POLICY BRIEF

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Economic Survey of Chile, 2005

Summary

Chile continues to be a strong performer and the economy has recovered in earnest from the 1998-2003 slowdown. Macroeconomic management has been exemplary and policies have been framed in rules-based, credible settings. Public finances are particularly robust, making the economy resilient to shocks. Structural reform is on-going, unleashing opportunities for growth. But Chile's income gap remains sizeable relative to the OECD area. Lifting the economy's growth potential is therefore Chile's overarching policy challenge.

Chile fulfils important framework conditions for innovation, including macroeconomic stability and investor-friendly FDI and trade regimes. But R&D intensity is low and financed primarily by the government in a fragmented National Innovation System that is not conducive to long-term planning. Further enhancing human capital would facilitate the development and diffusion of knowledge. The creation of the National Innovation Council can do much to boost policy coordination but the allocation of government funds will need to be carried out in a cost-effective, transparent, contestable fashion and geared towards encouraging business-financed innovation consistent with Chile's comparative advantages.

Regulatory reform in network industries is on-going. In electricity, recent reform has fostered competition and aimed at ensuring the security of supply in light of recurrent cuts in gas shipments from Argentina. Unbundling retailing from distribution would be advisable. In telecommunications, the central regulatory issue is how to

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encourage competition while setting efficient prices for dominant firms. Public-private partnerships have contributed to reducing Chile's "infrastructure deficit" over the years, but as this deficit is closing, governance will need to be enhanced to strengthen independent checks and balances and safeguard the budget from undue exposure to contingent liabilities.

Human capital accumulation, on and off the job, is essential for boosting productivity. Policies should aim to raise educational standards to the level of international top performers as a means of accelerating Chile's catch-up with the more prosperous countries in the OECD area. The quality of labour training can be improved to encourage the upskilling of those already in the labour force. Labour force participation can be raised by removing restrictions on full-time work and reforming the legislation on labour dispatching and subcontracting, which could encourage the use of more flexible labour contracts, while improving options for affordable childcare and pre-school education. ■

How to lift Chile's growth potential?

The Chilean economy has recovered in earnest from the 1998-2003 slowdown. The external environment has been supportive, with still abundant international liquidity and buoyant commodity prices, notably for copper. The rebound in private investment has been vigorous, raising the investment-to-GDP ratio to 25% in 2004, well above the level prevailing on average during Chile's "golden age" of rapid GDP growth (1985-97). Registered unemployment is only now beginning to come down, despite the closing of the output gap, largely because labour force participation, particularly for females, has up until recently outpaced job creation. The overarching policy challenge is to ensure that the momentum of the recovery, in particular the strength of private investment, is sustainable and translates into a durable increase in the economy's growth potential in the years to come. This can be achieved by encouraging innovative activity, continuing to strengthen pro-competition regulation, particularly in network industries, and lifting labour force participation and productivity. By doing so, Chile's income gap with respect to the OECD area is likely to close at a speedier pace. Chile's per capita income (adjusted for purchasing power parity) is currently less than 40% of the OECD average and less than 30% of that of the United States, leaving ample scope for further catch-up in relative living standards. The greatest long-term gains would be expected from progress in accumulating human capital, where Chile lags the most.

Chile's performance remains strong, underpinned by the authorities' competent stewardship of the economy. The perception of sound macroeconomic management is now well entrenched, and Chile is the only sovereign borrower in Latin America, other than Mexico, to enjoy an investment-grade credit rating. This achievement should not be underestimated. In particular:

- *Fiscal policy* has so far been guided by the structural budget surplus rule, introduced in 2000, but not set in law, calling for a budget surplus of 1% of GDP adjusted for the effects on public finances of the business cycle and fluctuations in the price of copper.
- Framed in a now fully-fledged inflation targeting set-up, *monetary policy* has been implemented in a forward-looking manner. Inflation is converging to the mid-point of the inflation target band of 2-4% and is expected to remain tame over the near term. The gradual withdrawal of monetary stimulus since September 2004 is appropriate.
- *Structural reform*, facilitated by a comparatively high degree of political cohesiveness, continues to aim at unlocking opportunities for growth, making the economy more resilient to external shocks, more diversified in its export base, and less vulnerable to the vagaries of international commodity prices. ■

Do fiscal institutions and pensions need further reform?

