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# The Socialist-Populist Chilean Experience, 1970–1973

Felipe Larraín and Patricio Meller

## 7.1 Introduction

Chile's experience under the Unidad Popular government of President Salvador Allende is a unique blend of socialism and populism that has not been present in other Latin American populist experiences. It was not merely an unsustainable expansion of aggregate demand to achieve distributive goals. Marxist ideology played a key role in the Unidad Popular economic program, as the ultimate goal was to replace the capitalist system with socialism.

Most of the economic discussion during the initial period of the Allende government was focused on the massive and deep structural changes that were being implemented in the Chilean economy. These involved a substantial transfer of assets and resources from the private sector to the state. Even though income redistribution was a high-priority goal for the Unidad Popular, the sharp and fast increases in real wages had an additional purpose: they were intended to increase the workers' political support for the program so that the government could advance with the structural changes from a strong base.

Macroeconomic policies initially played a highly supportive role for the implementation of the structural changes that the Unidad Popular promoted. But, as point out by Dornbusch and Edwards (1989), a sharp expansionary macroeconomic program is implemented by populists without any regard for internal or external constraints. Therefore, eventually, the initial success ends in complete failure.

The second section of this paper provides a short overview of the Chilean economy before 1970. It also includes the Unidad Popular's particular diag-

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nosis and perceptions of the Chilean economy and its economic proposals. As will become clear later on, populism is only one aspect of a more complex picture. Section 7.3 studies the deep structural reforms with a special discussion for each one of the main sectors: copper nationalization, land reform, bank statization, and industry takeover. Various effects of these reforms, including the uncertainty that they generated over property rights, are discussed at the end of the section. Section 7.4 provides an overview of the macroeconomic policies and their results. There it becomes clear that, after a seemingly successful beginning, the Unidad Popular experiment ended in a full collapse. Section 7.5 provides the conclusions.

## **7.2 The Chilean Economy before 1970 and the Unidad Popular Perspective**

### **7.2.1 Selected Aspects of the Chilean Economy before 1970**

During the 1950–70 period, Chilean economic performance was characterized by chronic and high inflation, moderate growth, and frequent balance of payments crises. In fact, the country's economy constituted one of the prototype cases used on the old structuralist-monetarist controversy. On the other hand, Chile had for a long time a very stable democratic political system that constituted a hallmark among Latin American countries.

A highly schematic description of the two administrations prior to 1970 highlights the elements that follow.<sup>1</sup> The government of President Jorge Alessandri (1958–64) was elected with the support of conservative and center-right parties, obtaining 34% of the votes. Initially, its main economic focus was inflation stabilization. Over the longer term, its perspective included two main elements: (1) After the success of the anti-inflation program it was considered that the improved economic conditions would automatically stimulate growth. (2) The distributive problems would mainly be solved by the trickling down of the economic expansion. The Christian Democrat administration of President Eduardo Frei (1964–70) came to power with an absolute majority of 56% of the popular vote. It was supported by a spectrum of political parties spanning from right to center. The government's main economic focus was the implementation of basic structural changes such as the land reform process and the Chilean participation in the ownership of the Big Copper Mines (owned by American companies at that time). The Christian Democrats' long-run perspective could be synthesized as an attempt to redistribute with growth, in a scenario of changes to the ownership structure of some economic sectors (copper, agriculture).

The Frei government, which preceded the Unidad Popular period, at-

1. For a detailed analysis and review of the economic policies of these two governments see Ffrench-Davis (1973).

tempted some basic structural reforms that were slowly implemented in order not to impair macro stability. In this respect, there was a certain perception that structural reforms could generate short-run disequilibriums. Thus, when there was an accumulation of inflationary pressures, priority was to be given to the restoration of macro stability. The agrarian reform process was implemented to change the existing skewed pattern of land tenure and to incorporate the peasants to the political and economic structure. "Chileanization" of the Big Copper Mines implied that Chile acquired a 51% share of the ownerships of the big mines through bargaining. Government expenditures on social areas were increased and oriented mainly toward middle- and low-income groups. At the same time, the government provided guidelines for wage readjustments, which included a 100% backward CPI indexation.

During the 1960s there was a sharp increase in political and social activity. The number of registered voters grew from 1.5 million people in 1958 to more than 3.5 million people in 1970; the percentage of voters with respect to total population, which had been around 15% prior to 1960, went up to almost 30% by 1970 (Bitar 1979). Furthermore, the number of people affiliated with unions doubled during the Frei government. In a six-year span, blue-collar union membership increased by 38%, white-collar union membership increased by 90%, and peasant union membership grew from less than 2,000 people (1964) to more than 114,000 people (1970); (see table 7.1).

A synthesis of the evolution of the main macroeconomic variables during the Frei government, using annual averages for the 1965–70 period, is provided in table 7.2. The growth rate (GDP) was 3.9%, while inflation reached 26%; the national unemployment rate was 5.6%; the increase of real wages was 9.7% per year; and the level of the fiscal deficit (as a percentage of GDP) was 2.1%. Table 7.2 also provides the evolution of these variables for each year between 1968 and 1970. It is clear from these figures that the first part of the Frei government had, in general, a better performance with respect to growth and inflation than that corresponding to the latter part.

Table 7.3 provides the evolution of external-sector variables for the 1968–70 period. Total exports were more than \$1.1 billion (in U.S. dollars), of which copper had a share larger than 75%. The 1968–70 period was positively influenced by the high world price of copper, which reached its all-time high

**Table 7.1**                      **Number of People Affiliated with Unions in Chile**  
(Number of Affiliates)

	Blue-Collar Workers	White-Collar Workers	Peasants	Total
1958	154,650	119,666	2,030	276,346
1964	142,958	125,926	1,658	270,542
1970	197,651	239,323	114,112	551,086

Source: Bitar (1979).

**Table 7.2 Selected Macroeconomic Variables in Chile, 1965–70**

	Economic Growth (GDP) (1)	Annual Inflation Rate (CPI) (2)	National Unemploy- ment Rate (3)	Annual Increase of Real Wages (4)	Fiscal Deficit (5)
1968	2.9	27.9	4.9	-2.0	1.5
1969	2.9	29.3	5.5	4.3	0.4
1970	3.6	34.9	5.7	8.5	2.7
Average, 1965–70	3.9	26.0	5.6	9.7	2.1

Sources: Col. 1, 2, 3, and 5: ODEPLAN and Central Bank.

Note: All figures are percentages; col. 5 is % of GDP.

**Table 7.3 External Sector Variables for the Period Prior to 1970 (in Millions of U.S. Dollars)**

	Exports FOB	Imports CIF	Current Account Balance	Balance of Payments	Level of International Reserves
1968	911	802	-135	118	125
1969	1,173	927	-6	175	285
1970	1,112	956	-81	114	394

Source: Central Bank.

in real terms during these years. Regarding international reserves, it had always been at the two-digit level before 1968. The relatively large level of foreign reserves achieved in 1970 (\$394 million; i.e., almost five months of imports) was considered by the Frei government as an indicator of responsible economic performance.

Popular perceptions about the Frei government in 1970 were mixed. On the one hand, there had been a good initial performance during the first three years, when growth increased and inflation was reduced. But on the other hand, at the end, there was a sense of frustrated expectations between the increased political and social participation and the expected economic outcome. In this respect it is interesting to note that in spite of a sustained and relatively important increase of real wages during the Frei government, the number of strikes increased considerably (see table 7.4). Moreover, the macroeconomic responsibility to contain inflationary pressures, which prevailed from 1967 on, was neither supported by nor understood by most of the workers, even though there was no deterioration of real wages and no significant increase of unemployment.

Perceptions about the evolution of the economy during the Frei government (i.e., a good performance at the beginning and a sharp slowdown later) hurt

**Table 7.4** Number of Strikes and Evolution of Real Wages

	1960-64 <sup>a</sup>	1965	1966	1967	1968	1969	1970
Number of strikes	98	142	586	693	648	1,127	1,580
Annual increase of real wages (%)	.0	13.9	10.8	13.5	-2.0	4.3	8.5

Sources: Number of strikes: Martner (1988); real wages: Ffrench-Davis (1973).

<sup>a</sup>Figures provided correspond to the total for the period, i.e., the total number of strikes was 98 during 1960-64; 0 was the annual average and the total change of real wages in the 1960-64 period.

the Christian Democrats' presidential candidate in 1970, who finished third in the election. Salvador Allende, as head of a coalition of left and center-left parties (the Unidad Popular), was elected President with 36% percent of the vote.<sup>2</sup>

### 7.2.2 The Unidad Popular Diagnosis of the Chilean Economy

According to the Unidad Popular (UP), the Chilean economy presented four major characteristics by 1970 that had to be corrected. According to them, the economy was monopolistic, (externally) dependent, oligarchic, and capitalistic.<sup>3</sup> In what follows, we provide the diagnosis of these problems from the UP's perspective.

The following indicators for the 1960s provided the evidence on the alleged monopolistic nature of the economy (i.e., its degree of concentration): (a) 248 firms controlled all of the economic sectors, and 17% of all enterprises concentrated 78% of total assets (Alaluf 1971). (b) In industry, 3% of the firms controlled more than 50% of value added and almost 60% of capital. (c) In agriculture, 2% of the farms owned 55% of the land. (d) In mining, three foreign (U.S.) companies controlled "large mining" copper production, which represented 60% of Chilean exports by 1970. (e) In wholesale trade, 12 enterprises (which represented 0.5% of the total) accounted for 44% of all sales. (f) In banking, the state bank (Banco del Estado) controlled close to 50% of all deposits and credits. However, it was pointed out that 3 banks (of a total of 26 private banks) controlled more than half of the remaining 50% (Bitar 1979).

These big monopolists had allegedly increased their share and their profits thanks to special state measures, like preferential credit lines, subsidies, special tax incentives, tariff differentials, and special access to foreign exchange

2. The candidate who finished second (former President Jorge Alessandri) got 35% of the vote, while the candidate of the Christian Democrats (Radomiro Tomic) got 28%. The total number of voters was 3 million, and the difference between Allende and Alessandri was less than 40,000 votes.

3. For a deeper discussion of these issues see Aranda and Martínez (1970), Caputo and Pizarro (1970), Ramos (1972), and Bitar (1979).

(Alaluf 1971). In short, and according to a UP analyst, “the role of the state has always been to favor large monopolistic capital and its fundamental interests” (Ramos 1972).

Different aspects were pointed out on the issue of Chile’s external dependence, including (a) the mono-export nature of the country, where copper (large, medium, and small mines) represented more than 75% of total exports. This implied that fluctuations of the copper price in world markets would have a major impact upon the Chilean balance of payments and upon government revenues. Also of note was (b) the relatively high profit remittances by foreigners, which represented around 20% of exports, and (c) the high share of multinationals in Chilean industry. Of the largest 100 industrial firms at the end of the 1960s, 61 had foreign participation.

According to Vuskovic (1970), the significant presence of foreign firms led to high dependence because of two main reasons. (1) Imported technology determined that Chile’s production methods were copied from the outside. (2) Chile also acquired the developed countries consumption pattern, that is, the “demonstration effect.” In synthesis, foreign forces imposed what to consume and what to produce. These issues highlighted the increasing importance and presence of foreign capital. And, moreover, the Chilean bourgeoisie had begun to acquire a pattern of preferences and interests that were more identified with international capital than with national interests.

The oligarchic feature was justified on the highly skewed income distribution of the 1960s. While the poorest 10% of the population had a 1.5% share of total income, the highest 10% income group had a 40.2% share of income. The ratio between the income of both groups was 1 to 27.<sup>4</sup>

Given the above characteristics, and from the UP viewpoint, the fruits of Chilean economic development were highly concentrated on a small privileged elite, thereby excluding low-income groups from the benefits. According to Vuskovic (1970), this process was self-perpetuating and worked in the following way: (1) The inequitable income distribution generated a given pattern of consumption and demand, and thus the market was dominated by the goods in demand from the high-income groups. Accordingly, modern firms’ production was designed only to satisfy this type of demand. (2) There existed a dual productive system, with a modern high-technology sector and a backward one. Only the modern sector incorporated technological progress in their production of goods for the high-income groups, while the backward sector remained stagnant. The increasing participation of foreign investment reinforced the prevailing dual structure of the economy. (3) Due to the relatively reduced volume of goods demanded by the high-income groups, and given its wide spectrum, modern firms produced a low level of output; therefore, they were operating at an inadequately low scale with a poor efficiency level. In

4. At the end of the 1960s the Chilean Gini coefficient was 0.51, lower than Brazil (0.58) and Mexico (0.58) but higher than Argentina (0.44) (Bitar 1979).

short, the production structure was inefficient, as it produced mostly non-essential goods for high-income groups. The small output scale led to a higher monopolistic concentration level, which reinforced the skewed initial income distribution pattern.

