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CHILE'S FDI POLICY: PAST EXPERIENCE AND FUTURE CHALLENGES[1]

Karen Poniachik,
Executive Vice-President, Chile's Foreign Investment Committee

1 Daisy Kohan, Rodrigo Cifuentes and Francisco Javier Díaz collaborated with research for this paper. Special thanks to Ruth Bradley for her invaluable comments.

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I. FDI IN CHILE: BUILDING A TRACK RECORD

Chile is widely recognized for its success in attracting FDI. Between 1974 and 2000, materialized foreign investment totaled US$ 52.4 billion. Of this amount, 83.4% entered the country after 1990. During the 1990s, FDI represented an annual average 6.4% of Chile's GDP, rising to 8.3% between 1995 and 2000.

FDI flows worldwide increased dramatically during the 1990s[2], when they expanded by a factor of 4.3 [3]. Although high-income countries were the main recipients, the share of low- and middle-income countries in global FDI increased from 12% in 1990 to 21% in 1999 (of which Latin America received almost half).

Within this context, Chile has achieved a notable performance. Between 1990 and 1999, FDI increased by a factor of 15.2 and the country's share of FDI in low- and middle-income countries doubled from 2.5% in 1990 to 5% in 1999. Chile received 10% of all FDI in Latin America in 1999, although its GDP represents only 3.6% of regional output and it has only 3% of the region's population.

Table 1 sets out figures for performance by country, including Latin American and East Asian countries that have been characterized by high economic growth or policies that favor foreign investment. The table shows that, in the 1990s, some Latin American countries began to show FDI/GDP ratios that were similar to those of successful East Asian economies (notably Singapore). By the end of the decade, Trinidad and Tobago, Bolivia, Nicaragua, Chile and Panama all had FDI inflows that were equivalent to between 7% and 9% of GDP.

Comparisons of FDI/GDP ratios across countries can be misleading, since small economies find it easier to achieve high ratios than large economies. Figure 1 sets out FDI/GDP ratios, corrected for the effect of country size, and confirms that small countries (with size measured by GDP) tend to have a higher ratio than larger countries.

By taking the best-performing countries at each income level, we can obtain an approximation to an "efficiency frontier" i.e. the highest level of FDI/GDP that a country can expect to attain, given the size of its economy. In Figure 1, this "frontier" appears as a straight line and the data shows that only Chile and Singapore crossed the "frontier". In other words, when the figures are corrected for country size, Chile and Singapore are seen to have outperformed all other countries between 1995 and 1999 in attracting FDI.

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2 Figures in this section use the latest data available in World Development Indicators, World Bank, 2001. In this database, countries are classified as having low, medium or high-income levels.

3 Or equivalently, they grew at an average rate of 18% per year.

Table 1. **Ratio FDI over GDP**
(percentages)

Country	1980-84	1985-89	1990-94	1995-99
Latin American Countries				
Argentina	0.5%	0.8%	1.4%	3.6%
Bolivia	1.2%	0.1%	1.5%	9.0%
Brazil	0.9%	0.5%	0.4%	2.6%
Chile	0.9%	1.5%	2.8%	7.7%
Colombia	1.1%	1.5%	1.5%	2.8%
Costa Rica	1.3%	1.5%	2.6%	3.7%
Dominican Republic	0.7%	1.3%	2.0%	3.8%
Ecuador	0.4%	0.7%	2.1%	3.2%
El Salvador	0.2%	0.4%	0.2%	2.4%
Guatemala	0.9%	1.8%	0.8%	1.2%
Honduras	0.4%	1.0%	1.3%	2.4%
Jamaica	n.a.	0.4%	3.2%	4.6%
Mexico	0.7%	1.3%	1.5%	2.9%
Nicaragua	n.a.	n.a.	1.0%	7.9%
Panama	0.1%	0.1%	2.8%	7.2%
Paraguay	0.4%	0.1%	1.5%	1.6%
Peru	0.1%	0.2%	1.9%	4.0%
Trinidad y Tobago	2.5%	1.0%	5.5%	10.0%
Uruguay	0.7%	0.4%	0.3%	0.8%
Venezuela	0.2%	0.2%	1.5%	3.7%
South-East Asian Countries				
Indonesia	0.2%	0.5%	1.2%	1.0%
Korea, Rep.	0.1%	0.4%	0.3%	1.1%
Malaysia	4.0%	2.3%	7.1%	4.0%
Singapore	9.3%	10.7%	10.3%	8.4%
Thailand	0.8%	1.2%	1.8%	3.3%
Vietnam	6.0%	6.5%	7.5%	7.1%

Source: World Bank (2001)

