

# Backgrounder

No. 1958  
September 18, 2006



Published by The Heritage Foundation

## How Chile Successfully Transformed Its Economy

*Hernán Büchi Buc*

Before Margaret Thatcher became Prime Minister of Great Britain or Ronald Reagan was elected President of the United States, Chile implemented unprecedented privatization and other reforms. From the mid-1980s to the Asian crisis in 1997, the Chilean economy grew at an average annual rate of 7.2 percent, followed by an average annual rate of 3.5 percent between 1998 and 2005. Such growth is very good compared to other countries. Chile's exceptional economic performance and the resulting welfare improvement have been recognized internationally and are the result of systematic application of sound economic policies.

However, the road was not always smooth. At some critical moments on the way to Chile's economic success, the process threatened to derail. For instance, Chile's gross domestic product (GDP) dropped 14.1 percent in 1982 during a strong worldwide recession. Simultaneously, the currency was overvalued, making it even more vulnerable to the decelerating international economy. Capital stopped flowing in, drastically reducing the ability to finance investment. The subsequent Chilean currency devaluation exacerbated the situation by reducing the real wealth of companies and people. The impact lasted two years, with unemployment increasing to over 23 percent of the labor force and real wages dropping by more than 10 percent.

Although many other countries in the region underwent similar crises, none of them suffered as extreme a one-year decline as Chile. Successful crisis manage-

### Talking Points

- Chile's economic transformation over the past 30 years is clearly a success story. From the mid-1980s to the Asian crisis in 1997, the Chilean economy grew at an average annual rate of 7.2 percent, followed by an average annual rate of 3.5 percent between 1998 and 2005.
- Opening Chile to the global economy and revitalizing the private sector were key to Chile's success. Instituting a flat tariff system, privatization of state enterprises, reconstructing a sound banking system, and the 1981 reform of the pension system were important components of these efforts.
- Learning to value entrepreneurial activity is also essential. Countries that value, admire, and stimulate their entrepreneurs have attained important momentum in the development competition.

This paper, in its entirety, can be found at:  
[www.heritage.org/research/worldwidefreedom/bg1958.cfm](http://www.heritage.org/research/worldwidefreedom/bg1958.cfm)

*An Economic Freedom Project Report*

Produced by the Center for International  
Trade and Economics (CITE)

Published by The Heritage Foundation  
214 Massachusetts Avenue, NE  
Washington, DC 20002-4999  
(202) 546-4400 • [heritage.org](http://heritage.org)

Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

ment stopped the bleeding. Ten years later, figures from the United Nations' Economic Commission for Latin America and the Caribbean (ECLAC) showed that Chile experienced the strongest economic growth of all countries in the region during the 1980s, except for a couple of Caribbean countries that were not affected by the external shocks.

Successful crisis management was critical because the extreme crisis jeopardized the reforms that the Chilean government had implemented beginning in 1974. These reforms included opening the economy to the world, privatizing some state companies, and restraining a severe inflationary crisis through fiscal discipline and tight monetary policy. These pioneering reforms held out the promise of future prosperity for our country.

By putting itself on the road to becoming one of the world's most open economies, Chile was a step ahead of other countries in adjusting to today's globalization phenomenon. Before Margaret Thatcher or Ronald Reagan, the Chilean government dared to privatize inefficient state companies. The balance in fiscal and monetary issues, which is now a requirement to join big economic and political blocs like the European Union, was achieved more than a quarter-century earlier by this small country in a southern corner of the world.

Could the recession of the early 1980s possibly throw overboard the efforts of all of those years? This was the question that I asked myself when, in January 1985, President of the Republic General Augusto Pinochet offered me the position of Minister of Finance.

### **The Chilean Economy, 1974–1984**

Before discussing the period when I served as Finance Minister, I would like to say something about the period between 1974 and 1984, when the Pinochet government began a radical transformation of the country's economy.