To summarize the UP perspective, Chile was characterized by a vicious circle, where the unequal original income distribution pattern generated a highly monopolistic productive structure, which reinforced the existing skewed income pattern. The structure of the economy got more and more oriented toward the satisfaction of consumption patterns of the high-income groups, while there existed stagnation of productive sectors producing (essential or basic) wage goods for the majority. The income and wealth inequalities led to a high degree of concentration of power, that is, only a few had control upon the main decisions. Thus, the interrelationship between political and economic power reinforced the prevailing structure of the country. In order to change the economic conditions it was required to alter substantially the property structure. This would generate a different demand pattern that would stimulate the production of basic goods consumed by the big majority. Then, economic resources would not be wasted in the production of nonessential goods (Vuscovic 1970; Bitar 1979).

### 7.2.3 The Unidad Popular Economic Proposals

The UP program made an explicit statement about its anti-imperialist, anti-oligarchist, and anti-monopolist nature, which set the tone for the deep structural changes that it proposed to follow. As a counterpart, the program stated that it would benefit workers in general (blue collar and white collar), peasants, and small entrepreneurs, that is, the big national majority. The UP government was going to be a historical experiment where the implementation of the transition toward socialism would be carried out using the existing institutional structure. Two elements were required to facilitate this transition: statization of the means of production and increased popular participation.

The political objectives of the UP were stated very clearly (Martner 1988). The alleged purpose was the establishment of the most democratic regime in Chilean history through the transfer of power from the dominant groups to the workers and the peasants. To achieve this, Chilean workers would have to acquire *real* power and use it effectively. The purpose of the structural changes was to “overcome capitalism.” What was at stake was the replacement of the then-current economic structure for the construction of socialism.

The UP structural reforms had a wide and deep coverage, including (a) the nationalization of Chile’s main basic resources—copper (the Big Copper Mines), coal, nitrate, iron and steel—which would imply a sharp confrontation with U.S. companies, (b) the expansion of the Social Property Area, which implied the statization of the largest industrial enterprises, (c) the intensification of agrarian reform, (d) statization of the banking system, and (e) state control of the main wholesale trade and distribution firms.



In short, the structural reforms aimed to put the control of the means of production in the hands of the state. The advantages of and the rationale for this objective were given as follows (Romeo 1971). (1) If the state achieved the control of the means of production, it would be in a better position to make economic decisions using a social criteria that would consider the welfare preferences of the large national majority (i.e., the workers). (2) This control would produce an increase of the economic surplus controlled by the state. With the additional resources obtained, the state would be able to plan and to guide economic development in a direction that would benefit the large majority. (3) In fact, "The main problem is not efficiency, but power; that is, who controls the economy and for whom? . . . What is at stake is the property of the means of production by a small minority; then, the real economic issues are: Who has the power to set prices, and therefore profits, and who captures the economic surplus and decides how to re-invest it. . . . To focus the discussion on efficiency avoids discussing who really has the economic power, and why a small minority who owns the means of production is able to subjugate the majority". In synthesis, as Minister of Economics Pedro Vuskovic declared, soon after Allende took office, "State control is designed to destroy the economic basis of imperialism and the ruling class by putting an end to the private ownership of the means of production" (as quoted in Moss 1973, p. 59).

One view inside the Unidad Popular stated that short-run macroeconomic policies were complementary and supportive of structural reforms, showing in this way that "it is possible to make deep structural reforms and at the same time achieve important positive results in income redistribution, growth, inflation, and employment" (García 1971). This, it has been explained, was due to the fact that even traditional macroeconomic policies have implicitly a class element: "short-run policies are, by definition, a tool to maintain the status quo," that is, these tools are not only the expression of a given institutional environment, but they are also oriented toward its consolidation. In this respect, UP macroeconomic policies cannot be analyzed separately; "this would be a serious analytical mistake. . . . They should be examined in the prevailing environment which would provide the rationale of why was done what was done" (García 1971).

In a distinct perspective, it is argued that the control of inflation was really a key UP objective due to political and economic reasons (Bianchi 1975). At the political level, the UP had pointed out during the campaign that it would get rid of inflation, and it criticized previous governments for their incapacity to control this problem. Moreover, due to the proximity of municipal elections (March 1971), the UP government wanted to show quickly an indicator of success. At the economic level, given the fact that the goal of income redistribution was going to be implemented through increases in nominal wages, it was important to slow down inflation to ensure an increase in real wages.

The key elements that provided the basis of the UP macro policy were the following: (a) The Chilean economy presented a large level of unused capacity and high unemployment. (b) There existed a high level of international reserves and industrial stocks. As has been pointed out (Griffith-Jones 1980), UP economists made no comments with respect to the limitations related to the following elements: (1) Specific sectoral capacity levels may be very different from global figures. (2) The utilization of available unused capacity is an element of the "once and for all" nature, that is, you can use it only once. (3) There was the mechanistic perception that structural transformations would very quickly help solve macro problems.

The main economic tools for short-run macroeconomic policy were the following (García 1971): (a) Nominal wage readjustment and price control. This would lead to increased real wages, which would then constitute the main redistributive mechanism. Moreover, higher real wages would increase the demand for basic goods leading to higher levels of production and employment. This process would reactivate and expand the economy using the existing unused capacity. (b) Increased public expenditures would complement the higher real wages in reactivating the economy. (c) Passive monetary and credit policy would provide the required liquidity for the expansion of the economy; monetary policy should not act as a brake to stop reactivation. (d) There would be a fixed nominal exchange rate, which would help to avoid cost pressures upon domestic production. (e) The nationalization of basic resources (copper) would expand exports and therefore provide additional foreign exchange. (f) The existence of a relatively high initial level of international reserves would provide the adjustment valve through imports, for eventual disequilibrium problems.

The UP view of anti-inflation policy was based on the following elements (Griffith-Jones 1980): (a) Inflation is really a structural phenomenon. Price control, elimination of the crawling peg system, and the implementation of the new economic structure would stop inflation. (b) State control of the greater part of the productive and marketing apparatus would lay the foundations to stop inflation. (c) Given price controls and wage readjustments, wages would increase more than prices, leading to a reduction in the unit profit rate. However, given the existence of unused capacity, the augmentation of output and sales would compensate the decline of unit profit while maintaining the overall level of profits.

According to a high UP authority, the effects of the previous measures will imply that very shortly "price increases will disappear and in the future inflation will be remembered as a nightmare of previous Governments which were the servants of big capital" (Millas as quoted in Bianchi 1975). A more moderate view was stated in the UP program where, as the outcome of structural transformations, inflation would disappear due to anti-monopolist measures and due to the support of the majority of the people.

### 7.3 Structural Reforms

#### 7.3.1 Redistribution of Real Assets

As we discussed in section 7.2, structural transformations of the economy were the fundamental element of the Unidad Popular program. These changes were centered around the redistribution of real assets in four main sectors of the economy: the big mining sector, agriculture, banking, and industry. The government resorted to a vast array of methods in order to transfer private property—both Chilean and foreign—to the state, and the redistribution of real assets was massive. As a result, the public sector experienced substantial growth during the 1970–73 period, as we analyze below.

#### *Nationalization of Copper and Other Mining*

Nationalization of the big copper companies had been in the agenda of both the Unidad Popular and the Christian Democratic candidates for president in the 1970 election. In fact, the process had already started during the preceding Frei administration, as mentioned before. The so-called “Chileanization” of copper had begun in 1967, when the State Copper Corporation (CODELCO) bought 51% of the El Teniente mine from Kennecott for \$80 million and acquired a 25% stake in the Andina and Exotica mines. When a dramatic surge in the world price of copper followed these agreements and increased the companies’ profits, the pressure mounted on the Frei government to expand the state’s ownership of the big copper mines. In 1969, the administration bought 51% of the Chuquicamata and El Salvador mines for \$180 million, to be paid for at an annual interest rate of 6% over the next 12 years. The terms of these agreements were criticized by some UP analysts as being overly generous with the foreign companies.<sup>5</sup>

The UP came to power and decided to complete the process of nationalization of the copper mines in the shortest possible time. This action had strong legislative and popular support, and the government decided to pursue the nationalization through a constitutional amendment rather than through a regular law. The project was approved unanimously in July 1971 by the opposition-controlled national Congress. The nationalization decree explicitly stated that the state of Chile had absolute and exclusive control over all Chilean mines. Nonetheless, as the goal was to nationalize only the big mining properties, a temporary provision allowed the private sector to continue operating small and medium-sized mines, although their legal status was not totally clear. All the big copper companies (Chuquicamata, El Salvador, El Teniente, and Exotica) however, came to be owned 100% by the state.

The most important problem that the government encountered as a result of the copper nationalization was not inside Chile. Rather, it was related to the

5. For a statement of this argument see De Vylder (1974, chap. 4).

issue of compensating the previous foreign owners, that is, the U.S. companies Anaconda and Kennecott. The indemnification was to be determined by the Comptroller General according to the book value of the companies as of December 1970. However, the president of the republic was authorized to deduct from this value the excess profits obtained by the foreigners since 1965. Allende used this provision to deduct some \$800 million from the total indemnification.<sup>6</sup> In practice, this meant that the owners of the three biggest mines got nothing.

This aggressive stance regarding compensation has been criticized by insiders of the Allende regime for opening a significant source of trouble in Chile's international relations on a matter that was negotiable. Bitar (1986, pp. 71–72) states that:

From a strategic point of view, what was essential was not the compensation paid but the control of basic wealth. . . . Winning this control was vital, and its importance rendered quarrels about the exact amount of compensation relatively insignificant. Furthermore, it seems clear that internal political support stemmed chiefly from the nationalization itself and did not depend on the amount given in compensation. Thus the decision to refuse compensation did not produce any new favorable political dividends. From the international point of view, the no-compensation decision and the principle of deduction for excessive profits were unacceptable to the U.S. government, both because of the loss they represented in themselves and because of the precedents they set. There was little advantage in thus linking the nationalization of copper with a larger problem, one with international implications and consequences beyond Chile's control. Our own conclusion is that the decision to deny compensation, even though juridically unobjectionable, robbed the Allende government of flexibility at a critical moment.

The government also took over the large coal, iron, and nitrate mines during the first half of 1971. Comparatively much less important than copper, this process had neither the drama nor the publicity that surrounded the copper nationalization. The foreign owners reached an agreement with the government and sold their property. Thus by the end of 1971 the UP program had already been completed in mining, as the government controlled all large mining operations in the country.

#### *Intensification of the Land Reform Process*

Land reform had been initiated before the Allende government came to power, bringing about major changes in agriculture beginning in the early sixties. A law of agrarian reform had been preceded by a modification of the constitution that permitted deferred payment for expropriated land.<sup>7</sup> Subse-

6. A detailed analysis of these nationalizations can be found in Vargas (1973).

7. The Agrarian Reform Law, law 15.020, was passed in 1962 under the administration of President Alessandri and was subsequently amended under the government of President Frei.

quent legislation made it increasingly difficult for landowners to oppose actions against property (i.e., it prohibited the division of farms to avoid expropriation).

The Allende government drastically intensified the process of land reform using the existing legislation. Clearly, the UP wanted to amend the law so as to increase the scope of the process, in particular extending it to farms below the legal limit of 80 basic hectares. But, lacking a legislative majority, this was not possible. In the words of Jacques Chonchol, the minister of agriculture,

The government decided, for two reasons, to use the Agrarian Reform Law which was approved during the Frei administration even though, in many aspects, it does not coincide with the U.P. Government's agrarian policy. We are using this law because, as a Government, we are obliged to act within the legal framework, and secondly, because any changes in such a complex and controversial law . . . would certainly have required many months of discussion, which would paralyze the agrarian reform process resulting in great frustration among the peasantry who are pressing for the acceleration of the process. Also it was felt that, given the political willingness to use the existing law much more thoroughly, it would be possible to accelerate the agrarian reform process. (quoted in Zammit 1973, p. 107)

In spite of the legislative constraint, the Unidad Popular took to the task with remarkable speed. By mid-1972, practically all privately owned farms of over 80 basic hectares had been eliminated. Not only were increasing numbers of farms expropriated under existing laws, but the occupation of agricultural land by peasants (*tomas*) also became a very popular way of de facto expropriation. For example, over 500 farms were illegally occupied in 1971.

By 1973 the land reform program had implied the expropriation of close to 10 million hectares from almost 6,000 farms, or 60% of Chile's agricultural land (Larraín 1988, table 10). About two-thirds of these estates were expropriated during the tenure of the UP government. In fact, the Allende administration expropriated more than twice as many farms in less than half the time than had the preceding Christian Democrat Government.<sup>8</sup> This major intensification of the land reform program from 1970 to 1973 required vast growth in the state's administrative apparatus responsible for its implementation. For example, the corporation of land reform (CORA), the most important government institution in this sector, saw its work force increase by 70% in this period.

A major challenge for the government was how to organize the reformed sector. The previous administration had favored the *asentamiento*, whereby each expropriated farm was transformed into a cooperative settlement of the former peasants. The Allende government introduced land reform centers

8. During 1971, the first year of application of the program, the UP expropriated almost as many estates as the Christian Democrats had in the whole period 1964-70.