Figure 1
FDI over GDP by level of GDP

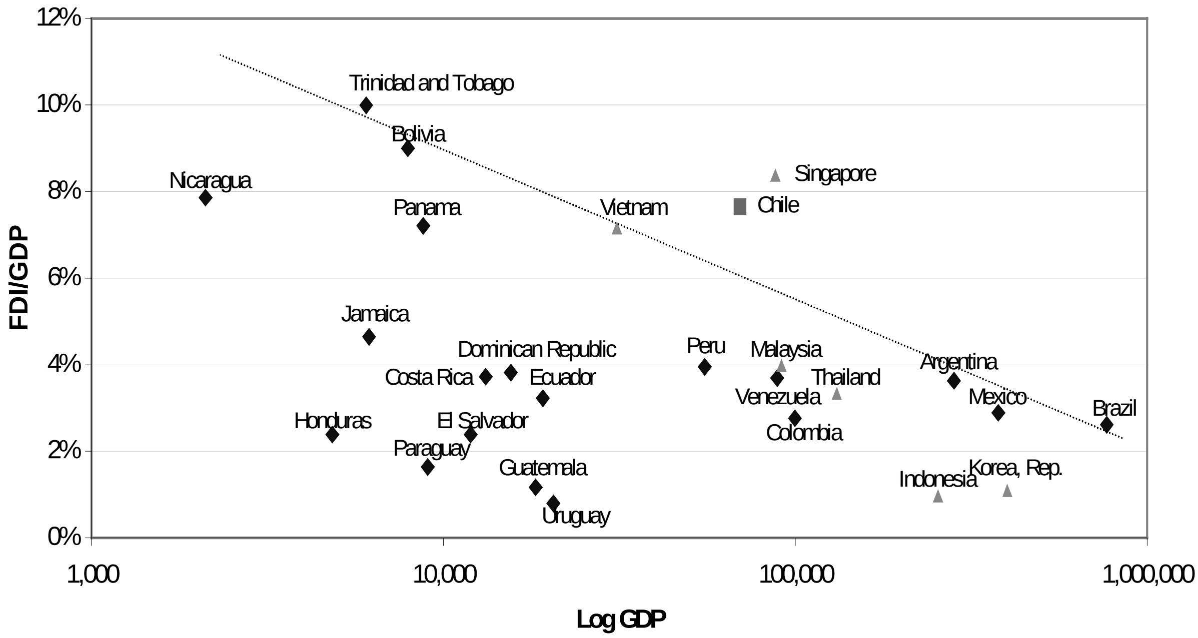


Figure 2
Foreign Investment Statute (DL 600)
Investment by Sector 1974-2000

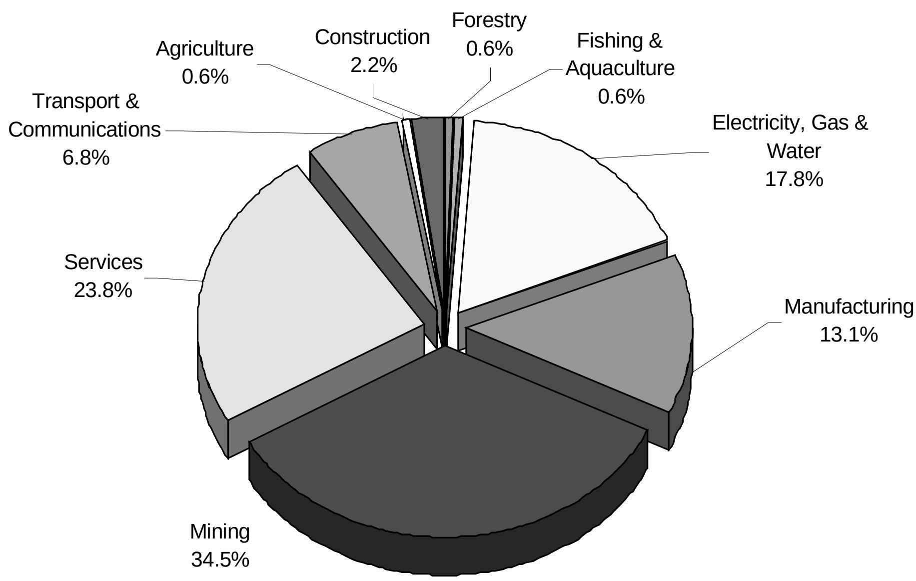


Figure 3
Foreign Investment Statute (DL 600)
Distribution of Materialized FDI by Sector

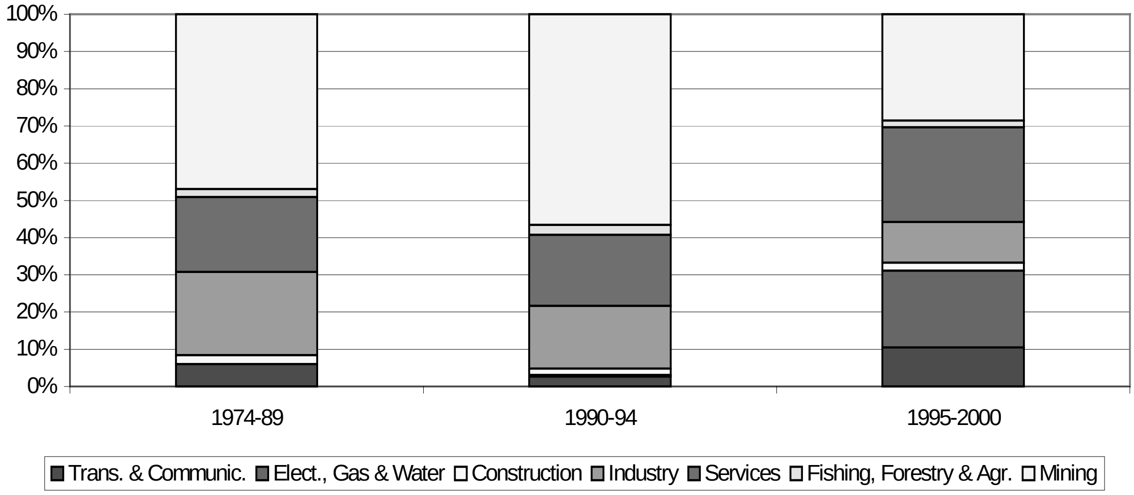
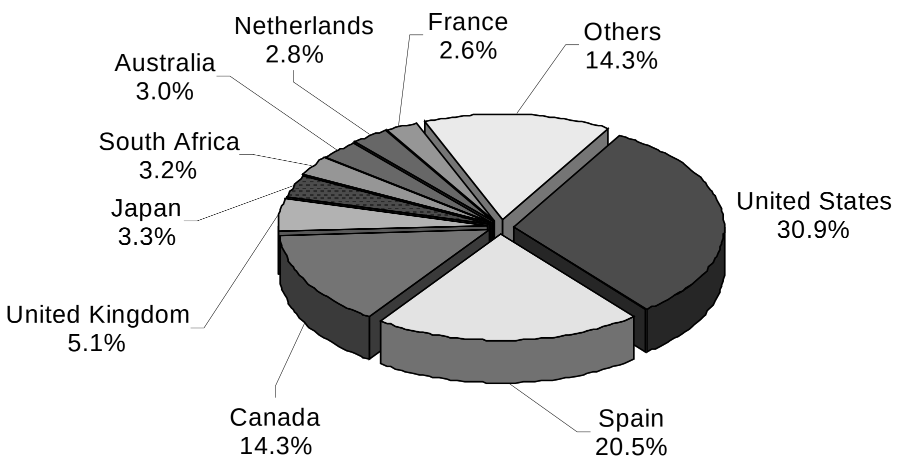


Figure 4
Foreign Investment Statute (DL 600)
Investment by Country of Origin



I.1. Distribution by Sector & Country of Origin[4]

Between 1974 and 2000, the mining industry accounted for 34.5% of foreign investment in Chile. As shown in Figure 2, it was followed by the services sector (23.8%), the electricity, gas and water industries (17.8%) and manufacturing (13.1%).

