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**PRIVATIZATION IN CHILE**

**A HISTORY AND EVALUATION**

**AND A PROGRAM FOR FUTURE USAID ASSISTANCE**

**REPORT BY**

**Paul H. Elicker**

**CENTER FOR PRIVATIZATION  
2000 Pennsylvania Avenue, NW - Washington, D.C.**

**October 1988**

**Prepared for the  
BUREAU FOR PRIVATE ENTERPRISE  
U.S. AGENCY FOR INTERNATIONAL DEVELOPMENT**

# **CENTER FOR PRIVATIZATION**

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## PRIVATIZATION IN CHILE

### **A HISTORY AND EVALUATION AND A PROGRAM FOR FUTURE USAID ASSISTANCE**

#### EXECUTIVE SUMMARY

This report is a history and evaluation of the Pinochet Government's privatization program from 1973 to the present. It evaluates the favorable and unfavorable results of this program. Against this background it suggests several directions in which future programs of USAID assistance in Chile might go together with recommendations of how such programs might be implemented.

The report is supplemented by an appendix that is a more detailed history of the government's privatization program. This is provided so that separate use or distribution can be made of this appendix.

#### A. HISTORY OF THE PINOCHET GOVERNMENT'S PRIVATIZATION PROGRAM

Chile's history of state control through state owned enterprises goes back to the late 1930's. By 1970 the government, principally through its development bank, CORFO, had taken over a relatively modest 14% share of the economy. The state owned enterprises performed indifferently because they had been taken over with little concern for sound economic decisions.

In 1970 the Allende presidency took office with an avowedly Marxist program. State owned enterprises expanded dramatically from 44 entities to 377 and up to 39% of the total gross national product. Whole industries such as power, transportation, communications, mining and finance were totally dominated by the state. In 1973 a military coup under General Pinochet overthrew the Allende regime, vowing to reverse the statism of that regime. The dominant moods of the initial phases of privatization were reactive and ideological: to turn as much as possible back to the private sector as quickly as possible without a master plan and without planning and without great selectivity as to buyers. The program sputtered through two recessions, and although there was a lot of activity, the early changes in the shape of the

economy through privatization were not economically as significant as was later the case.

The initial industrial privatizations employed heavy use of credit. The credit was operationally misused by certain banks for irresponsible acquisition programs and the government regretfully renationalized them.

By the time the 1982 recession that brought this to a head passed, a more rational and systematic privatization program had been installed. There was more competitive bidding, fairer prices were being achieved, and foreign capital and an emerging public stock market began to participate.

The government's privatization program was part of a larger program of overall economic liberalization. The initial objectives of the privatization program were to reverse the Allende program, to raise revenue and to increase industrial efficiency by turning operations back to the private sector. By 1985 another important objective had been added, that of broadening Chilean investor ownership. As companies were privatized, credits and tax incentives were used to create a new class of owners. This program was known as "popular capitalism".

## B. EVALUATION OF THE PRIVATIZATION PROGRAM

The program has been remarkably bold and persevering. It has reversed the statist trend and by now gotten more back into the private sector than was diverted to the public sector by the previous regime. By any standard the program is successful and Chile accomplished it alone without significant outside help. The use of debt/equity swaps and tax incentivised employee stock ownership plans were two brilliant inventions.

At first the program was hurried and unsystematic. It was also slow in getting off the ground with any economically significant achievements. Whether some of the values received were at maximum is questionable. By the mid-80's all this had been changed and improved.

The initial program as it has evolved will be pretty much completed by 1989. The government is already looking ahead to new programs in the field of privatization. Making this happen is dependent on the present government's continuing in office.

While it is unlikely that the degree of privatization now achieved will be turned back, it is also unlikely that any different government would press on further. !

### C. A PROGRAM FOR USAID ASSISTANCE

A program for USAID assistance related to privatization must, of necessity, given Chile's limited aid status, be financially modest. We see opportunities for aid assistance lying in three areas:

1. Assistance with those subjects unique to later stages of privatization. How companies are doing after they have been privatized needs to be systematically followed up. Measuring the impact of privatization on the economy, accomplished by computer modelling of some sophistication, would also be appropriate. *impact evaluation*
2. The present government's future intentions on privatization are to move into new areas. Privatization of services and privatization of vocational education are on the government's priority list. Since they are uncharted areas, some aid assistance in these areas would be in order. *INTEC?*

The government also intends to push into new industrial areas of privatization. These are areas where there is not much comparable experience elsewhere in the world, for example, railroads, port facilities, airport terminals. It is also interested in municipal services where there exists more relevant other-country experience.

3. Chile does not need help completing the main elements of its present program. Its own experience to date is its best guide. There are, however, a number of "spin-off" activities that can be developed into follow on subsidiary programs. ✓

The most important of these is in the area of employee stock ownership plans (ESOP's). Chile has used these with increasing frequency as a modest adjunct to

privatization occurrences; what it now wants to do is encourage and enable the private sector to adopt similar plans. Fortunately the tradition of having worker participatory plans exists, as does the tradition of creating credit and tax incentives to make them attractive.

Assistance in seminars and training programs is also appropriate and a number of program areas and organizations with whom USAID might work are identified in the body of the report.

The last area for consideration might be work aimed directly at further capital market development.

Overall, all of these programs are aimed at encouraging the private sector to pick up from the government further expansions of "popular capitalism".

#### D. CONCLUSION

Chile is one of the very few developing countries in the world with a by now nearly complete privatization program. It is ahead of the programs of other developing countries by several years and therefore has compiled many more "lessons to be learned" and accumulated a body of practice on which further pioneering can continue. The present government clearly has the will to push on and do these things.

Chile therefore represents a special opportunity. A modest amount of assistance rendered by USAID in Chile not only will pay special dividends there but it can be translated into usefulness for privatizations elsewhere in the world with possible greater potential benefit per dollar spent than in almost any other developing country.

## PRIVATIZATION IN CHILE

### A HISTORY AND EVALUATION

#### AND A PROGRAM FOR FUTURE USAID ASSISTANCE

##### A. INTRODUCTION

This report is organized in two basic sections.

The body of the report addresses itself to the question of what kinds of programs generally related to privatization are appropriate for sponsorship by AID from this point forward. In order to address itself properly to this question, the body of this report starts with a brief review of the history of privatization in Chile and an evaluation of the government's program to date. The appropriateness of future programs can only be judged by an appreciation of this recent past history. The body of the report, therefore, is primarily intended for USAID consumption in response to the assignment made by them.

The second part of the report is a sizeable Appendix consisting of a more detailed account and analysis of the Pinochet government's privatization program. Chile's privatization program was one of the world's first programs and one of its most important. It is important to give an account of this for its own sake and for comparison with similar later events in other countries, so that the lessons learned from Chile's experience can be made available and useful to others. As a history and evaluation, therefore, the Appendix stands on its own. It is expected to have other use and distribution than the body of the report. For example, it could be detached and circulated to officials of the Chilean Government or used in a variety of ways to make comparisons within another country.

##### B. HISTORICAL PERSPECTIVE

The privatization program of Chile under review covers the period from 1973 to the present. In order to understand the program, some prior historical perspective is necessary.

Modern Chile, both in the 1930's and in the post war period up to 1970 has experienced considerable periods when at least a moderate pattern of statism was dominant. A good starting point

in reviewing the events prior to the Pinochet government's privatization program is 1939 when CORFO was created. CORFO was created primarily to be a development bank and grew moderately during the post war period. As has been so typical of development banks, many of their investments were selected on non-economic grounds and were unwise. Investments could be made liberally because of CORFO's access to governmental borrowing. By 1970 there were 44 state owned enterprises, most of them were in CORFO and they represented 14% of the gross domestic product (GDP).