When the government of Salvador Allende fell in September 1973, Chile's annual inflation rate was 286 percent. Three months later, after the new government corrected the most obvious distortions caused by price controls, inflation zoomed to 508 percent. For example, the price of basic goods dou-

bled every two months. A family that used to buy five gallons of milk could now afford to buy just one gallon. At one point, these same families could not find milk in the grocery fridges. Milk could be bought only on the black market at a very high price.

Prices for the majority of basic goods were fixed by the government in 1973. Even though Chile was and still is a small economy, the level of protectionism was high. By the end of 1973, the nominal average tariff for imports was 105 percent, with a maximum of 750 percent. Non-tariff barriers also impeded the import of more than 3,000 out of 5,125 registered goods. Just as economic theory predicts, large queues in front of stores were usual in Santiago and other cities in Chile as a result of the scarcity caused by price controls.

The decline in GDP during 1973 reflected a shrinking productive sector in which the main assets were gradually falling under government control or ownership through expropriations and other government interventions in the economy. As a result, the government's share of total sector production reached 70 percent in 1973, except for the industrial sector where it was 40 percent.

The fiscal situation was chaotic. The deficit reached 55 percent of expenditures and 20 percent of GDP and was the main cause of inflation because the Central Bank was issuing money to finance the government deficit.

By the end of the Allende government, the gross savings rate was 6 percent and the investment rate was 7.9 percent—the worst figures since the 1960s. This meant that in many industries, no new machines were installed, no new firms were started, and fewer and fewer new jobs were created. There were no capital markets, and the government-controlled interest rates did not reflect scarcity of funding. The balance of payment (BOP) deficit increased over a period of three years, and the socialist government increased its foreign debt by 23 percent.

The most important economic reform in Chile was to open trade, primarily through a flat, low tariff on imports. Much of the credit for Chilean economic reforms in the following 30 years should be given to the decision to open our economy to the

rest of the world. The strength of Chilean firms, productive sectors, and institutions grew up thanks to that fundamental change.

The chaotic situation in Chile in 1973 deserves some thoughts:

- This crisis was homemade. It was different from crises caused by external shocks, such as the petroleum crises of October 1973 and 1979 and the debt crisis of 1982. One anecdote is instructive: When some people complained about the excessive increase in the money supply that was causing high inflation in 1973, the Central Bank president at the time said that money supply was a “bourgeois variable,” irrelevant in the construction of Chilean socialism.
- If Chile is now presented as a pioneer of free-market economic reform, we should remember that at the beginning of the 1970s, it was the complete opposite: a vanguard of controlled economy and big government.
- Someone could be tempted to think that the Chilean economy of the early 1970s was chaotic and inefficient but ethically correct because of its social commitment, but this could not be further from the truth. Social policies for housing, education, and health failed to help the 20 percent of Chileans living in extreme poverty. These social policies just further organized workers and middle-class interest groups.

After all, Chile was an experimental laboratory for the misguided intellectual ideas that prevailed at the end of the 1960s and beginning of the 1970s. Our people suffered the consequences. Now they are benefiting from the implementation of the correct ideas of economic freedom.

## Two Concerns and Two Lessons

When I became Minister of Finance in 1985, I had two main concerns: first, that a return of populist policies could cause the country to enter a downward spiral, undoing the existing reforms that promised to make Chile the Latin American poster child of sustained growth and reduced poverty, and second, that the political commotion generated by a crisis could undermine the scheduled return to democratic elections in 1988 as required by the con-

stitution. As a side note, these were the threats faced by our administration (and many other administrations) as we approached a critical election.

These two considerations led me to accept the challenge, and I do not regret it. On the contrary, the ensuing events contributed decisively to Chile’s becoming a successful case of economic reform at work. In this way, almost unintentionally, I became an actor on the Chilean political scene, even becoming a presidential candidate in the 1989 elections.

