# The Uses of Chile

## How Politics Trumped Truth in the Neo-Liberal Revision of Chile's Development

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## Executive Summary


The trail of recent hemispheric history is littered with Latin American countries that have adopted the radical model of economic policy termed "neo-liberalism" and subsequently seen dramatic reductions in their rates of income growth and a widening of their social cleavages. Against this continent-wide trend of economic disaster, Chile runs on, seemingly alone in its economic progress.

In country after country in Latin America, voters are electing candidates that ran on platforms that reject neo-liberalism. A recent study by researchers at the Inter-American Development Bank found that, of a total of 66 presidential and 81 legislative elections in 17 Latin American countries during the 1985-2002 period, incumbent parties that pursued trade liberalization and privatizations while in office lost between 25 to 50 percent of their previous votes when pursuing reelection.[1] In response, neo-liberalism's defenders are attacking these new progressive governments' policy initiatives by pointing repeatedly to Chile's economic "success" – namely decades of steady per capita growth rates that they attribute to Chile's strict adherence to the neo-liberal model.

This paper examines:

- The policies actually implemented by Chile during the recent decades of growth and finds that Chile, far from being a model of successful neo-liberal policies, is in fact a case study in the virtues of many non-neo-liberal policies.
- The resulting economic outcomes beyond the impressive per capita growth rates and finds steadily-high income inequality as essential services were privatized; export-led growth based on exploitation of a few natural resources – 90 percent being fisheries, copper, wood and other primary products – continued at an unsustainable rate; and the manufacturing sector continued to contract as a share of output.

The paper concludes that many of the neo-liberal policies that the Chilean government did adopt have caused economic harm or have not helped needy sectors of society and the environment, while much of Chile's success in terms of per capita income and export growth can be attributed to the successful use of non-neo-liberal policies.


[1] Eduardo Lora and Mauricio Olivera, "The Electoral Consequences of the Washington Consensus," Inter-American Development Bank Briefing, Oct. 26, 2004.

## Introduction

In March 2006, Michelle Bachelet was inaugurated with much fanfare as Chile's first female head of state. The ceremonies offered an opportunity for pundits and politicians to celebrate Chile's sustained high rate of economic growth, which stands in sharp contrast to the rest of Latin America. Over the last 25 years – a period of diminished rates of growth for the overwhelming majority of developing countries – the Latin American continent has suffered the worst economic growth performance in its modern history. From 1980-2005, real income per person in the region grew by only 13 percent. In the prior 20 years – 1960-1980 – per capita income in Latin American countries grew by 82 percent in real terms. In contrast, Chile has escaped the continent-wide trend, having more than twice the growth in the latter period as in the former period.[2]

Chile's growth rates in the past decade are constantly touted as evidence of the virtues of so-called "neo-liberalism." Neo-liberalism refers in part to the package of policies imposed through the structural adjustment packages countries must sign to obtain loans from the International Monetary Fund (IMF) and the World Bank. This same policy package, to differing degrees, has also been implemented through international commercial agreements such as the World Trade Organization (WTO) and the North American Free Trade Agreement (NAFTA). Additionally, the U.S. government has pressured countries to adopt aspects of this policy package as conditions for obtaining debt relief and trade preferences.[3]

Underlying these policies is a radical worldview: markets should be the primary institution making determinations about social and economic outcomes, and these markets must be freed from the inefficiencies of regulation and state intervention.[4] Specific policies favored by this policy mind-set include trade, finance and investment liberalization; privatization of services and other government assets; deregulation and/or harmonization of regulatory policies; establishment of new property rights including protections for intellectual property and special rights for foreign investors; budget austerity; and tight monetary policies. As we will see, Chile's actual policy history differed greatly from this "idealized form" of neo-liberalism.

[2] Center for Economic and Policy Research calculations based on the International Monetary Fund's September 2005 World Economic Outlook numbers. Jamaica was the only other Latin American/Caribbean country to not show a lower rate of growth decline in the latter period, with the 1980-2000 period growing slightly more than in the 1960-80 period. In any event, growth rates were low in both periods.

[3] Robert Wade, "The Invisible Hand of the American Empire," *Ethics and International Affairs* 17, no. 2, 2003; Demetrios Papademetriou, John Audley, Sandra Polaski, and Scott Vaughan, "NAFTA's Promise and Reality: Lessons from Mexico for the Hemisphere," Carnegie Endowment for International Peace, November 2003.

[4] However, neo-liberals-in-practice are very different from neo-liberals-in-theory. In practice, neo-liberals favor significant government intervention in the market, ranging from the use of government force to back the monopoly patents of pharmaceutical companies to the use of government-granted limited liability charters to shield corporations from the claims of their creditors and employees. *See* Dean Baker, *The Conservative Nanny State*, (Washington, D.C.: Center for Economic and Policy Research, 2006.)

## Creation myth of the "Miracle of Chile"

In an effort to encourage or coerce more countries to adopt neo-liberalism, the model's intellectual defenders have created the notion of "model pupils" – countries who, so the story goes, adopted neo-liberal policies and obtained high rates of economic growth as a result. The first generation of "models" consisted of the fast-growing economies of South Korea and Taiwan, which were held up as countries that pursued a policy of "free trade" and therefore grew faster. That these countries' export success was achieved with major government subsidies and interventions – and that they strictly limited imports and tightly regulated finance and investment policy – was conveniently omitted from the story. Their success based on non-neo-liberal principles continued until rapid financial liberalization triggered the 1997 Asian Financial Crisis, which then rolled back decades of economic development progress.