In 1970 in a three-way split, President Salvador Allende was elected on a Marxist platform that he proceeded to put in place with ruthless thoroughness, quickly causing national economic disaster. A large number of important private enterprises were nationalized including a majority of the mining, utilities, transport, communications and financial industries. This was accomplished rapidly and by means where the coercion involved was only thinly disguised. By 1973 there were 377 state owned enterprises representing 39% of the GDP.

On September 11, 1973 a military coup under the Chief of Staff, General Pinochet, overthrew the Allende regime and took power with a program dedicated on all fronts to economic liberalization, and with regard to privatization dedicated to the idea that the nationalized statist-oriented mold into which Chile's industry had been forced would be rapidly reversed.

### C. THE PINOCHET GOVERNMENT'S PRIVATIZATION PROGRAM, 1973-PRESENT

A more detailed history than that below is contained in the Appendix. Please refer to this history for greater detail.

#### 1. Sequence of Events

The Chilean Government's privatization program is divided into two phases. Its first phase covers 1973 through 1982 and the second phase covers 1985 to the present and is continuing. This division is useful because the objectives of each period, the techniques employed, and the logic of events that ensued is different in each of these periods.

**a. First Phase of Privatization, 1973-1982**

The government's first big move taken promptly on assuming power, was to reprivatize the agricultural sector by returning land to the former owners and by distributing the balance to farm workers.

The next year and a half was occupied by a recession, causing delay. But by 1976, privatization sales were in full gear. Major action began with a single drastic move by the government that year. Without exception, all subsidies were cut from 6.6% of total government expenditures to 1.8%. Privatization sales were conducted on a "first come - first served" basis with priorities strictly ad hoc and not subject to any master plan. For the most part, there were no valuations of what the government in fairness should receive. There were a limited number of bidders with virtually no foreign investment interest in Chile. Because of the haste and the lack of systematic approach in this first phase of the program, many enterprises wound up in the hands of those formerly wealthy and privileged, i.e. those who were on the spot and ready to invest their money to timely advantage. There is some evidence that the prices the government received were low, although not disastrously so. In all fairness, Chile's economic prospects were not bright at this point and there were relatively few takers.

The two dominant themes of this first phase were "reactive": in that the idea was to give back anything that had been nationalized and do this quickly and without being too particular and "ideological": a determination, primarily on the part of the President himself, that the Marxist attitude of the Allende regime and even the statism that had prevailed previously must be thoroughly wiped out.

By the end of this first period there had been a lot of activity and a considerable number of privatizations accomplished, but the important parts of the overall economy had not yet been tackled, so the amount of progress was limited. As an illustration, state owned enterprises had been privatized to the extent that over 20% of the GNP was government owned, down from the 39% of 1973, but still far more state-dominated than the 14% that had prevailed in 1970. Perhaps one of the reasons for this was that

collectively the military had serious reservations as to the extent of privatization that was advisable. The concept of the "strategic sector" developed. The "strategic sector" consisted of companies and industries where it was either prohibited to privatize them at all, or where at least government majority control would be maintained.

Chile's first phase of privatization came to a close in 1982 with dramatic events. In 1981 and 1982 a second major economic recession occurred. Tied in with this was the near failure of five banks including two major ones, the Banco de Chile and the Banco de Santiago. These banks, having been privatized, and with virtually no control over their use of credit, had embarked on a program of conglomerate acquisition of industrial companies pyramiding their credit to do so. The government, with great reluctance, was forced to "intervene" by renationalizing these companies. The size of this sector was considerable, by 1984 it represented 36.5% of all government loans. This renationalized sector is referred to as the "odd area" ("area rara").

**b. Second Phase of Privatization - 1985 to Present**

In 1985 the President settled once and for all the important issue of the "strategic sector" by issuing a definitive order to proceed with thorough privatization. This ended the resistance of the military which had by then been converted in any case and it reduced the concept of the "strategic sector" to a point where it is today almost meaningless, being confined to the copper mining and oil refining companies.

In late 1984 and in 1985 the government determined that the "area rara", having disengaged the banks from their industrial subsidiaries, should be returned to the private sector. In this instance, the government was anxious that ownership should not return to the "status quo ante" so it created a new class of stock for new investors with new terms of sale. This type of privatization was known as "popular capitalism". It involved inducing investors to buy by providing credit (in much more modest amounts than previously, and much more discriminately) with installment loan payments, and giving tax relief for investments made and held and for dividends received. This broadened

ownership considerably, but it was still biased in the direction of those who pay income tax in the first place, i.e. wealthier individuals.

There followed "worker capitalism" and "investment capitalism". "Worker capitalism" is what we would know as worker participation ownership or ESOP's.<sup>1</sup> This took the form of earmarking a certain percentage of total shares out of offerings that were increasingly by now being made to the general public through public channels. These shares were set aside in limited percentages of the total capitalization (10%-15%) with limited discounts (of the same magnitude) for employee purchases on credit and/or by installment.

"Investment capitalism" arose because of the rapidly rising importance during this period of the stock market and emergence of an investment community which became active in trading shares in a booming stock market. This activity got a big boost when, along with the reprivatization of the "area rara" banks, AFP's were also privatized as separate entities. AFP's were pension funds, previously government owned and previously part of their respective industrial enterprises. The AFP's then proceeded both to help create and to participate in a growing public stock market. The two largest AFP's were sold to foreign companies.

Other than these kinds of special sales, during this second phase, sales were for cash rather than on credit or by installment. Foreign buyers became important participants during this second phase. During the second phase, a much more predominant proportion of sales were made at a government-determined fair price and increasingly towards the end of the period were put through the public stock market. Under these circumstances, prices were more often

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<sup>1</sup> Technically not a proper term when applied to any country other than the U.S., since ESOP's involve specific tax treatment and preference unique under the United States law. In fact, Chile is one of the few other countries where there is any tax preference at all given to worker participatory shares.

determined by true market forces and sales were arranged by fair intermediaries, brokers or investment bankers.

A word should be said at this point about the patterns of employment and unemployment, always a major concern in privatization programs. Throughout the period 1973 to 1982 employment stayed at an average level around 2.8 million, thereafter increasing moderately within an improving economy, but employment in state owned enterprises during the second phase declined from 161,000 to 90,000 simply through elimination of redundancy. About half of the decline in employment in the state owned enterprises was due to eliminating "disguised unemployment", a term to signify the unnecessary loading-on of extra employees demanded by the Allende government, and resulting in inefficiency. Laws of long standing committed payment to terminated employees of one month per year of service up to a varying ceiling number of years. These commitments were honored by the government. The sometime agonies of redundancy have not been a major factor in the Chilean privatization experience.

If the objectives of the first phase were "reactive" and "ideological" with the added objective of increasing operating efficiency by relying on the assumed more efficient private sector, these objectives were continued during the second phase. The efficiency objective was supplanted to some degree and in the second period the dominant theme increasingly became broadened ownership participation - "popular capitalism" and similar programs.

The development of foreign investment interest in Chile coincided with another important part of the government's economic plans: to manage its mounting foreign debt. Brilliantly, the Chilean government (with conceptual help and some implementing assistance from foreign advisors) invented the debt/equity swap. A debt/equity swap is a transaction whereby the government accepts payment of debt in a foreign currency at a market-determined discounted amount and exchanges it for the full face value in local currency, provided the purchaser agrees to invest these proceeds in equity ownership of local companies. With equal brilliance, the equity ownership offered up was an important quantity of shares of concerns being privatized. Hence, foreign investment was introduced, admittedly on terms that

gave the foreign investor from a hard currency area a discriminatory advantage.

## 2. Evaluation of the Privatization Program

The program is evaluated by setting forth notable points of difference and notable points of similarity between Chile's privatization program and those of other experiencing nations. The most noteworthy favorable results of the program are set forth and the most noteworthy unfavorable results, winding up with some overall conclusions.

