powers built into Congress were also used to shield economic reforms from attempts to reverse them.[31]

4.3.3 The 1990s

One concern at the end of the military regime was the possibility that major economic reforms could be reversed, or populism could stall the economic recovery as well as reaccelerate inflation. Another was the diversity of the coalition (*Concertación*) that finally won the election, comprising a wide range of political parties from the centrist Christian Democrats to the Socialist Party of the late President Allende, still professing Marxist ideals. Last, but far from least, was the concern that after 17 years of a military regime, economic and social demands from organized labor and other groups would overwhelm the government, breaking fiscal and monetary discipline and dismantling key reforms, even against the will of the political leadership.

The return to democracy brought a deepening and not a reversal of the reforms. Some of the factors that can explain this surprising outcome are:

- *The economic success of the late 1980s.* From 1985 on, the economy had high and sustained growth, employment recovered, and new export activities flourished. Doubts about the wisdom of having low import tariffs and complaints about the social costs of economic reforms were disappearing. A genuine appreciation of the market economy was evident in the middle class. The continuity of market reforms and the ability to keep the economy working were the main themes in the political campaign to ratify Pinochet in 1988, as well as in the ensuing presidential campaign in 1989. The presidential candidate of the supporters of the military regime was Hernán Büchi. The prevailing mood, even among the opposition to Pinochet, was that Chile had paid dearly to build an economic system that was delivering results, and was not willing to risk it. This forced the *Concertación* to take a moderate stance on economic issues.
- *The collapse of the socialist system in Europe.* At the time of the transition, the economic failure of the socialist regimes in Europe was evident. Many leaders of the Chilean socialist and communist parties were involuntary front-row witnesses of that failure during the years of exile that preceded their return to Chilean politics. This was an important factor shaping the views of those who led the ideological renovation of the Socialist Party, who were also influenced by the experience of Felipe González in Spain.
- *The economic failure of the democratic transition in Argentina.* President Alfonsín of Argentina was greatly respected and admired in Chile for his management of the democratic transition in Argentina. The utter failure of his government to bring inflation under control and resume economic growth left a deep mark in the mind of the leaders of the *Concertación*. His resignation before the legal end of his tenure was a clear demonstration that a decent government could not count just on the reconstruction of the democratic system: to be successful it also had to deliver economic order and prosperity.
- *The revaluation of continuity.* A reappraisal of the economic reforms had taken hold in academic circles close to the *Concertación*. This was most evident at CIEPLAN, a group of economists and social scientists created under the leadership of Alejandro Foxley in the mid-1970s, after they were expelled or resigned from major universities, which at that time were under military rule. They were critical of the economic policies being implemented at the time. By the end of the 1980s they realized that macroeconomic orthodoxy, continuity of some key elements of the existing open free-market economy, and a commitment to social equity, could be combined with some hope of success.[32] At the same time, the old-political leadership of the *Concertación*, more inclined towards state intervention, had been severely traumatized by the economic and social consequences of the chaotic Allende period in the early 1970s and was also shocked by the failure of Alfonsín in Argentina. This made it receptive to the views emerging from intellectuals like those at CIEPLAN and other academic centers.
- *The presence of strong veto players.* Because of the senators designated by Pinochet, the Senate was controlled by the opposition. As this was enough to block any government initiative, it was evident that a confrontational approach would lead nowhere. This forced the *Concertación* to take a pragmatic approach, which gave the upper hand to the moderates, led by Foxley, who wanted to preserve some basic continuity in economic reform and stick to macroeconomic orthodoxy.

Thus, it was not just luck that brought to the forefront of the political and economic team of the *Concertación* the otherwise very unlikely combination of socialists like Correa (Minister General Secretariat of Government) and Ominami (Economy Minister), with Christian Democrats like Foxley (Finance Minister), Boeninger (Minister of the Presidential Staff) and Cortázar (Labor Minister), under the leadership of Patricio Aylwin, a severe critic of Allende, lawyer by profession, and, to this day, a very reluctant supporter of a free-market economy.

A necessary, but not sufficient, condition to prevent a policy reversal during the first democratic government was the fact that the leaders of the economic area agreed to continue with the same economic system. After ten years of criticism of the market economy, there were many actors expecting changes. The role of the state in the economy, trade policy, industrial policy, and labor regulations were among the important issues expected to be changed.

The new democratic system was completely different from the one prevailing until 1973. The Executive now has the exclusive right to set the legislative agenda in several areas and the president has veto power at different stages of the legislative process.

According to the binominal electoral system two representatives for each district are elected. Each district has competing lists (formed by parties or coalitions). The candidates of the two most voted lists are both elected, unless the winning list obtains twice the votes of the second list, in which case candidates of the winning list fill both vacancies. This system encourages the formation of coalitions and enhances the national leadership of parties (Aninat et al., 2004). There are six parties with congressional representation grouped into two large coalitions: *Concertación de Partidos por la Democracia* (center-left wing which has supported the four presidents since democracy came back to the country) and the *Alianza por Chile* (center-right wing). Given the difficulties for any list to double the other, the composition of Congress is approximately 50 per cent for each coalition.

The parties that comprise the two coalitions have different views on moral, social, and economic issues. Transactions often take place within each coalition. Negotiations also take place at the time of elections, when candidates have to be nominated for Congress or the presidency. Competition is important within each coalition, since it is likely that only one candidate from each will win.

Nine of the original 48 senators were not elected by popular vote, the so-called institutional senators. The Executive nominated two of them every eight years. The Supreme Court appointed three and the National Security Council (COSENA) the other four.[33] The members of this council are split between representatives of civil society (the president, the president of the Senate, the president of the Supreme Court, and the Republic General Comptroller) and the military (the heads of the army, navy, air force, and the police). Thus, the constitution of 1980 gave the armed forces some influence upon the political system and restricted the way in which the president nominated the head of the armed forces. One final ingredient in the composition of the Senate was that all former presidents who served for at least six years had the right to become lifetime senators.

Unless a broad consensus is formed, this structure deters changes. A constitutional reform enacted in May 2005 eliminated all non-elected members of Congress, but the electoral system was not reformed.

Given their heterogeneity, the institutional senators could not be considered as a bloc. However, they played a key role in the first presidential period. Although Pinochet nominated the first institutional senators, they decided to support the majority in all major legislative initiatives, once a clear majority had been set. Therefore, they forced the center-left coalition to negotiate with the center-right coalition and helped to reach cooperative solutions.

The binominal system provided an 'insurance' against abrupt changes. Depending on the initial conditions, this may be a blessing or a curse. As the reforms implemented prior to the return to democracy were successful, the binominal system provided a defense against reversals. But, as the binominal system does not foster competition between coalitions, competition is manifested inside each coalition. The outcome has been that the most radical elements of each coalition are gaining the internal battles and the center parties of both coalitions are losing ground. It is not inconceivable then that this system may end up producing a third coalition (between the two).

Next, we consider whether the elements necessary to achieve first-best policies were present in the period:

(1) *Small number of key players.* The electoral system has produced an equilibrium outcome of two strong coalitions that must negotiate.[34]
(2) *Actors must have strong intertemporal linkages.* The members of the Senate are appointed for eight years and the members of the Chamber of Deputies for four years. Both can be re-elected, while the president is appointed for six years with no immediate re-election.[35]
(3) *Policy and political moves have to be widely observable.* According to most international comparisons, Chile shows a high level of transparency and good quality of its institutions (Fuentes and Mies, 2005). As the Executive heavily dictates the legislative agenda, congressmen tend to follow the dictates of the leaders of the coalitions.
(4) *Good enforcement technologies have to be available.* Even though the Executive has more power than Congress, the intertemporal linkages and the political system create strong incentives to cooperate and build long-term relations. In addition, three politically independent enforcement institutions check upon the Executive: the Judiciary Power, the Constitutional Tribunal, and the General Comptroller.
(5) *The key political exchanges take place in arenas where conditions (1) to (4) are likely to be satisfied.* This is the case of Congress (see point (3) above).
(6) *The short-run pay-offs from non-cooperation are not too high.* As Congress is split between the coalitions; a non-cooperative strategy would paralyze the legislative agenda without changing the prevailing rules.