These elections were won by Patricio Aylwin, who led the transition process into democracy, but we also accomplished some important goals in that election. Aylwin won with 55 percent of the votes, which left an important minority opposition that could express itself and gain a strong representation in the National Congress. This strong minority representation was decisive in moderating the changes that threatened to dismantle the Chilean economic model.

In retrospect, trying to identify lessons that can be applied to similar situations, I realize that there are two main ingredients in a successful economic reform process.

First, changes must be integral and deep enough to be sustained over time. Regrettably, many of the reform processes in other Latin American countries that are considered to have failed were partial, incomplete plans—although sometimes well-inspired reforms—that lacked an understanding of the main conceptual challenges of the economy. In one case, Argentina made the additional mistake of giving the currency’s exchange rate a central role in the reforms, which led to their failure because they tried to substitute the lack of strong political institutions with the convertibility law—the law that determined that the value of the dollar would be the same as that of the peso—which then became the only support of the entire reform process.

A large team of highly qualified professionals and technicians is essential to accomplish fundamental change. As in most work, successful economic reform initiatives are not a result of the inspiration of one man; rather, they are the product of the efforts of a number of men and women trying to reach a common goal. In works of such magni-

tude, such as rebuilding after a terrible earthquake or other natural disaster, all fields have to be covered. This requires not only experts in macroeconomics and finances, but also people who understand the realities of other productive areas and sensitive issues like education and health. Consequently, we are not talking about a handful of outstanding qualified personalities, but about hundreds and even thousands of them.

In the Chilean case, Miguel Kast Rist, an economist from the Universidad Católica de Chile with post-graduate studies at the University of Chicago, played a fundamental role in recruiting these professionals, who were mostly young and with backgrounds of economic studies. He was a great leader, an enthusiast, and an inexhaustible worker. Tragically, Miguel died of cancer at the age of 33 after having served as a minister with two different portfolios and as president of the Central Bank. Leadership and a sense of urgency brought these teams together and enabled them to accomplish the integral changes necessary to sustain the reforms.

A second important element in the Chilean case was a crisis atmosphere. Even though the crisis caused great damage, it also opened an opportunity by generating a sense of urgency for change and by mobilizing the teams. The previously mentioned example of natural disasters is applicable in that they touch the souls of people and mobilize them in the pursuit of an objective. Hundreds of collaborators made personal decisions to devote themselves entirely to this task, despite having better-paid options that would have required less personal sacrifice, and they emerged from the crisis conditions with a sense of mission. Moreover, the implications of not reforming are better understood in an emergency situation.

At the end of 1984, Chile was in a serious situation. Nearly one in three workers was unable to find a productive job in the private sector, which lacked both adequate financing and a demand for its products. The official unemployment rate was nearly 20 percent, and almost another 10 percent participated

in government-financed emergency employment programs. This situation would set job creation as one of the key goals of our management.<sup>1</sup>

In sum, we acted in a critical moment that could have aborted the great economic reforms undertaken by Chile. Our accomplishments were rescuing the components of that transformation while recognizing that the process of change had to be integral and long-term. The availability of professional teams to carry out such tasks was key to the process.

## The Key Reforms

Many economic reforms transformed Chile. They were executed over many years and were all composed of certain permanent and fundamental elements. My job as Finance Minister throughout this difficult period was, at times, to expand some of the previous reforms and, at other times, to rescue them from the possibility of reversal. In this section, I discuss the basic and permanent reforms that, in my opinion, were essential to the transformation of Chile.

### Trade Openness and the Flat Tariff Rate System.

Chile is a small country with a small population located far away from the world consumption centers, which explains the importance of fully opening the country to foreign trade. Only the extreme ideological bias of the 1960s can explain such an aberration as the theories of “inside development” that Raúl Prebisch from ECLAC recommended to our country and others. In 1974, under the leadership of Ministers Jorge Cauas and Sergio De Castro, Chile started a profound process to reduce import tariffs. In 1979, a flat tariff of 10 percent (low for that time) was enacted for every import.