### **a. Points of Difference; Points of Similarity**

1. The first phase of Chile's privatization program was conducted in a hurry, whereas the second phase was more deliberate. In the first period there was a lot of activity but not a lot of economic result; most of the economic gains occurred in the second period.
2. Typically, at first a "strategic sector" category was created with the motive of restricting complete privatization but atypically these "strategic sectors" were loosened and in most cases all but abandoned in the face of determination to privatize, coming from the president.
3. The program was by any standard a bold and persevering one.
4. Remarkably, it was largely conducted alone without any policy help or programming from abroad.
5. The organization deployed to effect this program was a decentralized one of shared responsibility, in contrast to the more frequent method employed in other countries of appointing a privatization "czar" with centralized authority.
6. Privatization in Chile has been accompanied by only a relatively modest degree of governmental regulation.
7. The reduction in government ownership except for those enterprises that were returned to their original owners

Immediately, was gradual and was done in piecemeal steps.

**b. Favorable Results**

1. As commented above, the sense of urgency in the program and the resoluteness with which it was conducted from the very top was extreme and admirable.
2. Despite its unmanaged aspect, the program achieved prices for the government that may have been a little low in the first phase but were adequate in the second phase and overall. Debt service was high and indexed and debt obligation was in all but a few instances not forgiven.
3. Employment decreased in all government sectors and markedly so when state owned enterprises became private. The overall amount of employment was level despite chaotic swings in the economic cycle.
4. Lately, profit performance of the privatized sector has been very good. With a booming stock market, return on investment at market values has been excellent. Return on book equity has not been so good.
5. There is a fear of monopoly pricing power in Chile justified by the perpetuation of many of the monopolies, but in fact, due to increased exposure to competition for all sectors of ownership, consumer prices in real terms are actually down.
6. The broadening of ownership as part of a privatization program is unique outside of Western Europe. Programs such as "popular capitalism", "labor capitalism", and "institutional capitalism" were soundly conceived and executed and were effective.
7. The debt/equity swap was almost a Chilean invention and a brilliant one and equally brilliant was the linking of it to the privatization program.

**c. Unfavorable Results**

1. In its first phase, the privatization program was executed hurriedly and unsystematically. Too many companies were sold too quickly and possibly, although this is not certain, at prices that were slightly low.
2. At the same time, while there were a lot of privatizations, it was not until 1985 that major activity and transfer of significant whole industrial sectors began to take place.
3. Negotiations for sale of companies initially took place without a fair price being established and there was not enough openness of adequate information or enough competitive bidding. Initial customers for state owned enterprises therefore were predominantly the wealthy and privileged class.
4. In the first, phase excessive credit for sales was allowed. In the case of the privatized banks in the "area rara" sector this resulted in pyramiding which may have helped cause and certainly deepened the 1982 recession.
5. At various times there appears not to have been adequate continuing regulatory oversight following privatization.

**d. General Conclusions**

The following are overall broad conclusions on the entire sweep of Chile's privatization experience so far.

1. The most important fact about Chile's privatization program is that it has been very wide reaching and successful.
2. The program has been remarkable for its persistence and follow-through despite substantial economic upheaval and going through two recessions.
3. The overall objectives of the program changed somewhat between the first phase and the second phase. In the

first phase, the program was reactive and ideological. It also had the frank objective of revenue raising and planned on greater efficiency resulting from turning operations over to the private sector. In the second phase, the latter two objectives continue, but one of the dominant new themes introduced is that of broadening the base of private ownership.

4. Errors in the program occurred and were significant. They were due partially to initial hurry and perhaps to too much of a laissez-faire attitude and to the lack of a thought-through program. It is remarkable, particularly since Chile was a pioneer, that the country did not make more mistakes. The mistakes were serious, but none of them were crippling and the country did avoid many mistakes that they could have made and that have since been made by others even with the advantage of prior experience of pioneer countries to guide them.

### 3. Outlook

The first major point to be made about Chile's privatization program at this moment in time is that it has been largely accomplished. Of the 377 state owned enterprises all but 47 have been privatized or partially privatized to the point at which the GOC owns less than 50% of the outstanding stock. Privatization programs are being constructed for certain of the remaining state owned enterprises and should be completed by 1989. (60 of the original 377 enterprises are detailed in Exhibit I and summarized in Table 3 on page 63).

The pace of these final phases and the pace of future privatization thereafter depends on certain scheduled political events. There will by law be a plebiscite, on October 5th, 1988, which will vote "yes" or "no" whether the present government continues in power, adding over one year later an elected congress or whether at about the same time a new election for chief executive will also be mandated.

#### **a. Outlook Under Continuation of the Present Government**

The government's present privatization program will continue and be wound up and there will be new excursions into areas

some of which are not frequently experienced in other countries: possible privatization of the railroads, for example. The government will turn its attention also to privatization of services and of education, especially technical education, one of the country's strongest needs.

**b. Privatization if an Opposition Government Comes to Power**

Any opposition government would be a coalition of center-right to center-left parties. These factions have, as a political maneuver, become increasingly vocal in opposition to unfolding phases of the government's privatization plan.

This opposition has been met by disregard and continued determination to proceed with privatization on the part of the government. It is probable that under an opposition government, privatization would not be reversed. It might even be modestly continued by the opposition, depending on which factions were dominant. But the movement would certainly lose its champion and much of its political will.

In the event of a no-vote in the plebiscite, it is uncertain whether the government would slow down its privatization program and abandon any major new initiatives or whether it would hurry to get the bulk of its program through under the wire. The planning is for the latter, but no major new initiatives will be introduced before the plebiscite.

Who will win the plebiscite is also uncertain, with most polls rating it a toss up at the present time.

**4. Status and Attitude of the Private Sector**

Despite further explorations in privatization, before too long the government will evidently turn its attention to the sector that has to be its programmatic heir when the government's program is largely completed: the private sector itself and the reform of its attitudes and replacement of them with more progressive programs.

It has sometimes been observed of Chile, as of other parts of Latin America, that while the private sector has been a key factor in the economy of long-standing, its roots, given a climate of persistent statism, are shallow and need to be nourished and encouraged. Sometimes the attitudes of the private

sector seem to be almost those that prevailed in the United States before World War II, that of rejecting involvement with government and all its works. At other times, it seems plain that this attitude is changing and evolving in a more progressive direction and one that will integrate the private sector with society as a whole and its welfare. Certainly this is the attitude of the privatized sector. Significantly, this privatized sector considers itself more experienced and therefore more progressive than those of its brethren that have not experienced the change from nationalization to privatization. This sector considers itself ready and capable of leading the way into a more cooperative era.

The private sector's lack of cooperation with other sectors in especially noteworthy vis-a-vis labor unions. Much of the private sector recoils from the role of labor in the Allende regime and considers all of the labor leadership to be at least crypto-communist. In fact, communist domination of the labor unions no longer appears to be the case.

The academic community, at least the teachers if not the students, do not appear to be as adversarial as in other countries, undoubtedly due to the now fifteen year period of the dominance of private initiative economic thinking. And as noted frequently throughout this history, in Chile the military does not exercise an elsewhere all too frequently typical deterrence.

#### D. A GENERAL PROGRAM FOR USAID

It should first be noted that in Chile, USAID has the status of ADC (Advanced Developing Countries). This means a limited personnel presence and that funds will be limited.

There are several respects in which Chile represents a unique and special opportunity in ongoing privatization work. These opportunities are in three general areas:

1. Management of the later stages of privatization: Great Britain, Chile, and only a few other countries at most have travelled farthest along the route of privatization. But privatization is a process, and even in these countries it is a process that is far from being brought to a conclusion. Work in the later stages of privatization is important, would be

continued pioneering, and can provide further "lessons learned" to the benefit of other countries when they reach the stage now being pioneered by these countries.

