Chapter 1

Overview: Keeping momentum – an OECD economic assessment of Chile

On 7 May 2010, Chile became a member of the OECD, a testimony to its progress and accomplishments. The accession process took place in the difficult context of the 2008–09 recession and the devastating earthquake in February 2010. Nonetheless, the economy has rebounded quickly, showing a welcome resilience to external shocks. To help Chile build on this momentum and achieve increasingly higher living standards as fast and sustainably as possible, President Piñera's administration and the OECD agreed to prepare an economic assessment with policy options. This report highlights the opportunities and challenges ahead. Its goal is to inform policy makers of options for the future of Chile.

Key challenges

Once a relatively poor country, Chile has spectacularly transformed itself over the past decades. Ongoing progress in macroeconomic policy, structural reforms, trade and investment and regulation has brought prosperity to the country. A rich endowment of copper and other mineral reserves has been used cautiously to foster resilience in the face of unexpected headwinds. Moreover, a stable democracy with an effective rule of law has been established. A range of governance indicators relating to both political and economic conditions shows that Chile has caught up with, or even surpassed, OECD averages.

In spite of this progress, there is scope for further positive change. Income per capita remains significantly below the OECD average – making sustained and non-inflationary growth an important goal. Between 1986 and 2007, Chile's income per capita grew at around twice the rate in the OECD area and the income gap with richer countries was reduced substantially. Nevertheless, convergence slowed after 1998. At the average rate prevailing in the decade preceding the global economic crisis, it would take around 30 years to catch up with the current average OECD per capita income. Moreover, income inequality, as measured by the Gini index, is higher than in any other OECD country, and poverty appears to have increased once again during the recent recession.

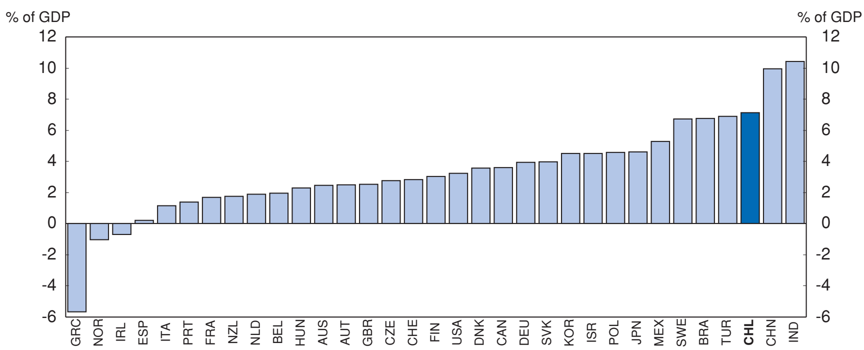
It is therefore appropriate that the government seeks to achieve fast growth while reducing income inequality. In the short term, the main challenge will be to maintain the delicate balance between pursuing a strong recovery and preserving price stability. Strong domestic demand, partly related to reconstruction spending after the natural disasters of February 2010 and booming international commodity prices risk stoking inflation. The government will also need to focus on structural reforms to spur more productivity growth which has been disappointing over the past few years. There will also be scope to enhance policies to reduce poverty and income inequality (Figure 1.1).

Faster convergence towards high living standards

One of the new government's key objectives is to raise average gross domestic product (GDP) growth to 6% over 2010–14. This will require structural reforms. The main reason for the persistent income gap with high-income OECD countries is lower productivity; the under-utilisation of labour resources explains a smaller part. Fast increases in productivity will therefore be key to sustained economic growth in the long run. While Chile has made substantive progress in upgrading its production structure from relatively low-productivity resource extraction to higher value added activities, restrictions in product and labour markets and the uneven quality of education, among other things, have prevented the country from taking full advantage of its potential. Following the footsteps of resource-rich OECD countries, such as Australia and Norway, which have successfully managed the transition from resource extraction to high-productivity services-based economies, will require structural reforms in these areas. There is also room to enhance the country's long-term growth performance by better utilising labour resources, as the labour market participation of women and youth remains low from an OECD perspective.

Figure 1.1. **Despite the 2010 earthquake, Chile is showing a strong recovery from the global recession**

GDP growth, 2009 Q3 to 2010 Q3



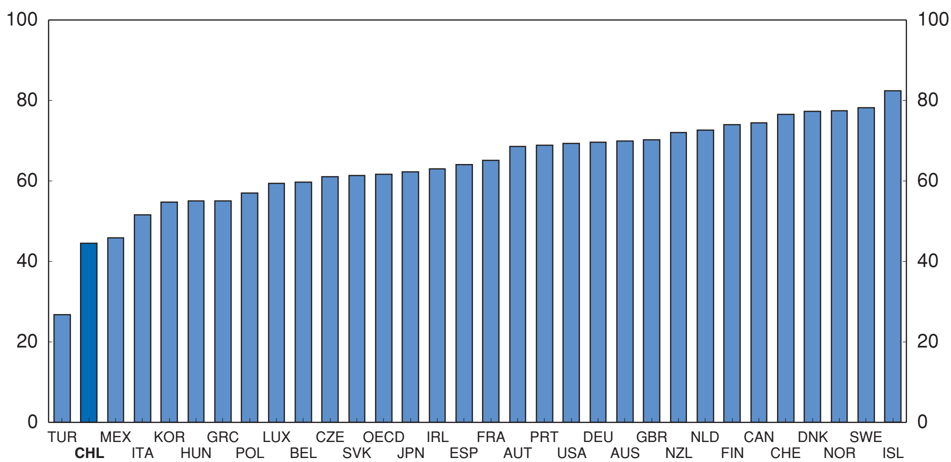
Source: OECD, National Accounts and Analytical database.