Both the reduction in the tariff and the transparency gained from a flat system were fundamental to achieving the competitiveness that the Chilean companies needed to compete worldwide. At the same time, the low, flat tariff helped to increase competition in domestic markets,

---

1. The magnitude of a crisis is a matter of perspective. I had the opportunity to discuss this subject with Margaret Thatcher, who told me that from the British perspective, the mediocre economic performance of England was considered “a crisis” when she took office.

where prices were liberalized after a period of gradual government intervention. However, the 1982 crisis caused a step backward, with tariffs increased to 35 percent on two occasions, which is where they stood when I took office. Fortunately, even on those occasions, the flat tariff structure was maintained, avoiding a distorting scheme of differentiated tariffs.

As a fundamental part of the economic recovery plan that we implemented, I decided to propose that the National Congress reduce tariff rates to 15 percent. Enactment of this proposal increased the competitiveness of Chilean goods and led to an important increase in exports. Under subsequent governments, the tariff rate was reduced first to 11 percent and then to 6 percent.

**A Stronger Private Sector.** If rescuing the radical opening of the Chilean economy was the first key task that we undertook, the second was the reconstruction of the private sector. Before my time at the Ministry of Finance, privatization of some state enterprises and many other reforms had been undertaken to allow the private sector to develop, but the crisis had completely undermined the capital of many Chilean companies. The successive devaluations of the peso in 1982 caused their U.S. dollar debt to explode in terms of pesos at a time when the financial sector was in crisis.

Our goal was to allow the companies to recapitalize, and we knew that tax incentives would be fundamental to that end. Therefore, we established an income tax that applied only to profits withdrawn from the companies, which strongly promoted their capitalization through reinvestment of their profits.

A second fundamental reform was to allow the private sector to recover, adding dynamism to the economy. In fact, important sectors such as electricity generation and distribution and telecommunications were still managed by state companies. After we implemented a massive privatization plan that included more than 50,000 new direct shareholders and several million indirect (through pension funds) shareholders, these companies were managed by private entrepreneurs that carried out important expansion plans.

In the power sector, an essential part of this task had already been completed when the government implemented a rate system that promoted efficient use of energy resources. At that time, the pension system was still in state hands, and there were no potential private buyers of utility companies' shares. Hence, the necessary conditions did not exist for the reformers to provide a coherent privatization proposal that could convince the opposition that defended state ownership. Years afterward, once the pension system was privatized, the scenario was different, and privatizing the utilities became possible. This is a synergistic example of the need for comprehensive reforms to progress in all fields.

On the other hand, every opportunity to carry out a reform in the correct direction must be used. Even if the scope of the reform is only partial in the short term, it might later produce more benefits.

Mining is a very important sector of the Chilean economy. For many years, copper has been our main export, and CODELCO, the state company that runs the most important state mine deposits, is the largest Chilean company. The 1980 Constitution gave the state ownership of "great copper mining," but the Mining Code included the possibility of "a full concession." As a direct result, our government also allowed private companies to exploit large ore deposits. Toward the end of the 1980s, investment in the main private copper deposits in Chile, such as La Escondida, started. Today, the vast majority of private mining activities are in the hands of foreign companies, which produce much more than CODELCO and at a lower cost.

We also worked to encourage foreign investment—a difficult task in the atmosphere of a payment crisis. For that reason, we modified the Foreign Investment Committee provisions, streamlining and expediting the procedures for investment projects. The spectacular expansion of Chilean exports during the 1990s and after 2000 is directly related to the fact that private enterprises could operate in the large mining industry.

The crisis of 1982 also left half of the Chilean banking sector in bankruptcy, and any effort to reconstruct a healthy private sector would have to

tackle this problem. In January 1983, the Minister of Finance decreed that the government would intervene in the two main private banks and liquidate others. When I was the Banks Superintendent, I had the opportunity to begin the process of reconstructing a sound banking sector. In this capacity, after the 1983 intervention, I was involved in analyzing banking industry regulations to clearly define the mechanism by which the banks could adjust assets while increasing capital and solvency requirements. Our goal was to channel the Chilean people's savings through the capital markets. Numerous reforms of the laws regulating corporations, financial sector regulations, and others contributed to this goal.

