



Political Crisis and Fiscal Policy in Chile 1938-1973

Roberto Pasten C.

Doctor (PhD) University of Alabama, AL, USA

Department of Economic, Finance and Legal Studies

Departamento de Economía, Recursos Naturales y Comercio Internacional

Universidad Tecnológica Metropolitana (UTEM), Santiago, Chile

rpasten@utem.cl

«Economic policy is subordinate, in its content, shape and form, to the political needs of increasing Popular Unity support.....; a central objective is to widen support for the government.»¹

Pedro Vuskovic.

**President Allende's Minister of Economy
1970-1972**

■ Abstract

The statement in quotes notoriously remarks the precedence of politics over economics during crisis times such as that of socialist government of President Allende. This paper through describes (political and economic) events, the underlying relationship between political instability and fiscal disarray. Prior to 1973, periods of political unrest were permanent, mostly explained by economic and social rearrangements starting at some point between the end of the Great Depression and the beginning of the

Second World War. Coincidentally, this period corresponds to one with a positive trend in the fiscal deficit. The year 1973 marks a break point in both the political deterioration and the fiscal disarray. The factual analysis in this paper seems to suggest that under political instability, the fiscal deficit has a positive trend and as a result, at some point, fiscal policy becomes unsustainable and therefore suboptimal.

Key words, political Instability, unsustainable fiscal deficit, fiscal policy
JEL Classification: H21, H62

| 1 Vuskovic (1973) page 50.

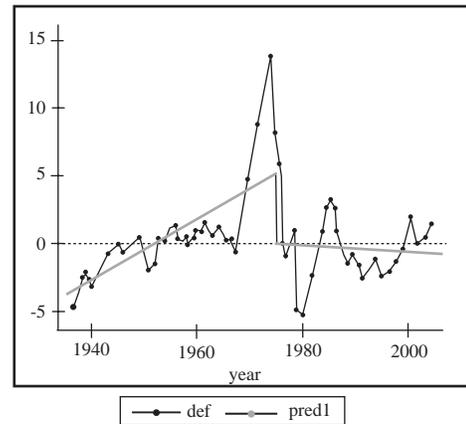
Figure 4 shows the pattern of the Chilean's Fiscal Deficit between 1935 and 2002. The graph clearly highlights the change in trend observed around 1973 (the year of the coup deposing President Salvador Allende). The aim of this paper is to describe some political and economic events that characterizes both periods, before and after 1973. In doing so it is possible to suggest that the positive trend in deficit prior to 1973 can be explained by the political turmoil that characterized the epoch.

Until the first two decades of twentieth century, the strategy of development that Chile adopted since the beginning of the Republic was based on the openness to international trade. Moreover, the participation of the public sector at that time was scarce. The Great Depression, first and the Second World War afterwards, changed everything. They caused the most important Chilean markets to be closed and therefore, the necessity of an industrial sector capable of replacing products originally brought from abroad. This strategy of development was in place for almost four decades. From the 1930s until the 1970s, the Economy became more inward than outward oriented. High tariffs together with other restrictions on the international trade were commonly used, and as mean of support for this new paradigm a large and active public sector became necessary.

In the political scenario, the beginning of the twentieth century saw the accumulation of wealth not only to the mine owners in the North but also to the land owners in the South. However, for the working classes there was no comparable improvement in living conditions. Indeed even during the presidency of Balmaceda there were strikes in the nitrate mines of the North, however, by the first years of twentieth century, such signs of social protest had become usual. This state of affairs has been called by historians

The Social Question. Absolutely related with this point, reformist parties such as the Socialist Party and the Communist Party emerged. The one-century supremacy of the Liberal and the Conservative Parties was being challenged by the emergence of these new political actors who had strong support in the low middle class and the working class. The eruption of less aristocratic presidents, more social participation and an inward-oriented economy together with political unrest characterized the period from 1938 until the deposition of President Salvador Allende in 1973.

Fig. 4 Fiscal deficit in Chile 1935-2002



Source of the data: Wagner, Jofre and Luders (2000) until 1999. From 1999 to 2002 corresponds to IMF's estimations.