The delegation to expert panels of responsibility for the estimation of trend output growth – a key parameter in the calculation of structural budget balances – as well as the reference price for copper, has greatly contributed to boosting transparency and confidence in the policy framework, by in principle helping to protect it from political interference. Insulating the fiscal stance from terms-of-trade fluctuations is a considerable achievement in the Latin American context, where reliance on natural resource-related revenue is often the main culprit for fiscal pro-cyclicality. Nevertheless, the authorities are not in favour of setting the fiscal rule in law, although they are taking steps towards maintaining the calculation of the structural budget balance as an integral part of the budget-making process in the years to come. This should encourage continued adherence to fiscal rectitude by successive administrations, regardless of their political orientation. *While the principle of the structural budget rule should be maintained, the actual level of the structural budget balance will need to be set for the near term. In doing so, it will be important to take into consideration the pressures on the budget that are likely to arise in the years to come in connection with the pension system, in addition to the financing needs of the central bank, whose capitalisation remains unresolved.*

Recent analysis suggests that the dynamics of central government debt pose negligible fiscal risk over the medium term, predominantly by virtue of its current low level in relation to GDP. The transition costs associated with the pension reform of the early 1980s are fading. But, based on partial information available to date, the coverage of the pension system and the density of contributions are low: only about 55% of the labour force currently contributes to a pension fund and, of these, one-half do so for no more than 60% of their working lives. As a result, there is considerable uncertainty about the future cost to the budget of the guarantee of a minimum pension to those workers who have contributed but at a level that is insufficient to ensure a retirement income at or above the minimum pension. A related issue refers to the assistance pensions, which are not an entitlement, and hence do not pose a fiscal risk per se. But the value of these pensions is currently about one-half of that of the minimum pension, and this discrepancy may well not be politically sustainable over the years. Closing this gap is likely to affect the incentives facing individuals to save for retirement and would in turn affect the density of contributions and the cost to the budget of alternative social protection policies over the longer term. *It is therefore important to find an appropriate balance between the incentives for saving for retirement and the desirable breadth of social protection, which should be high on the policy agenda*. *Dealing with these contingencies calls for pre-emptive action, which could involve some pre-funding, benefiting from the currently healthy fiscal position. Options for increasing the density of contributions, in particular for females and the self-employed, could also be considered*. *Fostering transparency in the disclosure of information on, and regular updating of, actuarial projections, preferably as an integral part of the annual budget-making process, would contribute to mustering the necessary public support for further reform in this area and allow individuals to save more, if necessary.* ■

How can public debt management and inflation targeting be improved?

Fiscal management has been beyond reproach in recent years. The main achievement in this area is the maintenance of a counter-cyclical policy stance. This owes much to the gradual reduction in the public debt overhang, resulting from continued adherence to the structural budget surplus rule and its well-functioning, credible mechanism for smoothing copper-related fluctuations in revenue through the Copper Stabilisation Fund. The consolidated net public debt (central government and central bank) came down to less than 6% of GDP in 2004 from nearly 34% of GDP in 1990. The stock of debt is much higher when taking into account government guarantees of public enterprise liabilities, as well as the "recognition bonds" issued to cover the transition costs associated with the pension reform of the early 1980s. *It will therefore be important to build on the achievements of recent years by resisting pressure for greater activism in the years to come justified on the basis of low indebtedness and the need to satisfy multiple social demands*. In particular:

- The steady decline in indebtedness has generated an "interest dividend", allowing scarce budgetary resources to be channelled to cost-effective, externality-rich social programmes, consistent with attainment of the government's social objectives, while maintaining a relatively low, pro-business tax burden. But Chile's record in education, evaluated by international standardised tests, as well as some health indicators, leaves ample room for improving the efficiency of government spending in these areas. *It will be important to ensure that future increases in public social spending translate into better outcomes and that sources of finance be found predominantly through the reallocation of budgetary resources away from lower-priority outlays, rather than by raising the tax take*.

- Low public indebtedness has also contributed to making the Chilean economy less dependent over time on external financing and hence more resilient to adverse shocks, although private external debt is large. *Domestic debt management has been prudent and could continue to gradually reduce the stock of USD-denominated liabilities and replace inflation-indexed debt by CLP-denominated debt paying a nominal coupon, contributing to the development of the domestic fixed-income market.* The authorities are aware that vigilance will be required to ensure that the withdrawal of USD-indexed debt does not put undue pressure on the foreign exchange market. Also, the pace at which inflation-indexed instruments are redeemed will need to be guided by a judicious assessment of the demand for these securities by pension funds and insurance companies, which hold the bulk of traded government debt.