The 1981 reform of the Chilean pension fund system deserves special mention. Under the leadership of Minister José Piñera, an individual capitalization account program was designed with specific contributions, administered by private institutions selected by the workers. The Chilean Administradoras de Fondos de Pension (Pension Fund Administrators or AFP) has been replicated in more than 20 countries, and more than 100 million workers in different parts of the world use these accounts to save for retirement.

The fluid capital market operations that this reform achieved were essential, not just to financing growth in the productive sector, but also to overcoming the investment scarcity that engulfed the Chilean economy after the crisis. In fact, the investment rate was barely 13.6 percent of GDP in 1982. The fiscal savings derived from the austerity policy on public expenditures that we imposed from the Ministry of Finance was the main factor in overcoming these saving and investment deficits. Once the main problems were surmounted, the private sector collaborated in this task through company and personal savings by using the new private pension savings system.

I think that maintaining continuity in the process of reform and economic transformation over several decades was fundamental, as was the integral nature of the reform process. Therefore, neither I nor my colleagues deserve the entire credit for the reforms that changed the Chilean economy.

For example, opening the economy to interna-

tional trade and worldwide integration was the work of reform leaders between 1974 and 1979. Our contribution was focused more on defending the progress to date in the face of a world economic crisis that was strongly affecting our external and fiscal accounts balances. As any minister of finance knows, this is a difficult task because of the immediate financing needs. What is key in these cases is not to lose the long-term perspective. Chile has recently signed free trade agreements with the United States and the European Union, in effect consolidating the earlier integration of our country into the world economy. These agreements could never have been achieved if Chile had not opened its economy to the world in the mid-1970s and maintained the reforms throughout the crisis of the early 1980s.

A more illustrative example of the continuity and synergy of remaining on the path toward progress is the impressive improvement of the road infrastructure in Chile, initiated by a reform in the middle of the 1990s that reached its apogee a couple of years ago. In order to finance the road concessions, it was essential to have institutional investors that needed to make long-term investments, such as the AFP and the life insurance companies. The Social Insurance Reform of 1980 gave life to these institutions, and we would not have funds to finance either these concessions or the highway construction without that important modernization.

This pension transformation also shows other synergies among reforms. When the private system began, the investment portfolios were very restricted and conservative because of the many concerns about private management of social security. However, as time went by, the investment of pension funds in stocks was authorized. At the same time, after the crisis of 1982, the privatization of state-owned companies was essential for the recovery of private investment and employment to pre-1982 levels. We needed private investors willing to purchase these state-owned enterprises and more investment instruments for the growing pension funds to own.

Gradually and with many safeguards, we authorized the investment of pension funds in stocks in the more consolidated privatized companies. Thus, the large increase in the price of these private companies' shares—the direct result of a much better

private management of the companies and of their expansion plans—benefited all Chilean workers through high returns on their pension funds.

In this section, I have highlighted the importance of opening the economy to the world, the existence of private enterprise as a growth agent, and the creation of a capital market that channels savings and investment as key policies of Chile's economic transformation. These reforms form a kind of matrix that was maintained constant throughout the years. There were also many other great reforms, such as improving financing methods and streamlining management in the public sector.

It would take an entire book to describe the many reforms that were implemented and how they worked together to transform our country. I have chosen a few of the most important ones to describe how one reform interacts with the others and the political strategy and timing to put them in place. All of the reforms, including the new social policies and the strengthening of the institutions, which I explain in detail in the next section, form an indispensable complement to Chile's economic transformation matrix.