With these and other model pupils in economic distress, China and India – also fast-growing economies – have become were the preferred case studies of the neo-liberal policy establishment, again a convenient selection of fast-growing countries whose "success" is built on the converse of the neo-liberal agenda.[5] Within Latin America, Argentina was long the neo-liberal poster child until it too crashed and burned. (Since replacing its IMF and World Bank-imposed policies, Argentina has become the fastest growing economy in Latin America.)[6]

This left Chile as the favored (and only) exhibit in the "model museum" to be held up as a regional template for developing countries. Chile's experience under neo-liberal policies was termed "the miracle of Chile" by conservative economist Milton Friedman.[7]

The mantra of Chile as the epitome of neo-liberal faithfulness could be seen in U.S. opinion pages in the lead-up to the recent Chilean election and Bachelet inauguration. *The Washington Post* editorial page celebrated that Chile "increasingly looks and behaves more like a European country than one of its neighbors," and posited that Bachelet "doesn't question the foundations of her country's growing prosperity – which are the very free trade, foreign investment and free markets that elsewhere in the region are demonized as 'neo-liberalism.'"[8] U.S. Secretary of State Condoleeza Rice gave the Bush administration's take on the Chilean model when it praised outgoing president, and Bachelet's fellow party member – Ricardo Lagos as a "strong force … for free economies throughout the region."[9]

[5] Economists Ha-Joon Chang and Ilene Grabel have shown why it is false to describe either set of countries as neo-liberal success stories: "[These] governments used a judicious mix of state intervention and market incentives (especially in relation to export markets) to promote a range of domestic industries. Governments also used a host of policy measures to modernize the industrial structure and increase productivity. These included: infant industry protections; export and other business subsidies; directed credit (in which state-controlled banks provided subsidized credit to designated industries); indicative investment planning; regulation and coordination of industrial investment; and both targeted and general support for R&D and training." *See* Ha-Joon Chang and Ilene Grabel, *Reclaiming Development: An Alternative Economic Policy Manual,* (Zed Books: London, 2004), at 75.

[6] Alan Cibils, "Argentina and the IFIs: Better Off Without Them?" *Foreign Policy in Focus,* Oct. 20, 2004.

[7] For an example of the tendency of policy-makers to confuse Chile's highly strategic export strategy with a policy of "free trade," *see* Lawrence E. Hinkle, Alberto Herrou-Aragon, and Francesca Castellani, "An analysis of Chile's trade regime in 1998 and 2001: a good practice trade policy benchmark," World Bank Africa Region Working Paper No. 71, July 2004.

[8] "A Leader for the 21st Century," *Washington Post,* Jan. 18, 2006.

[9] Larry Rohter, "Chile's Socialist President Exits Enjoying Wide Respect," *New York Times,* March 11, 2006.

Even the government of Chile repeats this myth in an effort to attract more trade opportunities for the country. At a recent briefing at the neo-liberal American Enterprise Institute in Washington, a Chilean government representative credited the country's "open economy and foreign trade orient[ation]" for the country's development success.[10]Also, President Bachelet publicly supports initiatives strongly supported by the United States but opposed by majorities in Latin America, such as the Free Trade Area of the Americas (FTAA) and the Doha Round of the WTO expansion negotiations.[11]

But, as with many past endeavors to hold up certain countries as paradigms of success based on a one-size-fits-all "model" for development, the neo-liberals' use of Chile conveniently omits important realities that disprove their thesis.

## Growing income inequality, diminished access to essential services and unsustainable reliance on natural resource exports: the Chile story less often told

### 1. Chile's economic inequality is among the worst in the world, even while targeted social policies aided those at the bottom.

Even considering the post-Pinochet period, income inequality in Chile remains startlingly high. Chile is one of the most unequal societies in the world, and has gotten more so since the 1960s, with the richest 10 percent of the population now accounting for nearly half the country's income.[12] Table 1 shows Chile's relative inequality ranking among select countries. Of over 120 countries for which the United Nations reports this data, Chile ranks among the highest in terms of income inequality.

[10] Power-point at the American Enterprise Institute, by Rolando F. Ortega, "U.S.-Chile Free Trade Agreement: implementation and results," ProChile, Embassy of Chile, May 23, 2006.
[11] *See* Michelle Bachelet, "For global progress, focus on fair trade," *Christian-Science Monitor*, Jan. 9, 2006; and David Haskel, "New Chilean Leader to Push Conclusion Of Free Trade Area of the Americas Pact," *BNA Report for Executives*, March 29, 2006. The Chilean government has a history of promoting the impression of Chile as a neo-liberal success story. *See* Osvaldo Rosales, "Chile-U.S. Free Trade Agreement: lessons and best practices," Paper by Chilean Director General for International Economic Relations for the U.S. Chamber of Commerce, April 28, 2003. The annual *Latinobarómetro* polls consistently show high levels of skepticism with regard to neo-liberal policies.
[12] Jaime A. Ruiz-Tagle, "*Chile: 40 años de desigualdad de ingresos*," *Departmento de Economía, Universidad de Chile*, Universidad de Chile Working Paper No. 165; United Nations University's World Institute for Development Economics Research's World Income Inequality Database v 2.0a, June 2005, accessed April 28, 2006.

**Table 1**

| Country | Rank Among Countries (1=most equal) | Gini Index[13] (1=most equal) | Income of Richest 10 % to Poorest 10% | Income of Richest 20% to Poorest 20% |
|---|---|---|---|---|
| *Denmark* | 1 | 24.7 | 8.1 | 4.3 |
| *Finland* | 10 | 26.9 | 5.6 | 3.8 |
| *South Korea* | 26 | 31.6 | 7.8 | 4.7 |
| *France* | 34 | 32.7 | 9.1 | 5.6 |
| *U.K.* | 51 | 36 | 13.8 | 7.2 |
| *Jamaica* | 63 | 37.9 | 11.4 | 6.9 |
| *United States* | 92 | 40.8 | 15.9 | 8.4 |
| *Argentina* | 106 | 52.2 | 39.1 | 18.1 |
| ***Chile*** | **113** | **57.1** | **40.6** | **18.7** |
| *Namibia* | 124 | 70.7 | 128.8 | 56.1 |

*Source: United Nations 2005 Development Programme Report*

Over Chile's growth spurt, real wages for the *average worker* continued their downward path begun in the 1970s, even while real minimum wages continued to grow as a result of active policies oriented at the *very poorest workers* (described later). Furthermore, the reliance of the Chilean labor market on export-oriented agriculture has created high bouts of seasonable unemployment and erratic behavior in household income over the course of each year. This combination of factors reveals a picture of the Chilean income distribution which shows a small cluster at the top and a large cluster just making ends meet.[14]

Nearly all economists agree that trade has been one of the factors increasing income inequality – the gap between the incomes of the rich and skilled and the poor and unskilled – in Chile and elsewhere in the last two decades plus. This is both a prediction of trade theory and an empirical finding in a large body of research.[15] A recent study concluded that trade liberalization in Chile has led to greater inequality between workers with a university degree and those with only a high school degree.[16] Even mainstream economists have acknowledged that Chile's trade liberalization has been biased against less-skilled workers.[17]

Furthermore, it wasn't until the 1990s that Chilean income growth led to substantial poverty reduction, and here too, non-neo-liberal policies helped achieve this goal. In the 1980s, nearly

[13] The Gini index is a common measure of income inequality. 0 represents a country with perfect equality and 100 represents a country with complete inequality.

