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**Chile: Economic Freedom
1860-2007**

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CHILE: ECONOMIC FREEDOM 1860-2007

This research built an index that permits evaluating the kind of economic freedom that has prevailed in the country from 1860 to 2007.

In order to perform this analysis, we defined indicators to measure policies and institutions that are crucial for development and that are considered in other studies about economic freedom, such as that developed by the Heritage Foundation's Fraser Institute that place Chile among the fifteen countries in the world with greatest economic freedom. These indicators are: the size of the government, a state that respects the rule of law and proprietary rights, inflation and healthy money, and international free trade.

The results of the study are conclusive regarding the existence of three (3) distinct periods in the economic history of our country. The first of them emerges during the 19th century and shows a continuous expansion of economic freedom and concludes toward the beginning of the 20th century. Then, beginning on the second decade of the 20th century, a new stage emerges with a reduction of economic freedom reaching its lowest point in 1973.

In the second part of this research, we relate economic freedom with the poverty percentages and per capita GDP values existing in each period, concluding that those periods with the greatest rating of economic freedom coincide with those of the country's greatest development and progress.

CHILE: ECONOMIC FREEDOM 1860-2007

I. Introduction

Economic growth is mostly attributable to the accumulation of factors of production and their more efficient use. This is achieved through capital stock increments via increased rates of investment. Also, through a greater number of persons willing to work and do things better thanks to their human capital.

But that's not all. The idea is that such factors; i.e. Work and Capital perform better; namely, become more productive. Consequently, we need free markets, the right to property, the rule of law, and macroeconomic equilibrium policies¹. In sum: economic freedom. The countries that have developed are those which - throughout their history- have had policies and institutions that promote such elements.

In order to measure economic freedom, we need to build an indicator. There are two different institutes that perform this sort of work in the world: the Heritage Institute, in the United States and the Fraser Institute in Canada. Despite applying somewhat different methodologies, they both assess economic freedom performance in countries and rank them according to their respective classification.

Our country, Chile, is not alien to the evaluation of these indicators; moreover, it is currently ranked among the top 15 countries that show greater economic freedom, according to such institutes. However, have we always performed in that manner? How has Chile performed -in terms of economic freedom- throughout its history?

¹ Larroulet, Cristián, "Políticas Públicas para el Desarrollo". Estudios Públicos 91, (Winter 2003). Pp.162-163.

These are questions worth asking and seeking answers to, especially when considering that Chile has applied very different economic models and policies.

With this purpose, we submit this study that evaluates Chile's economic freedom from 1860 to 2007. In order to carry out this analysis we defined indicators that measure policies and institutions that are crucial to achieve economic development and that are included in the economic freedom studies. In the second part of the study, we relate economic freedom to variables that measure economic welfare.

II. What are we going to measure?

The Fraser Institute uses 5 fundamental areas in order to develop this index and measure the degree of economic freedom; namely, (1) size of the government; (2) constitutional state and security of proprietary rights; (3) low inflation or access to healthy money; (4) free international trade; and (5) credit, work and business regulations. Each of these areas, according to the formula submitted, gets anywhere between 0 to 10 points; subsequently, the points of each area are averaged in order to obtain the final value of the freedom index for any given year.

All 5 areas represent a solid foundation in explaining economic growth and prosperity; reason why they were selected to evaluate the quality of the institutions and the economic policies applied.

In the first place, the size of the government is an indicator of the role played by the State in the economy and the room that it leaves for private initiative to make its own

contribution. Countries with a democratic system of government and low corruption, where the State does not tax individuals (through taxes or other instruments) excessively, provide stimulation for investments and innovation. In spite of that, the State must provide certain public goods –in addition to fiscal control and supervision- by protecting consumers from monopolies and minimizing negative externalities.

Then, the juridical and political structure required to have a Constitutional State to honor proprietary rights, also plays a key role in economic growth. The respect of proprietary rights incites to save, to invest and to trust financial institutions². The more such institutions are trusted, the greater will be the deposits and the amount of investments in the country. In turn, the image generated by an appropriate juridical structure and proprietary rights induce foreign investors to see investment opportunities in the country, which will eventually translate into increased domestic production.

Low inflation or access to healthy money, achieved with adequate macroeconomic policies, is fundamental to investments, employment and productivity. A stable macroeconomic policy that seeks equilibrium in monetary fiscal accounts provides adequate foreign account financing and ensures price fluctuation stability and stimulates entrepreneurship. On the other hand, freedom in international trade enables countries to develop on the basis of their comparative advantages. Thus, they specialize in the production and export of those goods & services that are less expensive for them and of a better quality. Moreover, this takes advantage of economies of scale, given increased production volumes thanks to access to international markets, which also triggers the advent of new technologies and stimulates competition.