Thus, reform reversals were very difficult in the prevailing legal and institutional framework. On the one hand, the *Concertación* required the cooperation of the *Alianza,* either to roll back previous reforms or to push new ones through Congress. This condition, which was absent in many other countries when democracy returned, can help explain the orderly transition in Chile. On the other hand, the *Concertación* was able to contain social and political pressures and to deepen some reforms.[36]

The democratic system provided an important validation of the reforms introduced under the military regime. The institutional structure helped to achieve political stability after the return to democracy. As it is not prone to changes, it generates stability. Deep structural reforms are possible only with consensus. If trapped in a bad equilibrium, the system would make it difficult to move away from it.

4.4 A further look at the reforms

Over the past 30 years, the Chilean economy, polity, and society have been significantly reformed. This section analyzes the characteristics of some of the reforms.

4.4.1 Trade integration

Perhaps the most drastic and deepest reform conducted under the military government had to do with international trade. This meant a big shift in the development strategy followed since the 1940s. The reforms of the military regime have been deepened by all the elected governments since 1990, using both unilateral tariff reductions and free trade agreements with several trade partners.[37]

In 1973 import tariffs ranged from zero to 750 per cent, with an average nominal tariff of 105 per cent and a mode of 90 per cent. Half the tariffs were above 80 per cent and only 4 per cent of the goods had rates below 25 per cent (Corbo, 1985). There were import prohibitions for 187 tariff positions, a 90-day import deposit requirement of 10,000 per cent of CIF (cost, insurance, freight) value, plus some other discretionary actions that could be taken by the Central Bank.[38]

The reforms

Trade policy reform was an important project for the group that conducted economic policy under the military regime. It was repeatedly mentioned in '*El Ladrillo*' and the idea of openness was present from the very beginning in the discourse of the new government (Méndez, 1979). However, the government had not defined the extent of reform until Chile pulled out of the Andean Pact (Table 4.1). The non-discrimination principle and the idea of avoiding rent-seeking were the driving forces.

Table 4.1: Trade reform

Period	Reform
1974	Maximum tariff was cut down from 700% to 220%, and tariffs in the range of 50% to 220% were reduced by 10%. The effects on imports were negligible.
1975	Further reduction in trade distortions. The government announced that by 1978 tariffs would be in the range of 25% to 35%.
1976	All the quantitative restrictions were eliminated and it was announced that a range of 10% to 35% for import tariffs was adequate (Méndez, 1979).
1977	Chile retreated from the Andean Pact and further tariff reductions towards a uniform 10% level were announced.
1979–82	Tariffs reached the uniform level of 10% in June 1979 and a fixed exchange rate regime was set. The low speed of convergence between domestic and international inflation rates (due in part to wage indexation based on past inflation) and a surge of capital inflows (as a result of the external financial liberalization) led to a large real appreciation of the peso.[a]
1982–85	The fixed exchange rate was abandoned in 1982 and, after several devaluations and a short episode of flexible exchange rate, Chile adopted a crawling peg system. The government decided to increase tariffs from 10% to 20% in 1983 and to 35% in 1984. Additional tariffs were imposed for electronic goods and automobiles, and a price band for certain crops (wheat, sugar, and oil seed) was implemented.
1986–88	Tariffs were reduced from 35% to 20% in 1986 and to 15% in 1988.

Note: [a] See Edwards (1989) and Le Fort (1988) for empirical evidence on the behavior of the real exchange rate.

Trade liberalization was conducted quickly. It introduced a large change in relative prices and resources allocations. Abolishing all non-tariff barriers (NTB) complemented the process of tariff reduction. Table 4.2 shows the evolution of the effective rate of protection (ERP) during that period. In 1974 the manufacturing sector was highly protected, while other tradable sectors, such as agriculture and mining, were subject to high, but negative rates of protection. Among those sectors, textile and apparel enjoyed the highest protection, which is typical of most countries with non-uniform tariffs. At the end of the process, in 1979, the ERP was similar across sectors.[39]

In 1991, the new democratic government reduced tariffs further to 11 per cent and changed the trade strategy from unilateral reductions to bilateral trade agreements, criticizing unilateralism on the ground that it did not obtain additional market access in exchange for lower tariffs.[40] Aylwin's administration signed agreements with Mexico, Colombia, Venezuela, Mercosur, and Canada. Between 1998 and 2002 tariffs were reduced from 11 per cent to 6 per cent uniformly for all goods.[41] By the end of 2003, Chile had signed agreements with the United States, the European Union and Korea, and by

Table 4.2: Effective protection rates, 1974–79 (%)

Sector	1974	1975	1976	1977	1978	1979
Food	161	105	48	28	16	12
Beverages	203	119	47	32	19	13
Tobacco	114	68	29	19	11	11
Textile	239	138	74	49	28	14
Apparel and footwear	264	164	71	48	27	14
Leather	181	98	46	36	21	13
Wood products	157	93	45	28	16	15
Furniture, except metal	95	58	28	17	11	11
Paper and pulp	184	114	62	37	22	17
Printing	140	75	40	32	20	12
Chemical products	80	53	45	24	16	13
Plastic	80	53	45	24	16	13
Petroleum and coal	265	101	17	0	12	13
Glass, pottery and non-metallic minerals	128	87	55	32	20	14
Basic metals	127	86	64	38	25	17
Metallic products	147	101	77	52	27	15
Electrical and non-electrical machinery	96	72	58	35	19	13
Manufacturing industry (average ERP)	157	93	50	31	19	14
Agriculture	30	27	19	11	10	10
Mining	7	18	24	17	13	14
Non-tradable	−30	−19	−11	−7	−4	−3

Source: Aedo and Lagos (1984).

2005 with China. Thus, tariff differences were again introduced according to origin and type of good, but now at a much lower level.

Political economy of the reform

Trade liberalization in the 1970s was coherent with the basic principles of the reform process. Non-discrimination across sectors and a market economy as the mechanism for resource allocation guided the process. Several groups lobbied against the abrupt trade liberalization.

Two factors help to explain why trade liberalization was possible. First, the Minister of Finance was in charge of trade policy and was not vulnerable to pressures from different groups. Second, the minister's decisions were technically supported and were easier to defend when confronted by protectionists. The Minister of Finance was advised by a highly regarded technical group called *Comité Asesor de Política Arancelaria* (Advisory Committee for Trade Policy).

Detractors of the policy inside the government were not absent. At the beginning, CORFO, the official development corporation, opposed this process, since its main objective was to promote industrialization. The representative of the *Junta de Gobierno* on the advisory committee was against the speed at which the reforms were taking place. Regional governors (who were members of the armed forces) also opposed the reform and actively lobbied the Junta to delay it.

However, representatives of the private sector in the advisory committee did not oppose the reforms. The representative of the agricultural sector was in favor of the reform because until 1973 the sector had been subject to a negative effective protection rate. The industrial sector did not block trade liberalization because almost all medium-sized and large industries had fallen under state control in 1970–73, and management of many of them had only recently been returned to their legitimate owners. Gratitude and the fear of a backlash certainly prevented many industrialists from playing a more active role in opposing trade liberalization.