The trend *"defest"* was fitted using (Swamy, 1970 and Swamy and Mehta 1975) Random Coefficients. Until 1973 trend's coefficient is 0.21 with standard deviation 0.045 and t statistic 4.68 (trend is significantly positive). After 1973 trend's coefficient is -0.02 with standard deviation 0.017 and t statistic -1.35 (trend is flat).

In contrast, the period after the deposition of President Salvador Allende marks a time of profound transformations of a different sort in both the political and the economic spheres. After a period of seven years of

strong and violent dictatorship a new constitution was enacted that marks the foundation of the political system prevalent in the country today. Even though the country has experienced some periods of political unrest (especially during the eighties, when a strong opposition to the regime erupted), it cannot be compared with the degree of polarization and confrontation observed prior to 1973.

Because the economic policies of the military regime resulted in macroeconomic equilibrium, low inflation and high growth, its policies of relying on the private sector, being open to trade and maintaining sound fiscal budgets have been kept in place by the coalition that deposed Pinochet and rules the country today.

The object of this paper is to describe by factual observation, the link emerging between political unrest and economic crisis. In particular, this paper attempts to highlight the relationship between political instability and increased fiscal disarrays in Chile. At the same time, it shows that when political stability is restored, a sound fiscal policy emerges.

Following this introduction, the chapter is organized in three sections. The following section (Section 2) describes the political and economic situation of Chile from the end of the Parliamentary Republic (during the 1920s) to the period that ended with President Allende's deposition in 1973. Section 3 describes similar aspects for the post-1973. Section 4 concludes this chapter.

■ 2. Political and Economic Crisis 1920-1973

First World War and the 1920s.

The First World War disrupted the Chilean Economy primarily through its effect on

nitrate exports. The exports of nitrate declined by 66 percent in 1919 and by another 50 percent in 1921 (Sutter and Sunkel, 1982). Seventy offices were closed down and around 10,000 workers fled to Santiago increasing the urban population living in marginal conditions (Collier and Sater, 2004). This caused copper to become a much more important source of fiscal revenue (In 1925 the tax on copper was raised by 12 percent, Collier and Sater, 2004).

Although the manufacturing sector flourished during the war, it did so primarily because of the disruption of foreign competition. When the war was over, manufacturers asked for and received additional protection by the state. In 1921 Congress raised import duties by 50 percent. As a result manufacturing grew dramatically between 1920 and 1928 and furthermore expanded dramatically the variety of goods produced (Collier and Sater, 2004).

In 1924, the Congress finally implemented a tax on income similar to that attempted without avail by several reformists during the nineteenth century. In 1925 an additional tax on income (global complementario) was imposed which exempted those earning low salaries in order to introduce some sort of equity into the system.

In 1920 a reformist President, Arturo Alessandri, was elected. He was the first president elected with the broad support of both urban lower and lower middle class workers. Congress opposed the social reforms proposed by the President and introduced at the same time a congressional dieta or salary arousing intense public hostility. Not unlike the case of President Balmaceda thirty years earlier, a bitter dispute between the President and the Congress erupted. The outcome of this dispute, however, was different because Alessandri's popular support was far wider.

Reformist members of the army demanded and obtained from the Congress the passing of the social reforms proposed by the President. In spite of this, the President saw himself as a sort of captive of the Armed Forces and chose to resign the Presidency on September 9, 1924. In September 11th a military junta was installed.

However, because of Alessandri's popular support a new Junta took power in January 23, 1925 and immediately recalled President Alessandri from exile. He resumed power on March 20, 1925. Under his tenure the Central Bank was created (August 25, 1925) and a new Constitution was promulgated (September 18, 1925). The Constitution of 1925 shifted power from the Parliament to the Presidency and thus put an end to the Parliamentary Republic. The Constitution of 1925 remained in place, nevertheless with some minor amendments, until 1980 when a new Constitution under the regime of General Pinochet was promulgated. Near the close of his mandate in 1925, President Alessandri resigned a second time after a struggle with his Minister of War, Colonel Carlos Ibanez. After Alessandri's resignation, Colonel Ibanez became the most powerful personality in the country. He maneuvered for the election of President Emiliano Figueroa in October 1925 and then forced the President to resign making himself elected President on May 23, 1927 with 98 percent of the vote and a turnout of 83 percent. The Ibanez's regime, (he was an admirer of Mussolini) was in essence authoritarian. Censorship of the press was restored, politicians were vanished, the Communist Party was outlawed and the labor movement was cruelly repressed.

