

The Importance of Human Capital and Institutions in an Economic Reform Process: A Comparison of Two Programs*

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Abstract

While the Klein & Saks team was working in the country, the Pontifical Catholic University of Chile entered into an academic agreement with the University of Chicago under the auspices of the U.S. government. The economists formed under this program would be very influential in Chile, as part of a new economic reform plan, since the mid-1970s. As we compare these programs we argue that one of the reasons why the Klein-Saks mission ultimately failed was because it did not articulate a critical mass of economists invested in their agenda. Together with institutions, human capital should be considered as an important element of a successful economic reform program.

Keywords: Economic history of Chile, human capital, institutions, economic reforms.

Introduction

During the 1940s and 50s, persistent inflation was a standard feature of the Chilean economy. This chronic nature of inflation would lead, over the years, to the implementation of a number of stabilization programs which, in turn, had fairly dissimilar degrees of success. However, in 1955, when the inflation rate for the first time reached particularly high levels in the country, the government of President Carlos Ibáñez del Campo decided to hire a team of foreign consultants to implement a (new) economic stabilization program. Although he officially took over in November 1952, by March 1955 Ibáñez had already appointed six different Ministers of Finance (Juan Bautista Rossetti, Felipe Herrera, Guillermo del Pedregal, Jorge Prat, Francisco Cuevas, and Sergio Recabarren), which obviously resulted in the implementation of different approaches to the country's inflation problems. This lack of perseverance and thus consistency in economic policy management led in 1955 to a critical situation prompting the government to make a drastic change in economic management. It is well known that the team that was eventually hired by the Chilean government was part of the Klein & Saks American consulting company, whose senior partner had had previous experience in economic consulting in Peru in the late 1940s. The mission arrived in Chile in September 1955, with the first results of their work becoming evident at the beginning of 1956, namely in terms of a reduction in the country's inflation rate.

* From: *Reformas económicas e instituciones políticas: La experiencia de la Misión Klein-Saks en Chile*, J.P. Couyoumdjian (editor), pp. 241-253.

It is worth noting that beyond their anti-inflation program the Klein-Saks Mission also developed a global reform program for the Chilean economy (Klein and Saks, 1958; see also Lüders in this volume). This program was not fully adopted, and several of the implemented initiatives did not last over time. As explained by Rolf Lüders, the costs of this inaction were eventually very high; consequently and in order to supplement Lüders' analysis, this article will address this issue. Specifically, it will be argued that one of the reasons why the global reform program failed is that the Klein-Saks Mission was not able to articulate a critical mass of economists advocating and persevering on such an economic reform project. In addition, the economic policy was influenced by changes in the political cycle, the latter being a strong barrier against the implementation of an adjustment and economic reform process in the country.

The Structural Weakness of the Klein-Saks Mission

Among several critical comments concerning the work of the Klein-Saks Mission while in Chile, the one made by Aníbal Pinto when the press announced that the Mission had been hired is especially noteworthy. In the magazine *Panorama Económico*, Pinto wrote,

No cases have been recorded where [missions of this kind] have rendered any benefits. And the reasons for this are very easy to see. General problems of an economic nature are deeply rooted in national life; they are inseparable from many political, social, historical, and other phenomena that go beyond the specialized scope of economists and even more of foreign experts. In this area, the blueprints of experts trained in their own schools, nurtured by idiosyncratic experiences, and lacking any solid knowledge of economic development problems will always be food for moths (*Panorama Económico* No. 126, July 15, 1955).

This expert mission would thus represent the epitome of the 'visiting-economist syndrome' (Hirschman, 1986), i.e., of the work of foreign experts acting as consultants in a given country, proposing global solutions based on rather basic knowledge of the real situation of the country itself. This is the original sin of foreign expert teams, which is compounded by the fact that the countries receiving their recommendations feel that they are imposing an external view that can even be alien to the actual local conditions¹.

Beyond this issue, there are a couple of additional aspects arising from this quote that are worth discussing here. On the one hand, it is important to consider that this disdain for the work of missions offering comprehensive economic solutions for macroeconomic problems runs counter (even for Aníbal Pinto himself, further in the quoted article) to a positive evaluation of the work carried out by teams comprised of technical consultants invited to discuss more specific matters. In other words, there are different areas and levels in international consulting work which may be more or less valuable for the receiving

¹ This seems to be a constant feature of programs such as this one. As explained by P. T. Bauer (2000), this has been the problem with many assistance programs implemented by international agencies in developing countries during the 20th century.

countries. In any case, more specific problems require other kinds of specialists, whose performance and relationship with the local public administration will also be different.