The inflation targeting framework for monetary policy-making has been strengthened over the years and is functioning well. In 1999, the central bank abandoned its policy of also targeting the nominal exchange rate, which it had pursued since 1984. In doing so, it has allowed the exchange rate to play a greater role in the stabilisation of activity in response to external shocks. In 1999-2000, the monetary framework for fully-fledged inflation targeting was put in place, including the upgrading of the central bank's modelling and forecasting capabilities and the strengthening of its communications strategy to enhance transparency and credibility in the policy framework. There are nevertheless options for consideration within the central bank's policy research agenda. With headline and expected inflation already safely anchored in the 2-4% target range, the central bank could consider the pros and cons of targeting core, rather than headline, inflation and the associated adjustments to the width of the target band. ■

What can be done to foster innovation?

The authorities place innovation policy among their policy priorities on their agenda for growth. Chile's main strengths in fostering innovation are: its relatively investor-friendly legislation on FDI; the presence of reasonably competitive pressures arising from product market regulations, discussed in the *2003 Survey*; a liberal trade regime, which facilitates the diffusion of foreign technology embedded in imported capital goods and inputs; and robust macroeconomic performance, with stable inflation and low interest rates, which fulfils a strong framework condition for innovation. But, at 0.7% of GDP in 2002, Chile's R&D intensity is low by international standards. Also, innovation activity is financed and carried out predominantly by the government. Options for private-sector financing of innovation, such as risk and venture capital, are limited. Human capital is low. *To tackle these problems, it will be important to select among different, often competing, alternatives those which are most cost-effective and with the greatest potential for fostering the diffusion of innovation*.

To foster innovation, the authorities are focusing on the creation of new sources of finance and on reforming the architecture of Chile's innovation system. These are laudable policy objectives. In particular:

- Central to the government's policy agenda is an increase in the availability of public funds for innovation with the use of revenue from the new mining tax, introduced in May 2005. But this will not in itself result in an appreciable improvement in innovation performance. While there is no "best practice" approach to balancing the policy mix, the experience of OECD countries suggests that an increase in direct government support for innovation can easily run into governance problems, with the risk of capture of government funds by interest groups. *The monitoring of individual programmes will need to be stepped up pari passu with the increase in financing to ensure that government support is cost-effective and funds are allocated in a contestable, transparent manner*.
- Innovation policy, regardless of the support instruments used, should be consistent with Chile's comparative advantages. Greater R&D intensity could contribute to improving the value-added content of exports, but scarce public funds should not be used to "pick winners". Innovation would have a high pay-off in most sectors if it focused on the diffusion of state-of-the-art technologies adapted to business needs and geared towards fostering network externalities. *This would favour support for general-purpose technologies with the broadest sectoral application possible, in particular information and communication technologies. Greater emphasis on support for applied research would be consistent with this objective*.
- The authorities are aware of the need to reduce institutional fragmentation. The overhaul of the institutional architecture of Chile's innovation system, coupled with the creation of the National Innovation Council linked to the Presidency to advise the government on innovation policy, will bear fruit to the extent that it contributes to greater policy coherence and fosters synergies among different stakeholders and funding agencies. *But governance challenges should not be underestimated. The creation of an additional institution in an already complex set-up without the appropriate rationalisation of the existing instances for policymaking and service delivery may do little to address the problem of fragmentation and overlapping of functions and responsibilities*. ■

Has regulatory reform gone far enough?

Chile's strong performance, and in particular the step-up in productivity over the past decade, is due to a large extent to the strengthening of pro-competition regulation since the early 1990s. But these achievements do not obviate the need for further reform. In particular:

- It is too soon to evaluate the impact on competition of new legislation approved in early 2004 for the *electricity sector* (*Ley Corta I*). New legislation (*Ley Corta II*) has also been approved to ensure the security of supply, against a backdrop of recurrent cuts in shipments of natural gas from Argentina. These are steps towards removing regulatory obstacles to the expansion of generation capacity. *Further liberalisation of electricity retailing would be welcome to allow retailers to design efficient price schedules adapted to consumer preferences*.
- In the *telecom sector*, the emergence of competition has been instrumental in reducing prices and facilitating access by the population to affordable services. The central regulatory issue in the sector is how to foster competition while simultaneously setting efficient prices for dominant firms. *Further network unbundling, if pursued, should therefore be consistent with the regulation of dominant firms. Because entry is decided on the basis of average costs, unbundled parts of a network should also continue to be priced at average cost and the remaining cross-subsidies would need to be eliminated*.
- *Public-private partnerships* have contributed to reducing Chile's "infrastructure deficit" over the years. But, as this deficit is closing, the social rates of return on new projects are likely to decline. *This calls for even more judicious project evaluation and enhanced governance to strengthen independent checks and balances and safeguard the budget from undue exposure to contingent liabilities*. ■

How to improve labour productivity?

