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Table of contents

Boxes

Tables

Figures

This Survey is published on the responsibility of the Economic and Development Review Committee of the OECD, which is charged with the examination of the economic situation of member countries.

The economic situation and policies of Chile were reviewed by the Committee on 5 December 2011. The draft report was then revised in the light of the discussions and given final approval as the agreed report of the whole Committee on 14 December 2011.

The Secretariat's draft report was prepared for the Committee by Nicola Brandt, Aida Caldera Sánchez, with statistical assistance from Roselyne Jamin, under the supervision of Patrick Lenain.

The previous Survey of Chile *was issued in January 2010.*

This book has...

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BASIC STATISTICS OF CHILE (2010 UNLESS NOTED)

THE LAND

Area (thousands sq. km)	756.6

POPULATION

Total (millions)	17.1
Inhabitants per sq. km	22.6
Net average annual increase over previous 10 years, per cent	1.1

EMPLOYMENT

Total employment (thousands)	7 131
In % : Agriculture	10.6
Mining	3.1
Manufacturing	11.3
Services	75.1
Unemployment rate (in per cent)	8.1

GROSS DOMESTIC PRODUCT (GDP)

GDP at current prices and current exchange rate (USD billion)	203.5
In % of GDP : Agriculture	3.1
Mining	19.2
Manufacturing	11.1
Services	66.5
Gross fixed capital formation (GFCF) as % of GDP	28.4

PUBLIC FINANCES (as % of GDP)

Current revenue	24.5
Current expenditure	20.6
Nominal balance	3.9
Consolidated net debt (central government and central bank)	–8.3

INDICATORS OF LIVING STANDARDS

GDP per capita USD PPPs (2010)	15 107
Internet users, per 100 inhabitants (2010)	36.6
Doctors, per 1 000 inhabitants (2008)	1.8
Infant mortality per 1 000 live births (2009)	7.9
Life expectancy at birth (total population, 2010)	78.6
Income inequality (GINI coefficient, 2009) (after taxes and transfers)	0.49
Poverty (% of people living with less than 50% of median income, 2009)	18.4

FOREIGN TRADE

Exports of goods (USD billion)	69.6
In % of GDP	34.2
Copper exports in % of total exports	57.8
Imports of goods (USD billion)	57.6
In % of GDP	28.3

THE CURRENCY

Monetary unit: Peso

Currency units per USD, average of daily figures	
Year 2010	510.0
November 2011	508.7

Executive summary

Chile's strong recovery lost some momentum as the world economy slowed, weakening copper prices and consumer confidence in Chile. Given considerable uncertainties regarding the health of the world economy, more supportive macroeconomic policies may be needed in the short run. In the longer run, reducing poverty and inequality is a key challenge. Both remain high by OECD standards, notwithstanding impressive progress. Redistributive transfers and progressive taxes are very limited. Better education and job opportunities for the poor would enable more Chileans to contribute to a more dynamic and productive economy and thus to higher welfare. The following measures would help Chile overcome the challenging situation of the world economy in the short run and attain stronger growth and a more inclusive society in the longer run:

- ***Supportive macro policies in the short-run.*** *Given the uncertain global environment monetary policy should remain on hold for now. A slow pace for consolidation is appropriate at the moment, but once the external environment improves the government should return to a structural fiscal balance to rebuild buffers against shocks.*
- ***A strengthened fiscal rule and higher tax revenues to finance long-term spending increases.*** *Chile's structural fiscal balance target has led to low debt and large assets in the sovereign wealth funds. The government plans to create an independent fiscal council, which could validate the correct application of the rule and assess the target chosen by the government as well as changes in the methodology applied. This shift should strengthen Chile's fiscal framework. There is also strong demand for higher quality education and social services in Chile, which is likely to mount as the country develops. The government already plans significant spending increases on such programmes, which will need to be financed on a sustainable basis. Higher environmental taxes would be a particularly efficient source of revenue. A reduction of regressive tax loopholes and of still-pervasive income taxes evasion would also make the tax system more progressive.*
- ***Higher cash transfers for the poor combined with support for recipients to find employment,*** *as envisaged by the government through the new Ingreso Ético Familiar programme. The government currently plans to target the bulk of the transfers to families living in extreme poverty. Over time, it should consider opening all new transfers to a wider range of participants, for example through a more gradual benefit withdrawal. This would also enhance work incentives for beneficiaries and limit fraud. To assess whether transfers should increase over time the government should evaluate the impact of higher cash transfers on recipients' work incentives, employment opportunities and capacity to invest in their human capital.*
- ***Better access to quality housing along with measures to reduce residential segregation and enhance mobility.*** *This could improve access for the poor to higher-quality education, social services and jobs. Better targeting of housing subsidies will be essential to free resources for those truly in need. At the same time the government should rethink subsidies, which are currently directed exclusively at home ownership. Means-tested rental cash allowances coupled with more*

balanced tenant-landlord regulations would strengthen the rental market, thus enhancing residential mobility and potentially reducing segregation. Other measures that would contribute to lowering segregation and inequality include: better enforcement of social housing quotas, more investment in infrastructure and social services in poorer neighbourhoods and development of unused land in urban areas.

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Assessment and recommendations

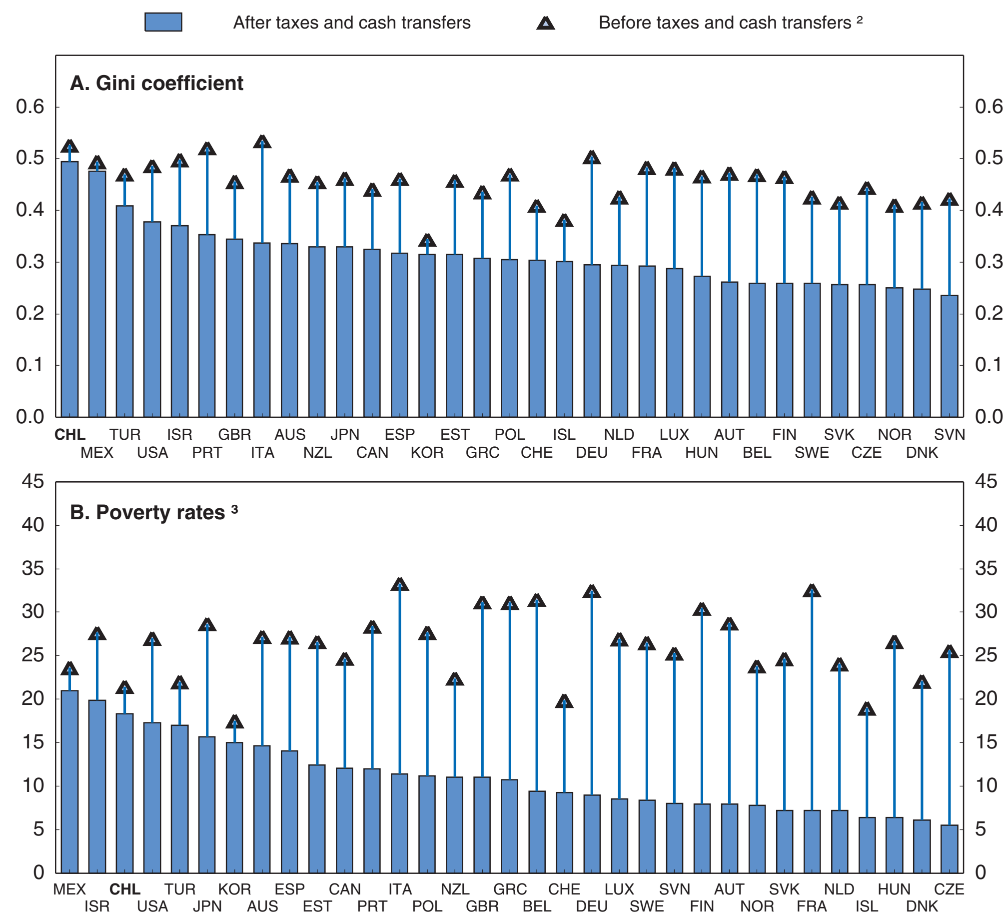
Chile's vigorous recovery after the global recession of 2008-09 and the devastating earthquakes and tsunamis of early 2010 has lost some momentum, as the world economy has turned down. GDP is projected to grow by 6½ per cent in 2011, but to ease to 4% in 2012. Provided that confidence improves and the global economy picks up again later in 2012, growth in Chile should rise to around 5% in 2013. However, as a small, very open economy with a large share of copper in total exports (close to 60% in 2010) Chile would be vulnerable to a sharper than expected global downturn, notwithstanding the fact that it recovered fast after the global crisis of 2008/2009 and proved resilient to the earthquakes and tsunamis in 2010. Chile's income gap with the most advanced OECD countries remains wide, mainly due to lower productivity. Poverty and inequality also remain high in comparison with other OECD countries, in part because the tax-benefit system does very little to redistribute income (Figure 1). Despite strong economic growth, inequality has been highly persistent over the past 20 years – notwithstanding some modest improvements in the past few years – and inter-generational social mobility is low. Chile's main challenge is to sustain high growth while distributing the gains more evenly across society. Better education and stronger product-market competition will be needed to foster productivity and reduce inequality. Efforts to enhance growth should be combined with measures to increase the employment of the poor and to improve their living standards.

Demand is keeping growth up but there are signs of a slowdown

Economic growth in 2011 was driven by consumption, easy access to credit and reconstruction of infrastructure and housing after the devastating earthquakes and tsunami of 2010. But recent data and confidence indicators point to a moderation in economic activity. Notwithstanding a recent slide in the copper price, the terms of trade remain favourable, but the current account has moved into deficit, as imports have expanded fast and both mining and industrial export volumes have grown only weakly. The peso appreciated strongly during the first half of 2011, but has recently started to depreciate amid declining copper prices. Concerns about overheating have decreased, as growth and headline inflation have stabilised (Figure 2). Lower commodity prices and a rapid succession of monetary policy rate increases during the first part of 2011 have helped contain core inflation during the upswing. With commodity prices weakening and growth set to slow, inflation should remain well within the central bank's target range (3% +/–1).

Figure 1. **Inequality and poverty across OECD countries**[1]

2009 or latest year available



1. Household income is adjusted by the square-root of the number of persons in the household. Provisional estimates.
2. Before transfers only for Greece, Hungary, Mexico and Turkey. Subsidies to buy a home are not included in Chile.
3. Poverty line defined at 50 per cent of the current median income.

Source: OECD, *Income Distribution Database*.

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Once the external environment improves the government should close the structural budget deficit

The government expects a budget surplus of 1.2% of GDP in 2011, thanks to strong economic growth and still high – albeit volatile – copper prices, and spending cuts of about 0.4% of GDP to counteract strong domestic demand and pressures on the real exchange rate earlier this year. After adjusting for the cyclical upswing and high prices of copper and molybdenum, in line with the government's fiscal rule, this still corresponds to a structural budget deficit of –1.6% of GDP, down from –2.1% in 2010. The government aims to gradually reduce the structural deficit to 1% of GDP in 2014, mainly by containing spending. The substantial cost of reconstruction (4.2% of GDP) and the external environment justify a slow pace of consolidation in the short run, although resolute tightening to close the structural deficit will be needed once reconstruction nears completion and the external environment improves. This would help replenish savings in the stabilisation fund, the *Fondo de Estabilización Económica y Social* (FEES), which has proven very useful as an

Table 1. **Summary of the *Economic Outlook 90*, OECD projections**

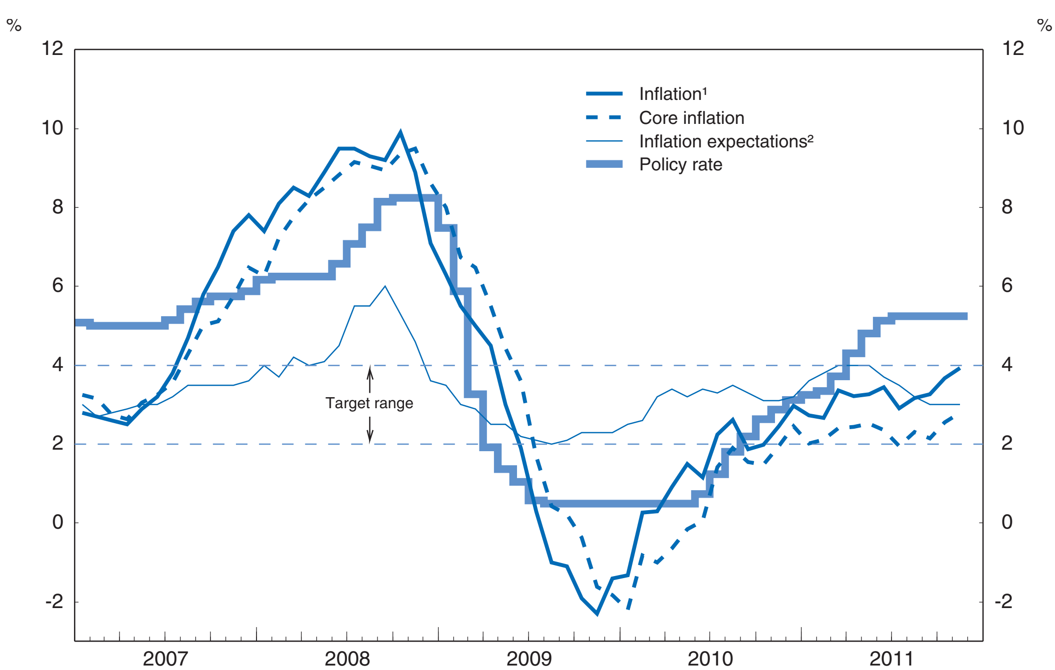
	2008	2009	2010	2011	2012	2013
	Current prices CLP billion	Percentage changes, volume (2003 prices)				
GDP at market prices	89 205.5	–1.5	5.1	6.6	4.0	4.7
Private consumption	52 860.0	0.9	10.4	9.4	6.4	7.0
Government consumption	10 603.2	7.5	3.3	3.6	2.4	2.4
Gross fixed capital formation	21 946.1	–15.9	18.8	16.3	7.7	8.8
Final domestic demand	85 409.3	–2.9	11.5	10.5	6.3	7.0
Stockbuilding[1]	567.2	–3.2	4.9	0.1	0.2	0.0
Total domestic demand	85 976.4	–5.8	16.4	10.3	6.4	6.9
Exports of goods and services	39 866.3	–6.4	1.9	7.4	4.6	4.7
Imports of goods and services	36 637.3	–14.6	29.5	15.2	9.5	9.1
Net exports[1]	3 229.1	3.2	–8.5	–2.1	–1.5	–1.5
Memorandum items						
GDP deflator	–	2.7	9.5	3.3	3.4	3.6
Private consumption deflator	–	0.9	0.2	3.3	2.8	2.8
Consumer price index	–	0.4	1.4	3.5	2.8	2.8
Unemployment rate	–	10.8	8.1	7.0	7.3	7.1
Central government financial balance[2]	–	–4.5	–0.4	1.2	–0.4	0.2
Current account balance[2]	–	1.5	2.1	–1.1	–2.2	–2.0

1. Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column
2. As a percentage of GDP.

Source: OECD, *OECD Economic Outlook 90 Database*.

Figure 2. **Inflation and inflation expectations**

At annual rates



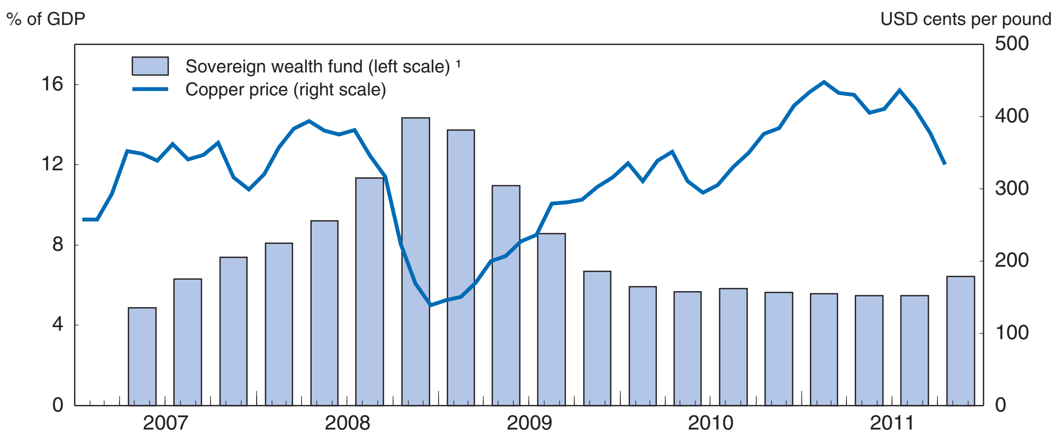
1. Consumer price index (IPC).
2. Eleven months ahead.

Source: Central Bank of Chile.

StatLink http://dx.doi.org/10.1787/888932563875

insurance against large shocks, helping to finance a strong fiscal stimulus in the recent recession. The fund's assets are increasing again, but relatively slowly considering historically high copper prices over the first eight months of 2011 (Figure 3). Nonetheless, if the economy weakens significantly more than projected, there is scope to introduce expansionary fiscal measures to sustain demand.

Figure 3. **Sovereign wealth fund and copper prices**



1. Fondo de Estabilización Económica y Social (FEES) at market price, government estimate for 2011 Q4.
Source: Gobierno de Chile, Ministerio de Hacienda, Dirección de Presupuestos; Central Bank of Chile.

StatLink http://dx.doi.org/10.1787/888932563894

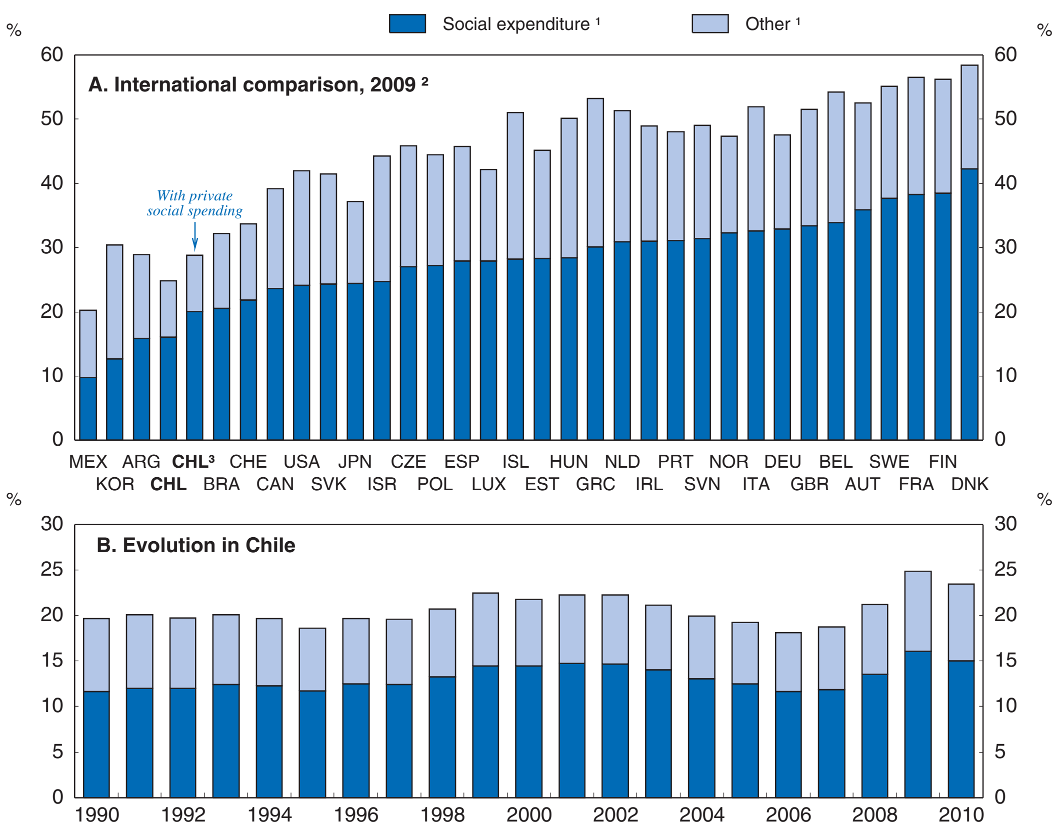
Chile's fiscal rule has served the country well. It has helped to shield the economy from swings in the price of copper and the economic cycle, thus limiting the volatility of public spending, activity and inflation. The basic pillars of the rule remain in place and enjoy wide political support: current spending is determined by a preannounced structural balance target, whereby revenues are adjusted for cyclical variations in output and copper prices. In an effort to increase transparency and diminish room for discretionary moves, the government has accepted several of the recommendations from a panel of experts (the Corbo Commission) it commissioned in 2010 to write a report about strengthening the fiscal framework. Transitory changes in tax rates will now be considered as affecting structural revenues, which is an improvement. As a result, the structural fiscal deficit is now considered to have reached 3% of GDP rather than 1.1% in 2009, when taxes were cut temporarily as part of the fiscal stimulus. The commission also recommended the creation of an independent fiscal council that would monitor fiscal policy and ensure the correct application of the fiscal rule (Corbo *et al.*, 2011). The government plans to introduce such an institution, and this is very welcome. It would facilitate public scrutiny of fiscal policies. The council could produce the estimates of potential growth and the long-term copper price used to compute the structural deficit, thus replacing the two existing committees currently in charge of these tasks. It could also assess whether the government's medium-term fiscal strategy is consistent with the fiscal rule and assess long-term fiscal sustainability based on projected spending and copper revenues. To enhance transparency and accountability, its reports should be published. The rule has become more complex as the government has fine-tuned its calculation over the years, but such methodological changes sometimes increase accuracy, as in the example above. A fiscal council will help to maintain the transparency of the fiscal framework and accountability, even when it becomes more complex.

In the medium term the government should increase the efficiency of the tax system and revenues

Chile's income inequality is high and the tax-benefit system does little to reduce it. Low inter-generational social mobility suggests that many Chileans do not have sufficient opportunity to improve their human capital and realise their full potential. Relatively low spending on education and social policies, compared with other OECD countries, contribute to this outcome. While private spending on pensions, healthcare and education is higher in Chile than in other countries, taking this into account does not change the general picture (Figure 4). Public expenditures on social protection and education are likely to increase as Chile's income level catches up and demand for higher quality public

Figure 4. **Government expenditure by function**

As per cent of GDP



1. Social expenditure: health, education and social protection; other: general public services, defence, public order and safety, economic affairs, environment protection, housing and community amenities, recreation, culture and religion.
2. Countries are ranked by share of GDP in social expenditures. 2006 for Argentina, Brazil and Canada; 2008 for Korea and Japan.
3. Including Chile's social expenditure adjusted for private expenditure on pensions, healthcare and below tertiary education.

Source: OECD, *National Accounts Database*; Chile: *Estadísticas de las Finanzas Públicas 2000-2010*; Mexico SHCP, *Cuenta de la Hacienda Pública Federal*.

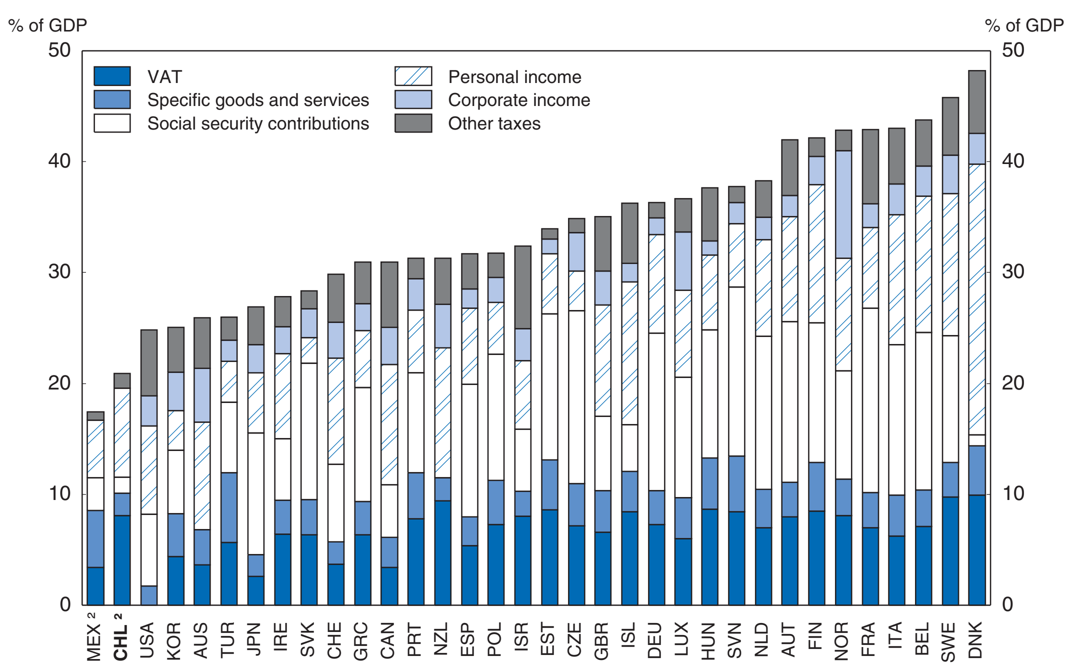
StatLink http://dx.doi.org/10.1787/888932563913

services becomes stronger. If properly designed, such spending increases would also improve economic opportunities for the poor, thus enhancing Chile's growth performance and mitigating inequality. The government has indeed increased spending on education and social policies significantly over recent years and envisages further increases. These are long-term spending needs, which will require additional revenue sources. This should be achieved through efficiency-enhancing measures, such as fighting tax evasion, closing loopholes, reforming property taxation and introducing environmental taxes. Such measures would correct distortions and aspects of the tax system that make it less progressive, while helping to collect more revenue.

The overall tax base is dominated by indirect taxes (Figure 5), and the extent of VAT evasion has been reduced to only 13% of potential revenue. However, one study puts the rate of personal and corporate income tax evasion each at a bit below 50% (in 2003), implying a loss of potential revenue of about 3 % of GDP (Joratt, 2009). Since then the rate of corporate income tax evasion has declined to around 30% of potential revenues in 2009. No recent estimates for personal income tax evasion are available, but assuming that these followed a similar trend, the potential revenues loss from the personal and corporate income tax would be around 2½ per cent of GDP. The tax authority should continue to introduce best practice measures to identify tax fraud. There is considerable room for tax avoidance in Chile, which can also facilitate evasion. One source is the large difference between the top personal income tax rate (40%) and the corporate tax rate (17%, temporarily increased to 20%), combined with numerous exemptions from capital gains taxation, including on transactions of residential property and liquid assets traded on an

Figure 5. **Tax revenue from different sources across countries**

2010[1]



1. 2009 for Australia, Greece, Ireland, Japan, Mexico, Netherlands and Poland.
2. Personal income tax collections include revenue from taxes on corporate income/profits in Chile and Mexico.
Source: OECD, *Revenue Statistics Database.*

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exchange. This creates incentives for high-income individuals to keep their savings in corporations created solely for that purpose (*sociedades de inversion* and *sociedades personales*) and to declare parts of their income as corporate earnings. The government should work to close these tax loopholes, for example by disallowing corporations which have the sole purpose of tax avoidance. Broadening the tax base by limiting exemptions to capital gains taxation would be another option. While this may limit or lock in some types of investment, it would make for a more neutral tax system that is easier to administer with fewer opportunities for tax avoidance.

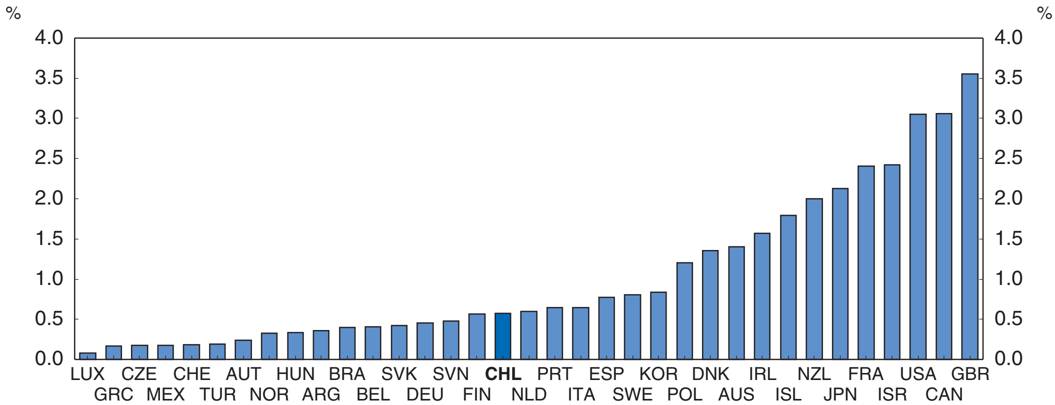
One efficient way to increase tax revenues in the long run would be to raise mining taxes, although this would involve difficult negotiations with the mining firms who recently received an extension of tax stability guarantees in return for agreeing to higher rates. Carefully designed taxes on natural resource rents are less harmful to growth than other types of taxes. Chile's current tax treatment of the mining industry is favourable by international standards (Lopez, 2011), despite the recent increase in the royalty rate (from 5% to 8-9%). For instance, in Australia the effective net income tax on mining firms is equivalent to more than twice the rate paid in Chile (Cenda, 2010). Colombia and Peru have recently raised their mining taxes. There should be room for Chile to raise its taxes on mining without discouraging investment, especially if these are accompanied with further improvements in the business environment, as envisaged in the government's competitiveness agenda.

There is room to reform real estate taxation, for which there are many exemptions that make this tax less progressive and distort investment decisions. As in most OECD countries, homeowners' imputed rental income is not subject to income tax. However, mortgage interest payments are deductible from taxable income, with a generous ceiling, and households generally do not pay capital gains tax on the sale of residential property. The income from letting out houses smaller than 140 square meters that have been built in line with certain provisions (*Decreto con Fuerza de Ley No. 2*, DFL2) is also tax free. The government has recently limited the tax treatment for these so-called DFL2 properties to two houses per owner, but this does not apply to the existing stock of DFL2 properties. Such houses are generally exempted from inheritance tax and benefit from a halving of property taxes up to 20 years after purchase. These advantages reduce tax revenue by about ½ per cent of GDP, a bit more than half the amount currently spent on housing subsidies. Partly as a result of this, property tax revenues are comparatively low in Chile (Figure 6).

The first-best solution to make housing taxation more neutral – taxing homeowners' imputed rental income – would be too complicated to implement. The government should instead abolish loopholes and exemptions in the recurrent housing property tax and consider higher rates, as taxes on real estate are generally less distortive than other taxes. Revenues currently amount only to about half of their potential fiscal value, according to government estimates. If raising property taxes sufficiently to replicate taxation of imputed rents turned out to be politically too difficult, a gradual withdrawal of mortgage interest deductibility would be warranted. More equal taxation relative to other investments would avoid distortions and it would also make the tax system more progressive, as wealthier homeowners tend to have higher value homes and benefit more from income tax deductions. To limit distortions with respect to other assets, the value of houses should be subject to the inheritance tax, and rental income should be subject to income tax for all houses. Moreover, housing construction benefits from a reduced VAT

Figure 6. **Recurrent taxes on residential immovable property**[1]

As per cent of GDP, 2009



1. 2008 for Australia, Greece, Mexico, Netherlands, Poland and Portugal.

Source: OECD, *Tax Database* and Development Center, *Latin American Revenue Statistics*.

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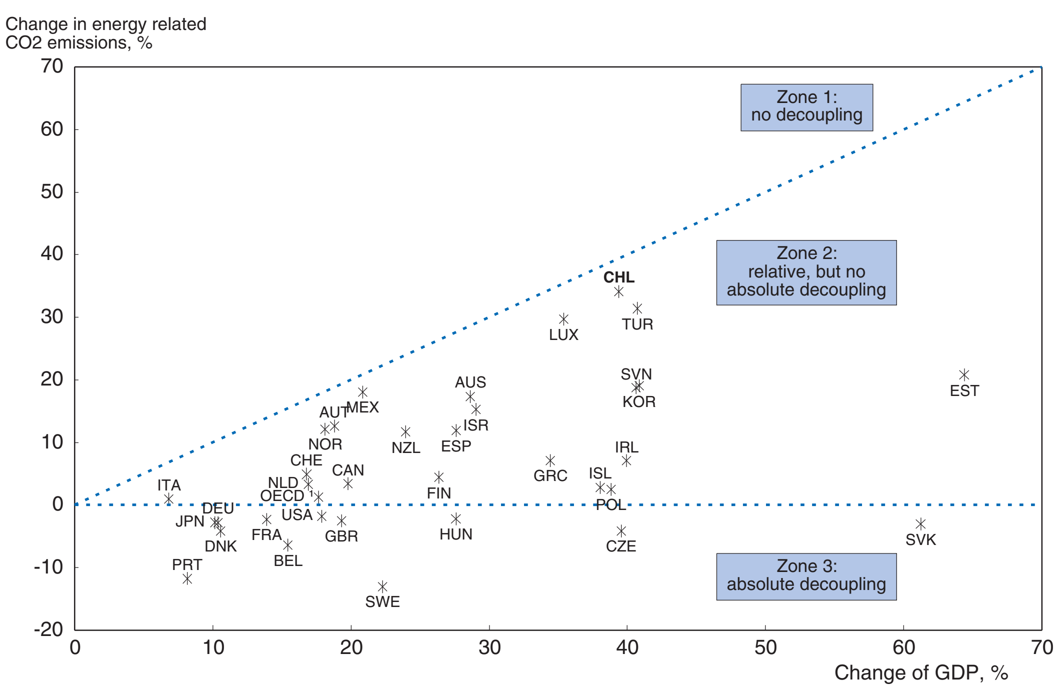
rate, representing a distortion relative to other goods of final demand. The associated tax benefit was capped in 2009, but limiting the benefit further would make the tax credit less regressive and reduce the associated fiscal costs.

Chile could strengthen its environmental taxes to help make its economic growth less carbon intensive (Figure 7). So far, the government has taken few measures to internalise

Figure 7. **The environmental impact of growth differs across countries**

2000-2008



1. The OECD area excludes Chile, Estonia, Israel and Slovenia.

Source: OECD, *Towards Green Growth: Monitoring Progress, OECD Indicators*.

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environmental externalities, such as greenhouse gas emissions. Chile's environmental tax revenues, which stem mainly from gasoline excise taxes, are low. Fossil fuels used in industrial production processes and electricity generation are subject to VAT only, as are highly-polluting solid fuels like coke and coal. Chile also has a price smoothing mechanism for fossil fuels used in transport, which applies a subsidy or surtax to domestic prices when they are outside a tolerance band around a weighted average of past and future prices on international reference markets. This resulted effectively in a fossil fuel subsidy which cost around 0.4% of GDP on average over 2000-09. The government has widened the tolerance band significantly, from +/–5% to +/–12.5%, which is a step in the right direction. In the future, the government wants to smooth prices through hedging operations on the derivative markets, transferring net costs or benefits to consumers through lower taxes on fossil fuels or surtaxes. Instead, however, the government should move towards abandoning price smoothing altogether and internalise more of the externalities associated with fossil fuels, perhaps by starting with higher taxes on road fuels in line with their CO_2 content and then broadening these taxes to other uses and fuels. Alternatively, road fuels could be complemented with an emissions trading system.

The current monetary policy is broadly appropriate

With the economy running above full capacity, supportive fiscal policy and commodity prices booming, the central bank was right to implement a quick withdrawal of monetary stimulus. In Chile food and energy price shocks tend to pass through to headline and core inflation much more quickly and strongly than in many other countries (Pedersen, 2010; Pincheira and García, 2010). Thanks to early monetary policy reaction, the increase in inflation since 2009 has been contained. Other factors also contributed to moderate inflation growth, including comfortable profit margins in the food sector, which provided room for suppliers to avoid raising prices one-to-one with international price increases. The central bank has left the policy rate at 5.25% since July, close to its estimated neutral level. With slowing inflation, well-anchored inflationary expectations and substantial uncertainties regarding the global economy, monetary policy should remain on hold for the moment. Should the downturn be stronger than expected, there is room for loosening.

In response to the strong copper price increases and – to a lesser extent – resurgent capital inflows the real exchange rate appreciated strongly until mid-year, but has recently depreciated strongly. For now, worries that capital inflows may contribute to a destabilising boom-bust cycle are limited, as the new surge in capital inflows has been matched by an almost equally strong increase in outflows, partly related to more flexible rules for pension funds to invest abroad. Nevertheless, the Chilean central bank has implemented a foreign exchange reserve purchase programme, with a total value of USD 12 billion in 2011. This action has brought its reserve levels more in line with those in other emerging market economies in a context of high uncertainty regarding commodity prices, fiscal stability and the strength of the international recovery. Chile is well advised to accumulate some reserves as a self-insurance against various shocks. However, accumulating foreign exchange reserves through sterilised interventions is a costly way to do this, given the interest rate differential with the United States.

Potential weaknesses in financial regulation need to be addressed

Thanks to careful regulation, Chile's financial system is sound overall, with little exposure to currency mismatches or the complex assets that have plagued financial institutions in other OECD countries. However, there are potential weaknesses. Household indebtedness, while still lower than in most OECD countries, has almost doubled over the last ten years, reaching 70% of disposable income in 2010. One of the fastest growing types of credit has been credit cards issued by retailers, which are mainly directed at lower-income households with difficulties in accessing bank credit. This now accounts for a third of all outstanding consumer credit. So far, authorities consider that the total amount of household debt is still manageable, but warrants close monitoring. The Superintendency of Banks can effectively supervise credit cards issued by retailers only through information provided by private auditors. The government should strengthen regulation to ensure that all credit cards are regulated and supervised rigorously. The recent case of the country's fourth-largest retailer, who fraudulently underreported its credit-card portfolio in financial statements, illegally rescheduled consumer credit without consulting card-holders, and is now on the brink of bankruptcy, illustrates the need for stronger supervision and consumer protection. The government is taking a number of measures in this direction. It has created a financial consumer protection agency and required banks to report the cost of credit more transparently. In addition, it plans to introduce a consolidated credit register for bank and retail credit to households, which will be useful for credit issuers and the regulator to assess risks, and to reverse the artificial segmentation of the credit market, which has made market access more difficult and increased costs. The government has sent a draft law to Congress to establish such a register, replacing a similar initiative launched in 2009, which made little progress. This should become a priority. The register should include the entire credit history of consumers.

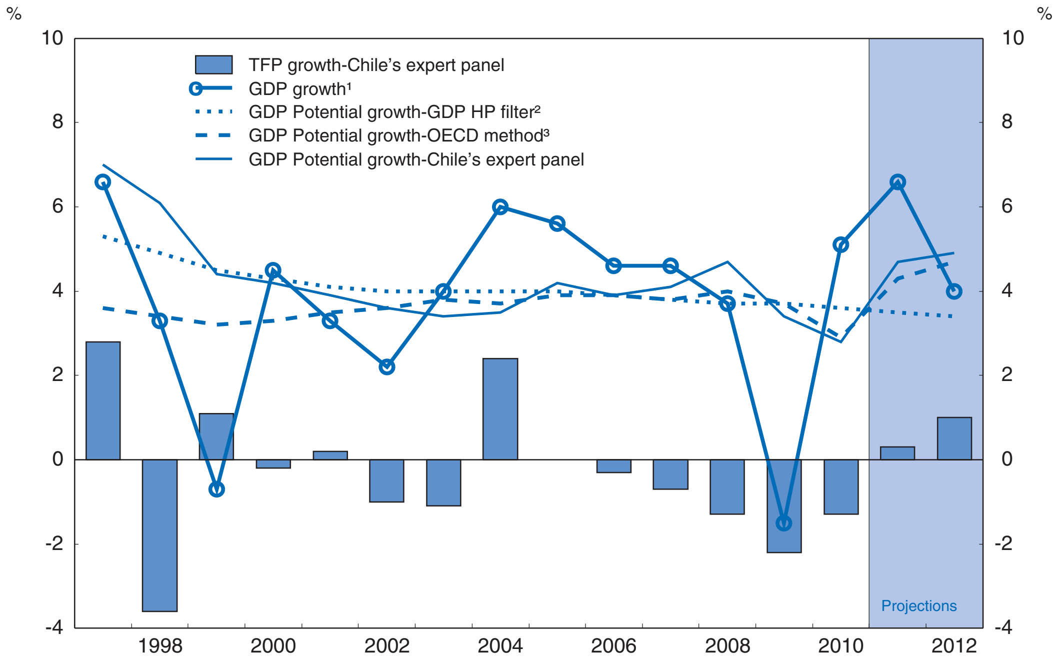
Box 1. **Recommendations to improve fiscal and monetary policies**

- Once the external environment improves, and reconstruction nears completion return to a structural fiscal balance to rebuild safety buffers in the sovereign wealth funds and ensure medium-term fiscal sustainability.
- In the long term, to finance likely increases in spending on education and social services, continue fighting tax evasion and close tax loopholes associated with income and real estate taxes. Consider increasing mining taxes, immovable property and environmental tax rates.
- Strengthen the fiscal rule by establishing an independent fiscal council, as planned.
- With slowing growth and inflation, loosen monetary policy if the global economy worsens further.
- Introduce a consolidated credit register for household credit, including on debt from non-banks. Ensure that all credit card issuers are supervised rigorously.