In the long run, the lesson that remains from my time as Minister of Finance is that the effects of good (and bad) policies reach far beyond what one might think. There is an important inertia in the effects of economic policies. More than one government has benefited from what a previous one has done, and others have paid the bill for the actions of the preceding government. To understand this simple truth about how a national economy can be transformed, the government's leaders must have a vision for the nation and give up their personal ambitions to act for the benefit of the whole country.

### **Prioritizing During the Crisis: The Importance of a Coherent Plan**

Between 1985 and 1989, when Chile was going through the crisis, I faced some important questions:

- What is the proper sequence of policies and reforms?
- How can one prioritize when facing many problems—all of them urgent?

These questions are difficult to answer, and the

answers surely depend on each situation, country, and moment. Often, it is the political viability of the actions that dictate what can be done, but in any case, there has to be a plan that is coherent and attempts to maintain and rescue the big framework of the pro-market basic reforms. In our case, we thought that the most important thing was to encourage job creation because of its immediate impact on people's levels of poverty.

However, companies could not create jobs if they had lost significant amounts of their capital investments. In the face of this problem and needing to choose sound measures that prompt rapid reactivation, we focused our attention on exports. Given the size and characteristics of the Chilean economy, exports will always be one of the fundamental engines of growth, and I had always thought that opening the economy to foreign trade was "the mother of all reforms." In addition, we were facing a crisis in our external account. For that reason, a fundamental component of our plan was to reduce import tariffs, coupled with decisions affecting the currency exchange rate, even if that meant worsening the problem in the fiscal accounts.

At least in the beginning, we tried to design all of our policies, including the one affecting the exchange rate, to have a positive effect on exports and on the import substitution sector, even at the risk of making a mistake about the magnitude of the signal we were sending. We were convinced that we were going in the right direction. The environment was not helping us, however, because the terms of trade had strongly deteriorated. For example, the price of copper, our main export commodity, decreased to \$0.57 per pound in October 1984. (Today, Chile profits from a higher price: more than \$3 per pound.)

Therefore, it was crucial for us to reduce the cost for the exporters, so we implemented measures like the valued-added tax (VAT) refund and easier terms to pay the VAT, and we eliminated all taxes affecting exports. Additionally, at the expense of fiscal revenues, we further reduced labor costs by reducing the rate of some transitory taxes remaining from the pension reform.

Another critical point of the crisis was the very low level of investment. We were trying to surpass

13.6 percent of GDP in 1984, but this time it would have to be done without counting on the rest of the world's contributions. The crisis had made it unthinkable to resort to a deficit in the BOP capital account as we had done before the crisis. Increased investment would have to rely on increased public-sector savings. Government expenditures, which had reached 30.7 percent of GDP in 1984, decreased to 20.6 percent in 1989. This, together with the increase of private savings, made it possible for the national savings rate to grow from an anemic 2.1 percent in 1982 to 17.2 percent in 1989.

The other vehicle for investment recovery was private savings, and here the debt-equity swaps, most of which were aimed at foreign investors, played a fundamental role. Tax reform was important. We attempted to make our profit tax system resemble a tax on expenditures by allowing people to pay taxes when they were spending, not beforehand. This change removed taxes from reinvested profits. In other words, corporate taxes were paid only after profits were withdrawn from the firm.

This last reform was highly criticized afterward, and subsequent reforms that increased taxes have almost completely reversed it and changed the tax base. I am convinced, however, that this reform was one of the key elements that allowed for the investment recovery. Other reforms worked toward the same goal, such as the possibility of recovering the VAT in the construction industry or using systems to accelerate depreciation that were especially important in large capital investments sectors such as mining. Today, some sectors in our society, in seeking greater tax revenues, see companies solely as sources of tax revenue to finance growing expenditures. Ironically, they fail to see that a properly designed tax system that gives companies incentives to produce more will increase indirect tax collection.

We have already explained the positive effect that privatization had on investment and the fundamental role that privatization played in our plan. With the pension and tax reforms, we aimed at recomposing the income of companies and the people. Reducing the tax burden on companies enabled them to increase investment levels, place their savings in the financial market, or pay their debts to the bank. In addition to improving the income of com-

panies and people, we needed to strengthen the capital market by allowing a large group of people to own stocks, which we accomplished through grassroots capitalism and labor capitalism.