Finally, excessive regulations in the credit, labor and business markets may stall economic growth via rules & regulations that limit market entry and the freedom to participate in voluntary exchanges. Excessive or poorly designed credit market regulations prevent good resource allocation and make competition difficult, thereby discouraging investments.

Excessive or erroneous regulations in the labor market thwart free agreements between employers and employees. A labor market with scarce but good regulations promotes a better circulation of labor, the quality of workers and better human capital. With respect to regulations of the business market; those countries with less bureaucracy and business start-up procedures promote investments, since their initiation costs are lower and have greater freedom to innovate³.

In this manner, the variables mentioned relate to economic freedom, and when the latter is higher it generates a better environment for entrepreneurship, innovation, work and investment thereby making economic development possible.

In building the 1860 -2007 Economic Freedom Index for our country, we will apply the above-depicted concepts grouped into 4 different variables, given the paucity of accurate historical data.

Consequently, we will elaborate our index considering: (1) the size of the government; (2) an indicator to enable appreciating the level of the rule of law and the security of proprietary rights; (3) inflation or the access to healthy money; and (4) the international trade freedom.

1) The size of the government:

In measuring this variable, we will apply a methodology aimed at obtaining fiscal expenditures including consumption, investment and transfers as a percentage of GDP.

The qualification of this component is equal to: $(V_{max} - V_i) / (V_{max} - V_{min})$ multiplied by 10. V_i represents each year's fiscal expenses. On the other hand, V_{max} and V_{min} are obtained from the maximum and minimum values of the entire 1860 - 2007 series, thus obtaining a V_{max} of 33 and a V_{min} of 4.

Those periods with a greater proportion of government expenses are allocated fewer points, since they entail taxes and regulations that hinder entrepreneurship.

² Olson, Mancur, *Power and Prosperity*. ("Poder y Prosperidad"). La Superación de las Dictaduras Comunistas y Capitalistas". Siglo XXI Editores, Argentina. Abril 2001.

³ Gwartney, James; Lawson, Robert. "Economic Freedom of the World: 2008 Annual Report, 2008. Pp 6-7.

2) Rule of law and proprietary rights:

Since we lack a historical series of indicators to measure this variable⁴, we will use an indicator which, according to specialized literature, enables appraising it indirectly. It has to do with measuring the confidence of banking institution agents by observing the percentage of deposits in the monetary supply. In other words, we calculate an institutional quality index that measures the relation:

$$(M2 - C) / M2$$

where M2 is private money and C is cash.

Then, in order to be consistent with our index, we will perform the same procedure performed at the time of obtaining the size of the government: we will apply the $(V_{max} - V_i) / (V_{max} - V_{min})$ formula multiplied by 10. On the other hand, the V_{max} and V_{min} values are set at 0.99 y 0.04, respectively, which are obtained from the series corresponding to the 1860 - 2007 period. In this manner, we will get a value between 0 and 10 in order to be able to subsequently weigh it against the other components and thus end up with our liberty index. The idea behind this indicator is that the way in which financial assets are kept depends on how proprietary rights are established. When economic agents believe to be operating in a stable environment, where proprietary rights are well defined and guaranteed, it is not risky to keep assets in deposits accounts and, consequently, keeping cash becomes a less attractive option. Thus, the proportion of deposits in the monetary supply will tend to increase. A better compliance with such rights will promote investments and will, therefore, lead to higher growth rates. The opposite situation, namely, one in which it becomes risky to keep money deposited in financial institutions, is caused by a poor delineation of the institutional structure⁵.

Thus, the indicator will tend to increase when economic agents trust that contracts will be honored and performed within an environment regarded as safe; consequently,

⁴ Actualmente se utilizan indicadores como la independencia judicial, la imparcialidad de los tribunales, la integridad del sistema jurídico, el cumplimiento legal de los contratos y la regulación sobre las restricciones a la venta de bienes de propiedad para medir el grado de protección que las leyes brindan a los derechos de propiedad privada y el grado en que el gobierno las hace cumplir; pero estas variables no presentan series muy antiguas para poder ser utilizadas en el análisis que pretendemos realizar.

⁵ Prados de la Escosura, Leandro; Sanz Villarroja Isabel. "Contract Enforcement and Argentina's Long-Run Decline". Universidad Carlos III de Madrid. Working Paper in Economic History, Septiembre 2006. p. 3.

there will be a greater proportion of the money supply deposited in financial institutions.