In a manner similar to that of Balmaceda previously, he implemented large scale

public works, especially new railroads. He also dramatically increased the public administration as a consequence of his more active intervention in the economy. Nevertheless, even though an increase in internal taxes had been enacted, custom duties remained the main source of fiscal revenue. Since total tax receipts continued to be too low for the works implemented, foreign debt began to increase dramatically. Foreign debt in 1930 was double that in 1920. Nevertheless, fiscal policy appeared to be sound because of strong revenues from nitrate exports and the growing receipts from internal taxes. This changed when the Great depression reached Chile during the second half of the year 1931.

The Great Depression and the II World War

According to Collier and Sattler:

The Great Depression administered the coup of grace to the nitrate companies. By 1932 the output of the remained eleven salitreras had declined to one-fifth of its 1929 level. Foreign sales dropped by 90 percent and the purchasing power felt down by a 64 % from the levels of 1928.²

By the beginning of 1931 the inflow of capital into the country stopped. Hence, at the end of the year, the government defaulted on its foreign debt. A wave of riots and their subsequent repression shocked the country. On July 27, 1931 President Ibanez went into exile to Argentina. The following day Congress declared vacant the Presidency. Juan Esteban Montero assumed power as Vice-president and was formally elected President the fourth of October, 1931. After a series of military plots, Montero resigned and a Socialist Republic was proclaimed by

| 2 Collier and Sater (2004) page 221

members of the Armed Forces. This Junta lasted less than two weeks. After a wave of military juntas controlling the country, elections were held in October 30, 1932. Arturo Alessandry was inaugurated December 24, 1932 becoming the first President to be reelected in more than sixty years.

Alesandri restored stability and established the foundations of the four decades of uninterrupted democracy that were ended by the military coup of 1973. The most remarkable feature of these tumultuous years was the emergence of new actors, the middle and working class playing a more relevant role than in the period of the parliamentary governments. Communists and Socialists, additionally, became important political forces defying the Liberal and Conservative supremacy. In 1938 President Pedro Aguirre Cerda was elected with the support of a Popular Front composed mostly by members of the Socialist Party, the Communists Party and the Radical Party.

Time of Permanent Political Crisis

The Period of time from the first government of a member of the Radical Party (1938) until the overthrow of President Allende (1973) must be characterized as a period of permanent political unrest. President Aguirre Cerda (1938-1941) was the first of three consecutive Presidents coming from the Radical Party, (the single most important party between 1930 and 1960). The Coalition (the Popular Front) that brought President Aguirre Cerda to power was formed by an alliance between radicals, communists and socialists. This Coalition became explosive for the president given the political heterogeneity of its members, and his period ended (he died during his tenure of natural causes) ruling with the support of only a fraction of his own party.

Worse was the situation for the following President Juan Antonio Rios (1942-1946), also a member of the Radical Party and also who died during his tenure of natural causes). In fact, Antonio Rios ended governing without a party.

The last radical government, presided by President Gabriel González Videla (1946-1952) was backed by a coalition that included the Communist Party, the Socialist, and the Radical Party. Early in his period, he outlawed the Communist Party triggering a wave of riots and political unrest.

In this scenario of violent political disruption, the Chilean Society turned to a former dictator Carlos Ibanez (1952-1958) and after him to an independent, Jorge Alessandri (1958-1964) son of the former President Arturo Alessandri Palma. Nevertheless both periods proved as turbulent as before ending with widespread riots and looting.

President Eduardo Frei was inaugurated September 1964. His support came from the Christian Democratic Party, a reformist party of catholic observants with aspiration of social reform and democratic commitment. He was elected with almost a 60 percent of the electorate. However these figures reflect more the fear held by the right that the emerging Marxist orientated parties might gain power rather than an overwhelming support for the incoming President.