On the other hand, the previous quote also points out the importance of developing a critical mass of supporters for the success of comprehensive international economic missions in a country. Unless there is previous political support for it, the proposed reform program will be short-lived (see also Hirschman, 1963). In this sense, we are faced with the paradox that the key component of a foreign expert team's reputation, i.e., its independence from internal political considerations, is also a big constraint on its influence capacity.

The Klein-Saks Mission had clear weaknesses in these areas, particularly due to a lack of political support, being practically dependent on President Ibáñez's anti-inflation will and conviction (which would also prove to be rather weak). Likewise, its dependence on foreign professionals was evident. Each time the mission work extended (note that its work was initially planned for a period less than a year, but it extended for several years), the implementation of the corresponding task forces had to be addressed several times in order to "ensure the availability of appropriate personnel"². This task force implementation problem was largely due to the fact that the mission's relationship with the local bureaucracy was quite limited. It could certainly be argued that this drawback resulted from a scarcity of local human capital in Chile; after all, the members of the foreign consulting team had significant experience in economic and financial matters, which qualifications may have been difficult to find in Chile at that time, when the capital market was constrained by existing regulations and the professionalization of the economy, especially as regards public policy-making, was just in its inception³.

Anyway, as the then Minister of Finance, Oscar Herrera Palacios, would recall in a conversation with Albert Hirschman in 1961, this Mission was comprised of too many short-term experts, being successively changed after working during brief periods of time⁴. This evidences a very clear limitation of the mission's work in creating a permanent team of technical experts involved and engaged in the reform process that was being undertaken.

² These were the words of J. Prescott Carter in a letter to the Minister of Finance Oscar Herrera Palacios with respect to an extension of the Mission's contract; see J. Prescott Carter to Minister Oscar Herrera Palacios; Santiago, April 2, 1956.

³ The (initial) list of Mission members, led by J. Prescott Carter, former officer of the First City National Bank of New York, and including L. Werner Knoke, Philip Glaessner, William E. Schmelze, Robert Carlyle Beyer, and Thomas H. Lockett, the Mission's Executive Secretary, was published in the national press before the Mission landed in Chile. The information, accompanied by a brief biography of each member, was published in the newspaper *El Mercurio*, on September 1, 1955.

⁴ Princeton University, Mudd Library, Albert O. Hirschman Papers, Box 40, Folder 3 (Chile –Interviews, 1961).

Meanwhile ...

In 1956, during the government of President Carlos Ibáñez del Campo, another event that would have a key impact on the Chilean economic history occurred: the Dean of the Faculty of Trade and Economic Sciences, Julio Chaná, and the head of the U.S. Technical Cooperation Program in Chile, Albion W. Patterson, signed a cooperation agreement between the University of Chicago and the Pontifical Catholic University of Chile, under the sponsorship of the United States government (Vial 1999). As a result of this agreement, renowned American professors visited Chile and dozens of Chilean professionals undertook postgraduate studies in both economics and business programs in this prestigious American university⁵.

In the following decades, the national economy changed dramatically due to this agreement because it resulted in a change in the human capital trained in the areas of economics and business administration. In addition, when in 1974 some of the economists who had studied at the University of Chicago went into public service by working in ministries related to the economic and social areas under the military government, these ideas were turned into public policies (Larroulet 2007).