In particular, *there is scope to improve competition policy and promote entrepreneurship*. Competition in some areas of product markets, especially in the services sector, remains weak by OECD standards, which reduces firms' incentives to reduce costs and enhance productivity. The recent reform of the competition law is well designed and tightens the rules against anti-competitive behaviour. *It now needs to be implemented efficiently. Reducing regulatory red tape for business start-ups and easing restrictions on entry in specific services sectors, which remain high by OECD standards, would further contribute to strengthening competitive pressures for firms*. This would also encourage entrepreneurship and thereby the adoption of new and innovative business ideas. The government recognises the importance of structural reforms in these areas and in January 2011 a law was passed that reduces the time needed to start a business from 27 to 16 days. Similarly, reforming the very burdensome bankruptcy procedure would improve the conditions for entrepreneurship, among other things, by giving creditors legal certainty and removing the stigma of failure.

Structural reforms in labour markets would raise the participation rate of women and youth, which are among the lowest in the OECD, and enhance labour productivity. Some OECD countries, such as Ireland, have managed to raise the female labour market participation from levels similar to the ones currently observed in Chile to around the OECD level over a relatively short period of time (Figure 1.2.). *Although the government has made substantive progress in providing childcare for working women over the past few years, there remains scope to further expand these programmes*. A recent government initiative to extend the maternity leave period may help women to better reconcile work and family life. The minimum wage, which is high from an OECD perspective, particularly hurts the employment prospect of youth. *The government should consider introducing a differentiated minimum wage, with lower rates for young workers*. To enhance labour productivity, the government needs to reduce the share of informal employment, which remains high vis-à-vis the OECD average. High severance pay has reduced employers' incentives to formalise employment relationships, trapping informal workers in low-productivity jobs without access to formal training. *Reducing severance pay while further expanding unemployment insurance, would go a long way towards a Chilean model of "flexicurity", characterised by more flexible employment relationships that would, nonetheless, grant better protection to workers*.

Figure 1.2. **Female labour force participation rates, 2008**

15-64 years



Source: OECD Labour Force Database.

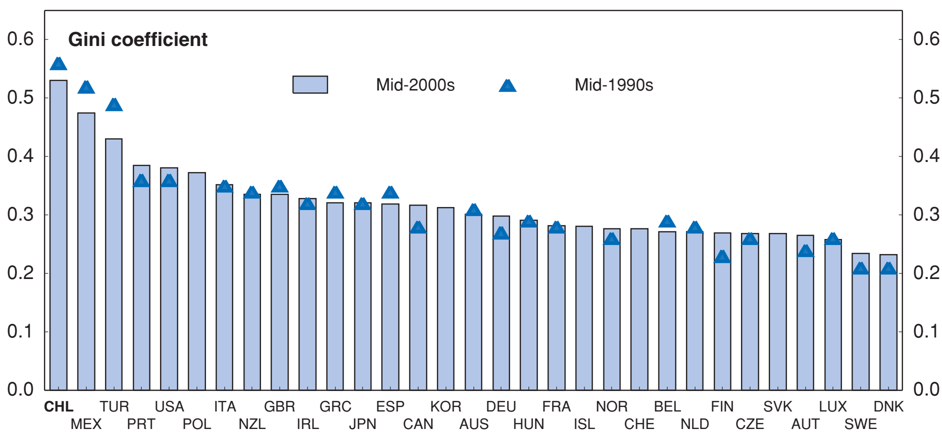
Policies to fully exploit the advantages of Chile's openness to trade and foreign investment may need to be improved to achieve faster technological progress and productivity growth. Openness to trade and foreign investment has intensified competition in domestic markets and facilitated access to imported intermediate goods. Yet, the considerable growth potential from openness to trade and foreign investment has not been fully exploited, as it remains concentrated in natural resource intensive sectors. Furthermore, the capacity of domestic firms to absorb advanced technologies and management practices is weak. *Innovation policy may have a useful role to play in strengthening the absorptive capacity of domestic firms, for instance by promoting training of Chilean workers in foreign firms and by strengthening links between public research institutions and private firms. Similarly, trade and investment policies need to be re-oriented towards strengthening links between foreign and domestic firms, particularly in the services sector.* The example of resource-rich OECD countries, such as Australia and Norway, shows that services linked to natural resource extraction may have considerable growth potential in Chile. *Promoting environmentally friendly policies may also contribute to the further diversification of the economy and sustainable long-term growth.* For instance, protecting Chile's exceptional biodiversity through appropriate market-based and regulatory instruments would boost Chile's attractiveness as an eco-tourism destination.

In the medium term, higher productivity growth will be sustainable only with a well-educated and highly skilled workforce. Although educational attainment has increased markedly over the past two decades and there have recently been signs of improving education quality, scores on standardised tests for secondary students remain appreciably below the OECD average, and opportunities for further education and training for the existing workforce are limited. The low skill level of the Chilean workforce has become a barrier to faster productivity growth, as workers often do not have the capacities to absorb and adapt the technologies needed to catch up with high-income OECD countries at the technological frontier. *In the area of secondary education, higher-qualified individuals could be attracted into the teaching profession by reviewing the remuneration system and by defining teacher career paths with attractive opportunities for promotion.* The outcomes of the secondary education system will also depend on the effective implementation of a newly established quality assurance system that will evaluate schools and take measures to improve quality in under-performing ones. While improving the quality of secondary education will be paramount to forming a new generation of highly skilled individuals, there is also a need to enhance the skills of the existing workforce. *This could be achieved by improving the incentives for lifelong learning, for instance by establishing a certification system for vocational skills at the national level, and by improving the quality of enterprise training.*

Reforming education and labour market policy to reduce income inequality

Strong economic performance and the improvement in average living standards since the late 1980s have had little effect on income inequality. With a Gini coefficient of 0.53, the degree of income inequality in Chile is currently higher than in any other OECD country and has barely been reduced since 1990, when it stood at 0.56. While social policies have contributed to cut poverty rates by half since 1990, they have fallen short of providing equal opportunities to all citizens. Compared to other OECD countries, social mobility is low in Chile, with children from disadvantaged backgrounds often ending up in low-skilled/low-paid jobs as adults. Reaching the government's objective of raising average GDP growth to 6% per year over the 2010–14 period will help to further reduce poverty, among other ways by creating job opportunities and easing the financing of social programmes. Nonetheless, additional efforts in the areas of education and labour market policies will be needed to enhance social mobility and further reduce income inequality to levels closer to those in other OECD countries (Figure 1.3).