The support obtained by the newly elected president was not sufficient to end the political unrest that had characterized the previous governments. The radicalization and polarization observed during Frei's presidency had complex causes. One of the more important causes, however, was that the Democratic Party had decided to rule alone rather than under a broad coalition such as those that had prevailed in the

previous governments. Also, it was to rule in the context of the Cold War with an opposition highly ideological and finally, there was the impact of the Cuban Revolution that some groups wished to replicate in Chile.

Furthermore, there were signs of an incipient terrorism that had never been seen before. Bomb attacks on the American consulate, on private businesses, and on civil servant's houses; aircraft hijackings; guerrilla's schools; and, as usual, attempts to overthrow the government by a part of the military. Furthermore, the repression was brutal. In one attempt by the police to evict squatters from a plot of land, eight people were killed and around fifty were wounded.

Another remarkable feature of this period was the view that the patronage enacted by the incumbent government was far more partisan than during the time of the Radical governments. Some writers have expressed eloquently after comparing both periods: "Power has turned out to be a supermarket business. Before it used to be the corner grocery"³.

The Campaign for president in 1970 was marked by violence. Now bomb attacks were common, as were street skirmishes, assaults on party offices and general strikes. The polarization was notorious between two of the three candidates in the contest. Salvador Allende, a socialist, supported by a coalition of Communist, Radical and other Marxist parties and Jorge Alessandri (the former President) backed by the right. The right mounted a campaign of terror that included fake images of Russian tanks in front of La Moneda.

Allende won a plurality in the election by a narrow margin. Since none of the candidates

had an absolute majority, the President was to be elected by the Congress. After several attempts by the right (allegedly with the support of the CIA) to influence against Allende in the Congress, the election was held and Allende was confirmed. Three days earlier, General Schneider, the chief of the Army, was assassinated in a failed attempt to kidnap him. This was the last effort by the right to impede Allende's ascension. Allende's election attracted worldwide audiences since he was the first Socialist President in history to have been elected democratically.

Allende Presidency

The Program of the Popular Unity (the coalition supporting President Allende) was radical. It paved the road to socialism through the expropriation of the copper mines, the acceleration of agrarian reform and the nationalization of both industry and the financial sector. These policies put considerable distance between the USA and Chile. (American companies had invested close to one billion dollars in the Chilean Economy.) It also intensified the relationship between Chile and other Marxist countries.

The radical measures implemented by President Allende were never shared by a broad majority of the country and a strong opposition existed. Early in 1970 the Christian Democratic Party joined the opposition. The break was intensified by the assassination of President Frei's former minister of interior by a band of leftist in June 1971. However many of the Allende difficulties came from his own coalition. The Popular Unity had two antagonist visions of how to build the Road to Socialism. For one group of moderates, including the Communists Party and the Radical Party, it was possible to implement moderate

| 3 Gross (1967), page 132.

reforms with broader support by forming an alliance with center moderate parties (President Allende shared this vision). For the other group, formed mostly by the Socialist Party (the president's own party) it was necessary to implement more revolutionary measures (in the Cuban fashion).

Soon resistance to Allende gradually mounted. A proposed constitutional amendment was rejected by the opposition; riots erupted; a strike organized by truckers was joined by other segments of the population. When an educational reform was proposed that would adapt the curricula to the new society it alienated groups previously neutral (the Catholic Church, parent's centers and a large part of the army officers).

In July 1973, attackers assassinated Allende's naval aid. At the same time, an attempt backed by the left of mutiny in the Navy was discovered. The opposition in Congress passed a resolution accusing the government of breaking the law. On September 11 the armed forces overthrew President Allende. La Moneda was bombed by jetfighters. At around 2 pm, President Allende shot himself with a gun machine that had been given to him by Fidel Castro a few months earlier.