3) Inflation or healthy money:

Through this component we will attempt to measure the macroeconomic policies implemented during the period under analysis; this is why we will use the Consumer Price Index (IPC, in its Spanish acronym) to obtain each year's rate of inflation.

The values between 0 and 10 are obtained from the $(V_{max} - V_i) / (V_{max} - V_{min})$ formula multiplied by 10. V_i represents the rate of inflation as an absolute value during the corresponding year. The V_{max} and V_{min} values were set at 606% and 0%, respectively; thus, the lower the inflation the higher the rating. Those periods that manage to achieve price stability are rated 10. On the other hand, when the rate of inflation creeps toward the series' maximum end, the rating moves toward 0.

4) International trade freedom:

In this component we attempt to measure the country's commercial policy throughout all these years. Thus, we evaluate tariffs and other trade barriers eventually affecting imports and exports. To that effect, we fixed our formula to represent such values, which is how we obtain values between 0 and 10. In this manner, we use the weight obtained through exports (X) plus imports (M) as a percentage of the GDP. Then, we obtain the values between 0 and 10 by means of the $(V_{max} - V_i) / (V_{max} - V_{min})$ formula multiplied by 10; where, V_i is set at: $1 - (X + M) / PIB$. On the other hand, the V_{max} and V_{min} values are fixed at 0.82 and 0.13, respectively, which are obtained through the 1860 – 2007 value series.

The higher the freedom to trade with the rest of the world, the higher the incentives to export and import; reason why the rating will also be high.

III. Results

Chart N° 1 shows the evolution of the index from the year 1860 to the present. Three (3) trends can be clearly discerned. The first is evident during the 19th century, which shows a persistent increase toward economic freedom ending toward the beginning of the 20th century. Then, as of the second half of the 20th century, begins a period of decreased economic freedom that peaks in the year 1973. And, finally, beginning on that same year, this trend is reversed, and economic freedom appears to increase systematically up to this date.

Chart N° 2 shows that for those periods that share results, the freedom index that we prepared and the Fraser Institute's freedom index that they prepared for Chile (1970, 1975, 1980, 1985, 1990, 1995, 2000 – 2006) are indeed quite similar. The fact that the correlation between both indices is 0.95 validates the methodology used in preparing our own index. The correlation between the periods that are common with the Heritage Foundation's index (1995 – 2007) is 0.83. Therefore, both results are very similar.

In line with what we stated above -in the sense that our index clearly shows three (3) different economic freedom periods in our nation's history- below we submit a more detailed analysis of each of such periods.

First period (1860 – 1918):

Throughout this period one is able to observe that index ratings grow as we move forward in time. Thus, we went from a rating of 5.08 points in 1860 to 8.16 points in 1918. On the average, therefore, the average economic freedom rating for the period is of 6.22 points.

- **Government size.** The size of the government has been expanding over time to an average of 9.42% of GDP, which leads to an average economic freedom index of 8.13 points.
- **Proprietary rights.** This indicator expanded from 5.0 up to 8.08 in 1918. There is increased confidence, which is reflected in increased sight and time deposits, obtaining quite high ratings in the index during the years 1906 to 1923 (close to

8).

- **Inflation.** The rate of inflation is quite low, averaging 3.33% between 1860 and 1918; which translates into an average of 8.89 points at the level of the economic freedom index.
- **International trade freedom.** On the other hand, exports and imports also expanded in relation to the GDP. Similarly, the average tariff rate hovers around 20%, fluctuating between a maximum of 27.8% of GDP to a minimum of 11.7 in 1984.

The index of these variables over GDP increases from values close to 0 up to 5.42, all of which translates into an increase of the economic freedom liberty.

Second period (1919 – 1973):

During this period one may appreciate a considerable drop in the ratings provided by the economic freedom index, starting in 1919 with 7.33 points and ending in 1973 with merely 2.23 points at the bottom of the entire series analyzed.

- **Government size.** The size of the government expanded from a level of expense equivalent to 6.77% of GDP in 1919 to 32.34% of GDP in 1972. During this period, it is mainly the role of the State which was modified and, consequently, the economic model, all of which led to changes in most of the variables obtained from our study; dropping from a rate of 9.05 points to just 0.22 points in 1972.
- **Proprietary rights.** A portion of the nation's industries was nationalized and, despite the creation of the Central Bank of Chile, the promulgation of a Banking & Monetary Bill in 1925, the sub index points dropped to a rating of 4.83 in 1972, averaging 6.99 points. The change introduced into the country's economic system lowered the level of confidence in its institutions.
- **Inflation.** Another component that had an impact on the results of these years was the spiraling inflation, as compared with the preceding period. Inflation averaged 33.7%, peaking at 606% in 1973.
- **International trade freedom.** One of the most significant points in the results obtained of these periods relates to the trade policy that was established.