Stronger economic growth will require measures to reinforce productivity growth

The government has adopted the ambitious goal of attaining average annual growth rates of 6% – a substantial increase from the average of the last ten years – and it wants to create a million jobs over 2010-14. Yet, potential growth is estimated to be closer to 4-5% percent than to 6% (Figure 8). Raising total factor productivity growth, which stagnated over the last ten years, will require stronger competition to foster efficiency at the firm

Figure 8. **Potential growth in Chile**



1. OECD STEP projections.
2. GDP filtered using the Hodrick-Prescott filter.
3. Product of trend labour force productivity and potential employment of the total economy.

Source: OECD calculations.

StatLink http://dx.doi.org/10.1787/888932563989

level, along with more rapid technology adoption and innovation. Chile will also need a better education system.

The government is making progress in improving the conditions for entrepreneurship and innovation. It has recently unveiled an "Agenda to Boost Competitiveness" comprising more than 50 measures to reduce red tape and foster competition, and Congress passed a law that reduces the time to create a company by more than half and the associated costs by 23%. The authorities envisage a reform of the bankruptcy law to speed up the closure of firms and reduce associated costs and uncertainties. This is welcome as the current procedure is lengthy and costly, holding back entrepreneurial activity and making access to credit difficult (OECD, 2010). The government plans to increase the cap for the R&D tax credit, broaden the target population and ease the certification process that establishes eligibility for the benefit. The take up of the tax credit, which was introduced in 2008, had been low, possibly because it was too narrowly targeted at firms contracting R&D with public research institutions, leaving aside internal R&D. Moreover, the certification process was too cumbersome (OECD, 2010). The new, better designed tax incentive might help stimulate stronger R&D investment in Chile, which is currently low.

One important catalyst of strong productivity growth is vigorous competition in product markets, which forces firms to reduce inefficiencies and innovate. The 2009 competition policy reform strengthened the enforcement of cartel law, by increasing the investigative powers of the National Economic Prosecutor, introducing a leniency programme and increasing fines. This has moved Chile closer to international best practice as discussed in the 2010 Economic Survey of Chile. Since then, the National Economic

Prosecutor has trained its personnel and hired new experts. Yet the government will need to do more to make the new law effective. Cartel fines remain too low (one recent fine amounted to USD 13 million, a mere 0.1% of the company's revenues in 2010), no advances have been made in making price fixing a criminal offence, and the leniency programme is hardly used, probably owing to low legal certainty, as participants are not exempted from sanctions. The government should link maximum fines to firms' revenues, establish legal certainty for participants in leniency programmes and make price-fixing a criminal offense. Stronger competition would lower rents and create opportunities for newcomers with a potential to reduce inequality.

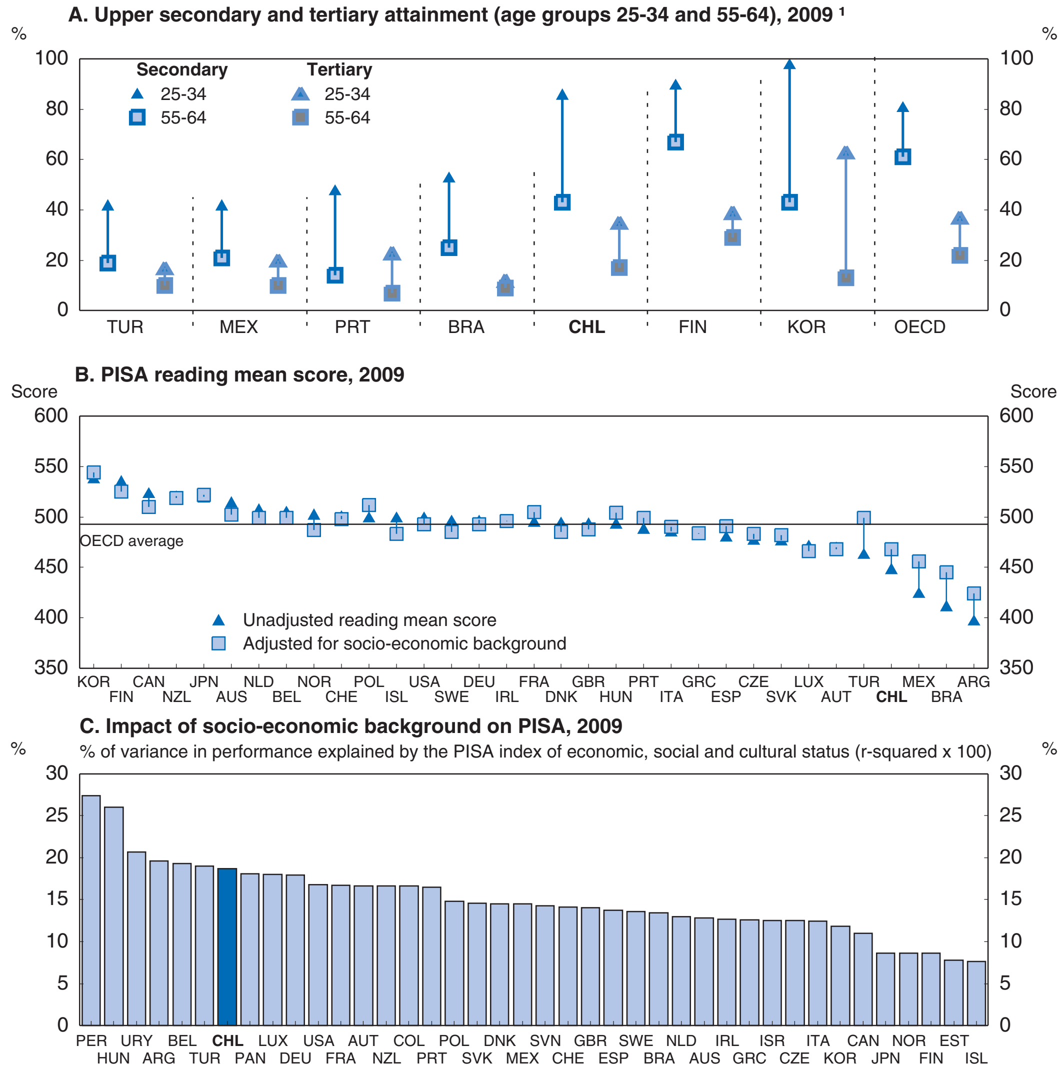
The government should further build on its efforts to improve the quality and equity of education

Notwithstanding recent progress, the government should make further efforts to improve the quality of education and ensure more equal access to high-quality education, as discussed in the *2010 Economic Survey of Chile*. This will enhance the productivity of the Chilean workforce, contributing to higher economic growth and lower inequality. Chile has made impressive progress in educational attainment (Figure 9, Panel A). Moreover, it achieved the largest improvement of all OECD countries in PISA reading results between 2000 and 2009. However, results remain substantially below the OECD average, even after adjusting for the relatively weak average socio-economic background of Chilean children (Figure 9, Panel B). Moreover, the influence of pupils' socio-economic background on their learning results within Chile (Figure 8, Panel C) remains strong, although Chile was one of the few OECD countries where this indicator showed a statistically significant improvement. This suggests that the government needs to do even more to ensure access to high-quality education for poorer children, including high-quality early childhood education and care.

Over recent years, the government has taken important steps to attract better prepared individuals to the teaching profession and this is important to improve the quality of education. It has further increased the voucher subsidy for poor pupils, introduced in 2008, so that it is now up to 60% higher than the standard voucher. The increased voucher will be extended to secondary school gradually starting 2013. The government plans to make it easier for schools to spend the extra money to hire new staff on a long-term basis, thereby increasing the chances for poor students to be taught by more qualified teachers. Both principals and teachers with excellent evaluations can receive salary bonuses in schools with many poor pupils. The hiring of principals has been professionalised in public schools. They have obtained more freedom to select their management team and they can now dismiss teachers with bad evaluations. The government plans to offer professional training for 10% of the country's principals each year. Chile is also in the process of establishing a new quality assurance system for schools with one agency, *Superintendencia de Educación*, enforcing the law and regulations at schools, and another one, *Agencia de la Calidad de la Educación*, setting national standards as well as evaluating the quality of learning results, teaching and school management. For the first time in decades, government institutions will be able to apply sanctions and – in the extreme – close down schools that do not comply with the law or provide poor education without showing improvement. These are important steps to improve education quality in Chile. The OECD recommended many of these measures in the *2010 Economic Survey of Chile*.

However, as discussed in the 2010 Survey, initial teacher education and professional development also need to improve. The government is envisaging steps to achieve this,

Figure 9. **Educational attainment and outcomes**



1. Excluding ISCED 3C short programmes.
Source: OECD, *Literacy in the Information Age 2000*; *Education at a Glance 2011*; *PISA 2009 Overcoming Social Background: Equity in Learning Opportunities and Outcomes, Vol. 2: Analysis*, OECD, Paris.

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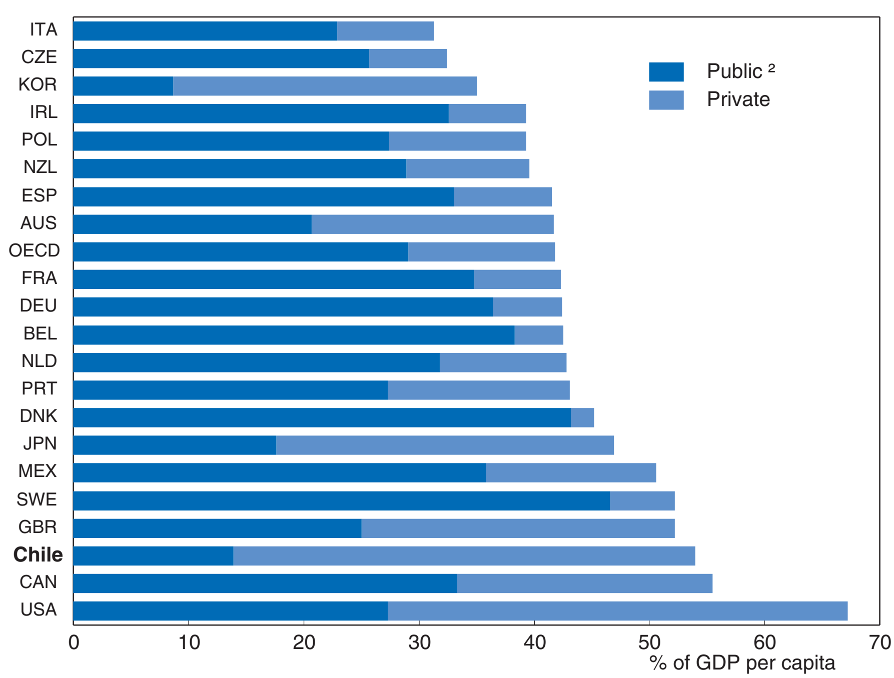
including improvements in accreditation standards. Although accreditation has been mandatory for some years, a number of teacher candidates are still enrolled in special programmes for initial teacher education (*Programas Especiales de Titulación*) which are inadequate regarding the quality of their educators and teaching programmes (Ruffinelli and Sepúlveda, 2005). The government will create a new agency, the *Superintendencia de Educación Superior*, that would be responsible for quality assurance and enforcement of laws in higher education, which could help in this respect. It is also in the process of developing standards for teacher education, albeit voluntary. Furthermore, the government developed an external exit exam for primary school teacher candidates, called *Programa Inicia*, which has revealed serious knowledge deficiencies among many candidates. A proposed law would make the exam mandatory for all candidate teachers to teach in publicly-subsidised schools. Introducing a notion of pass and fail into the exam and gradually developing it into a final exit exam as a prerequisite to obtain a teacher license would be one option to control quality in teacher education, which remains very uneven, as discussed in the 2010 Survey. Applying stricter entry standards for teacher education would be an alternative. The government has done this to some extent by offering scholarships for students with good university entry exam results who choose the teaching profession. Universities that accept students with these scholarships also have to introduce a minimum score in the university entry exam for other teacher students.

The coverage of tertiary education has increased impressively (Figure 8, Panel A). Chileans spend substantially on tertiary education in terms of GDP, but public per student spending as a ratio to GDP per capita is the second lowest across OECD countries (Figure 10). In part this owes to comparatively high university fees relative to most OECD countries (OECD and World Bank, 2009). These leave many students highly indebted compared to the situation in most OECD countries (OECD and World Bank, 2009), with limited mechanisms to reduce risks. Chilean budget figures show that between 2005 and 2012, public expenditure on tertiary education, including financial aid has almost doubled, albeit from a low base. Chile has a wide array of scholarship programmes with different eligibility criteria but a good part of them is only available to students from a group of traditional universities belonging to the so-called "*Consejo de Rectores*". A subsidised student loan scheme (*Fondo Solidario de Crédito Universitario*) with a real interest rate of 2% is similarly limited. Only a much more expensive scheme with a real interest rate of 6%, the guaranteed student loan (*Crédito con Aval del Estado*), is available to students from other

Figure 10. **Per student expenditures in tertiary education**

2008[1]



1. 2009 for Chile.
2. Including loan subsidies and scholarships.

Source: OECD, *Education at a Glance*, 2011.

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higher-education institutions, including vocational training, which are more likely to be attended by lower-income students Nevertheless, this scheme introduced in 2006 facilitated access to tertiary education for poorer students.

The government announced a broadening of scholarship schemes and credits for low-income students. Interest on the guaranteed student loan scheme will be lowered to 2% and the long-term goal is to allow all students, whose families belong to the poorest 40% of the population, to study with scholarships. Students whose household income belongs to the 20% above that would receive a combination of grants and loans. These plans follow standard OECD recommendations. The government should tie enhanced financing of education demand to stricter quality standards for universities that enrol students who receive subsidies. A new quality assurance agency, that the government plans to introduce for higher education, would be a means to define and enforce such standards, as would stricter accreditation. The government plans to introduce an income-contingent repayment scheme for student loans, as recommended in the 2010 Survey. This would make tertiary education more accessible, including for low-income students applying for technical training, where skill shortages are particularly pronounced according to employers.

Box 2. **Recommendations to strengthen economic growth**

- Ease bankruptcy procedures (OECD, 2010).
- Strengthen the new competition law by linking maximum fines to firms' revenues, establishing legal certainty for participants in leniency programme and turning price fixing into a criminal offense (OECD, 2010).
- Apply strict accreditation procedures to initial teacher education programmes and consider using the new external exit exam to license teacher candidates based on minimum standards (OECD, 2010).
- Streamline and extend student loans and scholarship schemes, making them available to every student of accredited institutions on the same terms, while strengthening quality standards for all institutions that enroll students benefitting from subsidies. Introduce income-contingent repayment schemes (OECD, 2010).

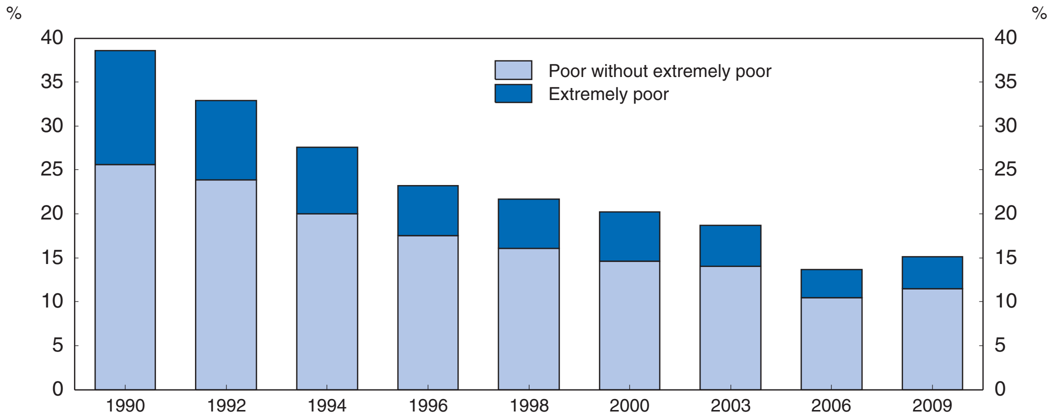
Higher cash transfers can help reduce poverty and strengthen economic growth

Poverty has declined substantially over the last twenty years (Figure 11) and it is now among the lowest in Latin America, though it remains high in OECD comparison. The income distribution is narrow at the lower end with income of many households hovering around the poverty line. Moreover, the unusually large gap between top and mean incomes contributes to a level of income inequality that is exceptionally high by OECD (Figure 12) standards. Given a low share of progressive direct taxes in overall tax revenues, the redistributive effect of the tax system is limited as well. Overall, taxes and benefits in Chile hardly lower the Gini coefficient, in sharp contrast to most OECD countries (see Figure 1), where they have a strong impact on the distribution of income.

The government is set to increase cash transfers to the poor through a new programme called *Ingreso Ético Familiar*. This is welcome, as Chile's cash transfers are well targeted to the poor, yet they are too modest to achieve a substantive redistribution. The new cash transfer should build on the infrastructure of existing ones. Over time different cash transfers should

Figure 11. **Poverty rates in Chile**

People with income below the national poverty line (absolute poverty) as per cent of population



Source: Casen.

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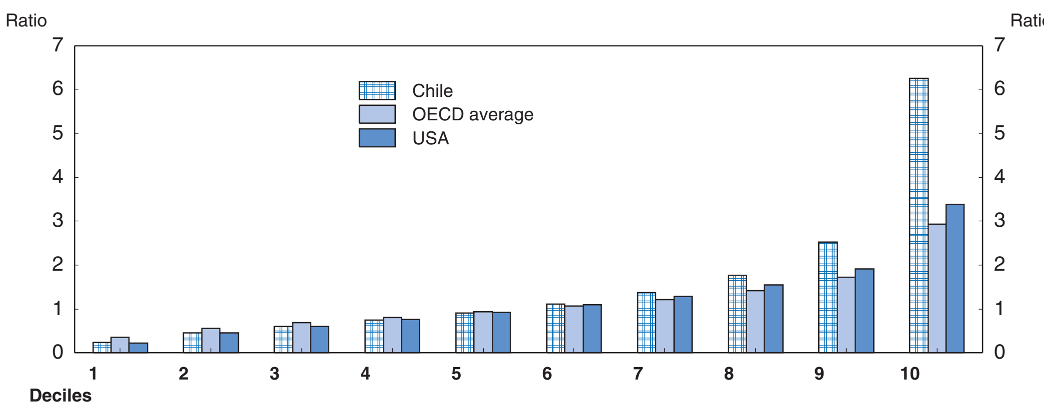
Figure 12. **Average household income by income decile**

Normalised with median household income



1. Relative poverty line at 50% of household median income. 2009 for Chile, latest year available for other countries.

Source: OECD, *Database on Income Distribution and Poverty*.

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be integrated to facilitate their administration and ensure efficient targeting. For the moment, extra spending on cash transfers will remain limited, though, as the government plans to spend an additional 0.07% of GDP on *Ingreso Ético Familiar* for a start, targeting most of it quite narrowly at families in extreme poverty. However, some elements will be available to families whose household income is among the lowest 30%, such as a wage subsidy for female workers. This will initially be limited to 100 000 beneficiaries, though.

Larger cash transfers to the poor and better instruments for them to invest in their human capital, including better schools, job intermediation and training programmes would all lower poverty. Financing this spending by limiting regressive and inefficient tax expenditures and strengthening property taxes, as suggested above, would help limit inequality, as would more equal access to high-quality education.

Cash transfers to the poor in low and middle-income countries have been shown to enhance health, education, cognitive skills and households' ability to save and invest, often with high rates of return (Hanlon *et al.,* 2010; Fiszbein and Schady, 2009). These are important factors for workers' productivity and their ability to earn better incomes. One way to make the system more transparent and ensure that features such as the withdrawal rate and overall transfer size can be managed efficiently would be to further integrate different cash transfers for the poor over time, as planned. Ending poverty through higher cash transfers alone would be affordable for Chile. Even though this may seem surprising given still substantial poverty rates, OECD Secretariat calculations suggest that the country would have to invest less than 1% of GDP to lift all households above the current national poverty line (for similar results see also Larrañaga, 2009). This reflects in part the narrow income distribution at the lower end. This calculation, however, is based on a pure accounting exercise without considering behavioural adjustments.

Transfer size also plays a role for people's ability to invest in their human capital and for their work incentives. Research suggests that the positive impact of transfers on school enrolment, health and cognitive skills increases with higher transfers, although there are signs of diminishing returns. At the same time, larger transfers may at some point start to undermine work incentives. There are only a few studies that have found a negative impact of cash transfers in low-income and emerging countries on employment and labour participation, but they are sometimes found in countries where transfers are relatively large, such as South Africa. It may thus be sensible to tie additional benefit receipt to work and job search requirements, if the government decided to increase cash transfers to the poor substantially. *Ingreso Ético* will come with a requirement for adult members to enrol in an employment programme, which could be a coach who helps recipients find a job and improve their employability according to current thinking. In the future, once the basis of *Ingreso Ético* is well established, the government could try out different increases in the transfer size in pilot studies to assess whether this would be a cost-effective instrument to further enhance well-being, human capital and employment.

The government plans to tie part of the benefit for the extremely poor to children's participation in health checks and regular school attendance. Families can receive an extra bonus dependent on their children's ranking in their class and there will be one-off bonuses for jobless adults who find employment rapidly or complete secondary education. The government also plans to introduce further bonuses for different achievements in the areas of health, education and savings for families belonging to the three lowest income deciles and a wage subsidy for women. While some studies suggest that well-designed conditionality can have extra benefits, overall the evidence is mixed. At the same time, conditionality can be costly to enforce. Unlike in other countries in the region, the incidence of malnutrition among children in Chile is low (comparable to that in the richest OECD countries), school attendance is compulsory and it is generally high, although in the target group almost 60% of the children miss more than 5% of their classes. Thus conditions regarding medical checkups and higher school attendance are in some sense redundant, although they may create further incentives for poor families to comply with the law. However, overall there should be a careful cost-benefit analysis for further conditions. In particular, tying a large part of the benefits to children's ranking in school should be revisited, as it can be divisive. It will put a lot of pressure on teachers grading these children and discourage parents from sending their children to better schools.

More generally, rather than tying different parts of the benefit to different conditions, the government may want to consider a simpler design. This could be a base benefit for households without market income, tied to work and job search requirements only, which is gradually withdrawn as household income increases. This would also be an opportunity to open benefits to families within a wider income range over time. Given the narrow distribution of low incomes in Chile, discrete cut-off points for benefits, which are used today, exclude from cash transfers many households who are hardly richer than benefit recipients. In addition, low-income households tend to move frequently into and out of poverty in Chile (Neilson *et al.,* 2008), but the proxy means test is rarely updated, so people who have left poverty may continue to receive benefits, while others who qualify may not. In such a context, withdrawing benefits gradually as income increases may be perceived as fairer and it should have a positive effect on incentives to work and provide accurate information when the government establishes eligibility.

The government plans to simplify the proxy means test for social programmes, update it more frequently and improve the fight against fraud by cross-checking with administrative data and using risk models. This is welcome. Currently, the test assigns scores to households based on a wide range of information that is not routinely verified or updated and the government uses econometric test to build the final score. The government will need to build substantial administrative capacity to better verify the data provided by households and to fight fraud. This will be costly, but also beneficial, as it would also help the government to reduce tax evasion. To reduce costs and allow for more frequent updates, the government should consider moving to a means test mainly based on declared income, perhaps complemented with a few indicators, which are relevant for the programme. This should be feasible, in particular if the government steps up its administrative capacity. Even in the lower half of the income distribution, it is possible to verify all income sources with administrative data for nearly 50% of all households (Comité de Expertos, 2010). This could be complemented with random verifications at benefit recipients' homes and workplaces. Brazil runs a very successful cash transfer programme which is less narrowly targeted than Chile's, with a means test that considers declared income and the number of children only.

The quality of schools, healthcare, public employment and other social services will be key for the ability of *Ingreso Ético* recipients to invest gainfully in human capital and reach their full potential. Municipalities administer schools, as well as social and employment programmes that accompany cash transfers for the poor, but they differ widely in resources and the capacity of their personnel to administer these programmes. The main source of own income for municipalities are property taxes, but these are subject to relatively high exemption thresholds, and thus revenues in poor municipalities with a lot of low-value housing are very weak. There is some redistribution of property tax revenues through the *Fondo Común Municipal* and there are central government transfers for various municipal tasks, including for the administration of cash transfers. However, the resulting degree of equalisation is weak compared with other OECD countries. Table 2 shows the ratio of average revenues per capita of the richest decile of municipalities to those of the poorest decile of municipalities, before and after fiscal equalisation. Even after fiscal equalisation, the disparities remain large in Chile.

The central government is currently envisaging larger transfers to municipalities with low tax revenues and a scheme to improve the qualification of the personnel who administer municipalities and this is welcome. Poorer municipalities need more resources to provide their citizens with high-quality services that help them overcome poverty. In the medium term, the government should consider developing fiscal equalisation further. Increasing property tax revenues along the lines suggested above would provide municipalities with vital extra resources.

Table 2. **Fiscal revenues per capita before and after equalisation**

	Highest capacity/lowest capacity[2]	
	Before equalization	After equalization
Federal/ regional countries		
Australia	1.3	1
Canada	2.4	1.7
Germany[1]	1.7	1.1
Spain	2.1	1.4
Switzerland	3.8	2.5
	Unitary countries	
Denmark	2.2	2
Finland	1.8	1.1
Norway	2.2	1.2
Japan	3.1	
Sweden	1.4	1.1
Portugal	12.7	2.1
Turkey	85.6	1.7
Chile	**20.6**	**2.3**

1. 2005 for Germany, 2010 for Chile, 2004 for all other countries; the data show actual revenues for Chile and revenue capacity for all other countries.
2. Ratio of maximum and minimum fiscal capacity of subnational governments before and after equalisation. For federal/regional countries the indicators are calculated for the state/regional level. For unitary countries revenues per capita are averaged by decile. In these cases the table shows revenues per capita of the richest decile as a ratio of revenues per capita of the poorest decile.

Source: Bloechliger and Charbit (2008), *Sistema Nacional de Información Municipal for Chile*.

The government has set an agenda for preventive healthcare to decrease the incidence of chronic diseases. This includes measures to prevent obesity, hypertension, diabetes and risks stemming from alcohol and tobacco consumption. This agenda will help reduce poverty and foster equality, and it should be implemented in full.

Box 3. **Recommendations to improve anti-poverty policies and reduce inequality**

Anti-poverty policies

- Continue to increase cash transfers, while further ensuring their effectiveness.
- Over time streamline the number of cash transfer programmes, by integrating them with the new *Ingreso Ético Familiar*.
- Keep the design of the new cash transfer simple and limit conditions, perhaps to job search and training requirements. Impose further conditions only if they are of proven effectiveness.
- Simplify targeting by relying mainly on household income. Over time make the benefits available to a wider range of beneficiaries, including by withdrawing benefits only gradually as income increases. Further pursue efforts to fight fraud more effectively.
- Once the basis for *Ingreso Ético* is firmly established, evaluate the effectiveness of the transfer and its different features, such as transfer size and conditionality, as planned, in improving households' ability to overcome poverty. Adjust design accordingly.
- Enhance fiscal equalisation to ensure that poor municipalities have sufficient resources to provide their citizens with high-quality services and continue efforts to improve these.

Box 3. **Recommendations to improve anti-poverty policies and reduce inequality** *(cont.)*

Additional measures to reduce inequality

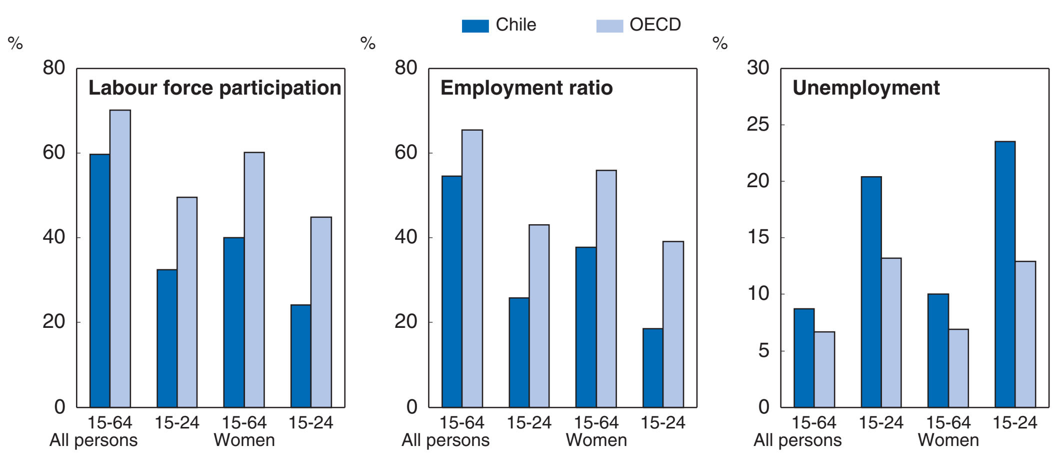
- Build on efforts to improve the quality of publicly-financed secondary education, including by further increasing the special voucher for poor children, and reforming the scholarship and loans system for tertiary education to make access more equitable.
- To finance higher spending on education and social services, phase out income, property and inheritance tax exemptions and loopholes, that make the tax system less progressive, and fight tax evasion.
- Improve product market competition by strengthening the anti-cartel law and the business environment with the Agenda for Competeveness.
- Implement the preventive healthcare agenda in full.

The poor, women and youth need more assistance to improve their employability

The ability to secure employment will be essential for the poor and other disadvantaged groups to leave poverty. In international comparison, the incidence of inactivity and unemployment is high among the poor, youth and women (Figure 13).

Figure 13. **Young people and women in the labour market**

Average 2000-09



Source: OECD, *Labour Force Statistics Database.*

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Many local labour offices (*Oficinas Municipales de Intermediación Laboral*, OMIL) lack sufficient financing and experienced personnel who are able to engage with local businesses and use the programmes designed by the central government to support low-skilled workers in upgrading their skills and finding a job. Some local labour offices do not have basic equipment. The central government is in the process of providing them with more funds and training, but resources remain small. These important efforts should continue and be strengthened. The government has also introduced a national online tool to facilitate job matching, the *Bolsa Nacional de Empleo*, and it has started engaging private job intermediaries for candidates who are hard to place. It plans to integrate public and private job intermediation with publicly-funded training programmes and this is welcome. OECD experience suggests that engaging private providers can be useful, but contracts and remuneration schemes should ensure that private providers do not cherry pick, but instead engage also with the more difficult cases and find durable employment for them. The government needs to follow up on private agencies' performance in providing training and job intermediation as well as fight fraud. The government also plans to require *Ingreso Ético* recipients to participate in employment programmes, possibly administered by a personal coach. All of this is welcome in principle, but the government should make sure that efforts to strengthen job intermediation are well co-ordinated.

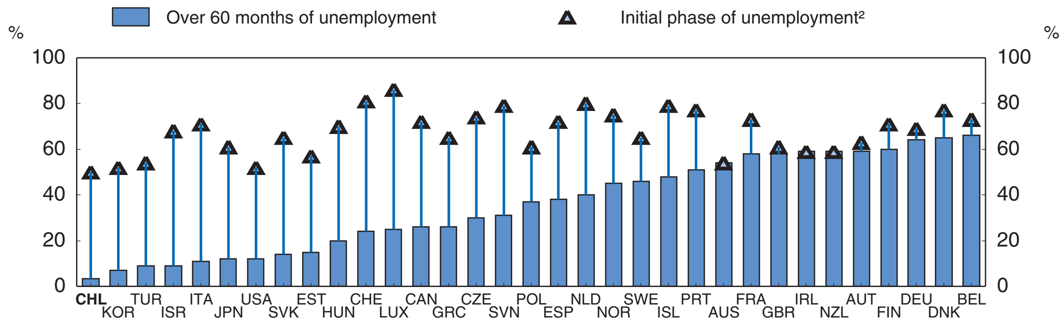
More than 90% of the central government budget for training measures is currently devoted to tax breaks for companies that decide to send their staff on training with certified institutions. Take-up is strongest among larger companies for their higher-skilled staff, the programme is obviously not available for the unemployed, and recent evaluations suggest that it has little or no long-term effect on wages or employment. The central government commissioned a technical report that evaluated existing training measures. It should use this opportunity to expand effective programmes, phase out or reform ineffective ones and focus training more on jobseekers with low qualifications. A better integration of the national training agency *Servicio Nacional de Capacitación y Empleo (SENCE)* with local labour offices is likely to make active labour market policies overall more effective (OECD, 2009a). The government considers establishing a permanent commission that will regularly review training programmes.

To better protect workers against unemployment and enhance efficiency, Chile should build on recent efforts to strengthen unemployment benefits further. When the system was introduced in 2002 the government started out with moderate benefits to assess sustainability first. Since then benefits have increased somewhat. The system is based on individual savings accounts and a complementary insurance fund, but savings in individual accounts are low for most workers; a large minority have accumulated less than one month's minimum wage. Access to the insurance fund was very restrictive until recently, so that most workers could benefit only from savings in their individual accounts. A recent reform eased access to the insurance fund, thereby improving chances for workers with indefinite contracts to obtain five monthly payments, declining from 50% to 30% of previous wages. Temporary workers can now access the insurance fund for two monthly payments with replacement rates of 35% and 30%. However, only around 15% of eligible workers exercise their right to use the fund, suggesting a lack of information about the new system. To address this, the government will require the administrator of the funds to carry out information campaigns, and this is welcome. Once it is better established, strengthening unemployment benefits further could help contribute to higher productivity, as this allows workers to search longer for a better job match. While unemployment benefits can undermine work incentives, this effect is unlikely to dominate in Chile because replacement rates and the duration of benefit receipt are very low (Figure 14). Chile could gradually increase the unemployment benefit duration and/ or replacement rates, while carefully evaluating the effect on the quality of job matches and job search intensity.

Extending unemployment benefits would be an opportunity to limit severance pay and make it more neutral. Currently, severance pay is the main pillar of protection against unemployment, but it is not effective for many workers and it is likely to contribute to labour market duality. Temporary workers and workers with short tenure, who are not eligible for severance pay, account for the bulk of job turnover. Only 6% of dismissed

Figure 14. **Unemployment benefit replacement rates (net of taxes), 2009**

Average for four family types and two earnings levels[1]



1. Unweighted averages (single and one-earner married couple with no children and lone parent and one earner married couple with two children) for earnings levels of 67% and 100% of average worker income, without social assistance.
2. Initial phase of unemployment but following any waiting period.

Source: OECD, *Tax-Benefits Models*.

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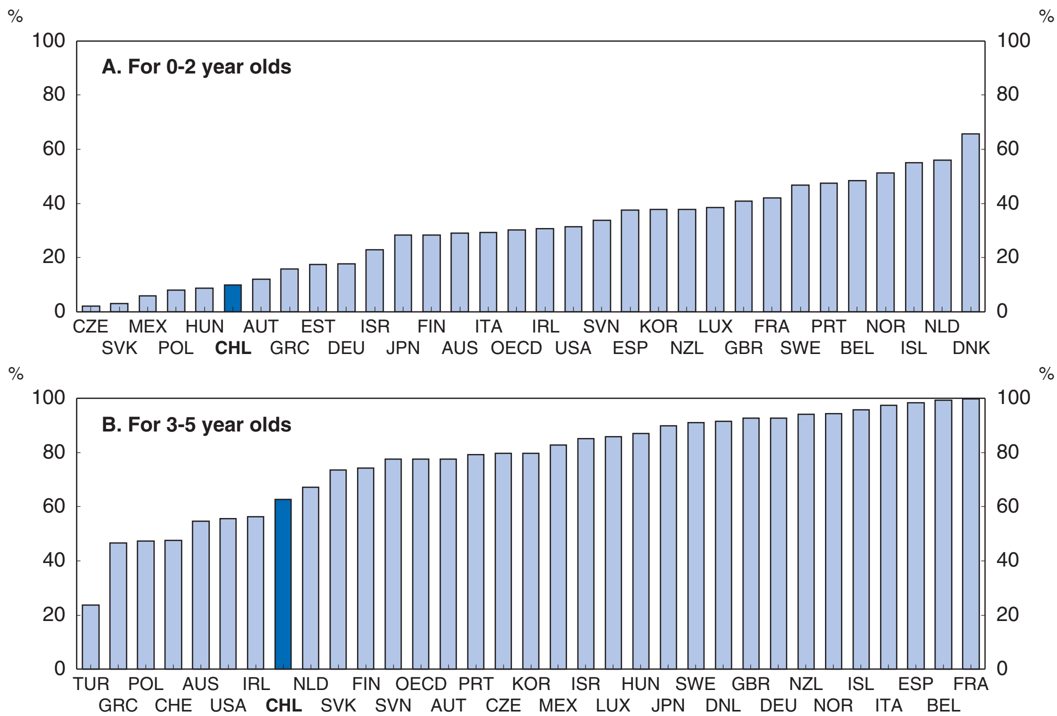
workers are eligible for severance pay, suggesting that employers go to a considerable length to avoid paying it. There seems to be a dual labour market, where a part of the workforce has considerable job security, but the rest face unstable work relationships with lower chances for training and career progression and a higher risk of paying the cost of crises. Severance pay has been shown to reduce the employment chances of young workers (Pages and Montenegro, 2009) and productivity and output growth (Caballero *et al.*, 2006; Micco and Pages, 2006). In return for lower severance pay, employers could be required to provide higher contributions to the individual savings accounts of all workers or to the unemployment insurance fund, which would avoid higher costs for indefinite contracts and thus the ensuing distortions. This could enhance acceptance of the reform, as workers consider severance pay as an acquired right.

The government needs to do more to promote female labour market participation, not least because the incidence of poverty among jobless women is high. It plans to implement a wage subsidy for women as part of *Ingreso Ético,* similar to a subsidy for low-wage workers under 25 from poor families introduced in 2009. While OECD experience with in-work benefits suggests that they are associated with positive, albeit small, employment effects, the subsidy for young workers and the root causes of low female labour participation should be evaluated before extending the scheme. Other measures that could help promote female labour force participation include continuing efforts to increase the number of publicly subsidised childcare places of high quality, as coverage remains low despite considerable efforts over recent years to extend it (Figure 15). Residential segregation may be an important cause of low female labour participation, because to accept a full-time job mothers who need to commute for one to two hours would need childcare for much longer than what is available. Measures to enhance residential mobility and limit segregation suggested below will thus be very important.

In contrast, the provision in the labour law that obliges firms with more than 19 female employees to provide childcare should be scrapped or made gender-neutral to avoid undermining women's employment opportunities. The government has also increased paid maternity leave from 12 to 24 weeks after childbirth. The extension in paid maternity leave is welcome as OECD experience suggests that an increase from such a low

Figure 15. **Coverage with early childhood education and care across OECD countries**

Share of children in formal childcare or in educational pre-school programmes, 2008



Source: OECD, *Family Database*.

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level can have beneficial effects on both child development and mothers' attachment to the labour market. At the same time the government has pursued fraud, which has been widespread, more strictly and with success.

Box 4. **Recommendations on labour market policies**

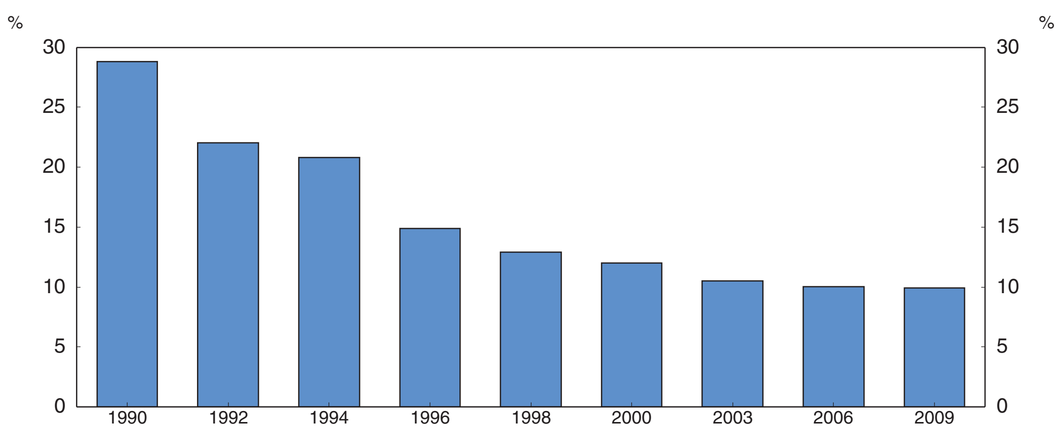
- Continue strengthening local labour offices to improve their capacity to help the unemployed. Make sure that private employment agencies have incentives to attend to low-skilled workers.
- Evaluate training programmes, streamline based on results and focus more on low-skilled workers and women.
- Extend unemployment benefits further and limit severance pay, while increasing employers' contributions to individual savings accounts or the unemployment insurance fund. Evaluate the effects of longer unemployment benefit duration and/or higher benefit levels to improve the design if needed.
- Evaluate the in-work benefit for poor, young workers and – if found successful – consider extending it to other groups.
- Continue efforts to extend the availability of affordable, high-quality nursery and kindergarten places, while lifting the requirement for firms to offer kindergarten places once they employ more than 19 women.