[14] *See* Patricio Escobar S., "Economy and the Labor Market in Chile: the behavior of salaries in the midst of a crisis," Global Policy Network, 2002.

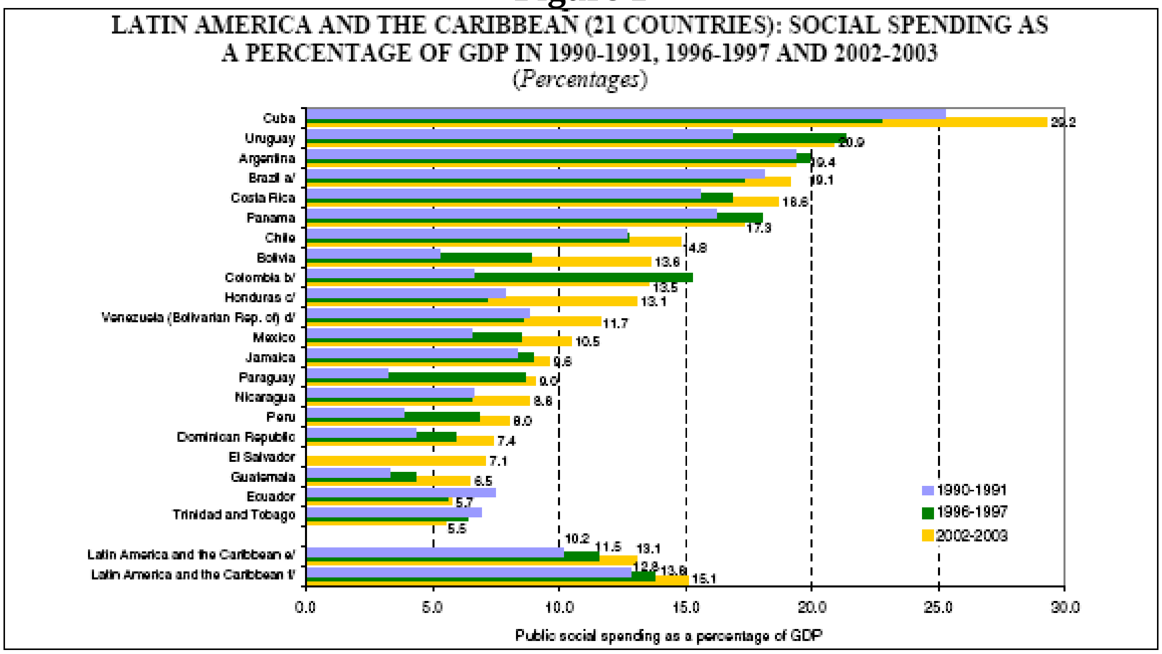
[15] *See* Paul Krugman, "Growing World Trade: Causes and Consequences," Brookings Papers on Economic Activity, 1995; William Cline, *Trade and Income Distribution*, (Washington, D.C.: Institute for International Economics, 1997).

[16] Elisa Borghi, "Trade Openness and Wage Distribution in Chile," *Centro di Ricerca sui Processi di Innovazione e Internazionalizzazione* (Italy) Working Paper No. 173, July 2005, at 1.

[17] Olga Fuentes and Simon Gilchrist, "Skill-biased technology adoption: Evidence from the Chilean manufacturing sector," Boston University Department of Economics, The Institute for Economic Development Working Paper No dp-150, November 2005.

half of all Chileans were poor: today, fewer than one-in-five Chileans are poor.[18] This change was brought about by reforms upon the return to democracy in 1990 that increased taxes and thus expanded social spending by 200 percent over the decade, which included minimum income insurance, education and housing programs. As Chile's former finance minister notes, "about 60 percent of Chile's poverty eradication in the 1990s can be attributed to economic growth and 40 percent to social policies"[19] – both economic outcomes that neo-liberal policies have not generally helped to promote. While neo-liberals generally favor both growth and some social policies in theory, in practice, neo-liberal policies have led to very little growth, because of the contractive fiscal and monetary mandates that often accompany neo-liberal structural adjustment packages. Chile, on the other hand, has had expansive fiscal policies, primarily through an increase in tax collections to fund social programs. As Figure 1 shows, Chile's social expenditure as a percentage of national income has been growing steadily since the early 1990s. Chile's profile in this regard is today much more in line with Latin American countries that have historically had stronger social protections and very different from Chile's anti-egalitarian, Pinochet-governed past.

**Figure 1**




*Source: United Nations Economic Commission on Latin America and the Caribbean, Social Panorama of Latin America, 2005.*

[18] "Poor and Indigent Population: Chile," Social Indicators and Statistics Database, United Nations Economic Commission for Latin America and the Caribbean, website, accessed May 1, 2006.
[19] Alejandro Foxley, "Successes and Failures in Poverty Eradication: Chile," *Reducing Poverty, Sustaining Growth – What Works, What Doesn't, and Why*, (World Bank: Washington, D.C., 2004), at 1.