Toward the beginning of the 20th century the country began to feel the impact of the drop in saltpeter prices and of the Dutch disease caused by the effects of saltpeter. The foregoing, in addition to the protectionist forces unleashed following the 1929 financial crisis, generated pressures to guard against foreign trade. Moreover, the intellectual influence exerted to introduce an import substitution model led to a closing of the economy, thereby drastically reducing the economic freedom index.

to the country's unilateral international opening and the large number of free trade agreements that were negotiated. Import tariffs dropped to around 2% on the average. In sum, during this period, the country's percentage of exports & imports over GDP went from 26.2% in 1974 to 86.3% in 2007.

Third period (1974 – 2007):

During this last period, one is able to appreciate a huge difference with respect to the previous years. Here, we observe a continued rise in the values reflected by our economic freedom index, going from a rating close to 3.07 in 1974 to a rating of about 8.67 in 2007.

- **Government size.** Fiscal expenditures averaged 21.36% of GDP during this last period analyzed, which leads to an average rating of 4.01 points in the economic freedom index. The change in the role of the State –from a central planning role to a subsidiary role- permitted an expansion of economic freedom.
- **Proprietary rights.** This is the period in which we obtained the highest sub index average with a value of 8.65, reaching a rating of 9.92 in 2007, a very high rating indeed – even for developed countries. Clearly, consumers decided to keep their financial assets in the institutions thanks to the application of public policies akin to a state that honors the rule of law and the right to private property.
- **Inflation.** The country's macroeconomic policies began to progressively yield successful results, to the point that during this last decade the country recorded its lowest and most controlled rates of inflation of its entire history. Although the average inflation during the period was 42.86%, the country managed to drop its rampant 1975 inflation rate of 369% to one of 2.6% in 2007.
- **International trade freedom.** The foreign trade component stands out significantly over the other components considered in our analysis. The freedom to trade internationally was significant thanks mostly

IV. Historical relationship between economic freedom and development

Evidently, the indices that were obtained constitute a good way to evaluate the country's performance and welfare. Thus, just like the Fraser Institute study that evaluated the ratings obtained by each country comparing them to their respective poverty levels⁶, our work also compared some of the data obtained with the poverty percentages of each period. As it may be inferred from Table N° 2 and Chart N° 3, the correlation between economic freedom and poverty is of 0.91. This means that in the period elapsed between 1960 and 2006 the country's 10% increase in its economic freedom index goes in tandem with its 9.1% drop in its poverty percentage.

Another analysis that we can perform with the data thus obtained from our study is to compare the economic freedom index in relation to Chile's per capita GDP with that of other relevant countries, such as the United States.

Cuadro N° 2: Correlación entre Pobreza y Libertad Económica

Años	% de Pobreza	Índice de Libertad
1960	48	5,65
1965	46	5,45
1970	42	5,21
1975	51,5	3,14
1980	41,5	5,98
1985	48	5,72
1987	45	6,34
1990	37,5	6,78
1992	32,6	6,93
1994	27,5	6,97
1996	23,2	7,77
1998	2,17	7,98
2000	20,6	7,90
2003	18,8	8,10
2006	13,7	8,53

⁶ Gwartney, James; Lawson, Robert. "Economic Freedom of the World: 2008 Annual Report", Chapter 2: Economic Freedom and World Poverty. Fraser Institute, 2008.

Gráfico N° 3: Índice de Libertad e Índice de Pobreza

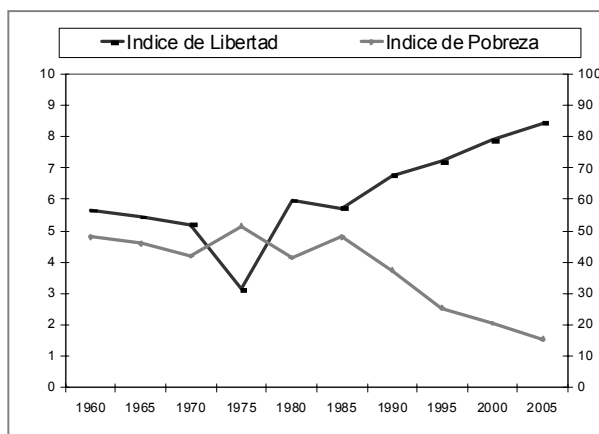
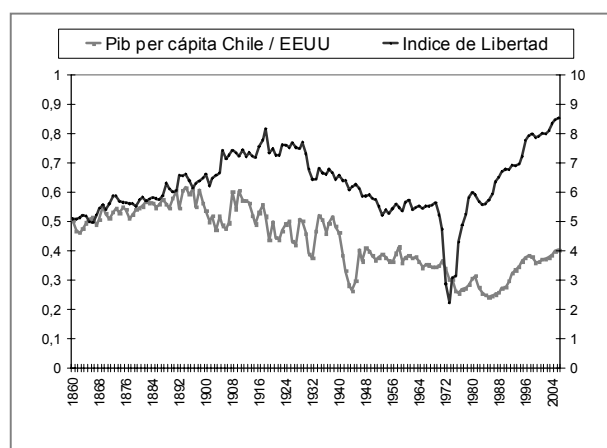