Better targeted housing subsidies and more residential mobility

Most Chileans live in adequate conditions, but 10% of the population still lives in houses that are overcrowded, built with inadequate materials or have poor access to basic services (Figure 16). House price growth has been contained, keeping housing affordable for most Chileans. For poorer households, however, it is often not affordable. Chile has a range of subsidies to buy a house, but these are poorly targeted, and earlier studies show that a significant part of them go to upper-middle income groups. At the same time, public support has not always led to sustainable solutions, with recipients slipping back into poor housing conditions. Moreover, by leading to a peripheral location of subsidised housing far from jobs and public services, public support may lead to poverty traps. Improving access to housing for the poor will be important if Chile wants to reduce inequality and poverty. Poor housing quality and overcrowding can hurt individuals' health and education, undermining their employability. Furthermore, a poorly operating housing market can restrict individuals' mobility, hinder the efficient allocation of labour and hurt economic performance.

Figure 16. **Share of population living in poor housing conditions**

As per cent of population



Source: OECD calculations based on data from Ministry of Housing.

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Chile has well-funded housing support programmes providing subsidies for buying, building or improving a home, but they do not always reach those in most need, and waiting times are long. The government has just reformed housing subsidies for the poorest 20% of the population, and has also redesigned and increased the number and value of subsidies for households with incomes above that. Yet Chile should consider narrowing the targeting of housing subsidies to low-income households, while reconsidering subsidies that may go to the 40% richest families. Households in the top quintiles do not have problems accessing the credit market and benefit more from favourable housing taxation than poorer peers. Phasing out this assistance would free resources to support those who need it most. Streamlining the broad set of current subsidies and phasing out those with very low take up and or poor targeting, such as the residential leasing (*Leasing Habitacional*), would improve the efficiency of the system making housing support more transparent and easier to administer.

OECD experience suggests that housing support targeted to low-income households is preferable to less targeted support as it can focus on households in greatest need and improve housing conditions at lower cost (Andrews *et al.*, 2011). An important condition to limit segregation and avoid poverty traps is to ensure that poorer families are integrated into middle-class neighbourhoods. In the past, high land prices have pushed construction of subsidised housing towards peripheral areas, reinforcing residential segregation, and the government has made only limited efforts to counteract this. Average household income in Santiago's richest commune is eight times higher than in the poorest and their heads of household have twice as many years of education (OECD, 2009b). Households in poor neighbourhoods bear high costs of commuting and thus limited access to high-quality jobs, but also to education and social services. Poor access to high-quality education can reduce social mobility even more, which is already low in Chile.

The government is buying some land for social housing in good locations to reduce segregation and improve the social mix, which is welcome. But reserves of land in good locations are limited. A complementary measure would be to better enforce and expand the existing quotas for subsidised housing in new development projects, so both rental and owner-occupied low-income housing can be built. Since 1997, developers of new projects have been required to devote at least 5% of land to social housing, but quotas are restricted to few specific locations (*Zonas y Proyectos de Desarrollo Urbano Condicionado*), project approvals are lengthy and there is no time limit for compliance. Including social quotas in more new projects, speeding up project approvals and imposing a time limit could contribute to better located social housing and more diverse communities. The government has also adjusted subsidies to allow poor households to buy houses in better locations. However, reducing segregation can only go so far. Improving infrastructure, public transport and social services in poor neighbourhoods will also be necessary.

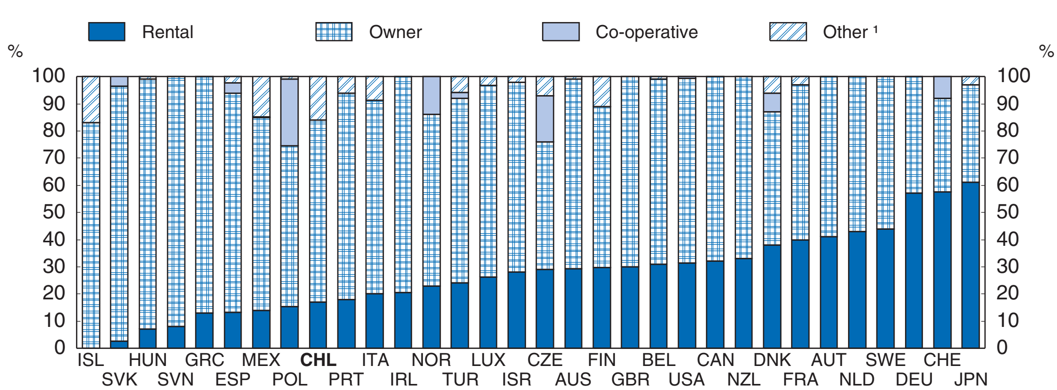
The government should also ensure minimum housing quality standards. Notwithstanding the substantial advances made, many Chileans still live in houses built with low-quality materials and inefficient heating systems – often based on firewood – which emit high levels of health-threatening pollutants (Sanhueza *et al.* 2006; Adonis, 2009). Chile is a highly seismic country, thus solid building structures and the quality of construction materials are particularly important. The government wants to increase the quality and energy efficiency of buildings through subsidies for upgrading, construction and retrofitting of subsidised housing for low-income owners to improve thermal insulation and reduce energy leakage. It also promotes the installation of solar thermal systems for public, commercial, household and industrial buildings. These efforts are welcome, but are likely to cover only a small part of the housing stock. Most countries apply basic building standards for energy efficiency, which have proven useful to reduce energy leakage and pollution. Chile, where standards are weak (Collados and Armijo, 2008) should do the same. Upgrading the 2007 thermal quality regulation would also help. In contrast, Chile's earthquake building codes are strong and generally well-enforced. The government could further limit earthquake and tsunami risks by reducing building permits on fault lines and risky coastal areas, building on pilot measures introduced after the 2010 disasters in affected areas. Better standards may increase the price of housing, but there are a number of measures the government can take to counteract this effect, including effective competition policy that enforces anti-trust rules and hinders collusive behaviour in the construction sector. Evidence suggests that competition is low in Chile, in particular in highly populated areas where low-income households live (Lefort and Vargas, 2011).

Another measure to ensure a well-functioning housing market with competitive prices is to ease restrictions on land usage. One issue is the allocation of building permits. At up to 450 days, the process is slow and the government plans to speed it up. Another issue is lengthy and cumbersome updates of land planning regulations, which have slowed construction projects in the past. This can restrict housing supply and push up house prices, in particular in areas where demand is high. The government plans to extend the boundary of the Santiago region, converting about 13% of agricultural land into land for construction. While this measure can increase the responsiveness of housing supply and contain house price increases, it may reinforce already pronounced residential segregation, increasing commuting costs and pollution if not accompanied by improved public services and infrastructure. The authorities should first encourage the development of underused lands within the region of Santiago, which could help regenerate the city, probably at lower infrastructure costs than greenfield investments.

Chile excessively promotes homeownership via various tax advantages and housing subsidies directed exclusively at ownership. This can distort household behaviour and hurt the development of the rental market, thus limiting labour mobility. Chile's rental market is among the smallest in the OECD (Figure 17) – even among other Latin American countries – and this is probably policy-induced, as tax policies favour owner occupancy over renting and there is no housing support for tenants. People change homes much less frequently in Chile than in other OECD countries (Figure 18), and this is particularly the case for subsidised homeowners, who occupy about 60% of the dwelling stock. Moving is harder for these families, in part because it is difficult for them to sell their home to climb the housing ladder or to move closer to a new job. The secondary market for subsidised housing is small, in part because until the late 1990s most subsidies were for buying newly-built dwellings. The government now grants subsidies for both new and second-hand homes, which should help the market develop.

Figure 17. **Tenure structure across countries**

As per cent of dwelling stock, 2009



1. For Chile, "other" includes free housing provided by relatives or employers as well as housing units for which there is no data on tenure type.

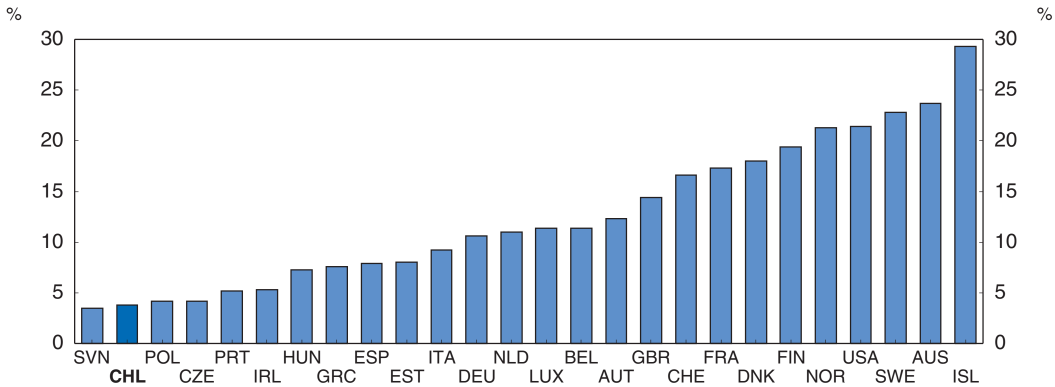
Source: OECD Housing Market questionnaire.

StatLink http://dx.doi.org/10.1787/888932564160

The government should reduce tax distortions in favour of owner-occupied housing and ensure the rental market works better, providing sufficient housing at affordable rents. One possibility to strengthen rental demand could be a means-tested cash benefit for low

Figure 18. **Residential mobility in OECD countries**

Percentage of households that changed residence within last 2 years[1]



1. For Chile refers to the percentage of households that changed commune.

Source: OECD calculations based on *2007 EU-SILC Database*, on HILDA for Australia, AHS for the United States, SHP for Switzerland and CASEN (2006) for Chile.

StatLink http://dx.doi.org/10.1787/888932564179

income households, earmarked to their rent payments. These are common in OECD countries and do not seem to hinder residential or labour mobility, provided that they are portable (OECD, 2011). Withdrawal rates for the benefit should be low enough to limit a negative impact on job search incentives or the willingness to move. These benefits should gradually replace a part of the subsidies directed at homeownership. Regulations currently protect tenants more than landlords and this should be balanced, as subsidies risk driving up rents when rental supply is inelastic without improving housing opportunities (Susin, 2002). Evicting a tenant who does not pay the rent should be made less costly by, for instance, speeding up court procedures, which currently take up to 240 days (Global Property Guide). Otherwise, incentives to invest in rental housing risk being undermined.

Box 5. **Recommendations on housing policy**

- Improve targeting of housing subsidies to low-income households.
- Over time redirect some of the housing subsidies to means-tested rental allowances for low-income tenants.
- Better integrate subsidised housing into wealthier neighbourhoods, enforce subsidised housing quotas and invest more in infrastructure, public transport and social services in poorer neighbourhoods.
- Upgrade thermal and energy efficiency standards for buildings and extend limits to construction on fault lines and risky coastal areas to the entire country.
- Make supply more responsive to demand by encouraging the development of underused land, speeding the reforms of land planning and allocation of building permits, and ensuring the rental market works well, by striking the right balance between regulation that safeguards tenants' and landlords' rights.
- Further reduce tax distortions in favour of housing by either increasing real state tax rates or phasing out mortgage interest deductibility. Tax rental income in the same way as investment in other assets, and make all houses subject to inheritance tax.

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ANNEX A1

Progress in structural reform

Past recommendations	Actions taken and current assessment
A. Strengthening fiscal responsibility legislation further	
Consider possibilities to further strengthen the fiscal rule.	The government commissioned a report on improving fiscal institutions and plans to implement many of its recommendations, including setting up an independent fiscal council that would monitor fiscal policy and the correct application of the fiscal rule.
Consider strengthening the insurance element of the unemployment benefit system, by easing access to the Fondo Solidario further and allowing to some extent for higher benefits. Severance pay could be lowered in return, for example by keeping it flat rather than letting rights increase with job tenure.	Temporary easing of access for workers affected by the earthquake.
Complement reports about the size of tax expenditures with evaluations of their effectiveness and efficiency.	No action taken.
B. Making the most of pension reform	
Gauge the willingness of own-account workers to pay for social protection through regular surveys, while strengthening enforcement capabilities when contribution becomes mandatory.	A panel household survey specifically focused on social security issues (Encuesta de Protección Social, EPS) was applied in 2009 (previously applied in 2006, 2004 and 2002). It includes detailed questions concerning employment status, history of retirement saving, and individual motives to contribute to the public social security system. Information campaign for own-account workers since October 2011.
Make health insurance mandatory for own-account workers at the same time and following the same timeframe as in the case of pension contributions, rather than delaying implementation until 10 years after approval of reform.	No action taken.
Ensure that options for correcting gender imbalances do not give women a higher retirement income than those accruing to men with the same contribution history, accounting for life-expectancy differentials.	No action taken.
Eliminate in a phased manner the gap that currently exists between the retirement age for males (65 years) and females (60 years) for contributory pensions.	No action taken.
Maintain the independence of the AFP regulator in the new proposed institutional setup.	The new *Superintendencia de Pensiones* kept the independent status.
C. Making the tax system more efficient	
Reduce the stamp duties gradually.	The government reduced the duty permanently by half.
Assess the net benefits of reducing the discrepancy between the top marginal rate for the personal income tax (currently at 40%) and the uniform corporate tax rate (currently at 17%).	The corporate tax rate has been temporarily increased from 17% to 20% to finance the reconstruction.
Assess compliance costs for micro- and small enterprises and continue to work to make the tax system more SME-friendly. Expand the ICT training programme for SMEs (MIPYME 10 000-2006). Further simplifying procedures to reduce the time it takes to pay taxes, especially by SMEs.	SMEs do not have to pay taxes on retained profits since 2010.

Past recommendations	Actions taken and current assessment
Consider abolishing or limiting remaining VAT exemptions.	The reduced VAT rate for housing construction was capped in 2009.
Consider strengthening subsidies for pension savings supporting low and medium income earners further, while capping tax benefits for high income earners.	Pension contributions above 900 UF pay income tax since 2010.
Close tax loopholes associated with corporations created for the sole purpose of deferring the payment of personal income taxes.	No action taken.
Consider increasing the property tax rate, if needed.	Property taxes have been temporarily increased (for residential properties above 96 million pesos) during 2011 and 2012 to finance the reconstruction. The beneficial tax treatment for DFL2 properties, which includes a halving of property taxes up to 20 years after purchase, has been limited to two houses per owner.
D. Fostering further financial sector development and improving financial regulation	
Gradually replace mandated quantitative restrictions by prudential regulations for pension fund portfolio composition to be issued by the industry regulator.	No action taken.
Continue pursuing efforts to establish a consolidated credit register for all credit card issuers, including non-banks. Bring all credit card issuers under the oversight of the Superintendency of Banks.	The government has sent a draft law to Congress to establish a consolidated credit register for bank and retail credit to households.
Take legislative action to establish group-wide financial supervision, among others by designating a based on the group's main activity.	The government created the Financial Stability Council to better co-ordinate the work of different supervisors.
E. Boosting the efficiency of health care programmes	
Extend the Solidarity Compensation Fund to FONASA as a means of further improving risk pooling.	A draft bill foresees risk pooling among private insurers as a first step to universal risk pooling across private and public insurers.
Consider a relaxation of mobility restrictions for FONASA beneficiaries under the Institutional Modality of care (while carefully evaluating the impact that this measure might have on insurance costs), and make the level of co-payments for homogeneous services equal for FONASA and ISAPRE policy holders.	No action taken.
Broaden the range of treatments that can be financed through diagnosis-related and prospective payments (PAD-PPP).	Since 2007 treatments for colon cancer, child and adult osteosarcoma, morbid obesity and traumatological surgery can be financed though PAD. The government is implementing diagnosis-related-group (DRG) financing.
Conduct service satisfaction surveys more frequently and disseminate the results broadly, including through health care insurers.	A Committee on Citizenship Participation in health issues is currently being established. A satisfaction survey will be conducted yearly by FONASA.
F. Facilitating access to better housing and neighbourhood conditions for vulnerable social groups	
Use public land for new subsidised housing developments, available zoning and environmental regulations permitting.	The government is re-converting public land for new subsidised housing developments.
Consider the option of buying land in advance for new subsidised housing developments.	The government is buying some land for new subsidised housing developments.
Boost co-ordination among the different policymakers in charge of urban planning, transport, public works and environment at the central- and local-government levels.	There was strong co-ordination to develop master plans for the reconstruction after the 2010 earthquake In Santiago there was co-ordination for the transport system ("Coordinación General del Transporte de Santiago", Transantiago), which has only a consultative role.
G. Education	
Extend the grants available for small enterprises for labour training to those that currently operate informally, conditional on the recipient enterprise taking the necessary steps to formalise.	Two different fiscal incentives were introduced for formal labour force participation among youths through a wage subsidy conditional on their paying social security contributions. In 2011 the government introduced a training subsidy for employees in micro and small enterprises. The 2012 budget increases training funds for low-skilled workers, including the informal sector.
Expand the skill-certification system to cover the most common occupations in industry and construction.	A national Labour Skill Certification System was established in 2008 as part of the *Chilecalifica* programme, which aims to develop a lifelong learning and training system. It targets especially low skills. There are standards established in several sectors, including industry, tourism, construction and technical and mechanical installations.

Past recommendations	Actions taken and current assessment
Evaluate whether teacher salaries should increase further to make the profession more competitive and define teacher career paths for publicly funded schools with promotions closely linked to performance.	The government introduced bonuses for excellent teachers, in particular when they teach in difficult schools and increased wages for principals significantly The higher voucher for poor children can now be used to increase teacher salaries.
Implement teacher evaluation in all publicly funded schools.	No action taken.
Make sure that deficient initial teacher education programmes are closed.	Some deficient programmes have been closed. Experts have been hired to review the accreditation system.
Upgrade the subject content knowledge of teachers, especially in the upper grades of primary schools, through richer curricula in initial teacher education programmes and post-graduate programmes for practicing teachers.	The government is developing – voluntary – standards for initial teacher education. A law foresees shortening primary school to 6 year, which will require specialised teachers teaching in grades 7-9.
Develop an induction programme over time	No action taken.
Introduce external exit exams for initial teacher education.	The pilot exit exam for teacher students, Inicia, will become mandatory for teachers at publicly financed schools for informational purposes.
Strengthen educational leadership by continuing efforts to train principals and by making sure they have sufficient time for teacher supervision and support.	The government plans to train 800 principals every year. Selection mechanisms were improved and there are now performance agreements between principals and municipalities.
Better prepare teachers for instructing pupils from different backgrounds and helping those at risk of falling behind.	There are now salary bonuses for teachers with excellent evaluations who teach in schools with many poor children.
Make sure that the prohibition of selection is implemented by schools, consider extending it to secondary schools and strengthening it by requiring lotteries at oversubscribed schools.	The Ministry is investigating complaints by parents. It is also creating an agency that will enforce this law in the future.
Create more equal and sufficiently flexible conditions for teacher employment and pay at all publicly funded schools.	Principals are now allowed to dismiss some teachers with bad evaluations. School managers have now more flexibility to aplly performance-based pay.
Make sure that teachers, school managers and parents have sufficient information how to read results of the national student achievement test, SIMCE, and complement it with richer quality indicators, including qualitative information and possibly value-added indicators.	The new Quality Agency is set to develop richer quality indicators. There were efforts to communicate SIMCE results in different ways.
Implement the legislated quality assurance system, while making sure that the newly created agencies interact efficiently.	The law that creates the Quality Agency and the Superintendency of Education has now been passed. Agencies will start to operate in 2012.
Make sure that all municipalities have qualified administrative and technical-pedagogical support staff.	The government improved the mechanism for selecting and supporting performance of directors of the municipal school administration.
Consider introducing higher subsidies at decreasing rates for several income brackets and limit top-up payments dependent on parents' income.	No action taken.
Evaluate results of the increased subsidy for poor children systematically and inform and support schools to make sure that successful methods are disseminated quickly.	Evaluations are now in progress.
Require all publicly funded schools to enter the Subvención Escolar Preferencial system with extra subsidies for poor children and use the new quality assurance system to exercise scrutiny for all schools on an equal footing.	Entering the system remains voluntary. The new Quality Agency will evaluate results.
Consider allowing private fee-based schools to accept some voucher children, with no or limited top-up fees, or imposing quotas.	No action taken.
After significantly expanding access, systematically evaluate quality at pre-schools and make sure that initial education prepares pre-school teachers and aides to enhance children's abilities and learning skills.	The government is working to further expand access to pre-schools. The Quality Agency will review pre-school education.
Hold schools accountable for their students' university access exam results and improve children's preparation for the exam at schools. Evaluate the university entry exam, consider enriching it beyond multiple-choice and moving to a centralised school exit exam over time.	Experts have been hired to evaluate the university entry exam.
Streamline scholarships and student loan schemes and make them available for all accredited tertiary education institutions.	The government plans to expand scholarship programmes for poor students significantly and unify the interest rate on different student loan schemes.
Consider the introduction of a matching mechanism in the differentiated voucher programme to prevent higher voucher receipts from substituting for municipality financed spending.	No action taken.

Past recommendations	Actions taken and current assessment
H. Strengthening the framework conditions for labour utilisation	
Improve possibilities to negotiate more flexible labour arrangements, among others on working time, while putting an end to the practice of employers splitting their enterprise for the purpose of wage negotiations.	The government has submitted a draft bill to adapt working hours for agricultural employees according to seasonal work demand. A draft bill would increase fines for companies that split for the purpose of wage negotiation.
Continue efforts to increase labour market participation of women and youths by reviewing part-time work regulations and strengthening vocational training	Two different fiscal incentives were introduced for formal labour force participation among youths through a wage subsidy conditional on their paying social security contributions. In 2011 the government introduced a training subsidy for employees in micro and small enterprises. The 2012 budget increases training funds for low-skilled workers, including the informal sector. The government has submitted a law to implement a similar wage subsidy for women as part of *Ingreso Ético.* Parental leave has been extended, now including fathers and temporary workers with a minimum social contribution record.
Monitor trends in labour supply during the period in which social security contributions by own-account workers will be voluntary (during 7-10 years after approval of the pension reform proposal) and identify the groups whose labour supply may be discouraged once social security contributions and health insurance become compulsory (10 years after approval of the pension reform proposal).	A panel household survey specifically focused on social security issues (Encuesta de Protección Social, EPS) was applied in 2009 (previously applied in 2006, 2004 and 2002). It includes detailed questions concerning employment status, history of retirement saving, and individual motives to contribute to the public social security system.
Public finances permitting, increase the supply of publicly-funded child care services, especially for low-income households.	Public day-care centres from JUNJI and INTEGRA increased by 70 000 places between 2006 and 2010. Nursery places increased by 45 000 places in the same period.
I. Measures to enhance competition, entrepreneurship and innovation	
Strengthen co-ordination among the municipalities, health, safety and other agencies to expedite business registration	In January 2011 a law was passed that states that commercial patents must be issued by municipalities immediately upon presentation of correct documentation.
Extend credit support under FOSIS to unregistered businesses, conditional on the recipient enterprise taking the necessary steps to formalise.	FOSIS provides support to unregistered businesses through entrepreneurship support and microcredit programmes to help these enterprises to formalise.
Ensure the National Economic Prosecutor receives sufficient resources. Strengthen deterrence for cartel participation by linking the maximum fine to revenues on the market involved in the conspiracy; make price fixing a criminal offence.	No action taken.
To encourage participation in the new leniency programme, clarify the conditions under which firms will be granted immunity through the publication of transparent guidelines.	No action taken.
Enhance consumer protection to improve the functioning of product markets through increased price transparency.	A new law creates a consumer protection agency in the financial sector. Banks are now required to provide borrowers with standardised loan templates detailing total costs.
Reduce entry barriers in retail and business services to discipline incumbent firms.	The government introduced a label of good payment practices for small firms as providers.
Reduce for start ups to both strengthen competition and the discovery of new entrepreneurial ideas.	In January 2011, a law was passed that reduces regulatory barriers for start-ups, and reduces the time to start up a business from 22 to 7 days, by easing the obtainment of permits and the payment of taxes, and by streamlining notification requirements diminishing total costs by 25%.
Reform the bankruptcy law to encourage entrepreneurial risk taking in non traditional sectors.	The authorities envisage a reform of the bankruptcy law to speed up the closure of firms and reduce associated costs and uncertainties.
In innovation policy, continue efforts to strengthen links between universities and firms and continue to move away from the narrow focus on R&D and support all forms of innovation in firms.	The government sent a bill to congress to increase the cap for the R&D tax credit, broaden the target population and ease the certification process that establishes eligibility for the benefit. The government through CORFO undertakes efforts to better link universities and businesses.
Publish the quantitative objectives for the industrial clusters and review public support if targets are not met; establish sunset clauses for public support.	No action taken.

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Chapter 1

Reducing poverty in Chile: Cash transfers and better jobs

Notwithstanding impressive progress, poverty and inequality remain high in Chile in OECD comparison, and the tax-benefit system does little to improve on this. The government plans to introduce a new cash transfer for the poor, the Ingreso Ético Familiar. *This is a welcome initiative. However, the transfer will be modest by OECD standards, at least initially, and it will be quite narrowly targeted at families living in extreme poverty. Over time, the government should consider increasing the size of this transfer and opening it to a wider range of beneficiaries through gradual benefit withdrawal. Strong support for the poor to find jobs of decent quality will be key to help them overcome poverty in a sustainable way.* Ingreso Ético Familiar *will come with an employment programme for beneficiaries. This should build on the existing infrastructure of active labour market policies, which will need to improve at the same time. The government should strengthen the capacity of local labour offices and use the current evaluation of training programmes to retain only those of proven effectiveness, while focusing them more on low-skilled workers and the unemployed. Strengthening unemployment benefits, while limiting severance pay, would make employment protection more effective and do more to avoid labour market duality.*

Introduction

Chile has made remarkable progress in reducing poverty over the last 20 years and it has now one of the lowest poverty rates in Latin America. Inequality has declined, as well, although more recently and much more modestly. Nevertheless, poverty and inequality remain high by OECD standards. Reducing poverty further would help reduce social problems. At the same time, education, social and labour market policies that help the poor invest in their human capital and strengthen their productivity would also contribute to unleashing growth potential. While Chile is currently enjoying strong growth, in part related to high commodity prices, the large share of poor workers with low productivity can quickly become a bottleneck for innovation and diversification.

The Chilean government has set itself the ambitious goal to eradicate extreme poverty by 2014, setting the foundations to eliminate poverty by 2018. One instrument to achieve this will be the introduction of the *Ingreso Ético Familiar*, a new cash transfer system for the poor. Higher cash transfers can help poor people save and invest in physical and human capital and they would make the tax-benefit-system more progressive, in particular when financed by closing regressive tax loopholes or increasing wealth taxes. The government has set itself the goal to achieve annual average growth of GDP of 6% and create a million new jobs – an increase by 15% – by 2014. Better job opportunities for the poor will be important to help them overcome poverty.

This chapter analyses Chile's opportunities to lower poverty and inequality further through social and labour market policies. It is structured as follows: The first part gives an overview over recent developments in poverty, income and wage inequality in Chile. The second part discusses the factors that will be important to consider for the Chilean government when designing its new cash transfer programme *Ingreso Ético Familiar,* in particular targeting, conditionality, the size of transfers and the quality of complementary government services. Perhaps the most important factor to help people leave poverty or avoid falling into it will be to strengthen their capacity to find employment. Female household heads and low-skilled workers, who are characterized by particularly low labour market participation, low wages and a high incidence of poverty, will need strong help. The third part of the chapter therefore discusses policies that would help more Chileans find a job of decent quality. It discusses the role of job intermediation, training programmes, in-work benefits, unemployment protection and family policies for more and better jobs.

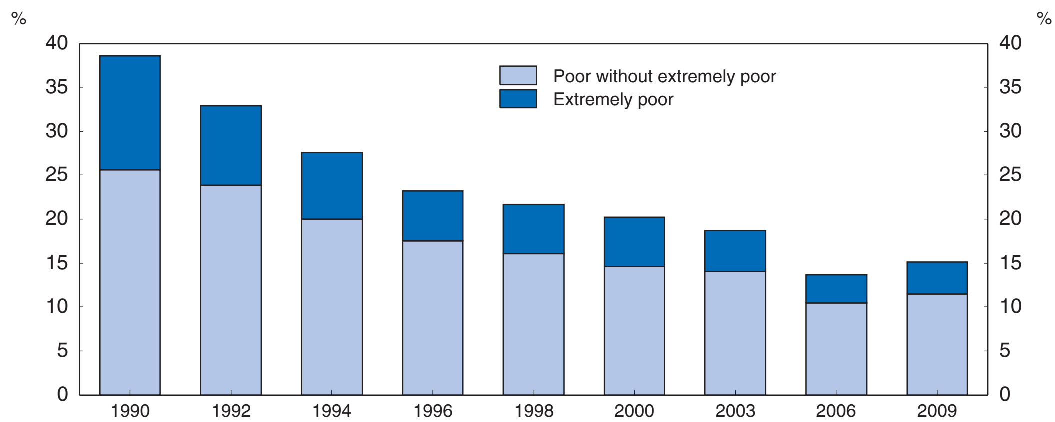
Poverty and inequality in Chile

Recent developments

Chile has experienced a remarkable decline in poverty over the last 20 years, with the share of people living below the national poverty line falling dramatically (Figure 1.1). Relative poverty, as measured by the share of the population living with less than 50% of the median income, has fallen as well. It is now among the lowest in Latin America (Figure 1.2) although it remains higher than in most OECD countries

Figure 1.1. **Poverty rates in Chile**

People with income below the national poverty line (absolute poverty) as per cent of population



Source: CASEN.

StatLink http://dx.doi.org/10.1787/888932564198

(Figure 1.3). Like in other countries households frequently move into and out of poverty in Chile (Neilson *et al.,* 2008).

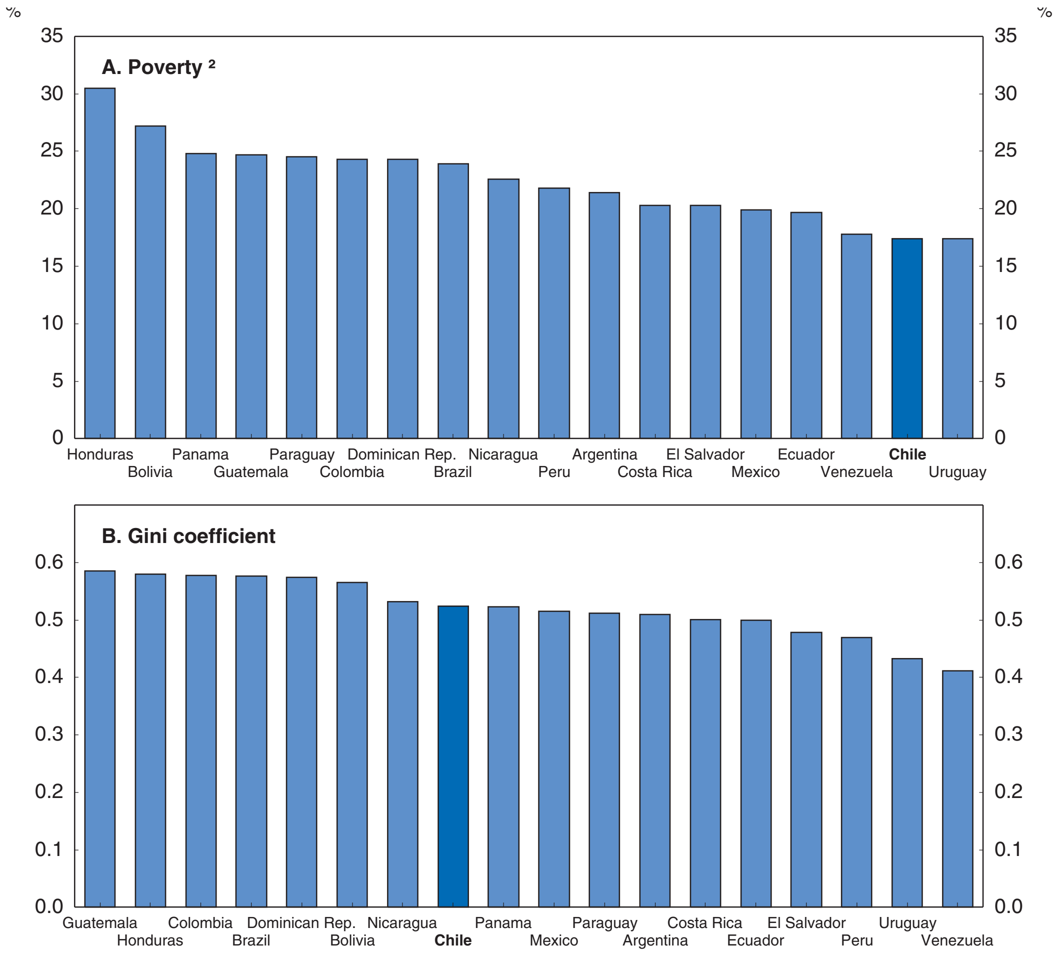
Children are in particular danger of being poor in Chile, while seniors are less likely to be poor than working age individuals (Table 1.1). In fact, the presence of a pensioner in the household lowers the probability of being poor, while the poverty risk increases monotonically with the number of children in the family, reaching more than 50% for households with more than 5 children (not shown). The low risk of poverty for people of pension-age is probably evidence that Chile's non-contributory pension scheme for the poor is effective. Single-parented households have a particularly high incidence of poverty. More than 85% of these households are headed by a female and the incidence of poverty among single-parented households with a male head is actually much lower. The poverty risk falls monotonically with the number of employed workers in the household, but households which depend only on informal workers have a higher poverty risk than those where some workers have a formal job.

Income inequality has started to decline, as well, although much more recently and more modestly than poverty. It remains important even in Latin America comparison (Figure 1.2) and is higher than anywhere in the OECD (Figure 1.3). The reason why income inequality has hardly moved despite an impressive decline in poverty is that the largest inequalities can be found at the top of the income distribution. The average income of the top decile is almost three times as high as the average income of the decile just below that (Figure 1.4). In contrast, income is distributed relatively equally among the rest of the population.

Poverty would perhaps be less of an issue if people were able to overcome it relatively easily by themselves. However, intergenerational social mobility is comparatively low in Chile, which is typical for countries with high inequality (Causa and Johansson, 2009). The intergenerational income elasticity, which measures the degree to which a man's income is determined by the income of his father, is higher in Chile than in other OECD countries (Figure 1.5). Recent estimates range from 0.57 to 0.74 (Nuñez and Miranda, 2010). This

Figure 1.2. **Poverty and inequality in Latin America comparison**[1]

2009 or latest year available



1. Household income, including labour and capital income as well as cash transfers, is adjusted by the household size.
2. Percentage of persons with household income less than 50% of the median.

Source: United Nations, ECLAC, *Panorama Social*.

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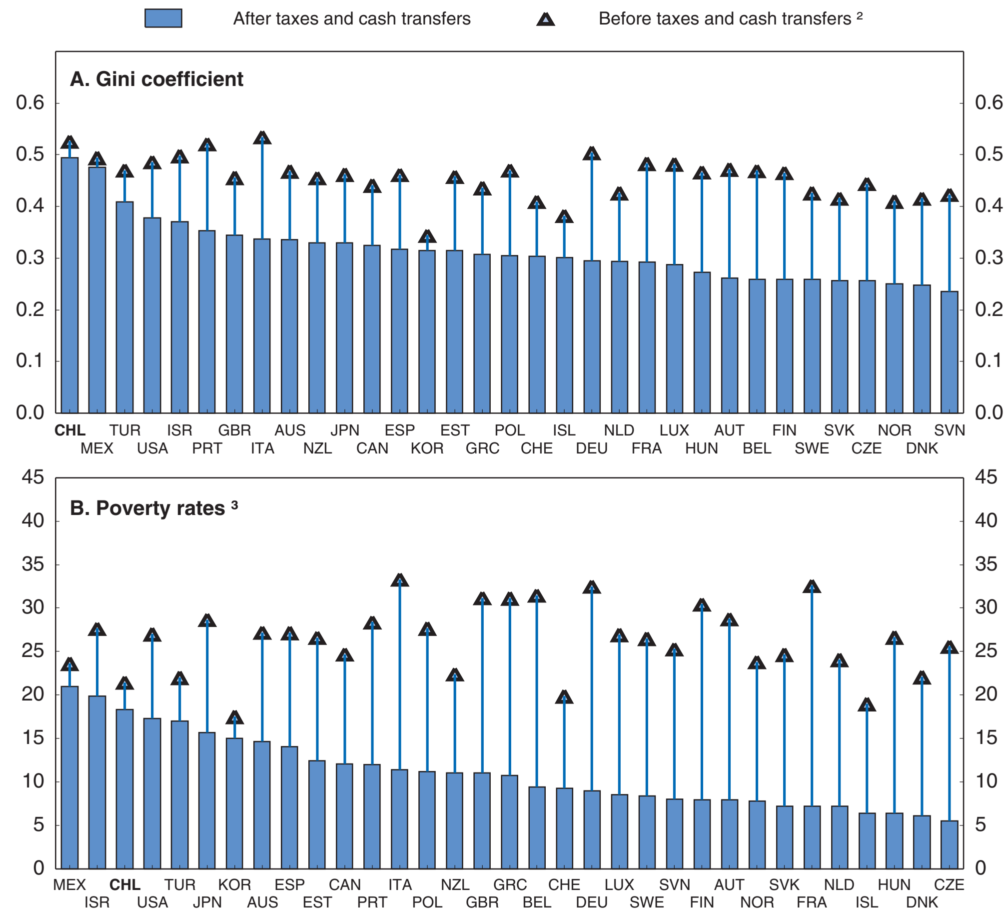
implies that a Chilean whose father earns twice as much as the father of – say – a friend is likely to earn 60-70% more than this friend.

The measures discussed in this chapter are mainly directed at reducing poverty. They will also contribute to reducing inequality, but since the largest inequalities come from the top of the income distribution, this will only go so far. There are complementary policies that will help further equity and have beneficial effects on productivity growth at the same time. Stronger competition policies, as discussed in the first chapter of this Survey, would strengthen productivity growth, while also reducing rents of incumbents and enhance business opportunities for newcomers, thus potentially contributing to social mobility. Raising the quality and equity of education (OECD, 2010) would strengthen the country's human capital and contribute to reducing inequality. Limiting tax exemptions and loopholes, that mainly benefit higher-income earners, would strengthen tax revenues, creating more room for higher, progressive cash transfers or stronger education and social policies.

Figure 1.3. **Inequality and poverty across OECD countries**[1]

2009 or latest year available



1. Household income is adjusted by the square-root of the number of persons in the household. Provisional estimates.
2. Before transfers only for Greece, Hungary, Mexico and Turkey, transfers do not include subsidies for buying a home in Chile.
3. Poverty line defined at 50% of the current median income.

Source: OECD, *Income Distribution Database*.

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Table 1.1. **Poverty across different groups, 2009**

Headcount of people with income below the national poverty line as per cent of the corresponding group

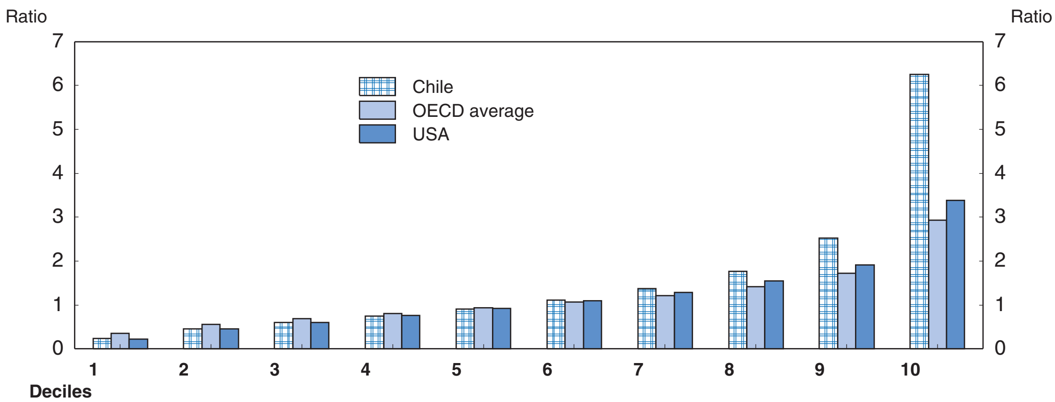
Group	All people	Children	People of working age	People above 65	Individuals in households without children	Individuals in households with at least 2 children	Individuals in households with a pensioner
Poverty rate	15.1	22.1	13.7	8.1	7.4	25.9	10.9

Group	Individuals in households with children, headed by a couple	Individuals in single-parented households	Individuals in households without workers	Individuals in households with at least one worker	Individuals in households with at least two workers	Individuals in households with informal workers only (no written contract)	Individuals whose households head has less than secondary education
Poverty rate	17	29.3	37.5	12.6	4.3	18.8	21

Source: OECD based on Encuesta de Caracterización Socioeconómica Nacional (CASEN), 2009.

Figure 1.4. **Average household income by income decile**

Normalised with median household income[1]



1. Relative poverty line at 50% of household median income. 2009 for Chile, latest year available for other countries.

Source: OECD, *Income Distribution and Poverty Database*.