The brief reversal during the debt crisis lasted until 1986, when a new liberalization process was launched. Support from the private sector remained because of the traumatic memories of the protectionist policies of 1940–73. Furthermore, the lower tariff pushed the real exchange rate further up, giving an additional boost to the exportable sector. The economic authority also introduced compensation for small exporters through indirect tax rebates.

When the *Concertación* took office, most of its member parties had been critical of the process. According to them, Chile gave away protection without negotiating any privileges, for example, market access. Nevertheless, in 1991 Foxley decided to present to Congress a project for an additional unilateral tariff reduction. In a historical vote, the law was unanimously approved.[42] This unprecedented support may have been due to the fact that lower tariffs were needed to avoid potential trade diversion coming from the preferential trade agreements, but there was something more than that. Workers and

entrepreneurs of some sectors expected tariff differentiation across sectors and higher protection.

Among the members of the coalition were two groups. One pushed for regionalism and Latin American integration. The idea was that after the consolidation of a Latin American bloc, Chile would be in a better position to negotiate jointly with large blocs such as the European Union and the US. The second group, led by the Minister of Finance and the Minister of Presidential Staff, took advantage of a visit by President Bush to launch the idea of a free trade agreement with the US. This was seen as a way to escape from regionalism, as in Mercosur, and to consolidate the openness of the economy. The idea received strong support from the private sector, as groups that were negatively affected by the unilateral openness saw the agreement with the US as beneficial for them. Nobody would have thought at that time that the agreement would take 12 years to be signed because the US presidents had difficulties in getting the necessary approval from Congress.

In the early 1990s, the law fixed a uniform tariff level, helping the government to resist pressures for higher tariffs, which emerged from time to time. In particular, some sectors asked for higher protection as an anti-dumping policy. However, these sectors were small (traditional agriculture and textiles). Unions were also asking for more protection, but good political management and the need for changes in the law, helped to keep the reform on track. The other key element is that, under the 1980 constitution, economic matters can only be initiated by the Executive. Remarkably enough, in all these years of discussion about constitutional reform, the issue of who has the initiative in economic matters has never been raised, suggesting that it enjoys legitimacy.

4.4.2 Fiscal policy and macroeconomic stability

Fiscal reform is at the core of the transformation of macroeconomic policies and outcomes. A major economic and fiscal crisis provided the necessary momentum to produce institutional changes and shifts in political attitudes.

In the 1950s and 1960s governments had severe difficulties in carrying out a fiscal policy consistent with the general objectives of macroeconomic policy and much was written in the structuralist tradition about inflexibilities in public expenditures, fiscal gaps, and so on. Political leaders recognized some of these problems and proposed constitutional changes to give more fiscal powers to the Executive and expand the authority of the ministry of finance in budgetary matters. However, most of these reforms did not prosper. The economic policies of *Unidad Popular* (1970–73) exacerbated fiscal problems and the size of the deficit reached catastrophic proportions. The military coup in 1973 put an end to those policies but the task of major fiscal adjustments remained.

The founding of the modern fiscal institutions and tax system

The efforts to balance the fiscal accounts hinged on three important policies: budget cuts, tax hikes, and devolution and privatization of companies. The fast economic recovery of the late 1970s helped to fortify government revenues, which in turn helped finance the shortfalls produced by the reduction in import duties.

At the beginning of the military government most of the effort was devoted to public expenditure control, with major cuts in government employment as well as reductions in public sector investment and real wages in the public sector.[43] The latter was made possible by the expedient of allowing a partial adjustment to past inflation.[44]

In 1975 three major reforms were introduced.

(1) The tax system was deeply reformed with the introduction of VAT (with an ample base and an initial rate of 20%), the introduction of automatic indexation, and the elimination of all special preferences. As a result, tax collection rose by 3 per cent of GDP, mostly thanks to the introduction of VAT.
(2) Control of public finances was unified (for both central government and public enterprises) under the Ministry of Finance and more specifically, the budget office (DIPRES by its Spanish acronym).[45] The government defined and combined the accounting and budgetary framework, expanding the budget's coverage to include all income and expenses of public entities. The responsibility for state management, which falls to the Executive branch, would be backed by attributions regarding the formulation of laws with an economic impact and, especially, definition of the spending ceiling and composition at the time of formulating the budget. The Executive branch was also given a margin of flexibility to manage the budget during the year. All of this was supported and reinforced by the 1980 constitution and confirmed by the 1997 constitutional court decision regarding the constitutionality of the norms on flexibility in budgetary administration. This general framework is contained in the State Financial Administration Law (DL 1263 from 1975), which was complemented by the norms of the 1980 constitution relative to legislation initiative and the budgetary process.
(3) SOEs that were running high deficits inherited from the previous government were privatized. An aggressive program to return companies under government management to their legal owners was carried out, but very little was done with the rest.[46] Since deficits persisted, DIPRES received a lot of power to control and enforce fiscal discipline in SOEs. Only after 1975 was privatization of the companies purchased by CORFO carried out, and the proceeds of the sales helped shore up public finances.

By the end of the 1970s the government began to run significant fiscal surpluses. With a new constitution in place, the time was ripe to introduce another major reform: the replacement of the old pension system, based on a pay-as-you-go scheme and different contributions and benefits for groups with similar characteristics, but different affiliations, to a fully funded system based on individual capitalization accounts (see Section 4.4.4). The new system started in 1980, and while affiliation to the new system by new entrants to the labor force was mandatory, existing workers could opt to remain in the old system or move into the new one. The rate of contribution was such as to give a rise in net salaries to those who moved into the new system. After the reform, the government was left with three major fiscal commitments:

(1) Pay retirement benefits to those who remained in the old system.
(2) A bond was issued to compensate the migrants to the new system for the contributions already made to the old one (recognition bonds).
(3) A guaranteed minimum pension was defined so that all of those who had 20 or more years of contributions could have that minimum pension, regardless of their accumulated savings by the end of their working life.

The size of the first two commitments was determined by the number of migrants to the new system, which was rather high, producing a pension revenues shortfall of 4.7 per cent of GDP at its peak in 1984, and which even now stands at about 3 per cent of GDP. Recognition bonds began to rise and became a significant expense in the mid-1990s, reaching 1 per cent of GDP at the end of the decade. These will peak at about 2.5 per cent of GDP in the coming decades, disappearing around 2025. The minimum pension guarantee has had a low impact so far (0.05 per cent of GDP in 2000), but it is expected to grow once the system reaches full maturity (Arenas and Marcel, 1999).[47]

The economic crisis in 1982 induced additional fiscal pressure. Tax revenues fell as a result of the deep recession. The government decided to bail out the banks, but not their owners, and subsidized debtors with dollar-denominated liabilities. Increased public debt made these transfers feasible. The debt was documented as public debt from the government to the Central Bank and still has considerable impact in the Central Bank balance sheet, representing a high proportion of the public debt today (Dirección de Presupuestos, 2003).

After the economy began to recover, fiscal discipline enabled a quick restoration of surpluses in the central government accounts. This process was helped by the second wave of privatizations that this time fell on more traditional public sector companies. During the 1980s the government sold the main telecommunications state monopolies, electric utilities, airlines, nitrate mines, iron and steel complexes, and so on. In 1984 the main goal of a new tax reform was to induce private savings by mimicking several characteristics of an expenditure-tax system. To achieve this goal, the system was consolidated at the personal level, so that income tax rates were applied in the same manner to all sources of income, and corporate taxes gave origin to credits in the personal income tax of the owners. Corporate and personal tax rates were reduced. In 1988, during the pre-plebiscite period, the rate of VAT was lowered to 16 per cent.