Until 1990, mining projects represented 47% of DL 600 investment, boosted by the government’s decision to lift restrictions on private investment in the exploration and exploitation of mineral deposits. Similarly, investment in financial services was encouraged by the deregulation of the financial sector. Since 1990, however, other sectors have gained in importance and the mining industry’s share of DL 600 investment gradually diminished to an average 28.5% in 2000 and 2001.

As shown in Figure 3, the decrease in the relative importance of mining was counterbalanced mainly by higher investment in the transport and communications industries (including telecommunications) and in the electricity, gas and water sectors. This new trend was mainly the result of privatizations in the energy and telecommunications sectors and of the intense competition that followed the deregulation of mobile and long-distance telephone services.

In addition, an Infrastructure Concessions program, launched in 1993, opened the way for the participation of private capital, mostly from abroad, in the construction and operation of roads and airports.

As from 1997, there has been a surge of M&A activity, mainly in the services, electricity and telecommunications industries, due partly to foreign companies’ interest in using Chile as a platform for expansion into other Latin American countries. Water privatizations and a concessions program for water treatment services have also captured important inflows of FDI in recent years.

Regarding sources of FDI, between 1974 and 2000, 30.9% of DL 600 investments in Chile originated in the United States, followed by Spain (20.5%), Canada (14.3%), the United Kingdom (5.1%) and Japan (3.3%). As a group, the OECD countries account for 90% of the DL 600 investments that have been carried out in Chile (see Figure 4).

II. FDI IN CHILE: REGULATORY FRAMEWORK

Chile has several competitive advantages that make it an attractive location for foreign corporations looking to develop new business and to expand in Latin America. One of the country’s most valuable assets is its stable and transparent policy framework for foreign investment, embodied both in the 1980 Political Constitution and in the Foreign Investment Statute, known as Decree Law 600 (DL 600).

II.1 Inflow Mechanisms

Since 1974, when the Foreign Investment Statute (DL 600) came into force, the vast majority of foreign investors have chosen to use this mechanism. Under DL 600, an investor signs a legally binding contract with the State for the implementation of an individual project and, in return, receives a number of specific guarantees and rights that are explained below. Between 1974 and 2000, investments worth US$ 43.8 billion, representing 84% of the total FDI inflow, used this mechanism.

4 This section refers to investment that entered Chile via DL 600, which is the main channel for FDI.

However, a simpler investment mechanism, Chapter XIV of the Central Bank's Compendium of Foreign Exchange Regulations (CFER), also exists. Under this mechanism, FDI need only comply with registration procedures. However, Chapter XIV does not carry all the guarantees that are provided by DL 600.

A third mechanism, Chapter XIX of the Central Bank's Compendium of Foreign Exchange Regulations (CFER), played an important role between 1985 and 1991, when it was used for investments totaling US$3.6 billion, mainly in the manufacturing and services sectors. However, this debt conversion mechanism is no longer in operation.

Table 2. **Foreign Direct Investment by Inflow Mechanism**
(Percentage of total)

Investment Mechanism	1974-2000	1998	1999	2000
Foreign Investment Statute (DL 600)	**83.5**	**91.5**	**93.0**	**80.2**
DL 600 Equity	62.0	67.3	88.1	68.5
DL 600 Associated Loans	21.5	24.4	4.9	11.7
Chapter XIV (CFER)	9.6	8.3	7.0	19.8
Chapter XIX (CFER)	6.9	-	-	-
TOTAL	100.0	100.0	100.0	100.0

Sources: Foreign Investment Committee (www.foreignvestment.cl), Central Bank of Chile (www.bcentral.cl)

II.2. Foreign Investors' Rights

Foreign investors in Chile can own up to 100 % of a Chilean-based company, and there is no time limit on property rights. They also have access to all productive activities and sectors of the economy, except for a few restrictions in areas that include coastal trade, air transport and the mass media. In the case of fishing, restrictions are subject to the rules of international reciprocity.

The State has a very minor productive role in Chile. Only a few strategic activities --such as exploration and exploitation of lithium, liquid and gaseous hydrocarbons deposits in coastal waters under national jurisdiction or located in national security areas and the production of nuclear energy-- are restricted to the State, although, under certain circumstances, foreign companies can invest even in these areas.

Under Chile's Constitution and its legal system, foreign investors are guaranteed non-discrimination. Whichever investment mechanism they use, foreign investors enjoy the same rights and guarantees as local investors and are assured of non-discretionary treatment by the State.

Any foreign individual or legal entity, as well as Chileans with residence abroad, can invest through DL 600. Under this mechanism, investors enter into a *legally binding contract* with the Chilean State, which cannot be modified unilaterally by the State or by subsequent changes in the law. However, investors may, at any time, request the amendment of the contract to increase the amount of the investment, change its purpose or assign its rights to another foreign investor.

DL 600 guarantees investors the right to repatriate capital one year after its entry and to remit profits at any time. In practice, the one-year capital lock-in has not represented a restraint since most productive projects require more than a one-year start-up period. Once all relevant taxes have been paid, investors are assured of access to freely convertible foreign currency without any limits on the amount, for both capital and profit remittances. In addition, they are guaranteed the right of access to the formal exchange market.

It should be noted that the Central Bank has the right to restrict access to the formal exchange market --made up by banks and other authorized dealers-- if adverse macroeconomic conditions make this necessary. However, DL 600 investors are exempt from these restrictions and their right to access the market in order to repatriate profits or capital is not affected.

Some projects --whether carried out by foreign or local investors—require specific authorization from relevant authorities. The authorization of The Chilean Commission of Copper is, for example, required for investments in mining, while the Undersecretariat of Fishing must approve fishing investments. Similarly, the consent of the Banks and Financial Institutions Regulatory Agency is required for investments in the banking sector and that of the Securities and Exchange Commission for the insurance industry and investment funds. A project's potential environmental impact is assessed through the Environmental Impact Evaluation System, a mechanism managed by the National Environment Commission.