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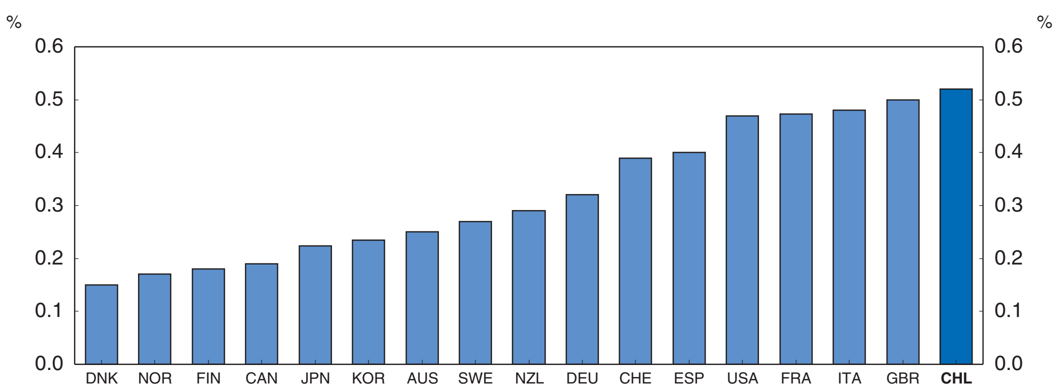
Figure 1.5. **Intergenerational earnings elasticity estimates**[1]



1. The height of each bar represents the best point estimate of the intergenerational earnings elasticity resulting from the extensive meta-analysis carried out by Corak (2006). The higher the parameter, the higher is the persistence of earning across generations and thus the lower is intergenerational earnings mobility.

Source: OECD, *Social Mobility in OECD countries: Evidence and Policy Implications* (forthcoming).

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What accounts for the decrease in poverty and income inequality?

Economic growth, with rising labour income for all income deciles, social policies and rising educational attainment, explain a part of the decrease in poverty and inequality in Chile. Labour income of the lowest income quintile rose on average 38% in real terms between 1990 and 2009 (Table 1.2). While the labour and capital incomes of higher income deciles rose even faster than that, a marked increase in monetary transfers that was strongest for the lowest income decile compensated for this difference. Research suggests that a decline in wage inequality that began in 1987 – after a strong increase since the early 1970s – can be attributed to a significant increase in the supply of workers with tertiary education (Eberhard and Engel, 2008). Nevertheless, wage inequality remains high in Chile in international comparison (Figure 1.6).

However, the positive impact of the tax-and-benefit system on equality is much lower than elsewhere in the OECD, owing to a less progressive tax system and a comparatively

Table 1.2. **Real income increases by quintiles of per capita household income between 1990 and 2009**[1]

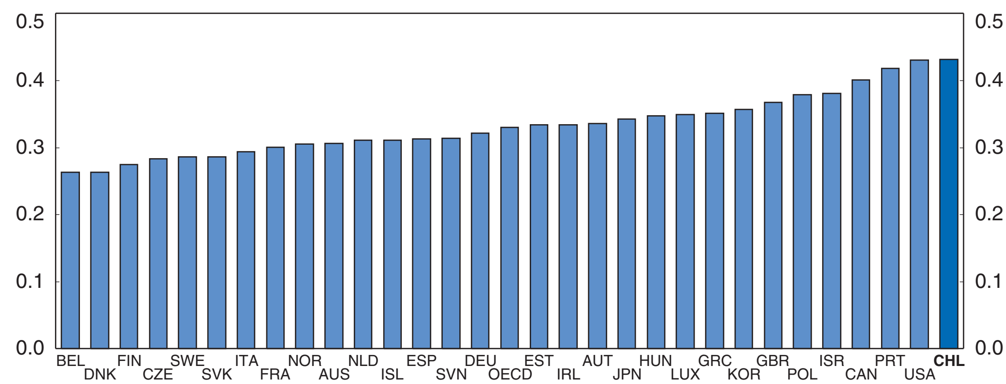
In per cent

	I	II	II	IV	V	Total
Capital and labour income	38	64	63	73	55	59
Monetary transfers	492	369	305	236	89	352
Total income	69	72	67	74	55	62

1. 2009 values are deflated with the deflator of the urban poverty line.
Source: Encuesta de Caracterización Socioeconómica Nacional (CASEN).

Figure 1.6. **Gini coefficients for the earnings of full-time employees**

15 to 64 year olds, 2008[1]



1. 2005 for Israel, 2007 for France, Korea and the United States and 2009 for Chile and Japan.
Source: Koske *et al.*, "Less income inequality and more growth are they compatible? Part II. The distribution of labour income" (2012).

StatLink http://dx.doi.org/10.1787/888932564293

small size of cash transfers (Figure 1.7). While the inequality of market income before taxes and transfers is, in fact, quite similar to Chile's in a number of OECD countries, taxes and transfers lower the Gini coefficient in these countries by an average of 10 points. In contrast, the impact of the tax-benefit-system on inequality is low in Chile and many other Latin American countries (see Figure 1.3), mainly owing to the low size of redistributive transfers and a low share of progressive income taxes in overall revenues.

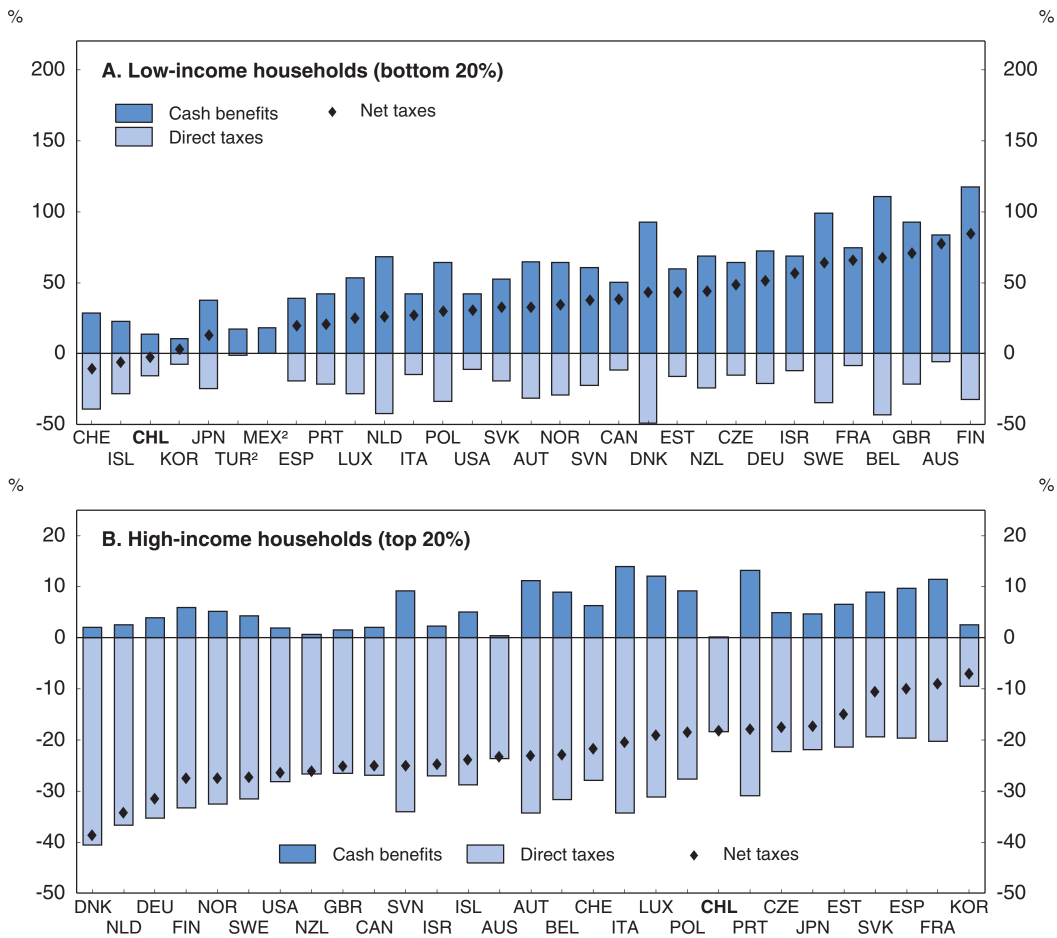
Cash transfers as an instrument to reduce poverty

The role of cash transfers for bolstering the income of the poor and increasing their productivity

While cash transfers are well-established in OECD countries as an instrument to reduce poverty and inequality, their use is less common in developing or emerging countries. Following the success of Mexico's conditional cash transfer programme *Oportunidades*, many Latin American governments have introduced similar programmes. The Mexican programme is conditional in the sense that recipients are required to send their children to school and to health checks, while participating in information sessions about health and other issues. Otherwise their benefits will be reduced or scrapped. Cash transfers for the poor also exist in developing and medium-income countries across Africa and Asia. Some of them come with conditions, others are unconditional.

Figure 1.7. **Tax and benefits for low and high income households**

As per cent of pre-transfer labour and capital income



1. Headed by working-age individuals. 2009 or latest year available.
2. Pre-transfer income is net of taxes.

Source: OECD, *Income Distribution and Poverty Database.*

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Studies show that cash transfers – whether conditional or unconditional – can help improve beneficiaries' wellbeing and their productivity on a wide range of dimensions. They improve child nutrition and health (Aguëro *et al.*, 2006; Duflo, 2003; Paxson and Schady, 2007), language skills (Fernald and Hidrobo, 2011, Paxson and Schady, 2007) and educational attainment (Case, Hosegood and Lund, 2005; for literature overviews see Hanlon *et al.*, 2010; Fiszbein and Schady, 2009) – all of which are important factors for children to grow up to become an autonomous and productive person with a good capacity to generate income. As an example, children's nutrition with its positive influence on health is important, because healthier children have been shown to achieve better results in cognitive skills tests and earn significantly more as adults (Case and Paxson, 2008). The programmes have also been shown to reduce child labour (Edmonds and Schady, 2009).

Research suggests that cash transfer programmes increase households' capacity to save and invest, thus generating higher income. Gertler *et al.* (2006) find that Mexico's *Oportunidades* programme helped poor rural households to invest in microenterprises and agricultural activities with an estimated rate of return of 17%. In South Africa recipients of the child support grant are twice as likely as comparable non-recipients to have a bank account or some form of savings (Delany *et al.,* 2008). Martínez (2004) shows that a universal pension in Bolivia helped poor households increase their food consumption by more than one and a half times the value of the pension. This resulted to a large extent from increased home production of meat and vegetables thanks to a more intense use of land when extra money was available to invest in animal ownership, crops and agricultural inputs. This suggests that cash transfers can help households, who have no or limited access to credit, to invest in improving their living standards.

Health, cognitive skills, education and people's ability to invest are important factors improving their productivity and well-being. Well-designed transfers could thus help Chile reduce poverty, while improving the productivity of its workforce, thus also strengthening the economy's growth potential. The impact on poverty would thus be both direct – through the transfer itself – and indirect, through the impact that transfers can have on recipients' health, education and skills and thus their ability to generate income. Ultimately, if this contributes to stronger economic growth, poverty can be further reduced through the effects that a general rise in incomes has on the low end of the income distribution.

Cash transfers to date in Chile

Chile has a range of different cash transfers (Box 1.1) targeted with a proxy means test that assigns scores to families based on employment, actual and imputed potential income, health status and family composition (*Ficha de Protección Social, FPS*). Cash transfers in Chile are currently rather small in size and quite narrowly targeted. Transfers connected to *Chile Solidario* increase household income by around 10% for the lowest income decile, and much less for income deciles above that (Figure 1.8). Only the non-contributory basic

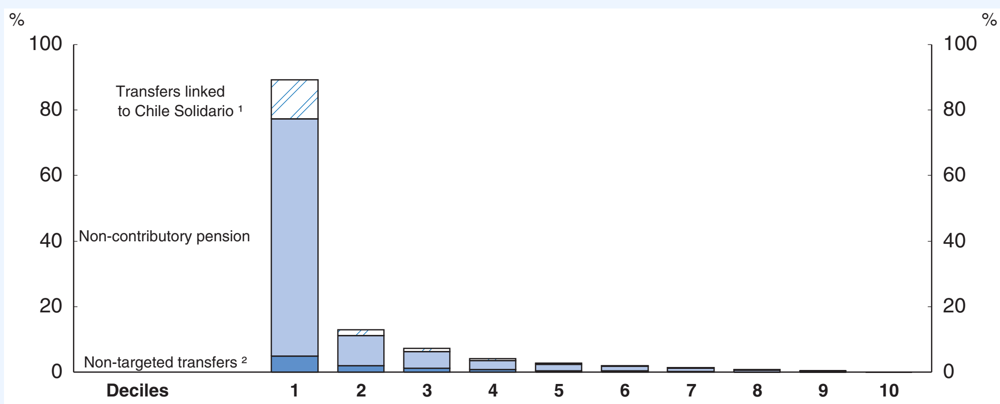
Box 1.1. **Cash transfers for poor families in Chile**

Chile Solidario targets families who live in extreme poverty (with a score in the proxy means test, the *Ficha de Protección Social*, FPS, below 4.213). There is a special programme for the sole elderly, the homeless and children with a parent in prison. Beneficiaries are granted preferential access to a range of social services, including housing, employment, healthcare, education and childcare. With the support of a social worker *Chile Solidario* recipients design an action plan, which is supposed to help them exit poverty. The plan is based on 79 minimum conditions out of which recipients are meant to achieve at least 13, in areas as diverse as housing, employment, education, health and domestic violence. There are regular meetings with the social worker to monitor progress. Benefits are decreasing over the first 24 months falling from 26 USD per month to 14 USD. After that beneficiaries receive an exit grant equivalent to 13.5 USD per month for 3 years. Given its relatively small size the benefit is mainly meant to motivate families to participate in the programme. *Chile Solidario* participants have preferential access to a number of other cash transfers, provided they qualify for them. This includes all cash transfers described in this box, but also the increased school voucher subsidy for poor children (*Subvención Preferencial Escolar*) and a subsidy for schools to help retain children in school the next year (*Subvención pro Retención Escolar*). These two subsidies go to the school, where the children are enrolled, not to its family. Preferential access is important, because most social programmes in Chile are rationed.

Box 1.1. **Cash transfers for poor families in Chile** *(cont.)*

Subsidio Único Familiar (SUF) is an allowance for poor families with pregnant women, school-age children or a disabled member who do not qualify for the contributory family allowance for dependent employees, because nobody in the family is affiliated with a social security institute. Thus, undeclared dependent employees and poor dependent workers can qualify for the benefit, as well as the inactive or unemployed. The allowance amounts to 6 776 Chilean pesos (13.5 USD) per month for households with a *Ficha de Protección Social* score below 11 734, which would correspond to the bottom 40% of the income distribution. This transfer is conditional on regular medical controls for children under 6 years and regular school attendance for children aged 6-18.

Figure 1.8. **Share of transfers in pre-transfer household income by decile, 2009**



1. Chile Solidario, Subsidio Único Familiar and water subsidy.
2. Unemployment benefits and social security family allowance.
Source: CASEN 2009.

StatLink http://dx.doi.org/10.1787/888932564331

Subsidio a la Cédula de Identidad is a financial support of 500 Chilean pesos (approximately 1 USD) to obtain an identity card for people who receive Chile Solidario.

Subsidio al Pago del Consumo de Agua Potable y Servicio de Alcantarillado de Aguas Servidas (SAP) is a subsidy for obtaining drinkable water, which covers the bill for 15 m^3 of water use each month for Chile Solidario recipients who are connected to the network.

Pension Basica Solidaria (PBS) and *Aporte Previsional Solidario* (APS) are the non-contributory basic solidarity pension and top-ups respectively for retired and disabled workers with savings shortfalls in the private pension system. Recipients need to have a FPS score of 12.185 or below to qualify.

solidarity pension makes up a large share of pre-transfer income, although only for the lowest income decile. As a comparison, the Mexican *Oportunidades* programme increases pre-transfer consumption of households in the two lowest income deciles by 33% on average (Fiszbein and Schady, 2009).

The government has recently made the decision to increase the cash transfers associated with *Chile Solidario* significantly with the new transfer system, the *Ingreso Ético Familiar*. The president sent the law proposal to Congress in late September 2011 and it is now under debate (Box 1.2).

Box 1.2. **The law proposal for *Ingreso Ético Familiar***

The subsidy will be targeted at those living in extreme poverty, around 170 000 families. Some bonuses will be available to a wider range of families, those belonging to the 30% poorest in the country. The government expects to spend 95 bn Pesos (190 million USD) or 0.07% of GDP in 2012.

In addition to the social worker, who helps Chile Solidario families cope with social and employment programmes (see Box 1.1), recipients will be required to enrol in a further employment programme. Current thinking is that this could be a coach who would help adult family members find a job and improve their employability.

There will be a monthly base transfer of 13 000 Pesos (around 26 USD) per family plus an extra 6 000 pesos (around 12 USD), which will be available for families who live in extreme poverty.

There will also be a conditional transfer, namely an extra monthly 8 000 pesos (16 USD) per child for families in extreme poverty who comply with certain conditions, including regular health checks for their children and regular school attendance – more than 90% of the time for primary school children and 85% of the time for secondary school children.

These payments will be available for 24 months.

In addition, there will be a range of bonuses for families who belong to the 30% poorest:

- Families with a child in the top 15% of his or her class will receive an extra 50 000 pesos (100 USD) per year and those with a child in the second 15% of his or her class an extra 30 000 pesos (60 USD).
- There will be an employment subsidy for working females from families whose incomes are among the 30% lowest in the country (the 40% lowest after 2012). It can reach up to 15% of their salary within a certain range, with an estimated average 25 000 pesos (50 USD). The subsidy is gradually phased in and phased out and will be paid to the worker and her employer in equal parts. It is rationed to 100 000 women initially.
- Adults who receive *Ingreso Ético* and complete secondary education can receive a one-time bonus.
- There will be a one-time bonus for recipients graduating from the employment programme early by finding a job.
- There will be further bonuses for different achievements in the areas of education, health, employment and savings.

When thinking about the design of *Ingreso Ético Familiar* it is important to assess *Chile Solidario*, on which the new transfer system should build. The small cash transfer that comes with *Chile Solidario* is not intended to lift people out of poverty by itself. Rather, it is meant as an incentive for recipients to make better use of social services and build a strategy to exit poverty with the help of a social worker. The main idea is that the poor lack the capacity and information to access cash transfers and social services, and that they need assistance to use these programmes effectively and develop skills to overcome poverty. Studies have found a positive impact of *Chile Solidario* on the take-up of transfers (Galasso, 2006; Carneiro *et al.*, 2009), such as *Subsidio Único Familiar* (Box 1.1). This effect is stronger in municipalities where different social services are better co-ordinated, for families served by social workers with lower caseloads and for families whose head has a relatively low educational attainment (Carneiro *et al.*, 2009). These findings point to the role of the quality of complementary social services in ensuring success of cash transfer programmes. Amior *et al*. (2010) suggest that neighbours' participation in *Chile Solidario* also has a positive effect on the take up of subsidies for households who do not receive *Chile Solidario* themselves. The authors provide some evidence that this is due both to better awareness of the existence of cash transfers and social programmes and a reduction of transaction costs, perhaps because the *Chile Solidario* programme spreads information on how to access these programmes to friends and neighbours. Studies have also found a positive effect on school enrolment (Galasso, 2006), on access to housing and employment programmes (Perticara, 2007; Galasso, 2006; Carneiro *et al.,* 2009) and on housing conditions (Larrañaga *et al.,* 2009; Carneiro *et al*., 2009).

However, results on the effect of *Chile Solidario* on employment, income and poverty are more mixed. While Galasso (2006) finds no positive effect on employment or income, Perticara (2007) finds a positive effect in rural, but not in urban areas. Larrañaga *et al*. (2009) find a positive impact on the number of employed people in participant households. Carneiro *et al*. (2009) find a positive effect on the employment of second earners, but none for household heads, including when they are single females. Gains in labour income per capita and a reduction in poverty, including extreme poverty, is confined to rural areas and to families with a head whose educational attainment is low according to this study. Larrañaga *et al*. (2009) find a negative impact on market income for urban, although not for rural households. The database they use does not allow the authors to assess the impact on disposable income, including transfers. Given that *Chile Solidario* provides recipients with preferential access to cash transfers, the authors conjecture that participants may replace market income with transfers to some extent. One theory why the impact of Chile Solidario in rural areas is stronger would be that access to information about cash transfers and employment services in the absence of *Chile Solidario* is more difficult in these areas than in cities, where people can more easily obtain information through neighbours or other networks. Overall, these results suggests that better help is needed for transfer recipients to find employment that allows them overcome poverty.

The role of transfer size

One aim of the new *Ingreso Ético Familiar* is to increase cash transfers and thus help lift more people out of poverty. In principle, Chile can afford reducing poverty significantly through transfers alone. Poverty gaps suggest that the country would have to invest less than 1% of GDP to lift all citizens above the national poverty line or even 10% above that (see Table 1.3), although it is important to note that this a static accounting exercise that does not take into account behavioural changes. Another way to look at this is to ask which share of their income relatively rich people would have to transfer to the poor to close the poverty gap. For example, income that is more than 2½ times above the poverty line, or within the top four income deciles, seems high enough to ask people to transfer part of their earnings above that to the poor. An income surtax with a marginal tax rate of 3% for income above this line would be sufficient to lift all Chileans out of poverty (Table 1.3). Increasing cash incentives so that fiscal costs increase by 1% of GDP, however, may undermine work incentives. Limiting cash transfers, while financing other social policies that help people overcome poverty, including education, training and employment programmes, may thus be preferable. Nevertheless, the poverty gap is a useful measure to assess the scope of the poverty challenge. In China, as an example, closing the poverty gap with a poverty line of 2 USD in purchasing power parity terms, which is well below the national poverty line in Chile, would require taxing richer individuals – those who earn more than 2½ time the Chilean poverty line – with prohibitive rates of around 100% (Ravallion, 2009). Compared to that, the Chilean problem is more manageable. However, for the moment the sum that the government plans to invest in additional cash transfers, 0.07% of GDP, is an order of magnitude smaller than the poverty gap. In fact the stated aim is to close the gap between families' income, including subsidies they receive now, and the national line for extreme poverty – not poverty – by no more than 85% with the monthly transfers.

How many people can be lifted out of poverty with cash transfers is not the only aspect to consider when deciding on the size of the transfer. Research has shown that transfer size can matter for the impact on recipients' ability to invest. Fernald *et al.* (2008) show that a doubling of cumulative transfers in Mexico's *Oportunidades* was associated with higher height-for-age scores, a lower incidence of stunting and better motor and language development. De Janvry and Sadoulet (2006) conclude that the marginal impact of transfers on school enrolment is large, as every 10 USD results in an additional 1½ percentage points in enrolment. They also note, however, that the impact of larger transfers depends much on children's and families' characteristics and is larger for older children and those living farther away from the nearest school. These researchers impose linearity on the relationship between the size of transfers and enrolment, thus not allowing for declining marginal impacts. Todd and Wolpin (2006) estimate a structural dynamic model of *Oportunidades* incorporating fertility and schooling choices and conclude, based on model simulations, that the positive impact on the number of years of schooling is linearly increasing up to the actual transfer amount. Thereafter, it increases at a slightly diminishing rate. Filmer and Schady (2011) find a strongly diminishing marginal impact on schooling of cash transfers that were allocated randomly at different sizes to different families in Cambodia. The role of the size of transfers for other dimensions, such as health and ability to make productive investments, however, has been less well researched.

Table 1.3. **Poverty rates and gaps depending on the poverty line, 2009**

Poverty line in % of the national poverty line	0.50	0.75	0.90	1.00	1.10	1.25
Poverty line; monthly per capita household income in US PPP	83.19	124.34	149.43	166.21	182.69	207.34
Poverty rate	3.74	8.12	12.01	15.12	18.23	23.30
Poverty gaps[1] as a % of GDP	0.10	0.28	0.48	0.65	0.86	1.27
Tax on income above 2½ times the urban poverty line that would close the poverty gap	0.48	1.33	2.24	3.06	4.07	5.96

1. The sum of all income shortfalls with respect to the poverty line in % of GDP.
Source: OECD based on Encuesta de Caracterización Socioeconómica Nacional (CASEN).

One problem might be that larger cash transfers could undermine people's work incentives, which would limit the positive impact on output and productivity. Research suggests, though, that such fears may be exaggerated at least in an emerging country context where these transfers tend to be small and beneficiaries have difficulties to make ends meet even if they have access to them. Studies of conditional cash transfer programmes in Brazil, Mexico, Nicaragua and Honduras suggest that they have no or very small effects on adult labour participation or hours, which are in some cases positive (Foguel and Paes de Barros, 2010; Parker and Skoufias, 2000; Alzúa *et al.,* 2010). Eyal and Wollard (2010) find a positive effect of South Africa's child support grant on the probability that mothers of recipient children participate in the labour force or are employed and a negative effect on their unemployment rates. OECD (2011) confirms these positive effects on labour market outcomes for poorer recipient mothers, while the positive impact on labour force participation in the sample comprising all recipient mothers comes with a higher probability of being unemployed.

Studies of programmes with larger cash transfers are more likely to find a negative impact on labour force participation or hours worked, although there are nuances to these results. Carvalho Filho (2008) finds that old-age pensions for rural workers in Brazil, which typically correspond to a minimum wage, reduced total hours and the probability that recipients worked. Bertrand *et al.* (2003) find a drop in hours worked for prime-aged individuals living with pensioners in South Africa, who receive comparatively generous benefits. The employment probability for prime-aged men falls according to these results, although the same does not hold for women. OECD (2011) results suggest that the presence of a pensioner in the household has a negative effect on females' probability to be employed, although there is no significant impact on their labour force participation. There is a negative effect on male labour force participation, although broad labour force participation is not affected significantly. This latter concept includes discouraged individuals who would be willing to take up a job offer, but have stopped active job search. However, there is a qualification to these results. Once migrating household members are taken into account, there is a small positive impact on employment of prime-aged adults with pensioners belonging to their household (Ardington *et al.,* 2009). One interpretation would be that increased household resources can be used to support migrants until they become self-sufficient, while pensioners can look after small children, allowing prime-aged adults to look for work elsewhere. Overall, these results suggest that cash transfers in middle income countries probably have to be quite large to undermine work incentives.

This suggests that unless Chile was to increase benefits significantly above those in Brazil or Mexico, the danger that there might be negative effects on work incentives is likely to be limited. Once cash transfers increase beyond that, though, Chile might want to monitor whether work incentives are undermined. Well enforced job search and work requirements would then be a solution. *Ingreso Ético Familiar* recipients will, in fact, be required to enrol in employment programmes, which may involve a coach who helps them improve their employability and find employment according to current thinking.

Once the first phase of *Ingreso Ético Familiar* is firmly established Chile could experiment in pilot studies with different increases in transfer sizes to study the impact on health, education, skills and employment. This would be important information to decide on possible future increases in transfer size. *Ingreso Ético Familiar* should build on existing cash transfers and over time it should be better integrated with at least some of them. The targeting mechanism for *Ingreso Ético Familiar* will take other transfers into account, but there will still be different procedures and conditions for access. Stronger integration would make the cash transfer system overall simpler, more transparent and easier to administer.

The role of targeting

The proxy means test that Chile uses for a wide range of social programmes has been successful in targeting various social programmes to the poorest, but it is probably quite costly. Eligibility is determined through interviews based on a questionnaire, the *Ficha de Protección Social* (FPS). Household's earnings capacity is evaluated with econometric methods predicting household members' potential income with information on their educational attainment, occupational status and history. Declared earned income only accounts for 10% of the score for potential earnings. Other variables that are considered are household composition and health status among members. The Ministry of Social Affairs transforms the indicators collected by interviewers at the municipal level into a score for each household with a method that is not revealed to interviewers or potential beneficiaries. A range of social programmes are then targeted based on discrete cut-off scores that differ from programme to programme. A recent review (Comité de Expertos, 2010), revealed a number of weaknesses. These are related to the incentives set through discrete cut-off points with immediate benefit withdrawal and relatively loose verification of complex information with weak sanctions.

Given the discrete cut-off points for eligibility potential beneficiaries have incentives to make false declarations on their characteristics that they believe may have a strong influence on their score, such as household composition and the educational attainment and disability status of members. Until recently there were no systematic documentation requirements for the information provided by households, it was up to interviewers and municipalities how they verify the information they receive and controls or sanctions for interviewees, interviewers or their supervising authorities were weak or non-existent. Households can ask for a re-assessment, but only those who believe that they would have a lower score than before are likely to do so. Otherwise, there is no mechanism to systematically update the scores. There is evidence that the accuracy of information is indeed questionable, as households and the incidence of disability according to the *Ficha de Protección Social* are much more numerous than they should be according to household survey data. More than 22% received a score that would correspond to the lowest decile of the score distribution according to a simulation with household survey data, thus more than double of what it should be (Comité de Expertos, 2010). These points to serious underreporting of various aspects of potential income or overreporting of needs.

Following the recommendations of the expert committee, the government wants to simplify the *Ficha de Protección Social*, to put more emphasis on verifiable data, thus allowing for cross-checking the information provided by families with administrative data sources, and to fight fraud with risk models. Scores will expire after two years and thus need to be updated regularly. These initiatives are welcome.

Withdrawing benefits more gradually would be an important complementary measure to attenuate incentives to make false declarations or avoid taking up employment. There is some anecdotic evidence that *Chile Solidario* recipients sometimes try to avoid taking up employment for fear of benefit loss (ClioDinamica, 2010). Opening the transfers to a wider range of beneficiaries over time would also avoid households above the cut-off point not receiving benefits, despite being relatively poor. This is a real issue in the Chilean context where the income distribution is narrow at the lower end, as noted above. Currently the government plans to keep targeting narrow under *Ingreso Ético Familiar.*

Given that Chile's means test is complex and that applying stronger verification would make it even more costly, one question is whether there would be more cost-effective targeting mechanisms. Madeiro *et al.* (2008) show that Brazil's targeted cash transfer programme, *Bolsa Familia*, which is mainly based on declared income, is almost as well-targeted as Mexico's and Chile's programme with their intricate proxy means tests. Chile might therefore want to consider targeting benefits mainly based on declared income, perhaps complemented by a small set of needs indicators, such as the number of dependent household members and disability among them. There could also be some complementary indicators for the specific social programme for which the means test is used, for example housing conditions in the case of housing subsidies. Household survey data suggests that it is possible to verify all income sources with administrative data for nearly 50% of all households in the lower half of the income distribution. In addition to that, random checks will be needed to verify that households do not have informal income in addition to their formal revenues. While this will require substantial investments in authorities' ability to verify benefit claims, this would hardly be more expensive than verifying information based on the *Ficha de Protección Social* and carrying forward its relatively complicated administration. Moreover, these investments are desirable by themselves, as they would help the government to fight informality and tax evasion more effectively.

Using declared income and updating the means test regularly rather than trying to assess potential income with a complex methodology would have the added benefit that the transfer could evolve into an income risk insurance over time. With a means test based on potential income that is not frequently updated, people who fall into poverty will often not be eligible for transfers. This would change if the means test was based on current, declared income. Such a test would allow the government to use cash transfers to protect households from income shocks, thus strengthening the automatic stabilisers of the economy. Gradual benefit withdrawal would also be easier with a simpler targeting mechanism.

Conditionality

Like many other cash transfer programmes in Latin America, *Chile Solidario* and *Subsidio Único Familiar* require recipients to comply with certain conditions to receive the transfers. In the case of *Chile Solidario* these conditions are personalised and developed by the recipient family with the support of social workers. They can concern health, education, employment housing, income, family life and legal documentation. The *Subsidio Único Familiar* requires regular medical controls for children under 6 and regular school attendance for children between 6 and 18. There will be similar conditions tied to the *Ingreso Ético Familiar* transfer.

One issue is whether conditionality is really necessary or effective to achieve the desired result. Monitoring conditionality is costly, and complying with the co-responsibilities is time-consuming for the household. If the poor invest too little into education or healthcare because they are credit-constrained and would be unable to satisfy their basic needs when investing, then unconditional cash transfers would be sufficient to solve the problem. They would also be more efficient, because they avoid enforcement costs and possible distortions, for example through inefficiently high investment in health or education.

Conditionality, on the other hand, may be justified if it enhances political acceptance of the cash transfers. Another issue may be that parents are misinformed about the returns to investments in education and health or their preferences may not be well aligned with those of their children. However, in those cases better information may be more efficient than imposing conditions on benefit recipients. Visits of social workers and mandatory participation in workshops may play this role in providing better information in Chile.

Some studies suggest that other characteristics than conditionality are more important for the success of cash transfers. In a statistical meta-analysis of research assessing the impact of cash transfer programmes on children's nutrition, Manley *et al.* (2011) find that the impact is not distinguishable for unconditional cash transfers and those with healthcare conditions, while programmes with conditions related to work and savings fare worse. Fernald *et al.* (2008) find that the cash component of the *Oportunidades* programme was associated with greater height, as well as better cognitive and language performance of children receiving the benefit, independently of conditions or nutritional supplements. On the other hand, there is also evidence indicating that, with good design, imposing conditionality can yield additional benefits. De Brauw and Hoddinott (2010) find that conditionality by itself did increase the impact of Mexico's *Oportunidades* on school attendance. This impact was particularly strong during the transition to lower secondary school, whereas there was no measurable effect on children continuing primary school. Results obtained by Attanasio *et al.* (2005) suggest that this may be due to the costs of schooling increasing with age. Thus, raising the grant for older children, while lowering it for smaller children, as an alternative to conditionality, can increase the effectiveness of the programme.

The conclusion for Chile would be that it is important to evaluate whether conditionality comes with additional benefits. *Ingreso Ético Familiar*, as conceived now, would have numerous different elements, some unconditional and many others tied to different conditionalities (see Box 2.2). Choosing a simpler set-up with requirements for adults to search for employment and enrol in training, if necessary to improve their employability, would be much easier to administer and may well be the most effective way to help the poor strengthen their capacity to improve their living standards. Unlike in other countries in the region, the incidence of malnutrition among children in Chile is low (comparable to that in the richest OECD countries), school attendance is compulsory and it is generally high, although in the target group almost 60% of the children miss more than 5% of their classes. Thus, conditions regarding medical checkups and higher school attendance are in some sense redundant, although they may create further incentives for poor families to comply with the law. However, this should be enforced for all children, not only the poor.

Some of the conditions to which the government plans to tie benefits may even have harmful side effects. One example is the transfer that families, whose income is in the lower third of the income distribution, can obtain based on their children's ranking in their class (Box 2.2). In particular, tying a large part of the benefits to children's ranking in school should be revisited, as it can be divisive. It will put a lot of pressure on teachers grading these children and discourage parents from sending their children to better schools.

To go for a simpler model, the government could launch a political discussion on what should be the base income that a household should receive when it can temporarily not secure any income. This transfer could be tied to training and job search requirements, along with support, and the transfer could be gradually withdrawn. This would be akin to France's *Revenu de Solidarité Active* (RSA). The transfer should be evaluated to understand the features that are most effective in strengthening poor households' capacity to overcome poverty for good.

The quality of complementary social services

When trying to enhance the poor's investment in human capital and their capacity to generate income, imposing employment, education or health conditions on benefit recipients is not sufficient. If schools or health services in poor neighbourhoods are of poor quality or not available at all, neither transfers nor conditions attached to them can be very effective. In Chile school enrolment is high, but the government needs to do more to close the gap in learning results between rich and poor children (OECD, 2010). The government currently invests a lot in schooling for poorer children. As long as results are evaluated to correct design, if needed, and ensure that the extra money is well spent, this may go a long way in providing better access to high-quality schooling for poor children. Chile should continue its efforts to invest more in the education of poor students.

Studies suggest that there are supply side constraints that can limit the success of *Chile Solidario* (OECD, 2009). Workloads for social workers are high in many cases and there is high turnover related to relatively low wages (Grupo de Politica Social, 2010). A study noted that employment programmes within Chile Solidario were not very well tailored to participant's needs nor to the local characteristics of the labour market. The programmes are often poorly co-ordinated with the business sector (Sur Profesionales Consultores, 2005). According to household survey data only 2% of *Chile Solidario* recipients stated that they had found a job through the local labour offices, and 4.5% thanks to *Chile Solidario* or the social worker that attends to them.

Municipalities differ strongly in resources and the capacity of their personnel to administer education and social programmes. The main source of own income for municipalities are property taxes, but these are subject to relatively high exemption thresholds, and thus revenues in poor municipalities with a lot of low-value houses are very weak. There is some redistribution of property tax revenues through the *Fondo Común Municipal* and there are central government transfers for various municipal tasks. However, the resulting degree of equalisation is weak compared with other OECD countries (Table 1.4). Average per capita revenues of the richest decile of municipalities is more than twice as high as those of the poorest decile even after fiscal equalisation. Within Greater Santiago the three richest municipalities have more than five times more resources per inhabitant than the three poorest ones. The Gini coefficient for average per capita fiscal revenues by decile also suggests that fiscal disparities across municipalities are high in Chile and fiscal equalisation does relatively little to correct this.

The central government is currently envisaging larger transfers to municipalities with weak tax revenues and a scheme to improve the qualification of the personnel who administer municipalities and this is welcome. Poorer municipalities need stronger resources to provide their citizens with high-quality services that help them overcome poverty. In the medium term, the government should consider developing fiscal equalisation further, either by devoting a larger share of municipal or central tax revenues to the redistribution fund, or by increasing earmarked central government transfers to poorer communities, as in the case of increased voucher subsidy for poor children. Increasing property tax revenues along the lines suggested above would provide municipalities with vital extra resources. If municipalities participated more in the revaluation of housing and decided on tax rates within limits set by the central government, this would also enhance accountability. The example of several OECD countries, including Switzerland and Sweden, shows that a high degree of fiscal equalisation is possible, while maintaining incentives for subnational governments to collect more revenues at the margin.

Table 1.4. **Fiscal disparities before and after equalisation**[1]

	Highest capacity/lowest capacity[2]		Gini	
	Before equalisation	After equalisation	Before equalisation	After equalisation
Federal/ regional countries				
Australia	1.3	1	5.0	0.0
Canada	2.4	1.7	10.0	7.0
Germany[1]	1.7	1.1	6.0	2.0
Spain	2.1	1.4	15.0	4.0
Switzerland	3.8	2.5	15.0	11.0
Unitary countries				
Denmark	2.2	2	8.0	4.0
Finland	1.8	1.1	11.0	3.0
Norway	2.2	1.2	13.0	5.0
Japan	3.1		20.0	
Sweden	1.4	1.1	6.0	0.0
Portugal	12.7	2.1	34.0	14.0
Turkey	85.6	1.7	53.8	8.0
Chile	**20.6**	**2.3**	**48.7**	**13.7**

1. 2005 for Germany, 2010 for Chile, 2004 for all other countries; the data show actual revenues for Chile and revenue capacity for all other countries.
2. Ratio of maximum and minimum fiscal capacity of subnational governments before and after equalisation. For federal/regional countries the indicators are calculated for the state/regional level. For unitary countries revenues per capita are averaged by decile. In these cases, the table shows revenues per capita of the richest decile as a ratio of revenues per capita of the poorest decile.

Source: Bloechliger and Charbit (2008), *Sistema Nacional de Información Municipal for Chile*.

The government should also regularly evaluate *Ingreso Ético Familiar* and the associated social programmes in terms of the impact on employment, wages, housing conditions or other desired results, as planned. This will help the government to correct design, if needed. When introducing new features of *Ingreso Ético Familiar*, such as employment or training programmes, it would be helpful to conduct pilot studies and test the impact of the programmes before rolling them out in the entire country.

Box 1.3. **Recommendations to improve anti-poverty policies**

- Continue to increase cash transfers, while further ensuring their effectiveness.
- Over time streamline the number of cash transfer programmes, by integrating them with the new *Ingreso Ético Familiar*.
- Keep the design of the new cash transfer simple and limit conditions, perhaps to job search and training requirements. Impose further conditions only if they are of proven effectiveness.
- Simplify targeting by relying mainly on household income. Over time make the benefits available to a wider range of beneficiaries, including by withdrawing benefits only gradually as income increases. Further pursue efforts to fight fraud more effectively.
- *Once the basis for Ingreso Ético* is firmly established, evaluate the effectiveness of the transfer and its different features, such as transfer size and conditionality, as planned, in improving households' ability to overcome poverty. Adjust design accordingly.
- Enhance fiscal equalisation to ensure that poor municipalities have sufficient resources to provide their citizens with high-quality services and continue efforts to improve these.