(Centros de Reforma Agraria, or CERAs), which were formed from the merger of geographically close previously private farms. However, this new form of organization met with resistance from the peasants. In the end of the land reform process, only a rather small fraction of the expropriated land was distributed to peasants through individual property or cooperatives, most of it during the Frei period. Almost all the estates expropriated or taken over during the UP government remained in the hands of the state.

Overall, the agrarian reform program had a significant wealth redistribution effect. Recent estimates indicate that former landowners had a capital loss of between \$1.2 and \$1.6 billion as of 1973, considering all expropriations of the 1965–73 period and the present value of the compensations they received. This amounts to between 100% and 130% percent of Chile's GDP in 1973. If we consider the restitutions of land effected during the military government, the capital loss of the previous owners is in the range of \$800 million and \$1.1 billion.<sup>9</sup>

### *The Statization of Banking*

The Unidad Popular initiated at the outset an organized attempt to obtain absolute control of the banking sector, as President Allende had publicly declared one month after taking office. During the first months of 1971, the government was able to acquire all foreign banks. This was achieved in a negotiation process that established the compensation to be paid in each case. But foreign banks represented just a tiny fraction of financial activity in the country. The big challenge was to attain control of the local private banks.

Lacking a legal basis to expropriate the banks, and feeling the impossibility of passing such a law through Congress, the government resorted to a simpler method. It opened a purchasing power for bank stocks at very attractive prices. At the same time, it started to intervene in banks based on two causes: the detection of some financial wrongdoing or the existence of labor problems that prevented normal operation. Faced with the option of selling shares at good prices or eventually ending with stocks of dubious value in troubled banks, stockholders in large numbers decided to sell.

This process was, as in mining and agriculture, extraordinarily fast. By the end of 1971, state control over the banking system was almost total. As Finance Minister Americo Zorrilla proudly announced in November 1971, "The nationalization of the banking system is practically completed. The state now controls sixteen banks which together provide ninety percent of all credit. . . . This process of nationalization has signified that the links between financial and industrial monopoly capital have been broken."<sup>10</sup>

Thus, in about one year, CORFO acquired majority participation in 14 commercial banks and less than 30% participation in five other banking insti-

9. From Larrain (1991, table 10), on the basis of figures provided by the Department of Agriculture Economics, Universidad Católica de Chile.

10. Quoted in De Vylder (1974, p. 161), from Zorrilla's *Second Exposition*.

tutions. Ultimately, the state came to control the most important private banks (among them Banco de Chile, the largest one) and an overwhelming part of credit. Of the 17 commercial banks in existence in September 1973, 14 were in the banks of the public sector and only three were left under private administration.

Participation by the state in financial operations was even greater than the banking situation suggests. Several other public institutions provided medium- and long-term credit, the most important of them being CORFO, the Agrarian Reform Corporation (CORA), the National Mining Corporation (ENAMI), and the National System of Savings Loans (SINAP). Overall, 85% of Chile's financial sector came into the hands of the state.

### *The Takeover of Industry*

Between 1970 and 1973, the UP government engaged in a major expansion of the "area of social property" (the state-owned sector). This program involved a massive takeover of firms, a step viewed as necessary to achieve official allocative and distributive goals. The profits of the expropriated companies were considered monopoly rents, which needed to be given to the companies' workers and the poor sectors of society, and resources needed for investment.

It was precisely in this part of its program that the UP encountered the bigger obstacles. Firm owners themselves constituted a stiff resistance to nationalization, much more so than in mining and banking and comparable to that of farmers in the south of Chile. For example, the method of purchasing shares in the open market, which had worked so well to acquire the banks, produced disappointing results among nonfinancial companies. Resistance of firm owners included the initiation of legal actions against the government, which generally had favorable reception in the courts, and even the outright physical defense of the properties.

The government lacked solid legislation for the nationalization of local industries, and so it resorted to an obscure law passed in the 1930s during the short period of the socialist republic.<sup>11</sup> This law, which had never been used before, stated several causes that could lead to a company's expropriation: price speculation, stockpiling, interruption of production, or the existence of unused productive capacity in times of shortages. The definition of these concepts was vague enough so that most companies could eventually qualify for expropriation. There was a caveat, however. Expropriation required full cash compensation, as determined by an independent court. In short, the law was there, but its use was expensive.

An alternative to expropriation was soon found to attain government control of private companies. Another little-known law of the 1940s established that companies could be subjected to intervention, and thus placed under state

11. Decree Law (DFL) no. 520 of 1932.

administration, whenever labor disputes occurred. Clearly, this procedure could not be used directly to transfer the ownership of the company. But in practice, this was many times the outcome. Labor disputes were often instigated by the authorities or carried out spontaneously in order to trigger government intervention. At that time, a firm's financial position had already deteriorated. Subsequent administration by a state-nominated director, and a growing scarcity of raw materials, further weakened the company. After a while, many owners were ready to sell their firms to the government.

The authorities also counted on an administrative procedure to weaken the resolve of company owners. A state agency, DIRINCO (Dirección Nacional de Industria y Comercio), was empowered to approve price increases for goods and services throughout the economy. By the simple expedient of denying the price adjustment at a time of rapidly rising wages, DIRINCO could jeopardize substantially the financial health of a company. This was another procedure used to convince entrepreneurs to sell.

By September 1973, CORFO controlled or had significant participation in 507 firms. Of these, 259 had been taken over through intervention with no actual transfer of property (see table 7.5). In spite of these impressive numbers, the UP was unable to sweep the industrial sector as it had done with mining, banking, and agriculture. This was, in fact, the only sector where the original program of the government went unfulfilled, as some major firms were still in private hands by September 1973. The most prominent case was that of the *Compañía Manufacturera de Papeles y Cartones* ("Papelera"), the top Chilean producer of pulp and paper and the major supplier of local newspapers.

What accounts for this partial outcome? On one hand was the private sector's substantial resistance to the nationalization of industry. On the other hand was the lack of adequate legislation to accomplish this task. As Eduardo Novoa, the most prominent legal expert of the UP government, put it in March 1972, "In order to be able to operate, this government has had to resort to a series of legal dispositions which lay almost forgotten. But once having used these to their maximum the moment has arrived when there is no legal mechanism with which to proceed any further" (quoted in Zammit 1973, p. 29).

### 7.3.2 Consequences of the Asset Redistribution Program

#### *The Expansion of the Public Sector*

As can be expected, the growth of the public sector was spectacular during this period. The "social area" of the economy increased its share of productive activities to unprecedented levels, as table 7.6 shows for six different sectors of the economy.

Having 1965 as a base year, public enterprises increased their share of output in utilities from 25% to 100% in 1973. In addition, by the end of the UP experiment the government came to control 85% of banking and mining, 70%



Table 7.5

## Public Sector's Stake in Productive Activities, 1970-73 (Number of Firms)

Industrial Sector	Participation in Equity Capital												Total
	Over 50%		10%-50%		Less than 10%		Majority Participation with Other Public Entities		Other Subsidiaries		No Participation in Equity Capital but Intervened		
	1970	September 1973	1970	September 1973	1970	September 1973	1970	September 1973	1970	September 1973	1970	September 1973	
Forestry	5	9	0	1	0	5	0	0	0	0	0	7	27
Fishing	4	7	0	0	0	1	0	4	0	1	0	8	22
Construction	1	5	0	1	0	4	0	1	0	2	0	10	25
Textiles	0	4	0	2	0	3	0	0	0	0	0	36	45
Chemicals	4	1	1	1	0	2	2	1	0	2	0	17	31
Energy	3	0	0	0	0	5	0	2	2	0	0	2	14
Electronics	2	2	0	0	0	0	0	0	0	1	0	16	21
Agriculture	1	5	0	0	0	0	0	0	0	0	0	0	16
Agro-industry	3	8	0	4	0	8	5	0	0	1	0	42	71
Metallurgy	2	5	0	2	0	0	1	1	0	23	0	49	83
Automotive	1	7	0	0	0	0	0	0	0	0	0	3	11
Pharmaceutical	0	1	0	0	0	1	0	0	0	0	0	3	6
Mining	0	6	1	2	0	1	2	1	0	1	0	13	27
Metals	0	1	0	0	0	4	0	0	0	0	0	0	5
Various industries	5	11	0	3	0	15	0	3	0	5	0	26	68
Services	0	0	0	0	0	0	0	0	0	0	0	27	27
Subtotal firms	31	72	2	16	0	49	11	10	2	36	0	259	488
Subtotal banks	0	14	0	2	0	3	0	0	0	0	0	0	19
Total	31	86	2	18	0	52	11	10	2	36	0	259	507

Source: Larrain (1988).

**Table 7.6** Public Enterprises' Share in Sectoral and Total Output (%)

Sectors	1965	1973
Mining	13.0	85.0
Industry	3.0	40.0
Utilities	25.0	100.0
Transport	24.3	70.0
Communications	11.1	70.0
Financial	n.a.	85.0
Output in all sectors <sup>a</sup>	14.2	39.0

<sup>a</sup>The estimates do not include agriculture.

of both transportation and communications, and 40% of industry. Overall, the public sector achieved direct control over 39% of the country's output (excluding agriculture).

#### *The Difference between Mining and the Other Sectors*

The UP program represented the most radical economic transformation since Chile's independence. But clearly, some aspects of the program were more controversial than others. The nationalization of the foreign-owned mining sector, especially of the big copper mines, had already started during the previous government and enjoyed the support of a vast majority of the country. In no other way would the UP have been able to pass the required legislation through Constitutional amendment, approved unanimously by Congress. And, to place it in perspective, this trend toward the nationalization of foreign companies' controlling natural resources was a general phenomenon throughout Latin America during the 1970s (e.g., Peru under Juan Velasco, and Venezuela under Carlos Andrés Pérez).

However, the situation in the other sectors was substantially different. The difficulties and controversies of the other elements of the program were evident in that the government was not able to pass through Congress one other significant piece of legislation that would expedite nationalizations. The land reform program was carried out using the laws that existed in 1970, and also through the use of some extralegal means (the *tomas*). Since occupations of farms and expropriations often occurred in estates below the legal minimum of 80 basic hectares, the government alienated basically all landowners, regardless of their size.

In banking, the procedures used were the simple purchase of shares for domestic banks and direct negotiations with private banks; in spite of major apprehensions about the implications of the government's near-total control of credit, opposition to the measures could not prevent the change of ownership from taking place.

Nonfinancial firms were, however, the toughest test of the program and the scene of greater confrontations. The government could not agree with the

congressional opposition on a list of enterprises to be nationalized, and no new legislation was passed for this purpose. To pursue their program, the authorities relied on obscure legislation of the 1930s and 1940s and on administrative means. These procedures, and the way they were applied, alienated not only the big entrepreneurs (the original targets of the program) but also medium and small company owners.

### *The Uncertainty over Property Rights*

One of the most fundamental effects of the UP program on the private economy was to spread general uncertainty over property rights. The economic effects of such an environment are clear. Private investments are scaled down dramatically, even to the point where they fail to cover the maintenance of existing capital. As the pace of expropriation accelerates, the horizons of asset owners are reduced to a few months, even weeks, and investment ceases altogether. The incentives are given to extract as much as possible from the asset with the available capital stock, while one is still the owner.

Uncertainty over property rights derived first from the Unidad Popular program, which stated:

*As a first step* [emphasis added], we shall nationalize those basic resources like large scale copper, iron and nitrate mines, and others which are controlled by foreign capital and national monopolies. These nationalized sectors will thus be comprised of the following:

1. Large scale copper, nitrate, iodine and coal mines.
  2. The country's financial system, especially private banks and insurance companies.
  3. Foreign trade.
  4. Large distribution firms and monopolies.
  5. Strategic industrial monopolies.
  6. As a rule, all those activities which have a strong influence over the nation's social and economic development, such as the production and distribution of electric power, rail, air and sea transport, communications, the production, refining and distribution of petroleum and its by-products, including liquid gas, the iron and steel industry, cement, petrochemicals and heavy chemical, cellulose and paper.
- (Quoted in Zammit 1973, p. 266)

The scope of the nationalization program is striking, as it encompasses all firms of significance. And the wording of point 6 is sufficiently broad that it leaves room for nationalization of just about any economic activity. Furthermore, the program explicitly states that this is just "a first step." Thus, it was reasonable to presume that nationalization would go beyond large companies.

This presumption proved to be correct. Industry and agriculture were the sectors most affected by property uncertainty. In industry, the government failed to specify the exact criteria that would lead to a firm's expropriation during the whole first year of application of the program. Late in 1971, it attempted to reach a congressional agreement based on the nationalization of

Chile's largest 254 firms, as measured by the size of their capital. But no accord was reached. Later on, the government pushed for a legislative agreement to nationalize a reduced group of 90 strategic firms, but to no avail. However, while the government was declaring its intentions to limit its program to the biggest firms, interventions occurred in a large number of medium- and small-sized firms. This spread uncertainty to the whole industrial sector.