All the rights guaranteed by Chile's legal framework are further protected by Bilateral Investment Treaties (BITs). As of December 2001, Chile had signed 50 BITs, 32 of which were already in force. In addition, Chile's Free Trade Agreements (FTAs) with Canada and Mexico include specific chapters on investment-related issues, including dispute-settlement mechanisms that are similar to those used in BITs.

II.3. Special Tax Advantages for Foreign Investors

Although Chile's Constitution is based on the principle of non-discrimination, DL 600 offers some tax advantages for foreign investors. These are not "tax breaks" or "tax holidays", but are intended to provide a stable tax horizon, acting as a form of "tax insurance". DL 600 offers several different tax options, but basically allows the investor to lock into the tax regime prevailing at the time an investment is made.

Invariability of Income Tax Regime: Under Chile's Common Tax Regime, a 35% tax is currently levied on distributed or remitted profits but, under DL 600, a foreign investor can opt to lock into a 42% tax on income for up to ten years. The investor, thereby, acquires immunity from any tax increases in the Common Tax Regime that may occur during that period. The lock-in can be waived at any time, but an investor cannot subsequently revert to the guaranteed 42% rate.

However, it should be noted that investors who do not remit or distribute profits are liable only for a 16% first-category tax[5]. If an investor subsequently remits profits, the first-category payment can be set against tax returns under both the Common Tax and Invariable Tax Regimes.

Invariability of Indirect Taxes: Foreign investors also have access to a regime that freezes Value Added Tax, as well as import tariffs on capital goods for the project, at their rate at the date of the investment. This special regime applies throughout the period authorized for the carrying out the investment. Additionally, imports of some of these capital goods are exempt from VAT, if they are not produced in Chile and are on a list published by the Ministry of Economy.

Special Regime for Large Projects: DL 600 investments in new industrial or extractive activities, including mining, are entitled to additional tax benefits, providing they have a value of at least US$ 50 million. This special regime was introduced in 1985 to reduce tax uncertainty and facilitate the

5 This will increase to 16.5% in 2003 and 17% in 2004 in order to compensate for revenue losses resulting from a reduction in personal income taxes, approved by Congress in 2001.

development of foreign investments requiring high levels of external credits and financing. Available for a period of up to 20 years, this regime allows an investor or recipient company to use accounting in foreign currency and to lock into existing practices on matters such as asset depreciation, carry-over of losses and the tax treatment of start-up expenses. In addition, because the regime was introduced at a time when exporters were still obliged to repatriate returns, it authorizes DL 600 investors to hold export returns in offshore accounts and offers a special tax arrangement for repatriated returns.

II.4. Direct Incentives and Subsidies

In line with its commitment to free-market economic policies and free trade, Chile does not use tax incentives to support productive activities or to attract new investment. However, it does provide certain inducements for investments in some isolated geographic regions and new industries, particularly those in the technology field.

Investors can, for example, tap into government schemes to promote workplace training and to increase industrial productivity. All these schemes, in the form of grants and tax rebates, are available equally to both local and foreign investors and are part of a wider government strategy designed to increase competitiveness by extending the benefits of economic growth to all areas of the country, promoting education and training and encouraging technological innovation.

All firms in Chile are allowed to set training costs of up to 1% of annual payroll against corporate tax payments and, in some remote areas, can also claim a tax rebate on labor costs and for some start-up expenses. Grants, which are managed mostly by the Chilean Economic Development Agency (CORFO), are limited in number and qualifying firms are selected on the basis of established criteria that reflect the government's development objectives.

In 2000, CORFO introduced a program of special incentives for investments in high-technology projects. As well as information technology and biotechnology, this covers projects that introduce new methods in traditional processes and new technology-based services. Both foreign and local investors in projects with a minimum value of US$ 1 million can apply for support under this program which offers grants towards pre-investment studies and the acquisition of fixed assets and staff training, as well as for R&D projects with a high commercial impact.

III. CHILE'S CHOICE OF FDI POLICY

All countries would like to tap into the positive externalities and spin-off effects of foreign investment. Along with an immediate impact on current account financing and job creation, foreign investment brings longer-term benefits in the form of technology transfer, increased export development, improved international integration and greater domestic competition.

As a result, countries are increasingly competing to attract FDI. This competition can come in many guises, but the literature distinguishes two main approaches – direct incentives, usually in the form of tax rebates and direct subsidies, or what Oman (2000) has termed the "beauty contest" approach.

Under a "beauty contest" strategy, a country does not offer direct incentives to foreign investors, but relies on its other competitive advantages to attract FDI. This approach usually involves (but is not limited to) upgrading infrastructure, strengthening macroeconomic fundamentals, increasing educational standards, guaranteeing the rule of law, and, in general, improving a country's "business climate".

The choice exists and it is a difficult one. Moreover, the two options are not mutually exclusive and some authors argue that direct incentives are always necessary. In practice, the “beauty contest” approach usually delivers a short list of countries, all with economic fundamentals that satisfy the potential investor. At that point, it may seem that direct incentives would “help” the investor to make a final decision or, in other words, to clinch the reward for a country’s efforts in improving its business climate.

However, direct incentives can have adverse consequences that are not immediately obvious and these need to be taken into account when designing incentive policies. Tax rebates and subsidies, exclusively for foreign investors, are a form of discrimination against local business which, in Chile, is forbidden by the Constitution. In addition, both tax rebates and subsidies reduce the fiscal resources that would otherwise be available for investment in, for example, education or infrastructure. In this way, the cost of the incentives may cancel out the positive externalities of higher FDI.

However, perhaps a more important objection to direct subsidies is their detrimental effect on transparency. Direct incentives are not usually disclosed publicly since this would only encourage investors to take them as a baseline from which to start negotiations. Similarly, direct incentives give government officials discretionary powers. The problems of "picking winners" are well known and history is not short of stories about governments that have picked the wrong winner. In addition, lack of disclosure and discretionary decisions help to create an environment of secrecy that contravenes the basic principles of good governance[6].