Because of space limits, I cannot detail all of the numerous reforms implemented between 1985 and 1989 that were important in positioning the Chilean economy in its current situation. They include reforming the management of public finances and numerous microeconomic reforms in diverse areas ranging from fishery and timber to water legislation to labor regimes in ports.

In the end, the most important thing is that the goals were fully met and the achievements were extremely important. From 1985 to 1989, annual job creation averaged 239,000. Never has the Chilean economy created so many jobs. At the same time, all of the other economic indicators improved, ushering in a period of stability that continues today.

### **An Essential Environment: Social Networks and Institutions**

I believe it is also important to mention two conditions that were essential to carrying out these reforms successfully.

- The first was the creation or reformulation of an efficient network of social protection for families that, as a result of the crisis and endemic lack of economic dynamism, were becoming or remaining poor.
- The second was the existence of a set of laws and institutions that provided stability to the economic policies and that helped to maintain those policies over time.

With respect to social policies, many things were done, but they were done without ever losing sight of the main issue: allowing the economy to create jobs. Job creation not only reduces poverty for those who find a job, but also, as demonstrated by income distribution studies in Chile, helps to improve income distribution in the new generations because human capital is more evenly available among different groups of the society.

Since the 1940s, Chile's social protection system had handed out health and education benefits free. It also included programs for the elderly, but these



were technically bankrupt, and the inflation rate during Allende's government lessened the purchasing power of the pensions, which led to the pension reform discussed earlier in this paper.

In education, the government made efforts to increase coverage during the 1960s, but public expenditures were highly regressive and did not help the poorest. For example, over 40 percent of the education budget was used to subsidize university-level education, which covered only 5 percent of the student population, most of whom belonged to the families with the highest incomes in the country.

In health, the public health provision network made important achievements in its first stage, but the dynamics of the sector led to increasingly higher spending on complex services that benefited only a very few. These increased expenditures came at the expense of care for the large majority of the population, whose health problems could be resolved without visiting a hospital through first aid, improved nutrition, and improved sanitation.

In housing, the middle and upper-middle class were receiving state subsidies, but the poorest sectors did not have a housing solution. This reality that the state assistance programs favored people who were not the poorest or most vulnerable groups in the country was highlighted by the Map of Extreme Poverty, a survey conducted in 1974 by the Faculty of Economics at the Universidad Católica de Chile. The map determined that 21 percent of the population was living in extreme poverty.

The reforms carried out to tackle these problems were aimed mostly at improving the allocation of government spending. That is, the programs increasingly were spending more on the poorest, helping them to improve their situation. During the 1982 crisis management, emergency employment programs were implemented and financed by the state. In addition to a subsidy to hire extra workers, the government provided a subsidy to poor families with unemployed heads of households, and some other assistance programs were reinforced. Fortunately, by 1989, the economy had completely recovered its ability to create jobs. The unemployment rate dropped to 5 percent, and the damage to the most vulnerable people of our country had

been controlled.

To achieve permanent results, social and economic reforms must count on an institutional framework that provides stability. The 1980 Constitution strengthened property rights, which were key to guaranteeing a favorable environment for investment and enterprise. Likewise, the Constitution established the autonomy of the Central Bank, which later restricted its own lending operations to the financial sector. This limitation eliminated one of the primary sources of inflation. The Constitution also restricted government spending, which now requires the approval of a law by special quorum. This practice of establishing special quorums for the approval of certain laws of great impact or for constitutional reforms also helps to ensure the stability and defense of the essential rights of minorities.

Other laws regulated who in the government can initiate legislative and financial matters. These provisions, which remain largely intact to this day, give only the executive the power to initiate fiscal expenditures. This provision is key to limiting the demagogic proposals that could damage the structure of the economy and garner enough populist votes under less stringent rules. Electoral systems that discourage political parties from fragmenting and encourage them to moderate their proposals also contribute to stability. This set of laws and institutions has helped Chile to become a country in which good public policies are most likely to be applied.