A similar problem happened in agriculture. The law established that only farms over 80 basic hectares—or those badly exploited or abandoned—would be subject to expropriation. However, many occupations occurred in smaller and well-exploited estates. In practice, all landowners worked under the threat of either expropriation or occupation, which ultimately had similar effects.

In banking, the uncertainty was quickly cleared. The nationalization was so fast and widespread that by the end of the first year about 90% of the sector was controlled by the state. The few—and small—remaining private banks may have still feared some form of state intervention, but they were not in a position to affect the results of the financial system in any significant way. In mining, the aim was to nationalize the large mines, whose property remained in foreign hands. As opposed to industry and agriculture, here the government stuck to its program, and no attempt was made to take over the medium- and small-sized mines owned by nationals. What may have affected private domestic miners was the general climate of uncertainty spilling over from the other sectors of the economy.

Could the uncertainty over property rights have been avoided? Bitar (1986) has argued that the publication of companies to be nationalized should have been made at the very outset and expropriation should have been carried out right away. This, in his view, would have precluded the negative effects over the medium- and small-sized entrepreneurs and, to the economy in general. In our view, however, uncertainty over property rights would not have been reduced significantly by such an action. First, the program of the UP stated that nationalization of large companies was only a first step. Second, the government would have had to publish the list and stick to it strictly; the problem was then how to control the pressure from labor unions, which in several cases pursued long disputes with company owners to trigger intervention. And finally, there was the experience of agriculture, where many medium and small properties not qualifying for expropriation were occupied indefinitely. To make a significant dent in the uncertainty, the government would have had to be prepared to enforce property laws, even if this implied the use of public force in illegal occupations. And this was quite unlikely.

#### *Management Problems in the Nationalized and Reformed Sectors*

It is widely recognized, even by insiders of the Allende regime, that the performance of the nationalized and intervened sectors was far from optimal. The main problems were to be found in the administration of properties that

came into the hands of the state, especially in industry. Bitar (1986), for example, recognizes that the emphasis on transferring ownership was not parallel to an interest in the administration of the nationalized companies. Others put it more bluntly. Alberto Baltra (a respected university professor and the leader of the Left Radical party, which left the government in April 1972), in judging the performance of UP management, stated: "Although it seems incredible, the social area did not work in a planned way during the UP Government. There was planning and planners, but plans stayed on paper. Companies under state control did not submit to an authentic social decision, but functioned according to the will of interventors (state designated managers), who lacked knowledge and experience" (1973, p. 56).

Neither were management problems in the state-owned mining sector insignificant, as many of the top managers and technicians of the mines left the country after the nationalization. For example, over 150 top professionals working at Chuquicamata left Chile in 1971.<sup>12</sup> An analogous exodus occurred in the other big mines. And the government did not have the qualified personnel or the organizational structure to handle the task.

Similarly, there were many difficulties in organizing production in the reformed sector of agriculture. Most prominent among them were the problems of incentives inherent to collective farming. Member workers of an agrarian unit continued to work for a fixed wage and received a given share of profits at the end of the year. Thus, there was little link between work effort and compensation.

Bitar (1986, p. 188) summarizes some of these problems with great clarity: "[In industry,] as in the agrarian reform and the nationalization of copper, there was also a delay here between state takeover and organization. This lapse is a consequence of the secondary importance attached to organization per se in the UP strategy. It was argued, of course, that the change in form of property ownership would allow the introduction of a new form of economic rationality, but how this rationality was to be attained was never specified."

## **7.4 Macroeconomic Policies and Results**

In the first part of this section we will examine the evolution of macroeconomic variables during 1970–73. Later on, we will conduct a more detailed analysis of the expansionary public-sector policies, centered on their most important aspect: the fiscal side.

### **7.4.1 The Year 1971: A Successful Beginning**

The Chilean economy experienced an unprecedented boom in 1971, the result of highly expansionary government policies. This generated a widespread improvement in the standard of living of the population, and a sense of

12. As reported in De Vylder (1974, p. 137).

total success among UP leaders. Yet a cool analysis of the economic situation could already perceive a mounting disequilibrium, as we analyze below.

### *The Measure of Success*

Looking at the traditional macroeconomic variables, the first year of the UP Government achieved relatively spectacular results for the Chilean economy (see tables 7.7 and 7.8). The annual growth rate of GDP reached 8.0% in 1971, much higher than the 3.6% of the previous year (1970), and the highest since 1950. Table 7.9 provides a sectoral breakdown for GDP growth. Industry and commerce were the top performers among all sectors during 1971 and showed a remarkable expansion compared to 1970. Between 1970 and 1971,

**Table 7.7**                    **Macroeconomic Indicators for 1970–71 (%)**

	1970	1971
Economic growth rate (GDP)	3.6	8.0
Inflation rate	36.1	22.1
National unemployment rate	5.7	3.8
Average increase in real wages	8.5	22.3

*Sources:* Central Bank, INE, and ODEPLAN.

**Table 7.8**                    **Quarterly Data for Inflation and Unemployment, Chile, 1970–71 (%)**

	Inflation Rate (CPI) Accumulated During Year		Gran Santiago Unemployment Rate	
	1970	1971	1970	1971
March	16.2	3.4	6.8	8.2
June	23.9	11.1	7.0	5.2
September	32.9	13.9	6.4	4.8
December	34.9	22.1	8.3	3.8

*Sources:* INE and University of Chile.

**Table 7.9**                    **Main Sectoral Growth Rates, 1970–71 (%)**

	1970	1971
Agriculture	3.6	-1.8
Mining	-3.0	6.0
Industry	2.0	13.6
Commerce	-1.5	15.8
Services	4.8	7.0

*Source:* Central Bank.

**Table 7.10**                      **Indices of Minimum and Real Wages for Blue-Collar and White-Collar Workers, 1970–71**

	Minimum Real Wages (1970 = 100)		Real Wages (April 1970 = 100)		Differential between Blue-Collar and White-Collar Minimum Wages
	Blue-Collar Wages	White-Collar Wages	Blue-Collar Wages	White-Collar Wages	
1970	100	100	100	100	49
Quarter in 1971:					
1	156	123	112	107	35
2	146	116	123	127	35
3	134	105	125	124	35
4	120	95	121	117	35

Source: World Bank.

the rate of growth of industrial output increased from 2.0% to 13.6%, while in commerce in 1971, the rate of expansion went from -1.5% to 15.8%.

Inflation decreased from 36.1% in 1970 to 22.1% in 1971. It is interesting that during the first half of 1971 the rate of price increase had been reduced to very low levels by Chilean standards. In the first quarter of 1971 inflation was 3.4% at an accumulated annual rate, compared to 16.2% in the equivalent period of 1970. During the second quarter of 1971, inflation reached 11.1% (also on an accumulated annual basis) compared to 23.9% a year earlier.

National unemployment registered a remarkable drop, from 5.7% in 1970 to 3.8% in 1971. Incidentally, this 3.8% figure was by far the lowest unemployment rate registered in Chilean statistics.<sup>13</sup> Quarterly unemployment data for Gran Santiago shows a reduction of joblessness from 8.3% in the fourth quarter of 1970 to 3.8% in the fourth quarter of 1971. At the same time, average real wages increased a remarkable 22.3% during 1971.

Another interesting outcome corresponds to the improvement of income distribution and to the reduction of income inequality even among workers, that is, low wage workers had higher real wage increases than relatively high wage workers (see table 7.10). The labor share in GDP increased from 52.2% (1970) to 61.7% (1971), whereas the average value of this variable during the 1960–69 period was 48.4%. Minimum real wages for blue-collar workers were increased by 56% during the first quarter of 1971, while in the same period real minimum wages for white-collar workers were increased “only” 23%. In this way, the differential ratio between blue- and white-collar workers’ minimum wage decreased from 49% (1970) to 35% (1971). The closing of the gap between white- and blue-collar workers was less pronounced if one looks at the evolution of the average real wage during 1971: while the average

13. National unemployment rates are available in Chile on an annual basis since 1961.

real wage of blue-collar workers increased by 20.3%, that for white-collar workers increased by 18.8%.

These results were obtained by a combination of policies oriented mainly toward obtaining an increase of aggregate demand. Wage policy implied increases of annual real wages which ranged between 39% (minimum blue-collar wages) and 10% (minimum white-collar wages), with an overall average of 22.3%. Central government expenditures increased by 36% in real terms, raising the share of fiscal spending in GDP from 21% (1970) to 27% (1971). As part of this expansion, the public sector engaged in a huge housing program, starting to build 76,000 houses in 1971, compared to 24,000 for 1970. Finally, monetary policy was accommodating, so as not to impair the expansion of demand and output: M1 increased by 119% during 1971. A more detailed examination of the public-sector expansion and its financing is provided in the third part of this section.

These policy measures were supported by widespread price controls. With nominal wage readjustments of over 40%–50%, nominal government expenditures increasing by more than 60%, and money supply augmenting by more than 100%, the annual inflation rate of 1971 (22.1%) seems surprisingly low. The single most important explanation of this phenomenon is related to price controls on the private sector and a freeze of tariffs and prices in the public sector. Two factors explain the relative success of price controls (World Bank 1979; Bianchi 1975). First, the government gained direct and indirect control of the different links in the chain between production and consumption through many institutional changes. The authorities increased the commercial functions of existing public marketing and control agencies and created several new ones; moreover, major private wholesaling and importing firms were nationalized. Furthermore, through Government intervention, credit lines facilities were related to pricing agreements. Finally, vigilant consumer committees were created at the neighborhood level (Junta de Abastecimiento y Precios, or JAPs), which had to watch that local stores obeyed official prices and maintained goods in supply. Second, the overall environment of structural reforms, where so many firms had been expropriated or taken over by the government, induced most entrepreneurs to follow official price guidelines. It was too risky not to do it, so, “entrepreneurs had to think twice before violating official prices, because this (UP) Government was not like the previous ones” (N. García as quoted in Bianchi 1975).

Thus, the overexpansion of real wages in 1971 was significantly related to the effectiveness of price controls. However, workers’ wage adjustments in bargaining surpassed the limits set up by the UP government-CUT (Central Unica de Trabajadores, the principal national union organization). This happened in spite of the fact that CUT was controlled by the UP political parties. Two principal elements explain this behavior: (1) the long tradition of unions to maximize wage readjustments, and (2) the competition from Christian



Democrat union leaders, who tried to outbid their UP rivals to gain popularity among workers (Griffith-Jones 1980).

### *Early Warnings of Disequilibrium*

Despite the overall bright picture that emerged in 1971, there were several indicators that suggested the presence of increasing disequilibrium throughout the year. (1) The budget deficit of the general government increased from 3.5% of GDP in 1970 to 9.8% in 1971. At a broader level, the consolidated nonfinancial public deficit increased from 6.7% (1970) to 15.3% (1971). (2) The credit to the public sector alone increased by 124%; more than 90% of the credit provided by the Central Bank to the public sector was in the form of high-powered money. This was one of the factors behind the 119% increase of M1. In short, monetary policy was totally out of control. (3) The level of international reserves dropped from \$394 million (1970) to \$163 million (1971), a 59% reduction. The loss of reserves could have been higher, but on November 1971 the UP government suspended external debt service and entered into rescheduling negotiations. (4) The trade balance changed from a \$95 million surplus (1970) to a \$90 million deficit (1971). The sharp drop of the world copper price from 64.1¢ a pound in 1970 to 49.3¢ a pound in 1971 is the main factor behind the trade balance deterioration. Drastic import controls, in the presence of an exchange rate appreciation, avoided a larger external trade deficit on 1971. Besides exchange controls, the main tool for import controls was the use of a 10.000% prior deposit requirement, an existing regulation that the UP government used intensively by significantly increasing the number of goods included in it. (5) While the overall consumption level increased by 12.4% during 1971, gross investment dropped by 2.3%; that is, gross investment reduced its share of GDP from 23.4% (1970) to 20.8% (1971). (6) Given the sharp increase of real wages and the tight price controls, there was a squeeze of corporate profits. (7) The first signals of shortages began to appear during the second half of 1971. These shortages were not considered by UP economists to be a serious problem. Rather, they were thought to be the natural outcome of income redistribution policies and a symptom of a past disequilibrium problem. The major increase of meat consumption in 1971 (+18%), for example, was related to redistribution. In the past, a high-income family consumed 180 kilograms a year while a low-income family consumed only 20 kilograms a year. Thus, a redistribution of income toward low-income families had necessarily to increase overall meat consumption (García 1971).

Answering the criticism that the economy was becoming overheated, some UP officials reacted as follows: "If the income redistribution policy would have failed, if the anti-inflationary policy would have failed, there is no doubt that there would have been enough unused capacity, international reserves, and stocks of goods, because that would have been a repetition of the traditional adjustment mechanism of the previous years. The success of the [UP]

economic policy is precisely related to the disappearance of slack variables” (Garretón 1975, p. 218).