However, despite these problems, direct incentives can sometimes be appropriate. As Blomström (2001) notes, there are cases in which positive externalities in some sectors are so clear --i.e. the "picking winners" problem is not present-- that direct incentives are justifiable.

In these cases, a good incentives policy should be based on:

- Non-discrimination between foreign and local investors. If incentives are used to develop a specific sector, they should be available independently of an investment’s origin.

- Clear rules for selecting beneficiaries. These should also be as objective as possible.

- Full public disclosure. This should include the terms of the incentives and their amount.

- Mechanisms to maximize externalities. Rather than simply providing standard tax breaks, mechanisms should be designed to maximize positive externalities and allow the local community to share the benefits of the investment.

Because Chile gives priority to transparency, non-discrimination and market-friendly policies, direct incentives do not fit into its scheme of public policies. Instead, it has chosen the “beauty contest” approach and focused on improving its fundamentals in a bid to become more attractive to foreign investors. One advantage of this approach is that the improvements work to the advantage of local firms, as well as foreign investors, and thereby benefit the entire country.

However, Chile does make a limited use of direct incentives to boost the development of geographically isolated or particularly depressed areas and to encourage the development of new industries. These incentives do not discriminate between foreign and local investors and tax breaks are available automatically to all firms that fulfill the required criteria, while government grants, managed by CORFO, are awarded on the basis of clear rules that reflect a scheme’s objectives.

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6 Oman (2000) and Blomström (2001) argue in this direction.

It is true that the tax advantages offered under DL 600 are available only to foreign investors. However, as described in the previous section, these are not tax breaks, but rather a form of insurance against possible future changes in taxation. This type of protection was considered necessary, and proved useful, when Chile was in the process of building its international credibility and FDI to developing countries was less common.

III.1 Empirical Evidence

There is important empirical evidence that supports Chile's approach by demonstrating that sound fundamentals, rather than direct incentives, are the key to attracting FDI. In a recent study, Stein and Daude (2001) used a large sample of countries to study the determinants of FDI and found a positive correlation between direct incentives and FDI. However, they found an even stronger correlation between FDI and a country's fundamentals and, particularly, the quality of its institutions.

Stein and Daude also studied several variables that are generally believed to influence FDI. They found that some, such as education and infrastructure, have the expected impact, but lose significance when other variables, such as the quality of institutions, are included. The case of education is particularly interesting. Although it does not seem to be an important determinant of FDI levels, it appears to have a significant impact on the type of FDI that a country receives. Other authors have found that a higher level of education increases the benefits that a country derives from FDI.

Variables that measure the quality of institutions try to differentiate between countries that suffer from excessive regulation, corruption and political instability and those in which the law is respected, the government honors its commitments and the civil service is competent. The variables used are those developed by Kaufmann, Kraay and Zoido-Lobatón and include freedom of political expression, government accountability, political stability, government effectiveness and efficiency, the regulatory environment, respect for the law and the level of corruption.

The results show that institutions do matter a great deal and that a country's regulatory environment is the single most important variable, while freedom of expression and accountability are the least important. The results also indicate that moving to the OECD average level, up from the average for Latin America, implies increasing FDI by a factor of 2.8. Similar conclusions are reached by other studies. Wei (1997) for example, concludes that corruption, because of its unpredictability, weighs more heavily than the level of taxation.

IV. FDI IN CHILE: KEY DETERMINANTS

As suggested by Balasubramanyam (2001), a country's legal framework is an important determinant of its ability to attract FDI. There is no doubt that this has been a key factor in Chile where the legal framework, described above, has helped to ensure stable and predictable rules and procedures.

However, Chile's business climate has also been identified as another crucial advantage. In 2001, the Economist Intelligence Unit (EIU) ranked Chile as possessing Latin America's most favorable business climate, based on its "strong policy record, macroeconomic stability and fair growth prospects". On a global scale of the best places to do business in the next five years, the EIU put Chile in 21st place among 60 countries.

Many factors go to make up this propitious business climate. However, they can be grouped into five basic categories: Macroeconomic Environment, International Integration, Institutions and Governance, Social Cohesion and Infrastructure.

IV.1. Macroeconomic Environment

Between 1990 and 2000, Chile experienced annual average growth of 6.4%, ahead of other Latin American countries and among the fastest rates in the world. Even in the current negative global scenario, Chile managed to grow by 2.9% in 2001, outpacing most of its emerging markets peers.

Economic growth has been accompanied by decreasing inflation, a sharp drop in public debt, stable external accounts and strong international reserves. This achievement is the result of Chile's commitment to economic liberalization and free-market policies, as well as of its pledge to maintain sound and responsible economic management.

Chile's process of economic liberalization and deregulation began in the 1980s under a military government, but has taken even larger steps forward since the country's return to democracy in 1990. The first reforms included the opening of the country to foreign trade and investment, the privatization of public companies, a reduction in the size of the public sector, the introduction of a pioneering social security scheme based on private pension funds, and the implementation of prudential banking regulation. In addition, the creation of an autonomous Central Bank in 1989 was a key factor in reducing inflation from 27% in 1990 to within the Central Bank's present medium-term target range of 2%-4%.

In recent years, a number of additional measures have been taken to reduce market inefficiencies and encourage competition, as well as to strengthen the institutions that guarantee Chile's stable macroeconomic fundamentals:

- In 2000, the government introduced a new fiscal policy which aims to maintain a structural budget surplus equivalent to 1% of GDP. This policy has the advantage of ensuring medium-term fiscal restraint, while permitting counter-cyclical measures in periods of slower economic growth.

- In 1999, Chile adopted a floating exchange rate and has now eliminated most capital controls. This reflects the authorities' commitment to the market as the mechanism for determining key prices in the economy.

- A far-reaching deregulation of capital markets, implemented in December 2001, aims to increase the liquidity of domestic markets, encourage savings and improve the access of new projects to investment finance. During 2002, the government plans to announce a second package of measures, including incentives for the development of a local venture capital industry.