**2. Chile's growth relies heavily on export of limited natural resources at unsustainable rates, while its manufacturing sector continues to contract.**

An engine of Chile's growth touted as evidence of the benefits of "free trade" has been its robust export rates. Yet, Chile's export success has relied heavily on exploitation of just a few natural resources. While the country has diversified away from copper exports somewhat, close to 90 percent of its exports have been based on natural resources such as salmon and wood and other primary products. Chile's export concentration ratios[20] are twice that of other export-oriented economies such as Malaysia and Australia, and this ratio is even higher for Chile's trade with non-Latin American countries such as the United States than it is with its neighbors.[21]

Chile's rate of exploitation of its renewable resources significantly outpaces their replacement rates. According to a study by *Chile Sustentable*, an environmental NGO based in Chile, mining alone makes up much of the economic output and more than 60 percent of regional exports in 5 of Chile's 13 regions – and nearly 100 percent in Chile's Region II. As the NGO's report shows, this over-concentration is of grave importance, since the so-called "multiplier effect" – or the tendency of activity in one economic sector to beget more economic activity in other sectors – of mining is much lower than of almost any other type of economic activity. For instance, for every dollar that is spent in the mining sector, other sectors of the economy see an increase of only $1.80, while a dollar of activity in financial services or public administration can see a multiplier of three to four dollars.[22]

While many countries simply haven't such natural resources to export, even Chile's blessed abundance will not provide continued wealth at the current rate of exploitation. Reliance on the exhaustible mining and fisheries sector portends "limits to the proposal for economic growth [and] for the pursuit of an open economy and external growth," in the words of distinguished Chilean economist Osvaldo Sunkel.[23] This factor is especially relevant because Chile's natural resource-based export growth has masked an important trend of contraction in Chile's manufacturing sector that has taken place since the 1970s. As Figure 2 shows, Chilean manufacturing has declined steadily from a high of 30 percent of GDP in the early 1970s to a low of 18 percent in 2000, taking the country back to pre-World War II levels of industrialization.

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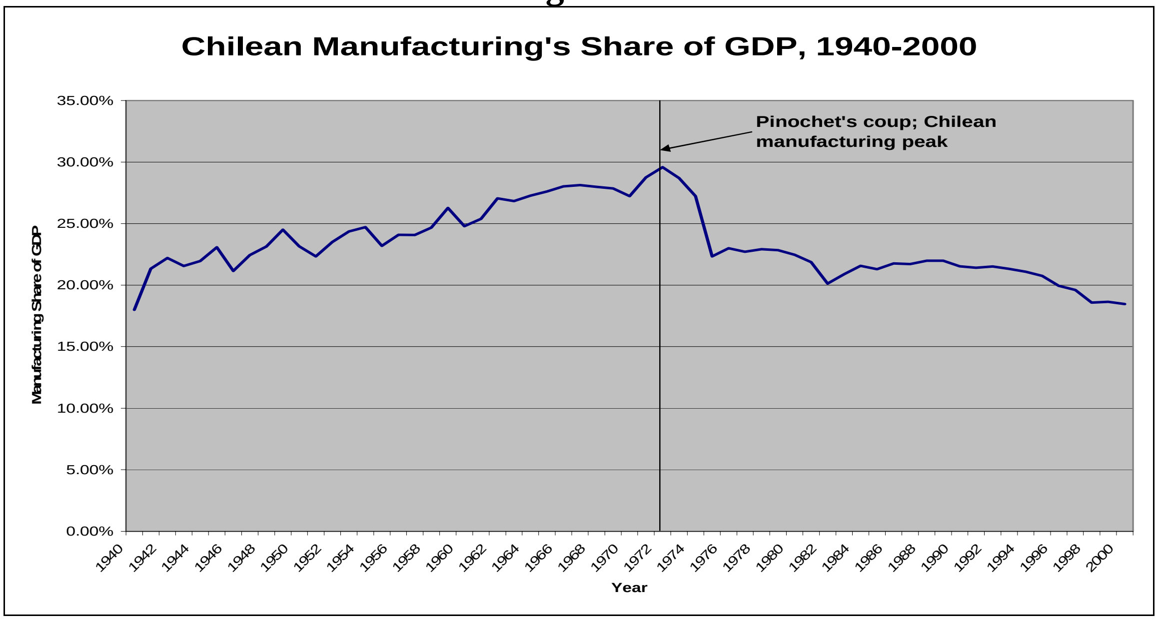
[20] "Export concentration ratios" are defined as the share of the country's top exports over its total exports.
[21] Mauricio Mesquita Moreira and Juan Blyde, "Chile's Integration Strategy: Is There Room for Improvement," Inter-American Development Bank Working Paper, April 2006, at 8-9 and 42.
[22] Chile Sustentable, "Desafios Socio-Ambientales Para El Desarrollo Nacional y de las Regiones Mineras," April 12, 2006.
[23] Osvaldo Sunkel, "Is the Chilean 'miracle' sustainable?" *Journal of Interamerican Studies and World Affairs,* Fall 1995.

## Figure 2




*Source: Oxford Latin American Economic History Database (OxLAD); author's calculations*

During the same period, Chile has suffered a sharp decrease in the "eco-efficiency" – or material input required to produce a unit of GDP – of the country's economy.[24] Chile's lack of export diversification also exposes the economy to price shocks in commodity markets, while greater export diversification could have increased the country's productivity and income growth rate.[25]

**3. Privatizations have cut access to essential services and undermined retirement security.**

Chile has fully or partially privatized virtually all of its essential services, including water, electricity, telecommunications, education, health, critical infrastructure and the social security system. The bulk of the privatizations occurred during the Pinochet dictatorship. While there were 179 state-owned firms in 1973, there were only 44 by 1989. As noted by a recent study, "privatization in Chile was not transparent in its early stages … Furthermore, policymakers explored untried policies in the absence of a free press – there is almost no record of privatizations that took place in the 1970's."[26]

Despite the Pinochet dictatorship's supposed ideological commitment to privatization, it is notable that it kept the country's most lucrative sector – copper – in state hands. *Codelco,* as the state-owned copper company is known, is the largest copper producer in the world, and opinion

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[24] Nicola Borregaard, "Trade Liberalization in Chile: What is the Evidence of its Effects and How Can Sustainable Development Be Safeguarded?" and "Trade-led Growth, Natural Resource Dependence, and Sustainable Development," Working Group on Development and Environment in the Americas, Discussion Paper No. 5, June 2004.