The Economic Background

The beginning of the hostilities in Europe in 1938 virtually closed the Chilean Economy which until then had been highly opened. This caused a change in the country's strategy of development turning toward the import substitution model that had been adopted by most of the Latin-American countries by that time. The change in the model also implied a more interventionist economic policy by the state. Additionally,

the rise of Marxist oriented political parties together with a broadening of political participation caused a shift in fiscal policy toward the satisfaction of increased social needs. The result was a period of high inflation and high deficits with which all governments had to contend until around the middle seventies. According to Collier and Sater:

(1) First the resulting deficit led to a depreciation of the peso; (2) this in turn sent up the price of imports and the cost of living; (3) demands for wage increases quickly followed; (4) the ensuing economic crisis forced the government to spend further funds to bail out the industries hardest hit by the wage increases and the depreciating peso; (5) these expenditures further devaluated the peso. And so the inflationary cueca [the national dance] went on, made worse by restrictions on interest rates, which, by falling behind inflation, actually declined in real terms provoking a spasm of borrowing and lending.⁴

The above description could be accurately applied to every government from President Pedro Aguirre Cerda (1938-1941) to President Salvador Allende Gossens (1970-1973).

The Import-Substituting Model

After the Great Depression of 1930 and the disruptions caused by the Second World War, Chile abandoned the model of a highly opened economy for a model based on inward-oriented development, favoring a national process of industrialization with active participation by the state (the number of civil servants doubled between 1919 and 1930 from 27,469 employees to 47,193;

| 4 Collier and Sater (2004) page 277.

Humud, 1969). This change in strategy was formalized around the beginning of the 1950s by a group of economists from the Economic Commission for Latin America and the Caribbean (ECLAC) based in Santiago under the leadership of Raul Prebisch. As was explained by Cardoso and Fishlow:

Attention to the foreign exchange constraint rather than to savings as the determinant of growth of peripheral countries was the principal macroeconomic novelty. In a world where the terms of trade moved against traditional primary export products, domestic production would have to substitute for non-essential imports, leaving foreign exchange for the needed inputs. Moreover, while technical progress in agriculture would leave labour unemployed, dynamic industry could absorb the growing population with increased productivity and incomes. Domestic production required protection against imports and a deliberate bias against exports of resources required by industry. In the microeconomic sphere, emphasis was placed on imperfections and discontinuities, both of which impeded effective operation of price signals. Whether in agriculture-where land concentration was notorious- or in industry -where new privileges provided shelter from market forces- the competitive model was flawed.⁵

From a fiscal point of view, the importance of taxes on commodities gradually diminished while subsidies to emerging industries increased. At the same time, due to social and sector-specific demands and

in addition to the increased responsibility assumed by the state for the conduction of the economy, expenditures increased, causing upward pressure on the deficit. Monetization of the deficit with the consequent inflation was unavoidable.

Explaining the early stages of implementation of the model, Collier and Sater pointed out:

The radical governments [1938-1952] soon discovered that foreign borrowing and the tax on copper were not sufficient to meet the cost of both the industrialization program and the normal (and now expanding) operations of the state. The Moneda spent the copper levies to meet its general expenses) or to subsidize imports such as food or fuels. In theory, no doubt, higher taxes levied on the wealthy might have been used to fund the governments and the income from copper to develop the economy. This was seen as either too dangerous politically or simply not feasible. Rather than increase taxation or impose an austerity program, the Radicals, like their predecessors, found a happy way out; inflation.

And they continued;

Labor wanted higher wages. Business did not want higher taxes. Both sides now had powerful allies. Congress cravenly capitulated to public pressure and authorized pay increases to civil servants well in excess of the rate of inflation. This measure, which increased salaries by between 20 and 90 percent, absorbed 25 percent of the national budget for 1952. Clearly an inflationary psychology was fast

| 5 *Cardoso and Fishlow (1992) page 200*

gaining sway: Chileans were coming to expect higher and higher reajustes (readjustments) at regular intervals. And certainly the González Videla government [1946-1952] had not difficulties printing money. Given such largesse, the Moneda recorded some of his highest deficits in 1950 and 1951. By now it seemed clear to many that the political parties possessed neither the skill nor the will to stop inflation.⁶

Copper remained the main source of government revenue under the presidency of Carlos Ibanes due to the low political cost associated to royalties (since they were paid abroad rather than within the country). But eventually they became prohibitively high for the mining companies. In 1953, Chilean copper production was only 14 percent of the world market whereas it had accounted for 21 percent five years earlier. A reform implemented by President Ibanes reduced royalties in exchange for shares in the mines. This measure alone increased investment in the sector by almost 100 percent.