At the end of the military regime, a new tax change was enacted, replacing the tax base for the corporate tax. This change meant that the actual tax revenues for 1990, the first year of the newly elected government, were far lower than budgeted, since the fiscal impact of that reform was severely underestimated by the outgoing fiscal authorities.

Fiscal responsibility: the economic keystone of the democratic transition

The 1990s began with an orderly transfer of power from the outgoing military regime to the newly elected one. During the early stages of the campaign, the economic and political leaders of the *Concertación* knew that the first priority was to secure macroeconomic stability. Before any new expenses were introduced, a tax reform had to be implemented to help cool down the economy and provide funds for social programs. The value added tax rose from 16 per cent to 18 per cent and corporate taxes went from 10 per cent to 15 per cent. These changes required congressional approval and government authorities were quick to negotiate these changes as a package with the main opposition party. The tax changes fell short of the initial goals, but were enough to maintain public finances on a solid footing, while increasing social expenditures. The opposition was willing to back these reforms because they felt that after the solid mandate gained by the *Concertación*, it would have been suicidal to block these initiatives and the whole political and economic system might have been jeopardized. On the other hand, there was a broad consensus on the need to have a successful consolidation of the democratic regime and the opposition was keen to prove that the institutions of the 1980 constitution could produce an effective democracy.

In 1991, with the peso under pressure to appreciate after foreign capital began to flow into the country, the government reached an agreement to lower the import duty tariff from 15 per cent to 11 per cent, compensating the lost revenues with increases in specific indirect taxes, so as not to change the overall tax burden.

Fiscal policy remained unchanged after Aylwin was replaced by Frei in 1994, with the fiscal accounts in surplus and a systematic reduction in public debt (Marfán, 1998). At the end of this presidential period, and taking advantage of the Asian Crisis, a further gradual reduction in tariffs from 11 per cent to 6 per cent was enacted, compensating the revenue losses with some indirect taxes (Vial, 2001).

The recession of 1999 caused a small deficit but by 2000 the fiscal accounts were back in the blue when the new administration led by President Lagos implemented a fiscal rule based on the structural balance of the government.[48] The structural balance, as defined in Chile, has two major corrections from the traditional balance: the standard one to fiscal revenues taking into account departures from potential GDP (and normal tax collection), and the special adjustment to copper revenues, based on a long-term projection of the price of copper. To improve transparency in the computation of the two corrections,

these parameters are set after public consultation with committees of outside experts.

The political economy of this reform

Under the leadership of Jorge Cauas, Sergio de Castro, and Juan Carlos Méndez, the first fiscal reform of the military government was designed by a team of economists and policy-makers from different sides of the political spectrum. Learning from the experience of the 1960s and 1970s, the norms instituted gave strong powers to the president and the minister of finance in all fiscal matters. The opportunity for change came with a major shock in 1975, after copper prices fell precipitously during the economic slowdown that followed the first oil crisis. The need for a major fiscal adjustment, on top of that of 1973, to compensate the revenue shortfall at a moment in which the government had little access to foreign credit, gave rise to budget cuts, privatization and tax hikes. The military government strengthened the influence of the minister of finance, who prepared the budget and presented it to the Junta for approval.

The new constitution in 1980 deepened the changes. It concentrated responsibilities for running the state in the Executive Branch and granted it clear primacy in all matters concerning public finances. This is reflected in the way the budget bill is processed in Chile:

- Congress has a fixed 60-day period for dispatching the bill. Failure to do so results in its automatic approval.[49]
- The income calculation is made known to Congress but is not voted on. Unlike other countries, particularly those with a parliamentary system, tax legislation is understood as having a 'permanent' nature, and cannot be altered by the (annual) budget law.
- Congress does not have the ability to increase spending or introduce new items. It can only approve or reduce the amounts the Executive proposed but, in a strict interpretation of the constitution, cannot eliminate them or reduce them so far that they impede the exercise of the functions that the Executive wants to perform. Congress cannot cut the proposed amounts of spending items allocated to cover commitments derived from permanent laws (pension payments, salaries to tenured public personnel, debt service, etc.).[50]

The fact that the constitution grants such 'advantages' to the Executive in the budget debate goes along with the full responsibility for macroeconomic management that also resides in the Executive Branch, particularly with the finance minister, who initiates the budget debate with a speech on the 'Public Finances Account'. During the military government these norms were less relevant since ad hoc committees headed by the members of the Junta carried out the legislative action. However, they became very important after the transfer of power to civilian rule. The political composition of Congress, differing interpretations of key aspects of the constitution, and the fact that the Executive needs congressional collaboration to approve other laws makes the legislative negotiation far more balanced in practice, but still limits the initiative of Congress to set the fiscal agenda.

After 1990 the political leadership was willing to go ahead with fiscal austerity for three reasons. First, the new leaders were aware of the political consequences of economic mismanagement, since all of them had gone through the economic chaos of the Allende period. Second, the military regime left power on a very high note, with the economy growing and the inflation rate coming down. Even though unemployment was still high, it had fallen from the heights of the crisis years, so there was a perception that economic failure would have caused a return of the pro-Pinochet opposition to power in the future. This was an important incentive for the *Concertación* to contain the social pressures. Finally, the economic failure of President Alfonsín in Argentina made a big impression on Chilean politicians. It made clear that restoration of political freedom, respect for human rights, and some punishment for previous abuses were not enough for political survival.

The diagnostic permeated even the presidential campaign, when candidate Aylwin took pains to explain to supporters that social demands had to be moderated and coherent with the available resources. After the election, the new team started negotiations with the opposition leaders even before being sworn in, and reached an agreement to raise VAT, roll back the change in the base of corporate tax, and increase personal income tax. The new law entered into effect in June 1990 at a time when the government was cutting down expenses within the budget left from the previous administration in order to balance public finances, which they did. Only in 1991 were they able to start increasing some social programs (Foxley, 1996).

Several studies concur that the concentration of budgetary power in the hands of the Ministry of Finance is of crucial importance for conducting a consistent fiscal policy (Alesina et al., 1996; Stein et al., 1998). However, the institutional framework cannot be the only explanation for good fiscal outcomes.

The most outstanding aspect is perhaps that the improvement in public finances has been maintained despite the institutional and political changes that have occurred since 1975. The legal framework for fiscal policy has remained stable with very few changes and the tax burden as a percentage of the GDP fell from around 20 per cent at the end of the 1970s and first half of the 1980s to between 18 per cent and 19 per cent in the 1990s (Table 4.3). The experience of previous decades and a strong conviction that the serious economic crisis at the beginning of the 1970s was largely caused by acute imbalances in fiscal policy have been essential factors in attaining agreement around a responsible fiscal policy.[51] It is no accident that the countries that went through the worst economic and political crises in the 1970s and 1980s

Table 4.3: Central government income, expenditures, and surplus (% of GDP)

Period	Total revenue	Total expenses	Overall balance	Copper and oil stabilization fund
1970–74	28.1	37.3	−9.2	0.0
1975–79	37.5	35.1	2.5	0.0
1980–84	36.2	36.2	0.0	0.0
1985–89	27.6	27.2	0.4	1.5
1990–94	21.9	20.3	1.6	1.5
1995–99	21.5	20.4	1.1	0.1
2000–03	22.2	22.7	−0.4	−0.6

Sources: 1970–80: Larraín (1991); 1980–86: built from rates of change of figures published by the Contraloría General de la República; 1987–2003: Dirección de Presupuestos. Estadísticas de las Finanzas Públicas.

have shown the greatest progress in consolidating a low and stable inflation rate, as well as greater fiscal discipline for the most part.