Figure 1.3. **Income inequality across OECD countries**[1]



1. After taxes and transfers.

Source: OECD (2008), *Growing Unequal?: Income Distribution and Poverty in OECD Countries*, OECD Publishing, DOI: 10.1787/9789264044197-en; Larrañaga, O. (2009),"Inequality, Poverty and Social Policy: Recent Trends in Chile", *OECD Social, Employment and Migration Working Papers*, No. 85, DOI: 10.1787/224516554144.

Achieving greater social mobility and reducing income inequality requires access to quality education at all levels of the education system for all Chilean children. OECD experience shows that early childhood care and education can be particularly effective tools to break the cycle of inequality across generations. The government has already made substantial progress in expanding nursery and kindergarten places, but there remains scope to further raise capacities and enhance the quality of early childhood education. In the area of primary and secondary education, the government has made significant efforts to improve the access of children from vulnerable backgrounds to quality schools, among other ways by introducing a differentiated voucher scheme. This scheme grants schools that accept students from vulnerable backgrounds more resources. Experience from top-performing OECD countries, such as Finland, shows that the Chilean government is correct to devote more resources to students who risk falling behind, but the efficient use of resources will have to be monitored and appropriate assistance will have to be provided to schools with limited capacities.

Reducing income inequality will require better job market prospects for low-skilled workers. The establishment of a minimum family income (*Ingreso Etico Familiar*, IEF), which will build on existing social programmes to provide conditional cash benefits, will contribute to the government objective of eradicating extreme poverty by 2014. However, there are limits to what can be achieved through income support for the poor. Reducing income inequality to levels similar to those observed in other OECD countries will require better integration of the poor into the labour market. This would also be a particularly effective way of enhancing social mobility, as being employed can change attitudes and behaviours that are transmitted to children. The IEF training and job-search requirements may promote the activation of low-income people, but bringing them into employment will also require enhancing the capacities of public employment services.

All chapters in this report deal with the three main policy challenges facing the new government (achieving stable and non-inflationary growth in the short term, boosting long-term growth, reducing inequality), with some chapters focusing more closely on implementation and measurement issues (Chapters 7, 9 and 13).

- **Achieving stable and non-inflationary growth in the short term:** Chapter 2 deals with monetary and fiscal policies that would preserve the strong economic recovery after the global economic crisis and the natural disasters of February 2010, while keeping inflation low. Chapter 8 looks at financial market policies that would further enhance the economy's resilience to adverse events.

- **Boosting long-term growth:** Chapters 3, 4 and 5 look at reforms on product and labour markets and in education policy that would enhance the economy's long-term growth potential by raising productivity. Chapters 11 and 12 analyse trade and investment policies that would allow Chile to reap the full benefits of openness by strengthening links between foreign and domestic firms, and diversifying into services. Chapter 10 highlights how environmental policies could support sustainable long-term growth.

- **Reducing inequality:** Apart from dealing with education quality issues, Chapter 4 proposes reforms to improve equity in education. Chapter 5 includes an analysis of policies that would particularly improve labour market prospects for low-skilled workers, and Chapter 6 looks at social policy.

Chapter summaries

Chapter 2: Locking in growth: Macroeconomic and structural policy challenges

The main challenge for macroeconomic policy in the short term is to return to a path of stable and non-inflationary growth. Chile was well prepared to deal with both the global recession of 2009 and the earthquake and tsunami of early 2010. The macroeconomic framework had largely shielded the economy from overheating in the copper price boom that preceded the crisis, and the government had accumulated a large financial buffer. As a result, the central bank could provide a large monetary stimulus without un-anchoring inflation expectations, and the government could easily finance a large fiscal stimulus. These exemplary macroeconomic policies contributed to the strong rebound of economic activity and ensured that the economy rapidly overcame the aftershocks of these adverse events. In the short term, macroeconomic policy will need to preserve the momentum of the recovery while containing inflation. As argued in past OECD Economic Surveys of Chile structural reforms may contribute to further enhance the economy's resilience in the face of adverse events and accelerate convergence towards income levels prevailing in advanced countries.

If the recovery continues as currently expected, monetary and fiscal policy should continue the exit from exceptional stimulus. Activity rebounded vigorously after the natural disasters of February 2010, with output growing 7% in the third quarter and domestic demand expanding by almost 20% (annual rates). The dynamism of domestic demand and increases of international commodity prices have already led to increases in inflation, which the market expects to be above the central bank's target of 3% by the end of 2011. If activity continues to be as strong as currently expected, with excess capacities diminishing rapidly, the central bank should continue to withdraw exceptional monetary stimulus to maintain medium-term inflation expectations well anchored. Similarly, under the same conditions, fiscal policy should make early progress towards reducing the structural budget deficit.

Financial buffers have been partially depleted and should be restored to handle possible future contingencies. During the economic emergency of 2009, the government used a mix of debt issuance and repatriation of assets in the sovereign stabilisation fund to finance the fiscal stimulus. This reduced the assets in the sovereign stabilisation fund by around half, and net government assets decreased from a peak of around 20% of GDP at the end of 2008 to around 10% in June 2010. Although from an international perspective the government remains in an enviable position to face economic and natural emergencies, the depletion of assets in the sovereign stabilisation fund has been relatively fast and it may be prudent to restock it. This would restore safety margins to deal with possible future economic or natural emergencies and preserve the country's low sovereign risk premiums. It would also alleviate the pressure on the Chilean peso, which has appreciated strongly over the past year.