[25] Chilean copper supplies in particular could be exhausted well before 2020, giving Chile less than 15 years to continue earning export revenues predominately off of one product. *See* Mesquita Moreira and Blyde, at 9 and 12.

[26] Ronald Fischer, Rodrigo Gutierrez, and Pablo Serra, "The Effects of Privatization on Firms and on Social Welfare: The Chilean Case," Inter-American Development Bank, Latin American Research Network Working Paper #R-456, May 2003, at 3-4.

polls show that over 90 percent of Chileans oppose privatization of *Codelco*, notwithstanding demands from many neo-liberal pundits to that effect.[27]

Despite the mainstream consensus that Chilean privatization went relatively smoothly for a Latin American country, it is telling that leading opinion polls show that a majority of Chileans do not think that privatization has been beneficial for the country.[28] Moreover, economists at the Inter-American Development Bank have found that while

> "privatized firms enjoyed significant improvements in efficiency, … these gains were no different that those experienced by other private firms in their respective economic sectors. This allows us to conclude that *Chilean state-owned enterprises were efficient before privatization*. In terms of profitability, privatized firms in the regulated sector enjoyed particularly sizeable gains. In fact, *employment in those firms increased after privatization, suggesting that they were not overstaffed under government control*. … The profitability in the regulated sector is due to the more efficient use of physical capital and to the fact that *the regulators were unable to transfer increased profits to consumers*" [italics added].[29]

This study goes on to show that, contrary to the conventional neo-liberal "wisdom," the privatized utilities that were the most strongly regulated post-privatization experienced larger improvements in efficiency and profitability than those that were less regulated – showing that regulation is not incompatible with improvements in corporate performance.

Below are examples from a few sectors that experienced privatization.

**Water.** Beginning in the late 1980s, the Chilean water system began to be privatized. The driving principle behind this privatization was that individual users should be forced to pay the full cost of their water usage (plus an amount that would allow the private and mostly foreign companies to make a profit), and that any amount of social subsidy should be eliminated. According to a publication put out by the World Bank, despite insignificant expansions of the percentage of the population with access to water production and distribution in Chile, the average real price of water and sanitation services tripled in the dozen years following privatization.[30] The NGO Food & Water Watch has found that hundreds of poor families have been kicked off of water coverage for inability to pay, while the Chilean Organization of Consumers and Users (ODECU), a Chilean public interest organization, reviewed 15,000 water bills and found that water rate increases were at least 100 percent and even reached 200 percent in some cases.[31]

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[27] "Privatize Codelco?" *Latin Business Chronicle*, September 2005.
[28] "LatinoBarómetro Report 2005: 1995-2005, A Decade of Public Opinion," Corporación LatinoBarómetro, at 76.
[29] Ronald Fischer, Rodrigo Gutierrez, and Pablo Serra, "The Effects of Privatization on Firms and on Social Welfare: The Chilean Case," Inter-American Development Bank, Latin American Research Network Working Paper #R-456, May 2003, at iii.
[30] Gabriel Bitrán and Pamela Arellano, "Regulating Water Services," *Public Policy for the Private Sector*, (World Bank), Note Number 286, March 2005, at 4.
[31] Food & Water Watch, "Chile – Water Privatization Showcase," Website, accessed Sept. 18, 2006.

**Education.** The Pinochet administration's final act while in office was to partially privatize the school system, creating a system of vouchers and decentralization that drained the public school system of needed resources. According to an investigation by *The New York Times*, in Chile, "private schools spend at least five times more per pupil than the poorest public schools do." In response to student strikes, the Bachelet administration recently announced a set of major investments in the failing public school system.[32]

**Health.** Chile's partially privatized health care system – where a part of the system is public and a part is private – has led to a bias against adequate coverage for poor and middle class people, as well as the elderly and infirm.[33] The privatized system is twice as costly as the public system, and serves mostly the rich, young and healthy. One study showed that only about a fifth of the population is covered by the system, while 7.2 percent of the private system's beneficiaries were older than 65.[34]

President Bachelet, in another sign that Chile is less neo-liberal than some pundits seem to think and that people in Chile know privatization has not yielded socially acceptable results, has announced a series of initiatives to improve access to services, including mandated free hospital care for everyone over 60 years old. Another Bachelet promise is to create 800 new state-funded nursery schools during her four-year term to benefit 25,000 infants. "Inequities begin at the crib, when not all children have the same opportunities," she said. "Because of this, I want to start my government with a clear signal that we want to promote conditions of equality for everybody."[35]

**Social Security and pensions.** Meanwhile, the failure of the privatized Chilean social security system has been widely publicized. According to the Center for Economic and Policy Research, the privatized social security system is much less efficient than a public system would be, since the former is denied the economies of scale in administrative costs that the latter enjoys. In fact, administrative costs in the Chilean social security system are as high as 15 percent a year, as compared with 0.3 percent in the public U.S. system – just one of the many inefficiencies of such a policy.[36] One reason for the inefficiencies is the commissions charged to the pensioner every time she makes a re-allocation of her portfolio assets. According to one study, only three percent of workers knew the commissions charged by the privatized social security fund managers,[37] suggesting that the system is not functionally transparent.

Both candidates in the recent Chilean election agreed that the social security system had to be overhauled, because of the enormous fiscal strain of the privatization on the government. But one

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[32] Larry Rohter, "Chilean Promised a New Deal; Now Striking Youth Demand It," *New York Times*, June 5, 2006.
[33] Ricardo Sanhueza and Jaime Ruiz-Tagle, "Choosing Health Insurance in a Dual Health Care System: The Chilean Case," *Journal of Applied Economics*, Vol. V, No. 1, May 2002, at 157-184.
[34] Ronald Fischer, Rodrigo Gutierrez, and Pablo Serra, "The Effects of Privatization on Firms and on Social Welfare: The Chilean Case," Inter-American Development Bank, Latin American Research Network Working Paper #R-456, May 2003, at 72.
[35] Eduardo Gallardo, "President Michelle Bachelet orders free hospital care for Chileans over 60," Associated Press, March 14, 2006.
[36] Dean Baker, Testimony Before the House Committee on Ways and Means, Subcommittee on Social Security, "Protecting and Strengthening Social Security," June 16, 2005.
[37] Ronald Fischer, Rodrigo Gutierrez, and Pablo Serra, "The Effects of Privatization on Firms and on Social Welfare: The Chilean Case," Inter-American Development Bank, Latin American Research Network Working Paper #R-456, May 2003, at 68.

of the most telling facts about old-age pensions in Chile is that the all-powerful military dictatorship of Pinochet opted to keep military pensions under state control.[38]

## Chile's export and growth success based on use of non-neo-liberal policy tools

### 1. Chile's growth boom occurred after the restoration of the pragmatic use of state policies following Pinochet's extreme free market experiment.