The Structural Balance Rule introduced in 2000 was in a way a culmination of a process initiated earlier. That process helped build the necessary credibility to gain access to international financial markets at reasonable costs, a prerequisite for such a rule.

4.4.3 Financial market reforms

There were two main reforms of the financial system. The first started in 1974 and deregulated the financial sector. The second, resulting from a deep macroeconomic and financial crisis, took place in the early 1980s and established a new institutional framework.

Financial liberalization in the 1970s

Low levels of intermediation and a long history of financial repression characterized the financial sector by 1974 (Edwards and Edwards, 1987). Interest rate controls yielded negative real interest rates for several years. Under Allende, the banking sector was nationalized and severe restrictions were imposed on the allocation of credit.

The deregulation of the financial sector involved releasing credit controls (credit limits, interest rate controls, reserve requirements and restrictions on foreign borrowing, and so on). Reserve requirements were reduced over the 1975–80 period. In 1975 interest rates paid and charged by commercial banks were liberalized. The minister of finance and the Central Bank led this reform, which initially required little new legislation, as interest rates were set free and regulations eliminated. It only became evident after the financial crisis of 1983 that the old banking laws were inadequate for the operation of a modern financial market. Major sources of controversy were the extremely high level of interest rates and the slow convergence towards normal levels.

Another important piece of the reform was the privatization of banks controlled by the government. The legislation restricted individuals from acquiring more than 3 per cent of a bank's property, while the limit for private firms was set at 5 per cent of a bank's stock. However, economic groups found a way to get around this rule (through the creation of investment companies) and the property of banks became highly concentrated. According to Edwards and Edwards (1987) a few economic groups controlled more than 80 per cent of the equity of private banks. These groups participated in the privatization of productive firms. As these firms needed to be capitalized, the groups used the banks to intermediate financial resources toward them.

At the beginning, firms owned by the groups borrowed from the banking sector competitively (not necessarily from the bank owned by the group). As the government fixed the exchange rate and indexed wage contracts, abrupt real appreciations of the peso followed. Moreover a slowdown of the non-oil exporting economies and a sudden fall in the terms of trade severely affected real incomes. The firms owned by the groups were mainly involved in the tradable sector and suffered the consequences. Banks stopped lending them money, which made firms borrow from related banks. The additional credits were used to pay past loans, rolling over bad credits.

This situation created what Harberger (1985) called a 'false demand' on top of the 'true demand' for credit. This false demand was used to refinance loans that could not be paid. Due to the lack of risk classification, losses did not appear in financial statements.

The crisis of 1982 and the reforms of the financial sector

Despite the commitment to a fixed exchange rate after June 1979, the peso was devalued in June 1982. Many banks and private companies were highly leveraged in dollars and their capacity for serving the debt was damaged. As interest rates never converged to international rates, between 1976 and 1982 companies ended up paying real interest rates on 30-day loans ranging from 11 per cent to 57 per cent.

The financial sector was not ready to face the fast reforms, and inadequate financial practices aggravated the macroeconomic crisis (Larraín, 1989). These practices were the consequence of an implicit insurance on deposits, a moral hazard problem, the absence of prudential supervision, the propagation of highly leveraged conglomerates, and the inexperience of domestic bankers in operating in an unregulated environment. Groups owned banks and related companies that went bankrupt when conditions deteriorated and external financial resources became scarce.

De la Cuadra and Valdés (1992) state that the banks made no effort to take the collateral before the crisis worsened because they had no control over the borrowers; the judicial system was very inefficient; and the banks and the conglomerates were related – the owners of the banks would not execute collateral that also belonged to them.

Two extreme solutions were at hand: let the banks go bankrupt or bail out the banking system (Larraín, 1989). The first had no direct cost for the government but was considered to have huge negative effects for the real sector. The second was considered too costly and against the market-oriented principles that guided the government. An intermediate solution was finally implemented: banks' shareholders and future generations of taxpayers would have to pay the losses. This triggered the second stage of the reforms.

During 1980–83, 11 banks and six financial companies were subject to intervention and some of them were liquidated. Between 1983 and 1984 an intense debt rescheduling process took place, and interest rates and conditions for debtors were changed. The banks that had been subject to intervention were 're-privatized' during 1985–86, through the so-called system of 'popular capitalism', whereby the banks were sold to small stockholders who had access to governmental credit under special conditions.

A new banking law was enacted in 1986. It was intended to prevent a banking crisis and to provide more transparency.[52] The law required a more active role of the superintendent in evaluating banks' risk, according to loan classifications, more disclosure of information, and a strict enforcement of restrictions on how to conduct business with parties related to a bank. The government also restricted the insurance to depositors, as a way of inducing depositors to seek more information on bank risk.

Fuentes and Maquieira (2001) argue that the introduction of prudential regulation and supervision explains a good deal of the differences between the development of the financial market and the low level of arrears in the banking system. This type of regulation induced banks to introduce better screening techniques and to share information on the indebtedness levels of individuals and firms.

The political economy of the reforms

As with other reforms, the prevailing idea was that the market should allocate resources. The principles behind the first stage of financial liberalization were established in 1974. Undurraga (1974) states that the policies intended to make the financial system more competitive and efficient were based on:

- Non-discrimination among financial institutions and instruments of similar characteristics. Similar institutions and instruments should face the same legal and tax constraints.
- Broadening the scope of business for financial institutions and provision of more flexibility to their operations to facilitate innovation and adaptation to market requirements.
- Elimination of preferential treatment to priority sectors, especially through interest rate subsidies. The Central Bank was forbidden to give credit to non-financial companies.

Economic authorities were considering the non-discrimination principle and a movement towards universal banking as early as 1974. The idea was that commercial banks should be the exclusive providers of lending services, unifying the role of commercial banks, development banks, and financial companies (De la Cuadra and Valdés, 1992). Competition in the financial market was seen as a way of imposing market discipline (Barandarian and Hernández, 1999).

The bail out of Banco Osorno in early 1977 contradicted this view. A year before, several small financial intermediaries (*financieras*), some of them unregistered, went bankrupt and the government did not bail them out. In the case of Banco Osorno the principle of 'too big to fail' was applied. The authority needed to build a reputation to gain access to the international credit market. Furthermore, the reforms were just starting and the bankruptcy of an important bank was seen as an element that could negatively affect them.

On a bigger scale, a similar dilemma was faced in the banking crisis of 1981–83. The ratio of non-performing loans to banks' total equity increased from 22.4 per cent to 158.1 per cent between 1981 and 1983. The competing groups in the economic team that advised the government proposed three solutions. De la Cuadra and Valdés (1992) call these groups the financial market repression school, the free-banking school, and the state supervision school.

The financial repression school believed that the government should bail out the banks by absorbing their losses and taking over bank ownership. The central argument was that banks cannot be controlled and that they should be administered by the state. This was equivalent to a return to the situation prevalent before 1975 and was discarded because of the disastrous past experiences of state-owned banks.

The free-banking group considered that insolvent financial institutions should go bankrupt. Shareholders and depositors would have to absorb the losses. This alternative carried a political cost, not considered crucial at that time. The problem with it was that two-thirds of the system would have to file for bankruptcy, providing a negative externality to the whole economy. In addition, there was concern that such losses would abort the pension reform, as a large fraction of the funds were invested in the banking sector.

The third alternative was an intermediate solution, in which government should intervene, and losses should be absorbed by shareholders and the government (taxpayers), and to a small extent by depositors. The group supporting this solution proposed establishing prudential regulation and a close supervision of the financial institutions. Several practices were proposed which were later formally established in a new banking law. The new rules gave more power to the superintendence of banks and financial institutions to supervise the banks. A more transparent and efficient credit system was implemented from 1980. As a first step, loans were rated in four categories (A, B, C and D).[53] This empowered the regulatory agency to obtain information on the 300 most important debtors of each bank. It also required banks to classify the loans (consumer loans, mortgage loans, and so on).