Structural reforms will be needed to resume the pace of convergence with OECD living standards of the 1990s. In the 2000s, growth of per capita GDP slowed to less than half the pace of growth during the "golden age", 1986–97, and GDP per capita remains around two thirds lower than in advanced OECD countries. As shown in several OECD Economic Surveys of Chile, continuing and consolidating structural reforms to enhance human capital, to strengthen competition in product markets and to improve the functioning of labour markets would go a long way towards resuming faster catch-up with OECD living standards. Reforms to address quality and equity issues in secondary and vocational education and to foster innovation in firms would spur productivity growth and the adoption of new technologies. Productivity and investment could also be boosted by easing burdensome business regulations for start-ups, reforming the inefficient bankruptcy procedure and implementing the new Competition Law effectively. In labour markets the main challenges are to raise female labour market participation from low levels and reduce informality, which remains high by OECD standards.

Chapter 3: The productivity challenge: Enhancing competition, entrepreneurship and innovation

The stagnation of productivity after 1998 prevented Chile from growing even faster over the past two decades. Whereas macroeconomic management has improved markedly, a number of weaknesses in structural policies have prevented faster productivity growth: product market competition, as measured by price-cost margins, remains weak by OECD standards. Further, regulations on entry and exit discourage entrepreneurial risk taking and the diversification into new and higher-productivity activities. Although recent reforms of the innovation policy framework aim at broadening the focus of innovation policy from basic public research to all forms of innovation, technological and non-technological innovation in firms remain low.

A recent reform of competition law increases the investigative powers of the National Economic Prosecutor, introduces a leniency programme and increases the level of fines for cartel infringement. The well-designed reform must now be implemented effectively. The National Economic Prosecutor should receive sufficient resources to cope with a likely increase in caseloads, and deterrence for cartel participation would be strengthened by making price-fixing a criminal offence, as planned by the government. The current maximum fine remains too low to deter large corporations and risks undermining the effectiveness of the leniency programme, as immunity becomes more attractive the higher the fine. The authorities should therefore consider linking the maximum fine to sales on the relevant market.

Regulation of start-ups and the bankruptcy law need to be improved to foster entrepreneurship. OECD indicators show that administrative burdens on start-ups are higher than in most other OECD countries. Entry regulations in specific services sectors, such as registration and notification requirements in retail and exclusive rights in professional services, also appear to be more restrictive than in most other OECD countries. The government has recently enacted laws to reduce red tape for small and medium-sized enterprises and reduce the time to open a business from 27 to 16 days. To enhance entrepreneurship, Chile should further reduce administrative burdens on start-ups and facilitate entry into specific services sectors. The bankruptcy procedure is burdensome and grants creditors limited protection, which not only slows the exit of low-productivity firms but also holds back entrepreneurial risk taking and makes access to credit difficult. The government enacted a law that simplifies bankruptcy procedures for small and medium-sized enterprises. The authorities have also launched an inter-ministerial working group to assess options for reform, including the creation of specialised bankruptcy courts. Efforts to improve the bankruptcy procedure should be continued to facilitate the exit of inefficient firms and encourage entrepreneurial risk taking in innovative sectors.

Efforts to broaden innovation policy beyond basic research should be continued, but cluster strategies should remain based on market-like mechanisms, and potential risks should not be overlooked. The authorities have taken several measures to improve relationships between industry and the scientific community to make scientific research more market relevant. Among other measures, a research and development (R&D) tax credit has been introduced that requires the participation of research institutes external to the firm, and funding mechanisms that require matching public grants with funds from private businesses have been strengthened. As in most OECD countries, the government has started to support the formation of industrial clusters, which can foster diversification into non-traditional high-productivity sectors. But potential risks to public resources should not be overlooked. To avoid spending public resources without any inducement effect, or on sectors that turn out to be failures, clear performance objectives should be specified. For clusters that meet performance objectives, the need for continued public support should be reviewed periodically (sunset clauses), as private financing should eventually replace public support. For clusters that continually fail to meet their performance objectives, support should be withdrawn early to avoid the lock-in of failures.

Chapter 4: Quality, equity and equality aspects in the education system

Chile has made impressive progress in educational coverage and attainment, but despite recent improvements the quality of primary and secondary education is still lagging behind most other OECD countries. Primary education coverage is near universal and secondary and tertiary attainment rates have increased significantly in the last years. Yet, scores on standardised student tests, such as the Programme for International Student Assessment (PISA), remain well below the OECD average. One reason for uneven education quality is that, in contrast to top-performing school systems such as Finland; Hong Kong, China; Korea; and Singapore the Chilean education system fails to attract the most qualified individuals to the teaching profession. The government should therefore continue efforts to increase pay and offer scholarships for gifted students who plan to become teachers. In addition, teacher career paths in all publicly funded schools should be defined, while granting some flexibility in terms of teacher employment and pay to all school types. Clear opportunities for promotion to interesting positions for well-performing teachers would further increase the attractiveness of the teaching profession. Further policy options for improving teaching quality include more stringent accreditation requirements for initial teacher education programmes; changes in curricula in order to provide teachers with sufficient knowledge of subject content and professional training for practicing teachers; and the establishment of external exit exams to certify teachers.

Enhanced quality of primary and secondary education could also be achieved by strengthening quality assurance systems. Until recently, the Chilean education system was mainly based on free school entry and school competition, without government intervention to ensure minimum quality standards. Instead of enhancing learning outcomes for all students, schools seem to have competed by selecting the most able students, at least to some extent. To address this issue, the government has recently prohibited such selection until the sixth grade of primary school, and it plans to introduce a quality assurance system. A new superintendence will be responsible for monitoring school compliance with laws and regulations, and an agency will evaluate education quality in schools. Both agencies will have the authority to impose sanctions in case of non-compliance or underperformance. These reforms bring Chile closer to OECD best practice, but the government should ensure that new agencies co-operate efficiently to avoid inconsistent policies across agencies and the duplication of tasks.