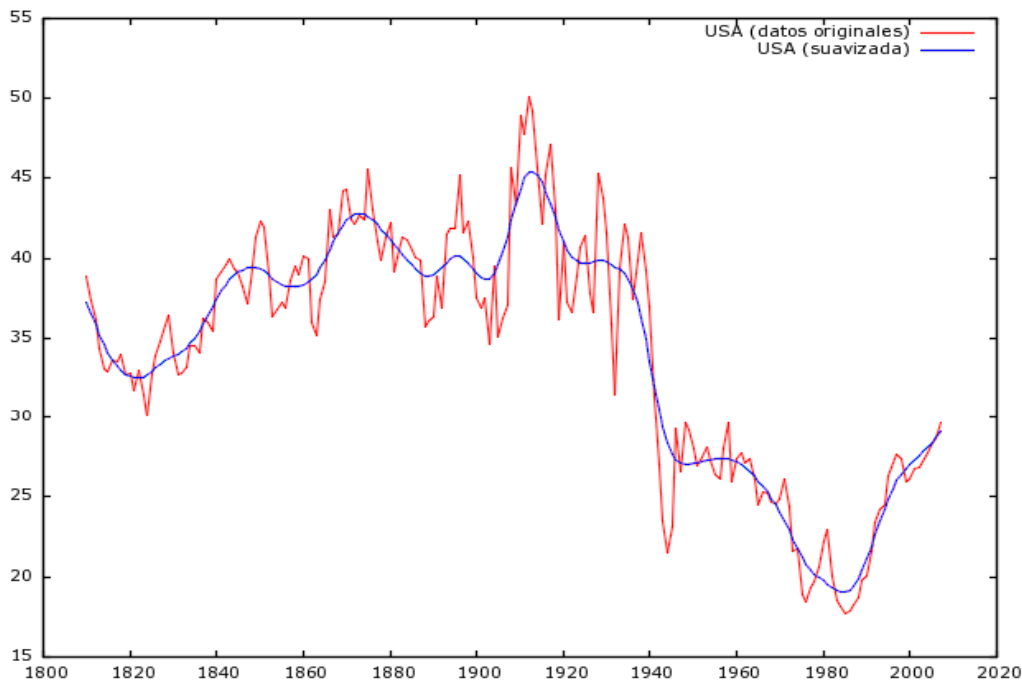
Concerning the first point, thanks to the influence of the economists from the University of Chicago, a clear change in the teaching of economics was evidenced, the latter currently being addressed according to a consistent model of a free market economy and other financial and accounting topics. In this way, the agreement had a decisive impact on the modernization of teaching programs in both the Catholic and other Chilean Universities (Larroulet and Domper 2004). Thus, the course programs, readings, and recommended texts progressively came to be the same as those taught at the most prestigious universities in the world.

When these economic management ideas had the chance to be turned into public policies, a favorable setting for the implementation of a free market economy in the country was established⁶. In this period, the emphasis was not only placed on training economists with the required human capital, but another stage was undertaken: setting the policies and institutions that would make development possible. This resulted in a break in the economic growth trend in Chile (see also, Galetovic 1998, Larroulet 2003, and Lüders 1998). This process is clearly illustrated in Figure 1, which precisely shows the convergence of the Chilean economy (in terms of GDP per capita) towards the development levels attained by the United States economy in the early 1980s.

⁵ In Chile, American professors also participated in the economic discussions of the time, including debates on inflation issues; for more information on this topic, see, for example, the work of John Deaver (No. 164, April 12, 1957) in the magazine *Panorama Económico* and the discussions between Flavián Levine and Martin Bailey (No. 159 and 160, December 28, 1956 and January 1957).

⁶ The document *El Ladrillo* shows the role of these professional teams during this process; for more information on this document, see id (1992) and Fontaine (1988).

Figure 1
 Long Run Economic Growth: Per capita GDP CHILE/ Per capita GDP USA - Convergence



Source: Lüders (1998)

As observed in the previous figure, this process of implementation of appropriate public policies has persisted since the return to democracy in 1990. The governments of the *Concertación* coalition, whose leaders had criticized the economic reforms implemented during the 1970s and 80s, kept the foundations of these policies and their fundamental institutions. Moreover, they made sure that public office positions in the economic area were held by professionals with postgraduate degrees from highly prestigious international universities. In other words, we can raise the hypothesis that a positive externality of the agreement between the Pontifical Catholic University of Chile and the University of Chicago has been an improvement in the quality of teaching, public debate, and economic and business policies.