This happened at a time when the government was under severe political pressure and the nationalistic faction had taken the upper hand in a cabinet reshuffle. After intense debates, the third alternative was applied with the political support of the Ministry of Internal Affairs. The resources needed for the bail-out convinced the authorities to enact the new bank regulation.

As the owners of the banks were also the owners of the borrowing firms, the intervention meant that shareholders lost the property of the banks and the firms that were not able to pay their loans. The owners of the economic groups (banks and borrowing firms) lost their capital and their personal assets. The National Security Council investigated the responsibility of the shareholders in the crisis. As a result long judicial processes started.[54]

In summary, this reform started as a consequence of a deep economic crisis. The new banking law was the initial step in the revamping of the banking system. As the savings accumulated in pension funds became too big for the limited size of the domestic market, new laws were enacted in the 1990s to open up new investment opportunities, first in local equity and to a lesser extent in variable and fixed income abroad. In later years, the laws have been relaxed and regulation has been adjusted in conformity with new international standards.

The subordinated debt that other banks owed to the Central Bank as a consequence of their bail-out became a major contentious issue in the 1990s. It was solved in the mid-1990s with a change in the law that required a difficult political negotiation with the banks and Congress.

4.4.4 The new pension system[55]

In the late 1970s the military regime initiated several 'modernizations', as they were called, most of them in the social area. The best known is the pension reform, because it represented a drastic departure from international practice, as well as from Chilean tradition.

Social security was introduced relatively early in Chile, before the mid-1920s. Pensions were based on a 'pay-as-you-go' (PAYG) scheme, a system that was eventually adopted by all countries with a market economy. Under PAYG, contributions are pooled to pay for defined benefits, and are financed by mandatory contributions by workers. When a country is in the initial stages of the demographic transition, the system should be accumulating a sizable surplus. Adequately invested, they should help finance pensions once the system reaches maturity. Because of this feature, the system is vulnerable to political pressure by well-connected groups.

Chile represents an extreme case of capture by interest groups. The system quickly degenerated into a constellation of pension institutions; each designed for a special constituency, with special norms concerning contributions, value of pensions, retirement age, and so on. About 80 per cent of the working population depended on the *Servicio de Seguro Social* (SSS) run by the state, with the lowest benefits and without protection of pensions against inflation. By contrast, some *'cajas'* catered to the need of a few thousand affiliates, allowing for early retirement after 20 years of work and with pensions equivalent to salaries at the time of retirement. By the end of the 1970s the government was contributing 7 to 8 per cent of GDP to make up the financial shortfall of the system.[56] Financial projections made at the budget office showed an explosive growth of fiscal outlays originating in the deficit of the pension system (Hepp, 1980).

The problems were evident well before the late 1970s. Many studies had been made about the subject and reforms were proposed. The best known of these studies, a monumental piece of work, had been carried out during the presidency of Jorge Alessandri in the late 1950s and early 1960s, under the leadership of Jorge Prat, a respected politician. As with previous and subsequent attempts, this effort did not lead anywhere, because of political opposition.

When the Chicago Boys entered the military government in the mid-1970s, they set out, among other objectives, to restore a lasting equilibrium to government finances and to reform the pension system.[57] One key step in the achievement of both objectives was a proposal – approved by the legislative power in 1978 as Decree Law No. 2488, but for political reasons only implemented in 1979 – to fix a mandatory minimum age of retirement, valid for all social security institutions, except the military. This minimum was set at 65 years for men and 60 years for women.

The importance of this reform cannot be understated. Fixing uniform minimum retirement ages eliminated one of the most important sources of discrimination and privilege in the PAYG system. It also increased the number of years workers had to contribute in most social security institutions, thereby improving their finances, as well as those of the whole system. This allowed a very significant reduction in contribution rates, which boosted employment.

Curiously, but not surprisingly given the substantial loss of special privileges, the reform did not affect the institution that was in power (the armed forces). It also meant no losses for most blue-collar workers who were in the SSS and who already retired after 65 (60 for women) years of age. However, the government was aware of the negative political impact this reform had on some powerful and privileged groups of workers. This reform was finally approved in 1979, after General Leigh had been dismissed and General Pinochet had consolidated his power over the army, and at a time when the government could afford some of its political costs as it had a high approval rating and the economy was booming.

The principles of the new mandatory, individual account, defined contribution, and privately managed pension system

'El Ladrillo' (CEP, 1994) had a chapter on the need to replace the PAYG scheme with a fully funded, mandatory defined contribution, and privately managed pension system. The main characteristics of the system were embodied in the legislation.[58]

The system is based on the principles of individual freedom, individual responsibility, and social responsibility with respect to the needy. The three pillars of the system are: (1) low income assistance and minimum pensions are available for the poor, irrespective of their contributions; (2) pensions should be directly proportional to contributions made;[59] and (3) the management of the pension funds should be private and competitive.[60]

The new system has a completely different base from that of the old one. It has solidarity, but is paid for by all taxpayers, not only workers. Except for the poor, pensions are directly related to contributions, which minimizes the intra- and inter-generational transfers, and significantly diminishes the incentive to evade pension contributions. Competition between pension fund managers as well as a careful institutional design assures that it is in the best interest of financial managers to achieve the highest rate of return for the pension funds, at limited levels of risk, defined by regulations on the investment portfolio. There was free entry to the system and provisions were made in order to facilitate voluntary affiliation and changes between pension fund managers (AFPs).

The new pension system is coherent with respect to the general principles on which the model was built. There is a reasonable degree of choice with respect to (1) the amount of total contributions to be made,[61] (2) the provider, (3) the amount and form of the pension payments, and (4) the age of retirement.[62] The counterpart of this choice is the responsibility which each individual has in deciding the quality of the pension. The system is highly regulated, but authorities have almost no discretionary power – that is, rules dominate over discretion. Furthermore, the state plays a subsidiary role, because it (1) created the legal framework of the system, which otherwise would certainly not exist at this time, (2) monitors its proper functioning, and (3) finances part or total pensions, but only for those who otherwise could not even reach a minimum pension level. However, the state does not operate the pension fund administrators, which are private firms. Finally, for obvious reasons, the pension system requires strict respect for property rights and, given the proportion of the population that participates and has an interest in it, indirectly contributes to the strengthening of those rights.[63]

The political economy of the pension reform

José Piñera, the Minister of Labor, was responsible for the detailed design of the new system and its approval by the Junta.[64] The economic team, especially the Ministry of Finance, headed by Sergio de Castro and the Budget Director Juan Carlos Méndez, and ODEPLAN, led by Miguel Kast, supported the reform, and had a key role in the special committee set up to reform the pension system, led by Alfonso Serrano, Undersecretary in the Ministry of Labor, that included, among others, Hernán Büchi, who later on became a very influential minister of finance and presidential candidate, and Martín Costabal, who later became budget director.

Pinochet and the members of the Junta approved the social security reform project at a meeting in April 1980. Piñera had previously presented the idea and basic principles of the reform to Pinochet, who endorsed it, but was not willing to force workers to transfer from the old to the new system. Therefore, the project allowed workers to choose, during the initial five years, the system they wanted to belong to. In so doing, workers were to have the last word about which system would prevail. If few workers had chosen to transfer, a counter-reform would in all likelihood have taken place.