2. New frontiers: privatization is a long process. Whereas today Chile is considering privatization in certain new areas as described below, it will be some time until other privatizing countries reach this stage. Help provided Chile on its pioneering forefront helps not only that country, but at a later date has the potential for helping many other countries.
3. Spin-off programs: by now Chile has had a massive privatization experience. Inevitably, this has generated a number of potential side activities that are specialized with some requiring help in the form of specialized expertise. USAID is able to provide this kind of expertise at relatively little cost.

Given the above history and the current situation, any general program for USAID should have the following characteristics:

1. It is neither necessary nor appropriate for USAID to fund or attempt to guide or plan a major role in the mainstream of Chile's current privatization program. The program has been successful, it is now in the final phase of winding up its program of conventional privatization, at least before it takes on new initiatives in uncharted territory. Chile, in balance, has been doing very nicely and does not need any important degree of help from us on its present program.
2. Any major help should be out front working on the privatizing of industries in which there is little previous experience.
3. While Chile neither needs nor wants help in the wind-up phases of its present mainstream program, it has expressed considerable interest in various specific or sophisticated spin-offs from the basic program where they acknowledge that we can help. We have referred to these programs as "spin-off" or

"cutting edge" programs.

4. Any assistance must of necessity be financially modest.
5. A large part of any assistance should shift its focus to help and support for the private sector. It is the private sector that in the end will pick up the ball in the cause of economic progressivism. We must include help for the private sector both by helping create new attitudes and by helping with specific "cutting edge" programs.

#### E. MANAGEMENT OF THE LATER STAGES OF PRIVATIZATION

There is almost no country in the world that has not at least considered privatization as an option for the pragmatic solution of gathering economic problems.

As a very rough estimate, something over 50 countries have had specific privatization experiences or can point to their country's "privatization program", however incompletely developed. But the striking fact is that for the vast majority of these countries the privatization process has not proceeded very far. Most of the countries have not even come near to reversing the nationalization process that took place in the 1960's and 1970's. Chile is one of the very few countries that has been in privatization long enough and has accomplished enough that is major, so that it can be said to have compiled a true privatization "history".

What are the later stages of the privatization process? What happens next? The fact is, we can guess, but we really don't know.

Two developments that have not yet been actually experienced seem to suggest themselves:

1. Serious observers of the privatization scene know that privatization is a process. It doesn't end with the event of privatizing a specific company. What happens to a company after it has been privatized and how it can be helped to be a success, is a matter of legitimate concern. Many newly privatized companies

will have a difficult road to travel, especially at first and will need and perhaps would welcome help.

This may well be work more appropriate to the IESC, which is, after all, another arm of the same Bureau for Private Enterprise of USAID.

It seems clear there should be program of post-privatization follow-up of newly privatized companies.

2. Scholars of privatization recognize that privatization is not an end in itself and the saying "good things need to happen, when you privatize" is a recognition of this fact. Did "good things happen"? is another area of obvious post-privatization concern that will come to the forefront in Chile before it does in other countries. Such evaluations can, and up to now have been, extremely informal. We think the time will come, perhaps soon in Chile and other countries that are quite far along in the privatization process, when a much more thorough study of the macro-economic effects of privatization will be needed. Such studies would obviously be extensively computer-aided. (See further discussion on page 22)

Unlike the other individual programs described below, such a program could be relatively expensive. Also unlike the other programs, this is the kind of study that would be pioneering and of potential future wide application. If such a program of study were adopted, it is the kind of program that might be more appropriately funded by USAID, Washington, than by USAID, Chile.

#### **F. PROGRAMS ON NEW FRONTIERS OF PRIVATIZATION**

To date, almost without exception, the Chilean companies that have been privatized are the kinds of companies that by now have also been privatized in other countries. Moreover the types of companies now being privatized are by now mostly repeats. For example, Chile has a large number of power generation and distribution companies, including the giant, ENTEL. No help is needed in privatizing the two or three remaining eligibles that are still state owned. Chile's own experience in privatizing its

formerly public power companies is the most relevant experience that the government can possibly have available.

By contrast, some of the new areas that the government is considering are areas where new ground is yet to be broken.

The whole area of services is one of Chile's major new privatization concerns. Some of this is reasonably well plowed ground; municipal sewage disposal, for example. This is the kind of service, as is the case with many services, that is frequently contracted out and in fact Chile already has many contracted-out forms of privatization in the service sector. It is also giving active consideration to privatizing the water works. In this particular area, there is not a great deal of specific experience. Great Britain has it under active consideration at present. Another area being studied, privatization of port facilities and of airport terminals, is not unheard of, especially in Asia, but it is new to the Chilean government. As one example, the government is very much interested in whether an advisable pattern would be to privatize a port (the government owns the ten major ports) as a single entity or whether to break it up and contract it out in pieces. It wants advice on the subject and wants to know what the practice in other countries has been.

Much less well-travelled is the second major privatization in the services area: education, especially the vocational training that is one of Chile's perceived major needs. There has been relatively little world experience in this area. Even in the United States, this area of education is not yet a reality, having gotten no further than a series of new ground-breaking recommendations in the Report of the President's Commission on Privatization.

While in Chile, we received an interesting inquiry from the government's working staff level. In considering privatization of railroads, Chilean officials want to set forth their options as they see them and benefit from whatever scant experience exists elsewhere in the world. To our knowledge, the privatization of railroads has been confined to the United States and Japan, with Britain now considering it seriously and a few developing countries doing so more incidentally. We provided such information as there is and such observations as we have to

the interested government officials in September; our letter on the subject was routed through USAID Santiago.

In all these new areas Chile can continue to innovate in privatization and the present government continues to exhibit the will to do so. It is appropriate that we help and if we do, given Chile's already substantial experience with privatization under its present government, this is another example of how work in these advanced areas could yield more significant economic or social returns than similar frontiersmanship in almost any other country.

#### G. SPIN-OFF OR "CUTTING EDGE" ACTIVITIES

These consist of certain specialized activities, some of which require specialized knowledge. Employee stock ownership participation plans, seminars and training programs, a variety of organization support programs and capital market development are the principal areas identified.

##### 1. Employee Ownership Plans (ESOP's)

###### a. Analysis and Comparisons

One form of employee ownership plans (they will be referred to by this term from now on in this section) is the least dramatic of the several varieties. This is a plan in which the issued employee shares are not exercised directly but are held by a trust as to voting rights and where there are restrictions on sale by the employees, sometimes only after an elapsed time period and sometimes only on retirement. This, after all, is not so very different from a pension plan, particularly from AFP's as they are administered in Chile. This kind of plan is limited in its ability to create new broadened appeal and it is of minimal effectiveness in creating company loyalty. AFP-type plans are important and play an important role as investment pools and in providing investment potential but they are clearly not any wave of the future and not what the government has in mind as it searches for new innovations in employee ownership plans.

The type of employee ownership plan created under "popular capitalism" as part of the privatizing of state owned

enterprises differs in detail from ESOP's in the United States. These differences, insofar as we can determine them, are shown in Exhibit II but the fact is that employee ownership plans in Chile and ESOP's in the United States are more notable for their broad similarities than for their particular differences. Both have the general aim of broadening ownership, both have been adopted relatively frequently (proportionally somewhat more in the United States) but both are spotty in frequency and in an overwhelming number of cases have involved relatively small minority interests rather than employee majority control. In both, usually, but not always, these offerings to employees are coupled with public offerings and usually there is preferential pricing in favor of the employees. Both have used credits against future earnings as collateral against future payment. Importantly, and this is almost unique in the world, in both the United States and Chile there are important tax inducements set up for the purchasing employee. Furthermore, the United States and in some case, we believe Chile, offer tax advantages to the various participants other than employees in such an employee ownership creation.