Gráfico N° 4: PIB per cápita Chile/EEUU e Índice de Libertad Económica



Source: Castro, Rodrigo. *Poverty level estimates. (Estimaciones de Niveles de Pobreza)*. Mimeo. Libertad y Desarrollo, 2008.

Chart N° 4 shows that in those periods in which the economic freedom index increases its rating, the relationship between Chile's per capita GDP and that of the United States also increases. Between the years 1918 and 1979, one may observe that Chile's GDP stagnates when compared to that of the United States⁷.

⁷ Lüders, Rolf. *Chile's Economic Growth: Lessons from History. ("Crecimiento Económico de Chile: Lecciones de la Historia")*. Administración y Economía, UC. Número 64, 2007, pp.11-15.

V. Conclusions

We designed an economic freedom index and applied it to the period comprised between the years 1860 and 2007 that enabled establishing three (3) distinct periods in Chile's history. In two (2) of them, the economic freedom index increased; although between 1974 and 2007 the index ratings increased significantly, between 1860 and 1918 economic growth was steadier and had a more stable trend, but with good ratings on the part of the index.

On the other hand, we have a period between the two ones indicated previously, from 1919 and 1973, which shows a systematic drop in the ratings of the economic freedom index.

As shown –which is not strange in the light of economic history- those periods with the highest economic freedom ratings coincide with periods of more progress.

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Series IPC:

1810 – 1995: Braun, Juan, Braun, Matías, Briones, Ignacio, Díaz, José, Chilean Economy 1810-1995. Historical Statistics. Working Document N°187, Catholic University Institute of Economics, January 2000, pp. 100-103.

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International Commercial Policy:

Export and Import Series:

1810 – 1995: Braun, Juan, Braun, Matías, Briones, Ignacio, Díaz, José, Chilean Economy 1810-1995. Historical Statistics. Working Document N°187, Catholic University Institute of Economics, January 2000, pp. 151-154.

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1996 – 2007: Central Bank of Chile, Statistical Database, National Accounts, http://si2.bcentral.cl/Basededatoseconomicos/951_455.asp?f=A&s=PibOrDsTc_A_Em1.

Proprietary rights:

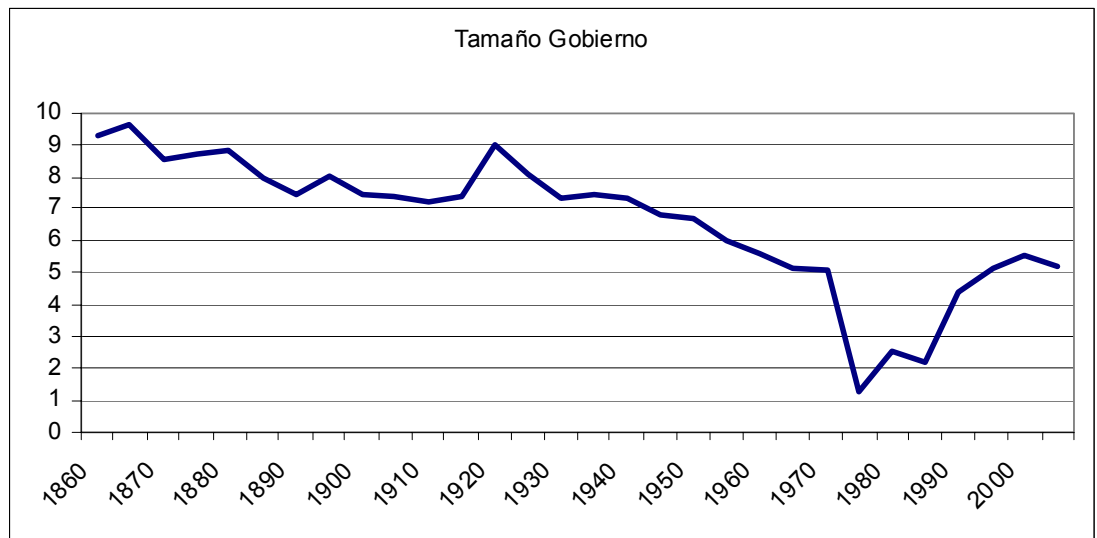
Series C y M2:

1860 – 2000: Jeftanovic, Pedro, Jofré, José, Lüders, Rolf, Paglia, Marcelo, Chilean Economy 1860-2000. Monetary Statistics. Working Document N°189, Catholic University Institute of Economics, April 2003, pp. 82-84.

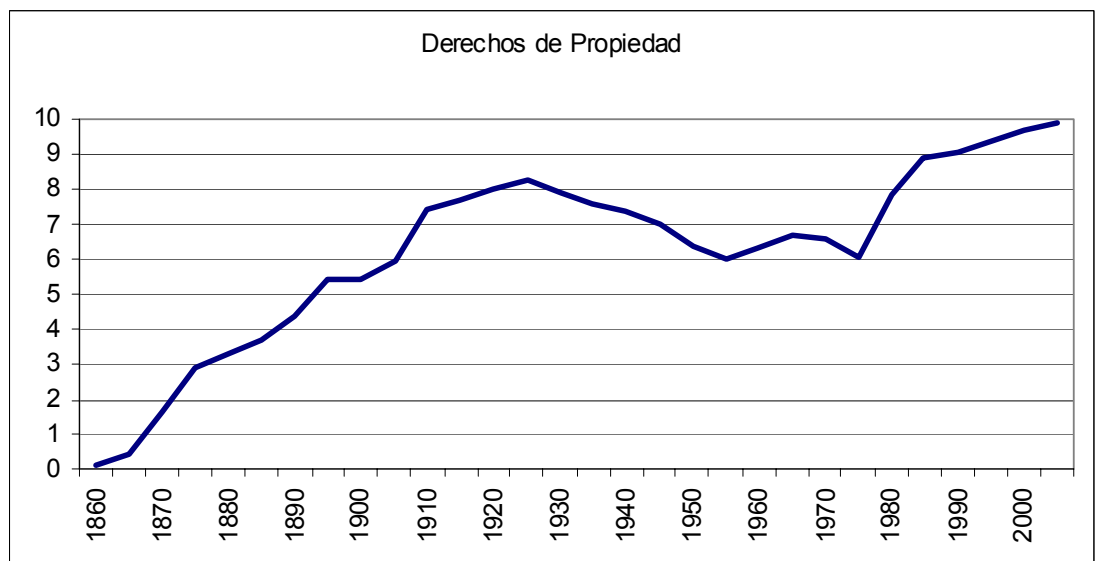
2001 – 2007: Central Bank of Chile, Statistical Database, Monetary Aggregates
http://si2.bcentral.cl/Basededatoseconomicos/951_417.asp?LlamadaPortada=SIDury

VII. Annex 1

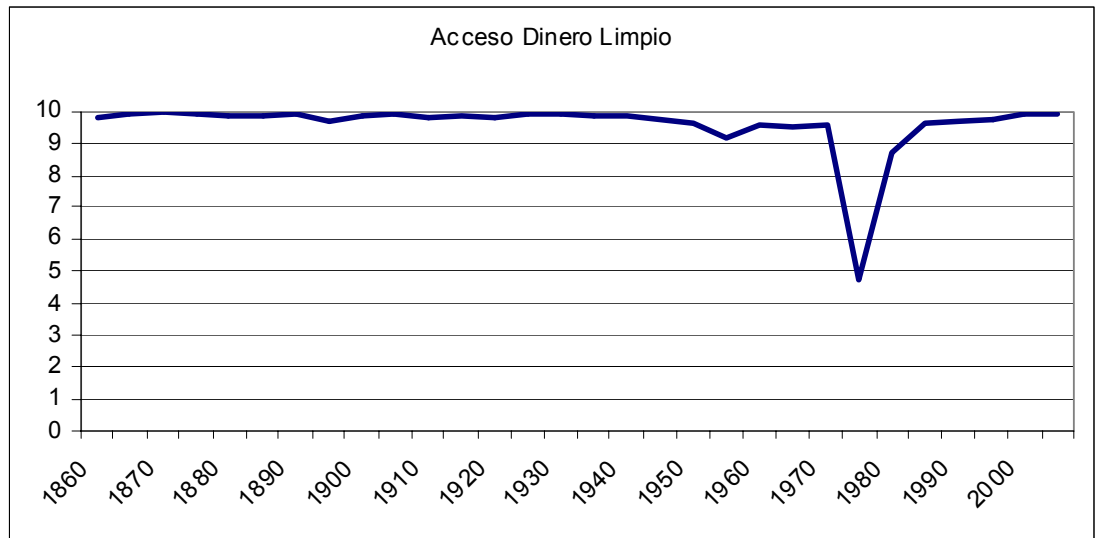
Below are charts according to a 5-year moving average, along with certain relevant data of each of the components considered in preparing the economic freedom index in Chile's history.