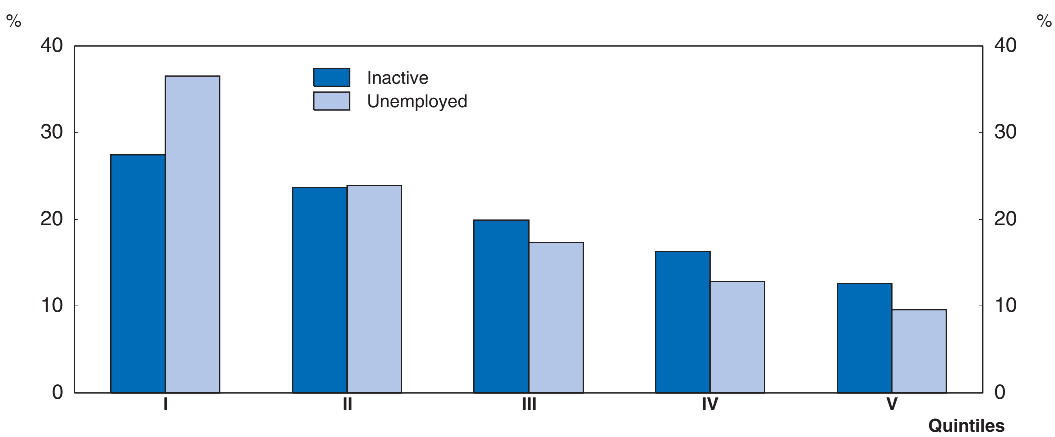
Improving labour market outcomes for workers at risk of poverty

Women, youth and the poor need help to improve their labour market outcomes

One of the key ingredients to help lift transfer recipients out of poverty in a self-sustaining way will be to help them find employment and develop their skills. Unemployment, inactivity and informality are particularly widespread among the poorest households (Figures 1.9 and 1.10). Low-skilled workers are much more likely to oscillate between the formal and the informal sector and inactivity or unemployment than workers with higher skills. This will have a negative impact on their retirement income later on, but also on the development of their skills through training-on-the-job and experience. Thus, supporting policies are needed to ensure that low-skilled and poorer workers can develop their full potential on the labour market and obtain employment.

Figure 1.9. **Inactive and unemployed people across income quintiles**

As per cent of total



Source: CASEN 2009.

StatLink http://dx.doi.org/10.1787/888932564350

Overall, recent labour market performance in Chile has been good. Unemployment has decreased from above 10% in early 2009 to 7%. More than 950 000 new jobs have been created since January 2009. While 55% of this job growth is accounted for by low-paid activities – own-account workers without employees, household services and unpaid family members – the quality of salaried employed has improved to some extent. The number of temporary jobs and of jobs without any social security or a work contract has contracted, while indefinite employment relations and those with a work contract and pension health and unemployment insurance have increased, lifting their shares in total dependent employment.

Yet, overall the Chilean labour market shows clear signs of duality, as the shares of temporary work (28%) and employment without social security (more than 20%) remain large, with negative consequences for employers' and employees incentives to invest in human capital, in particular if it is firm-specific. Temp agency jobs have increased almost five-fold since early 2010 and employment with subcontractors has grown by 15%, while jobs with a direct relationship to the employer have contracted. Subcontracting and temp agency jobs, which now account for 17% of salaried employment, tend to be less well paid than employment with a direct relationship to the employer, with mean wages more than

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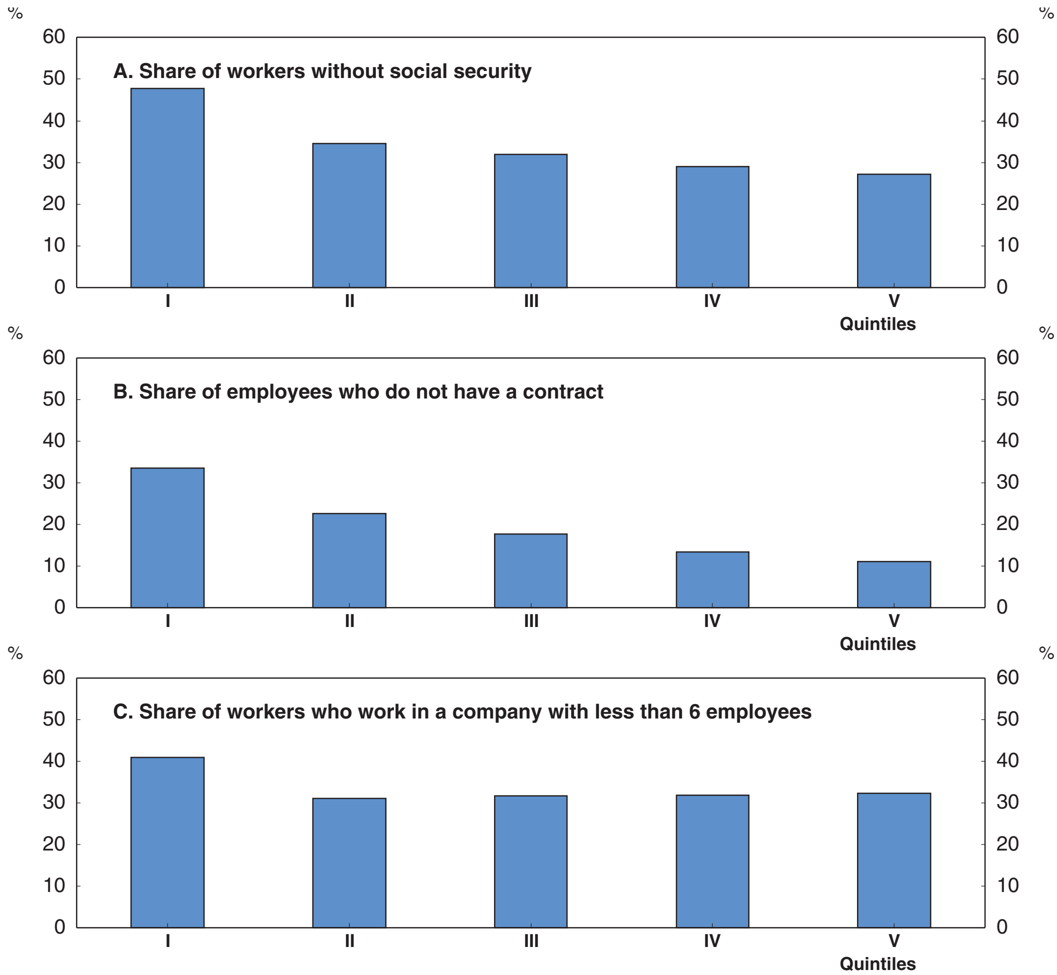
Figure 1.10. **Informality and job quality across income quintiles**

As per cent of total in the quintile



Source: CASEN 2009.

StatLink http://dx.doi.org/10.1787/888932564369

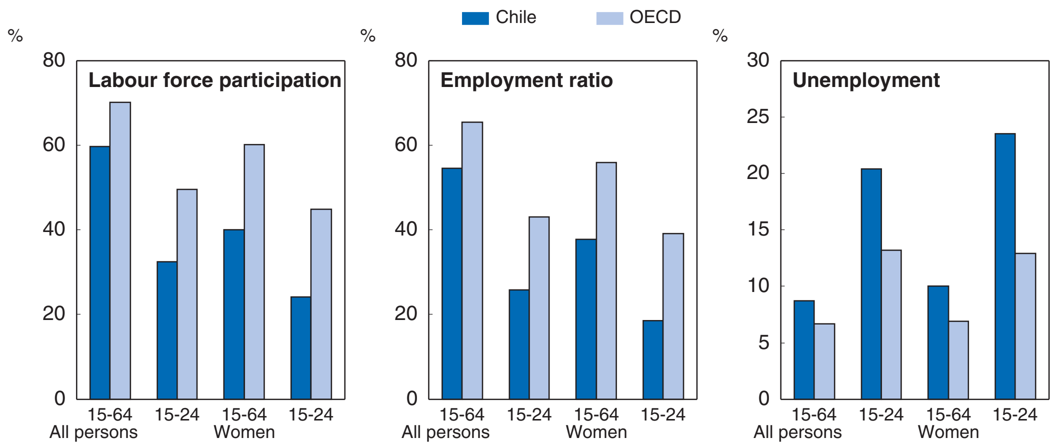
20% lower than for regular work relationships. In addition, there is a risk that incentives to invest in human capital are weakened, when the employment relationship is not direct.

Notwithstanding recent improvements, unemployment has been higher in Chile than in the OECD on average, although this picture has changed somewhat after the recent recession, as employment recovered quickly in Chile in contrast to a number of OECD countries. The overall unemployment rate in Chile is now in line with the OECD average. However, the youth and female unemployment rates are still well above the OECD average, although the gap has narrowed compared to the average over the last 10 years, which was substantial (Figure 1.11). Labour force participation, in turn, continues to remain well below the OECD average in Chile, mainly owing to a particularly low female labour force participation – among the lowest in the OECD.

Women earn much lower wages than men, with salaries of 85% of those of men, and 70% if the self-employed are included. Over the last 20 years, only the gender wage gap for workers with more than 13 years of education has diminished with women's salaries

Figure 1.11. **Young people and women in the labour market**

Average 2000-09



Source: OECD, *Labour Force Statistics Database*.

StatLink http://dx.doi.org/10.1787/888932564388

climbing from 55% of those of men to 67%. While some of this is due to observed and unobserved characteristics, such as education, work experience, pure discrimination is consistent with the available data and models (Bravo *et al.,* 2008). Discrimination between men and women is unconstitutional in Chile. To enhance this, the government passed a law in 2009 that explicitly disallows discriminating wages between men and women who perform similar tasks.

Training and job placement services

Strengthening the local labour offices

Important elements to help low-skilled workers, women and youths improve their prospects on the labour market will be effective job counseling that guides them towards training and places them in jobs that fit their skills. In these areas there is room for Chile to make further progress.

Chile's local labour offices (*Oficinas Municipales de Intermediación Laboral*, OMIL) are relatively underdeveloped. They vary a lot in terms of technical equipment and qualified personnel. Capacity to provide effective job counseling is lacking in particular in rural areas. A study on the government's re-inforcement programme for labour offices suggests that some small and rural offices lack basic equipment to the point that they used the placement incentive pay they received from the Ministry of Labour for acquiring basic material, while bigger and better equipped offices were able to invest this money in personnel to liaise with enterprises (ClioDinamica, 2010). According to household survey data only a bit above 1% of employees feels that an OMIL has helped them find a job.

Networks of local labour offices with local businesses are often weak, which makes it more difficult for job counselors to match employers and employees effectively. In a number of cases, the skills of the job placement personnel are not sufficient to perform their tasks effectively. Hiring and training well-qualified staff will be particularly important to help low-skilled workers, guide them towards training and place them in formal, dependent employment or help them to create their own business. The labour offices are often not well prepared to counsel low-skilled workers, such as *Chile Solidario* participants.

The fact that only 3% of *Chile Solidario* recipients are registered with OMILs may well be a testimony to the weak confidence that these clients have in the value of OMIL services. The low skills of these workers and the fact that they are used to informal and independent work, but generally have little experience with formal, dependent employment, requires experienced job counselors who are well prepared to work with these clients.

The government is working to improve the functioning of job intermediation services, tripling resources allocated to local employment offices in 2011 (now 2.4 billion pesos, or 0.002% of GDP). The programme includes flat transfers and an incentive pay system for successful job placement as well as training for the personnel of the local labour offices. One question is whether it makes sense in the current context, where OMILs have such different capacity, to assign performance bonuses. Maybe the focus in the first stage of reinforcement should be to level the basic capacity of OMILs that are particularly weak. In the second stage, when the capacity of different OMILs is more even, the central government could then move towards assigning performance bonuses, as well.

The government has recently started a training programme for OMIL employees. The seminars focus on skills to adjust intermediation services to individual clients as well as to local labour market conditions and to build networks with local businesses. The aim is to establish a permanent training programme for OMIL personnel provided by a university.

Chile should continue these important efforts. In particular, the government should assess what needs to be done to ensure that local labour offices have comparable capacity across the country. This may require more effective fiscal equalisation, as discussed above. Low-income municipalities with many low-skilled citizens, who have difficulties in finding jobs of decent quality, are in particular need of high-quality employment services and weak municipal resources should not be an impediment to this.

There are good reasons to enhance the quality of job intermediation in Chile. OECD experience suggests that job intermediation programmes are particularly successful in reducing the time spent in unemployment, while increasing employment rates and earnings (Kluve, 2010; Card *et al.*, 2010), while classroom and on-the-job training programmes yield only small effects in the shorter term, but bigger effects in the long term. In a developing country context Betcherman *et al.* (2004) confirm that job placement services are relatively effective and costs are comparatively low, although they are of limited use by themselves when structural unemployment is high and there is little demand for labour. The government plans to integrate private and public job intermediation with publicly-funded training programmes and that will be welcome.

The government has also started to engage private providers into job intermediation through the *Bono de Intermediación Laboral*, which pays job intermediation agencies for placing jobseekers. OECD experience suggests that partial outsourcing of job intermediation services can be cost effective. However, the public agency must be prepared to monitor private agencies' performance in providing job intermediation services and training, compare with its own results and fight fraud. In Chile this will be particularly important, as the role of private placement agencies is currently limited, with only ½ per cent of employees stating that they have found their jobs thanks to a private agency. The Ministry of Labour should conduct such evaluations, as this would be beyond the capacity of municipal labour offices. The fees for the private agency have to be designed to reward sustainable job placements and minimise fraud as well as the risk that private agencies cherry pick and choose only the most employable candidates. Chile foresees higher payments for placing hard to place candidates, which is a sensible approach, but agencies can choose freely from a pool of candidates open to all private agencies. Unless fees for the hard to place are high enough, agencies may prefer to concentrate their efforts on workers who are easier to place. Letting agencies bid for predefined pools of candidates, which are diverse in terms of work experience and qualifications, would prevent agencies altogether from cream-skimming and it would allow the government to compare their performance if each of them had a pool with a similar composition. Agencies could be paid depending on the share of candidates that they place with premia for finding jobs for hard to place candidates. The government plans to pay out fees to agencies fully only after the candidate has been retained for three months in the new job. Another possibility to create incentives for agencies to search for longer-term employment would be to withhold part of the fee until candidates have spent a year in their new job.

The government also created an electronic platform for job search, *Bolsa Nacional de Empleo*. The tool has the potential to make it easier for job counselors to place their clients and jobseekers can access the tool directly. In 2009 only 1% of employees stated that they had found their job through this tool. At the time, it was only available for jobseekers visiting an OMIL. Since then the government has made the tool available through the internet, which has increased its use and potentially its effectiveness.

It is not yet clear how the envisaged employment programmes for *Ingreso Ético Familiar* will fit into the structure of municipal labour offices, private placement services and publicly-financed training programmes. The current thinking is that an employment coach will attend to recipient families to help them improve their employability and find a job. Chile should evaluate its different efforts to improve job intermediation services and make sure that they are well co-ordinated or even integrated. Over time, it should retain only the most effective of the different programmes. Concentrating efforts to train staff at municipal labour offices that is specifically qualified to guide low-skilled workers towards training and employment may well be more efficient than pursuing a patchwork of different structures that could be difficult to administer and monitor.

Training, public employment programmes and wage subsidies in Chile

Training and other active labour market programmes can be useful in raising jobseekers abilities to generate income. However, publicly financed programmes in Chile are insufficiently targeted at those who need training most to overcome barriers towards employment. Around 80% of total public training resources are devoted to *Bono de Franquicia Tributaria para la Capacitación*, a programme that offers tax breaks to employers who decide to send their employees on training with certified institutions. This programme disproportionately benefits higher-income workers with higher education who work in large enterprises with sophisticated human resource management. Less than 5% of the programme's resources go to workers with basic education or less (Castro and Viñaspre, 2011; Larrañaga *et al.*, 2011). Moreover, recent studies commissioned by the government suggest that the programme has no measurable effect on salaries or employment in the long run (Larrañaga *et al.*, 2011). This may be related to institutional problems. As an example, more than 70% of the training programmes financed by *Franquicia Tributaria* lasted less than 18 hours.

There are other training programmes that are of doubtful effectiveness. One example is *Bonificación a la contratación de mano obra*, which combines wage subsidies for a period of four months with training subsidies for companies who hire a previously unemployed worker.

The programme has a special arm for *Chile Solidario* recipients with higher subsidies for young workers. A study found no significant impact of the programme on the probability that beneficiaries remain in employment or receive higher wages (Agrouc, 2009).

On the other hand, several programmes directed at low-skilled workers seem to have significantly positive impacts on employment and wages, especially when they are longer-term and combine classroom training with practical work experience and job intermediation (Larrañaga *et al.,* 2011).

The central government created a commission that has evaluated existing training measures. Based on the result the government plans to increase slots for successful training programmes more than threefold in 2012 and it wants to reduce the tax break for *Franquicia Tributaria*. This is welcome. The government should indeed use this opportunity to gradually phase out or reform programmes that show little or no effect on beneficiaries' wages or employability, such as *Franquicia Tributaria*, expand those that have proven useful and develop more effective programmes to help groups with difficulties to find employment, such as the low-skilled and women. Programmes of this type are currently small-scale and they are dispersed across many different institutions. Streamlining and developing Chile's training programmes, to ensure that they are efficient, will be important to help the poor improve their living standards. Chile should consider bundling training and employment programmes at one institution, for example SENCE, to facilitate rigorous evaluations and strategic planning. Better integrating SENCE with the network of local labour offices and training job counselors might promote the flow of information between both institutions and facilitate tailoring programmes to the need of job seekers (OECD, 2009). The plan to integrate job intermediation services and training programmes will be helpful in this respect. The government also considers creating a permanent commission that would regularly review training, job intermediation and other labour market programmes and policies led by SENCE.

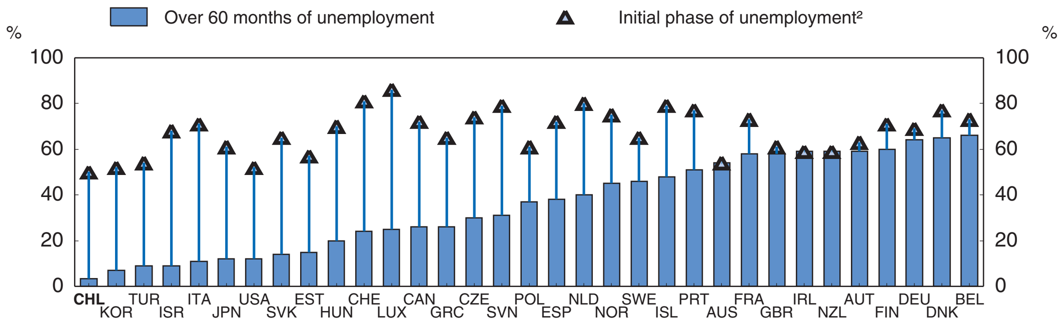
Effective and efficient protection for workers from the effects of unemployment

Should unemployment benefits be extended further?

The unemployment benefit system created in 2002 in Chile is mainly based on savings in individual accounts with small complements from an insurance fund, called *Fondo Solidario*. The system started out with moderate benefits, which allowed the government to assess sustainability first. Until a reform in 2009, access to the insurance fund was very restricted. As a result the fund was involved in only about 6% of the cases of benefit receipt. Account balances for many workers are too low to ensure benefits providing adequate protection. Workers on fixed-term contracts and low-wage workers in particular, who are most likely to experience unemployment, contribute less regularly, owing to frequent movements into and out of formality, and with relatively low average amounts. To this date a large minority of workers has accumulated less than a monthly minimum wage in their accounts, only around 10% of workers have more than 5 monthly minimum wages. The replacement rate of unemployment benefits and the duration is short. In fact, Chile has the lowest average replacement rate over 60 months in the OECD even after a recent reform that extended benefit receipt for many workers (Figure 1.12) Around 85% of the workforce is affiliated to the system, but only about half of these workers contribute to their accounts every month. Around 20% of private salaried workers, who are obliged by law to contribute to the system, do not.

Figure 1.12. **Unemployment benefit replacement rates (net of taxes), 2009**

Average for four family types and two earnings levels[1]



1. Unweighted averages (single and one-earner married couple with no children and lone parent and one earner married couple with two children) for earnings levels of 67% and 100% of average worker income, without social assistance.
2. Initial phase of unemployment but following any waiting period.

Source: OECD, *Tax-Benefits Models*.

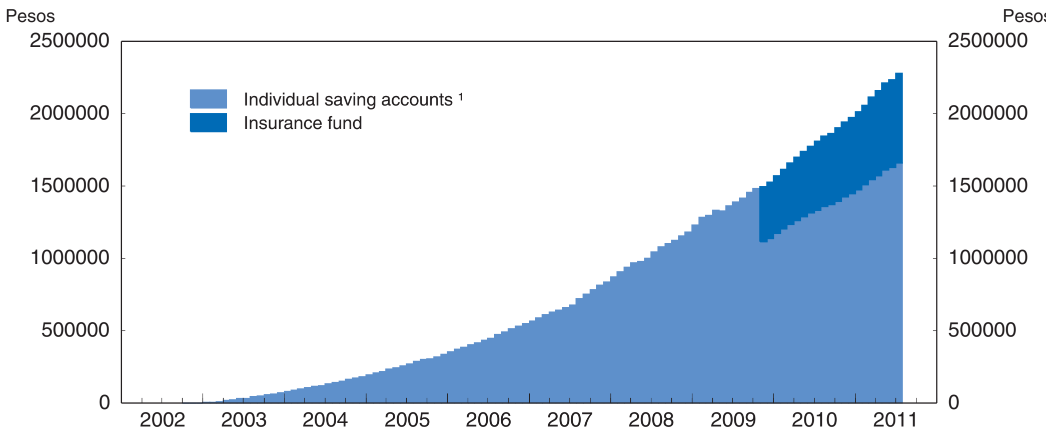
StatLink http://dx.doi.org/10.1787/888932564407

A reform in 2009 eased access to the insurance fund, making it easier to top up own savings to ensure five monthly payments for dismissed workers with indefinite contracts, with the replacement rate tapering off from 50% to 35%. The government also eased access to the insurance fund for workers on fixed-term contracts, who can now receive two monthly payments with a replacement rate of 35% and 30%. Payments for beneficiaries of the *Fondo Solidario* can be extended for two further months with a replacement rate of 25% each when the unemployment rate is more than a percentage point higher than the average over the last four years. Workers who draw on the *Fondo Solidario* are required to look actively for work and cannot decline a job offer. After the earthquake in 2010 access to unemployment benefits was temporarily eased for workers, who became unemployed or whose work places were seriously damaged as a result of the natural disasters.

However, the large majority of workers with a right to the insurance fund payments, around 85%, never uses it, pointing to a need for better information. Another reason could be that costs of the requirement to visit a local labour office every month during benefit receipt do not match the benefits in terms of effective job search assistance (Comisión de Usuarios del Seguro de Cesantía, 2010). In some cases, workers may be deterred by the provision that they can draw on unemployment insurance fund only twice in five years, or they may expect their unemployment spell to be short-lived. The government should conduct a survey to find out what the problem is. It launched an information campaign about unemployment benefits and pensions in December of 2011 and it will require the private administrator of the unemployment benefit funds to provide its affiliates with better information. This is a welcome initiative.

Despite the recent reforms that extended the access to unemployment benefits and prolonged the duration of benefit receipt, funds accumulated in the individual savings accounts and the *Fondo Solidario* continue growing (Figure 1.13). This suggests that unemployment benefit contributions could be reduced. However, labour tax wedges are very low in Chile and thus the benefit of reducing contributions in terms of improved employment are likely to be limited (Figure 1.14). Alternatively benefits could be extended, either through higher transfers and longer benefit receipt or by using parts of the funds to finance better job search assistance and training measures.

Figure 1.13. **Development of funds in the unemployment benefit system**



1. Before November 2009, this corresponds to the sum of funds in individual saving accounts and the insurance fund.

Source: Superintendencia de Pensiones.

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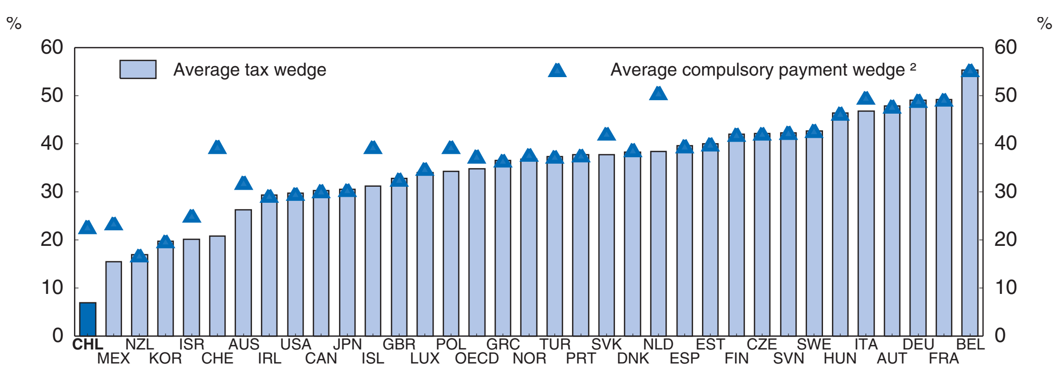
Figure 1.14. **Average compulsory payment wedge and average tax wedge**[1]

As per cent of augmented total labour costs, 2010



1. For a single person at 100% of average earnings, no child.
2. Comprises income tax, social security contributions and compulsory contributions to private social security, such as pensions, healthcare and unemployment benefits.

Source: OECD, *Taxing Wages Database*.

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In theory, unemployment benefits can have negative or positive effects on workers' future employability. They can help workers without savings or access to credit to hold out for a job that better matches their skills, thus increasing their productivity in their next job (Acemoglu and Shimer, 2000), their wages and employment duration. Unemployment benefit extensions also have important benefits for recipients, because they facilitate consumption smoothing (Gruber, 1997). On the other hand, unemployment benefits with long duration and high replacement rates could weaken job search incentives. If this contributes to long-term unemployment it could damage employment prospects permanently, if skills become obsolete because of structural change or because workers lose them to some extent, when not practising their profession over a long period of time. Another risk is that employers take unemployment of long duration as a signal of poor skills or motivation, making it increasingly more difficult over time for the unemployed to find a job.

Macroeconometric evidence based on a sample of OECD countries suggests that higher benefit replacement rates and longer duration of benefit receipt are associated with higher average unemployment rates (OECD, 2006). However, recent evidence based on individual data and microeconometric techniques paints a more nuanced picture. Evidence for the US and Germany suggests that extension of the duration of benefit receipt had only modest effects on job search efforts and duration of unemployment (Card and Levine, 2000; Schmieder *et al.*, 2009). This may be different for the level of benefits. Recent research based on data recording individual's use of time suggests that the impact of the unemployment benefit replacement rate on search efforts is large enough to explain the difference in the unemployment rate between the United States and Europe (Krueger and Müller, 2010). On the other hand, a study using administrative audit data of job search efforts finds that 95% of the unemployment maintains an active job search and higher benefits actually produce higher search efforts (Young, 2010).

Even if higher unemployment benefits or longer duration of benefit receipt had an impact on the duration of unemployment, this could be positive if it was because benefits allow workers to hold out for a better job. Indeed, recent evidence suggests that the larger part of the impact of unemployment benefits on the length of unemployment spells is due to liquidity problems of households facing credit constraints rather than moral hazard effects (Chetty, 2008). However, OECD results for Brazil suggest that there may be some form of moral hazard, as some households seem to combine benefit receipt with informal employment (OECD, 2011). On the other hand, other authors found no impact of unemployment benefit duration in Brazil (Cunningham, 2000), and others found that income support reduces the exit probability to the informal sector, while increasing the exit probability to the formal sector (Margolis, 2008). The latter result would indicate a positive effect of unemployment benefits on the quality of job matches. Overall, evidence of such effects across different countries is mixed. Card *et al.* (2007) and Van Ours and Vodopivec (2008) find no effects, while Caliendo *et al.* (2009) for Germany and Tatsiramos (2009) for a number of European countries find positive effects. Gangl's (2004, 2006) results suggest that more generous unemployment benefit systems increase the duration of joblessness, but also the wages in the new job, although this finding is not confirmed by Schmieder *et al.* (2009). Centeno (2004) finds that higher unemployment benefits lead to jobs with longer tenure.

The evidence on the effects of higher benefit replacement rates and longer duration is unclear as to whether positive or negative effects dominate, but this is likely to depend on the starting point, as well. Benefit replacement rates and unemployment benefit duration are much higher in most OECD countries than in Chile and thus work disincentive effects are likely to be less important in Chile.

This suggests that Chile should consider increasing the size and also the duration of its unemployment benefits, but should evaluate the effects carefully. Chile could increase benefits and duration gradually, while collecting the necessary data to gauge the impact of these increases on job search efforts, the length of unemployment spells and the quality of job matches thereafter. One issue that the government needs to take into account is that the assessment of the sustainability of the system may change fundamentally as more workers get informed about the possibility to draw on unemployment benefit.

Chile should consider allowing access to unemployment accounts for workers with temporarily reduced hours during crises. This has helped mitigate the impact of the recent recession on employment in a number of OECD countries and may work better than the programme that allows workers to go on training funded by unemployment benefits.

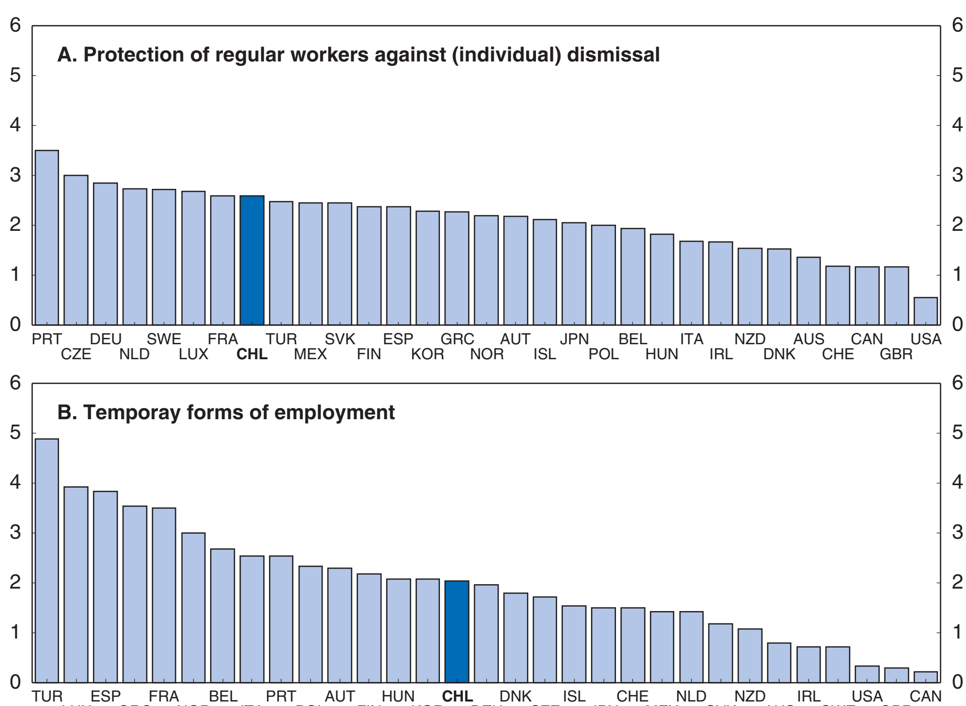
More generally, Chile could benefit from a more flexible approach to working hours. The reference period for working time is a week. While part-time work is possible, it cannot exceed 30 hours a week. For full-time workers daily working hours cannot exceed 10 hours, weekly working hours cannot exceed 45 hours and workers cannot work less than five or more than six days. One way to make the system more flexible would be to allow social partners to negotiate monthly or annual working time that can be distributed freely over the reference period, while the law could perhaps impose maximum average working hours per week or a daily maximum that cannot be exceeded. The government recently submitted a draft law to Congress that would allow social partners in the agricultural sector to negotiate longer overtime within a monthly reference period under collective agreements.

Should severance pay be reduced?

With a stronger protection through unemployment benefits, Chile could reconsider its employment protection legislation. While employment protection for workers on temporary contracts is about average in Chile according to the OECD's employment protection legislation (EPL) indicator (Figure 1.15), a large share of new jobs recently created is informal or short-term as a result of subcontracting and the use of temporary work agencies, as discussed above. This indicates that employers are reluctant to create longer-term employment relationships. One reason may be that employment protection for

Figure 1.15. **Employment protection legislation (EPL), 2008**

Scale from 0 (least restrictions) to 6 (most restrictions)



Source: OECD, *OECD Indicators on Employment Protection Database.*

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workers with indefinite contracts is stronger in Chile than in most other countries, mainly owing to relatively high severance pay that increases with seniority. This is still the main pillar of worker protection against unemployment in Chile, as in many other countries in the region.

OECD experience suggests that high costs of dismissal for permanent workers combined with lax regulation of temporary contracts can lead to a dual labour market (Blanchard and Landier, 2002; Dolado *et al.,* 2002; OECD, 2004) where a part of the workforce can become locked in unstable work relationships with lower chances for training and career progression and a higher risks of paying the cost of crises. Sixty per cent of annual labour turnover is accounted for by workers on contracts with limited duration (Dirección del Trabajo, 2007), although approximately 70% of all dependent jobs are of indefinite duration. This is an indication that employers react strongly to severance pay by terminating job relationships, preferably with workers without entitlements. Only workers with job tenures above 12 months are entitled to severance pay and this group is as small as 6% of all formal and informal employees who become unemployed. Moreover, a significant part of laid-off workers who do have a right to severance pay seem to receive none or less than they are entitled to. Many firms going bankrupt have not provisioned for severance pay, as there is no obligation to do so, and cannot pay (Cowan and Micco, 2005). In that sense, severance pay does not serve as a very effective protection for laid-off workers.

There is some evidence that severance pay that increases with job tenure has negative effects on employment and participation rates of young workers in Chile, while favouring prime-aged and older workers, although with no significant effects on aggregate employment and labour participation (Pagés and Montenegro, 2009). This study finds that the adverse effect on youth employment is essentially driven by the link between severance pay and job tenure. Caballero *et al.* (2006) show that in countries with stricter job security regulation the adjustment of employment to its optimum level after shocks is slower, also reducing output and productivity growth. Micco and Pagés (2006) findings suggest that job security legislation reduces employment and output in very volatile sectors, mainly through a reduction in net entry.

Given that severance pay provides protection only for a small fraction of workers, while probably contributing to labour market duality, Chile should reconsider its employment protection. One possibility would be to limit severance pay, by making it flat rather than increasing with seniority. The government should make severance pay available to all workers, by increasing employer contributions to individual savings accounts or the insurance fund. This would make the system more neutral.

Workers consider severance pay an acquired right and reforms are therefore politically difficult to implement. A reform package that strengthens unemployment benefits while limiting severance pay should be more acceptable to workers, while improving their protection and providing them with more equal opportunities to find a high-quality job. If entitled workers start to use the unemployment benefit system more, higher contributions may be needed at some point to strengthen benefits, while maintaining the system's financial sustainability. However, this may still be efficient. García, Gonzalez y Navarro's (2009) research suggests that lowering severance pay while increasing wage taxes to finance better unemployment protection for dismissed workers would have a positive impact on well-being in Chile.

What role for in-work benefits in Chile?

In 2009 Chile introduced an in-work benefit (*subsidio al empleo joven*) for low-wage workers under 25 whose family belongs to the 40% poorest in the country according to their score in the *Ficha de Proteccion Social* (FPS). The subsidy can reach up to 20% of wage income for those workers with the lowest wages and is gradually withdrawn with rising wages, with a third of the subsidy going to the employer and two thirds to the employee.

While no thorough evaluation of the Chilean scheme is available, OECD experience with in-work benefits suggests that they are associated with positive, albeit small, employment effects. When targeted on family income, as in Chile, they can also be a cost-effective instrument to reduce income inequality, in particular when the income distribution is wide (Immervoll and Pearson, 2009). In-work benefits can have a negative effect on incentives of second earners when they are targeted on family income. In Chile, there may be an element of this phenomenon, as the benefit is targeted on the wage rate of the young worker, on the one hand, and the *Ficha de Proteccion Social (FPS)* score of her family, on the other. While the subsidy is withdrawn gradually, as the wage increases, the withdrawal with respect to the *Ficha de Protección Social* score is abrupt. This risks limiting the positive effect that the in-work benefit is supposed to have on young people's work incentives for those who live in families with a FPS score close to cut-off point. It might even deter other members in the family to take up employment for fear of losing the wage subsidy.

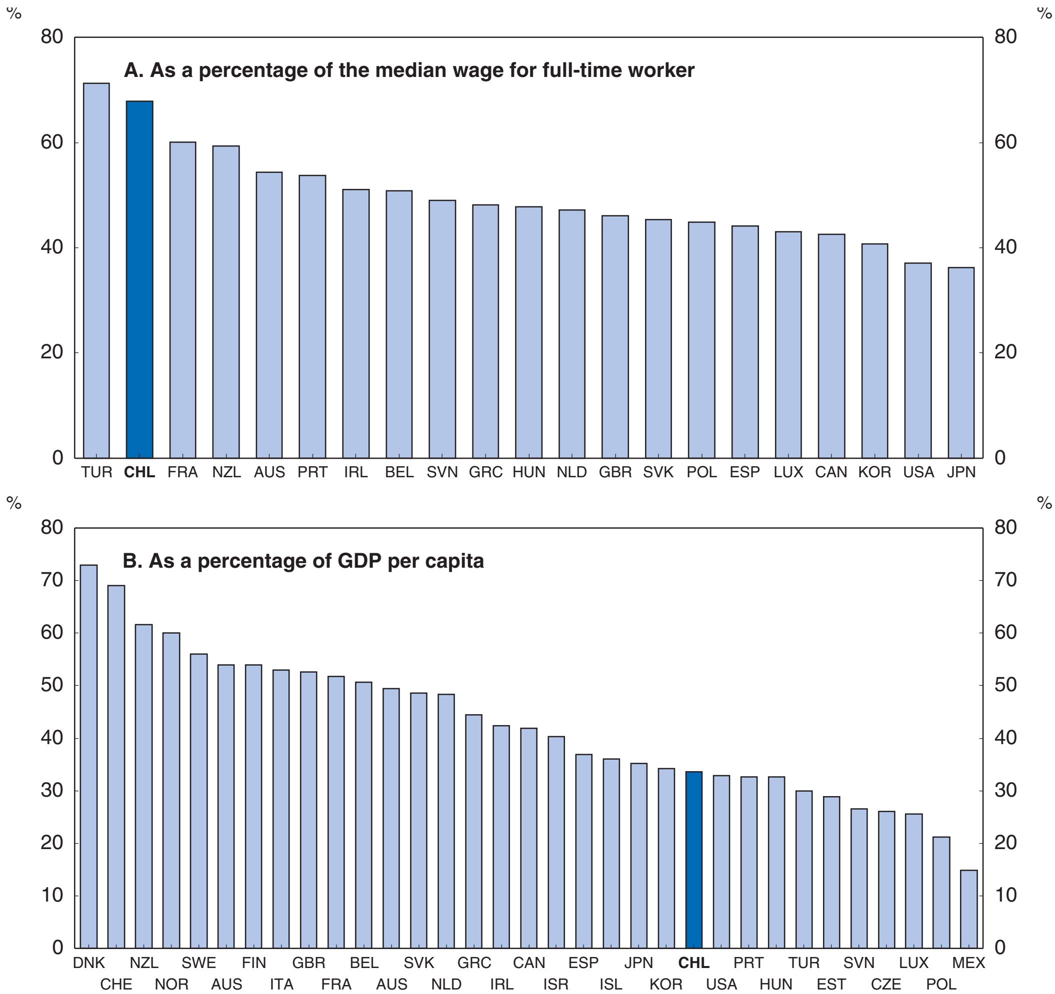
The government plans to introduce a similar wage subsidy for low-income women as part of *Ingreso Ético Familiar*. However, before extending the benefit to other groups the government should carefully evaluate the impact of the subsidy on young workers' employment and on the income distribution. One way to avoid potential work disincentive effects associated with abrupt benefit withdrawal would be to opt for a gradual phasing out as workers' FPS score increases. This would become easier if the FPS score were to depend mainly on family income, as suggested above. Work incentives of the young and their family members would be enhanced even more if the in-work benefit was targeted at young workers' wages only without considering their family income.

The minimum wage in Chile is relatively high in international comparison as a ratio of the median wage, but this is partly because the wage distribution is so narrow at the lower end. Expressing the minimum wage as a percentage of GDP per capita results in a different picture (Figure 1.16). Like in-work benefits, minimum wages can enhance labour supply, as they increase take-home pay for workers. Minimum wages can also help to reduce wage inequality (Koeniger *et al.*, 2007 and Checchi and García-Peñalosa, 2010), although they are less effective than more targeted measures, as minimum wage earners may live in high-income families. On the other hand, they avoid some of the efficiency problems associated with better targeted measures, such a negative work incentives in the withdrawal range in the case of in-work benefits. In combination with in-work benefits they can be particularly useful, because the size of benefits needed to attain a given income is smaller with a wage floor. The minimum wage also prevents the employer from lowering wages beyond it in response to an in-work benefit, thus ensuring that a larger part of the benefit goes to employees.

On the other hand, a minimum wage that is above many workers' productivity can reduce labour demand and thus employment. While evidence on the effect of minimum wages on employment is very inconclusive, with many studies finding no impact on employment and unemployment, including in Chile (see OECD, 2006; Martínez *et al.,* 2001),

Figure 1.16. **Minimum wages across OECD countries**[1]

2009



Source: OECD; *ILO Wage Report 2011*; IMF, Word Bank; CASEN.

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some studies suggest that minimum wages may have a negative effect on employment prospects of some groups, such as low-skilled or young workers (for an overview over the literature see see Neumark and Wascher, 2007). The OECD therefore recommends differentiated minimum wages with a lower rate for young workers. The part of the Chilean in-work benefit that goes to employers lowers the labour costs for young workers and is thus to some extent a substitute for a lower minimum wage rate for young workers, although associated with fiscal costs. Chile has a reduced minimum wage for workers under 18, but not for young workers above that age.