**b. Target Audiences**

1. The government of Chile has been successful in popularizing and sloganizing programs of broadened ownership. Notwithstanding there somewhat limited overall result, the use of ESOP's in privatization has helped achieve the goal of broadening stock ownership. A rough estimate shows that approximately 60,000 employees acquired stock in these programs at a future total cost to them of several thousand U.S. dollars each. Popularization of all these various programs should continue and it is possible, although perhaps not likely, that design of public awareness programs to make them increasingly popular could merit some assistance. This would aim at increased public awareness of, and therefore predisposition towards participation in the same type of programs that have been offered up to now.
2. But more importantly, as was brought out in a clarifying discussion with the Ministry of Economics,

the government's objective is to adapt its present program. The present program has been aimed, up to now, almost exclusively at state owned enterprises at the time of privatization. (The case of the steel company [CAP], is an interesting exception, apparently a unique one, given the special circumstances and history of that company as set forth in the Appendix to this report). The government's object is clear: it is to adapt the previous "special circumstance" employee ownership experience during privatization to a plan more appropriately appealing of adoption by the private sector, hopefully a voluntary or willing adoption.

What should the features of such an employee stock ownership program tailored to the private sector be?

**c. Type of Program and Features**

The precise characteristics of an appropriate program require further study. It is necessary to learn what would appeal to employees and what would be acceptable to employers and this cannot be determined in the abstract. However preliminary it may therefore be, it appears that the program should have the following characteristics:

1. It should be direct. Shares should not be held in a trust and there should be no intermediary organization, let alone one that holds voting authority or other restrictive powers. Shares should be granted and promptly distributed to employees. Only in this way will they feel some responsibility of ownership.
2. Shares should be freely salable, with only minimal restrictions or delays as to eligibility. Employees should be able to sell their shares at any time if they are to experience tangibly the full benefits of ownership. The main fear in this is usually that employees will receive the shares and then promptly turn around and sell them because they have a preference for tangible goods. Most experience in many countries says this will not be the case. If there is a satisfactory program, employees tend to hold on to their shares. Of course this experience in Chile has

taken place in rising markets, not so much in falling ones. It is also somewhat contradicted by the apparent experience in Chile in 1987 when workers, principally blue collar workers rather than the office salary class, apparently were net sellers of stock grants.

3. Stock ownership need only be a minority of the total company and the program will still be effective. I believe that in Chile there are only three or four companies that have become wholly owned by employees. In Chile this condition is the exception and this is also the case for ESOP's in the United States and in most other countries. The average percentage of employee ownership of all ESOP plans in the United States, including those that are wholly owned, is just under 30%. An ownership offering pattern of 15-20% is therefore perfectly acceptable.
4. Should there be employee representation on the board of directors? In Chile's privatization experience this has been somewhat the pattern. CAP has three employee representative board members out of seven. The more usual pattern is to have one such director who is usually labeled the "workers representative". As a result, we have the suspicion without documentation that there is some restriction in his voting or other powers.

Our recommendation is that there be no employee representation on the boards. This could be a judgment that on further study of Chilean practice and specifics proves to be wrong, but we would start off with a plan that did not grant membership on the board of directors, at least not initially. This may also be contrary to current Chilean worker attitudes, and representation may, practically speaking, be almost mandatory, in which case we think it should at least be minimal.

Our reasons for recommending no representation if this can be done are as follows.

First, from the point of view of effective governance of the company, time after time experience has shown that a board is more effective if its members are appointed with their qualifications being "total", i.e. that they possess the ability to confront issues in terms of what is best for overall corporate health. This type of board member serves the company and society better than a partisan or factionalist director who tends to judge every issue from a special biased viewpoint. Chrysler's experience in having a labor union director has not been successful. Experience in West Germany, where worker representation on "the board" is legally mandated, is instructive. In practice it has evolved that there are two boards. The one with the worker director takes largely formal actions, the "real business" of the board is conducted by the other board. If the practice of mandatory workers' directors were widespread, it would not surprise us to find the executive committee of the board evolving in the same way, although we are not familiar with the prevalence or practice of executive committees in Chile.

Even from the workers' point of view, we think board representatives can be an unsuccessful idea. Collective bargaining under union contract is by its nature adversarial and we are far from convinced that placing a worker representative in the councils of the adversarial camp does anything more than compromise collective bargaining in addition to creating a factional board.

5. Employee stock grants can very well be offered at a discount and credit can be allowed on their purchase. Despite some excesses in the past, there is no longer any reason of safety or otherwise why discounts cannot be allowed and credit granted. At least the first of these practices is customary in other countries. Discounts can be moderate, practice in the United States is 15-20%. The use of credit as a means of employee payment can be an acceptable use of credit even when there is no collateral other than the future earnings of the company. The availability of credit and the period of time the employee must hold stock

have to be part of an internally consistent integrated program designed to discourage or prevent excessive early cash-in. We don't have a feel for the amount of credit that is both effective and prudent. Under recent Chilean law, employees can use their severance pay for any stock purchase programs that may have been offered, if and when they resign. Moreover, at various times in the past, they have been allowed to borrow, index free, with payment only on retirement. To be attractive, terms have to be at least as liberal as they have been in the past under comparable circumstances, except where those liberal limits have historically proven to be excessive.

6. The most important incentive to the private sector to offer such plans is probably tax advantage. To our knowledge, only Chile and the United States share the conclusion wherein employee ownership plans are stimulated by special tax concessions. Prior acceptance of this principle and practice in itself is a big advantage favoring the success of any future Chilean programs. The whole question of tax requires special study and is further discussed below.

**d. Other Tax Aspects**

1. Appeal to the private sector - The government's fundamental objective is to come up with an ongoing program for employee ownership participation as successor to the government-sponsored programs that have accompanied privatization. There are, of course, only two ways that this can be accomplished: it can be legislated or the program can be voluntary, embodying sufficiently attractive features so that private industry will want to adopt such programs. Fortunately, Chile now has a tradition of providing attractive features for such programs in the form of loan credits, installment repayments and various tax incentives.
2. Attractiveness for all parties involved - Exhibit III, attached, is a memorandum previously provided to you, summarizing the tax and other advantages available to

those participating in an ESOP in the United States. The feature to be especially noted is that there are benefits to all parties involved: not only to the employee participants, but also to the corporation itself, to the selling owners, and to the lending agencies. Attractive features of this sort for all interested parties should be considered.

3. Necessity of study - what makes an attractive feature depends on the details of precedents already established plus surveys of what features would be attractive to whom and why. In addition, what is doable is very much bound up with local law. This suggests a detailed study be made by the GOC with technical assistance from those experienced with ESOP's in the United States.

## 2. Capital Market Development

One of the criticisms sometimes levelled at Chile's privatization program is that the Chilean capital market, now very active, did not develop as early and as vigorously as could have been the case if conscious effort to develop it had been undertaken. The market is by now well developed, but two steps to further encourage this process are suggested:

1. Prospectuses and other explanatory material accompanying offers of privatization today are of a much higher quality than they were at first when they were almost non-existent. I am not familiar what the current "standard package" presenting an offering is, but any further improvement would in itself, over time, give a boost to further capital market development.
2. Countries embarking on privatization programs, or even those continuing them, today have as almost a standard ingredient the mounting of a public awareness program. It is interesting to note that most successful public awareness programs have not been built around the general concept of increasing public support for the general concept of privatization. Rather, the mounting of a publicity campaign has usually accompanied a specific offering and has been aimed more at the merits and attractiveness of that specific offering rather

than at promoting the merits of privatization in general. This has very markedly been the case, for example, in Great Britain. The Chilean government might adopt this type of approach at the time of the next major offering. LAN-CHILE is an offering that will automatically attract attention, but the question is whether this offering will be strong enough and therefore sufficiently non-controversial. (Recent advance publicity on the LAN-Chile offering suggests that they are following the approach of heavy publicization.) Remaining offerings of ENDESA might be an even better candidate, except this does not have the drama of being an offering in which majority government ownership becomes majority private ownership.

3. In general terms USAID can help Chile in the capital markets area by helping to remove constraints and by helping open up opportunities.