The first generation of neo-liberal policies in Chile was imposed by the brutal Pinochet military dictatorship that "disappeared" and murdered over 3,000 people.[39] In the words of one observer, an uncritical celebration of the Chilean model – particularly in the years of the dictatorship – is like celebrating "that Hitler's rearming of Germany pulled their economy out of the Depression. Except that in the case of Chile, those who would defend the destruction of democracy cannot even point to an economic boom ushered in by fascism."[40] Indeed, Chilean growth only took off in a sustained fashion after the years of radical economic experimentation by the Pinochet regime were brought to a close.

Many propagators of the "miracle of Chile" myth confuse the early Pinochet period – which was much closer to a "free market" system but was also a massive economic failure – and the late Pinochet period and return to democracy, when pragmatic use of both the market *and* state policies was the norm. Despite substantial rates of export growth in the early years of the Pinochet dictatorship, sustained income growth did not follow: in 1975, less than two years after Pinochet's massive opening of the economy, gross domestic product (GDP) actually *contracted* nearly 15 percent. Furthermore, the indiscriminate liberalization of the early years – which included the elimination of all non-tariff barriers and a steep reduction of customs tariffs – started the long-term contraction of the manufacturing sector discussed above.

In the words of Nobel Prize in Economics winner Joseph Stiglitz, while Pinochet's deregulation of the banking sector led to financial crises in the 1970s and 80s, the 1990s through the present represented a period of "success of combining market with appropriate regulation." Or in the words of Chile's finance minister under the first post-Pinochet, democratic government: "If you compare the performance of the economy in the best Pinochet years with the performance of the economy [during] democracy, I challenge you to find one single economic or social indicator in which democracy hasn't performed much better."[41]

### 2. The Chilean government employed active trade policies and subsidies.

Indeed, in order to strengthen the link between export growth and the rest of the economy, the Chilean government undertook a series of ambitious, state-led economic policies that are more

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[38] Dan Restrepo, "The Chilean Heroes of Social Security Privatizers," Center for American Progress column, Dec. 10, 2004.
[39] Chilean National Commission for Truth and Reconciliation "Rettig Report," February 1991.
[40] Mark Weisbrot's column, Center for Economic and Policy Research, Oct. 8, 1998.
[41] Interviews with Joseph Stiglitz and Alejandro Foxley, "Commanding Heights: The Battle for the World Economy," Transcript on PBS.org, May 2003.

commonly associated with non-neo-liberal South Korea than with the preferred neo-liberal policy recommendations. These included:[42]

- A comprehensive system of "duty drawbacks" for exporters, as well as other tax benefits. The system reimburses Chilean exporters for any tariffs they pay to import capital or other inputs, and has special incentives for small scale exporters, as well as those firms that specialize in non-traditional exports.[43] Special additional tax credits and duty benefits were provided to develop the auto industry. This mechanism is a classic tool for promoting exports while limiting imports, defying simplistic notions of "trade openness." The total value of these benefits amounted to a subsidy to the private sector of hundreds of millions of dollars a year. The Chilean policy – part of which is still in place – also promotes export diversification away from natural resources by favoring producers of alternative products.
- An aggressive governmental export agency – *ProChile* – that collects information on foreign markets for private sector exporters back home.[44] A related program helps provide government funds to pay the fees for any consultants that exporting firms hire to help promote exports or improve management.
- A partially state-owned venture capital organization – *Fundación Chile* – that funds private sector technological innovation and dissemination and builds "demonstration companies." This agency, which enjoys a government subsidy and 50 percent of whose equity is government-owned, specializes in developing companies in high-tech and other favored industrial clusters, and then selling off the companies to the private sector once they become competitive. Examples include the development of the salmon fishery industry in the initial phases, and then ongoing technological support, such as through improvements in salmon sanitary practices. In 2003-04, *Fundación Chile* leveraged $3 million to create companies, with accompanying private funds of $12 million.[45]
- Extensive alternative sources of public export financing – including from the government Production Financing Corporation (CORFO, for its Spanish initials) – that favor non-traditional exports and the import of capital inputs into exportable products. CORFO also offers "export insurance… which subsidizes 50% of the cost of insurance against the risk that the exports will not be paid for."[46]
- A handful of public agencies that offers financing for production and professional training that benefit exporting as well as non-exporting firms.
- Substantial government investment in expanding roads, ports, and other infrastructure, as well as the funding of technical education for professionals involved in commerce and

[42] Manuel R. Agosin, "Trade and growth in Chile," Economic Commission for Latin America and the Caribbean Review, August 1999; and Carla Macario, "Chile: from policies that subsidize exports to policies that enhance competitiveness," *Integration & Trade Journal*, Institute for the Integration of Latin America and the Caribbean, Department of Integration and Regional Programs, Inter-American Development Bank, January-August 1998.
[43] Interestingly, this policy is not associated with significant wage growth for unskilled workers. *See* Ivan T. Kandilov, "Do Exporters Pay More? Plant-level Evidence from an Export Refund Policy in Chile," University of Michigan, Ann Arbor, unpublished, October 2004.
[44] Ironically, *ProChile*, an agency that was created out of industrial policy, is one of the biggest propagators of the myth of "Chile as free market." In a blurb for the 2004 Asia-Pacific Economic Cooperation Summit, *ProChile* celebrates Chile's "unwavering commitment to market liberalization." *See* "Chile's Economy," at http://www.apec2004.cl/index.asp?CatID=11&idioma=ing.
[45] *See* Agosin at 94; *FundacionChile.cl* website.
[46] Macario at 118-119.

economic development. While neo-liberals acknowledge the need for this investment in theory, in practice, the tight fiscal and monetary policies required by the IMF and World Bank have deprived many countries of the revenues needed to pursue this type of investment.