There is a need to improve outcomes for students with sub-standard results even more than for the others to reduce inequality in education outcomes, which remains high by OECD standards. The socio-economic background explains a large share of the variance of PISA test scores compared to other OECD countries, indicating that the school system does little to provide equal opportunity to all children. The government has recently increased the value of the education voucher for children from poor families. To receive the higher subsidy, schools must register with the *Subvención Escolar Preferencial* (SEP) and will be subjected to a relatively stringent quality assurance system. While the extra money could help poor children obtain a high-quality education, the government should closely monitor the schools' results and provide support to ensure the money is spent efficiently. To achieve high education quality in schools enrolling a high number of vulnerable children, particular attention will have to be paid to students at risk of falling behind, as the experience in top-performing OECD countries such as Finland has shown. It would be desirable to integrate the quality assurance system for SEP schools into the planned quality assurance system for all schools, once it is established, which would prevent it from becoming a disincentive for schools to register with the SEP programme.

Investing more in early childhood education would also contribute to improving equity in the Chilean education system. Although the government has made important progress in increasing the capacity of early childhood education through the expansion of kindergarten and nursery schools, there remains scope to enhance its quality by developing standards for initial education of pre-school teachers and more stringent accreditation procedures for initial education programmes for pre-school teachers.

Chapter 5: Employment challenges: Labour market flexibility, informal employment and employability

The main challenges in the Chilean labour market are low levels of labour market participation among women and youth and low labour productivity, partly due to a high share of informal employment. The female labour market participation rate stood at 47% in 2009, compared to an OECD average of 62%, and only 26% of youth were in employment, compared to 40% on average in the OECD. Around 30% of workers are estimated to be employed in the informal sector.

A high minimum wage and high severance pay for permanent workers contribute to a segmented labour market. The minimum wage expressed as a proportion of the average wage is higher than the OECD average, which may have raised unemployment and informality, in particular for low-skilled and young workers. The government should consider increasing the age for receiving a full minimum wage from 18 to 25 and prescribe lower rates (increasing with age) for younger workers. Severance pay is also high by international standards, reducing employer incentives to formalise employment relationships. The government should consider reducing severance pay while further expanding unemployment insurance. This would both protect workers more effectively during temporary spells of unemployment and improve incentives for formal work.

The expansion of unemployment insurance as an alternative to severance pay requires enhanced employment services and job-related training. The Chilean unemployment compensation scheme is based primarily on individual accounts financed through employer and employee contributions. These accounts have the advantage of providing strong incentives for job search, but they may provide insufficient protection to some workers who have accumulated only small balances in their accounts, or during periods of high unemployment. Therefore, in 2009 the government eased access to the Solidarity Fund, which pays unemployment benefits independent of individual account balances. As this re-introduces an element of moral hazard by reducing worker incentives to look for a job, the public employment service needs to be enhanced and the possibility of merging it with the national employment agency should be considered.

A further barrier to hiring is collective agreements that often fail to provide an appropriate degree of flexibility for employers, while protecting only a relatively small group of labour market "insiders". Employment relations are characterised by a lack of trust between employers and workers, partly because of weak and unpredictable enforcement of labour regulations and limited coverage of unions and business associations. To achieve more co-operative labour relations, the government should promote union representativeness and collective bargaining in enterprises. Flexibility for employers could be achieved by including issues other than wages, such as working hours, overtime, shift work and social benefits, in collective agreements.

There is a need to enhance vocational education and training (VET) and lifelong learning to raise labour productivity. The VET system, which is especially important for mobilising human capital and supporting future economic growth in emerging countries such as Chile, remains fragmented. The lack of articulation between the different levels and institutions that provide VET inhibits the recognition of professional qualifications. To facilitate the acquisition of relevant professional skills, the government is currently setting up a qualifications framework to certify vocational skills at the national level. This effort to develop the education and training system for lifelong learning must be accorded high priority and should be complemented by improvements in the quality of enterprise training, in particular in the smallest firms. There is also a need to improve workplace training in upper secondary education and achieve effective consultation between the VET system and employers.

Chapter 6: Improving equality and reducing poverty

Despite sustained economic growth and a sharp decrease in absolute poverty over the past two decades, social mobility in Chile remains low and inequality high. Poverty decreased from around 39% of the total population in 1990 to around 15% in 2009 but inequality, as measured by the Gini index, remains higher than in any other OECD country. Social mobility, as measured by the correlation between fathers' and sons' incomes, is among the lowest in the OECD. The government has made important efforts to combat poverty through social programmes such as *Chile Solidario*, which gives the poorest households access to health and education services and provides limited cash benefits. The government has also introduced a basic solidarity pension guaranteeing a minimum pension to workers with patchy employment histories who fail to accumulate sufficient balances in their individual accounts. Although the Chilean social assistance system is good at identifying needy households, spending on social assistance remains limited and has had little impact on income inequality. As unequal countries at a given point in time also tend to be the ones with the least social mobility, there is a need to reduce the different forms of inequality to break the cycle of disadvantage across generations and promote equality of opportunity. OECD experience suggests that targeted early childhood interventions in the areas of health, nutrition and education are essential tools to promote social mobility.

Improving job opportunities for the poorest households would also contribute to reduce inequality and enhance social mobility. Employment rates among the poorest 10% of households are around 30%, whereas they are around 70% for the richest 10%. Helping parents find work can be more effective than cash transfers in fostering social mobility, as parental behaviour is transmitted across generations. The training and job-search requirements in the Ethic Family Income (EFI) programme, which will modify and replace existing social programmes, may boost the labour supply from disadvantaged households, but the quality and capacity of public employment services must be improved. The existing employment services infrastructure has been inadequate to help many disadvantaged households get into paid employment. As the EFI will entitle poor households to services and cash transfers conditional, among other things, on their current income, the government should reinforce its efforts to adapt the Social Protection Record to accurately measure short-term income changes. This would allow better targeting and improved incentives to work.