The major constraints are:

- (a) Reluctance of companies to go further than they may be legally required to do in areas of financial and operational disclosure in their prospectuses and elsewhere.
- (b) Reluctance of the public to invest in securities, to be decreased by public awareness campaigns.
- (c) Development of intermediaries: investment banks, venture capital firms, etc.
- (d) Political hurdles; advice can be rendered on how to surmount them.

The major opportunities that USAID might make available are funding of private enterprise development programs and use of buy-ins to USAID's PEDS program.

The Center for Privatization is not the vehicle with the expertise in these areas.

### 3. Seminars

#### **a. Basic Needs and Purposes**

In the course of our study in Chile one theme presented itself over and over again. This theme was that the government had gone quite a long way in terms of what was ultimately possible in the field of privatization and that before long ongoing programs would have to be picked up by the private sector. Accompanying this was the frequently expressed apprehension that the private sector was neither willing nor able to occupy this role today.

Under these circumstances seminars can help. They expose people to other ideas under non-threatening circumstances, they attract participant involvement and interest, and most of all they just get people used to talking and thinking about concepts that they may not even have listened to earlier.

#### **b. Seminar Configuration**

Seminars responsive to both the basic needs and purposes discussed above would be most effective if they are conducted on a small scale in an informal atmosphere. For these purposes we think they should have the following characteristics:

1. have about 20 participants but in no case more than 30;
2. last two to three days;
3. be confined to participants from and experience in Chile, or at most be limited to Latin American nations.

On the subject of privatization, the experience of Bolivia, Costa Rica, Honduras, Jamaica and to a lesser extent the Dominican Republic are especially pertinent. If only by virtue of the importance of their presence in the area, nearby Brazil and Argentina and their thoughts have to be of interest. But these seminars should be "work shops" not "summit meetings". anything that smacks of an "international conference" tends to take away from the basic objective.

4. There should reading material or case study material distributed in advance.
5. It is important that the work shop atmosphere be furthered by as much participation and dialogue as possible. It would be a bad idea, during a three-day session, to have no lectures at all, but it would be an equally bad idea to have nothing but lectures. Adults learn new concepts through discussion and participation more than they do through lectures.
6. It is assumed that either a government ministry or a major private corporation will be the sponsor. The sponsor would send out the invitations to selected proposed participants.
7. The sponsor should make an effort to have participants come from different jurisdictions (private vs. public, labor vs. capital, and with varying geographical representation).
8. The sponsor should make an effort to have participants all representing approximately the same levels of authority in their separate organizations.

**c. Subject Matter**

The subject matter should be narrow rather than broad. As an example, a proposed seminar should not be addressed to the general topic of privatization but should limit itself to two or three aspects.

Typically the privatization process in a country proceeds from generalities (why privatize?, reconnaissance of what has been done already, design of a master plan) to prioritization (identifying state owned enterprises and readying them legally and in intended sequence for sale) to specifics of "how to". In line with the "how to" orientation of the proposed seminars, subject matter should focus on the "how to" subjects at the "latter" end of the privatization process. Examples of possible subject topics at the end of the sequence are:

1. Valuation: how to arrive at the appropriate price for a company intended for privatization.
2. Marketing, i.e. bringing buyer and seller together: how to use existing structures in the banking community and elsewhere to do this, how to attract prospective buyers, how to negotiate with them.
3. Redundancy: how to deal with the unemployment that sometimes results from privatization, both through government and private mechanisms and the help of each. This topic is especially useful if seminar participation is very labor-capital oriented.
4. Swaps: debt/equity swaps as a buyer-inducing privatization mechanism.

**d. Comparison with Conference of July 18 & 19**

On July 18 and 19 a seminar (or more properly a conference) on "The Private Sector and the Free Enterprise System in the Development of Latin America" was held in Santiago. As you will note from reviewing the characteristics of the seminars proposed for future USAID support listed above, the proposed characteristics are very different from those of that Conference. This is because the objectives of the seminars discussed here and those of the Conference were very different. That conference, in essence, was one step in the process of creating a general public awareness and appreciation of the broad principles and merits of having the private sector actively involved in national privatization policies. That conference was to make people aware; the proposed seminars have a different purpose: to involve participants in actual work with other segments of society. That conference was a "summit meeting", these seminars are "work shops".

The Conference fulfilled its purposes and was a success as measured by sizeable attendance, the prestige of persons addressing the conference, and the amount of press coverage.

Post conference follow-ups are an important part of making any conference effective. It would be appropriate for USAID to:

1. Assist SOFOFA (sponsor of the conference) in publishing and disseminating results of the conference;
2. Promote small meetings of Chilean participants in the conference from both the public and the private sectors to follow up on the consequences, meaning, and especially on desirable actions to be taken on ideas presented at the conference.

**e. Studies**

Paragraph 2 on page 19 suggests that there is need for "a much more thorough study of the macro-economic effects of privatization" and further suggests that it is at least our opinion that such a study appears to be an appropriate candidate for USAID/Washington funding.

Such a study starts with a computer-devised economic model. Such a model to be useful must be not be abstract but a model of the economy of an actual country. A number of econometric consulting firms have created such models in whole or in part, and the raw data on which such a model would be based also exist in various stages of organization, but we do not know of any model already adapted and ready for the input of privatization assumptions. We understand the World Bank is exploring how to study and how to gather data along these lines.

We think that such a model could, in the first instance, have its construction completed in the United States without initial benefit of fine-tuning from the field in the host country. This could be added as a second stage when the country to be the subject of such a model had been selected. Fortunately quite a number of countries are reasonable model countries to start with and quite a number of countries could benefit from adapting a completed model from one country to their own country.

The academic community, both in the United States and elsewhere, is another important source of such data and modelling. Insofar as Chile might be part of creating or adapting a Chilean model, Catholic University's Economic and Administration Faculty is a potential local participant and source.

#### 4. Training Programs

Another appropriate USAID assistance area is training programs. The basic purposes of training programs for the Chilean private sector are very similar to those described above for seminars. Therefore, the guidelines and format set forth above for seminars apply also to training programs. Our impression is that there are quite a sizeable number of local activities, at least in Santiago, that you could work with by providing minimal sponsorship and some overall guidance. All of them seem potentially worthwhile and in most cases contain enough substance so that perhaps the most valuable thing USAID can do would simply be to pull these activities together and coordinate them in some overall program. Some of these organizations are listed below with a few brief comments on each.

##### a. US PVO Accion International

A major element of the proposed Advanced Developing Country (ADC) program of the new USAID office in Chile will be directed at reinforcing the private sector by strengthening its social responsiveness. The program is planning on collaborating with several PRE-sponsored efforts. For example, the PRE Bureau has approved use of \$100,000 of its guarantee authority to the US PVO Accion International to help it establish a Chile presence. The guarantee will be used to obtain local bank loans for relending to very small enterprises. A local PVO affiliate, PROPESA, was legally chartered in March of 1988 to develop and implement the Chile program. PROPESA's board is composed of leading Chilean businessmen who have already mobilized more than \$80,000 of local contribution. The USAID program will provide \$300,000 of additional support to Accion International to help strengthen PROPESA through technical assistance and training and to help cover initial operating costs. PROPESA's board of directors will provide a useful

forum for reaching important elements of Chilean private sectors.

**b. SCORE**

Similarly, the ADC program contemplates drawing on PRE's relationship with the SBA-supported SCORE organizations in the U.S. Initial diagnostic work by SCORE could lead to a USAID-supported program in Concepcion, Chile, an important industrial center.

**c. Concepcion Chamber of Commerce**

The Chamber of Production and Commerce in Concepcion administers technical training schools and it supports entrepreneurial ventures, preferring to work with existing firms, helping them to survive and prosper. It brings together academics as well as businessmen with those who need the help. Once again, USAID can help by "networking" and coordinating rather than having a primary role or picking up any sizeable portion of the tab. The Chamber of Commerce seems eager to have an association with USAID at the earliest possible opportunity.