Chile's sound macroeconomic fundamentals have been recognized by many international institutions. The *2001 Global Competitiveness Report* of the World Economic Forum (WEF) ranked Chile as the most competitive country in Latin America and in 27st place among 75 countries. In the report's Macroeconomic Environment Index, Chile is ranked in 21st place, in a better position than Austria, Sweden and Denmark.

International credit rating agencies not only award Chile a privileged place within Latin America, but also put it in a very favorable position as compared with other emerging markets. During 2001, Chile's country risk held steady at an average of 179 basis points over US Treasury bonds, while other Latin American and emerging market sovereign bonds traded at an average spread of 882 and 837, respectively. In late December, when Argentina's country risk hit a record of 5,500, Chile's spread was running at only 157 points.

IV.2. International Integration

International integration favors FDI not only because it increases the market to which a country has access, but also because investors view it as a seal of good behavior. In order to achieve international integration, a country needs to fulfill certain conditions, such as macroeconomic stability. These, in themselves, make a country more attractive for FDI[7], but the risk of failing to reach an international agreement is also a strong deterrent against a departure from good behavior.

Most studies attest to the importance of market size as a key determinant to FDI. Because Chile has a domestic market of only 15 million inhabitants and its per capita income is still under US$ 5,000, integration into global markets is vital. Chile has adopted a policy of market enlargement by establishing an extensive network of trade agreements that include FTAs with Canada and Mexico, an association agreement with the MERCOSUR block, bilateral treaties with Venezuela, Colombia, Ecuador and Peru and an agreement with the Central American countries, as well as membership of the APEC forum.

By early 2002, negotiations on FTAs with the United States, the European Union and the EFTA countries had made substantial progress and Chile was also holding exploratory trade talks with South Korea and New Zealand. In addition, Chile actively supports efforts to establish a Free Trade Area of the Americas (FTAA).

For imports from countries with which it does not have a trade agreement, Chile applies a flat tariff which is scheduled to drop to 6% in 2003 as part of a five-year program on one percentage unilateral annual reductions. This program, along with Chile's FTAs and its low level of non-tariff barriers, make it one of the world's most open economies.

Answering a common concern among FDI investors, Chile has been active in negotiating double-taxation agreements. As of March 2002, it had signed agreements with Argentina, Canada, Mexico, Ecuador, Peru, Brazil, Poland and Norway, of which the first three were already in force. In addition, negotiations were underway with South Korea, Malaysia, Germany, Spain, Finland, France, the United Kingdom, Sweden and New Zealand.

International integration has helped Chile to diversify its exports. More than 5,600 companies now export almost 4,000 different products to 176 countries. As a result, copper represents only 39.8% of returns, down from 46.1% in 1990. Chile's exports are also geographically diversified between Asia (31% of total returns), Europe (27%), Latin America (22%), and Canada and the United States (18%).

IV.3. Institutions and Governance

According to Transparency International (2001), Chile is one of the most transparent countries in the world. In its *Corruption Perceptions Index 2001*, the organization ranked Chile in 18th place out of 91 countries, putting it on a par with Ireland, Germany and the United States.

Similarly, in a study of transparency in 35 countries, published by PriceWaterhouseCoopers in 2001, Chile and the USA tied in second place after Singapore. The study looked not only at corruption as such, but also at a country's legal and judicial system, its regulatory environment, economic policies, accounting standards and corporate governance.

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7 Blomström op cit.

Chile achieved its highest scores on legal and regulatory environment, accounting standards and macroeconomic policy. According to PriceWaterhouseCoopers, Chile's low level of "opacity" – as it calls lack of transparency – has an impact on FDI flows equivalent to imposing a 5% tax on investment returns, while the average figure for the sample was 24.2%.

The WEF also recognizes Chile's achievements in this area, by placing the country in 21st place in the world in the Public Institutions Index and in 13th place in the Corruption Subindex.

Strong institutions have been a feature of Chile's history, helping to provide predictability. However, through its commitment to modernization, the government is also striving to ensure their ongoing efficiency and fairness.

This modernization program includes a major overhaul of the country's judicial system. The reform, which is being implemented gradually as from 2001, seeks to improve access to justice and reduce trial times. Similarly, a new law regulating tender share offers has improved protection for minority shareholders' rights and set higher standards of corporate governance. According to Santander Investment (2001), Chile's minority shareholders now enjoy better protection than in any other Latin American country.

IV.4. Social Cohesion

In empirical studies, social issues are not typically included as a determinant of FDI. However, in our experience, they increasingly concern foreign investors, both as issues in their own right and from the point of view of political and institutional stability.

Chile's high economic growth has gone a long way to improve social conditions and reduce poverty. In addition, since the return of democracy in 1990, active social investment policies have been implemented. In 1990, 39% of Chileans lived below the poverty line, but by 2000, this had dropped to 21%.

According to the United Nations Development Program (UNDP), Chile has Latin America's third highest level of human development. However, the government aims to make further progress in this direction, reducing income inequality and attempting to ensure that all Chileans have access to the benefits of economic growth.

The most direct impact of social investment on FDI is through improvements in educational standards and labor productivity. This is commonly measured as the rate of enrolment in secondary education and Figure 5 sets out gross enrolment ratios[8] for Latin American and South East Asian countries. Chile occupies third place in Latin America, after Uruguay and Cuba, and is fourth in the overall sample.

The coverage of primary and secondary education in Chile reaches 99% and 90%, respectively, and 27% of students go on to higher education. Similarly, according to the United Nations Economic Commission for Latin America and the Caribbean (ECLAC), average schooling is 10.4 years, the highest in Latin America.