Chile's income gap relative to the OECD area reflects not only a deficit in labour utilisation, owing to relatively low labour force participation, particularly for females, but more importantly, lower labour productivity, which has risen over time but continues to lag behind that of OECD countries. Anecdotal evidence suggests that in mining and some agribusiness activities, now among the most dynamic sectors in the economy, labour productivity is already on a par with the best performers in the OECD area. *The challenge is to raise productivity elsewhere in the economy, including in services through human capital accumulation, on and off the job*. In particular:

- Educational attainment has increased but performance remains poor in comparison with OECD countries. The government is aware of the weaknesses in this area and has taken measures to address them. Government spending on education is on the rise, facilitated by the interest dividend arising from continued prudent fiscal management and the ensuing reduction in public indebtedness. Options for facilitating access by the low-income population to higher education include a recently approved reform of student loans, extending government guarantees for loans from private banks. This is important because returns to education are estimated to be high. *Policies should aim to raise educational standards to the level of international top performers as a means of accelerating Chile's catch-up with the more prosperous countries in the OECD area. But an increase in outlays will deliver stronger performance only if maintained over time and accompanied by monitored improvements in the quality of teaching.*
- The availability of labour training financed through tax rebates and, more recently, the increase in grants for small enterprises in lieu of tax relief, are steps in the right direction. But such incentives would still fail to reach some groups of self-employed persons and their family members, who are most likely to be outside the formal labour market and for whom the return on investment in human capital accumulation is likely to be low. *While the scope for subsidising job-related training is debatable, policies should continue to focus on improving the quality of labour training and governance in service delivery*.

To lift labour force participation, which is low by international standards, even among prime-age males, greater flexibility is needed for the allocation of working time. Part-time work is important for a significant group of female employees and the availability of good-quality, affordable childcare and pre-school education could encourage labour force participation in the case of families with dependent children. *Regulations on full-time work should allow working time to be reduced by any number of hours, and not necessarily by up to one-third, a limit that currently triggers some special provisions.* Moreover, reform of legislation would be welcome in the case of labour dispatching and subcontracting. Based on current practices, client enterprises are responsible for work supervision, while the dispatching firm retains a legal role as an employer. *It is advisable to introduce legislation to formally clarify these responsibilities. At the same time, strengthening the legal framework for subcontracting could encourage a more widespread use of flexible labour contracts*.

To sum up

This *Survey*'s general assessment is that Chile continues to perform strongly. The pace of the recovery in 2004, particularly in investment, leaves little doubt that the 1998-2003 slowdown was predominantly cyclical. External conditions have been favourable. More importantly, policies – framed in rules-based, credible settings – have put public indebtedness on a declining path, allowing fiscal policy to play a more stabilising role than in the past, anchoring longer-term expectations and prudently managing natural resource wealth. This is exemplary, and the current administration's main legacy. A lasting challenge for future administrations is to carefully balance the need for preserving fiscal rectitude and satisfying social demands in a low-debt environment, where the opportunity cost of government largesse may be underestimated. Structural reforms under consideration need to be discussed in a broader context that would take into account of linkages and synergies among different policy areas. Innovation policies can be strengthened in pursuit of durable growth, but the likely increase in direct government support will need to be assessed against the objective of raising R&D intensity at the enterprise level. Further regulatory reform will contribute to a better investment climate to the extent that it continues to foster competition. Raising human capital, both in schools and in the workplace, improving the use of labour inputs and lifting productivity will be essential for closing Chile's gap in relative living standards. ■

For further information

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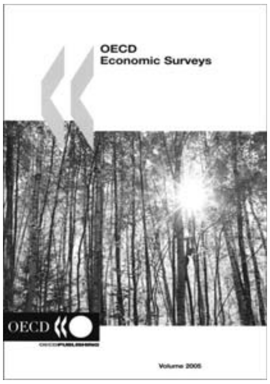

- **Additional Information:** More information about the work of the OECD Economics Department, including information about other publications, data products and Working Papers available for downloading, can be found on the Department's Web site at *www.oecd.org/eco*.
- **Economic Outlook No. 77,** June 2005. More information about this publication can be found on the OECD's Web site at *www.oecd.org/eco/Economic_Outlook*.

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