**d. IESC**

In addition, The International Executive Service Corps (IESC) maintains a small office in Chile. While no specific role has been identified yet for an ADC activity with IESC, the USAID Representative is interested in working together with this PRE-supported US PVO.

**5. Training Programs: Representative Subject Matter**

The need for training programs in three specific areas appears to be specifically pertinent to the current need for improving the social responsiveness of Chile's private sector:

1. Labor-Management Relations - Political history in Chile has almost conspired to keep labor and management from having a useful and rational dialogue. It is therefore all the more needed. The history of labor management relations in countries where that have

atrophied under military rule and floundered with the return of civilian rule is frequent and could easily occur in Chile. The creation of dialogue is therefore important and the inexperience and reluctance to some degree to participate on the part of the private sector makes it all the more urgent that something be done in this area. The appropriateness of leadership by Catholic University seems the best known available possible local resource for any labor-management training dialogues. The Dean of the Catholic University Business School is a member of the Labor Management Council and has a U.S. Masters degree in labor relations. Such expertise and credentials in this field are understood to be rare in Chile.

2. Technical and Vocational Education - Over and over again, various people emphasized the great lack and consequent strong need of Chile for technical and vocational education. In recent years the GOC has turned over the administration of technical high schools (liceos) to various private sector organizations. In 1988, the CORFO affiliate for technical training, INACAP, was turned over to the National Confederation of Production and Commerce for administration. INACAP is a post-secondary training organization established in 1951 and operating a wide variety of programs involving some 24 specialties. In 1986 over 35,000 participants attended INACAP courses. The GOC's attempts to forge linkages between technical training entities and the private sector are meritorious. However, there is some question about the capacity of the private sector to respond in other than a traditional manner. The experience in the U.S. in this regard could profitably be shared with the Chilean private groups now charged with the responsibility of technical training. The ADC program in Chile can serve as a vehicle for this purpose.
3. Private Sector Involvement - It should be kept constantly in mind that involvement of the private sector is a natural and necessary successor to government's having lead the way in continuing industrial revitalization. Training in "concepts of leadership", for example, are quite common in the United States and seem

in order and needed in Chile. Several representatives of the privatized sector endorsed needs along these lines and stated that executives of privatized firms are able and willing to lead the way in such training.

In this connection the training work of CIPE (Center for International Private Enterprise) can serve as one appropriate model. This organization provided a grant under which COD (the Center for Leadership Development) of the U.S. Chamber of Commerce conducted "concepts of leadership" courses in Costa Rica with participation from throughout Latin America. The courses were one week long with participants attending each week in each of three years, about 20 per class.

## APPENDIX I: PRIVATIZATION IN CHILE

### HISTORY AND EVALUATION

#### A. POLITICAL BACKGROUND

In September 11, 1973, occurred one of the most dramatic events in the history of Chile. On that date, Salvador Allende, the elected Marxist president of Chile, was overthrown by a military coup. The cabinet and government of the military junta that assumed control under General Pinochet embarked on a reversal of the state-ownership, state-oriented policies of Allende and previous regimes since the 1930's. One of the main themes of this reversion was the dismantling of the nationalized state that had been largely created by Allende and the privatization or re-privatization of previously nationalized enterprises.

It is important to recognize that privatization was just one of the government's overall programs of economic liberalization. It is also important to recognize that this economic liberalization was embarked upon, almost uniquely in the world's history, without being accompanied by political democratization. The rules under which political democratization will evolve were, however, set forth in a newly adopted constitution in 1980. The first procedural steps provided for this will only come into play beginning in late 1988.

Most of the Western world thinks that political and economic democracy must go hand in hand, but Chile is a case where economic liberalization has been accomplished under what is still an authoritarian military government. A balance between politics and economics has yet to be developed.

Privatization in Chile has been successful, one can even say highly successful. It has, at least since 1985, been accompanied by relatively high economic prosperity, at least for the general economy and for the bulk of the people, if not for the unfortunate one quarter of the population below the poverty level. Lack of democracy notwithstanding, a fair evaluation would conclude that the great majority of the people are economically better off today than they were in 1973 and before.

## **B. HOW THIS APPENDIX IS ORGANIZED**

This history and evaluation is the story of privatization from the end of the Allende regime through July 1988. It is discussed somewhat in a vacuum, i.e. without more than occasional reference to the overall economic scenarios and policies that were being played out during this same period.

It proceeds according to the following outline. First, there is a historical account of the sequence of privatization events. There then occurs discussion of the magnitude and direction of the action that took place, followed by details of the program.

As to details, in any "classic" scenario of privatization in a hypothetical country, the following are the typical sequential steps:

1. Development of a program of prioritization. How and why were priorities decided upon? According to what principles? What specific companies would be privatized and in what sequence?
2. Political and legislative clearances
3. Valuation: How it was decided what would be a reasonable price to receive for each enterprise?
4. Marketing: How were buyer and seller brought together and under what system was there preselection of and preference given to the more desired customers?
5. Negotiation: This is closely related to the Marketing step and brings in the financial element. Often, in the more developed world, this is the "investment banking" phase.
6. Terms of sale: This deserves separate consideration.
7. Special Aspects: In this section we have discussed many particular points that do not fit conveniently under the above headings.

In discussing Chile's privatization program, most commentators have dealt with a first phase covering the period 1973 to 1982, and a second phase covering the period from 1985 and continuing up to the present. This history also follows this approach, because it makes sense; the objectives, pattern and results of the first period were markedly different than those of the second period.

This study then discusses the outlook for privatization from now on under alternative political scenarios, one assuming that the present government continues in office, and the other one with the Center opposition achieving power through democratic means.

The next section contains an evaluation of Chile's privatization.

This Appendix concludes with a series of "case histories" from certain industries where detailed facts were made available. These details are sufficiently different and of sufficient interest to recap them as "case histories". The privatization history for four industries is profiled:

1. Electric Power Generation and Distribution
2. Communications
3. Banks and Pension Funds
4. Steel

### C. FIRST PHASE OF PRIVATIZATION 1973-1982

This period is largely a history of the reactive moves made by the Pinochet government that assumed power in the last part of 1973. To understand what it was reacting against, it is necessary to go back somewhat before this period.

#### 1. Sequence of Events

A good starting point is the creation of CORFO in 1939. CORFO is a government owned corporation created to engage in three activities:

1. It was to serve as a development bank in the classic sense that became so prevalent in the post war period. It was created with government funds and it borrowed money, both nationally and internationally, to start up or invest in a wide range of business activities that the state judged to merit sponsorship.
2. It was intended from the beginning that it would take an active part in the management of these activities and actually run some of them.
3. As an activity of somewhat lesser magnitude, it was also chartered and continues to engage in certain research and development activities again judged by the government to be worthwhile.

As has since been so often the case, many of CORFO's Investments were selected for non-economic reasons and proved to be economically unwise.

CORFO's growth accelerated when the Allende regime came to power in 1970, at which point it became the principal vehicle used to create or take over state-owned enterprises. The number of these grew during the Allende period. This is dramatically illustrated by the following statistics:

- In 1970, there were 44 state-owned enterprises, most of them in CORFO, representing 14% of the Gross Domestic Product (GDP)
- By 1973, this was up to 377 enterprises representing 39% of the GDP and employing 5.6% of the total labor force. A list of the major enterprises by name and field of activity at this point in time is included as Exhibit 1. The increase in concentration of government ownership in certain of the major industrial sectors between 1965 and 1973, is shown in Table 1 below:

TABLE 1:  
SHARE OF STATE OWNED ENTERPRISES IN GROSS OUTPUT (%)<sup>1</sup>

<u>Sector</u>	<u>1965</u>	<u>1973</u>
Mining	13.0	85.0
Industry	3.0	40.0
Utilities	25.0	100.0
Transport	24.3	70.0
Communications	11.1	70.0
Financial	N/A	85.0
Public Enterprises as Percent of GDP	14.2	39.0

Because the status and subsequent history of disposition of these enterprises is somewhat different by type, it is helpful to think about them in four different categories. The first category consists of enterprises managed by CORFO, including much of the mining and industry categories and, importantly, also including all of the electric power utilities. The second group is a mixture of some utilities, petroleum production and refining, the post office and some communications activities. The common denominator for this group is that they were created as state-owned enterprises by law. Therefore, the contention is that what was created by law must be privatized by law rather than by simpler processes of decree. The distinction between acts taken as a matter of law and those accomplished by governmental decree is, of course, different than in a legislative democracy. This distinction is detailed in Exhibit IV.

