

Economic Survey of Chile, 2010

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Summary

Sound fundamentals and strong macroeconomic management have provided a buffer against the global economic recession, which nevertheless hit Chile both through a sharp deterioration in its terms of trade and the collapse of world trade. There was room for decisive macroeconomic stimulus thanks to sound monetary policy and prudent fiscal policy during the boom years. This, together with the rebound in copper prices – Chile's main export – and the revival of global trade, has contributed to a turnaround in activity. The economy is now coming out of recession, yet unemployment is projected to remain initially high and inflation is likely to stay low. Macroeconomic policy should thus remain supportive in the near term. Assuming that the recovery becomes more robust, as projected, policy stimulus should be gradually withdrawn so as to set growth on a medium-term sustainable and non-inflationary path.

The medium-term macroeconomic framework is strong and receives wide support. The economy benefitted enormously from the macroeconomic policy framework implemented by successive governments. Still, there is room for further improvement in the medium term. The financial system is generally well regulated and has thus far held up well, but a better co-ordinated approach to financial conglomerates and stronger supervision of non-banks may be needed. Additional strengthening of the insurance element of the unemployment benefit system, in tandem with lowering severance pay, would provide more effective protection for the unemployed and would enhance labour market flexibility. Broadening the tax base by reducing inefficient tax expenditures could help obtain the tax receipts necessary to finance the likely increase of public spending in the medium term, notably on education, pensions and social programmes. It would also make the tax system more progressive.

Additional reforms to foster competition, entrepreneurship and innovation are needed to stimulate productivity. Chile's productivity appears to

This policy brief presents the assessment and recommendations of the 2010 OECD Economic Survey of Chile. The Economic and Development Review Committee, which is made up of the 30 member countries and the European Commission, held a special seminar to discuss this survey with the participation of the Chilean government. The starting point for the Survey was a draft prepared by the Economics Department of the OECD which was then modified following the discussions in the seminar, and issued under the responsibility of the Secretary-General.

have stagnated in the past decade, thus weighing down on medium-term growth. Recent competition policy reforms that strengthen enforcement of cartel law must now be implemented effectively. In particular, the National Economic Prosecutor should receive sufficient resources and the relatively low ceilings on fines should be reviewed. Enhancing consumer protection would help improve the functioning of product markets by fostering price transparency. Facilitating entrepreneurship could also have beneficial effects on productivity and economic dynamism; for this purpose, regulatory “red tape” burdening start-ups should be reduced and bankruptcy procedures could be further simplified. Recent initiatives to promote innovation are also welcome, but the objectives for the sectoral clusters should be accompanied by appropriate monitoring procedures and sunset clauses for public support to be adequately implemented.

The quality and equity of primary and secondary education have to be improved further. Notwithstanding impressive progress in school enrolment, much remains to be done if Chilean children are to reach OECD standards in learning outcomes. Better qualified teachers and improved initial teacher education and training are key. More equal conditions for schools to compete are needed and the government has started to address this with the prohibition on selecting pupils up to sixth grade. The increased school voucher for poor pupils is an important opportunity to help these children improve their results, which would enhance both the average level and the equity of outcomes.