Nevertheless, the increase in copper revenues was not high enough to cover the increased deficit. Furthermore a domestic tax reform never could be implemented. (An attempt made by Felipe Herrera to increase taxes on the rich resulted in him being thrown out of office.) Given the political turmoil of these times, an increase in wages was authorized in order to reduce social unrest. It proved ineffective when the rate of inflation reached 70 percent per year. At the same time unemployment had almost doubled in comparison with the previous year. The peso lost its value by two thirds in comparison with the previous year.

A mission supported by American lenders arrived in the country at the end of 1955 (The Klein-Saks Commission), however most of the (laissez-faire flavored) measures proposed by the commission were rejected by the Congress. The government also never reduced spending as advised. Furthermore, a readjustment of salaries was authorized with the consequent increase in the rate of inflation (33 percent in 1958). Still some politicians defended the measure. For example, Rafael Tarud denounced less than adequate readjustment as cruel; *“the solution [he suggested] lay in reducing the privileges of those elites who have remained tragically backward in their understanding of the social dilemma.”*⁷

The economic platform of President Jorge Alessandri (1958-1964) was aimed at stopping inflation and it centered on the following points: increased investment in public works, housing and industry; increment in production and a halt to wage readjustments. The program was financed with external loans in the context of the *Alliance for the Progress* established by President Kennedy as a shield against the proliferation of socialist regimes in the region.

A monetary reform was implemented that replaced the existing currency and the exchange rate was pegged to the dollar. This policy stayed in place for almost two years and caused a dramatic reduction in the inflation rate (it was 5.4 percent in 1960). However, a speculative attack on the escudo (the new currency) was followed by a devaluation that accelerated the rate of inflation. It was aggravated by the strongest earthquake in Chilean history (and for some accounts the most violent in world history)

6 Collier and Sater (2004) page 274

7 Rafael Tarud. *Contra el Despojo de los reajustes*. Cited by Collier and Sater (2004) page 279

that mainly affected the South of the country. Several towns were literally erased from the map and the whole productivity of that Region was affected for several years.

Two big reforms were implemented by President Eduardo Frei (1964-1970). An agrarian reform and the “chilenización” of the copper mines. The latter consisted in the acquisition of a 51 percent government holding in the mining companies. With the price of copper at its highest level in history (in part due to the Vietnam War), the government’s tax receipt increased by almost 100 percent (in comparison with Alessandri’s year). In 1969 the high price of copper, combined with some fiscal innovations (raise and indexation of taxes, a new wealth tax and the reassessment of property values) yielded the first balanced budget in twenty years (0.4 percent of GDP).

However, by the end of Frei’s term in office, it seems that the government had lost control on the economy. Inflation was running high, something most writers explain by the failure of union leaders to put a halt to wage increases.⁸

The name of the political program of President Allende (1970-1973) was “the Road to Socialism”. Economically speaking, the object was a Socialist Economy. Some of the measures implemented were: the nationalization of copper (100 percent ownership), acceleration of the agrarian reform (Allende had promised to expropriate all estates larger than eighty basic hectares, and by 1972 there were no estates exceeding this basic limit), and the nationalization of the most significant industries.

A key object of the measures implemented by the government was to improve the conditions of low paid workers and in general those worst off. The idea was that it would be possible to reach this aim by providing employment either in the new nationalized industries or on public works (during 1971 funding for public works almost doubled). Furthermore, it was believed that the measures would stimulate private consumption.

He adopted the same policy of every predecessor, insulating consumers from the effect of inflation through automatic wage readjustments. (During his first year wages were increased by 55 percent while inflation for the previous year was about 33 percent; Collier and Sater, 2004.) Additionally, social spending was increased dramatically in areas such as housing, health and education.

The negative effects of inflation were disregarded by the authorities since a broad price control was implemented. However by the middle of 1972 stocks had been exhausted and it was difficult to find basic goods at the legal price. Eventually inflationary pressures became too strong and the government had to allow prices to increase. In 1972 the cost of living rose by 55 percent, and then the rate of inflation doubled in just one month (August 1972). Over the next year it increased by most of 300 percent (Collier and Sater, 2004).