At the end of 1971 there were many signals suggesting that inflation would significantly accelerate in 1972: the large increase of money supply, the large fiscal deficit, the new wage readjustment of January 1972, the practical impossibility of further contracting corporate profits, the depletion of stocks and inventories, the sharp contraction of international reserves, and the appearance of shortages and black markets in many different goods. However, the reaction of UP authorities was practically null. While in the official speeches of 1970 inflation was considered to be a key variable, in the finance minister’s November 1971 message to the nation not much was said with respect to inflation. The only mention made in this respect stated that the same anti-inflationary policy of 1971 would be maintained during 1972.

#### 7.4.2 Decline and Full Collapse, 1972–73

The decline and full collapse of the UP experiment during the years 1972–73 is a clear consequence of the “successful” overexpansive policies implemented in 1971. The favorable initial outcome increased the UP government’s popularity. In this context, criticism related to the presence of distinct types of disequilibria were disregarded as mere technical observations.<sup>14</sup> Moreover, the UP government had a difficult dilemma; a cut of real wages was a necessary step in order to reduce the existing disequilibria, but this solution would hurt its progressive and revolutionary image (Dornbusch and Edwards 1989). Ideology prevailed, that is, maintenance of the progressive and revolutionary image was more important than reduction of the disequilibria.

#### *Macroeconomic Disequilibria*

Up to 1972, nominal wage readjustments were provided at the beginning of the year. In this respect, the wage readjustment policy of 1972 followed the same pattern of the previous year; that is, the official policy specified increases of nominal wages fully indexed to the 1971 CPI (22.1%), with (nominal) minimum wages increasing more (32%). But again, during the first quarter of 1972, wages increased more than the amount specified by the official policy. Even the government did not follow its own wage policy, and public-sector (employment-weighted) average wages increased by 48% (see Bianchi 1975 for disaggregated data information). This was not a useful way to reduce the 1971 public deficit of 15.3% (of GDP).

The increase of the public-sector wage bill, the large expansion of subsidies to the state-owned enterprises (4.6% and 9.5% of GDP in 1972 and in 1973, respectively), and the deterioration of tax collection (revenues dropped 3% of

14. This seems to be a general pattern with Governments implementing populist policies; Governments think that “*Deus et machina*” type of solutions will appear in the future which will solve the technical disequilibria (Sachs 1990). In the UP case, it was thought that the structural transformations carried on in the present would solve future problems.

GDP in 1972, and a further 3% of GDP in 1973) generated an impressively large and increasing public deficit of 24.5% in 1972 and 30.5% in 1973. (This subject is examined in more detail in the next section). Given the rudimentary characteristics of the prevailing capital market, a significant part of the public-sector deficit (60% in 1972 and 73% in 1973) was financed by money issued by the Central Bank. The final outcome was an increase in the total quantity of money by 173% in 1972 and 413% in 1973; between 1970 and 1973 the total quantity of money was augmented almost 30 times.

The large increase in the quantity of money clearly had destabilizing effects upon repressed inflation, shortages, and the external disequilibrium. Black markets spread for most goods, and the gap between official and black market prices increased. On the external front, the overvalued exchange rate led to export smuggling.

Table 7.11 provides a perspective about the evolution of the years 1972–73 within the overall period. The following elements can be observed: (1) The drop of GDP was relatively not so spectacular in light of the paralyzed market environment of the economy. Growth rates of 1972 and 1973 were -0.1% and -4.3%, respectively. (Table 7.12 provides the growth rates for the main GDP sectors. See fig. 7.1 for the evolution of industry's annual growth rate.) (2) Inflation (as measured by the CPI) exploded, reaching the highest consecutive levels in the long history of Chilean inflation: 260.5% in 1972 and 605.1% in 1973. (See fig. 7.2 for the evolution of inflation by quarters.) Note, however, that the wholesale price index (WPI) provides an inflation figure larger than 1,000% for 1973. (3) The national unemployment rate had a small increase,

**Table 7.11** Evolution of Main Macroeconomic Variables, 1970–73 (%)

	1970	1971	1972	1973
Economic growth rate (GDP)	3.6	8.0	- .1	- 4.3
Annual inflation rate (CPI)	36.1	22.1	260.5	605.1
National unemployment rate	5.7	3.8	3.1	4.8
Annual increase of real wages	8.5	22.3	- 11.3	- 38.6

Sources: Central Bank, CIEPLAN, and ODEPLAN.

**Table 7.12** Main GDP Sectoral Growth Rates, 1970–73 (%)

	1970	1971	1972	1973
Agriculture	3.6	- 1.8	- 7.4	- 10.3
Mining	- 3.0	6.0	- 3.8	- 2.3
Industry	2.0	13.6	2.2	- 7.7
Commerce	- 1.5	15.8	3.8	- 6.4
Services	4.8	7.0	- .2	- .6

Source: Central Bank.

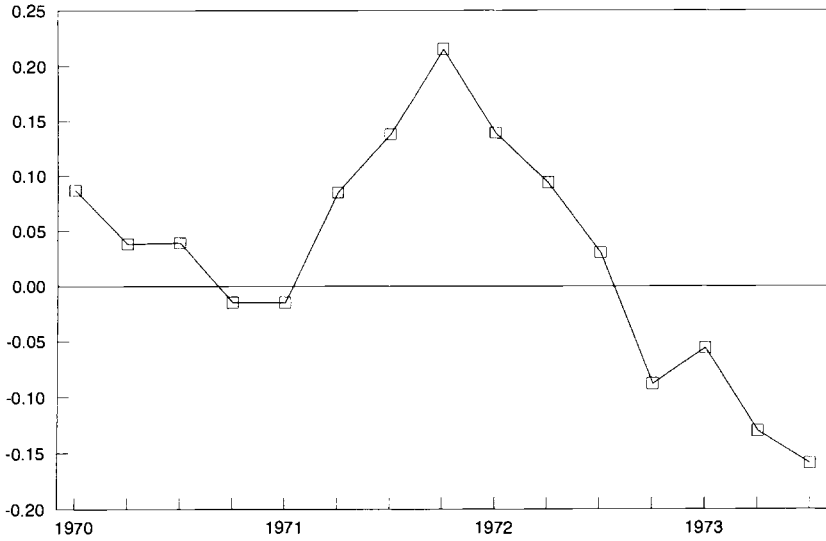


Fig. 7.1 Industry annual growth (in percentages)

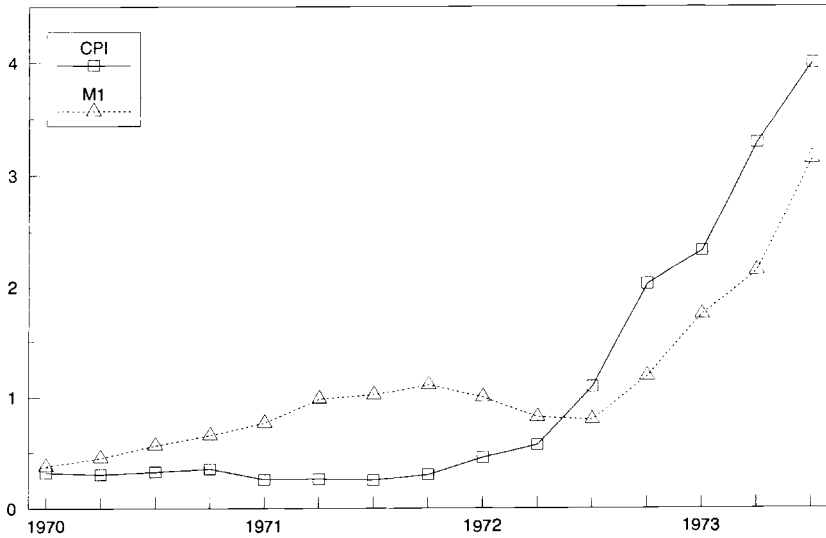


Fig. 7.2 Inflation and M1 annual growth (in percentages)

from 3.1% in 1972 to 4.8% in 1973. (4) Real wages dropped spectacularly, by -11.3% in 1972 and -38.6% in 1973. This last figure includes a 30% cut induced in the fourth quarter of 1973, after the military coup. (See fig. 7.3 for the quarterly evolution of real blue-collar wages.) In any case, it should be remarked that the mechanism of using nominal wage readjustments to increase real wages and to improve Chilean income distribution failed completely. It took eight years, up to 1981 (during the "peak of the boom") for real wages to recover the level they had held in 1970 before the UP government.

A disaggregated evolution of real wages tends to present a very dramatic situation, even if the exact figures depend upon the type of deflator used, in a context where black markets and barter prevailed. Table 7.13 shows that, even within the UP period, blue- and white-collar minimum wages had half the real purchasing power of 1970 by the third quarter of 1973; it is also observed that white-collar real wages had a larger drop than blue-collar wages.

When shortages and bottlenecks spread, the external sector constitutes the escape valve; a restricted supply of imports is visualized by most agents as the main economic constraint. However, the drop of domestic production constituted in many cases the principal factor related to internal food shortages, as in the agricultural sector. Table 7.14 shows the sharp increase of 51.4% of total imports (in current dollars) between 1970 and 1973; while food imports increased 2.3 times between 1970 and 1972 and 3.8 times between 1970 and 1973, imports of capital goods dropped (in current dollar terms) during the same period. Table 7.15 shows the large surge of wheat imports from 200,000

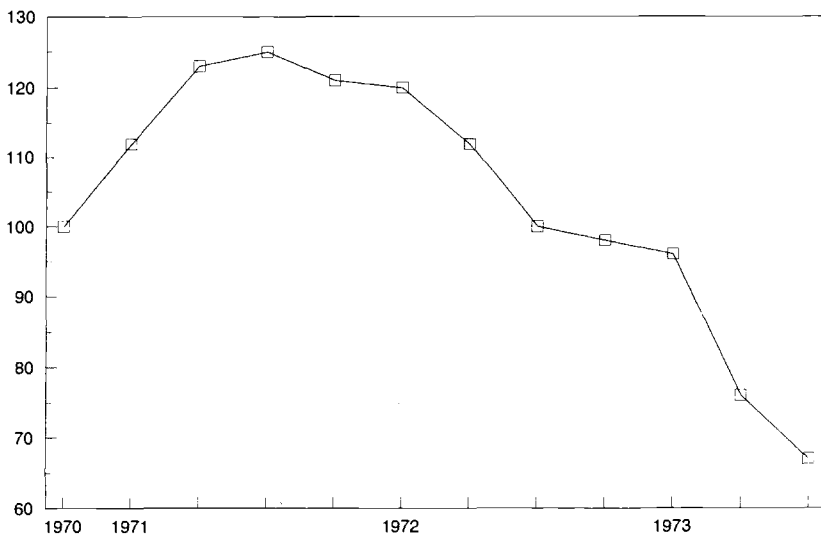


Fig. 7.3 Index of blue-collar real wages (April 1970 = 100)

**Table 7.13** Minimum Real Wages and Average Real Wages of Blue-Collar Workers and White-Collar Workers, 1970-73

	Minimum Real Wages (1970 = 100)		Average Real Wages (April 1970 = 100)	
	Blue-Collar	White-Collar	Blue-Collar	White-Collar
1970	100	100	100	100
Quarter in 1971:				
1	156	123	112	107
2	146	116	123	127
3	134	105	125	124
4	120	95	121	117
Quarter in 1972:				
1	151	106	120	111
2	125	88	112	101
3	94	66	100	93
4	121	82	98	92
Quarter in 1973:				
1	96	64	96	118
2	81	49	76	62
3	50	32	67	54

Source: World Bank.

**Table 7.14** Selected Components of the Balance of Payments, 1970-73 (Millions of U.S. Dollars)

	1970	1971	1972	1973
Total exports (FOB)	1,112	999	849	1,309
Copper exports	839	701	618	1,049
Total imports (CIF)	956	1,015	1,103	1,447
Food imports	136	192	318	512
Imports of capital goods	276	248	186	243
Trade account	156	-16	-253	-138
Current account	-81	-189	-387	-295
Overall balance of payments	114	-300	-231	-112

Source: Central Bank.

tons (1970) to 951,000 tons (1973) while domestic production decreased by 43% during that same period.<sup>15</sup>

Central Bank net (short-run) international reserves were reduced to \$62 million in 1972, which represented a decline of 62% with respect to the 1971 level; that is, the UP government lost 84% of its initial stock of international

15. A similar situation is observed with many other food products.

**Table 7.15** Domestic Production and Imports of Wheat, 1970–73  
(Thousands of Tons)

	1970	1971	1972	1973
Domestic production	1,307	1,368	1,195	747
Imports	200	367	745	951

Sources: INE and ODEPA.

reserves in a mere two years. By 1973, the level of available net (short-run) international reserves were equivalent to 22 days of imports.

#### *Shortages, Black Markets, and Rationing*

During the second half of 1972 there was a coexistence of high and accelerating inflation (at the three-digit level on an annual basis), widespread shortages, and proliferation of black markets. Two segmented goods markets with two different price systems prevailed in the economy: the official market and the black market. The differential between them went as high as five to ten times for a wide range of goods.