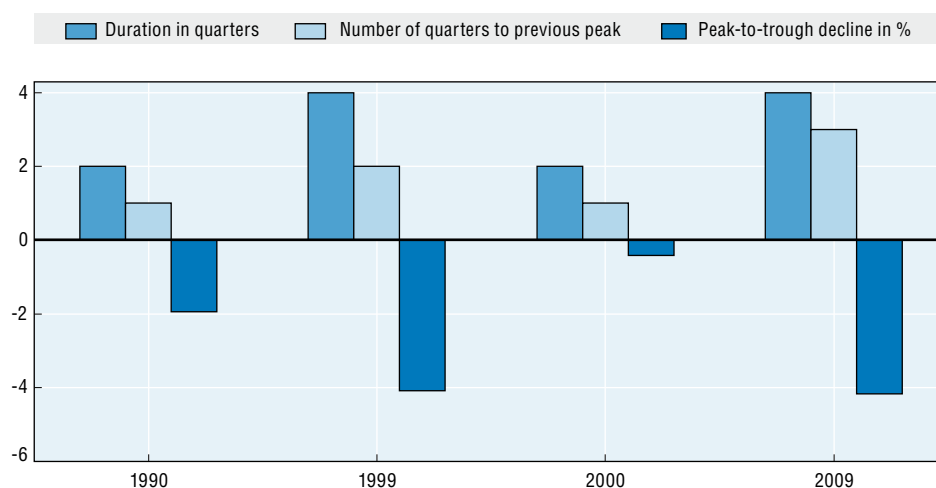
The economy of Chile has performed strongly since the early 1990s, establishing a track record of robust growth, rising living standards, well contained inflation and recurring budget surpluses. This enviable outcome owes a lot to the sound macroeconomic framework implemented by successive governments. However, despite its strengths, the economy was not immune to the global financial and economic crises. As a small open economy relying on exports, particularly of copper, Chile was hit hard by the meltdown of international trade and the plunge in commodity prices, which exerted negative effects on domestic demand and activity. The government rapidly introduced counter-cyclical policies and, with the help of a rebound of copper prices, the economy is coming out of recession. Once the upturn is under way, the challenge will be to return to a path of rising living standards on a sustainable basis. Although income per capita on a purchasing power parity basis has increased sharply over the past two decades, it remains at only 44% of the OECD average. To foster convergence, key policy reforms require further enhancing product market competition, improving the conditions for entrepreneurship and innovation and improving the quality of education. Despite fast growth of per capita GDP and a reduction in poverty, income inequality, as measured by the Gini coefficient, has not declined markedly over the past 20 years and remains very high by OECD standards, notwithstanding some recent improvement. Sustained growth will need to be accompanied by the right social policies to further reduce poverty and improve income distribution. ■

When should the macroeconomic stimulus be withdrawn?

Chile was hit hard by the collapse in world trade and commodity prices, notably the decline in copper prices by more than half. Domestic demand was also severely affected by the worsening environment, with both gross capital formation and consumption falling sharply. GDP growth was negative during four consecutive quarters between mid-2008 and mid-2009 and unemployment increased rapidly during the same period. However, a good part of the drop in the terms of trade, especially copper prices, was reversed by mid-2009 and world trade started to grow again, helping activity to bottom out in the second half of the year. With support from a substantial macroeconomic stimulus, growth is set to increase in 2010 and gather further pace in 2011.

Faced with rapidly deteriorating activity and declining inflation, *Banco Central de Chile* reacted vigorously in the first half of 2009 by reducing the monetary policy interest rate from 8.25% to 0.5% and finally taking non-conventional measures, such as reducing short term debt issuance and establishing a term liquidity facility. While the economic environment improved in the second half of 2009, activity nonetheless remained below potential, the unemployment rate stayed close to 9% and consumer prices declined mildly. This is why the central bank decided to hold the policy interest rate close to its minimum level for a prolonged time period and to use its policies with flexibility so that projected annual inflation stands at 3% over the policy horizon. Assuming the economy regains strength in 2010-11, as projected, and that prices stop falling thanks to the supportive monetary policies, the stimulus should be withdrawn in time to keep inflation expectations well anchored. *Unless inflationary pressures build up appreciably faster than expected, interest rates should remain low well into 2010 and then be raised gradually.*

Figure 1.
THE CURRENT RECESSION IN COMPARISON¹



1. Cyclical turning points are identified with an algorithm developed by Harding and Pagan (2002). A recession is defined as the period from peak to trough of seasonally adjusted GDP. Dates on the bottom axis correspond to the year of the cyclical trough.

Source: OECD Economic Outlook 86 Database.

The government was also quick to enact a well-targeted fiscal stimulus in 2009. The package comprised temporary measures in favour of public investment, a cash allowance for low-income households, tax reductions and a temporary increase in subsidies for training programmes. In addition, some permanent measures were introduced, including an extension of unemployment benefits to workers with fixed-term contracts and a wage subsidy for young, low-wage workers. The slump in activity and copper prices, along with the fiscal measures, could see the 2008 fiscal surplus of more than 5% of GDP move to a deficit of around 3½ per cent of GDP in 2009. Notwithstanding the recent deterioration of the budget balance, Chile continues to enjoy the benefits of low debt and positive net financial assets. *It can thus afford to keep some of the fiscal stimulus measures in place in 2010 to provide further support to domestic demand. Assuming the recovery gains pace as projected, fiscal stimulus could be further withdrawn in 2011.* ■

What measures could be taken to strengthen regulation of financial markets?