Achieving consistency of social policy across ministries and avoiding duplication of work will require effective collaboration and co-ordination between the new Ministry of Social Development and other stakeholder ministries. Therefore, clear guidelines on the distribution of responsibilities between the new Ministry of Social Development and the stakeholder ministries need to be developed. This will require strong leadership from the President's Office, the Budget Office and the new ministry.

Chapter 7: Enhancing the capacity of Chile's public administration

Sound public finances put the government in a comfortable position to finance the implementation of its ambitious agenda, but there is a need to enhance strategic planning. The detailed outline of the government's agenda in the *Compromisos 21 de Mayo* is in itself a commendable measure, as it increases transparency and accountability. While prudent fiscal management over the past few years will facilitate the financing of the government's agenda, more needs to be done to extend the time horizon of strategic planning and achieve better co-ordination between ministries. Currently, strategic objectives can change after 12 months and co-ordination between ministries on longer-term objectives is limited, which can jeopardise longer-term government priorities. Weaknesses in strategic planning can be particularly problematic in complex policy areas, such as education, health and social policy, which often need the interaction of several ministries and which require time for results to become apparent.

Resource flexibility will need to be promoted further, in particular by enhancing the capacity of human resources. The natural disasters and mining accident of 2010 have demonstrated that flexibility in the government's capacity to move human and financial resources to strategic priorities can reduce pressure on public spending and lead to more efficient public service provision. In response to the earthquake, for instance, the government swiftly shifted financial resources to reconstruction projects. An important element of resource flexibility is the capacity of the public administration's staff to implement the government's strategic priorities. In Chile, the duality between public employees who are hired on permanent contracts (*planta* system) and those that are hired on more flexible contracts (*contrata* or *honorarios* system) can generate inefficiencies. In particular, it can lead to short-termism and the loss of institutional knowledge when employees on short-term contracts leave. The government should consider giving public sector managers more flexibility to adapt to needs and reward performance.

Administrative streamlining should be continued across all areas of public administration. This has hitherto focused on specific sectors, such as small and medium-sized enterprises, international trade and health. To avoid possible incoherency, the government should consider a comprehensive approach across all sectors of public administration. Reforms should be based on consultation with the public, thereby ensuring that regulatory reform is driven by the needs of citizens and firms.

Chapter 8: Strengthening the financial system in Chile

Compared to many other OECD countries, Chile's financial system has weathered the global financial crisis relatively well, but further improvements in the regulatory and supervisory structure may nonetheless be needed. During the global financial crisis no major banking failures occurred and the Chilean financial market recovered quickly from the initial uncertainty. This was in large part due to prudent regulation, and in particular a prudent approach to authorisation of complex financial products. Although the Chilean financial system proved to be resilient during the global financial crisis, the government could take measures to modernise the regulatory and supervisory frameworks to prevent future vulnerability. The current move to consolidate credit information concerning banks and non-banks would enable informed credit ratings of retail consumers, and limit the potential negative impact on bank soundness.

Chile has quantitative investment regulations, which effectively drive investment decisions such as the extent of diversification in the portfolios of insurers and pension funds. However, risk management processes are needed to manage and mitigate operational risks, and to complement investment regulations.

Full, risk-based supervision that focuses on a more pro-active risk assessment by the supervisors of insurers and pension funds is currently being piloted in Chile and is expected to be rolled out at the beginning of 2011. With the introduction of a more risk-based supervisory system, formal risk-management guidance from the supervisors is likely to be forthcoming.

A long-standing issue is the independence of the financial supervisory authorities. The supervision of financial entities is shared between the Superintendence of Banks and Financial Institutions (SBIF), the Superintendence of Securities and Insurance (SVS), and the Superintendence of Pensions (SP). While the Chilean supervisors are generally considered competent, there is scope to grant them greater operational independence. The government could consider introducing minimum terms for the heads of supervisory agencies and ensure these can only be removed for reasons specified by law. Their appointment should be carried out through a transparent and competitive selection process and their terms of office should not coincide with the ones of the president.

Almost all banks, securities market intermediaries and pension funds, and many insurance companies, form part of corporate groups with activities in at least one other financial sector. Yet, Chile does not have a system of consolidated supervision and relies on “firewalls” between activities and voluntary information exchange in the Superintendents Committee. International best practice indicates that supervisors should supervise financial groups on a consolidated basis and apply prudential standards to all activities conducted by the group. In Chile, it is unclear to what extent individual supervisors have adequate information regarding the entirety of group activities. The government should therefore establish a system of consolidated and group-wide supervision, which would help detect the build-up of risk in complex groups and conglomerates early on, and thereby further enhance the resilience of the Chilean financial system.

The level of financial education of Chile's population is uneven and could be strengthened. OECD best practice shows that a consistent national strategy on financial education can be an important element in strengthening the financial system to prevent problems such as over-indebtedness of consumers. The government could consider including financial education in school curricula and further improve the transparency of information and advice on all financial products. In the Chilean pension system, households bear most of the responsibility for their future pension income. Chile has made some significant initiatives to improve financial literacy and awareness in the area of pensions, but this remains a key challenge for Chile going forward.

Chile has a strong pension system and regulation is comprehensive and generally well-designed. Nevertheless, a few key reforms could further strengthen the system and help secure pension savings for Chileans. These reforms would include improving coverage of the system to the informal and self-employed sectors, raising contribution levels, promoting later retirement.