The official explanation given by UP economic authorities for the large increase of shortages and black markets was the following: Shortages and black markets were due to the counterrevolutionary action of reactionary groups and enemies of the people (“enemigos del Pueblo”); “the black market is the synthesis of the antipatriotic action of the Conservatives. . . . It is a lie to impute present consumption problems to bad Government policies” (see Banco Central, *Boletín Mensual*, January 1973).

Within a context of shortages and black markets, the use of nominal wage readjustments to maintain the real purchasing power of low-income groups becomes ineffective. The official CPI underestimates the real inflation rate, and the access to goods offered at official prices becomes crucial. Then, UP economists argued that direct government control over the distribution of goods and rationing became the necessary and efficient mechanisms to combat black markets and to guarantee the maintenance of real consumption of low-income groups.

On December 1972, the minister of finance announced that the following measures would be implemented in order to deal with shortages and black markets (see Banco Central, *Boletín Mensual*, January 1973): (1) The creation of a national state agency (Secretaría Nacional de Distribución) would centralize the wholesale trade in order to avoid the flow of goods to the black markets. The state-owned enterprises would send all their production there, and they would stop payments in goods to its workers. Special sale agreements “which will be difficult to reject” would be offered to private firms. (2) At the retail level there would be direct control over distribution of goods so that “all families would receive a basket of goods according to their real needs”; for this purpose the agency “established a quota of goods per family

like oil, sugar, rice, coffee, meat, up to a total of 30 goods which would be distributed by the JAP. . . . The JAP would define the real requirements per family”.

The impact of an official speech announcing that “rationing is coming” was the following: (a) There was a sharp increase of demand, especially for non-perishable consumption goods. Everyone tried to get, first, all those goods specifically listed by the minister of finance and second, all the types of consumption goods that were assumed to be included in the “basket of 30 goods.” In short, the official announcement of measures to solve the problems of shortages and black markets increased considerably the prevailing shortages; most families tried to keep home stocks of every consumption good that was found on the market. (b) The political opposition to the UP government became stiffer. There was a perception that the Chilean economy would end up having the state institute widespread comprehensive rationing under the JAPs’ control (where money would be displaced by party credentials and connections). (c) Moreover, there did not exist at that time the infrastructure to implement the rationing scheme; there were only scattered “popular food baskets” (*canastas populares*) distributed by some state agencies to their political clientele and to JAPs located in low-income communities.<sup>16</sup>

In spite of the dramatic and chaotic situation, the UP government obtained 45% of the vote in the March 1973 parliamentary elections. Several distinct factors were at play. There was an important increase in the number of “popular food baskets” distributed in the period prior to the election. Rhetoric and ideology also played an important role, that is, the low-income groups perceived that the “UP government was their government,” and that they had to support it in the good and bad times. However, after the March elections, the situation deteriorated considerably more, and the economy started on the path to a full collapse. The end of the story is well known.

#### 7.4.3 The Fiscal Explosion

The UP government pursued from the outset an aggressive policy of fiscal stimulation. Spending by the general government increased markedly,<sup>17</sup> and was mostly concentrated on current items. As table 7.16 shows, the bulk of the fiscal expansion involved wages and social security payments, which rose by more than 7 percentage points of GDP from 1970 to 1972, and transfers to the rest of the public sector (included in the item “other” of the table). The growth in investment by the general government during the same period was

16. It is estimated that in 1973 there were between 2,000 and 2,500 JAPs in the whole country, with 50% of them located in Santiago.

17. The general government includes both centralized institutions whose financing depends on the Treasury, and decentralized institutions, which generally have their own sources of funds to complement the Treasury’s contributions. The latter enjoy greater independence in the use of their funds; they include, e.g., the state-run social security system.



of a second order of importance—only 1% of GDP—as compared with current spending.

Public enterprises were another important cause of the expansion in public expenditures during this period. As shown in table 7.16, the bulk of the increase in their current expenditures came from purchases of goods and services other than labor, which rose by almost 5% of GDP between 1972 and 1973. The rise in their wage bills was more moderate than was true for those in the government, mostly because of a smaller increase in real wages. Quite remarkably, during 1973 the total sales of goods and services were insufficient to cover purchases of intermediate inputs.

However, we have not yet mentioned what became the most substantial source of increased public spending during 1972 and 1973: the subsidies necessary for the continued operations of medium- and large-sized private industrial firms taken over by the government. The authorities had expected to benefit from surpluses in those companies, but in practice they proved a major drain on public resources. The disruption in production provoked by this process necessitated government contributions of almost 9% of GDP in the form of subsidies during 1973 (table 7.16 and fig. 7.4a).

These expansionary policies became unsustainable in 1973, and general government spending fell abruptly. This drop was accelerated after the coup of September 1973, which clearly influenced the figures for that year. Most of the contraction occurred in the same items that had experienced the unprecedented growth in the previous two years; the wage bill and social security contributions fell to even lower levels as a proportion of GDP than they had been in 1970. Judging from the evidence presented in the previous section, it is clear that most of the crash was borne by real wages. The decline in investment was also pronounced (1.6% of GDP), even if softer than that of current spending. The decrease in the real values of current and capital expenditures was even more pronounced than the ratios to GDP shown in table 7.16, however, given that GDP collapsed by over 4% in 1973.

The contraction in government spending during 1973 was not attributable to a change in the economic strategy pursued by the UP administration. Instead, it was the result of both an unsustainable policy of demand expansion, which ran into bottlenecks on the supply-side and gave rise to very high inflation, and to changes in the last quarter of 1973 following the military takeover.

#### *Inflation, Increased Subsidization, and the Revenue Side*

The mounting fiscal deficits of 1970–73 were not only due to an expenditure surge, as public revenues also dropped significantly during this period. Part of this drop had its origins in the substantial decline of copper prices in 1971, coupled with the fixing of the copper exchange rate at an artificially overvalued level. The combination of these effects drastically reduced the revenues of copper companies and thus the taxes those companies paid to the government.

**Table 7.16a Public-Sector Operations (% GDP): General Government Compared to Public Enterprises**

	General Government					Public Enterprises (Excluding CODELCO)			
	1970	1971	1972	1973		1970	1971	1972	1973
Current revenues	31.58	32.81	29.14	23.55	Current revenues	9.14	9.29	9.90	11.43
Taxes	25.50	26.35	23.60	20.37	Sales of goods and services	6.64	6.64	8.04	7.83
Direct taxes	7.73	6.19	4.28	5.68	Transfers from general government	.71	1.12	1.38	2.51
Personal and business income	3.82	4.80	3.52	4.76	Transfers from private sector	1.68	1.47	.26	.75
Copper companies	3.10	.38	.05	.55	Other	.11	.06	.22	.33
Property	.81	1.01	.71	.37	Current expenditures	9.28	11.12	12.54	19.40
Indirect taxes	10.82	11.66	11.13	10.12	Wages and salaries	3.63	4.67	5.30	4.72
Goods and services	9.11	9.82	9.52	9.69	Purchases of goods and services	4.84	4.40	5.83	10.34
International trade	1.71	1.84	1.61	.44	Taxes and transfers	.14	.20	.06	1.62
Other, net of VAT rebates	.00	.00	.00	.00	Interest on public debt	.40	1.03	.63	1.88
Social Security contributions	6.96	8.51	8.19	4.58	Internal	.18	.30	.29	1.57
Nontax revenues	6.07	6.46	5.53	3.17	External	.22	.73	.34	0.31
Sales of goods and services	1.76	1.57	1.09	1.21	Other	.27	.82	.72	.84
Profit transfers and other revenues	4.31	4.89	4.45	1.96	Savings	-.14	-1.83	-2.64	-7.97
Current expenditures	25.27	32.21	33.01	26.02	Net capital revenue	-.01	-.01	-.09	-.13
Wages and salaries	9.81	11.82	12.92	9.41	Revenues	.03	.01	.01	.01
Purchases of goods and services	2.58	3.23	2.77	4.17	Revenues less financial investment and other transfers	-.04	-.02	-.11	-.14
Social Security payments	8.60	11.87	11.86	6.03	Capital formation	2.23	2.32	1.97	2.27
Transfers and subsidies to private sector	3.43	1.82	2.26	1.73	Total expenditures	11.51	13.44	14.51	21.67
Interest on public debt	.73	.72	.62	.68	Overall surplus	-2.38	-4.16	-4.70	-10.37
Internal	.20	.16	.40	.04	Financing	2.38	4.16	4.70	10.37
External	.53	.56	.22	.64	External (net)	.16	2.25	1.87	-.46
Other	.13	2.75	2.58	3.99	Drawings	.99	2.81	2.41	.30
Savings	6.31	.60	-3.87	-2.47	Amortizations	-.83	-.57	-.54	-.75
Net capital revenue:	-3.56	-2.99	-2.86	-2.21	Internal (net)	2.22	1.91	2.83	10.83
Revenue	1.66	3.15	.94	2.16	Banking system	1.02	2.11	3.80	N.A.
Revenues less financial investment and other transfers	-5.23	-6.14	-3.80	-4.38	Other and statistical discrepancies	1.20	-.20	-.97	N.A.
Capital formation	6.26	7.38	7.38	5.84					
Total expenditures	31.53	39.58	40.39	31.86					
Overall surplus	-3.51	-9.76	-14.12	-10.52					
Financing	3.50	9.76	14.12	12.27					
External (net)	-.07	-.59	-.09	.95					
Drawings	1.12	.71	.25	2.11					
Amortization	-1.19	-1.29	-.34	-1.16					
Internal (net)	3.58	10.35	14.20	11.32					
Banking system	3.14	12.45	14.42	10.23					
Other and statistical discrepancies	.43	-2.10	-.22	-.65					

Source: Larrain (1988), tables 4, 6, and 8.

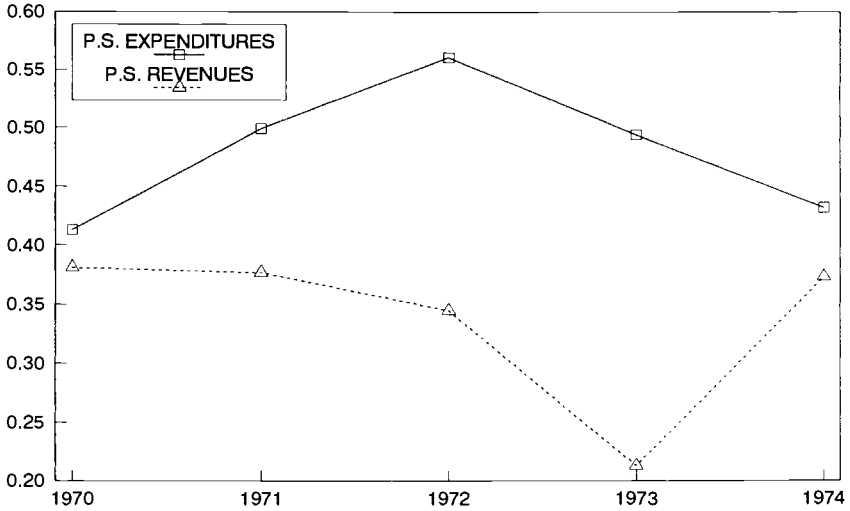
**Table 7.16b** Public-Sector Operations (% GDP): Consolidated Nonfinancial Public Sector

	Consolidated Nonfinancial Public Sector			
	1970	1971	1972	1973
Current revenues	38.14	37.65	34.48	21.26
Taxes	25.50	26.35	23.60	20.37
Direct taxes	7.73	6.19	4.28	5.68
Indirect taxes	10.82	11.66	11.13	10.12
Social security contribution	.96	8.51	8.19	4.58
Nontax revenues	12.63	11.30	10.88	.88
Net sales of goods and services	6.33	4.87	5.82	-2.22
Profit transfers and other revenues	6.31	6.43	5.06	3.10
Current expenditures	30.86	39.45	46.41	41.05
Wages and salaries	15.83	19.54	20.50	15.76
Social security payments	8.60	11.87	11.86	6.03
Transfers and subsidies to private sector	3.43	1.82	2.26	1.73
Interest on public debt	1.13	1.75	1.55	2.67
Other	1.86	4.47	5.63	5.36
Subsidies to social area	.00	.00	4.60	9.49
Savings	7.28	-1.79	-11.93	-19.79
Net capital revenue	-3.57	-3.00	-2.96	-2.35
Capital formation	10.41	10.48	9.64	8.35
Total expenditures	41.27	49.93	56.05	49.39
Overall surplus	-6.69	-15.28	-24.53	-30.48
Financing	6.68	15.27	24.53	30.48
External (net)	.09	1.66	1.82	.08
Internal (net)	6.60	13.61	22.71	30.40

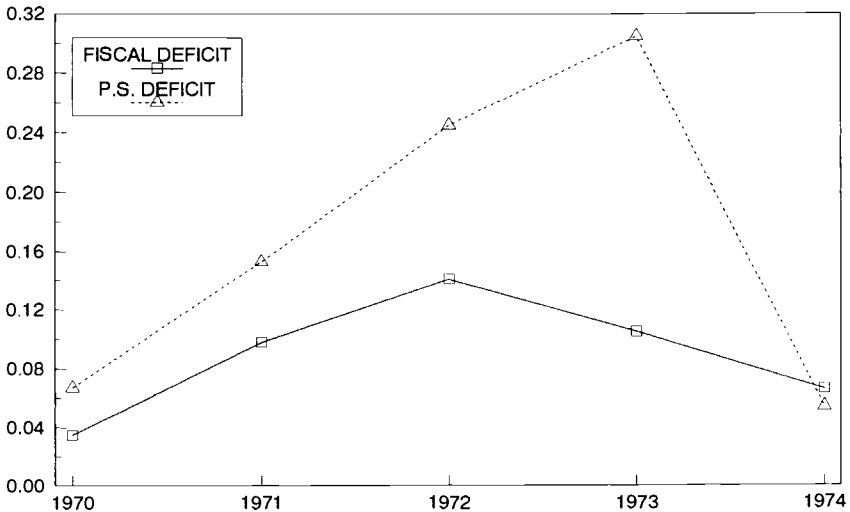
Another important player in the evolution of public revenue was inflation, which rose from almost 35% in 1970 to over 600% in 1973. Prices started to increase in 1972 at a faster pace as a consequence of the money-financed fiscal expansion. In the presence of significant lags in tax collections, rising inflation depressed fiscal revenues and thus fed back into the fiscal deficit (the Olivera-Tanzi effect).