Thanks to prudent financial supervision and careful regulation, Chile's financial system seems comparatively sound with little or no exposure to currency mismatches or to the toxic assets that brought down OECD financial markets. To keep credit flowing during the crisis the government extended credit guarantees by state agencies, recapitalised state-owned *BancoEstado* and allowed insurance companies and other non-bank financial institutions to provide credit. It increased the ceiling for debt financing of subsidised housing, while lowering the capital requirement for bank credit with guarantees from government funds. *While it is important to facilitate access to credit in the current environment, some of these measures imply laxer prudential standards and should therefore be subject to close monitoring. They should be reassessed once the recovery is well entrenched.* Despite a dominance of financial groups and conglomerates operating in several segments of financial markets, co-ordination between the separate supervisors for banking, for insurance and securities and for pensions remains limited. Since it is difficult for separate supervisors to detect intra-group risks of financial contagion, there is a need for close co-operation. Recently introduced information sharing between regulators in committees is welcome, but should be formalised and deepened, *and consolidated information for financial conglomerates should be collected. In the longer term, the government should take action to establish group-wide financial supervision. One option would be to designate a "lead supervisor" based on the group's main activity.*

Department stores' issuance of credit cards, mainly targeted at lower-income households with higher credit risk, now accounts for more than 80% of cards in circulation though a minor share of total credit. Credit rating agencies have downgraded several of the department stores because of mounting losses this year. Banks and department stores do not share full information on credit histories, weakening their ability to evaluate their clients' credit risk. *The recent draft bill to create a consolidated credit register is welcome. The authorities*

need to carefully monitor non-bank credit issuers to detect potential threats to systemic stability. The Superintendency of Banks should supervise all credit card issuers. ■

Can the fiscal policy framework be improved further?

Chile's macroeconomic framework – a structural fiscal rule, inflation targeting and flexible exchange rate – has been largely successful in shielding the economy against overheating in the last copper price boom. Nevertheless, *the framework could be strengthened further*. For instance, Chile should consider the experiences of OECD countries that complement their fiscal rule with a ceiling on expenditure growth. During booms, such ceilings help to accumulate additional funds, which can then be used counter-cyclically in sharp downturns. Any improvement should seek to balance the cost of changing a rule that is working and receives wide support with the benefits that it might bring. *Fiscal policy could also be made more counter-cyclical by strengthening the automatic stabilisers, including through an enhanced unemployment benefit system.*

Unemployment benefits largely rest on individual savings accounts with small complements from an insurance fund, the *Fondo Solidario*, which had very restrictive access until recently. Severance pay rights are often several times higher than unemployment benefits, contributing to slower adjustment of the economy after adverse shocks. Furthermore, severance pay is only available to workers on indefinite contracts; it is likely that this discourages employers from offering indefinite contracts, thus contributing to the comparatively large share of workers on fixed-term contracts. The government has recently strengthened the unemployment benefit system by easing access to the *Fondo Solidario* and opening it to workers on short-term contracts, who account for the largest part of job turnover. *Increasing unemployment benefit replacement rates for all workers and extending duration, both of which are currently very low compared to OECD countries, while simultaneously restricting severance pay would provide more effective protection. It would also allow for more efficient job search, thus maximising workers' productivity through a good match. Strengthening the Fondo Solidario would be the best option as insurance would provide more effective income protection than individual savings. Unemployment benefits should be moved up with great care, however, as excessively high unemployment benefit replacement rates could reduce incentives for job search.*

As in other emerging economies, public spending accounts for a small share of national income at present. As Chile converges towards higher levels of living standards, it is likely that the demand for public services will increase. The goals of economic convergence and of building an equitable society also call for developing further public policies, such as for poverty reduction or better educational outcomes. Existing social programmes to reduce poverty and inequality are well targeted and efficient, but they remain small by OECD standards, despite significant expansion in recent years. A further increase of public spending in these areas is therefore not only plausible, but

also desirable, although it should continue to be well targeted, efficiently implemented, and sustainably financed.