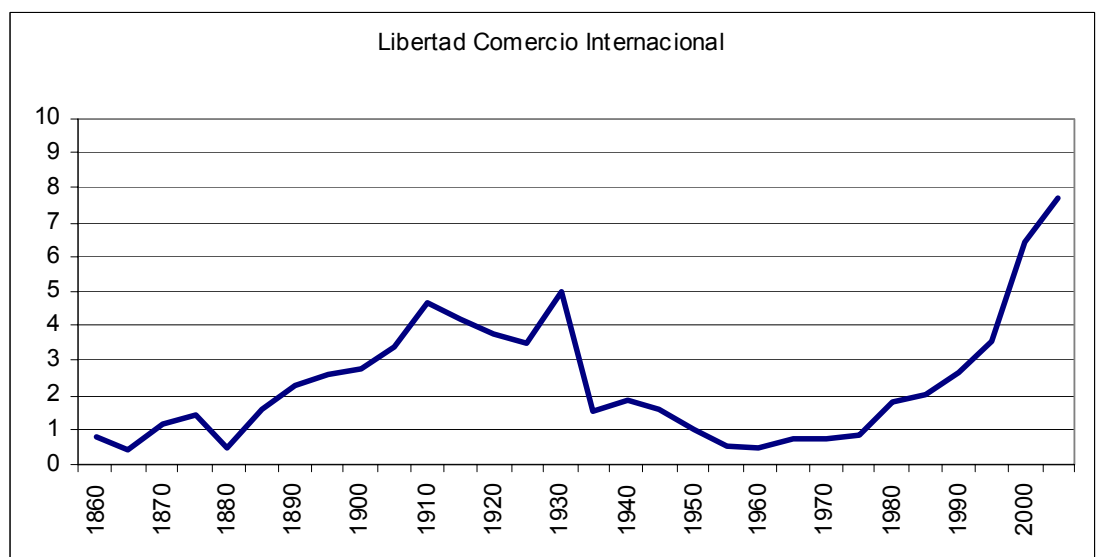
Years	Average%	Index Average	Max. Value	Min. Value
1860 -1918	9,423	8,130	9,909	6,424
1919 -1973	14,585	6,350	9,045	0,027
1974 -2007	21,363	4,013	5,831	0,669



Years	Average%	Average Index	Max. Value	Min. Value
1860 - 1918	0,43676	4,49219	8,18175	0,09195
1919 - 1973	0,67380	6,98734	8,46582	4,97995
1974 - 2007	0,86478	8,99769	9,91981	6,12920