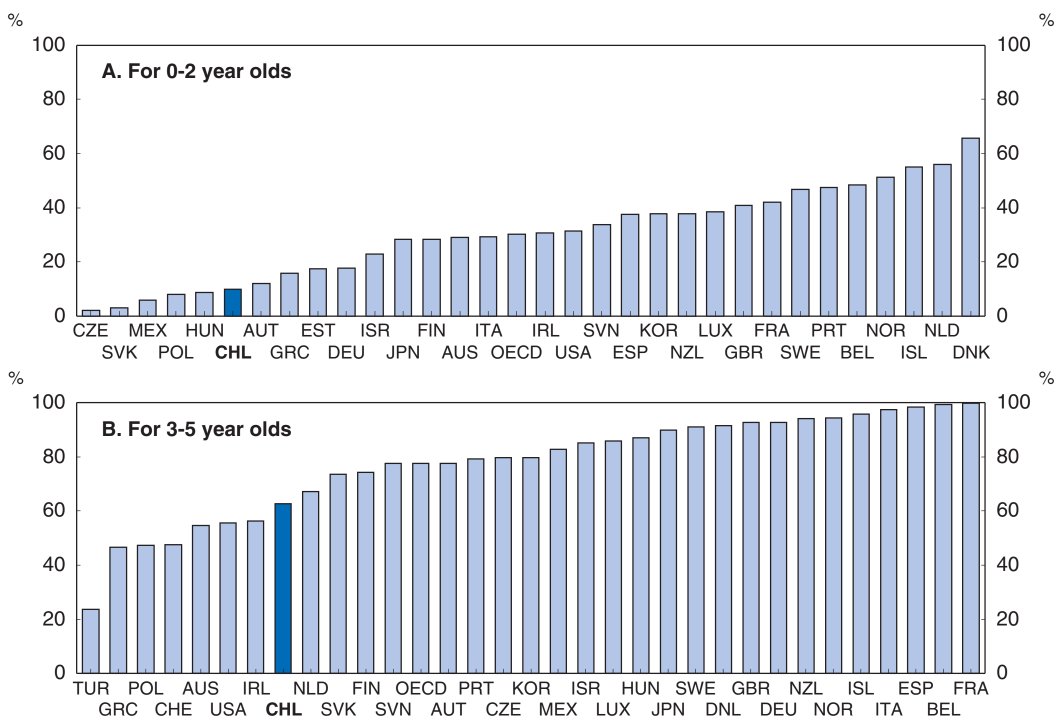
If a negative impact on employment dominated, minimum wages could actually have a negative impact on income inequality despite compressing the wage distribution. Among the few studies that explore this issue some find that this is indeed the case (Checchi and García-Peñalosa, 2008), while a recent OECD study finds no significant effect on employment with the positive impact of minimum wages on the wage distribution dominating (Koske *et al.*, 2012).

Female labour market participation

The relatively weak position of women in the Chilean labour market is likely related to a number of barriers to employment for them, in particular for single mothers with low wages. While Chile has made important efforts to increase the number of nursery and kindergarten places, coverage is still low in international comparison (Figure 1.17). Moreover, residential segregation is likely to exacerbate the problem, as mothers who have to commute for several hours a day would need childcare for much longer than what is available to accept a full-time job. According to household survey data 10% of inactive women cite difficulties to secure childcare as a reason. The government is making substantial efforts to increase childcare coverage, which has increased from 33% to 40% for children up to age 7. The government wants to increase enrolment of children below 4 by 3% by 2014 and ensure universal coverage for children in the two lowest income deciles for children aged 4 and 5. These important efforts should continue.

Figure 1.17. **Coverage with early childhood education and care across OECD countries**

Share of children in formal childcare or in educational pre-school programmes, 2008



Source: OECD, *Family Database*.

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Some labour regulations that are meant to favour women actually risk turning against them. As an example, enterprises with more than 19 women have to provide a kindergarten place for the first two years. Since children have both a father and a mother the rationale for this regulation is not quite clear. Moreover, this regulation can deter companies from employing more than 19 women. Chile should consider scrapping this provision or, at a minimum, making it gender neutral by obliging firms with a certain number of employees to provide childcare facilities or financial support for alternative providers. However, aiming to provide free childcare for the – say – 40% poorest families, while asking for co-payments from richer families is likely to be a more effective way to help families reconcile work and family life.

The government has extended state-funded maternal leave after birth from 12 to 24 weeks. It is capped at a monthly salary subject to social contributions of around 2 800 USD. The extension is longer for children with health problems and those with siblings. The extra 12 weeks can be further increased to 18 weeks if the mother and her employer agree on a part-time arrangement, in which case the mother can opt for 50% of the corresponding benefit. Mothers can transfer their rights to the father for 6 weeks or 12 weeks if the parents take the leave on a part-time basis. At the same time, the government has taken stricter measures to counteract the common practice to extend maternity leave by providing sick certificates that some doctors issue without any medical basis. The government also eased access to paid maternity leave for temporary workers with a minimum record of social charges, regardless of whether they were employed at the time of birth.

Studies have shown that parental leave can mitigate the negative effect of children on women's wages by shortening the time after which she returns to work (Burgess *et al.,* 2008; Berger and Waldfogel, 2004) and increasing the likelihood that women return to their pre-birth job, thus allowing them to capitalise on the benefits of accumulated tenure with their existing employer, such as seniority, training and access to internal labour markets (Baker and Milligan, 2008). However, this holds true only for relatively short periods of leave, while periods of leave that exceed one year can lead to a substantial loss of human capital and a decrease in wages (Ruhm, 1999). Bassanini and Venn (2008) present some evidence that an increase of maternity leave from short durations can increase productivity, with a stronger effect when the leave is paid rather than unpaid. Plans to increase paid maternity leave after childbirth are thus welcome.

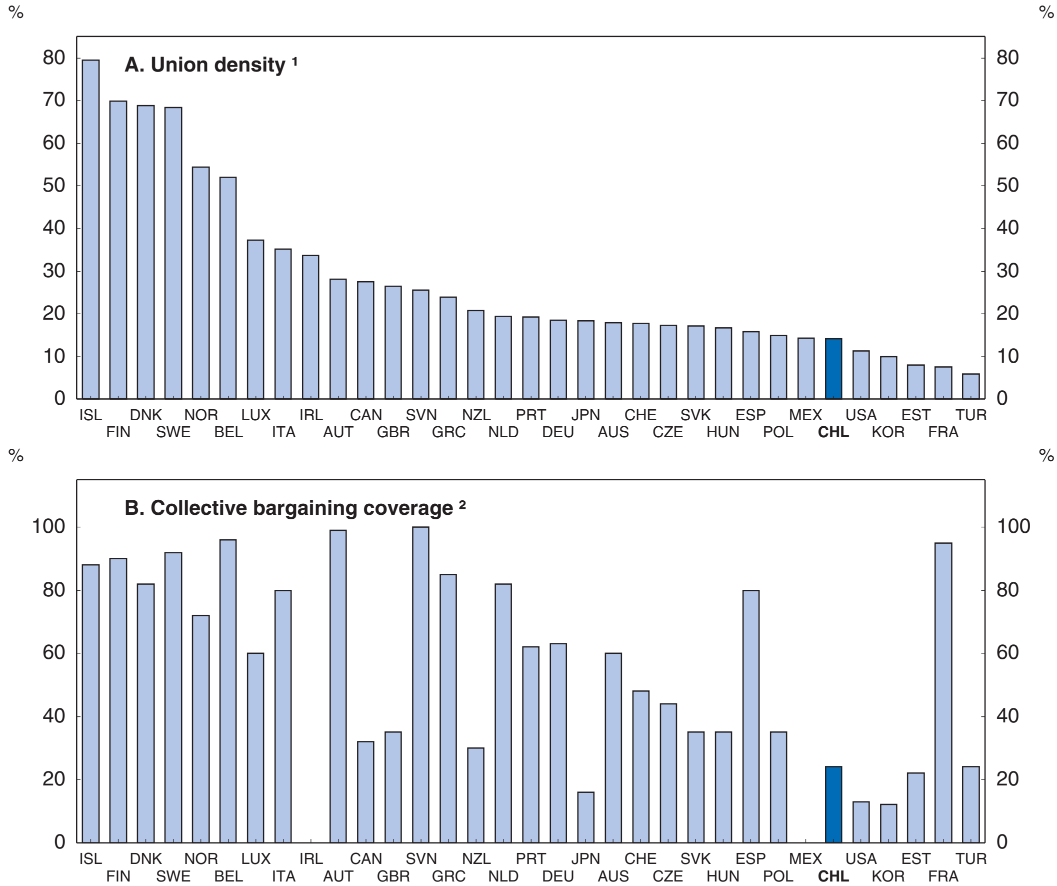
Labour relations

Unionisation density and coverage are relatively low in Chile (Figure 1.18) and strongly concentrated on the public sector. Chile's legislation allows strikes and wage negotiations only at the firm level, unless firms and unions agree otherwise. The common practice of companies to obtain a tax identification number (RUT) for each of their subsidiaries, at which point these are considered as a separate company, effectively results in wage negotiations at the plant level.

There is little evidence that wage negotiations at the firm level have a negative effect on employment outcomes. At the same time, stronger unions have been found to have beneficial effects on wage equality. Empirical studies based on macro data (Koske *et al.,* 2012) suggest that, on average across countries, a rise in union density or union coverage is associated with lower wage inequality. Calderón and Chong (2009) investigate the relationship between unionisation and the Gini index, thus accounting for both wage and employment effects. They find that unions lower inequality.

At a minimum, the government should put an end to the practice of breaking up companies for the purposes of wage negotiations to build confidence in labour relations. This might increase the scope for leaving more of the details of work arrangements to collective negotiations, possibly leading to more working time flexibility and enhancing co-operation of social partners in designing training programmes. In fact, the practice of

Figure 1.18. **Union density and collective bargaining coverage**



1. Trade union density corresponds to the ratio of wage and salary earners that are trade union members, divided by the total number of wage and salary earners. Density is calculated using survey data, wherever possible, and administrative data adjusted for non-active and self-employed members otherwise. 2010 or latest year available.
2. Coverage is the share of wage and salary earners who are covered by collective bargaining agreements.

Source: OECD, *Labour Force Statistics Database*; *OECD Social, Employment and Migration Working Papers 89*, Danielle Venn (2009), *Legislation, collective bargaining and enforcement: Updating the OECD employment protection.*

StatLink http://dx.doi.org/10.1787/888932564521

breaking up companies for wage negotiation purposes is illegal and labour courts or the Labour Directorate can fine companies for such a practice. The government has submitted a law to Congress that would force companies to engage in collective wage negotiations together if they produce the same good and share a centralised organisation. This initiative is welcome.

Box 1.4. **Recommendations to improve the functioning of the labour market**

- Continue strengthening local labour offices to improve their capacity to help the unemployed. Make sure that private employment agencies have incentives to attend to low-skilled workers.

Box 1.4. **Recommendations to improve the functioning of the labour market** *(cont.)*

- Evaluate training programmes, streamline based on results and focus more on low-skilled workers and women. Integrate SENCE better with the local labour offices.
- Extend unemployment benefits further and limit severance pay, while increasing employers' contributions to individual savings accounts or the unemployment insurance fund. Evaluate the effects of longer unemployment benefit duration and/or higher benefit levels to improve the design if needed.
- Evaluate the in-work benefit for poor, young workers and – if found successful – consider extending it to other groups. Consider making it dependent on individual worker's income only or phase it out more gradually with respect to family income.
- Continue efforts to extend the availability of affordable, high-quality nursery and kindergarten places, while lifting the requirement for firms to offer kindergarten places once they employ more than 19 women.
- Work to improve labour relations, including by strengthening union's negotiation power, at a minimum by forcing firms to end the practice to obtain multiple tax identification numbers to artificially break up their company for wage negotiation purposes.

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Chapter 2

Building blocks for a better functioning housing market in Chile

Chile has made good progress in improving housing conditions, but still around 10% of the population lives in either overcrowded houses, or of inadequate quality and/or with poor access to basic services. Improving further housing conditions of the poor is important for curbing poverty and reducing inequality. First, better targeting of housing subsidies will be essential to free resources for those truly in need. The government should also rethink subsidies, which are currently directed exclusively at ownership. Means-tested rental cash allowances coupled with more balanced tenant-landlord regulations would strengthen the rental market, thus enhancing residential mobility and potentially reducing segregation. Second, better enforcement of social housing quotas for new building projects coupled with investments in urban renewal and social services in poorer neighbourhoods and developing unused land in urban areas could also help to reduce inequalities. Third, effective thermal and energy standards for buildings would improve the quality of the housing stock, protect public health and reduce air pollution. Limiting construction in fault lines and risky coastal areas could also increase Chile's resilience to natural disasters. Fourth, taxing housing so owing is not favoured over renting would reduce distortions and make the tax system less regressive. Finally, enhancing the responsiveness of housing supply to demand would ensure there is a good match between housing construction and demand, and avoid that public support gets capitalised into housing prices.

Chile has made important advances in improving access to housing during the past two decades. Twenty years ago about 20% of the Chilean population was living in substandard housing conditions, either in deteriorated housing, overcrowded houses or in informal settlements lacking access to essential services such as electricity, sewerage, or drinking water (Ozler, 2011). Chile has put in place ambitious housing subsidy programmes, that coupled with investments in infrastructure and broader social policies, have helped to improve Chileans' living conditions. A key contributing factor has also been Chile's sustained good macroeconomic situation and stability that has resulted in increased household income and savings and reduced the cost of access to housing finance. Today most Chileans live in adequate housing and the number of people living in informal settlements has sharply decreased. But, a still substantial 10% of the total population lives in poor housing conditions.

House price growth has remained contained keeping housing affordable for most Chileans. For poorer households, however, housing is too expensive. Chile has a range of housing subsidies to help the less well-off access housing in ownership, but these do not always reach those in most need, as a substantial part of subsidies goes to upper-middle income groups. At the same time, public support has not always led to sustainable solutions, with recipients slipping back into poor housing conditions. And, by leading to a peripheral location of subsidised housing far from jobs and public services, public support may have hindered social mobility and a faster decline in poverty and inequality. Improving access to housing for the poor will be important if Chile wants to reduce inequalities and poverty. Poor housing quality and overcrowding can hurt people's health and their opportunities to access high quality education, undermining their employability. Housing support is also excessively focused on promoting home-ownership. The rental market is tiny, there are no housing allowances for tenants and taxation excessively favours owner-occupied housing over other investments. This can restrict people's mobility, the efficient allocation of labour and hurt economic performance in the long-run.

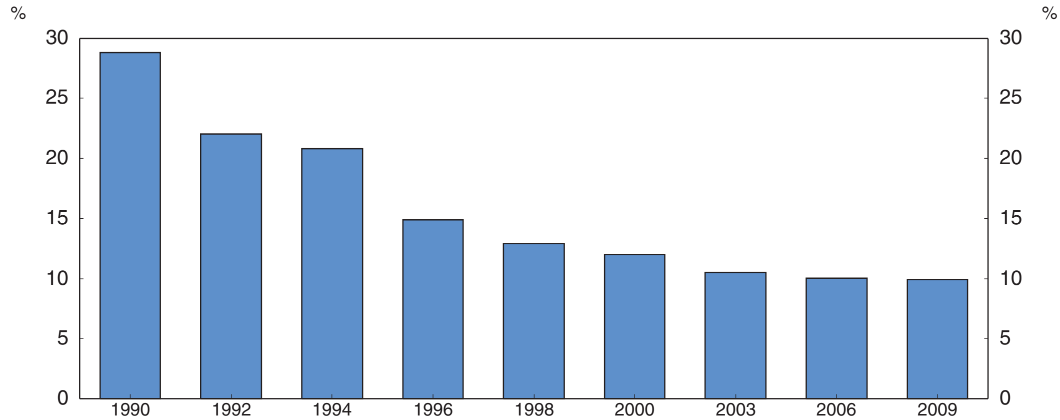
This chapter examines the main features of and recent developments in the Chilean housing market. After assessing the factors hindering access to better housing for poorer people, it discusses policy options to improve the functioning of the housing market so it can deliver reasonable quality housing at affordable prices. The analysis draws on information on housing policies collected through a survey administered to OECD member countries in spring 2010, and extended to Chile in 2011 for the purpose of this chapter. The information allows a comparison of key policy settings that influence the functioning of the housing market, including public housing support for low-income households, housing taxation, transaction costs and rules guiding the functioning of the rental market.

A significant share of the population lives in poor housing conditions

Today most Chileans live in adequate housing, though, there is still a substantial number (Figure 2.1) living in poor housing conditions, mostly overcrowded housing, but

Figure 2.1. **Share of population living in poor housing conditions**

As per cent of population



Source: OECD calculations based on data from Ministry of Housing.

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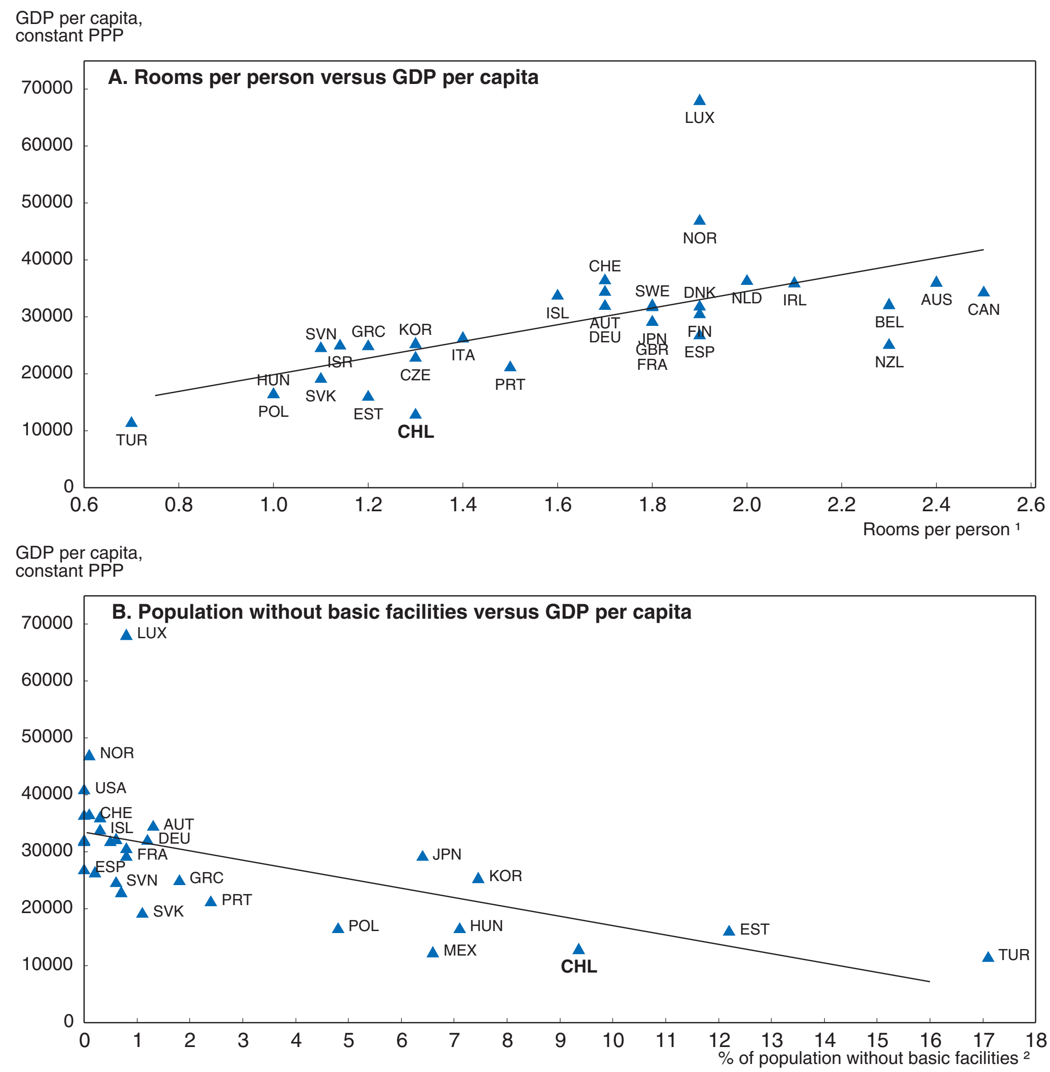
also housing built with inadequate materials or with poor access to basic services. Both housing size and access to basic facilities have substantially increased over the last decades, in line with Chile's income, but remain poor by international standards (Figure 2.2). For instance, while the percentage of households with access to safe water increased from 62% to 94% between 1960 and 2009, this trend is uneven across geographical areas, in particular between urban and rural areas. About 40% of rural households lacked access to clean water in 2009 and 34% of them had poor sanitary conditions (Universidad Andrés Bello, 2011).

The Chilean government has traditionally measured the number of households that live in very precarious housing conditions through a concept called the "housing deficit". Government estimates indicate the stock of such inadequate housing at the end of 2009 was over 400 000 houses, out of which over 80% were overcrowded and the remaining of very poor quality (Figure 2.3). The most acute housing needs are concentrated among low-income households. The bottom two income quintiles account for about 60% of housing needs. Households headed by a woman, people with disabilities, senior citizens and ethnic minorities also have a higher incidence of worst-case needs than other households (MINVU, 2010). Others are "drop-ins" – popularly called *allegados* – who seek a temporary housing solution by living with friends and family or building additional rooms in their backyards. A smaller group of people in need of better housing are those living in illegal settlements (*campamentos*). Although the total number of people living in illegal settlements has sharply decreased and today represents a small share of the population (less than 1%).

The earthquake and tsunami that hit Chile in 2010 increased the number of people living in poor housing conditions by about 25%. Given the scale of the disasters the loss of human lives, though tragic, was relatively small at around 600 victims. This owes much to Chile's good building codes for earthquakes. Over the years, Chile has adopted better building codes, which have been periodically upgraded, to take into account previous earthquake experience and international innovations in earthquake mitigation technologies. This proved essential in the last earthquake (American Red Cross, 2011; Kovacs, 2010). Building codes are also well enforced. Chile has a law that holds building

Figure 2.2. **Housing quality**

2009



1. Average number of rooms shared per person in a dwelling.
2. Measured as the percentage of dwellings not having an indoor flushing toilet for the sole use of their household.
Source: OECD, *Compendium of well being indicators* (2011); World Bank, *WDI Databank*.

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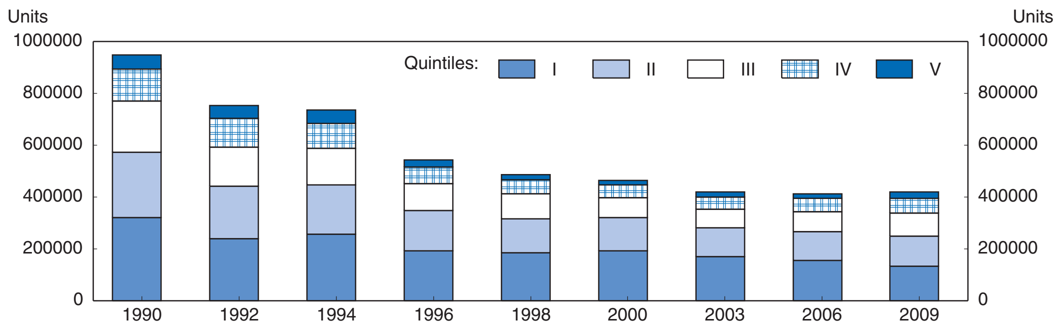
developers liable for the first 10 years of a building's life for any losses resulting from inadequate application of the building code during construction. About 370 000 houses (approximately 10% of the total housing stock) were destroyed or damaged, many of them as a result of the tsunami. Many of the destroyed houses belonged to relatively poor people and had been built with bad quality materials and located in more risky areas (Mideplan, 2011). Others were old houses made of dried clay that did not withstand the earthquake. More generally the disasters generated important economic losses worth around 30 billion USD (15% of GDP) and imposed a large reconstruction burden on the state (Box 2.1).

Low quality of housing materials not only increases risks in the event of an earthquake, but also energy consumption and pollution. Indoor pollution is high in Chile

Figure 2.3. **Stock of inadequate housing**[1]



1. It includes the number of: *i)* very crowded housing units, where households share their home with a second household that is income-dependent on the host household *ii)* very crowded housing units, where households share their home with two or more households, and where each household has its own budget independently of the host household *iii)* poor quality housing units, for example lacking basic facilities or built with low-quality materials and informal housing.

Source: Ministry of Housing.

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Box 2.1. **Economic consequences of the 2010 earthquake and tsunami**

In February 2010 Chile was hit by the strongest earthquake in its recent history and a tsunami that destroyed several towns. In the immediate aftermath of the earthquake, output in the most affected areas decreased sharply, but the impact on the national economy was limited and short-lived. Still, the disasters generated important economic losses worth around 30 billion USD (15% of GDP), as estimated by the Chilean government, with the largest part (about USD 21 billion) due to the destruction of infrastructure, a bit less than half of it borne by the public sector:

- **Direct costs:** The earthquake destroyed major infrastructures, including ports, roads, energy and communications, as well as an important number of houses, hospitals and schools. The total worth was about USD 21 billion (about 12% of 2009 GDP). Half of these losses were in public infrastructure. In the private sector, the most affected industries were agriculture, winery and fisheries, where ¼ of the installed capacity was destroyed. Tourism was also hit, as the affected regions are important tourist destinations. Housing was strongly affected by the disasters. Around 370 000 houses were destroyed or damaged (MINVU, 2010; Muir-Wood, 2011), approximately 10% of the total housing stock.
- **Damages to short-term economic activity:** In the immediate aftermath, output in the most affected areas decreased sharply contributing to a 3% drop in GDP in the first quarter of 2010. Despite of this temporary drawback the impact on the national economy was limited and the economy swiftly rebounded in the second quarter growing by 5% on year-average in 2010. Compared to episodes of natural disasters in other OECD and emerging economies (OECD, 2004), the events did not lead to significant worsening of the trade deficit or increases in the country risk premia. Consumer confidence and the stock market also rebounded quickly after the disasters.
- **Impact on potential output:** Such disasters reduce potential growth by injury and loss of life and damage to a country's stock of tangible fixed assets. The central bank estimates that the 2010 disasters reduced Chile's potential output by 1-1.5% during 2010, mainly due to the destruction in the capital stock. The capital stock was reduced by 3% of the net capital stock of 2009 (Central Bank of Chile, 2010).

Box 2.1. **Economic consequences of the 2010 earthquake and tsunami** *(cont.)*

- **The burden of reconstruction:** The earthquake damages were partly covered by insurance. However, a big part of the financial burden from reconstruction fell on the state (Table 2.1). The government was quick to implement a substantive reconstruction plan, focusing on rebuilding public infrastructure and providing financial assistance to families in the lowest three income quintiles who needed to rebuild their homes. The reconstruction is being financed from a number of sources: temporary as well as permanent increases in taxes and budget reallocations, including from a national fund that allocates a percentage of national copper sales to the army (*Fondo Ley Reservada del Cobre*). Also private donations and other sources including a small withdrawal from Chile's copper fund (Table 2.1). Most public infrastructure projects have been completed and over 70% of housing subsidies allocated. Most housing reconstruction though still needs to start. The Ministry of Housing plans to allocate the remaining housing subsidies (70 000) and launch most of the housing construction works by the end of 2011. The objective is to conclude the reconstruction works by 2014, which seems feasible.

Table 2.1. **Public sources of financing and reconstruction spending, 2010-13**

	Milllions of 2010 USD
Tax receipts[1]	3 625
Expenditure reallocations	2 920
Fondo Ley Reservada Cobre[2]	1 200
Donations (Fondo Nacional de Reconstruccion)	308
Other sources	378
Total financing	**8 431**
Emergency costs	443
Total capital spending net of efficiency gains	7 988
Housing	2 310
Health	2 142
Education	1 206
Public infrastructure	1 170
Other	1 160
Total spending	**8 431**

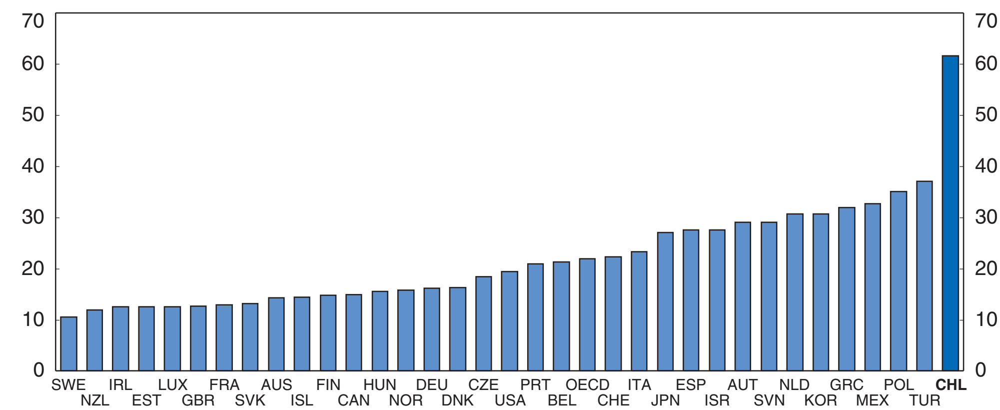
1. Higher tax receipts include temporary increases in corporate and immovable property taxes (*Impuesto Territorial*), a reform in the mining tax, permanent increases in tobacco taxes, and reduced tax advantages.
2. Allocates 10% of CODELCO's sales, the national copper producer, to the army.

Source: Ministry of Finance (2010) and (2011).

due to inefficient heating systems (often based on firewood) which, coupled with poor insulation, provide little heating but emit high levels pollutants that threaten health (Sanhueza *et al.*, 2006; Adonis, 2009). Particulate matter (PM10) levels are by far the highest in the OECD (Figure 2.4), and exceed three times the level the World Health Organisation considers safe for health. Poor insulation also increases energy consumption and undermines Chile's efforts to reduce CO_2 emissions and improve its environmental sustainability.

Figure 2.4. **Exposure to air pollution by particulates**

Micrograms per cubic meter, 2008[1]



1. Average concentration of particulate matter (PM10) in cities with population larger than 100 000.

Source: OECD, *Compendium of well being indicators* (2011).

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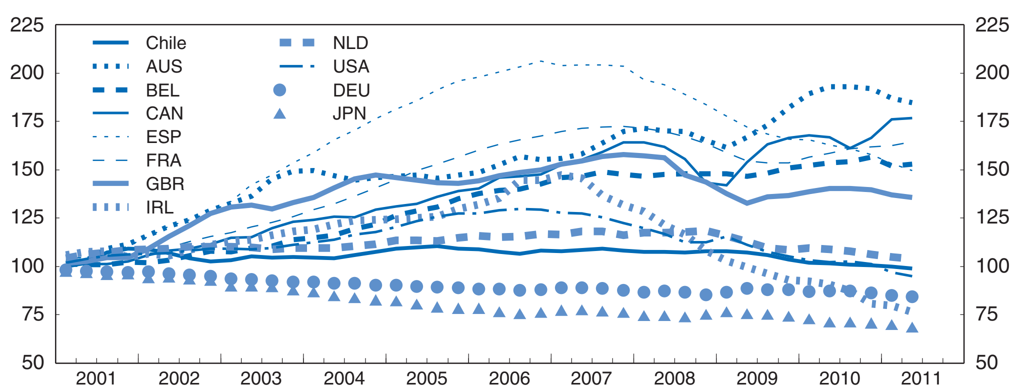
House price growth has remained contained keeping housing affordable for most Chileans

As opposed to many OECD countries, where prices rose strongly since the mid 1980s, house prices have remained broadly stable in Chile during the last decade (Figure 2.5) in line with fundamentals (Parrado *et al.,* 2009). This has kept housing affordable for most households. Price increases have been mostly driven by higher household income and lower long term interest rates. However, this evidence should be treated with caution as Chile's house price data are patchy and only cover the Santiago region.

Figure 2.5. **Real house prices to real wages**

Index 2000=100



1. For Chile house price data is average house price in CPI-Indexed Units of Account (UF) per square meter for property in the region of Santiago. Other countries real house price index.

Source: Collect GFK; INE; *OECD Economic Outlook Database.*

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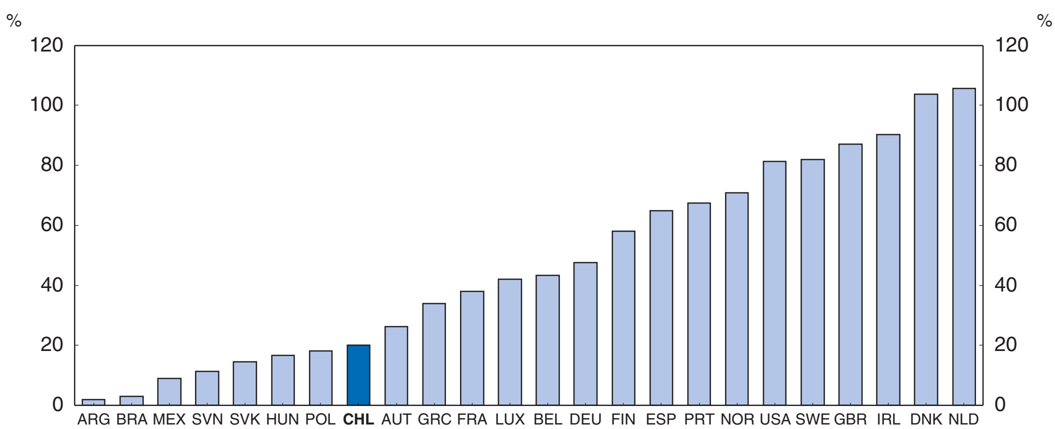
A deeper housing finance market has facilitated access to credit

Lower borrowing costs are a result of Chile's successful macroeconomic policies and institutions, which have granted stability, alongside the increase in the depth and efficiency of the mortgage market. Over the past two decades the size of the Chilean mortgage market (as measured by the stock of outstanding mortgages) has more than doubled to 20% of GDP, becoming the largest market in the region (Figure 2.6). Confidence in the government's macroeconomic policies and the creation of mortgages indexed to inflation have reduced credit and liquidity risks and encouraged the emergence of long-term institutional investors, in particular pension funds, which have added stability and liquidity to the market by investing in guaranteed bonds and to a lesser extent mortgage-backed securities. This has allowed banks to offer long-term financing with little or no maturity mismatch in their balance sheets. Greater competition has also led to higher efficiency in mortgage lending (Morandé and García, 2004). This together with bigger economies of scale derived from a larger number of mortgage transactions and volumes of financing has led to historically low borrowing costs (Figure 2.7), allowing a greater number of households to access credit.

Figure 2.6. **The size of the mortgage market in selected countries**

Stock of outstanding mortgage as a % of GDP, 2009



Source: European Mortgage Federation, *Hypostat 2009*; Galindo *et al.* (2011).

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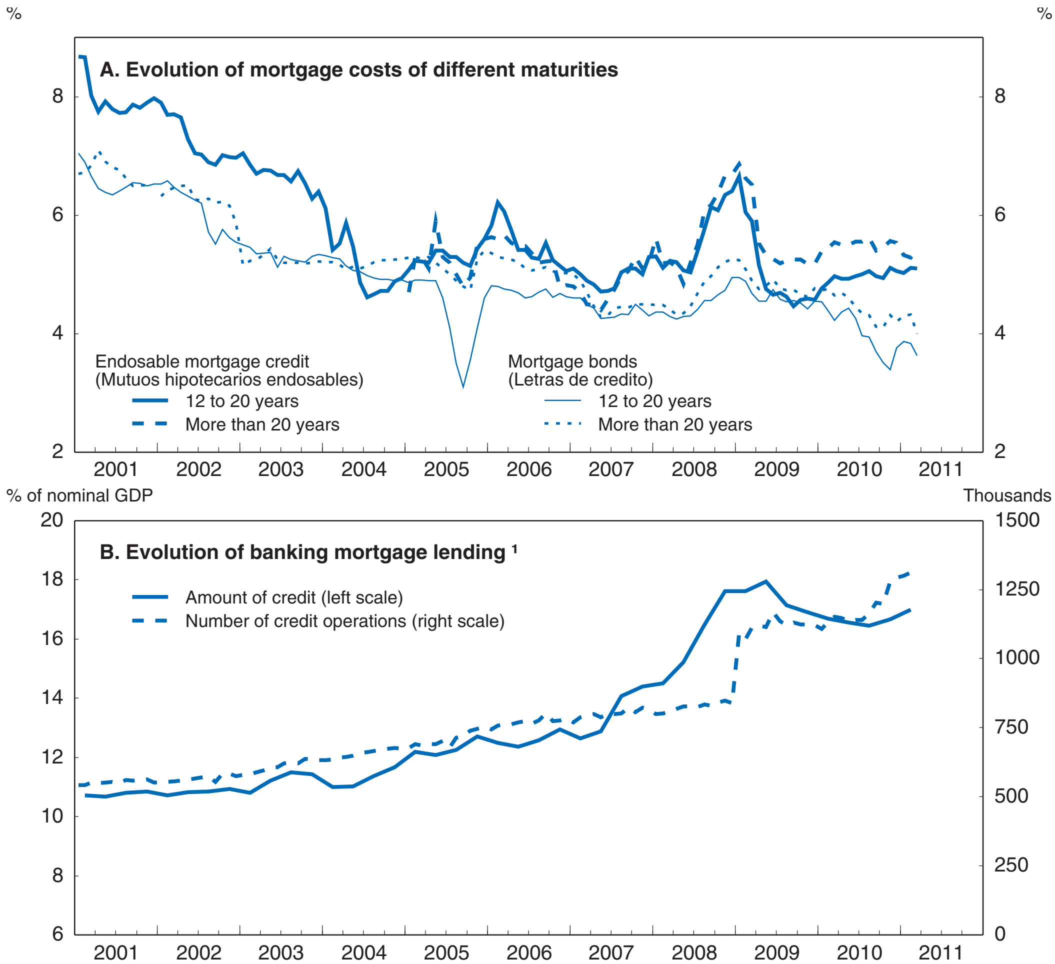
Cheaper access to credit has led to an increase in household indebtedness, which has almost doubled in the last ten years. Yet, at 70% of disposable income in 2010, it remains lower than in most OECD countries. The banking sector is the most important source of household mortgage credit (85%), but at less than one third of all bank assets (Central Bank of Chile, 2010), its exposure to the housing sector seems limited. Credit risk has been contained by several factors, including more prudent maximum loan-to-value ratios (75% or 80%) than in most OECD countries and mostly fixed inflation-indexed rates (Table 2.2), protecting borrowers from short-term interest rate fluctuations. Partly because of this, Chile's housing market fared relatively well during the recent global financial crisis (Galindo *et al.,* 2011; Micco *et al.,* 2011). Another contributing factor to reduced financial risk is the private banking sector's focus on relatively less risky consumers and products (Aparici and Sepúlveda, 2010).

Figure 2.7. **Mortgage market developments**



1. Includes endorsable mortgage credit, mortgage bonds and non-endorsable mortgage credit.

Source: *Superintendencia de Bancos e Instituciones Financieras* (SBIF) Chile; Banco Central de Chile, *Informe de Estabilidad Financiera* (2010-I).