The reform was announced on 1 May 1980. According to Piñera, the opponents of the reforms included people from the right and left, civilians and military, people in and outside government. Some opposed it in principle and others because of vested interests in the old system. First, those who received special privileges under the old system were, of course, opposed to the reform. Second, opposition also came from the so-called 'social security specialists', who only knew about PAYG systems. They could not conceive a system based on different principles. Third, managers of the social security management institutions, generally retired military personnel, who could not understand why the government was going to relinquish the power they believed it had over vast pension fund resources. Fourth, opposition came from labor leaders, who had recently suffered a defeat over the new labor law that was approved only shortly before the new social security system and ended their monopoly. Fifth, the political opposition to the military regime was also against the reform. Although not allowed to express itself openly as such, this opposition was very active and did have a voice in the press and influence on government decisions in socio-economic matters. Sixth, some opposition came from the economic right, which in general approved the market economy, but did not understand the benefits of several of the 'modernizations', including that of social security, because they were born and raised under a system where social matters were taken care of exclusively by the state.

The final and perhaps most powerful opposition came from the military advisers to the president and the generals who ran the pension system of the armed forces. The latter did not agree to join the new system. The former saw the discussion about the pension reform as an opportunity to achieve a reorientation of all economic and social policy, which they felt was too liberal and would cause the disintegration of society. However, some generals in the advisory committee to the president either changed their minds, as they learned more about the project, from opposition to neutrality or abstained from active opposition. Among these, Piñera mentions General Alejandro Medina, Fernando Lyon, and especially important, Chief of Staff, Santiago Sinclair. This proved decisive, and once the political field cleared, after the promulgation of the new constitution in 1980, President Pinochet gave the final go ahead to the reform.

The reform was a decisive success with most of the labor force switching into the new system in about a year, albeit they were encouraged by gains in take-home pay in the range of 12 per cent, as a result of the reduced rate of contributions in the new system. The next test came as a result of the banking crisis in 1982–83, but as was mentioned above, precautions were taken to shield the system from financial losses.

By the end of the 1980s the system was consolidating. It showed very high rates of return and legislation was passed to open them up for investment in local equity, and in a very limited manner for investments abroad.

The final test came after the transfer of power to democratically elected authorities that chose not to reverse the reforms. This was not only the result of political calculation, but also the belief that the pension system was working, as reflected in subsequent reforms to introduce more flexibility for investment by the pension funds. In later years further changes have been made to improve the system, by allowing wider limits for investments abroad, the creation of multiple funds (five) in each AFP, based on different limits for investments in equity, to give affiliates options based on their risk aversion and age. New incentives have also been given to promote voluntary contributions with generous tax breaks.

Currently there is an important debate about future adjustments to the system to improve coverage, provide better protection to the poor and improve competition among AFPs, but there are no proposals to revert to a PAYG system.

4.5 Concluding remarks

Few countries have faced such dramatic changes in such a relatively brief period of time as Chile. From being an economy that was in tune with the meager performance of other Latin American economies, Chile became a pioneer in the implementation of bold and innovative reforms.

Unquestionably, some of the main reforms conducted in the first years of the military regime would have been difficult to implement with the same speed and depth under a democratic government. Nevertheless, countless experiences of frustrated reforms in similar situations prove that this type of government provides neither necessary nor sufficient conditions for conducting reforms. There are also cases in which major economic crises provided conditions to introduce sweeping reforms in democratic countries, even under very weak governance conditions.

Why did Chile make reforms fifteen years earlier than the Washington Consensus? The disastrous shape of the economy after the Allende government provided fertile ground for profound reforms. But more instrumental was the existence of sufficient critical mass in terms of the human capital necessary to lead the reforms. The ideas for reform and the team to make them happen incubated during the crisis and the military regime provided the means to bring them forward.

Why did the reforms go so deep? The military government delegated the conduct of the reforms to the technocrats. In addition, the government knew that it would stay in power for a long period of time, which created strong intertemporal linkages.

Why, rather than reversing the reforms, did the change in the political system deepen them? The return to democracy shows something atypical in Chile. The economic success of the late 1980s, the memory of Allende's economic crisis, the collapse of the communist regimes, and the experience of Argentina and other democratic governments in the region, played a critical role in shaping a political climate that favored continuity. The polity showed signs of maturity by not changing the spirit of the reforms and in some cases advancing them. The new democratic government knew that the economic situation was key to making the democratic system last and did not cave in to pressures from different agents. In addition, some key institutions of the 1980 constitution played a major role: veto players had a deterrent effect on counter-reform proposals, and, most important of all, limited the power of Congress to set the legislative agenda. The electoral system also played a role, both by securing a balance of power in Congress and by strengthening the powers of party leaders, increasing their capacity to enforce party discipline among Congress members.

As the analyses of some of the most important reforms show, building institutions with special emphasis on empowering the ministry of finance and the technocracy installed there helps to explain why some of the many pressures for reversal could be avoided. Equally important was the creation of laws that made it costly and difficult to modify the reforms. The rules of the game, based on a strong presidential system that acts as the main veto player, and the binominal system induced the need for broad consensus.

Can this political institution be exported? The binominal system generates a balance in the Congress and therefore facilitates the status quo. If the country has reached a good equilibrium, this political structure helps to maintain it. If the country were in a bad equilibrium, it would not help it to move. The stability brought about by the binominal system comes at the cost of reduced political competition, to a point that it would be deemed unacceptable for almost any country to adopt it voluntarily. A strong presidential system is also positive when the country is capable of building state capacity to sustain and deepen the reform (Rius and van de Walle, 2005). Of course, strong presidential powers are only as good as the president. If he or she were in favor of reversing reforms, it would certainly be a major weakness. What is interesting in the case of Chile is that political leaders such as Aylwin, Frei, Lagos, and Bachelet, coming from very different backgrounds, were willing to adopt a favorable view of the reforms and work to deepen them.

Notes

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1. See Harberger (1959), Davis (1967), Cruzat (1969), Lüders (1970, 1990), Ffrench-Davis (1973), Heskia (1973), Butelman et al. (1981), Larraín and Meller (1990), Barahona et al. (1993), and Borner et al. (1993).
2. A coalition led by the Radical Party (center-left) that included the socialist and, initially, the communist parties.
3. See Lüders and Wagner (2003).
4. The successes of Germany and Russia during the 1930s, in which governments instead of markets played a key role in the allocation of resources, had a decided influence. So did some economic ideas, especially those of Keynes. Contrary to popular belief, the ECLAC import substitution doctrine was not articulated until after the new model had begun to be implemented. ECLAC began its operations in 1947 and its doctrine can be considered as one way to rationalize the economic policies already adopted in several Latin American countries, after the breakdown of international trade during the Great Depression.
5. Critics of the liberal development model always existed (Encina, 1911). They only gathered support after the Great Depression.
6. The average fiscal deficit to GDP ratio was 1.2.
7. Chile suspended service of its foreign debt early during the Great Depression and only resumed servicing it in the 1950s.
8. The Central Bank of Chile was created in 1925 and had a governing board in which government-appointed directors were a minority, while those representing commercial banks, the private sector, and labor were a majority. The composition of the board gradually changed and in the second half of the 1960s the government appointed all board members.
9. See Lüders (1970) and Ffrench-Davis (1973).
10. These included the post office, electricity generation and distribution, the water and sewage company, the national petroleum company, the national steel mill, 50 per cent of the largest copper producers, the national port company, the national airline, the national railroad, a state bank, and even a national bus company.
11. The firms included in this process were public utilities, commercial banks and other financial institutions, the large wholesale trading firms, and 100 per cent of the large copper producers.
12. See Hachette and Lüders (1993).
13. There is no evidence that a crisis always fosters reforms as it may actually destroy institutions (Fanelli and Popov, 2005).
14. Documented in what is popularly referred to as *'El Ladrillo'* (CEP, 1994).
15. The origins of the 'Chicago Boys' and their role in the military government are discussed in Valdés (1995) and Fontaine (1988).
16. Mandatory indexation to past inflation (preserved until the 1982 crisis) limited wage movements. This may have been one factor contributing to generating and intensifying the crisis.
17. These companies, which were managed by 'intervened' commercial banks, and banks themselves, constituted what has been called the 'odd sector', because legally those companies and banks had private owners, but were managed by the government.
18. This difference between the pre- and post-recession periods reflects the different preferences of the two major economic policy-makers of the time. Sergio de Castro, the leader of the economic reforms, favored a 'hands-off' policy, while Hernán Büchi, the most influential economic policy-maker of the post-recession period, favored more active government policies.

