The Americas:

Chile's Left Covets the Fruits of Economic Success

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SANTIAGO -- Chile's socialist president, Ricardo Lagos, wants to be seen as a market reformer with a heart. His visit yesterday to the New York Stock Exchange -- to celebrate "Chile Day" -- is part of an effort to reassure investors that under his stewardship Chile will, once again, become the region's leading performer.

After having posted one of the fastest rates of growth in the world from 1987 to 1997 -- almost 8% a year on average -- Chile's economy has slowed considerably during the past three years. In 1999 the economy contracted by 1%. Mr. Lagos has said that Chile would recover in 2000, with a rate of growth of at least 6%.

Unemployment figures released last week, however, suggest that the economic recovery is running into trouble. Instead of declining, as the president promised, the rate of unemployment is increasing. This poses a serious challenge to Mr. Lagos, who promised during his 1999 campaign that 200,000 new jobs would be created this year. At 10.2%, up from 9.4%, the unemployment rate is an embarrassment for the administration. Chileans, who had become accustomed to the prosperity generated by the market reforms of the 1980s and early 1990s, are increasingly concerned about the country's economic future.

What makes Chile's economic blues particularly puzzling is that the Lagos economic team has, by and large, followed market-friendly policies. A major effort has been made to improve the government's finances, which badly slipped during former President Eduardo Frei's last year in office. Capital controls have been abolished, as have capital gains taxes on foreign investors. A new fishing law aimed at reducing distortions in this important sector has been submitted to Congress, and a bill that would modernize and ease regulations in the electric sector is almost ready. According to new measures being studied by Economics Minister Jose de Gregorio, every

government agency will have tight deadlines to rule on permits and licenses. Under this legislation, if there is no ruling within the predetermined time limits, the permits will be automatically approved.

Despite these good measures, Chile has economic problems thanks to deep political conflicts and contradictions within the ruling coalition, a mix of socialists and Christian Democrats known as the Concertacion. To wit, two separate wings of power are now fighting to set the government's tone. One, led by Minister of Finance Nicolas Eyzaguirre, is economically liberal, and has a vision of greater market freedom, while the other is a throwback to populist economics. Last week Mr. Eyzaguirre acknowledged this when he said that within the government there were influential groups that opposed progress and wanted to return to the state-dominated policies of the past.

A labor-reform bill about to be sent to Congress is a clear example of the anti-market forces. By forbidding firms to hire replacement workers during a strike, this bill would greatly increase the effective cost of labor. This higher cost will hit particularly hard small- and medium-sized firms, which have traditionally hired the largest number of workers.

What is more serious, however, is that according to recent statements by Minister of Labor Ricardo Solari, the government is considering active involvement in labor conflicts, as an arbiter. This will inject politics into the labor bargaining process and is a major step backward. As former U.S. Secretary of the Treasury George Schultz has repeatedly pointed out, one of the most important aspects of successful labor policies is keeping the government out of labor negotiations.

Paradoxically, Chile's current labor legislation provides for an efficient -- although little used -- privately run arbitration procedure. Indeed, Chile is one of the few countries with a "final offer" arbitration mechanism. According to this procedure, once the arbiter is called in by the negotiating parties, he is constrained to rule in favor of one of the two proposals made by the parties. In this way, the system introduces incentives that discourage the parties from making extreme demands as a bargaining strategy.

Ill-conceived labor reform is only one of Mr. Lagos's problems. Equally, if not more serious, is the rejection by some key government officials and Concertacion legislators of the modernization process, particularly in the area of privatization.

During the 1970s and 1980s Chile embarked on an ambitious privatization program that was at the heart of the country's robust 1987-97 growth spurt. Yet the country continues to maintain a large number of state-owned-enterprises, including the copper giant Codelco, the mining

complex Enami, the oil company Enap, as well as a large number of water supply companies. While moving the country to the next stage of development obviously requires a revitalization of the privatization program, the opposite is happening.

Two weeks ago the executive vice president of Codelco announced that the company had decided to acquire a controlling interest in a Canadian-owned mining firm. Though it now seems that this particular deal will not go through, the fact that Codelco is expanding rather than being privatized is disturbing. Market skeptics within the administration even oppose a plan to list the company publicly on the stock exchange.

Moreover, in recent weeks Mr. de Gregorio has had to publicly defend the sale of one state water company, part of Mr. Lagos's timid privatization program, from attacks by two prominent Concertacion senators. When the debate got too hot, Mr. Lagos himself stepped in, and decided to temporarily halt the privatization process.

Chile is at a crucial juncture, and Mr. Lagos has to make a key decision. He either sides with the market skeptics and statists, or he fully supports his finance and economics ministers, and asks them to put together a truly innovative pro-competition program. Such a program would have to include the privatization of all state-owned firms -- including, of course, Codelco -- a modern labor law with no active government role in the bargaining process, massive deregulation, a firm commitment to further market opening and lower effective tax rates. Supporting the market skeptics will endear him to "third way" advocates but will condemn Chile to becoming the "miracle that was."

Enthusiastically embracing the pro-modernization option will require political courage, but will also give Chile the opportunity to recapture the magic of the 1987-97 Chilean miracle.

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