The Olivera-Tanzi effect was clearly at work in Chile and helps explain the low levels of tax revenues in the period 1970–73. Indeed, a regression (for the 1950–82 period) with the public-sector deficit as the dependent variable shows that a 10% rise in inflation increases the deficit by 1.2 percentage points of GDP. This result shows that inflation has a bigger effect in depressing the revenues of the public sector than on reducing expenditures. A simple look at

**a. Public Sector Expenditures and Revenues  
(Percentages of GDP)**



**b. Fiscal and Public Sector Deficits 70-74  
(Percentages of GDP)**



**Fig. 7.4 Public and fiscal sector information**

the numbers suggests that this story fits well the Chilean situation in the period 1970–73. In every year in which inflation increased, tax revenues fell, reaching their lowest level as a proportion of GDP in 1973.

### *The Tax System*

Certain tax systems are better equipped to cope with inflation than others, and thus the relationship between inflation and fiscal revenue is neither stable across countries nor over time within a country. The tax legislation in Chile in the early seventies was not suited to an inflationary environment, even if a partial indexation of income taxes was introduced in the late sixties. With lags in collections estimated to be around one year, the rise in inflation to levels well above 100% in 1972 and 1973 accounted for a sizable part of the decline in tax revenues during those years.

Another aspect of the tax system that conspired against higher revenues was significant evasion,<sup>18</sup> the result of many factors, among them: insufficient and inefficient policing by the Internal Revenue Service (SII); the proliferation of groups receiving special treatment, which helped to produce a highly complicated tax system that encouraged taxpayers to disguise one source of income as another in order to qualify for a lower tax rate; and the existence of an indirect sales tax applied to the total value of every transaction (rather than a value-added tax), a provision that significantly encouraged evasion. In the words of Ffrench-Davis, by the end of the sixties “big scale evasion persisted, as well as a number of special tax treatments which benefited a minority” (1973, p. 185). This process was intensified during the UP government, as Cheyre (1986) has documented.

### *Increased Subsidization*

It is interesting to look at the revenue side of public enterprises when attempting to explain their deficit. Even if inefficient management had been one cause of the decline in real revenues by the end of the period, it is only part of the picture. It is clear that the prices charged for almost all the goods and services produced by public firms fell significantly in real terms from 1970 to 1973 (table 7.17). Perhaps the most dramatic case was that of electricity; its price declined by over 85% in the period. A similar trend was apparent in gasoline sales and telephone services. In the case of other fuels (gasoline, kerosene, diesel oil, and fuel oil), the downward trend was clearly present in 1970–72, when their prices decreased by an average of 40% in real terms, while world prices were steadily rising. In 1973 there was a substantial adjustment in the cost of oil in the international markets.<sup>19</sup> Thus, income trans-

18. The real value of tax revenues almost doubled in the second half of the sixties after the rates were raised and new taxes were introduced. However, revenues seemed to be far from their potential.

19. The world price of oil increased by approximately 100% between 1970 and 1973, even before the first oil shock of 1974. After adjustments in 1973, the domestic prices of fuels remained only 40% higher, on average, than their levels in 1970.

**Table 7.17 Real Prices of Selected Public Enterprise Output (1970 = 100)**

Year	Electricity	Postal Services	Telephone Services	Fuels				
				L.P. Gas	Gasoline	Kerosene	Diesel Oil	Fuel Oil
1970	100.0	100.0	N.A.	100.0	100.0	100.0	100.0	100.0
1971	87.6	169.0	N.A.	102.6	79.5	83.6	90.0	84.6
1972	67.7	177.0	100.0	67.7	69.4	61.1	68.1	57.8
1973	13.5	67.0	76.7	80.6	141.6	140.4	146.5	181.8

Source: Larraín (1988), table 9.

fers to the private sector in the form of increasingly higher subsidies through controlled prices for goods and services sold by public enterprises contributed some points to the growth of the public deficit during the Allende government.

As a result of the spending pressures and the decline in revenues, the consolidated public-sector deficit soared from 6.7% of GDP in 1970 to 30.5% in 1973, a level unprecedented in Chilean history (fig. 7.4*b*). One-third of the deficit can be attributed to subsidies for the “social area”; the rest was divided almost evenly between the general government and public enterprises. As table 7.14 shows, in 1973 all the financing came from internal sources, the overwhelming part of which was monetary emission. This pattern is not surprising, given that the executive branch of the government traditionally controlled the Central Bank.

A different interpretation of the deficit than ours is provided by Vuskovic (1975, pp. 18–19), who claims that “behind the fiscal deficit lie the open and covered resistance of the bourgeoisie against contributing the resources to sustain the basic public services and to improve the income of public sector workers; the refusals of Congress to approve new taxes, and the budgetary cuts that it imposes; and even an active campaign of resistance against the payment of existing taxes.”

## 7.5 Conclusions

The Chilean UP experience does not fit into Paul Drake’s definition of a “reformist set of policies tailored to promote development without explosive class conflict” (as quoted in Dornbusch and Edwards 1989). Sharp structural reforms and open conflict were major elements in Chile during 1970–73. It fits several but not all of the elements of the so-called populist paradigm (Dornbusch and Edwards 1989). The main discrepancy lies in the initial conditions of Chile’s experience. The previous government, helped by rising copper prices, had improved income distribution and the standard of living of the population and had introduced significant structural changes (agrarian reform and copper Chileanization). The UP government did not receive a stagnant economy, but one that had decelerated from a strong showing in the initial

three years of the previous administration. Rather than stagnation or outright depression, Chile's case at the time was better characterized as one of pent-up expectations that went unfulfilled.

The policy prescription was indeed reactivation, redistribution, and restructuring, but the relative weights were very different when compared to the other populist experiments of the subcontinent (with the exception, perhaps, of Juan Velasco's populist authoritarianism in Peru). The weight of structural changes was overwhelming, while reactivation and redistribution were in an important way subordinated to it. As we have pointed out, expansionary policies were deemed necessary by the UP leaders to provide a strong base of support for the radical changes that were being implemented in the Chilean economy and society. There is no doubt that the fundamental goal of the whole experiment was this radical transformation and not a mere improvement of income distribution and a higher growth rate. The UP was talking of nothing less than substituting a capitalist system with a socialist model, and they really meant it.

Notwithstanding these caveats, the other elements of the populist paradigm were basically present in the Chilean case. The UP government inherited an important stock of international reserves—equivalent to around five months of imports—which provided a substantial cushion for its expansive policies. Yet UP authorities emphasized (understandably) that the cushion was really provided by the existence of major unutilized capacity in the industrial sector. But the key for a populist government to be able to hold an expansionary party, is the existence of foreign exchange cash (in either reserves or loans). Whatever the source of the initial cushion, the Unidad Popular acted with no regard for macroeconomic constraints.

The phases of populist experiments (as identified in Dornbusch and Edwards 1989 and Sachs 1990) are indeed present in the Unidad Popular experiment. The initial expansion of 1971 drives output and real wages upward and reduces unemployment; remarkably, it goes with reduced inflation. But by the end of 1971 the signals of disequilibrium were clear for a dispassionate observer. Bottlenecks appeared in strength during 1972, and 1973 witnessed the collapse of the whole experiment. Political instability mounted, and a coup ultimately replaced the UP Government with a military junta.

In the end, ideology proved to be a bad substitute for macroeconomic realism. When shortages are either considered to be a good symptom of the performance of the economy or deemed to be the "fault of the Chilean bourgeoisie and the international system" (Vuskovic 1975), when the fiscal deficit is blamed on the noncooperative bourgeoisie, and when JAPs are considered a good mechanism to increase people's participation, then ideology obscures the perception of reality to the limit. In light of Chile's experience of 1970–73, the problem of the Unidad Popular economic policies was deeper than trying "a rapid attack on all fronts at the same time" (Bitar 1979, p. 193). It was the failure of ideology.

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## Comment Simón Teitel

The Larraín-Meller paper describes very well what happened in Chile during the Allende government and what led to the failure of its economic program. However, one might argue that the experiment that the authors analyze went well beyond populism; it was really an attempt to bring about socialism without a revolution or foreign invasion—an international first! Moreover, the analysis of this particular case cannot be restricted just to *macroeconomics*, but should include, as the authors do, some of the important *microeconomic* preconditions and consequences of the reforms that were undertaken.

These comments are organized as follows: (1) background and nature of the program, (2) macroeconomic features and constraints, (3) microeconomic diagnosis and performance, and (4) lessons for the future.

### Background and Nature of the Program

The Unidad Popular (UP) program was not based on an effort to recover from an IMF adjustment program or from an otherwise recessionary economy. Chile had experienced low to moderate economic growth, as well as favorable terms of trade (due to high copper prices) during the two preceding years. Substantial foreign reserves,<sup>1</sup> sizable unused industrial capacity, and probably

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Comments by S. Payson are appreciated. The points of view expressed in this paper are those of the author and do not purport to represent the official position of the Inter-American Development Bank.

1. Since the estimates of foreign exchange amounts vary from an equivalent of four months to an equivalent of six months of imports, by no means can these be considered as very large re-

also inventories, made possible an initially noninflationary expansion in demand fueled by the increases in real wages and public expenditures engineered by the government. By reducing real prices and squeezing profits, price controls further contributed to the stimulation of demand.

Although several of the changes resulted in an improvement in the distribution of income, the redistribution objective was superseded by a major attempt to alter, drastically, the structure of ownership in all major economic sectors. The extent of the reforms undertaken is particularly striking in view of Allende's rather narrow base of political power. The UP only received approximately one-third of the electoral vote. (In comparison, Frei, the previous president, had been elected by a clear majority.) Although the UP claimed to carry out its reforms legally, and within the existing institutional structure, it is unclear how it could be argued that the fundamental changes in property rights they tried to implement did not entail major institutional changes.

In all fairness, and as the authors do not fail to note, nationalization of the mining sector, and agrarian reform in agriculture, had already been initiated before the Allende government and had received substantial support—especially in the case of mining. However, similar attempts in industry and banking were more controversial.

Nevertheless, with the exception of the manufacturing sector, Allende's government nationalization failures can mostly be traced to implementation errors, including a lack of control of the processes and management inefficiencies, rather than to strong opposition.

### Macroeconomic Features and Constraints

An initial shift in demand was attained by increasing wages and public expenditures. Still, given the increases in nominal wages (40–50%), in central government expenditures (more than 60%), and in the money supply (more than 100%), the 22% annual inflation rate of 1971 seems quite low. The authors attribute this low rate to effective price controls in the private sector and a freeze on the prices of public services. Nevertheless, real wages increased beyond the established limits due to a lack of restraint by unions.

Although all the initial measures clearly were one-time instruments, the first year increases in output, employment, and investment, while also reducing inflation, were impressive. However, as well described by the authors, symptoms of macroeconomic instability were already present after the first successful year of the program—particularly, the increase in the fiscal deficit. Other indications of macroeconomic incoherence appeared later on.

Early warnings (1971) of macroeconomic disequilibria were: (i) the in-

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serves, especially when compared, for example, to the level of reserves with which Perón started his first presidency, which was equivalent to four years of imports. See Carlos F. Díaz Alejandro, *Essays on the Economic History of the Argentine Republic* (New Haven, Conn.: Yale University Press, 1970), table 73, statistical appendix.

crease in the government budget deficit from 3.5% of GDP in 1970 to almost 10% in 1971; (ii) a 124% increase in credit to the public sector; (iii) a drop in international reserves from almost \$400 million in 1970 to \$163 million in 1971; (iv) a trade balance shift from a \$95 million surplus in 1970 to a \$90 million deficit in 1971 (the fall in the price of copper from \$0.64 per lb. in 1970 to \$0.49 in 1971 was a key factor in this deterioration); and (v) an increase in consumption accompanied by a drop in investment.