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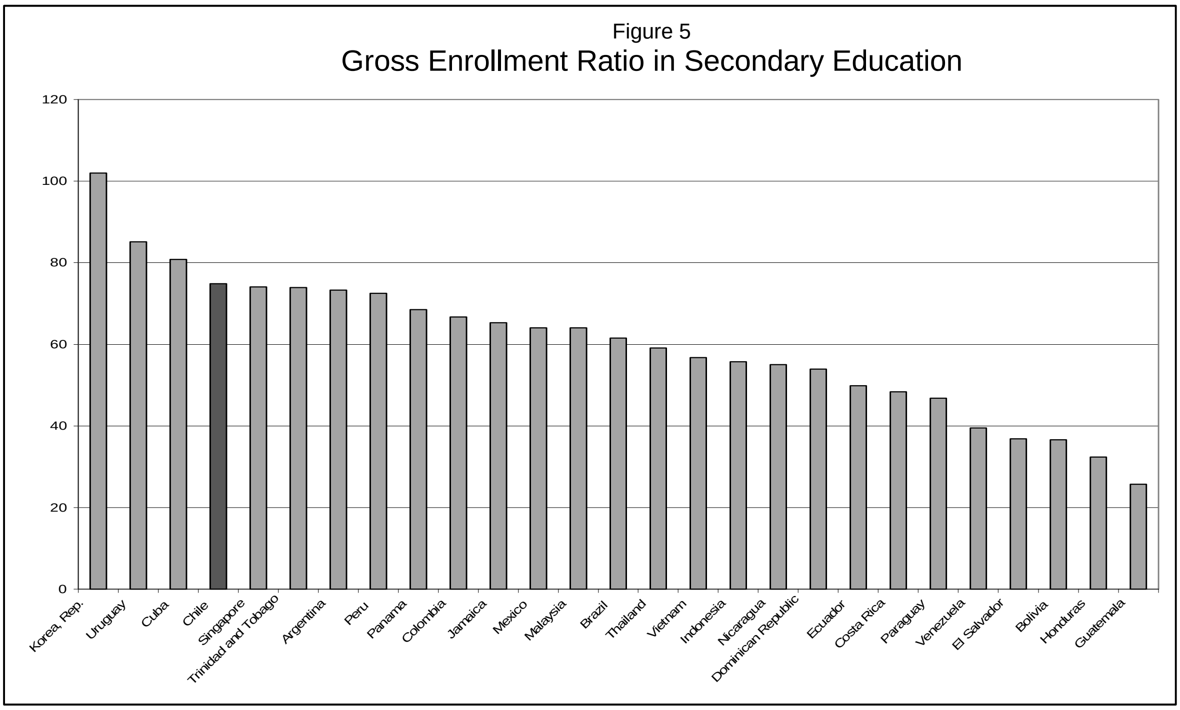
8 Gross enrollment ratio is the ratio of total enrolment, regardless of age, to the population of the age group that officially corresponds to a given level of education. Net enrollment considers only students of the official school age. Data on the latter definition is too scant for a relevant comparison.



Nonetheless, in 1995, the government launched a major educational reform in a bid to improve the quality of schooling and to lengthen the school day. By 2000, public spending on education had reached 4.2% of GDP, up from 2.5% in 1990. Combined with private spending, this brought total expenditure on education up to 7% of GDP.

In a further attempt to improve social welfare, the government is setting up an unemployment insurance scheme, which is due to start operations in mid-2002. Like Chile's private pension system, the scheme is based on individual savings account, to which both a worker and the employer will contribute. These accounts will be managed by a private administrator and have the additional advantage of helping to increase the liquidity of Chile's capital markets.

IV.5. Infrastructure

According to the EIU's *Worldwide Business Cost Comparison for 2001*, Chile is the 6th least expensive place in which to do business, out of a sample of 31 countries. That is partly because of Chile's relatively low taxes and labor costs. However, the report also highlights infrastructure, particularly with regards to telecommunications, transport and office-space costs, as a factor in Chile's favor.

Chile began to privatize its utilities and infrastructure in 1980s, setting a lead that other Latin American countries subsequently followed. As well as gains in service standards, privatization and deregulation have meant lower charges, mostly as a result of increased competition. In the energy sector, for example, private investment has given Chile one of the region's lowest levels of service interruption, while international telephone calls from Chile are identified as the cheapest in Latin America.

Fixed telephone density increased to 22% in 2000, up from 6.7% in 1987, and has since been surpassed by the penetration of mobile telephony. Similarly, the construction of new fiber optic cable links has improved the quality of Chile's communications with the rest of the world.

The government is actively promoting access to Internet in a bid to avoid a "digital gap" within the country. Commuted Internet connections grew by 23.4% in the second half of 2000, while dedicated connections increased by 223.3%. Independent estimates suggest that, in 2000, the number of Internet users rose by almost 30% to 1.8 million.

The government's infrastructure concessions program, launched in 1993, initially focused on roads and airports, in which it has meant substantial improvements. The scheme is now being expanded to include public-private partnerships for the construction and operation of new prisons, irrigation reservoirs, urban development projects and recreational facilities.

V. PRESENT AND FUTURE CHALLENGES

Chile's attractive business environment is the result of a policy-driven strategy that has focused on building sound macroeconomic fundamentals and strong institutions, promoting competition and international integration and creating a fairer society in which all citizens enjoy the benefits of economic development. In turn, this business environment has been a key determinant of Chile's success in attracting foreign investment.

However, changes both in Chile and in the international economy have created new and complex challenges. In this context, it would be wrong to assume that a policy, which has worked in the past, will continue to do so in the future.

Most of Chile's productive activities and public services are now privately owned. As a result, future FDI in these sectors will be confined largely to M&As, which depend on global markets and the strategic goals of international corporations, rather than exclusively on the business environment of a particular country. Similarly, most of Chile's known mineral deposits are already being developed and, at current prices, foreign firms are less prepared to invest in new exploration projects. In addition --and more importantly-- other countries have joined the race to capture FDI flows. And many of them offer generous tax incentives in a bid to lure multinationals.

The second phase of Chile's infrastructure concessions program and the recent deregulation of its capital and financial markets have created new investment opportunities. However, we now need to attract FDI in other new areas, particularly the services and technology industries.

The expansion of these industries would allow Chile to add value to its abundant natural resources and to take greater advantage of the export opportunities created by the country's increasing international integration. In addition, the services and technology sectors tend to have a significant impact on the job market, creating new and high-quality employment opportunities.

One of the main challenges that Chile now faces is to increase the competitiveness of its technology sector, which lags well behind the competitiveness of most other sectors of the economy. In its *2001 Global Competitiveness Report*, the WEF ranked Chile in 27th place on overall competitiveness, but only in 42nd place for the technology industry. According to the WEF, Chile's level of technological development is "normal" for its income level, but we are aware that this leaves a great deal of room for improvement.