Chapter 9: Regional development policies: Co-ordination across levels of government

A stronger regional approach to economic development in Chile would help to better exploit regional growth opportunities. This would improve the country's overall performance and contribute to reduce persistent income per capita discrepancies across Chilean regions. Although part of these discrepancies results from differences in unemployment rates, the major part is attributable to gaps in productivity.

Improving productivity will require context-specific territorial policies, in particular in the areas of innovation, and education and training. Currently, economic development strategies are mostly decided from the centre, and R&D and the leading higher education institutions are concentrated in the Capital. Further efforts to promote more equal opportunities for human capital enhancement across regions may be needed, including in the areas of in-work and vocational training. In addition, the government's cluster strategy may benefit from taking into account regional needs and growth opportunities more effectively. Finally, improving access to infrastructure, basic services and telecommunications in rural areas and peripheral regions represents a potential source of growth. Boosting regional growth through these context-specific territorial policies would not only benefit growth at the national level but also territorial cohesion, an important element of a sustainable open economy

Chile has traditionally been a country with a high degree of fiscal and regulatory centralisation. In recent years, some responsibility for regional planning has been delegated to the regions. Recent reforms transferred several administrative functions to the regional and local level, and strengthened multi-level governance arrangements (programming agreements). This will probably bring benefits in terms of better alignment of sectoral and regional policy priorities and identification of growth opportunities. Yet, there is a need to further extend the regions' responsibilities in the planning and co-ordination of regional policies. The devolution of more responsibilities to the regions should be accompanied by efforts to enhance the regional authorities' capacities, and to strengthen performance management.

Chapter 10: Chile going green

Chile's rapid economic development over the past two decades has been accompanied by mounting pressures on natural resources. The booms in mining, forestry and aquaculture have contributed to air, water and soil pollution. Since the 1980s Chile has implemented environmental policies, often using innovative instruments and regulatory reforms. For instance, it has pioneered tradable permit mechanisms for water rights, particulate emission permits in Santiago, and fishing quotas, which have provided valuable experiences for Chile and other countries. However, there is a need for integrating environmental objectives into a wider range of key economic sectors, such as mining, forestry, tourism, energy, agriculture, aquaculture and transport, to achieve green growth. The government should make broader use of market-based instruments, such as environmental taxes and permit trading. For instance, there is scope to apply the experiences from the tradable permit schemes pioneered in the 1980s and 1990s to a wider range of activities.

Chile's water resources and export-oriented agribusiness sector are likely to be adversely affected by climate change. Although Chile participates in the Clean Development Mechanism (CDM), with around 40 projects to reduce greenhouse gas emissions completed since 2004, it has currently no legally binding emission limits under the Kyoto Protocol. The government could make further progress in reducing GHG emissions by formulating a national mitigation strategy that would include emission reduction targets and action plans for key economic sectors. There is also scope to phase out the stabilisation scheme for fuel prices, which effectively acts as a subsidy and counters the country's efforts to encourage the shift to renewable energies. Partly due to the cessation of gas imports from Argentina, Chile is planning to expand energy capacity through investments in new coal-fired power plants. From the perspective of private enterprises, this is particularly profitable because externalities associated with coal use are not internalised through fiscal instruments. The government should consider a carbon pricing scheme, which would re-direct current investments in energy capacity towards renewable energy sources.

Chile's unique natural resources and biodiversity are vital assets for economic sectors such as agriculture and tourism. As a result of its geographic isolation and its different latitudes, Chile boasts a large variety of ecosystems and a large number of endemic species. Whereas Chile adopted a National Biodiversity Strategy in 2003 and specific policies on endangered species in protected areas and wetlands in 2005, the national target of protecting 10% of all significant ecosystems by 2010 has not been met. Partly, this is due to the failure to acknowledge that the country's biodiversity is a vital asset for its tourism industry and that not meeting the National Biodiversity Strategy's targets may hamper the industry's future development. The government should therefore complete the implementation of the National Biodiversity Strategy. Sufficient resources should be devoted to reaching the target of protecting 10% of all significant ecosystems in Chile, possibly by making the tourism sector contribute to nature management and by making more extensive use of payments for ecosystem services.

The mining sector, an intensive water and energy user and a major emitter of air and water pollutants, represents a particular challenge for environmental policy. Copper mining accounts for a significant share of the country's power consumption. A significant share of sulphur oxides and particulate emissions and much mining wastewater from large companies remains untreated. Environmental concerns in the mining sector should be addressed under the polluter-pays principle, using economic and other instruments.

Chapter 11: Diversifying exports and improving competitiveness

Trade liberalisation has brought Chile substantial growth benefits, but exports remain heavily concentrated in natural resource intensive sectors. The country embarked on unilateral trade liberalisation in the late 1970s, and by 1990 it was applying a low uniform multilateral tariff of 15% on all imports. Formerly shielded sectors had to put up with import competition and exporters gained access to cheaper intermediate goods, which after an initial phase of adjustment raised productivity and GDP growth in the late 1980s and 1990s. Over the past two decades, the government has consolidated these reforms, bringing the multilateral tariff to 6%. Moreover, it signed a large number of regional trade agreements, which has brought the average applied tariff even lower (to around 1%) and has given Chilean exporters preferential access to their main export markets. As a result, Chile is now one of the most open economies in the world outside East Asia, with a ratio of trade to GDP of around 80%. However, the natural resource intensive copper, agriculture and agro-food sectors account for around two thirds of total exports, with other manufacturing and services accounting for the rest.

The specialisation on natural resource intensive exports reflects, to some extent, Chile's comparative advantage, but there remains scope to better exploit the benefits from the economy's openness. Natural resource intensive sectors generate only limited technological spillovers, since links with the rest of the economy are generally weak, as in the mining sector, or the level of technological sophistication is low, as in parts of the agricultural and fisheries sectors. Moreover, the mining sector generates only very little employment (less than 1% of total employment), although it accounts for around 15% of GDP. In the long term, sustainable GDP and employment growth can be achieved only through productivity growth, which requires advances in technology. The main challenge for trade policy in Chile is therefore to diversify into exports that are technologically more sophisticated and more closely linked to the rest of the economy.