**3. The Chilean government has re-regulated the finance sector to bring stability.**

After eliminating most restrictions on speculative inflows of foreign capital and experiencing severe financial problems during the Pinochet dictatorship, the Chilean government in later years acted to limit such destabilizing capital flows by establishing the very sorts of capital controls shunned by neo-liberals. While keeping the doors wide open for actual foreign direct investment, the government required that those obtaining loans or financial investment from abroad, including investments in the Chilean stock market, deposit a 30 percent non-interest-bearing compulsory reserve requirement (to be maintained for one year, regardless of the term of the financial instrument involved). Such a policy gives strong incentives for foreigners to invest in Chile, but only if they plan on making productive investments, which are more likely to lead to job creation and other benefits for Chile. "This system is very costly for short-term flows but has only a low cost for those with a time horizon of more than one year," according to a study written for the United Nations Economic Commission for Latin America and the Caribbean (ECLAC).[47]

Research also shows that Chilean financial regulators have been unusually adept in controlling the banking sector and the financial derivatives markets – feats which many *developed* countries cannot often manage. Economists at the Central Bank of Chile credited the wide-ranging system of bank regulations in Chile for the country's relatively healthy corporate governance – unusual for an economy such as Chile's in which a few major holding groups control wide swaths of the private sector.[48]

Economists Randall Dodd and Stephany Griffith-Jones explain in a forthcoming paper how three government bodies in Chile regulate the financial derivatives markets, including the Central Banking, the Superintendent of Banking, and the pension fund regulator. These bodies set limits on the maximum foreign exchange exposure and other requirements that pension fund managers in Chile must meet. This leads to financial markets in Chile working exceptionally well, and also offers protections from the instabilities that plague many developing country markets.[49]

These capital management policies, which are very different from the standard neo-liberal model favoring deregulation, also included a tax on foreign borrowing (which limited Chilean firms' exposure to exchange rate risk) and a strengthening of banking regulations. As a consequence, "the appreciation of the Chilean currency and the current account deficit (as a share of GDP) were smaller than in other Latin American countries that were also recipients of large capital inflows," according to the Political Economy Research Institute.[50] These currency controls

[47] Agosin, at 90.
[48] Manuel R. Agosin and Ernesto Pastén H., "Corporate Governance in Chile," Central Bank of Chile Working Paper No. 209, May 2003.
[49] Randall Dodd and Stephany Griffith-Jones, "Report on Chile's Derivatives Markets," Economic Commission for Latin America and the Caribbean, forthcoming report, 2006.
[50] Gerald Epstein, Ilene Grabel and Jomo K.S., "Capital Management Techniques in Developing Countries: An Assessment of Experiences from the 1990s and Lessons for the Future," Political Economy Research Institute

worked to insulate Chile from the 1995 “Tequila Crisis” that pummeled other Latin American currencies after Mexico’s peso crash, and from fallout after the 1997 Asian Financial Crisis spread to numerous other developing countries.

## WTO and U.S.-Chile FTA threaten Chile’s progress

Many of the non-neo-liberal policies that have been the source of Chile’s past success are at risk of being the latest casualties of the neo-liberal model. Since 1995, Chile has been a WTO member, and in 2004, Chile implemented a trade agreement with the United States. The tools that set Chile apart as a country willing to experiment with non-neo-liberal policy tools deemed appropriate for the local context are precisely those most threatened by WTO and U.S.-Chile FTA rules.

For instance, the Chilean government believes that its highly successful duty drawback system and several sectoral policies (such as the auto sector policies) are WTO-illegal export subsidies, and has thus voluntarily eliminated or dramatically reduced the scope of these policies in 2003.[51] In ECLAC’s estimation, if Chile does not retain its historic, extensive coordination between the private and public sectors, the country “will run the risk of having an increasing concentration of a relatively small range of natural resource-intensive commodities, thereby increasing the economy’s vulnerability to external shocks.”[52]

There are also ample concerns about the U.S.-Chile FTA, which led to a surge in bilateral trade (in Chile’s case nearly doubling from $6 billion in 2003 to $11 billion in 2005).[53] Despite this, U.S. foreign direct investment (FDI) in Chile is a far lower share of total FDI in Chile since the FTA was signed that it has been historically. Since 1974, the United States has been the top foreign investor in Chile, representing an average share of 26.5 percent of all FDI in Chile. Focusing on just 2004-05, however, the United States’ FDI share sunk to 2.8 percent, far behind Spain’s share of 60.8 percent, and behind that of Australia, Canada, and the United Kingdom. The drop in the United States’ relative share of FDI goes against the neo-liberal justifications for the signing of a trade agreement, which argue that FDI is one of the main reasons – if not the very top reason – for signing such a pact. *ProChile* has hypothesized that U.S. FDI may be increasingly diverted to Asian countries,[54] a fact which further exposes the falseness of the

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(University of Massachusetts Amherst) Working Paper No. 56, April 2003, at 12-18. For further evidence of Chile’s successful insulating of the harmful effects of speculative, short-term capital inflows, *see* Gabriel Palma, “The Three Routes to Financial Crises: The Need for Capital Controls,” Center for Economic Policy Analysis, Working Paper No. 18, November 2000.

[51] Chile voluntarily reported these “subsidies” to the WTO’s Committee on Subsidies and Countervailing Measures every year through 2004, after the elements of the policies that Chile considered WTO-illegal had been eliminated. *See* Chile, “Updating and New and Full Notifications Pursuant to Article XVI.1 of the GATT 1994 and Article 25 of the SCM Agreement,” WTO’s Committee on Subsidies and Countervailing Measures, G/SCM/N/95/CHL, March 24, 2004.