In order to increase the provision of public goods and keep public finances sustainable in the medium term, government tax revenues may need to be expanded. Broadening the tax base by abolishing some of the less efficient and regressive tax exemptions and working to increase the yield of the income tax system would contribute to this goal. The government has already limited the VAT tax credit for housing construction. *It could also reassess the highly regressive exemption from VAT of health and education services, which benefit mainly higher income households.* Tax exemptions for contributions to private pension funds and accrued returns to savings, although common in OECD countries, are costly and they disproportionately benefit high-income earners with high marginal income tax rates, while the vast majority of tax-exempt workers do not benefit. Moreover, evidence that tax subsidies are effective in increasing pension savings of higher income earners is scant. The government recently introduced the opportunity for medium- and low-income earners to opt for a pension subsidy instead of a tax allowance. *The government should further strengthen subsidies for low- and medium-income earners while capping tax benefits for high-income earners. This could be done with refundable tax credits or flat subsidies to ensure that support for savings reaches those who need it most.*

The large difference between the corporate and the top marginal income tax rates creates incentives for high-income individuals to keep their savings in corporations often solely created for this purpose, such as *sociedades de inversión*. *The government should close the tax loophole associated with these vehicles.* ■

What can be done to enhance productivity growth?

Lagging labour productivity explains the major part of the per capita income gap with OECD countries, while weak labour utilisation due to low participation of females and youths explains a smaller part. The apparent stagnation of productivity over the past decade accounts for most of the slowdown in GDP growth. Although macroeconomic management has improved markedly over the past two decades, a number of weaknesses in structural policies have contributed to the uneven productivity performance: product market competition, as measured by price-cost margins, remains weak by OECD standards. Further, regulations on entry and exit discourage entrepreneurial risk taking and the diversification into new and higher-productivity activities. Although recent reforms of the innovation policy framework aim at broadening the focus of innovation policy from basic public research to all forms of innovation, technological and non-technological innovation in firms remains low.

A recent reform of competition policy increases the investigative powers of the National Economic Prosecutor, introduces a leniency programme and

increases the level of fines for cartel infringement. *The well-designed reform must now be implemented effectively. The National Economic Prosecutor should receive sufficient resources to cope with a likely increase in caseload, and deterrence for cartel participation would be strengthened by making price fixing a criminal offence, as planned by the government.* Competition in product markets would be enhanced by more price transparency from more effective consumer protection, and by further strengthening the enforcement of competition law, in particular in the area of cartels. The current maximum fine remains too low to deter large corporations and risks undermining the effectiveness of the leniency programme, as immunity becomes more attractive the higher the fine. *The authorities should therefore consider linking the maximum fine to sales on the relevant market.* The effectiveness of the leniency programme will also depend on legal certainty for potential applicants. The publication of a preliminary guideline on the conditions under which the National Economic Prosecutor will grant immunity is therefore a welcome measure and the final guideline should spell out these conditions as precisely as possible.

OECD indicators show that administrative burdens on start-ups are higher than in most OECD countries. Chilean entrepreneurs face more procedures, longer delays and higher costs when starting a business. Entry regulations in specific services sectors, such as registration and notification requirements in retail and exclusive rights in professional services, also appear to be more restrictive than in most OECD countries. *Chile has recently passed a law to reduce red tape for small- and medium-size enterprises. To enhance entrepreneurship, Chile should further reduce administrative burdens on start-ups and facilitate entry into specific services sectors.*