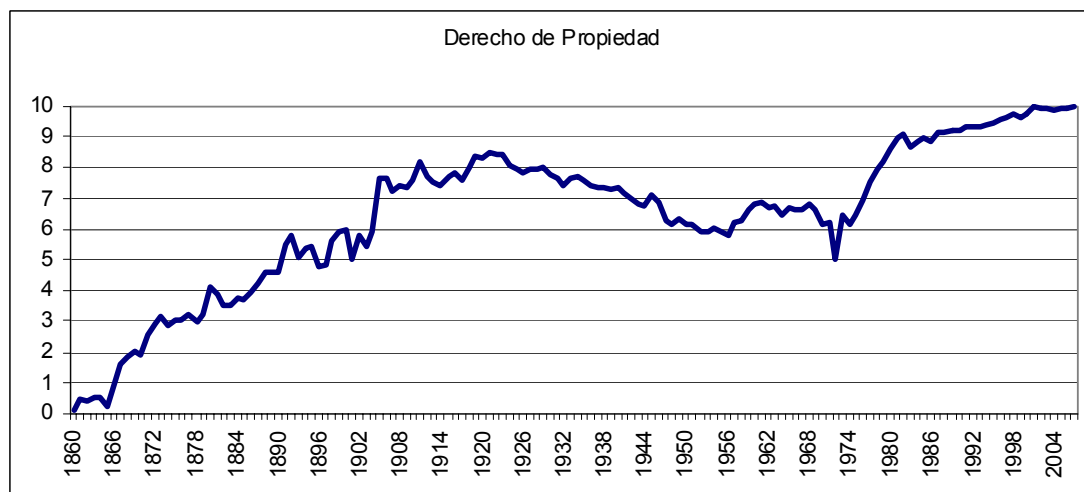
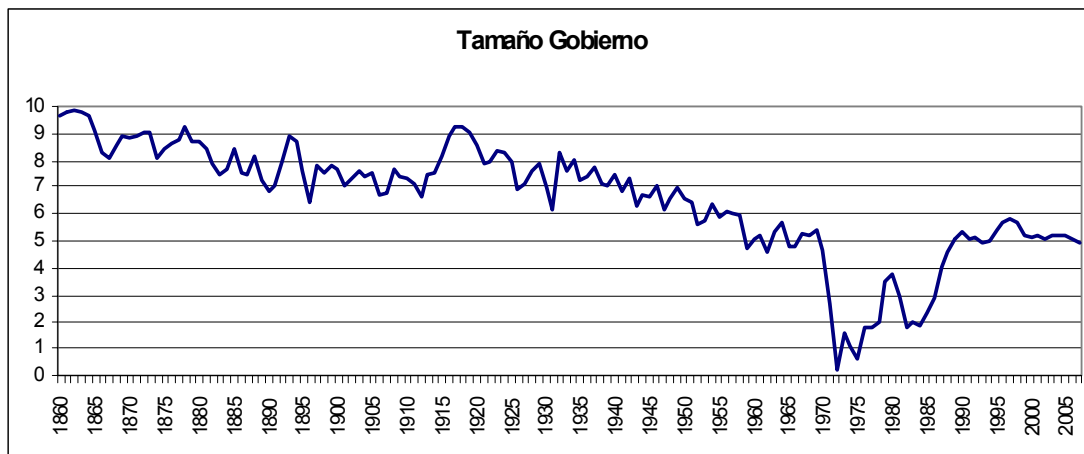
Years	Average %	Average Index	Max. Value	Min. Value
1860-1918	3,328	9,892	9,999	9,497
1919-1973	33,694	9,436	10,000	0,000
1974 - 2007	41,864	9,309	9,982	3,909

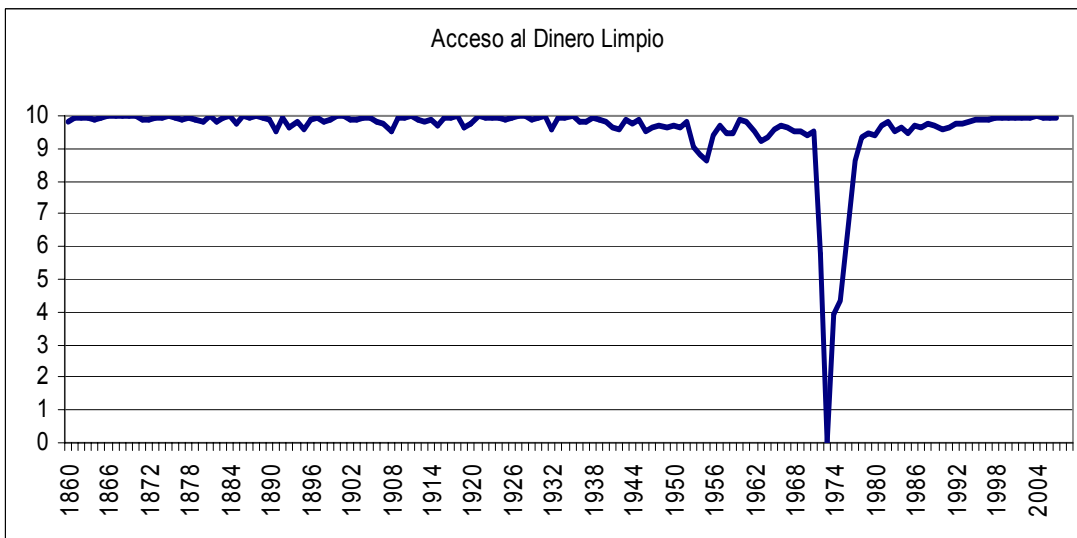


Años	Promedio%	Promedio Índice	Valor Máximo	Valor Mínimo
1860 -1918	0,342	2,348	5,419	0,100
1919 - 1973	0,296	1,678	6,086	0,074
1974 - 2007	0,470	4,203	9,894	1,163

VIII. Annex 2

Below are charts of each index component, according to the rating obtained in each period.





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