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Table 2.2. **Mortgage and financial market features in OECD countries**

	Regulatory limits on loan-to value	Prevailing type of interest rate	Typical maturity (years)	Mortgage equity withdrawal
Australia	100% if insured	Mainly variable	25	Yes
Austria	. .	Fixed (75%); variable (25%)	25	No
Belgium	None	Fixed (75%); mixed (19%); variable (6%)	20	No
Canada	95% if insured	Fixed and mixed (92%); variable (8%)	25	Yes
Chile	75% and 25% of the borrower's income for loans under UF 3 000. And 90% for state subsidised housing	Fixed (57%); mixed (4%); variable (39%)	25	No
Czech Republic	. .	Fixed (mixed)	20	. .
Denmark	0.8	Fixed (75%); mixed (10%); variable (15%)	30	Yes
Estonia	. .	Variable	30	. .
Finland	None	Fixed (2%); variable (97%); other (1%)	17	Yes

Table 2.2. **Mortgage and financial market features in OECD countries** *(cont.)*

	Regulatory limits on loan-to value	Prevailing type of interest rate	Typical maturity (years)	Mortgage equity withdrawal
France	60% to be eligible for mortgage-backed securities	Fixed/mixed/other (86%); variable (14%)	15	No
Germany	60% to be eligible for mortgage-backed securities	Mainly fixed and mixed	25	No
Greece	. .	Variable	15	No
Hungary	. .	Variable (mixed)	11	. .
Iceland	. .	. .	. .	. .
Ireland	80% (only for building societies)	Variable (70%); rest mainly mixed	20	Limited
Israel	. .	Variable	15; 30 (max.)	. .
Italy	80% (100% if guaranteed)	Fixed (28%); rest mainly mixed	15	No
Japan	None	Fixed (36%), mixed and variable (64%)	25	No
Korea	40-60%	Variable	3; 20 (max.)	. .
Luxembourg	. .	Variable	20-25	. .
Mexico	. .	Variable	. .	. .
Netherlands	None	Fixed (74%), mixed (19%), variable (7%)	30	Yes
New Zealand	. .	Mainly fixed	25	. .
Norway	. .	Mainly variable	17	Yes
Poland	. .	variable	5-32.5	. .
Portugal	. .	variable	25-30	. .
Russian Federation	. .	Fixed/ variable	15-20	. .
Slovak Republic	. .	Variable	. .	. .
Slovenia	. .	Variable	10	. .
Spain	80% to be eligible for mortgage-backed securities	variable (?75%); rest mainly mixed	20	Limited
Sweden	None	Fixed (38%); mixed (24%); variable (38%)	25	Yes
Switzerland	None	Mainly variable	15-20	. .
Turkey	. .	Variable	10	. .
United Kingdom	100% (only for building societies)	Mixed (28%); variable (72%)	25	Yes
United States	90% if guaranteed	Fixed (85%); mixed (15%)	30	Yes

Source: ECB (2009), Catte *et al.* (2004), de Serres *et al.* (2007), *Financial Stability Report Central Bank of Chile* (2008) and Central Bank of Chile (2009)

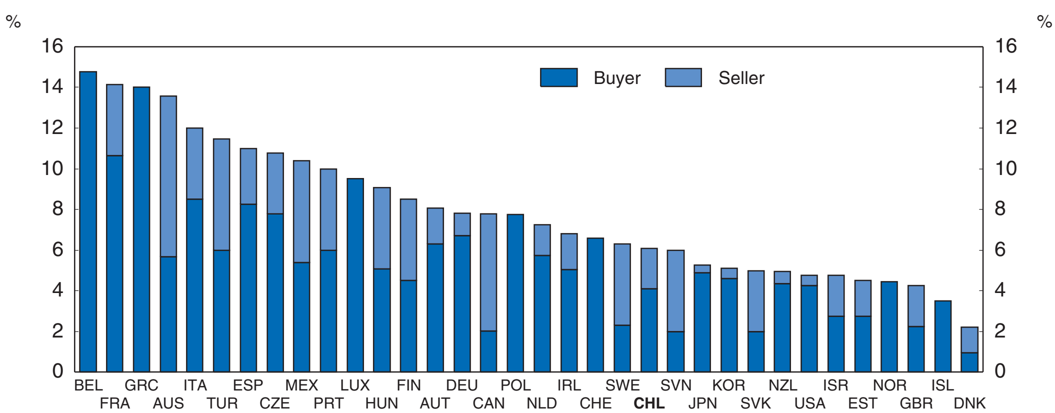
A more efficient and resilient mortgage market could improve access to credit

Chile has one of the most developed and deepest housing finance markets in the region (Galindo *et al.*, 2011), nonetheless there is room for improvement. The government has actively contributed to the development of the mortgage market through several instruments. These include generous housing subsidies and mortgage credit guarantees. The government has also channelled vast amounts of money through the state-owned bank (*Banco Estado*) (Galindo *et al.*, 2011), which has particularly contributed to improving access to credit to lower income families. *Banco Estado* accumulated about 80% of all mortgage credits for the two lowest income quintiles at the end of 2010 and about ¼ of the value of outstanding mortgages. The state-owned bank also channels most housing subsidies. Using the state-owned bank to fuel the mortgage market has contributed to promote housing finance and limited private-sector lending risk. But it has also concentrated risk in the state bank, which has a share of risky mortgage loans – with 90 or more days in arrears – that is about three times higher (about 11% in September 2011) than in private banks (4%), according to official data. It may have also reduced competition in the mortgage market for middle and low income households (Pardo, 2002). This could lead to higher mortgage costs and a lower range of available mortgage products in this market segment. The government should ensure there is sufficient competition in the banking sector and to rely more on targeted housing support rather than on the provision of mortgage credit through the state bank.

An efficient mortgage market, with low borrowing and transaction costs, is key for a well functioning housing market. It can improve access to credit for middle-income household but also free resources so the government can focus on helping the truly disadvantaged or credit constrained households. For instance, average transaction costs for buying a home (*e.g.* stamp duties, legal fees, notary fees, etc.) are low in Chile relative to other OECD countries (Figure 2.8). And the fact that Chile subsidises the administrative costs and guarantees loans for subsidy recipients, has reduced transaction costs by reducing the legal and economic risk to issue credit to these households (IADB, 2007). But Chile could further reduce transaction costs and mortgage approval times through better mortgage contract standardisation; better access to information on the credit history of a potential client, or for instance its tax credit record (IADB, 2007). This would improve the functioning and transparency of the mortgage market and would also facilitate regulatory oversight.

Figure 2.8. **Transaction costs**

As per cent of property value 2009[1]



1. 2011 for Chile.

Source: Calculations based on OECD Housing Market questionnaire.

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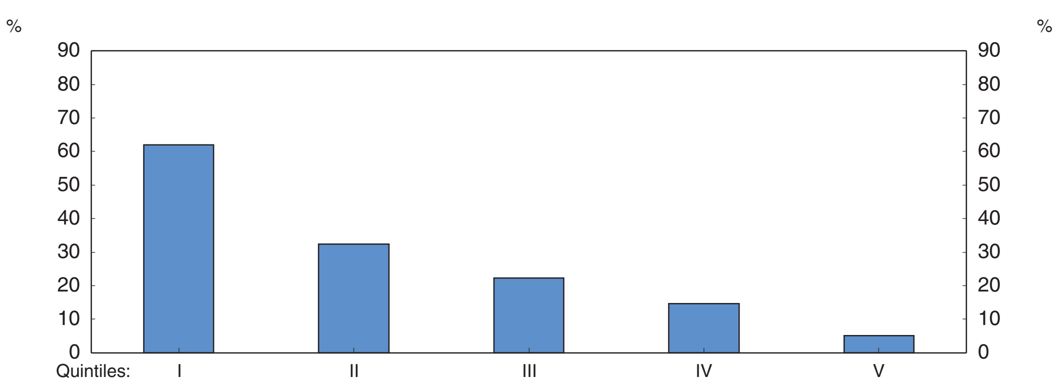
Chile should also improve the efficiency of its legal system as it affects borrowing costs and financing costs for lenders and investors, and can be key in mitigating lending risks. Effective foreclosure procedures are important in this respect. Mortgage foreclosure procedures are clearly defined in the Banking Law and are relatively fast in Chile compared to neighbouring countries, nonetheless eviction procedures can take more than a year (IADB, 2007; Lex Mundi, 2008) and could be improved. Chile has an executive judgement procedure in which non payments can be automatically relayed to the court (Morandé and García, 2004), however, the owner protection legislation has precedence over an executive procedure and allows the owner to appeal, thus postponing a court decision. Chile could consider implementing a stronger foreclosure law by, for instance, speeding up legal procedures. This would make the legislative framework more balanced, protecting borrowers, but also giving lenders support to grant credit. It would also facilitate orderly and efficient mortgage foreclosures and keep borrowing costs down.

Thanks to careful regulation, Chile's banking system is sound with low exposure to household debt or the complex assets that have shaken financial markets in other OECD countries. However, the supply of mortgage loans has tended to move towards higher loan-to-value ratios, and this should be monitored. Indeed, while until 2000 almost 70% of all mortgage supply was through letters of credit subject to prudent maximum loan to value ratios (75%) and fixed interest rates, currently most housing credit is through non-endorsable mortgage credits, which have greater flexibility in terms of maturities, types of interest rates (variable and mixed) and higher loan-to-value ratios, even above 100% for creditworthy borrowers (Matus *et al.*, 2010). Although mortgages with a loan-to-value ratio above 100% are still marginal, and average loan-to-value ratios remain low relative to other economies (73%, see Table 2.2), these developments should be closely monitored. Mortgage information should be tracked through credit registries. This would allow lenders to gauge the probability of default. Information on housing transactions, including prices, should also be tracked and made available, as it helps appraisers value prospective house purchases and allows lenders to keep track of the value of their collateral.

For poor households housing remains too expensive

Chile has experienced a remarkable decline in poverty over the last 20 years, but poverty and inequality remain high by OECD standards (Chapter 1). Because low income households have lower permanent income, wealth, and often have informal jobs, for them the mortgage market is a too costly option to finance their home. For instance, given current mortgage market conditions for first-home buyers, households in the bottom quintile would need to spend about 60% of their total monthly income in servicing a loan for a relatively cheap home (Figure 2.9).

Figure 2.9. **Affordability: share of household monthly income for mortgage payments**



Note: Calculations based on information from the *Superintendencia de Bancos e Instituciones Financieras* about conditions prevailing in the mortgage market at the time (LTV of 75%, fixed interest rates, 20 years maturity, 4.99% annual interest rate). House price 1 000 UF (USD 45,000), about the average price of an apartment in a cheap area of Santiago.
Source: OECD calculations.

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Housing subsidies have widened access to housing…

Chile has put in place ambitious housing subsidy programmes that have helped to widen access to housing during the last two decades. The main objective has been to deliver home ownership and reduce the significant stock of inadequate housing (see Figure 2.3). The instruments to achieve this objective have shifted over the years. Public provision programs – directly building houses or supporting supply – were the main tool during the 90s. These have been eliminated and replaced by demand-side targeted subsidies or vouchers. The government gives subsidies to first-time homebuyers who want to buy or build a home and who fulfil some basic eligibility criteria (Box 2.2), including some minimum savings. Subsidies at up to 75% of the housing price are quite generous to ensure that beneficiaries do not run into high debt burdens. Only relatively better-off subsidy beneficiaries – in the second income quintile or above – are in fact allowed to take on a mortgage to complement the subsidy. To reduce credit risks further and ensure banks lend to subsidy beneficiaries, the government also gives some guarantees to the bank. Such housing subsidy schemes are common in many Latin American countries. The main idea is that applying for a subsidy will, first, encourage families to save and, then, owning a home will improve their material and financial capital, helping them to overcome poverty.

Box 2.2. **Chile's housing subsidies**

There is a wide range of housing subsidy programs in Chile. The main features of the most important programmes in terms of public expenditure and number of subsidies (*Fondo Solidario de Vivienda, Título I* and *Título II*) are sumarised in Table 2.3. First-time homebuyers can apply for a housing subsidy as long as they comply with some minimum eligibility criteria (Table 2.3). Subsidies are then allocated based on scores taking into account different criteria, until funding is exhausted. Candidates who didn't receive a voucher remain in the queue. Beneficiaries are issued a voucher with an expiry date (after 21 months), which they can use to shop around for a home or to build their own home, adding their savings and – in the case of better-off households – their credit to their funding.

There are also other housing-related subsidies:

- **Subsidies to improve housing quality:** through upgrading, extension and thermal retrofitting (*Reparación y Mejoramiento, Ampliacion de Vivienda, Acondicionamiento Térmico*).
- **Subsidies for the maintenance and repair of community facilities, public spaces or street pavements:** (*Programa Barrio*).
- **Leasing subsidy:** The idea of the leasing programme (*Leasing Habitacional*) is to help families who cannot afford saving any money, even if little, to access homeownership. Recipients sign-up a rental contract with a real estate company with the obligation to buy the home at the end of the contract. With the subsidy recipients can pay the rental charges and eventually the home.
- **Residential mobility programme:** The residential mobility programme (*Movilidad Habitacional*) allows households who bought their home with a subsidy to sell it and buy another (more expensive) home with the subsidy.

Box 2.2. **Chile's housing subsidies** *(cont.)*

Table 2.3. **An overview of the most important housing subsidies, 2011**

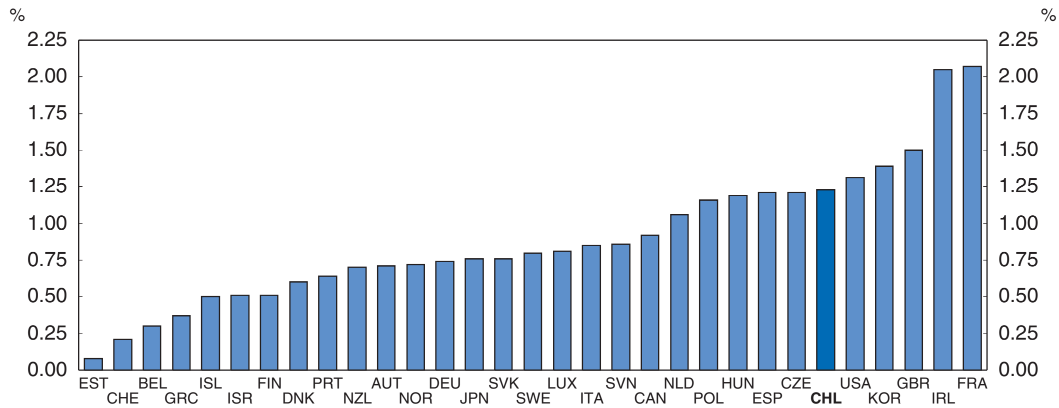
	Without credit for vulnerable groups (*Fondo Solidario de Vivienda*)	With optional credit for emerging groups (*Titulo I*)	With optional credit for middle-income households (*Titulo II*)
Official target population	Most vulnerable families that cannot obtain a mortgage.	Monthly household income between 250 000 and 450 000 pesos (*i.e.* 3th, 4th and 5th income decile in 2009).	Monthly household income between 450 000 and 900 000 pesos (*i.e.* 6th, 7th and 8th income decile in 2009).
Minimum eligibility criteria	Older than 18 years old. Minimum required savings. Not being a homeowner. Not having received a housing subsidy in the past. Being part of a family group (except for people with disability, older than 60 yrs old, indigenous minorities, widows). Foreign applicants a certificate of permanent residence (at least 5 yrs old).		
	Max. 8 500 points of carencia habitacional in proxy means test *Ficha de Proteccion Social.*	Max. 13 484 points in proxy means test *Ficha de Proteccion Social.*	No ceiling in terms of points in proxy means test *Ficha de Proteccion Social.*
List of criteria to determine priority	*i)* Family size and characteristics (*e.g.* single person household, disability); *ii)* Social and housing vulnerability (*e.g.* covercrowding, housing type, access to water, sanitation).	*i)* Family size and characteristics (*e.g.* single person household, disability); *ii)* Average savings; *iii)* Waiting time; *iv)* Socio-economic characteristics based on the *Ficha de Proteccion Social*; *v)* Political prisoner (*Informe Valech*); *vi)* Completed military service as of 2004.	*i)* Family size and characteristics (*e.g.* single person household, disability); *ii)* Average savings; *iii)* Waiting time; *iv)* Socio-economic characteristics based on the *Ficha de Proteccion Social*; *v)* Political prisoner (*Informe Valech*); *vi)* Completed military service as of 2004.
Minimum savings requirement	10 UF (USD 455).	30 UF (USD 1 363).	50 UF (USD 2 272).
Maximum housing price	Between 750 UF-950 UF (About USD 40 000)depending on location.	1 000 UF (USD 45 444).	2 000 UF (USD 90 888).
Maximum subsidy	Between 280 UF-420 UF depending on location.	Between 450 UF-650 UF (USD 20 449-USD 27 266) depending on location.	Between 300-350 UF (USD 13 633- USD 15 905) depending on location.
Subsidy top-ups (maximum values)	Disability (20 UF). Location subsidy (200 UF). Housing size larger than 37.5 m^2 (50 UF).	Disability (20 UF). Location subsidy: if located in *Proyecto de Integración Social*) (100 UF).	Disability (20 UF). Location subsidy: if located in Proyecto de Integracion Social (100 UF) or *Zona de Renovacion Urbana* or Desarrollo Prioritario (300 UF) or Zona de Conservacion Historica (300 UF).
Mortgage loan	Not allowed.	Allowed.	Allowed.
Application	Individual or organized groups though the Ministry or an eligible institution.		

Source: Based on Ministry of Housing (2011) reports and Ministry of Housing website.

In many ways Chile's housing subsidy programmes have been successful in improving the living conditions of the poor. At 1.1% of GDP in 2010, public spending on housing support is much higher than in many OECD countries (Figure 2.10). This is partly because housing support in Chile is for buying a home rather than for renting, as in most OECD countries, and therefore more costly. But it also indicates the high importance the government places on solving the housing problem. The stock of deficient housing has substantially fallen over time (see Figure 2.3). About 70% of all building permits granted between 1976 and 2007 were for houses built with some sort of public support, mostly through demand subsidies, but also directly built by the state (Simian, 2010). Many subsidies have been handed out (Figure 2.11). Although illegal settlements still exist, they

Figure 2.10. **Public spending on housing and community amenities**

As per cent of GDP, 2009[1]



1. 2006 for Canada and 2005 for New Zealand.

Source: OECD, *National Accounts Database*; Chile, *Estadísticas de las Finanzas Públicas 2000-2010*.

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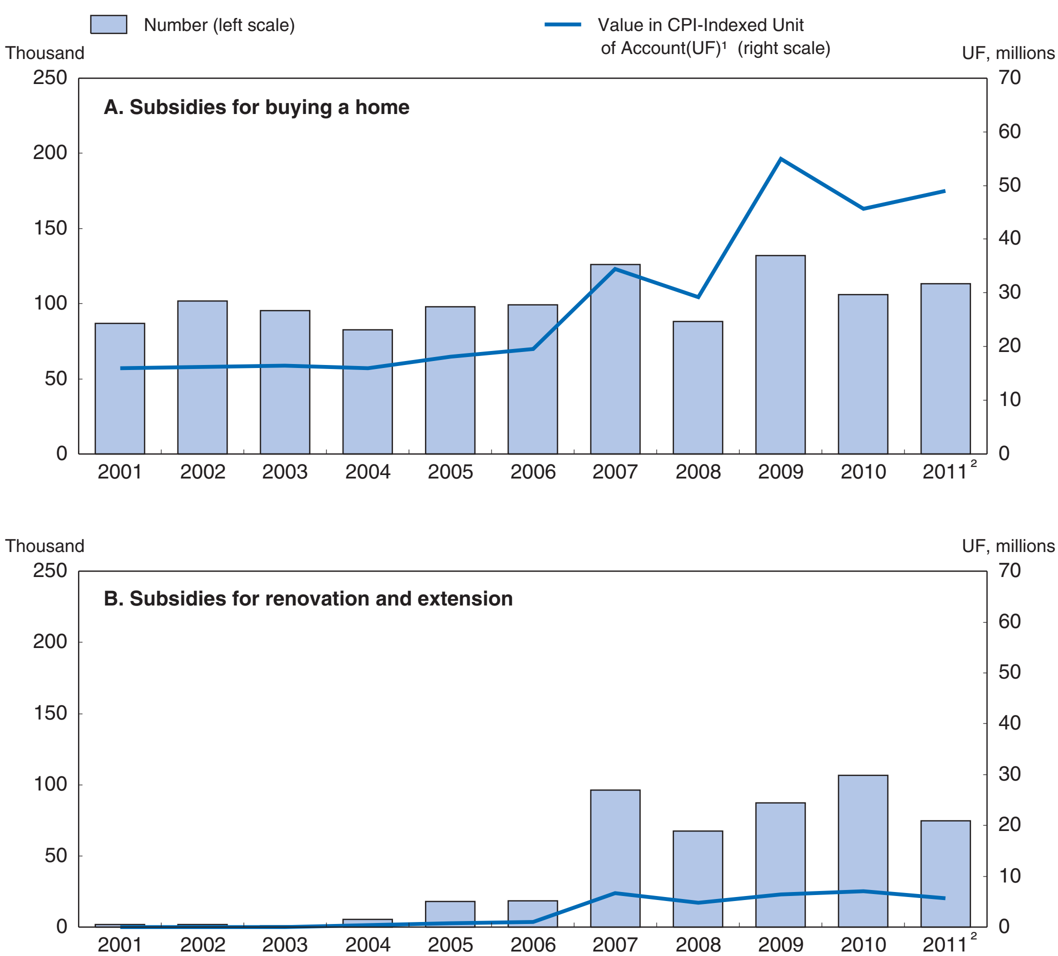
Figure 2.11. **Number and value of housing subsidies**



1. The CPI-Indexed Unit of Account (UF) was 22136 Chilean pesos on 9 November 2011.
2. Projected spending.

Source: Observatorio Habitacional, MINVU.

StatLink http://dx.doi.org/10.1787/888932564730

are mostly a problem of the past, and basic services are available to most citizens (see Figure 2.2).

An assessment of Chile's housing subsidies regarding key design features as well as their performance in terms of equity – targeting and coverage – and efficiency shows that subsidy programmes are fairly transparent and visible (Table 2.4). For instance, eligibility criteria and the dates for application are published on the internet and available from the regional offices of the Ministry of Housing and municipalities upon request. Beneficiaries

Table 2.4. **An assessment of Chile's housing subsidy programmes: key features, equity and efficiency**

Criterion	Description	Assessment
Transparency	Clarity of the programme's eligibility and participation criteria; Effective implementation by relevant authorities.	Fair. Eligibility and allocation criteria are published on the internet and available from the regional offices of the Ministry of Housing and municipalities upon request. Beneficiaries are chosen in open competitions by a clearly defined body and the list of beneficiaries published. However, subsidy programmes and eligibility criteria change relatively often and the weights given to different selection criteria is not obvious, which may make it difficult for people with poor skills to apply.
Visibility	What is the degree of political visibility of the subsidy? Are citizens/taxpayers aware of the true cost of the subsidy?	Fair. Subsidies are explicit and up-front thus visible and the total amount of subsidies spending is reported in the budget and annual accounts of the Ministry of Housing and on the Ministry of Housing website. However, there are no ex-post evaluations of programme effectiveness.
Administrative simplicity	Whether subsidies are easy and relatively inexpensive to manage; households are aware of the existence of the subsidy: the average household needs help to register in the program?	Poor. There are many different categories of housing subsidies (with different subcategories) which can make it hard to administer. Households can ask for information and help to file their application and to municipalities and other associations, but the usefulness of this support depends on available resources.
Flexibility	Extent to which programmes can be modified or stopped without major political unrest or disruptive effects on the economy.	Fair. Subsidy programmes are defined in legislative decrees and do not need Congress approval in order to be modified. Programmes have been substantially modified over the past 30 years. To the extent that subsidies have been in place for over 30 years and housing represents an important share of total construction stopping them altogether would be unpopular and likely affect economic activity.
Targeting/Vertical equity	Who are the official target of the subsidy? Are these the neediest? Does the subsidy not only use income criteria but gives different treatment for different types of households (*e.g.* households with children, female households).	Poor. In 2011, although 56% of all funding for housing is targeted to the first income quintile (*Fondo Solidario de Vivienda*), the remaining 44% is targeted to the quintiles above that up to the 9th decile. The selection procedure gives higher points for family size and other features but evidence suggests the means proxy test (*Ficha de Proteccion Social*) is an unreliable measure of income and household situation. There is no housing assistance for renters (17% of the population).
Coverage	What share of the population effectively received the subsidies?	Poor. Although targeting has improved over time, earlier evidence suggests a significant proportion of subsidies still goes to the upper-middle income groups and only about 22% of beneficiaries come from the bottom quintile (*e.g.* Aparici and Sepúlveda, 2010).
Efficiency	Could the same resources be used more efficiently? Are improvements in housing conditions sustainable? Is there evidence of crowding out of multiplier effects of spending)?	Poor. The number of bad quality housing has substantially decreased over time. But some of the targeted households can access housing through the finance market at reasonable costs. Some subsidised housing units are empty, others are rented, and some deteriorated fast. An excessive focus on homeownership may have squeezed the rental market.

are chosen in open competitions by the regional offices of the Ministry of Housing and the list of beneficiaries is published. However, the eligibility and allocation criteria change frequently and there is a large variety of subsidies with different eligibility criteria. This makes it difficult for potential beneficiaries to apply, in particular when considering that limited literacy is widespread among low-income households in Chile (OECD, 2000). It also complicates administration of these programmes.

… but subsidies do not always reach those most in need

At the same time Chile's housing subsidies do not always reach those most in need. Although the targeting of housing subsidies has improved over time, earlier studies show that a significant proportion of subsidies go to the upper-middle income groups (about 30%) and only about 22% of the beneficiaries come from the bottom quintile (Table 2.5). This is in part because by definition programmes are not targeted only to the most vulnerable, as in other OECD countries (Scanlon and Whitehead, 2011), but are more universal. In addition to poorer households, better-off households belonging to the fourth and even the fifth income quintile are also eligible (Table 2.3). Maximum eligible house prices are meant to dissuade wealthier households from applying for subsidies, but this ceiling is fairly high (about 90 000 USD), and the maximum size of the subsidy is respectable (15% of the price of the house), which makes applying attractive even for better-off families. For instance, the average price of an apartment in the Metropolitan region of Santiago, which also includes very wealthy communes, such as Vitacura, is only about 30% more expensive than that.

Table 2.5. **Recipients of housing subsidies by income quintile (% of total subsidies)**

I	II	III	IV	V
21.8	23	23	20.1	12.1

Source: Aparici and Sepúlveda (2010) based on CASEN (2003).

The selection and allocation mechanisms that determine who is eligible and who has priority to receive housing support have some deficiencies that may help to explain why some subsidies leak to richer families. There is no household-income ceiling. Instead eligibility for most programmes is based on discrete cut-off scores based on a proxy means test (*Ficha de Protección Social*) – that assigns scores to families based on employment, actual and imputed potential income, health status and family composition – together with some basic eligibility conditions, such as minimum savings, lack of homeownership and of prior housing subsidy receipt (Table 2.3). Evidence suggests that there is a lot of fraud; and the government is currently working on simplifying the system and implementing better controls (Chapter 1).

Scores that are used to allocate subsidies are based on a wide range of criteria that varies from programme to programme. All programmes give points for family size and socio-economic characteristics. Sometimes, but not always, housing characteristics, waiting time, savings and the score from the *Ficha de Protección Social* are also taken into account. For instance, the government has recently added housing characteristics (*e.g.* crowdedness, poor access to basic services, poor building quality) to the list of eligibility criteria to allocate subsidies for low-income households and this is welcome. These characteristics are related to true housing needs and are arguably difficult for the household to manipulate and easy for authorities to verify. But housing characteristics are not taken into account to allocate subsidies to higher income households. Instead other features are used, which have little obvious justification from a poverty alleviation point of view, such as completion of military service (Table 2.3). Although these criteria are meant to target housing support better, their complexity may also render application more difficult to understand for poorer households and possibly more costly to administer.

The fact that too many people are eligible may also explain why, regardless of positive macroeconomic developments and general improvements in affordability, the number of people waiting for a subsidy has sharply increased over time. The number of applications for housing subsidies has increased over the last ten years, according to the OECD housing questionnaire, and the number of savings accounts opened for the purpose of obtaining a housing subsidy has increased sevenfold since 1990, to more than 3 and ½ million in December 2010. At the average rate at which subsidies were allocated during the past 10 years (Figure 2.11) the average wait for any kind of subsidy would be more than 25 years, if all the people with a housing saving account were to be allocated a subsidy.

Making housing subsidies more efficient and equitable through better targeting

The government is making efforts to improve the targeting of housing subsidies. It has just reformed housing support for the poorest 20% of the population, and redesigned and increased the number of subsidies for households with incomes above that. As a result, in 2011, 56% of housing subsidies are officially targeted to the first income quintile (through the *Fondo Solidario de Vivienda*), which is welcome. Yet the government should consider further narrowing the targeting of housing subsidies exclusively to low income households, while reconsidering subsidies that may go to the 40% richest families, as the middle income housing benefit. Resources are limited and the number of people waiting for a subsidy greatly exceeds the number of available subsidies. Households in the top quintiles do not generally have problems getting a mortgage and benefit more from favourable taxation.

At the same time the government should also ensure that eligibility criteria truly identify those most in need of housing. Eligibility criteria could be simplified further, by replacing the proxy means test (*Ficha de Protección Social*) by information on declared income, as recommended in Chapter 1 for other social cash transfer programmes. While this might potentially require substantial investments in authorities' ability to verify claims, this would hardly be more expensive than investing in the authorities' capacity to verify information in the *Ficha de Protección Social*.

More should be done to streamline and evaluate the effectiveness of housing support. Many programmes have been phased out in the past (*e.g.* progressive housing programme) and new programmes have been introduced (*e.g. Programa con crédito opcional para sectores medios*) without a clear assessment of why the programme needed to be replaced or whether it had succeeded. This risks undermining the transparency of the system and public trust in it (Castañeda and Lindert, 2005). Housing subsidies have also been used for a wide range of objectives: help the poor, increase homeownership, improve the quality of the housing stock, and encourage the private sector to finance low-income housing. These are common and natural objectives of housing policies in countries with large housing deficits. But a housing policy with multiple objectives makes housing support more difficult to manage, more costly and harder to evaluate. Refocusing public housing support on helping low-income households would improve upon this. The authorities could also evaluate ex-post the coverage of subsidies and their effectiveness in improving housing conditions. They could use existing panel household data (CASEN) to check whether those who received the subsidy were truly the neediest and whether their housing conditions significantly improved.

Housing support would also be less complicated as well as easier to administer and to evaluate if the broad set of subsidies were streamlined. For instance, evidence by Simian (2010) suggests that the residential leasing subsidy (*Leasing Habitacional*) is very poorly targeted and could be phased out. Even if this program was meant to help the poorest, the number of subsidies is very small, the take up low and money mostly goes to households in the top two income quintiles.

Housing subsidies have not always led to better living conditions

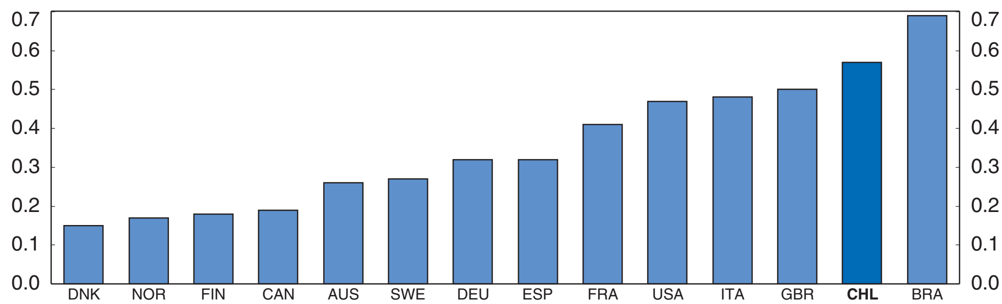
At the same time, improvements in housing conditions have sometimes not been sustainable. To provide housing for those in need and maintain the number of subsidised units built each year, the government financed small and sometimes poor quality housing (Vargas, 2006). The deficient quality of construction and upkeep in some cases led to premature deterioration causing the beneficiaries to slip back into poor housing conditions (Marcano and Ruprah, 2008).

The government often also bought the cheapest available land without providing the basic public infrastructure. This concentrated the poor in certain areas, often in the outskirts, especially in the city of Santiago, where the expansion of the city has been mainly driven by housing policy (Sabatini *et al.*, 2001; Gilbert, 2004). What is more, rising land prices meant that construction companies built subsidised housing projects further and further away from the city centre where land was cheaper, and supplied lower quality of housing to keep prices low and margins high (Morandé and Gimenez, 2004). This led to greater inequality, not only in terms of income, but also in education performance. Santiago's richest commune has an average household income eight times higher than the poorest and household heads have twice as many years of education (OECD, 2009). These inequalities risk being reinforced over generations, in a society where social mobility is already low (Figure 2.12). For instance, richer municipalities have better education and achieve better results on basic education performance tests than poorer ones (OECD, 2009). Poor access to high quality education risks transmitting poverty from generation to generation.

Given that many subsidised housing residents commute to the centre of Santiago for work, the peripheral location of subsidised housing has also led to substantial costs in terms of time, congestion and pollution. About half of all the jobs in the Santiago region, where over 50% of the Chilean population live, are located in the central communes of Santiago, Providencia and Las Condes (Rodríguez and Vignoli, 2008). Long commuting distances not only imply greater costs in terms of money and time for subsidy recipients, but also greater pollution for all citizens. Air pollution, caused by transport and the use of small-scale burning of wood or coal, is an important problem in Chile, and in particular in Santiago, which is one of the most polluted cities in the world. High pollution can lead to a wide range of diseases and premature deaths (Sanhueza *et al.,* 2006). Some studies even suggest that high levels of pollution may account for almost half of annual deaths in the city of Santiago (Ostro, 2008; Mancilla, 2007).

Figure 2.12. **Social mobility: strength of the link between individual and parental earnings**[1]

Intergenerational earnings elasticity: estimates from various studies



1. The height of each bar measures the extent to which sons' earnings levels reflect those of their fathers. The estimates are the best point estimate of the intergenerational earnings elasticity resulting from an extensive meta-analysis carried out by Corak (2006) and supplemented with additional countries from d'Addio (2007), Dunn (2004) for Brazil and Nunez and Miranda (2010) for Chile. The higher the value, the greater is the persistence of earnings across generations, thus the lower is the intergenerational earnings mobility.

Source: D'Addio (2007), Dunn (2004), Nunez and Miranda (2010).

StatLink http://dx.doi.org/10.1787/888932564749

Better standards to improve housing quality and protect public health

Chile has learnt from its experience and improved the quality of subsidised housing. It now imposes quality and size standards on subsidised housing and grants subsidises for upgrading and expanding housing size. More could be done, though, to bring the quality of the housing stock to minimum standards and, in particular, to reduce pollution (see Figure 2.4). The government wants to improve energy efficiency through subsidies for constructing and retrofitting for low income households to improve thermal insulation and reduce energy leakages. It also promotes the installation of solar thermal systems for public, commercial, household and industrial buildings. These efforts are welcome, but are likely to cover only a small part of the housing stock. The government should combine these efforts with basic building standards for ground heat transfer, air infiltration, ventilation and heating. These are common in most countries and have proven useful to reduce energy leakage and pollution. A thermal quality regulation defining the standards for ceilings, walls, windows and floors was approved in 2007. However, standards are relatively weak and they should be stricter to meaningfully improve energy efficiency (Collados and Armijo, 2008).

Chile is a very seismic country making solid building structures and the quality of construction materials key construction features. Chile has good and well-enforced building codes. To limit the cost of possible future earthquakes or tsunamis, the government should keep building codes up to date and enforce their application, as this proved an essential element limiting deaths in the 2010 earthquake. This experience also suggests that regular updates and enforcement of codes are particularly important in the case of poor households, who cannot afford high quality houses and may often rely on self-construction. The location of housing is also important. The government is using the reconstruction to relocate people from the affected areas to safer ones and to develop pilot measures to improve Chile's resilience to earthquakes. But to the extent that massive relocations are difficult and costly the government could extend the pilot measures to the entire country and also limit the development of settlements in fault lines by restricting building permits or reducing the construction of public infrastructure and services in such areas when possible. In the 2010 events most casualties were caused by the tsunami. The government is working on a national early warning procedure for tsunamis and on identifying risky coastal areas. Restricting building permits when needed could also be an option. These measures may increase the price of housing and risk making it less affordable for low-income households. But there are a number of measures the government can take to ensure housing supply functions well that are discussed below and this would help to counteract any upward pressure on prices.

Over the longer term, Chile may also need to develop policies to limit government contingent liabilities due to natural catastrophes. One third of the damage resulting from the 2010 disasters was covered by insurance and insurers processed claims relatively quickly. But, very few houses are covered against earthquakes, about 24% according to Muir-Wood (2011), imposing a big reconstruction burden on households and eventually on the state (see Box 2.1). After the earthquake, the insurance regulatory authority (*Superintendencia de Valores y Seguros*) reacted by speeding the processing of claims and temporarily allowing insurers to shorten procedures to accelerate inspections and payments. A bill presented in the Senate proposes compulsory earthquake insurance purchase. Its design should emphasize adequate enforcement in order to increase insurance penetration rates ensuring the schemes viability. In addition, the government should perhaps consider subsidising the cost of catastrophe insurance for low-income property owners who cannot afford it or provide some type of state guarantee to reduce the cost of insurance.

Measures to reduce segregation and avoid poverty traps

The government is buying some land for subsidised housing in more central locations as a means to reduce segregation and improve the social mix. This is welcome as OECD experience suggests that if social housing is not well integrated into different neighbourhoods it can lead to segregation and poverty traps (Andrews *et al.* 2011). The new policy approach may contribute to more mixed neighbourhoods, but reserves of land in good locations are costly. A complementary and possibly less costly solution would be to better enforce the existing quotas for subsidised housing, as a number of OECD countries have done (*e.g.* Spain, Ireland) with good results. In Chile developers of new projects have been required to devote at least 5% of land to subsidised housing since 1997, but these are restricted to few specific locations (*Zonas y Proyectos de Desarrollo Urbano Condicionado*), project approvals are lengthy and there is no time limit for compliance (Trivelli, 2011 and Castillo, 2010). Expanding the existing quotas for subsidised housing to more new development projects, favouring both rental and owner-occupied low-income housing, could contribute to better located subsidised housing and more diverse communities. Speeding up project approvals and imposing a time limit would also help. The government has also adjusted subsidies to allow poor households to buy houses in better locations. However, reducing segregation can only go so far. Improving infrastructure, public transport and social services in poor neighbourhoods will also be necessary, as discussed below.

As a complementary measure to speed up construction and make housing affordable for poorer households the government plans to extend the boundary of Santiago (metropolitan region) and add 13% of what is mostly farm land. While this measure can encourage additional supply and increase affordability, it may reinforce residential segregation as most poor people already live in peripheral areas. It can also increase commuting costs and pollution more if not accompanied by improved public services and infrastructure. An alternative to free land would be to encourage the development of waste or underused lands within the region of Santiago. Estimates suggest these are substantial and approximately of the same total size as what the expansion of the city boundary would bring (Trivelli, 2011). Redeveloping under-used land has the advantage of sparing land for other uses, such as agriculture or green areas, at the same time as it helps regenerate the city probably at lower infrastructure costs than greenfield investments. Such land reserves are typically located in areas where public services already exist, so the government often needs to spend less in making them habitable. If the government were to pursue the expansion of the boundary of Santiago, it should require developers to contribute with some land for subsidised housing (to buy and to rent) when the new boundary is negotiated. The UK is a good example of successful employment of the land-use planning system to ensure that new land development projects include affordable housing. Thanks to this approach owners and developers contributed to finance its costs (Scanlon and Whitehead, 2011).

There are a number of other factors that may further be slowing the responsiveness of housing supply. Chile should tackle these to ensure a good match between housing construction and demand. The government plans to speed up the allocation of building permits, which currently takes up to 450 days, slowing down construction projects. Another issue is lengthy and cumbersome reforms of land planning regulations, which have also slowed construction projects in the past (Echenique, 2004). The land planning law (*Ley General de Vivienda y Urbanismo*) has not been substantially modified for the past forty years and may be seriously outdated. The authorities should speed up the approval of land planning regulations as its efficient design and enforcement. These measures will improve the responsiveness of housing construction to changes in price signals and ensure that public support, either through direct subsidies or tax advantages, does not get capitalized into housing prices.

The responsiveness of housing supply is also affected by the degree of competition in the residential construction industry (Barker, 2004). Evidence suggests that competition in the construction industry is low in Chile relative to other non-manufacturing industries, and in particular among large construction companies (Duffau and Pasten, 2009). This is mostly due to high barriers to entry, such as high sunk costs of investment, but also because public infrastructure tendering rules give advantages to large firms. There is also some evidence of collusive behaviour in the residential construction market in Santiago, in particular in areas where low-income households live (Lefort and Vargas, 2011). Low competition in the residential construction sector can lead to higher housing prices and lower supply than under more intense competition. Under lower competitive pressures construction companies may also have fewer incentives to improve housing quality. The government should ensure competition policy and anti-trust rules are effective and hinder collusive behaviour in the construction sector.