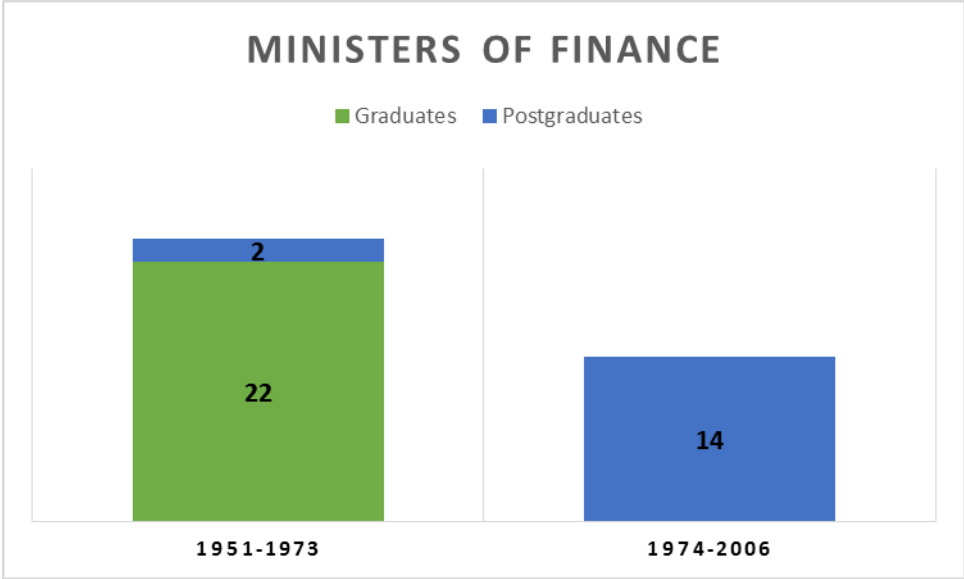
Two facts illustrate this statement. The first is the verification that, according to the latest ranking published by *América Economía*, five Chilean universities are among the ten MBA programs with the best academic staff in Latin America⁷.

On the other hand, this can also be noted from the professional training of the highest economic authorities in Chile over time. As shown in Figure 2, illustrating the evolution of the academic background of Chilean Ministers of Finance over the past 50 years, between 1974 and 2006 all the ministers had a Master's or PhD degree. This fact attests to the

⁷ *América Economía*, June 2009.

professionalization of the economy in Chile during the 20th century (Montecinos 1998, Silva 2009). Anecdotal evidence on the professionalization of public agencies in other levels (including the advisory teams of the highest economic authorities) must also be taken into account here.

Figure 2



Source: based on *América Economía*

A Comparison of Two Programs

The existence of a sound political institutional framework is a sufficient condition to implement an economic reform program; however, the availability of a solid economic team and a critical mass of economists with the required human capital is an essential condition as well.

General Carlos Ibáñez del Campo did not have the necessary conviction to implement the reforms proposed by the Klein-Saks Mission. Almost two decades later, General Augusto Pinochet did have such conviction; however, perseverance in the reform program was a very complicated issue at several moments, especially after the crisis of the 1980s (Fontaine 1988). Obviously, there are significant differences between the existing political settings in these two periods that may have influenced the behavior of those who ruled the country. This is also associated with considerations of an institutional nature. By mid-1950s, Chilean economic policy was exposed to several sectoral pressures. Therefore, the vested interests associated with the entrepreneurial state led economic policy to critically depend on political balances in the National Congress (Ibáñez 2003). Without a fiscal or monetary constitution constraining political influence on economic policy management in the

country, economic management could not lead to an actual process of economic reforms focused on development⁸.

On the other hand, there is another difference between these episodes which has not been sufficiently highlighted. The argument presented here is that, beyond other considerations, the Klein-Saks Mission did not generate a critical mass of professionals supporting and persevering in the proposed reform program (and this human capital did not previously exist). The critical mass concept applied here is that used by Thomas Kuhn (1962); this concept implies recognizing and emphasizing the role played by all the parties (and stakeholders) involved in economic discussions in terms of adopting current paradigms. Arnold Harberger (1993) has highlighted the key role played by a group of 'heroes' in the reforms implemented in the country during the 1970s and 80s. It may be added that the 'Chicago Boys' team generated an actual paradigm change in Chile. This is an important factor in explaining their success.

⁸ Regarding the idea of a 'fiscal constitution', see Buchanan and Brennan (2000) and Buchanan (1999). In this sense, the economic reforms implemented during the military government transformed the political and economic institutional framework, strengthening the right of ownership and establishing the State's subsidiary role in the economy.

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