[52] *See* Macario, at 129. According to the USTR’s 2006 *National Trade Estimate Report on Foreign Trade Barriers,* Chile’s tax and duty incentives to exports are still in place.

[53] Chilean imports from the United States grew faster than Chilean exports to the United States, even though Chile still maintains its trade surplus with the United States. *See* Ortega 2006.

[54] Ibid.

argument – made constantly by officials in Washington and elsewhere – that FTAs help insulate Latin American countries from losing out to Asia as U.S. investors increasingly shift their attentions eastward.

Furthermore, the future prospects for sound financial regulation are being undermined by the U.S.-Chile FTA. As a condition for signing the pact, the Bush administration required that Chile forswear the use of most forms of capital controls. Article 10.8 of the U.S.-Chile FTA states that out that "Each Party shall permit all transfers relating to a covered investment to be made freely and without delay into and out of its territory," and goes on to spell out that this includes all forms of profit repatriation, dividend, interest and other financial payments.[55]

Jagdish Bhagwati – one of the world's fiercest proponents of trade liberalization – testified before the U.S. Congress that the consensus in the economics profession was that capital controls can be effectively used to avoid rapid financial outflows. Bhagwati said that the U.S.-Chile FTA's effective prohibition of the application of capital controls is "difficult to understand in terms of economics," and worried that linking the two issues would bring "trade liberalization … into disrepute."[56]

Further, the FTA could chill the improvement of Chilean environmental regulations, by imposing draconian investment rules that give foreign investors rights to challenge domestic environmental regulations.[57] Similar investment rules in the NAFTA led to U.S. and Canadian investors suing the Mexican government for over a billion dollars in claims. In these cases, foreign investors claimed damages for scores of policies, ranging from environmental regulations to economic development policies that would not have been grievable under U.S. law.[58]

Chile's current trade strategy is to complete the Doha Round and accumulate as many bilateral trade agreements as possible. However, preliminary research by Inter-American Development Bank economists suggests that the main constraint on Chile's continued export growth is not the trade barriers on which these negotiations are focused, but is transportation costs, both to Chile's export markets in Asian countries, as well as to its Latin American neighbors on the other side of

[55] U.S.-Chile Free Trade Agreement, Chapter 10, Article 10.8. Provisions elsewhere in the agreement (such as in Chapter 12 on "Financial Services," Article 12.10.3), while seeming to offer some exceptions to Article 10.8, do not in fact permit governments to use capital controls to protect the nation's currency, or allow the government to distinguish between national and foreign investors – a key distinction in any financial crisis that involves foreign money.

[56] Jagdish Bhagwati, Testimony Before the House Committee on Financial Services, Subcommittee on Domestic and International Monetary Policy, Trade, and Technology, April 1, 2003.

[57] Kevin Gallagher, Frank Ackerman, Hernan Blanco and Annie Dufey, "Marginalizing Environmental Impacts: Comments on USTR's Environmental Review of U.S.-Chile Free Trade Agreement," Globalization and Sustainable Development Program, Tufts University, November 2001.

[58] Mary Bottari and Lori Wallach, "NAFTA's Threat to Sovereignty and Democracy: The Record of NAFTA Chapter 11 Investor-State Cases 1994-2005," Public Citizen's Global Trade Watch, February 2006. In one notable case, the U.S. firm Metalclad sued the Mexican federal government under a secret NAFTA tribunal for a provincial government's denial of a permit to expand a toxic waste dump into a protected ecological reserve. Throughout the case, the provincial government of San Luis Potosí (which had denied Metalclad's request for a permit) was pressured into weakening its environmental regulations, and at one point, the Mexican federal government even tried to pressure the province to fork over the $15.6 billion that the NAFTA tribunal has instructed the federal government to pay Metalclad. The 12-year track record of similar cases under NAFTA shows how FTA investment rules undermine public interest regulation, and even federalism.

the Andean Mountains.[59] Thus, Chile may desire to return to the era when the state helped coordinate infrastructural improvements, rather than focusing on trade negotiations, which have very little bearing on transportation costs.

## CONCLUSION

The actual lived experience of the Chilean model is in contradiction to neo-liberals' claims, who have suggested that merely because Chile sought out export markets and foreign direct investment, it was somehow following a neo-liberal strategy.[60] On the contrary, these are goals of every government – neo-liberal or otherwise. Certainly it was the goal of Latin American governments, which have – as neo-liberal commentators have noted – presided over countries where "the situation of a majority of the population has stagnated."[61] What made the difference in Chile was that the government was pragmatic about what pieces of advice it took from the neo-liberal establishment, and preserved the right to regulate to accomplish important policy goals.

Many policy-makers in Chile have wisely avoided the "neo-liberal model pupil" tag. President Bachelet has gone so far as to laud fellow Latin American leaders that have opposed neo-liberalism as representing a desire to "work to eradicate poverty and eliminate inequality" – a gesture which stands in sharp contrast to the Bush administration's efforts to marginalize the reformers.[62] Nonetheless, as this report shows, pundits are continually trying to split Chile from its neighbors and urge the country's government to play the neo-liberal role.

Unfortunately, Chile may find that WTO and FTA rules have shrunk its policy space to something far smaller than what it was when the country bucked the regional trend, and actually saw some economic and social development in the late 20th century. Therefore, developing nations should take note of the failure of neo-liberal policies and the success of non-neo-liberal policies in Chile – as well as the challenges the country faces for having shackled itself to WTO and FTA policies – before accepting at face value the old myth of the "miracle of Chile."

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[59] *See* Mesquita Moreira and Blyde, at 35.
[60] It's worth noting that advocates of neo-liberal policies have also made the same claims regarding China, in spite of the fact of that China employs strict currency controls and a state-owned banking system. For a typical example, *see* Sidney Weintraub, "Chile as a Template," *Issues in International Political Economy No. 35,* Center for Strategic and International Studies, November 2002.
[61] Ibid, at 2.
[62] Cristina Dunn, "Bachelet defends Morales and Chavez, indirectly mocks Bush," *MercoPress*, May 12, 2006.