Housing support excessively promotes homeownership

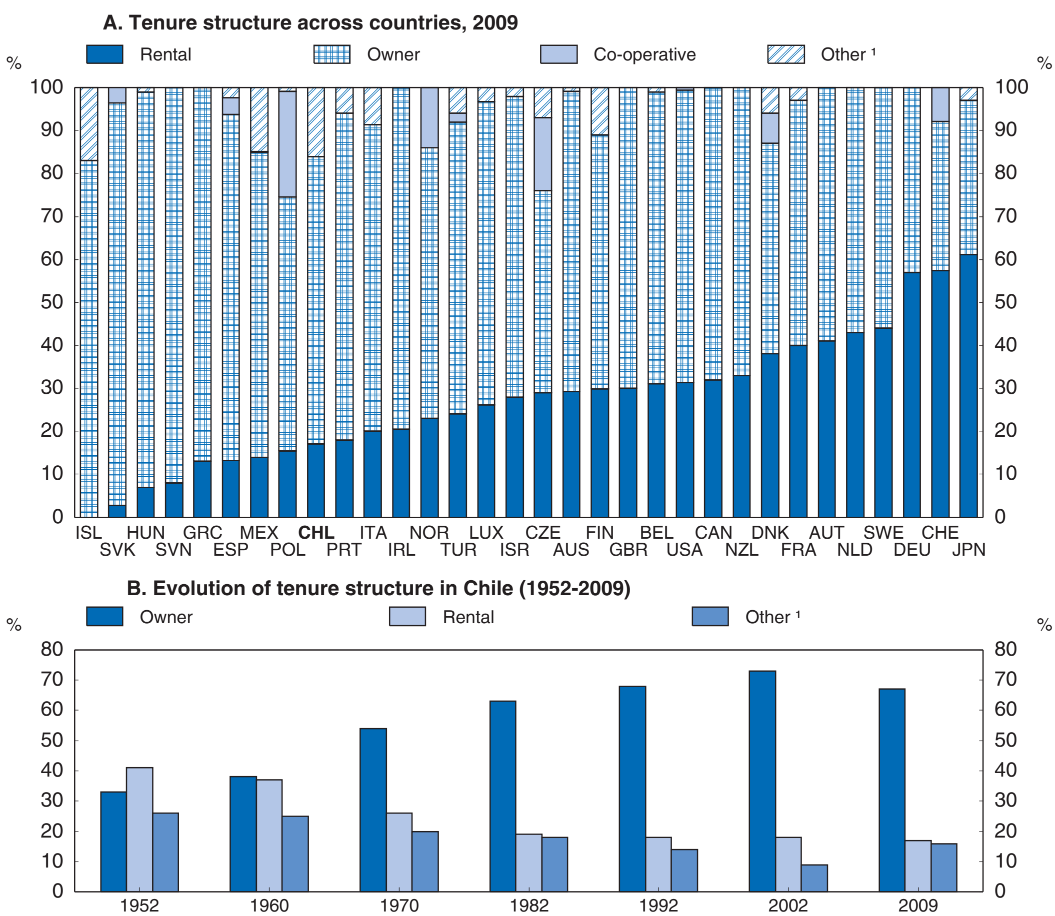
Increasing homeownership has been among the main objectives of Chile's housing policy over the past 30 years. There is no direct housing support for tenants and homeowners are directly and indirectly supported by the state. While most OECD countries grant a favourable tax treatment to owner-occupied housing, Chile's housing subsidies focused exclusively on ownership are in sharp contrast with housing support in most

OECD countries. Chile's main motivation for homeownership subsidies is to encourage poor households to save and increase their assets, as a means to escape out of poverty. However, subsidised housing, because of its relatively poorer quality and location, is typically not accepted by banks as collateral for a mortgage (Morandé and Gimenez, 2004), suggesting its poor liquidity as an asset.

This disproportionate policy focus on homeownership may have squeezed Chile's small rental market. At 17%, it is among the smallest in OECD countries and its size has decreased over past decades (Figure 2.13). The rental market is even smaller than in some Latin America countries (Galindo *et al.* 2011), and contains a substantial share of informal contracts (about 40%). A small rental market, in particular in the low-rent segment, may not only prevent households from exercising their tastes and preferences, but can also force credit-constrained households, such as the young or poor, to live with their parents or family. This may be contributing to overcrowded housing conditions in Chile (see Figures 2.2 and 2.3) and the high share of people living with family and friends.

Figure 2.13. **Tenure structure**

As per cent of dwelling stock



1. For Chile, "other" includes free housing provided by relatives or employers as well as housing units for which there is no data on tenure type.

Source: OECD Housing Market questionnaire; Universidad Andrés Bello (2011).

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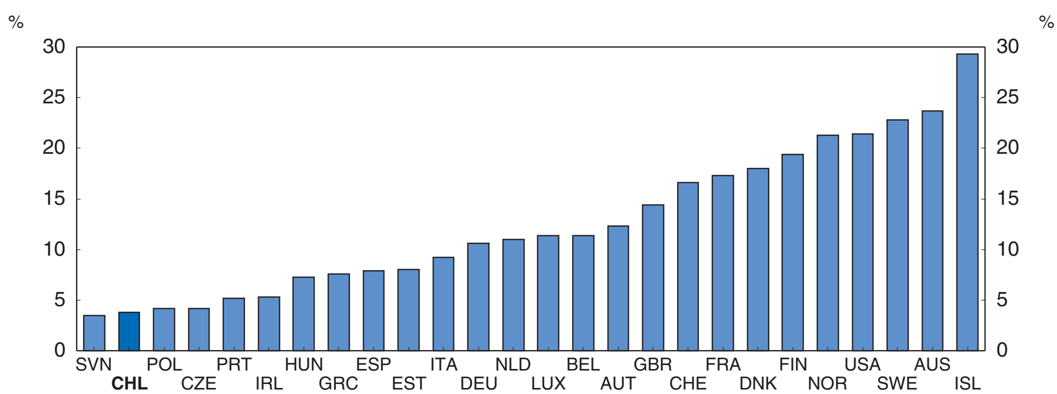
Another factor that may discourage the development of a rental market is strict rental regulations. In Chile, while tenants can terminate rental contracts (one year or more) quite freely, landlords cannot. Even if the tenant does not pay the rent or violates the rental contract in other ways, the landlord needs to recourse to judicial eviction. Such evicting proceedings are long and costly (Global Property Guide): it can last up to 240 days to evict a tenant who doesn't pay the rent. Given the difficulty to evict a tenant, landlords may prefer to rent out their home at high price to trustworthy tenants who can afford paying that rent, which helps to explain why, in Santiago at least, the market seems focused at the high end.

A negative side effect of a small rental markets is a low degree of residential mobility. Given that it is more costly for homeowners to move than for renters, a small rental market may prevent households from easily moving close to their jobs and undermine their economic opportunities. It can also, more generally, hurt labour market reallocation and growth (Rupert and Wasmer, 2011; Head and Lloyd Ellis, 2011). If housing markets do not work well, for instance by providing housing at affordable rents/prices, then job offers will be less attractive due to the difficulty to relocate (Rupert and Wasmer, 2011). Indeed residential mobility in Chile is the second lowest among OECD countries (Figure 2.14); only about 3.25% of all households move on average every year.

Figure 2.14. **Residential mobility in OECD countries**

Percentage of households that changed residence within last 2 years[1]



1. For Chile refers to the percentage of households that changed commune.

Source: OECD calculations based on 2007 *EU-SILC Database*, on HILDA for Australia, AHS for the United States, SHP for Switzerland and CASEN (2006) for Chile.

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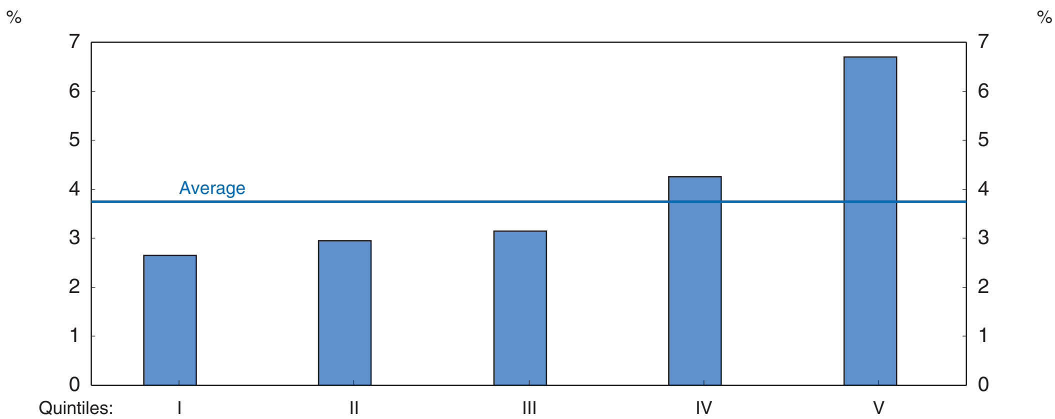
Mobility is particularly low among poorer households (Figure 2.15). Subsidised homeowners, who occupy about 60% of the dwelling stock, are also less mobile (Simian, 2010). Moving is harder for subsidy recipients, in part because it is difficult for them to sell their home to, for instance, climb the housing ladder or get close to a new job. One reason is that within most subsidy programmes houses cannot be sold or rented in the five years following purchase. In addition, the secondary market for subsidised housing has traditionally been small. The focus on providing very low cost units for homeowners in far away locations may have limited the resale value of subsidised housing. Until 2006 the majority of subsidy recipients –*Fondo Solidario* recipients- were not allowed to buy second-hand homes with their subsidy (Razmilic, 2010). This may have limited the liquidity of the second-hand housing market for subsidised homes, since these are typically cheaper and would be mostly demanded by low income households who are eligible for a subsidy.

Figure 2.15. **Residential mobility in Chile by income quintile**

Percentage of households that changed commune



Source: CASEN (2006).

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Making housing support more tenure neutral would uncover hidden demand and improve mobility

The rental market is typically the most flexible segment of the market for cash-strapped households (the poor or young) and very mobile ones. However, in Chile it is a limited option. Current policies to exempt net rental income and the fact that municipalities apply a surtax on non-occupied houses are measures typically used to encourage the development of the rental market in other OECD countries. But in Chile this has proven insufficient. A complementary option is to strengthen rental demand by giving rental cash allowances to needy households. Many OECD countries have such policies and these are particularly significant in Ireland, the United Kingdom and some Nordic countries (Andrews *et al.*, 2011). An advantage of portable housing allowances over subsidies for homeownership, or direct provision of social housing, is that they do not seem to hinder residential and labour mobility, as long as allowances are not tied to a home (ECB, 2003; Hughes and McCormick, 1981; 1985). These subsidies should also be means-tested, earmarked to rent payments or ideally to a median or norm rent and only be used for housing costs. Withdrawal rates for the benefit should be low enough to limit a negative impact on job search incentives or the willingness to move, as withdrawing the benefit increases the effective marginal income tax rate (Immervoll *et al.*, 2008). Rental cash allowances should gradually replace a part of the subsidies directed at homeownership in order to make housing support more tenure neutral.

An important precondition for rental allowances to function is that there be sufficient supply of rental housing, as evidence suggests that rent allowances can be passed onto higher rents if supply is inelastic (*e.g.* Gibbons and Manning, 2003; Kangasharju, 2003; Susin, 2002). This may occur if granting rental allowances generates additional demand for rent and rental supply does not respond. For instance, upon receiving a rental allowance single mothers may move out of their parents' home, or drop-ins (*allegados*) out of their friends' home. If supply is inelastic rental allowances will increase demand and rents as the increase in rental housing supply will fail.

Therefore a first step should be to ensure that regulations in place give the right incentives for the private sector to invest in rental housing, either by developing new housing for rent, or by upgrading existing housing units. Rental regulations currently protect tenants more than landlords and this should be redressed. The government could promote the use of standard written rental contracts so that landlords and tenants understand their rights and responsibilities. This could contribute to reduce informal rental contracts. Evicting a tenant who does not pay the rent should be made less costly by, for instance, speeding up court procedures, which are currently quite slow. More legal certainty coupled with the security of rental income provided by the government rental allowance could contribute to stimulate investment in housing for rent to low income households.

Improving public transport and reducing commuting costs which are substantial, in particular in Santiago, where most of the population live, would also facilitate mobility and access to jobs, while contributing to improve the living conditions in poorer neighbourhoods. The government has done great efforts to improve the functioning of the public transport system in Santiago (*Transantiago*), which have borne some results. For instance, accidents, which used to be very common before *Transantiago* was set up in 2007, have decreased by more than half. Air pollution has also decreased substantially with the introduction of new more environmentally friendly buses (Figueroa *et al.*, 2011). However, some deficiencies still remain. Commuting times have increased up to 50 minutes in one direction according to recent estimates (Universidad Andrés Bello, 2011). Some areas of the city are not well covered, which forces commuters to change several times lines or means of transport increasing commuting time and costs. This penalizes poor households most. The government has recently extended the coverage of a transport allowance for children to low-income households, and this is welcome as such support can improve their mobility and access to jobs. More should, however, be done to reduce commuting times and ensure a good coverage of public transport in Santiago. Improving key services in poor neighbourhoods, such as schools, and health services will also be a key ingredient to reduce poverty and inequalities (Chapter 1).

Owner-occupied housing receives a preferential tax treatment

The tax code gives incentives to own rather than to rent in Chile, with relatively light taxation of housing relative to other investments. Tables 2.A1.1 and 2.A1.2 in the Appendix compares the taxation of housing across OECD countries. As in most OECD countries, the service income provided by owner-occupied housing (*i.e.* imputed rents) is not taxed as income (Table 2.A1.1), but mortgage interest is deductible from taxable income up to a generous limit (of about USD 7 600). Chile has housing property taxes (*Impuesto Territorial*) that could in principle offset mortgage interest deductibility, but they have many exemptions and are not large enough. Private households do not also pay capital gains tax on the sale of any real state property, as long as they keep it for more than a year and if the transaction is not habitual or between related parties.

Houses that are smaller than 140 square meters, which are 80% of the country's stock and most new construction, benefit from favourable tax treatment (*Decreto con Fuerza de Ley No. 2*, DFL2), although the government has recently limited these to two houses per owner effective for properties purchased after 2010. Private landlords' rental income from those so-called DFL2 properties is income tax free. DFL2 houses are also exempted from inheritance tax if they are new and acquired through a real estate agent, and they are subject to property taxes at only half the usual rate for up to 20 years. Exemptions from inheritance tax create an asymmetry as other assets are taxed.

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Housing construction also benefits from a reduced VAT rate. This creates a distortion relative to other construction and consumer goods that are taxed at the standard rate. It is more expensive to administer, and can lead to tax evasion and avoidance. Overall these preferential tax treatments translate into 0.5% GDP foregone revenue, according to government figures (*Servicio de Impuestos Internos*).

Most OECD countries grant a preferential tax treatment to owner-occupied housing based on the belief that homeownership has positive spillovers for society. For instance, homeownership has been linked to better education outcomes for children, a greater engagement in the community and higher probability of voting. Some studies show that children from homeowners have better test scores and behaviour than renters' children (Haurin *et al.,* 2002). Other studies show that homeowners are more active and informed citizens and create more stable neighbourhoods (Di Pasquale and Glaeser, 1999). These findings, however, tend to suffer from identification problems and it is not clear what is the cause and the effect. For instance, children of homeowners may perform better at school than those of renters simply because of unobserved socio-economic factors.

On the other hand, there is strong evidence that tax subsidies, such as mortgage interest deductibility, can have negative side-effects. They tend to encourage excessive leverage and get capitalized into house prices. Where housing supply is tight and demand strong, such fiscal subsidies can also have a redistributive element, generating capital gains for current owners at the expense of newcomers and actually hinder their access to housing (Wolswijk, 2010). They are also regressive, both because wealthier households are more likely to be homeowners in the absence of tax subsidies, and because they are subject to higher marginal tax rates. For instance, most Chileans do not benefit from mortgage interest deductibility, as 82% of tax payers fall below the income tax threshold. As a result, the deduction provides larger benefits to wealthier households, who would probably buy homes anyway, than to poorer ones, and has at best a small effect on homeownership.

A tax reform to reduce distortions, improve equity and promote a more balanced housing market

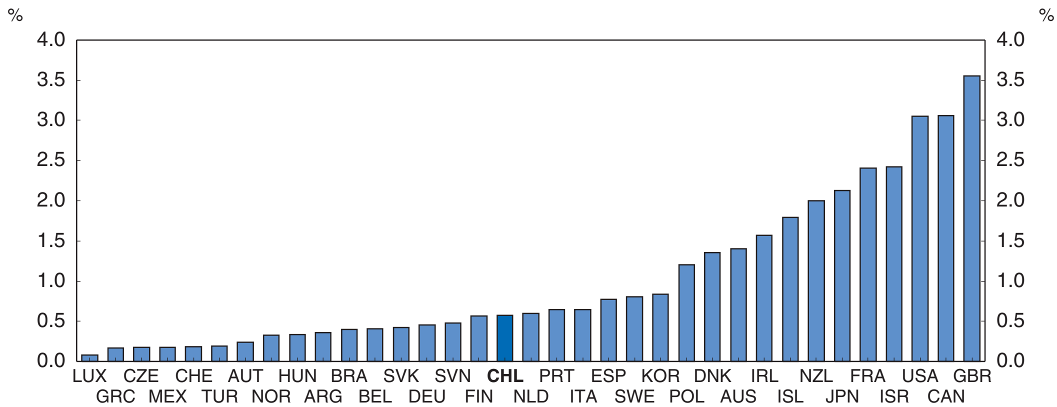
A reform to restore neutrality between housing and other investments would ideally involve taxing housing income in the same way as investments in other assets, thus taxing owners' net imputed rental income and private landlords' net rental income. This section discusses the practical issues surrounding such tax reform.

Within a comprehensive income tax system, owner-occupied imputed rental income should be taxed in the same way as other investment goods, with mortgage interests and other running expenses (*e.g.* depreciation, property taxes) being deductible. In practice, taxing imputed rents is complicated by the difficulties in estimating the rental value. Thus few OECD countries do it (Table 2.A1.1), and those that do often substantially underestimate imputed rents.A second-best solution is either to eliminate mortgage interest deductibility or to scale-up taxes on immovable property sufficiently to equalise what would be the taxation of net imputed rental income (on the assumption that imputed rents are proportional to property value).

Chile should increase its revenues from residential property taxes (*Impuesto Territorial)*. This could offset the generous mortgage subsidy and go towards a more equal treatment of housing relative to other investments. Revenues are low, in international comparison (Figure 2.16), although such taxes are relatively efficient, easier to enforce and involve

Figure 2.16. **Recurrent taxes on residential immovable property**[1]

As per cent of GDP, 2009



1. 2008 for Australia, Greece, Mexico, Netherlands, Poland and Portugal.

Source: OECD, *Tax Database* and Development Center, *Latin American Revenue Statistics*.

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fewer distortions. Enhancing property tax revenues is also important because Chilean municipalities greatly rely on property taxes to finance key public services such as education and basic health care, which fall under local responsibility (OECD, 2009). About one third of total municipal funding comes from the *Fondo Común Municipal,* a national revenue sharing mechanism set up in 1979 as a counterpart of the decentralization of responsibilities towards municipalities. Half of the fund's resources come from residential property taxes and most municipalities derive most of their funding from it (Horst, 2009). The resulting degree of equalisation is, however, weak compared with other OECD countries and leaves some of the poorer municipalities in a weak position to finance the minimum provision of goods and services (Table 2.6). Taxes on immovable property are also a good way to finance local expenditures. They are fairly predictable sources of funding, given that there are relatively less cyclical fluctuations in the tax base, and there is less scope for tax avoidance (Valenzuela, 2008).

Property tax revenues are low partly because of the many loopholes and exemptions in the property tax. Approximately 65% of properties do not pay any property tax at all, and this reduces tax revenues by half according to government estimates (*Servicio Impuestos Internos*, 1st semester 2011). Properties below a certain taxable price level (about USD 34 523) are exempted. Besides owners of DFL2 houses a long list of public and private institutions is also fully exempt from real estate taxes or pays, at most, 50% of the property taxes (Valenzuela, 2010). Among those that receive the largest breaks are the police and the army (Valenzuela, 2008), which has little justification in terms of income distribution or poverty objectives. The government should phase out exemptions for DFL2 houses, and reconsider the long list of public and private institutions that are exempt.

Property tax rates are also possibly too low. The 2006 revenue act (*Ley 20.033, Ley de rentas II*) made reassessments of property values obligatory at least every five years. This was an important step forward, as before that reassessments took place only every 10 years. But the law also capped the growth in aggregate property tax revenues to 10%. To keep the increase in national revenues below this threshold, tax rates are typically lowered and the minimum taxable price level is increased. In the 2006 revision, tax rates were reduced by 2 percentage points across the board and the exempted price level increased by

Table 2.6. **Fiscal revenues per capita before and after equalisation**

	Highest capacity/lowest capacity[2]	
	Before equalization	After equalization
Federal/ regional countries		
Australia	1.3	1
Canada	2.4	1.7
Germany[1]	1.7	1.1
Spain	2.1	1.4
Switzerland	3.8	2.5
	Unitary countries	
Denmark	2.2	2
Finland	1.8	1.1
Norway	2.2	1.2
Japan	3.1	
Sweden	1.4	1.1
Portugal	12.7	2.1
Turkey	85.6	1.7
Chile	**20.6**	**2.3**

1. 2005 for Germany, 2010 for Chile, 2004 for all other countries; the data show actual revenues for Chile and revenue capacity for all other countries.
2. Ratio of maximum and minimum fiscal capacity of subnational governments before and after equalisation. For federal/regional countries the indicators are calculated for the state/regional level. For unitary countries revenues per capita are averaged by decile. In these cases the table shows revenues per capita of the richest decile as a ratio of revenues per capita of the poorest decile.

Source: Bloechliger and Charbit (2008), *Sistema Nacional de Información Municipal for Chile*.

30% leading to a revenue loss of USD 30 million in 2006 (Joratt, 2009). The government should phase out the cap on the growth of aggregate property tax revenues. To increase public acceptance of higher property taxes, the government could keep the current gradual increases in individual taxes following a reassessment and even consider special arrangements to reduce liquidity constraints for people with low incomes or illiquid assets. These could include a better assessed minimum taxable price level.

If raising property taxes sufficiently is politically too difficult, an alternative is to phase out mortgage interest deductibility. Many OECD countries have done this over recent years (*e.g.* Australia, Canada, Germany, Spain, United Kingdom). Phasing out mortgage interest deductibility is not easy either, not least because such breaks are typically quite generous and construction and real estate lobbies are very powerful in most countries. It may be easier for Chile though. As most Chileans do not benefit from the mortgage subsidy, opposition may be weaker. To facilitate its political acceptance and to prevent sharp changes in property values and household cash flows, the government should phase it out gradually. It could for instance cap the mortgage interest deduction further, or limit the rate at which it is deducted.

The government should also phase out rental income exemptions for the so-called DFL2 properties. Deductions of all costs involved in producing that income should be allowed, in the same way as with income from other investments (*e.g.* shares or investment in small businesses). Likewise, DFL2 properties should be subject to the inheritance tax, as are other assets in Chile and in line with common practice in the OECD (Table 2.A1.2). Creating a good and flexible framework for housing construction and tenant-landlord relations, as suggested above, would counteract any negative effects that higher taxation may have on housing supply.

Exemptions from capital gains on property sales are also unusually generous. While most OECD countries exempt capital gains from the sale of the principal residence, they generally do tax capital gains on secondary homes to establish neutrality relative to other assets that pay capital gains and avoid diverting savings excessively towards housing (Table 2.A1.1). In a way, capital gains tax exemptions for housing property are less likely to create distortions, given that other saving vehicles also have tax advantages (pension funds, and saving funds), and a wide range of shares are exempt from capital gains. This favourable treatment, however, implies a tax break for relatively affluent households who own more expensive houses, it complicates the tax code and facilitates tax planning. The government should consider limiting exemptions to capital gains taxation. While this may limit or lock in some types of investment, it would make for a more neutral tax system that is easier to administer with fewer opportunities for tax avoidance.

The reduced VAT rate for housing construction should be capped further. The tax benefit was capped in 2009 for properties below a certain price (4 500 UF, USD 209 804), which is a step in the right direction. But the maximum price threshold is still high. The benefits are also greater for more expensive properties. Although neutrality considerations would support charging the standard VAT on all new construction, this would reduce housing supply incentives for low cost housing in the short term, which is not desirable, given that poorer households have greater housing needs (Figure 2.3). The government should however consider capping further the reduced VAT rate for housing construction as this would make the tax benefit less regressive and would contribute to reducing fiscal costs.

Box 2.3. **Recommendations to improve the functioning of Chile's housing market**

- Improve targeting of housing subsidies to low-income households.
- Over time redirect some of the housing subsidies to means-tested rental allowances for low-income tenants.
- Better integrate subsidised housing into wealthier neighbourhoods, encourage the development of underused land, better enforce subsidised housing building quotas and invest more in infrastructure, public transport and social services in poorer neighbourhoods.
- Upgrade thermal and energy efficiency standards for buildings and extend limits to construction in fault lines and risky coastal areas to the entire country.
- Further reduce tax distortions in favour of housing by either increasing real state tax rates or phasing out mortgage interest deductibility. Tax rental income in the same way as investment in other assets, and make all houses subject to inheritance tax.
- Make supply more responsive to demand by speeding the reforms of land planning and allocation of building permits, and ensuring the rental market works well, by striking the right balance between regulation that safeguards tenants' and landlords' rights.

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ANNEX 2.A1

Table 2.A1.1. Housing-related taxes: Interest rate deductibility, imputed rent and capital gains tax

	Mortgage interest deductibility	Tax on imputed rents	Capital gains tax (CGT)		
			Primary residence	Secondary residence	Other assets
Australia	No	No	No	Yes. 50% on the capital gain at the taxpayer's marginal rate if the holding period is 1 year or more. Assets held for less than 1 year attract full capital gain tax.	Yes. 50% on the capital gain at the taxpayer's marginal rate if the holding period is 1 year or more. Assets held for less than 1 year attract full capital gain tax.
Austria	Yes. For incomes less than EUR 50 000.	No	Exempt if held more than 2 years. Otherwise taxed at personal income tax rate.	Taxed at personal income tax rate. No tax after 10 years holding.	Yes
Belgium	Yes. After 1 Jan. 2005, deductible up to EUR 2 770 for the first 10 years and EUR 2 080 thereafter.	The imputed rental income from a taxpayer's main dwelling is subject to immovable withholding tax but not to income tax.	No	Yes. 16.5% tax if held less than 5 years, no tax after 5 years holding. 33% tax if speculative intent.	Shares purchased with speculative intent taxed at 33% rate; other shares exempt.
Canada[1]	No	No	No	50% of capital gains are included in net taxable capital gains, taxed at marginal personal income rates.	50% of capital gains are included in net taxable capital gains, taxed at marginal personal income rates.
Chile	Yes	No	Exempt if held for more than one year. Otherwise taxed at the personal income tax rate.	Exempt if held for more than one year or less than 4 years in the case of an apartment. Otherwise taxed at the personal income tax rate.	Exempt shares if substantially and regularly traded on a recognised Chilean stock exchange. Exempt shares of risk capital companies, mutual funds, joint-stock companies up to a certain threshold.
Czech Republic	Yes. Deductible up to a limit of CZK 300 000.	No	Exempt if held for 2 years. Otherwise taxed at 15%. If sold within 2 years, exemption still applies if gains are used for housing.	15%. Exempt if held for 5 years.	Taxed as personal income, flat rate of 15%.
Denmark	Yes. The tax deduction on interest has a taxable value corresponding to approximative 33%.	No	No	No	Capital gains from shares are taxed at rates of 28% below DKK 48, 300 and 42% thereafter.
Estonia	Yes	No	Exempt.	Holiday houses are exempt if held for more than 2 years.	Taxed as personal income, general rate 21%.
Finland	Yes	No	Exempt if hold for less than 2 years; otherwise taxed at flat rate of 28%.	28%	28%

Table 2.A1.1. **Housing-related taxes: Interest rate deductibility, imputed rent and capital gains tax** *(cont.)*

	Mortgage interest deductibility	Tax on imputed rents	Capital gains tax (CGT)		
			Primary residence	Secondary residence	Other assets
France	Tax credit for interest on loan for principal residence for 5 years. The credit is equal to 20% up to EUR 3 750 per year, increased by EUR 500 per year for each dependent person. The limits are doubled for couples.	No	No	Exempt from capital gains taxation after 15 years holding.	Taxed as personal income and subject to a flat rate of 28.1%.
Germany	No	No	No	No	Exempt if asset sold after 10 years.
Greece	Yes. Mortgage loans taken after 2002, a credit of 20% of the annual mortgage interest on principal home is granted (on the first EUR 200 000 of the loan).	Yes on principal dwellings larger than of 200 m^2 and on second house larger than 150 m^2.	No	No	No
Hungary	No	No	Exempt if property held for more than 5 years. Otherwise taxed at 25%.	Exempt if property held for more than 5 years. Otherwise taxed at 25%.	Generally, a 25% tax rate is applicable.
Iceland	An interest compensation payment is made to individuals who incur interest with respect to their residence.	Yes. 70% of rent taxed at 15%.	Exempt if held for more than 2 years. Gains from residence held for less than 2 years exempt if reinvested another residence.	Yes	15%
Ireland	Yes. Relief of 20% on the interest of qualifying loans for 7 tax years (higher rates for first homebuyers). Mortgage interest relief is restricted to EUR 3 000 for singles and EUR 6 000 for married/widowed taxpayers.	No	The primary residence is exempt from capital gains taxes, but the increase in value due to the development of the property is taxable.	Yes	Taxed at 25%. First EUR 1 270 of gains exempt.
Israel	No	No	No	. .	Taxed at 20%. For significant shareholders taxed at 25%.
Italy	Yes. Tax credit equal to 19% for principal owner-occupied dwellings with maximum tax credit EUR 760 and for construction or recovery of principal owner-occupied dwellings maximum tax credit is EUR 491.	Exempt in the case of principal owner-occupied dwellings.	No	Exempt if held more than 5 years. For dwellings sold within 5 years, either flat tax of 20% or normal progressive income tax.	Yes. Qualified shareholdings 49.72% of the capital gain is subject to progressive personal income tax rate if certain holding restrictions are met.
Japan	No	No	After 5 years holding taxed at 15%. Less than 5 years holding taxed at 30%.	After 5 years holding taxed at 15%. Less than 5 years holding taxed at 30%.	Yes. The tax rate applied is 15% (7% from 2003 to 2011 for listed stocks).
Korea	No	No	Exempt if held for more than 3 years. Otherwise taxed between 6-35%.	6-35% depending on the amount.	6-35%

Table 2.A1.1. **Housing-related taxes: Interest rate deductibility, imputed rent and capital gains tax** *(cont.)*

	Mortgage interest deductibility	Tax on imputed rents	Capital gains tax (CGT)		
			Primary residence	Secondary residence	Other assets
Luxembourg	Yes. Deducted up to a maximum amount which depends on period of occupation and taxpayer's family situation and varies between EUR 750 and EUR 1 500.	Yes. Imputed rent at 4-6% of unit value of the dwelling based on valuation on 1 January 1941.	No. Special rules apply to speculative gains, defined as a holding period less than 2 years.	Yes. If property held for less than 5 years.	Taxed at maximum rate of 19.475%. Special rules applies to speculative gains, *i.e.* holding less than 6 months.
Mexico	. .	. .	No	No	Yes
Netherlands	Yes.	Yes. Imputed rent of up to 0.55% of market value of the dwelling.	No	No	. .
New Zealand	No.	No	No	No	No
Norway	Yes. Deductible from ordinary income, tax value of 28%.	No	Exempt if the owner has occupied the house in 12 out of the last 24 months.	28%	28%
Poland	No	No	Exempt after 5 years holding. Exempt from tax if they are used within 2 years on the taxpayers own dwelling or to pay mortgage loan. Otherwise taxed at 19%.	. .	19%
Portugal[2]	Yes	No	Exempt if proceeds re-invested in another principal residence within 2 years. Otherwise 50% of the gains are taxed as personal income.	50% of gains from immovable property is taxed as personal income.	Taxed as personal income.
Slovak Republic	No	No	Exempt after 2 years holding.	Exempt after 5 years holding.	Taxed as personal income.
Slovenia	No	Yes	Exempt after 3 years holding period.	. .	20%. The rate is reduced by 5%percentage points for each 5 years of holding so that gains are exempt after a 20 year holding period.
Spain	Yes	No on principal dwellings.	Exempt if re-invested in another principal residence. Individuals over age 65 years are exempt.	Yes	Yes
Sweden	Yes. Deductible against capital income, in case of deficit then 30% tax reduction against labour income.	No	All capital gains are taxed, but may be deferred if reinvested. Otherwise, taxed at 22%.	Yes	Yes
Switzerland	Yes	Yes	Yes	Yes	Yes
Turkey	No	No	Exempt if held for more than 5 years.	. .	. .
United Kingdom	No	No	. .	Yes	18%
United States	Yes. Applies to loan up to USD 1 million.	No	First USD 250 K (USD 500 K if married) excluded if dwelling occupied 2 years over 5 year period.	Yes	Yes. 15% is a typical maximum, but tax rate can be higher.

1. Information for Canada is non-verified.
2. Information for Portugal is non-verified

Source: OECD Housing Market questionnaire.

Table 2.A1.2. **Housing related taxes: Property, wealth, inheritance and consumption taxes**

	Recurrent taxes on land and buildings	Wealth tax	Inheritance tax	General consumption tax – VAT			Cadastral value (year and frequency of updating
				New dwellings	Other dwellings	Other durable goods	
Australia	Yes. Land taxes levied at a sub-national level. New South Wales: AUD 100 plus 1.6% of the land value between AUD 376 000-AUD 2 299 000, thereafter 2%.	No	No	Yes. Tax levied on new residential construction and improvements at a 10% rate.	No	10%	. .
Austria	Yes. The tax is levied at a basic federal tax rate (usually 0.2%) multiplied by a municipal coefficient ranging up to 500%.	No	No.	No.	No	20%	1973, not automatic.
Belgium	Yes. Taxed as a percentage of the Kadastraal inkomen. General regional rate (1.25% for Brussels and Wallonia and 2.5% for Flanders) and the local municipality rate.	No	Yes	New dwellings taxed at 21%.	Maintenance and repair taxed at 6%.	21%	1980, only annual indexation.
Canada[1]	No	No	No. Although a form of tax imposed through deemed disposition provisions in income tax.	Yes. 5% is levied on new residential construction but purchasers of owner occupied properties of less than CAN 450 000 receive a partial rebate. All investment properties subject to full consumption tax.	No	5%	
Chile	Yes. Levied on annual basis on urban or rural property on the base of the official cadastral value.	No	Yes. DFL-2 houses are exempted from the inheritance tax as long as the deceased bought it directly from a real estate agency and was the first owner.	New dwellings get a capped VAT tax credit (65% for residential construction not exceeding 4 500 UF (USD 209 804) with a ceiling of 225 UF (USD 11 656).	Maintenance and repair taxed at 19%.	19%	2009, every five years.

Table 2.A1.2. **Housing related taxes: Property, wealth, inheritance and consumption taxes** *(cont.)*

	Recurrent taxes on land and buildings	Wealth tax	Inheritance tax	General consumption tax – VAT			Cadastral value (year and frequency of updating
				New dwellings	Other dwellings	Other durable goods	
Czech Republic	Yes. Building/real estate and land tax. Real estate tax of CZK 2 per m^2 multiplied by a coefficients ranging between 1-4, 5 depending on the size of the municipality.	No	Yes. Direct relatives, spouses and more distant relatives are exempt.	VAT of 20 %; 10 % for social housing.	. .	20%	
Denmark	Yes. *Municipal tax*: 1.6-3.4% based on the value of the land only. *National tax:* standard rate of 1% of taxable value up to DKK 3 040 000 and 3% above threshold.	No	Yes. Inheritance exceeding DKK 255 400 is taxed at 15% for close relatives and 36.25% for others. Spouses are exempt.	Yes. From 2011 newly build property will be subject to full VAT. Resale is not taxed.	Sale and lease of property is exempt from VAT.	25%	2009, every 2 year.
Estonia	Yes. Land tax levied on market value of land at a rate of between 0.1% and 2.5%. Tax base has not been updated since 2001.	. .	No	No	No	20%	2001
Finland	Yes. 0.22-0.5 per cent of the taxable value of the property depending on the municipality.	No	No	No. Construction services are taxable at 22%.	No	22%	2009
France	Yes. Two types of taxes: a property tax (taxe foncières) and a residence tax (taxe d'habitation).	Yes. Net wealth tax on market value of assets exceeding EUR 790 000, rate ranging 0.55-1.8%. A deduction of 30% is granted for the principal residence.	Yes. Tax free allowances: Spouses EUR 76 000; Between parents and/or children: EUR 46 000.	Exempt for first transfer of dwelling occurring within 5 years of completion. Otherwise taxed at 19.6%.	. .	19.6%	1970, none.
Germany	Yes. Real estate tax on the fiscal value at a federal rate of 0.35%, multiplied by a municipal coefficient ranging between 100-900%. Average multiplier for Germany is 400%, implying a rate of 1.4%.	No	No	No selling. Yes for construction of new dwellings.	No	19%	
Greece	Single tax on real estate 3% on the objective value of the property which is situated in Greece and belongs to companies.	No	Yes	19%	. .	19%	

Table 2.A1.2. **Housing related taxes: Property, wealth, inheritance and consumption taxes** *(cont.)*

	Recurrent taxes on land and buildings	Wealth tax	Inheritance tax	General consumption tax – VAT			Cadastral value (year and frequency of updating
				New dwellings	Other dwellings	Other durable goods	
Hungary	Yes. Building tax: HUF 1 241.29 per m^2 or 3% of fair market value. Land tax: HUF 275, 84 per m^2 or 3% of fair market value.	No.	Yes	25%	No	25%	
Iceland	Yes	. .	Yes	Yes	No	Yes	2009, annually.
Ireland	Yes. A local charge of EUR 200 per dwelling payable by owners of private rented accommodation, holiday homes and other non-principal residences.	No	Yes. Taxed at 25% on amounts over EUR 414 799 for inheritances by children, EUR 41 481 for other relatives, and EUR 20 740 for others. Dwelling houses except in certain circumstances.	13.5%	. .	21%	. .
Israel	No	No	No	. .	. .	. .	. .
Italy	Yes. Primary residence exempt from real estate tax provided it is not deemed a luxury residence. Tax depends on the Municipal Council and it varies from 0.4% to 0.9%.	No	Yes	10%	No	20%	. .
Japan	Yes. Two taxes: A municipal tax levied at 1.4% of the assessed value of the land or building. City planning tax is levied within the range of 0.3% or less on the assessed value of the land or building.	No	Yes	5%	5%	5%	2009, every 3 year.
Korea	Yes. Property tax levied on the standard value of the property. 0.2-0.5% for land; 0.25 for buildings; and 0.1-0.4% for houses.	No	Yes	0 or 10%.	0 or 10%.	0 or 10%.	2008, annually.
Luxembourg	Yes	No	Yes. Inheritance in direct line of the deseased are exempt from tax. For others, the tax varies between 2-15%.	3%	No	15%	. .

Table 2.A1.2. **Housing related taxes: Property, wealth, inheritance and consumption taxes** *(cont.)*

	Recurrent taxes on land and buildings	Wealth tax	Inheritance tax	General consumption tax – VAT			Cadastral value (year and frequency of updating
				New dwellings	Other dwellings	Other durable goods	
Mexico	Municipality tax ranging between 0.05-1.2% of the cadastral value.	No	Yes	No	No	16%	. .
Netherlands	Yes	Secondary homes are subject to tax.	Yes	Taxed at 19%. Exempt if newly constructed dwelling sold at least 2 years after first actual use.	No	19%	2008, annually.
New Zealand	No	No	No. A gift duty is imposed on the donor at a rate between 5-25% of the gift value.	Taxed at 12.5%.	Taxed if vendor GST registered.	12.5%	varies, annually/ every 3 years.
Norway	Yes. Tax rate at 0.2-0.7% of value of the assessed value, which is usually 20-50% of fair market value.	Yes. Net wealth in excess of NOK 700 000, subject to national tax is levied of 0.4% and a municipal tax is levied at 0.7%.	Yes	25%	No	25%	2010, annually
Poland	Yes. Rates range in 2009: PLN 0.37-0.62.	No	Yes. 3-20% according to degree of relationship and value.	New houses less than 300 m^2 and apartments less than 150 m^2 will be subject to 7% VAT. Additional surface will be subject to standard 22% VAT rate.	No	22%	. .
Portugal[2]	Yes	No	No	No	No	20%	. .
Slovak Republic	Yes. Land tax levied at 0.25% of tax base, which is a fixed value per square meter, last adjusted in 2004. Tax on buildings and apartments is EUR 0.033 per m^2.	No	No	19%	19%	19%	. .
Slovenia	Yes. Land and building compensation duty is levied by municipalities on owners and users (renters, etc.) of land and buildings. For owner-occupiers, the first 160 m^2 of a dwelling is exempt. Tax rates range from 0.1-1.5% of the value of the property.	No	Yes	Taxed at 8.5%.	. .	20%	. .

Table 2.A1.2. **Housing related taxes: Property, wealth, inheritance and consumption taxes** *(cont.)*

	Recurrent taxes on land and buildings	Wealth tax	Inheritance tax	General consumption tax – VAT			Cadastral value (year and frequency of updating
				New dwellings	Other dwellings	Other durable goods	
Spain		No	No	Taxed at 7%. Social dwellings promoted by public developers taxed at 4%.	No	16%	. .
Sweden	Yes. Municipality fee based on the assessed value of the property, with a maximum of SEK 6 387 or 0.75% of assessed value for single family houses (SEK 1 277 or 0.4% of assessed value for apartments owned by residents associations). New buildings are exempt from the fee for the first 5 years.	No	No	Full VAT on production costs.	. .	25%	2007/2009, every 3 years.
Switzerland	Yes	Yes, at cantonal level.	Yes				Every 5 years.
Turkey	Yes	No	Yes. Progressive rates with tax free allowances for close/immediate family.	1% on properties < 150 m^2 and 18% on properties over 150 m^2.	. .	18%	. .
United Kingdom	Yes. Owners and renters must pay a Local Council tax based on assessed or imputed value of the property in April 1991.	No	Yes. Levied at 40% on the value of estates above Pounds 255 000.	No VAT on construction of dwellings but materials/labour for any repairs/ extensions attracts tax of 17.5%.	Reduced rate of 5%.	17.5%	1991, no plans.
United States	Yes. Local tax.	No	Yes. Will be re-imposed in 2011.	Very rare, 2-3 states.	Very rare, 2-3 states.	Yes. Sales tax, rate depend on state.	varies by city/ county.

1. Information for Canada is non-verified.
2. Information for Portugal is non-verified.
Source: OECD Housing Market questionnaire.

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