## Final Reflections

In retrospect, we can be highly satisfied with the path Chile undertook. Today, our country is in a much better situation than its neighbors, which either have been unable or have not known how to find the path to progress. Sadly, they seem to be reverting to the same failed economic policies that had harmed their people in the past.

Perhaps the reason for this regression is that it is not easy to be successful in economic and social matters, as demonstrated by the majority of the world's countries that fail even to approach development thresholds. In countries that adopt misguided policies year after year, carrying out the changes needed to improve their poor realities is difficult. Many of the policies that they pursue, while appearing on the

surface to favor the poor, are in fact based on ideologies, technically ill-conceived, or simply driven more by pressure groups than by the majority.

The worst thing that could happen to our country would be to legitimize some of these bad policies in response to an ideology or to demagoguery. Today, the anti-globalization claims so prevalent in many countries in the region seem to have those ingredients.

Transforming a country's economy requires understanding that reforms are not the property of a targeted specific group, a political party, or even a government. Good economic policies are everyone's policies and form part of the country. When this concept is ingrained in people's minds, the rational behavior is to defend reform efforts and not to attempt to destroy them through the political process. In this sense, the ideal is for good policies to become part of the country's culture.

Regrettably, I believe that Chile has not taken this last step. I do not think that our country's culture has yet incorporated all of the elements that are propitious for development. It has accepted some, but not all. This point can be better illustrated through some of these elements that take root in people's culture and then transform themselves into allies of development.

The concept of opening Chile to the international economy and becoming part of the globalized world is, in my opinion, generally assimilated into the Chilean culture. This is a major contrast with other Latin American countries that have chosen other paths. Chileans no longer readily accept the nationalist or ethnic proposals, nor do they identify themselves with a strong ideology.

The consolidation of this idea of Chile in a globalized world has taken many years. The free trade agreements with the United States, the European Union, China, and many other countries are not the last links in the chain that started in 1974, when the country decided to open its economy to the world. Something similar has happened with the macroeconomic equilibrium. The majority of the people support controlling inflation and balancing the fiscal account and the external account.

Another important element is to achieve a culture

that fosters growth. Learning to value entrepreneurial activity is essential. Countries that value, admire, and stimulate their entrepreneurs have attained important momentum in the development competition. Regrettably, on this point, we have failed. In my view, there still persists a trend toward socialism that claims success for the government and its policies when the country grows and employment raises but blames entrepreneurs for economic downturns and unemployment. A persistent demagoguery wrongly stresses that the luck of the workers can be changed by simply changing a law or regulations, when we know that only a dynamic economy will continually create more and better jobs.

Another deceptive idea that creeps into the minds of Chileans is that only stronger state regulation will defend consumers' rights. Our governments love to promote such regulations at every occasion, forgetting their negative impact on the entrepreneur. The truth is precisely the opposite. Fewer regulations mean more entrepreneurs and more competition, which make consumers better off by offering them a wider and cheaper array of goods.

Finally, our Latin American countries may have held onto the mercantilist mentality for too long, believing that state policies protect companies and help them to grow. This was never so, and the countries that have understood this have opened their economies, making them more competitive and more prosperous. At the other end of the pendulum are people who see companies as mere instruments to finance the state through the generation of tax revenues. To make companies more competitive overseas and help them to become successful is a formidable task. Overwhelming them with more taxes and regulations to the point of subsistence is surely the quickest way to return to underdevelopment.

Maybe this is the next task to consolidate Chile as a developed country—incorporating into its culture an appreciation of entrepreneurial activity.

—*Hernán Büchi Buc is President of the International Economy Center at Libertad y Desarrollo in Santiago, Chile. He served as Chile's Minister of Finance from 1985 to 1989.*