19. The provisions that had to remain were free and voluntary affiliation to unions, decentralized negotiations at the firm level, and the freedom for firms to hire and lay-off employees without the consent of the government authorities or the unions.
20. As a result of their lobby, workers in the state conglomerate managing the ports received very generous concessions in a specially legislated severance package.
21. The actual privatization proceeded smoothly and quickly, under the leadership of CORFO. By the end of Frei's term all major companies were privatized or in the final stages of the process. See Aninat et al. (2004) for a discussion of the main aspects of the policy-making process in this case.
22. After two weeks of strikes and school takeovers by some high-school students, President Bachelet has recently appointed a commission comprising a cross-section of participants of the educational sector to propose yet another educational reform.
23. Universal coverage of secondary education has been reached in most of the major urban areas.
24. Although it is too early to judge the results of this reform, preliminary evidence suggests a significant shortening of the process time and clear signs of improvement in terms of accountability of those involved in the investigation, judgment and sentencing.
25. The exception was the first half of Eduardo Frei Montalva's presidency (1965–70).
26. Rius and van de Walle (2005) point out that there is not enough evidence to support the claim that an autocratic regime has a higher propensity to reform than a democratic regime. They argue that the main opposition to reforms is clientelism, where the political power provides some benefits to key constituencies to remain in power. Clientelism can be present either in autocracies or democracies.
27. Calderón and Fuentes (2005) provide cross-country evidence of the importance of policy complementarity for economic growth. Gallego and Loayza (2002) and Fuentes et al. (2004) do so for Chile.
28. The effect of macroeconomic policies on reform reversals is highlighted in Fanelli and McMahon (2005b) and Liew et al. (2005).
29. The new constitution that replaced that of 1925 had been drafted by a special commission and approved, after difficult negotiations, by it, the Junta, and the State Council, the latter headed by former President Jorge Alessandri. One outstanding feature of the constitution is that it put a time limit on the military government at a moment at which the government was under no pressure to relinquish power.
30. In Spanish this is the Ministro Secretario General de Gobierno.
31. Constitutional changes which eliminated the designation of senators were recently approved. In June 2006, Pinochet was under house arrest under charges of tax evasion.
32. The views of this group can be found in the many publications by CIEPLAN (Foxley, 1983). The main political and economic elements of the strategy of the Aylwin government can be found in the proceedings of a seminar held at CIEPLAN in early 1990, just before the inauguration. They contain brief presentations by Correa, Boeninger, Cortázar, and Foxley, all of whom held key cabinet positions during the Aylwin administration (Muñoz, 1990).
33. COSENA has as its primary objective to serve as a formal meeting place of the top authorities of the country to air sensitive policy issues, as well as to enforce the law. It was created as a device aimed at avoiding an institutional breakdown like the one that took place in 1973.

34. This element is also emphasized in Rius and van de Walle (2005), where they discuss how a small number of veto players increases the probability of reforms.
35. The 2005 constitutional reform reduced the term of the president to four years, with no possibility for re-election, making presidential and congressional elections simultaneous.
36. Sometimes it may be easier for the party that is (ideologically) less likely to implement a successful reform (Cukierman and Tommasi, 1998a).
37. The trade reform and its effects has been the object of numerous studies (Edwards and Edwards, 1987; Cauas and De la Cuadra, 1981; and Ffrench-Davis, 1981).
38. Chile had one of the highest trade distortions in the world (Edwards, 1995).
39. Fuentes (1995) analyzes the changes in productivity and resource allocations due to the trade reform.
40. Saez et al. (1995) analyze the trade policy of the Aylwin administration.
41. Tariffs are lower or nonexistent for goods imported from countries that have preferential trade agreements with Chile.
42. It is ironic that two decades before, during Allende's government, a freely elected Congress approved, also by unanimity, the nationalization without compensation of the copper mines. These two votes reflect, perhaps better then anything else, the change in the mood of the country brought about by the economic reforms.
43. See Larraín and Vergara (2000).
44. The computation of the CPI in 1974 severely underestimated actual inflation that year, facilitating the process.
45. For more background, see Dirección de Presupuestos (1974).
46. For more details, see Hachette (2000) and Arellano and Marfán (1987).
47. The proponents of the reform were aware of this fiscal shortfall and took steps to generate the necessary resources to finance it (Hepp, 1980). The Chilean pension reform has been accompanied by overall fiscal surpluses over the whole period (except during the debt crisis) and helps to explain the significant rise in domestic savings after the 1980s.
48. The rule is a policy decision, without a formal backing in any law, and states that the central government will maintain a 1 per cent surplus in the structural balance.
49. Constitutional experts do not agree on what 'dispatching of the law' means. Some even hold that there are doubts regarding which budget should go into effect if a bill has been approved in the first round by the Chamber of Deputies.
50. In the Budget Law of 2000, the fixed expenses derived from permanent laws reached 66 per cent of the total. These laws force the Executive to provide the resources to make the payments, which means that there is no discretionary space for either the executive or legislative branches in these matters.
51. See Méndez (1979) and the annual presentations of the public treasury statement by the respective finance ministers during the 1990–99 period.
52. See Ramírez and Rosende (1992) for a summary of the changes in the banking legislation.
53. Category A: normal loans, with high probability of recovery; Category B: loans with some weakness in the conditions under which they were granted; Category C: loans with uncertain recovery; Category D: defaulted loans, that is, loans not paid.
54. The most important one, concerning the BHC group led by Javier Vial, finished in 2005, with a complete clearance of all charges. Vial died in 2004 when the matter was still unresolved, 20 years after the start of the judicial process.
55. This part of the chapter draws from World Bank (1994), Piñera (1991), and Corbo et al. (1997).

56. Superintendencia de Seguridad Social (1992).
57. The existence of this team – which in the broader acceptance of the name, was comprised mainly of graduates from the University of Chicago, from other US universities, and also many from the Pontifical Catholic University of Chile – is believed to have been one of the key elements of the successful reforms of 1974 and following years (Piñera, 1991). Others were (1) the existence of true leadership; (2) an element of surprise to avoid the organization of resistance to a particular reform; and (3) the appropriate use of the media to relay the benefits of a given reform.
58. Decree Law 3500, which went into effect in May 1981.
59. This reduces the tax element of the contribution and the negative effects of social security on labor supply.
60. At the time of retirement, retirees can choose to invest the accumulated funds in an insurance annuity or a system of 'programmed or phased withdrawal'. Under the latter, the retiree receives an actuarially determined amount each year, enjoying a higher pension in the initial years after retirement, but potentially receiving a lower pension income than under the insurance scheme.
61. Tax-exempt voluntary contributions can be made. The limit of these is almost four times the mandatory contributions.
62. Early retirement is possible if accumulated funds can finance the minimum pension level.
63. For a detailed description of the system see Corbo et al. (1997).
64. Piñera (1991) describes the characteristics of the process that led to the approval.