The Economic strategy of the Popular Unity government backfired. It collapsed the whole productive apparatus. For some analysts it was caused by the rude opposition of the middle and upper classes together with the hostility of US toward the

⁸ Although some observers were optimistic about the economic situation, some of them expressing: “Chile in 1970 was prospering on the point of take off toward full development” (Elliot 1993, page 8).

government. However, such policies have never been successful any where or at any time. For our purposes it is enough that these policies were implemented in order to obtain political support as Allende's own minister of Economy Pedro Vuskovic stated: "Economic policy is subordinate, in its content, shape and form, to the political needs of increasing Popular Unity support.....; a central objective is to widen support for the government."⁹

■ 3. Political and Economic Structural Reforms 1973-

By the first days following September 11, 1973, the regime of Augusto Pinochet had taken strong measures. Congress went out of sessions (It resumed again only in 1990, when a democratic regime replaced the military government), the Popular Unity parties were banned and the remaining political parties went to recess and were banned indefinitely in 1977. A curfew was imposed that lasted for several years. Newspapers and magazines attached to the left disappeared and a strict censorship was imposed to the rest of the media. The public servants were purged and the most important institutions of the Republic (including universities) were placed under military control.

A new Constitution was voted September 11, 1980. It markedly increased presidential power and authority. It gave the president a term of office of eight years and limited the power of Congress. (It also displaced Congress to the port-city of Valparaiso, one hundred miles away from the governmental apparatus.) One-third of the Senate was appointed. The military influence was stretched. Pinochet himself had the right to

be appointed for a new eight-year period after a referendum of ratification (that he finally lost in 1990).

The strength of the authoritarian system was in place for almost seventeen years until the end of the Pinochet era. However most of the political reforms are still in place given the high quorums required to amend the Constitution. With minor expressions of protest (pacific rather than violent) the political calm characteristic of the first years of the Republic had been restored. This relative political calm has been enjoyed by every government after the restoration of the democracy.

Economic Reforms

The harsh structural economic adjustment implemented by the military government at the beginning of its mandate was influenced by a group of economists formed under the highly liberal school of thought at the University of Chicago. Under their advice all price controls were abolished in 1973 and the domestic currency devalued more than 500 percent.

Due to the recession caused by the first oil shock, the reforms slowed down. Nevertheless, in 1975, coincidentally with the consolidation of Pinochet's power, Milton Friedman (one of the Chicago's guru) visited the country. He insisted on the need for a shock treatment in order to contain inflation. His advice was followed and the group of economist implemented that very same year the most drastic economic reforms that have ever been seen in the Chilean economy. Public spending went down dramatically, the money supply was contracted and wages were kept down. In spite of the strong recession caused by these measures, the

| 9 Vuskovic (1973) page 50.

economic program of reforms was accelerated.

The following years saw the privatization of public companies at an impressive pace, the reversal of the agrarian reforms implemented by the previous presidents, imports tariffs were reduced, the tax system modified, and a new monetary reform implemented. Although the reforms were ruthless, they became the trademark for the economic policies implemented by every government of the coalition that replaced Pinochet in power.

■ 4. Conclusions

The present paper explores, in an informal way, the strong linkage between political instability and increasing fiscal disarrays in Chile 1920-1973. Prior to 1973, periods of political unrest were usual, mostly explained by a productive and social rearrangement starting some point between the end of the Great Depression and the beginning of Second World War.

At the same time, it is possible to observe a positive trend toward higher and higher fiscal deficits. The year 1973 marks the end of both, the political deterioration and the fiscal disarray. This evidence is suggestive that under political uncertainty, the fiscal deficit has a positive trend and as result, at some point, fiscal policy becomes unsustainable and therefore suboptimal.

Contrarily to the assertion above, the period posterior to 1973 is a period of profound political and economic reforms. During this period it was possible to enjoy political stability along with sound fiscal policies. This is suggestive evidence that under political certainty, there is no incentive to distort

fiscal policy between elections and therefore the officeholder follows the full information optimal fiscal policy.

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