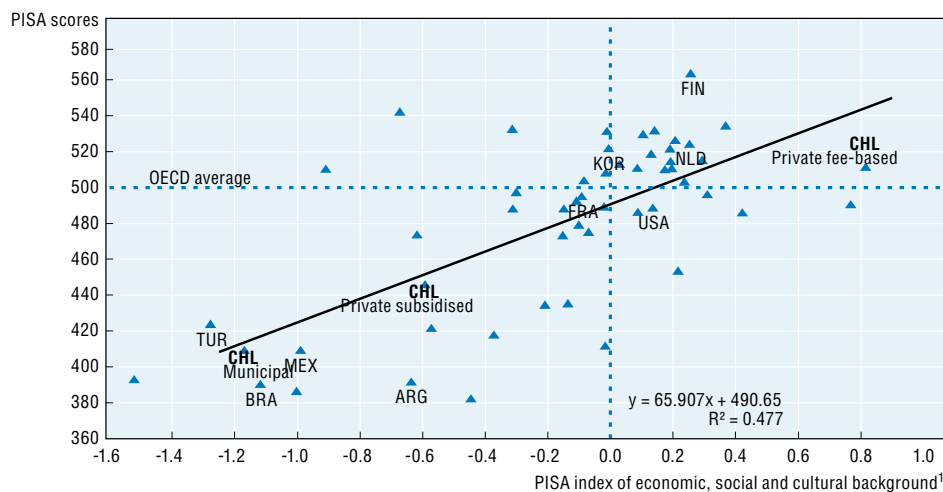
The bankruptcy procedure is inefficient, which not only slows the exit of low-productivity firms but also holds back entrepreneurial risk taking and makes access to credit difficult. According to the World Bank *Doing Business* indicators, Chile's bankruptcy procedure is lengthier and more costly than in most OECD countries. Moreover, the protection of creditors during bankruptcy appears to be weak. As creditors anticipate low recovery rates, they can become reluctant to give credit to potentially very productive but risky businesses. Several initiatives to make the bankruptcy law more efficient are under way and, in particular, the government enacted a law that simplifies bankruptcy procedures for small- and medium-size enterprises. The authorities have also launched an inter-ministerial working group to assess options for reform, among others the creation of specialised bankruptcy courts. *Efforts to improve the bankruptcy procedure should be continued to facilitate the exit of inefficient firms and encourage entrepreneurial risk taking in innovative sectors.*

Until recently, the innovation policy framework focused on basic research in public institutes and universities. As a consequence, the private business sector's propensity to engage in technological (product or process) and non-technological (marketing or organisational) innovation is low by

OECD standards. The authorities have taken several measures to improve industry-science relationships to make scientific research more market-relevant. Among other measures, they introduced an R&D tax credit that requires the participation of research institutes external to the firm, and they strengthened funding mechanisms that require matching public grants with funds from private businesses. The authorities have also started to move away from a narrow focus on R&D to support all forms of technological and non-technological innovation, among others by broadening the support programmes of the economic development agency. *Efforts to strengthen links between firms and universities and support all forms of technological and non-technological innovation in firms should be continued.*

Most OECD countries encourage the formation of industrial clusters, which may be justified on economic grounds if there are positive externalities for the economy at large. In Chile, the formation of industrial clusters may foster the diversification into non-traditional high-productivity sectors, but potential risks to public resources should not be overlooked. *To avoid spending public resources without any inducement effect or on sectors that turn out to be failures, clear performance objectives should be specified.* For clusters that meet their performance objectives, the need for continued public support should be reviewed periodically (sunset clauses), as the objective should be that private financing eventually replaces public support. For clusters that continually fail to meet their performance objectives, support should be withdrawn early to avoid the lock-in of failures. The authorities have started to specify the clusters' outcome targets in terms of exports, which should now be complemented by transparent protocols on the conditions under which public support will be withdrawn. ■

Figure 2.
SOCIAL BACKGROUND
AND PISA SCORES
2006



1. The PISA index of economic, social and cultural status (ESCS) summarises various aspects of socio-economic background, including parents' education and occupational status and students' access to educational resources. It is normalised to 0 for the OECD average. A higher index value indicates a higher socio-economic background.

Source: OECD PISA Results 2006.

How could the quality of education be improved further?

Chile's PISA scores have improved recently, probably owing to considerable efforts since 1990 to improve results, especially in schools serving the poorest children. However, average scores still fall well short of OECD standards, even when accounting for Chile's lower income level. In addition, they are more strongly dependent on students' socio-economic background than in any OECD country, suggesting that until recently schools did not do enough to help disadvantaged pupils attain better results. Municipal and private subsidised schools, which serve more than 90% of all children, are financed by a system of vouchers, providing until recently an essentially flat subsidy per student. Private subsidised schools are allowed to ask for top-up fees from parents, up to a limit. Private subsidised, but not municipal schools had been largely free to select and expel students until 2009. This had created incentives to compete by attracting students that are easier to teach, limiting the beneficial effects of school competition on the quality of education. The government has now prohibited selection by ability or socio-economic background until sixth grade in publicly funded (municipal and private subsidised) primary schools. *It should make sure that this is enforced, while considering extending the prohibition of selection to secondary school.* The creation of an independent agency for quality evaluation and assurance, the *Agencia de Calidad de la Educación*, and an agency ensuring schools' compliance with the law, the *Superintendencia de Educación* is welcome. It may provide information that fosters competition on quality and make sure that the government intervenes when results fall short of minimum standards.