The first shortages appeared during the second half of 1971, and by the end of 1971 there were also indications that inflation would accelerate in 1972. These indications included: an increase in the money supply, new wage adjustments, a depletion of inventories, further contraction of international reserves, and the emergence of black markets for many products. Still, the government did not react by emphasizing the fight against inflation, as it had done at the beginning.

The collapse took place in 1972–73. Expansionary policies became unsustainable, and government spending fell sharply. The areas most affected were those that had been increased substantially before. As an example, the share of wages in GDP fell to a value that was even lower than it had been before 1970.

The fiscal deficits of the period were aggravated by the fall in copper prices and by the maintenance of an overvalued exchange rate. The overvalued exchange rate was maintained for fear of the inflationary impact of devaluations, but it resulted in lower export revenues for the mining companies and thus in lower government tax revenues. Rising inflation also contributed to a fall in revenues due to the lag in tax collections. Public enterprises' prices had not kept up with inflation, thus substantial subsidies were required that also contributed to the expansion of the fiscal deficit. For example, the price of electricity declined in real terms by 85% in the period 1970–73. As a result of all these factors, the consolidated public-sector deficit increased from 6.7% of GDP in 1970 to 30.5% in 1973.

Thus the misalignment of the basic prices in the economy (wages, exchange rate, and the interest rate), which favored the initial expansion in domestic demand and absorption, when maintained for a longer period of time eventually led to macroeconomic instability.

### **Microeconomic Diagnosis and Performance**

The diagnosis of UP economists included some interesting microeconomic ideas. They assumed that a deficit in consumption (and consequently in production) existed because of the skewed distribution of income that favored consumption by the few. They maintained that this pattern of consumption led to diseconomies of scale in production and reflected the demand for luxury goods by the rich. These luxury goods were more capital intensive than the "simple" consumer goods demanded by the majority of the population, and

thus, led to a less than desirable employment level. In addition, it was argued, the structure of production reflected oligopolistic concentration resulting in monopoly rents that could be returned to the general population if the producers were forced to increase their output and to lower their prices.

Undoubtedly, the increase in purchasing power of the population, via the increase in salaries and price controls, gave rise to a substantial shift in demand that resulted in a reactivation of industrial production with all its attending benefits: larger runs, economies of scale, and lower production costs. As for the composition effect of this shift in demand, admittedly, there might have been not only significant differences in the propensities to consume among different socioeconomic classes, but also in their tastes and preferences. On the other hand, the claim regarding changes in factor intensity due to changes in the product mix seems more questionable. Some luxuries, like jewelry, cosmetics, and furs, may be more labor intensive than other goods favored by the working class—such as processed foods or consumer durables. Moreover, the employment effect of the shift in demand that took place, by the sheer size of the income effect, would be likely to dominate any factor-substitution effect due to differences in the factor intensity of the new product mix. Still, this interesting proposition remains to be tested by careful empirical studies.

The same could be said for the issue of the existence of monopoly rents in the manufacturing sector as a justification for leeway to reduce prices while still maintaining feasible enterprises. It was assumed that while the unit profit rate of industrial firms would be reduced, the increase in output and sales would compensate for it and maintain the overall level of profits. However, among the reasons for the increase in public spending were the large subsidies required for the continued operation of the industrial firms taken over by the government. Instead of sharing the monopoly rents with the population, these enterprises become a major drain on public resources (about 9% of GDP in subsidies during 1973 due to the disruption in production generated by the socialization process).

The cancellation of the indemnification to the foreign owners of mines, via the allegation of “excessive profits,” was probably the most egregious mistake made by the Allende government. Perhaps even a partial payment would have sufficed to temper the foreign opposition. Instead, foreign owners of mines had a very strong argument against the government, while support for the nationalization of the large mines had indeed been unanimous (This support was particularly striking taking into account that the Congress was controlled by the opposition.)

A failure of the agrarian reform was that the expropriated estates largely remained in the hands of the state rather than being distributed among the farmers. Similarly objectionable was the illegal occupation of farms (or *tomás*) in the face of an otherwise very rapid expropriation program. Because of the occupations of farms, irrespective of their size, the government managed to alienate all types of landowners.

In order to assume control of the industrial sector, the government had to find excuses. The unions obliged with labor disputes, which at times were also instigated by the government itself. It was also possible for the government to refuse price increases, which were tantamount to the survival of firms, in an effort to convince owners to sell their enterprises. These methods alienated not only large entrepreneurs (the original targets of the program), but also medium and small-size proprietors. Owners of industrial firms put up a much stronger resistance than those in other sectors, and, consequently, the takeover of industry could not be completed.

In spite of all the difficulties in carrying out the changes in asset ownership, in 1973 the government had control of 100% of utilities, 85% of banking and mining, 70% of transportation and communications, and 40% of industry.

One standard critique of expropriations concerns the negative impact of so-called uncertainty over property rights. However, the general influence of this effect may have been overstated. In Chile, the main effect probably resulted from the “certainty” that substantial changes in property rights would indeed be forthcoming. Seeing that the prices set by larger firms were being controlled, and their profits squeezed, entrepreneurs recognized that the rules of the game were changing unfavorably for all of them. This provoked opposition and surely had negative effects on planned investment. Even small firms, which could originally have counted on not being expropriated, could not ignore the existence of an antiprivate economic environment. Moreover, in a dynamic context, such firms could not expect to thrive and succeed because if they were to grow rapidly, they would soon become an expropriation target.

Thus many undesirable effects were generated by the “certainty” of the changes in ownership which were to be expected from a Socialist government, even for those who might have expected to be personally exempted from them. This argument is, to some extent, recognized by the authors in connection with mining, a sector in which the government kept the original targets and did not try to take over small and medium-size mines.

### **Lessons for the Future**

The Allende program had three of the expected phases—initial success, signs of macroeconomic disequilibria, and bottlenecks and collapse—but, as noted, was not preceded by a depression or an IMF adjustment program. It was also very different from other populist experiments in the extraordinary weight it placed on structural changes rather than on reactivation and redistribution. The objective was a change in the economic system from capitalism to socialism, with perhaps a brief populist “prelude” to broaden the support of the government before undertaking major structural reforms.

The question initially posed by the organizers of this conference remains unanswered. Are redistribution policies cum growth possible without running into macroeconomic instability? Clearly, in the long run, the only source of

real income increases is via productivity growth. Other means to change incomes are one-shot affairs based on using up existing unutilized resources or temporarily squeezing profits by means of price controls. They do not entail long-term solutions.

One assumption underlying the question appears to be that domestic demand should remain preeminent and that it must be increased via redistribution. The disregard for the need to complement domestic demand with foreign demand for industrial exports is particularly troubling because, while it is true that domestic demand will generally remain dominant, exports of manufactures are needed to break the dependence on erratic revenues from exporting raw materials, and to serve as a catalyst for productivity enhancement in the industrial sector, which could raise overall productivity.

In this respect, Ranis has argued that Latin America may have “missed the boat” because of its failure to develop labor-intensive exports earlier in its industrialization process (in contrast to the East Asian exporting countries).<sup>2</sup> However, this argument disregards the substantial differences in natural resource endowments that have existed between the two regions. Exports of manufactures from Latin America have been shown to include products based on natural resource processing as well as those originally manufactured for the internal market under protected import substitution.<sup>3</sup> Further expansion of such exports is possible without creating a major disruption in industrialized countries because the extent of penetration of Latin American products in those markets is generally limited. Chile has been quite successful in expanding nontraditional exports: some are manufactures, others natural resource products such as fruit and wood products. Brazil and Argentina are successful exporters of food products, as well as chemicals, metal products, and machinery. Venezuela is expanding its exports of metallurgical and metal products together with those of petrochemicals. Colombia has successful exports of leather goods and textiles, together with flowers and other natural resource products.

As a corollary, given the critical importance of these exports, there could be little tolerance for overvaluation of the currency or for wage increases not based on real productivity growth. Moreover, the incentives initially required by industrial exporters should be kept in a sustained fashion and made very clear to perceive.

Another point involves the definition of populism. Evidently, some people follow Lewis Carroll’s dictum and call things by the names they wish to call them. However, it must be recognized that substantial differences exist between “classical” populism, based on the existence of populist movements (e.g., with charismatic leaders such as Perón and Vargas), socialist experi-

2. See the discussion of Simón Teitel, “Industrialization, Primary Commodities and Exports of Manufactures,” in *The Balance between Industry and Agriculture in Economic Development*. ed. N. Islam (New York: International Economic Association, Macmillan Press), pp. 315–41.

3. See Teitel (n. 2 above).

ments, (like Allende in Chile or the “Sandinistas” in Nicaragua), and incomes-policy-based non-orthodox stabilization programs (such as the Austral and Cruzado plans in Argentina and Brazil, respectively), all of which are at times also labeled as populist programs. Obviously, not all bad economic policies are populist policies, and not all wage and price controls imply populism.

In recent years we have witnessed the failure, in Chile and other countries, of extreme reform-minded programs from both the right and left. We have also seen that these programs may end up having opposite effects to those originally intended—Chile is a prime example.<sup>4</sup> The question then becomes, Can such mistakes be avoided in the future?

The recent political constellation in Latin America includes a new phenomenon that goes beyond the previous seesaw of rightist and leftist experiments. It is the popular election of charismatic leaders, who, although running on a populist platform, choose, once elected, to carry out pragmatic programs. Presidents Carlos Meném and Carlos A. Pérez are good examples of this new development. Is this the wave of the future? The new Chilean government has issued reassurances that the macroeconomic stability and equilibrium attained during the latter part of the Pinochet regime will be preserved as a matter of high priority. The message seems to be that whether one comes from the right or the left, macroeconomic equilibrium must be respected. We know, however, that this, by itself, will not be enough to guarantee democratic socioeconomic development—Colombia represents the most relevant counterfactual example.<sup>5</sup>

These days, structural reforms are also proposed as a necessary element in all economic programs. These reforms are quite dissimilar to populist or socialist prescriptions, and proceed from very different diagnoses.<sup>6</sup> A major problem arises, however, from the divorce between the reforms that are proposed, and often carried out, and the means to reactivate the economy. Re-

4. Interestingly enough, the stabilization cum reforms programs attempted later on in the Southern Cone countries, including Chile, while obviously not sharing at all the basic motivation of the Allende program, all resulted in similar overvaluation phenomena. See Vittorio Corbo, Jaime de Melo, and James Tybout, “What Went Wrong with the Recent Reforms in the Southern Cone,” in *Growth, Reform and Adjustment: Latin America’s Trade and Macroeconomic Policies in the 1970s and 1980s*, ed. S. Edwards and S. Teitel. Special issue of *Economic Development and Cultural Change*, vol. 34, no. 3, (April).

5. This country not only has a record of relative macroeconomic stability but also has had one of the longest stretches of elected governments. Yet, it could be argued that today no other country in Latin America stands closer to a violent institutional breakdown than Colombia. R. Albert Berry and Francisco E. Thoumi, “Post-War and Post National Front Economic Development of Colombia,” in *Democracy in Latin America*, ed. D. L. Herman (New York: Praeger, 1988), pp. 63–85.

6. An interesting twist in the argument has been proposed by Sachs and others who argue that a more egalitarian distribution of income is a prerequisite for gaining support from the general population for the deep structural reforms now being attempted in many countries in the region. See John Sheahan, “Development Dichotomies and Economic Strategy,” in *Hirschman’s Thinking and a New Development Strategy for Latin America*, ed. S. Teitel (forthcoming).

duced government size, price stability, and income redistribution have not been shown to be sufficient to induce investment, and, without investment, no further economic growth or productivity increase that permits real wages to rise will be forthcoming.

One of the puzzles raised by the failure of populist programs concerns the reason for a government to continue carrying out policies that lead to its own demise. Is it due to irrationality, that is, the pursuit of extreme ideological agendas in the presence of adequate knowledge? Or is it due to a lack of information, thus reflecting honest mistakes, which, had the government known better, would have been avoided so that the government could continue to stay in power?

To better understand this problem we may have to cease considering the government as a monolithic entity. Recently I had occasion to converse with an eminent member of Alfonsín's economic team, and I was impressed by the reverence that the technician still held for the politician, even after fully experiencing the consequences of the *caudillo's* failure. This led me to think about asymmetries in the access to technical information and political power. While the government may pursue a program with strong political objectives (Allende), or constraints (Alfonsín), either of which may render it a failure because of its economic implications, the technical imperatives of the situation may not become clear to the politicians until it is too late. If they were able to share more of their political power (or share it earlier) with economic technicians, and if the latter were able to share more of their knowledge (or share it earlier) with the politicians, such *fracasos*, as recently experienced in Latin America, could perhaps be avoided.

In addition, it must be recognized that, due to limitations in our knowledge, many of the interactions and macroeconomic effects of such programs are not always easy to foresee, in particular those related to how people form expectations and react to certain economic measures.