The World Economic Forum and Harvard University recently released their *Networked Readiness Index* (NRI)[9], an assessment of countries' capacity to exploit new information and communication technologies (ICTs). It ranked Chile 34th in the world and second in Latin America, giving it high scores on ICT policies, telecommunications infrastructure and e-government. However, the country scored poorly in other areas, including its readiness to make new technologies accessible to a majority of the population.

According to the WEF, the transition from a middle-income to a high-income country means evolving from a technology-importing economy into a technology-generating one. This requires changes in government priorities and spending patterns, as well as the design and implementation of public policies that foster innovation through investment in R&D and education. Capital markets and regulatory systems also need to be adapted to facilitate the start-up of high-technology enterprises.

This is one of the challenges now facing Chile, even though it is a leader in connectivity in Latin America --it currently enjoys South America's highest computer and Internet penetration rates-- and its progress on e-government is recognized internationally. Rising to the challenge, President Ricardo Lagos has proposed a series of measures to further increase connectivity, encourage the growth of e-commerce and e-learning and to promote the development of a venture capital industry, as well as continuing to advance in the use of e-government.

As part of this policy, the government is making a specific effort to encourage investment in high-technology industries. After analyzing Chile's competitive advantages --principally its infrastructure, the availability of skilled labor and its low operating costs-- the government identified service industries, such as call & contact centers and back office operations, and software development as its main targets.

This focus inevitably raises the issue of tax incentives. In a recent interview[10], Jeffrey Sachs, Director of the Center for International Development at Harvard University, said he was *"convinced that tax incentives are a good way to attract technological companies to a country and I do not think that Chile has explored that path appropriately"*. This is a particularly sensitive point in Chile. Several years ago, Intel's decision to install a computer-chip plant in Costa Rica, rather than Chile, generated a heated debate as to whether Chile should have offered tax incentives.

We are aware that incentives can tilt an investment decision, especially if a firm has to choose between two otherwise very similar locations. As suggested by Blomström *op cit*, this is particularly true if the incentives offered reduce the initial investment outlay.

This is the reason behind the Chilean government's recent decision to offer the package of financial incentives, described at the end of Section II. These incentives, in fact, proved to be a key factor in a multinational company's recent decision to base its regional Latin American call-center in Santiago, rather than in other possible locations with similar fundamentals, infrastructure and operational costs.

However, we don't see this strategy as a departure from the principles that have guided our FDI policy until now. The incentives are available equally to foreign and local investors and are, therefore, in line with Chile's commitment to non-discrimination. In addition, they do not seek solely to attract FDI, but are part of a broadly-based development plan, designed to promote activities with large potential externalities and spin-off effects in areas such as job creation, technology transfer, R&D, education and training.

Extrapolating from the case of Singapore, cited by Bergsman (2000), these incentives seek not so much to increase FDI flows as to attract specific projects that will influence the structure --not the total amount-- of

9 World Economic Forum (2002)

10 *El Mercurio*, February 2nd, 2002

economic activity. However, this goal cannot be achieved only through incentives. As Blomström points out, “in addition to investment incentives, governments should also consider their efforts to modernize infrastructure, raise the level of education and labor skills, and improve the overall business climate as parts of their investment promotion policy”.

That is precisely what Chile’s main policy measures seek to achieve:

Technological innovation: In a bid to encourage technological innovation, the government is setting up public Internet access centers around the country and providing soft loans to help teachers and small firms to acquire PCs. Government training programs not only include Internet and computer courses, but are also beginning to use distance learning systems. In addition, Congress has passed a law authorizing the use of electronic signatures and is currently debating a bill that would bring Chile’s legislation on intellectual property rights into line with international standards.

Modernization of the State: An Inter-American Development Bank report (2001) revealed that setting up a new business in Chile involves 12 different legal steps, as compared to an average of three in developed countries. The government is making a special effort to harness new technologies to help reduce bureaucracy, increase the transparency of its operations and improve the public’s access to information. In addition, as part of its bid to eliminate red tape, it will seek Congressional approval for a bill on administrative silence that would assume that a permit or other type of application has been granted, if a government office fails to process it within a stipulated time limit.

International integration: The government aims to continue strengthening Chile’s international integration by negotiating additional free trade treaties and double-taxation agreements. Rapid progress is being made in this area and will further expand Chile’s export markets, thereby creating new business opportunities.

Upgrading infrastructure: The second phase of Chile’s infrastructure concessions program, launched in 2001, comprises projects worth US $5 billion. Like the first phase, it includes roads and airports, but has also been expanded to new areas, such as prisons, irrigation projects, recreation centers and real estate projects.

Finance for new companies: A second phase of the reform of Chile’s capital markets reform, due to be announced in mid-2002, will include measures to improve start-up companies’ access to finance and encourage the development of a venture capital industry.

Improving competitiveness at a micro level: Now that Chile has largely completed its privatization program and its markets have been deregulated, attention is turning to microeconomic measures that would eliminate distortions and increase competition. The measures that the government is preparing include an update of electricity industry regulation and improvements in consumer protection as well as new regulation for the fishing industry and changes to bankruptcy legislation.

Strengthening democracy: After a decade of stable democracy, the government plans to seek Congressional approval for a number of measures that would increase the representativeness of the country’s political system. These include the elimination of non-elected Senators and the introduction of a higher degree of proportional representation in the electoral system.

Most importantly, however, the government plans to continue its **policy of active social investment.** This includes a major overhaul of Chile’s health system, of which the first stage was announced in early 2002. Partly by ironing out inefficiencies in the present system, the reform aims to provide greater equality of access to healthcare. However, the underlying goal of this reform, as of the ongoing educational reform, is not only to improve productivity and increase Chile's competitiveness but - primarily - to ensure that lower-income Chileans enjoy the benefits of economic growth.

We are convinced that these programs and policies will not only mean sustained growth, but also improve the quality of life of all Chile's citizens. In an added spin-off, we also anticipate that they will enhance Chile's ability to compete in the "beauty contest" for FDI.

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