The education voucher was recently increased substantially for the poorest children (*Subvención Escolar Preferencial, SEP*) with some extra payments for schools where these children are concentrated. This is based on the well-founded assumption that it is more difficult to educate vulnerable children, especially when they are concentrated. *One good use for the extra resources would be to increase wage incentives for teachers of proven excellence to teach in schools with many poor children. Another good use for the extra funds could be to provide principals with sufficient staff to delegate administrative tasks and train principals continuously to develop their educational leadership skills.* Chile has already launched promising programmes to train principals and it should develop them further. *In general, the government should provide for independent evaluation of methods financed with the extra resources to promote learning outcomes of students with poor results. It should identify good practices and provide schools with the necessary assistance to help disseminate them through the system.*

In principle, the increased subsidy for vulnerable children could be an incentive for more advantaged schools to accept vulnerable children and meet their educational needs. However, schools are not required to enter the SEP system. *Accepting the SEP should become mandatory to promote socio-economic integration.* The government's plan to integrate the separate quality assurance system for SEP schools into the general national quality assurance system for all publicly funded schools, once it is fully developed, is welcome. This will reduce the risk that the special quality assurance system for SEP schools could be a disincentive to enter this system.

Substantial increases of teachers' wages over the past 15-20 years have attracted increasingly better prepared students to the profession, but a recent pilot exam for primary school teaching graduates has revealed remaining deficiencies. *To attract more talented individuals the government could work towards defining teaching career paths for publicly funded schools, with promotions more closely linked to performance.* Chile has already developed a well thought-out teacher evaluation programme, which would be a good basis to implement such career paths. *It currently applies only to municipal school teachers and should be extended to all publicly funded schools, as teacher quality is wanting across the entire system.* Currently, private subsidised schools have much more flexibility over teacher employment and pay, creating unequal conditions to compete. *All schools should have some flexibility to decide on teachers' wages and on hiring or dismissing them.*

Chile needs to build on its efforts to improve training for teachers at all levels of education. *First, the quality control of initial teacher education programmes needs to become more effective. Parallel to university programmes, special programmes (Programas Especiales de Titulación) currently train a substantial percentage of candidates, although they have been found to suffer from serious deficiencies regarding entry requirements, the quality of their educators and their teaching programmes. The government should ensure that the accreditation process leads to closure of deficient programmes.* *Second, given the persistent weaknesses of basic and secondary education, many students arrive at university with insufficient literacy and numeracy skills. As long as learning outcomes at school have not improved sufficiently, universities should systematically offer remedial classes to make up for this.* *Third, primary school teachers are trained as generalists and their training does not include sufficient subject content knowledge even for lower grades. This problem becomes especially acute in the upper grades of primary school which currently lasts eight years. The government plans to reduce primary school to six years and this is welcome, because secondary school teachers have more specialised training. However, this will require a rapid expansion of the available programme that offers a post-graduate degree in specific school subjects for practicing teachers (Postítulos de Mención) so that their subject content knowledge is upgraded quickly. Initial teacher programmes should upgrade the teaching of subject content knowledge as well. Aspirant and practising teachers alike need more specialised training in how to identify students at risk of falling behind and provide them with the support they need to catch up. One way to ensure that initial teacher education helps candidates attain appropriate standards of knowledge and abilities would be to develop centralised external exit exams to certify teachers. OECD experience suggests that this is useful in a system like Chile's where teacher education programmes are of very variable quality.* ■

**For further
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Economic Outlook No. 86, November 2009.

More information about this publication can be found on the OECD's website at www.oecd.org/eco/Economic_Outlook.

Economic Policy Reforms: Going for Growth, 2010 edition.

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