To achieve greater export diversification, the government could build on existing areas of comparative advantage. Other mineral-exporting countries, such as Norway and Brazil, have diversified into mineral-related services, such as exploration, engineering and construction. Apart from opening new markets and new business opportunities, this has often brought upgrades in technologies, thereby enhancing productivity at home. Similar opportunities of diversifying into related services exist in the agri-business sector, in which marketing services can support the move from producing low-margin commodities to higher-margin differentiated products, as the experiences of the wine, salmon, pork and poultry sectors have shown.

The government's cluster initiative may help identify unexploited export opportunities, but risks to public resources should not be overlooked, and the government should continue to focus on improving the framework conditions for exporting. As part of the cluster initiative, the government will provide priority support to a number of specific sectors, including through the provision of sector-specific public goods, such as infrastructure and training, and the preferential allocation of innovation grants. The cluster strategy targets sectors with high growth potential in which Chile is seen to have a comparative advantage, which it has yet not fully exploited. While the cluster initiative has spurred a useful public debate on potentially unexploited export opportunities, there are risks to public resources of targeting resources at specific sectors. In general, the government's priority should be to improve the framework conditions for exporting through structural reforms to enhance human capital and to improve the functioning of product and labour markets. Human capital shortages and regulatory barriers to competition have hampered the development of services exports, which can play a key role in export diversification, as the experience of other natural resource abundant countries has shown. Structural reforms to address these issues would go a long way towards bringing services exports closer to their potential and to emulate successful mineral-rich OECD members, such as Australia and Norway.

Chapter 12: Making the most of an open foreign investment regime

Chile's foreign investment regime is very open, but foreign direct investment (FDI) remains heavily concentrated in natural resources, potentially limiting beneficial technology spill-overs. There are no prior-approval or screening requirements for FDI, and foreigners are legally granted the same treatment as nationals. Moreover, strong macroeconomic performance, sound institutions and a generally growth-friendly regulatory framework have enhanced the attractiveness of Chile as an FDI destination. As a result, Chile boasts one of the highest ratios of FDI to GDP in the OECD.

In the area of investment promotion and facilitation, there is a need to clarify the roles of the involved government agencies. A better co-ordination of investment promotion efforts and a reduced duplication of tasks could be achieved by clearly assigning responsibilities for country image building, investment generation, linkage promotion and policy advocacy. Furthermore, as the challenges for investment facilitation have shifted, there is a need for adaptation of the relevant agencies: away from giving investors certainty and focusing more policies to strengthen linkages with the domestic economy. The interest of foreign investors in special contracts that guarantee the invariability of tax treatment and the repatriation of profits and capital (DL600) has gradually decreased, as Chile's macroeconomic and fiscal framework improved markedly over the past two decades. As a consequence, investment promotion and facilitation can focus on strengthening linkages between the domestic economy and foreign firms and attracting investments with strong spill-over effects. These investment targeting policies can be useful to enhance the absorptive capacity of the domestic economy, but risks to public resources of targeting specific sectors should be borne in mind. Chile has distinguished itself by avoiding the pitfalls of special incentive schemes for foreign investment and any new program should carefully balance costs and benefits.

Chapter 13: Measuring progress and well-being: New concepts, new policies

Chile's accession to the OECD provides an opportunity for the government to improve broader measures of people's well-being, and to bring the priorities and concerns of the country into this agenda. Material living standards are generally measured using GDP, but well-being encompasses a wider range of elements. Over the past few years, in many OECD countries the gap between the development of GDP and households' perception of their well-being has grown. While GDP measures an economy's volume of production, it does not take into account a wide range of economic and non-economic factors, such as non-market household production, leisure, social conditions, inequality and the environment. Better accounting for these elements would enable the government to base policy, implementation and evaluation on a broader range of indicators. The government should identify critical dimensions of well-being, bringing together academics and civil society organisations to analyse the relevance and robustness of the data.

Some of the elements directly influencing well-being can be integrated in a monetary framework. In national accounts, health and education services received by households are measured based on the costs of the inputs used rather than the value of the output produced. A more accurate picture would be obtained by developing measures of health and education output, distinguishing between price and volume effects. With few exceptions, services produced by households for their own use, such as caring for family members, are also omitted from national account measures, even if (illustrative) calculations show that household production is large relative to conventionally measured GDP. Leisure time also contributes to individual well-being but, as it is not purchased on markets, it is not reflected in national account measures, leading to an implicit bias against countries that opt for enjoying more free time. GDP per capita measures also fail to account for differences in household size across countries; because of economies of scale in household consumption, for a given level of GDP per capita, individual well-being may be higher in countries with larger households. Finally, higher GDP may benefit only a small fraction of the population; changes in inequality can be taken into account by ‘weighting’ average incomes in each income decile or by looking at income changes at different points in the income distribution.

A more comprehensive view of well-being can be obtained by complementing monetary and non-monetary measures. Social conditions such as health and education determine well-being of each individual and of society as a whole. Indicators of social conditions are often only weakly associated with GDP per capita. In Chile, for instance, the GDP per capita gap with the United States widened in the late 1990s, while the gap in life expectancy, a measure of population health, continued to narrow. The natural environment also affects people’s well-being, by affecting their health status and the amenity value of the natural habitat for current and future generations. While an increase in GDP per capita may raise a society’s capacity to deal with environmental problems, it may also lead to pressure on the environment through higher energy and water consumption and higher emission of pollutants. Finally, individual well-being is to a large extent subjective and can be measured through surveys. While richer OECD countries generally report higher levels of life-satisfaction, the relationship between income and life-satisfaction is weak. In Chile, for instance, reported life satisfaction is close to that in much richer OECD countries such as France, Italy and Spain.

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