THE DAILY CALLER

The remarkable story of Chile's economic renaissance

By Daniel J. Mitchell & Julia Morriss | 07/18/2012

Thirty years ago, Chile was a basket case. A socialist government in the 1970s had crippled the economy and destabilized society, leading to civil unrest and a military coup. Given the dismal situation, it's no surprise that Chile's economy was moribund and other Latin American countries, such as Mexico, Venezuela, and Argentina, had about twice as much per-capita economic output.

Today, by contrast, Chile has passed Argentina to become the richest nation in all of Latin America. For three decades, it has been the fastest-growing economy in the region. Poverty has fallen dramatically, and living standards have soared.

Let's look at how Chile became the Latin Tiger.

Pension reform is the best-known economic reform in Chile. Ever since the early 1980s, workers have been allowed to put 10 percent of their income into a personal retirement account. This system, implemented by José Piñera, has been remarkably successful, reducing the burden of taxes and spending and increasing saving and investment, while also producing a 50-100 percent increase in retirement benefits. Chile is now a nation of capitalists.

But it takes a lot more than entitlement reform, however impressive, to turn a nation into an economic success story. What made Chile special was across-the-board economic liberalization. This chart, based on the five key variables in the Fraser Institute's Economic Freedom of the World (EFW) report, shows how Chile moved in the right direction over time.

	1980	1990	2000	2009
Size of Government	5	6.51	6.12	7.65
Legal Structure and Security of Property Rights	7.23	6.95	6.53	7.2
Access to Sound Money	2.31	7.65	9.3	8.97
Freedom to Trade Internationally	6.91	7.25	7.46	7.83
Regulation of Credit, Labor, and Business	6.9	6.82	6.98	7.52

Regarding business taxation, retained profits used to be taxed at almost 50 percent, but the tax rate was dropped to 10 percent in 1984. It hasn't stayed at that low level, but the rate has remained below 20 percent, so the tax system isn't a big barrier to production and businesses have freedom to invest more. Chile's score for size of government shows significant improvement since 1975. The pension reform presumably helped, as did reforms that lowered the top income tax rate from 58 percent in 1980 to 40 percent in 2005. But even that 40 percent rate doesn't capture the full benefits of reform. Personal income tax brackets were widened, helping many people protect more of their income from the government, and investors and entrepreneurs can benefit from lower tax rates by setting up businesses.

Not surprisingly, lower tax rates generated many benefits. Chile cut out many of the loopholes that favored certain interest groups and encouraged inefficient economic choices. Tax evasion dropped significantly because businesses didn't have to pay as much and their taxes became less complicated. Indeed, the government collected more total revenue because of the lower tax evasion. According to Friedrich Schneider's data on shadow economies (measuring "market-based legal production of goods and services that are deliberately concealed from public authorities"), Chile has the smallest underground economy in the region, with a country average score of 20.3. In comparison, Colombia scores a 41, Mexico a 30.2, El Salvador a 47.4, Ecuador a 36.6, and Brazil a 40.5.

Chile's former finance minister, Hernán Büchi, wrote a book about Chile's transformation, and he outlines the massive privatization plan that generated substantial benefits. Some of the major sales included the fuel distributor Copec, the main electric company Endesa, telephone and steel companies, and some of the banks, which took on private investors. The newly privatized companies had much more opportunity for development and expansion, exports increased, and new enterprises began to grow.

Helped by the privatization of these companies, Chile maintains a fairly good score for property rights. This has been especially evident in the mining sector. Büchi mentions how private investors entered the scene and production costs fell while production went up. This was seen around the country as markets were deregulated and private property rights were protected.

The access to sound money score improved dramatically between 1980 and 2010 as inflation decreased to less than five percent and freedom to have foreign bank accounts increased.

Along with expanding foreign currency freedom, Chile also improved its score in freedom to trade internationally. Export taxes, previously a crippling barrier, were almost eliminated, allowing foreign competition into the market. According to Büchi, domestic saving has risen to 18 percent and the average tariff dropped from 105 to 57 percent. In 1979, a 10 percent uniform tariff was put in place.

Büchi notes that as a result of these reforms, Chile's exports went from $3.8 billion to $8.1 billion from 1985 to 1989.

The regulatory burden also was decreased. The World Bank reports that it used to take up to 27 days to begin a new business in Chile; it now takes seven. Büchi mentions that investment rose from 11.3 percent of the GDP in 1982 to 20.3 percent in 1989. Domestic saving also rose during that time, from 2.1 percent of the GDP to 17.2 percent. As businesses experienced greater freedom to expand and develop, Chile saw more innovation with higher profits and savings.

So what does all this mean? Let's take a look at per-capita economic output in the major Latin American nations. As you can see, Chile was near the bottom in 1980 and now leads the pack.

This has meant good things for all segments of the population. The number of people below the poverty line dropped from 40 percent to 20 percent between 1985 and 1997 and then to 15.1 percent in 2009. Public debt is now under 10 percent of GDP and after 1983 GDP grew an average of 4.6 percent per year. But growth isn't a random event. Chile has prospered because the burden of government has declined. Chile is now ranked number one for freedom in its region and number seven in the world, even ahead of the United States.

The lesson from Chile is that free markets and small government are a recipe for prosperity. The key for other developing nations is to figure out how to achieve these benefits without first suffering through a period of socialist tyranny and military dictatorship.

Daniel J. Mitchell is a senior fellow at the Cato Institute. Julia Morriss is studying Law and Society at American University in Washington, D.C.