The third category is occupied solely by CODELCO, the national copper company, which has always been treated and viewed as a special category. It is the largest corporation in Chile and the second largest source of state revenues. The fourth group consists of the banks: both the Banco Central, which is the central reserve bank, the Banco del Estado and various banks

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<sup>1</sup> Source: U.S. Dept. of State, American Embassy, Santiago  
"State Enterprises: Backbone of the Chilean  
Free Market Economy", July 18, 1985

that were nationalized or at least certain of them, and various other financially oriented enterprises such as insurance.

As of 1973, except for CODELCO and ENAP (the oil refining and distribution company) most of the state owned companies were losing substantial amounts of money and the aggregate result was a major loss creating, massive cash drains and a significant source of inflation as a result of compensating monetary growth.

Importantly, almost all of the agricultural sector had also been nationalized. Allende had run on a platform of land reform and his faction (elected by a plurality but not an absolute majority as a result of the Center parties splitting) was importantly indebted to his rural constituency. As a result the agricultural sector had been subjected to statist-oriented agricultural reform and many farms had been expropriated.

The Pinochet regime's first big move, taken early on, was to re-privatize promptly most of the expropriated agricultural sector. Land was returned to former owners, particularly where the expropriation process had been inconsistent with specified agrarian reform legislation. The state owned collective farms acquired during the Allende regime through expropriation and by predecessor regimes were divided and distributed as individual units.

During the next few years, the government was getting its bearings, and constructing its economic programs of which privatization was only a part. However, as we shall see, during this "get ready" period it cannot be contended that in the field of privatization any systematic planning was done; at least we did not run across any surviving evidence of a master plan.

In 1976, in one sudden dramatic action, the government threw privatization in high gear by drastically cutting all subsidies without exception. They were cut from 6.6% of total government expenditures to 1.8% in one single move. This obviously accelerated both the necessity to privatize and the wish to accomplish it. By 1976, therefore, privatization sales were gaining momentum and occurring with increasing frequency.

## **2. Magnitude and Direction of Effort**

The prevailing pattern of sales made and to whom they were made during this first phase indicates, that by and large, there was no consistency or underlying plan. The government sold to anybody in what seems a pell-mell effort to privatize.

During this period, the military took a position all too familiar in privatization programs throughout the developing world. They drew a distinction between enterprises that they agreed, perhaps grudgingly, could be privatized--these were mostly industrial enterprises managed by CORFO--and those sectors that they designated as "strategic sectors." Following a typical LDC pattern, this sector consisted of copper mining, petroleum refining and distribution, communications and, with some exceptions, the electric power area, generation more so than distribution.

There were two dominant themes during this period. The first theme was "reactive": to give back everything that was nationalized and put it back the way it was before or in any case to sell it without being particular to whom.

The second theme is one that is relatively rare in privatization programs in the developing world. The privatization program during the first phase had a strong ideological component, whereas in most countries, the pragmatic component is almost completely dominant. This unique condition existed because of fairly unique circumstances: the Pinochet government was reacting in revulsion against a violent, strongly Marxist government that had rapidly put through, as statistics cited above show, an almost complete nationalization of the entire country.

"Reactive" and "Ideological" are therefore the two words describing this first phase.

## **3. Details of the First Phase Privatization Program**

### **a. Prioritization**

We are not aware of any important schedules of prioritization, and therefore conclude there were none. It

was strictly "first come, first served." In all fairness, it has to be said that the evaluation of the economic outlook for Chile at this point, especially abroad, was not promising. There were not many takers. Foreign investors had no interest in loaning money to Chile, let alone investing in the country.

**b. Legal and Legislative Clearance**

This is the step wherein companies selected for forthcoming privatization are legally disengaged and any necessary enabling legislation is enacted.

In Chile this step was relatively simple. When enterprises were returned to former owners, they were often returned free, almost entirely so in the agricultural sector. The only legal restraints were that the return would require a quit claim on the recipients' part.

**c. Valuation**

In most privatization programs elsewhere in the world, there is a systematic attempt made to determine fair market values. This was not done during Chile's first phase. One would therefore logically expect prices to have been lower than they should have been and such statistical evidence as exists shows that they were somewhat low but not drastically so.

However, even this statement must be considered with some caution. At the time, the economic outlook for Chile was not promising. Moreover, during this period Chile experienced two severe depressions, one in 1975 and another in 1981-82. Any statement that a price is low, must be judged against where the country is in the business cycle. Moreover, the companies for sale were burdened with heavy debt from which, without exception, there was no forgiveness on sale. Nominal interest rates were very high, reflecting a high rate of inflation that was the inheritance from the Allende government (between 400% and 500% in 1973 and 1974). The Pinochet government did not get inflation under control until about 1980 and as an effect of the 1981-82 depression. In summary, the prices realized by the government during

this first period were "low", but in the context of the then economic circumstances they were not as low as they might seem today.

**d. Marketing**

The predictable results of a "first come - first served" marketing policy and a lack of prioritization was that privatization during the first phase period and particularly at the beginning of this period tended to transfer companies to established centers of wealth. Many companies were sold to already wealthy families in Chile who had been the former possessors of economic power and who had preserved some of this power within the shrunken private sector that prevailed during the Allende regime. In fact, five families account for more than half of the non-agricultural value conveyed during this period. As stated above, there was almost no foreign interest in buying, despite Chilean attempts to arouse it.

**e. Negotiation**

Negotiation was predominately with a single prospect at a time, and in any case on a "best offer" basis. Nevertheless, the government received a substantial amount of money during this period, particularly towards the end of it. A total of \$1.2 billion U.S. dollars at the 1984 rate of exchange had been received by the end of 1982.

**4. Special Aspects of the First Phase**

The period was brought to a close in 1981-82 by two dramatic events:

The first was the government's first attempt at making a public offering on the relatively small and inactive Chilean stock market of a minority interest in SOQUIMICH. SOQUIMICH is a significant company, the country's only producer of nitrate fertilizer. While its profit performance at that time was lackluster, considering the chronic worldwide poor condition of the fertilizer industry, SOQUIMICH had done reasonably well, and it is today again highly profitable. Nevertheless, the shares were priced too high and the offering of a minority part of the

government's ownership (it had been nationalized during the Allende regime) had to be withdrawn.

It is unusual for any significant "milepost" privatization first effort to end in failure. Usually the government in question takes more care to make sure that this does not happen than was apparently the case here.

Even more dramatic were the events of 1981 and 1982 when a second economic recession occurred. Five banks, of which the two most important were Banco de Chile and Banco de Santiago, two very large banks, brought themselves to the brink of insolvency. However distasteful it may have been, these banks had to be rescued in January 1983 by being renationalized, i.e. "intervened" by the Pinochet government.

Much of their condition had been brought on by the looseness of the privatization program and their own resulting conduct. These banks that were intervened, by 1985 represented 36.5% of all government loans. They had originally been privatized with substantial amounts of credit and had then proceeded without any restraining regulation, to obtain further credit, go on an acquisition binge, actually, in many cases, using the acquired stock of a first acquisition as collateral for succeeding acquisitions. Thus, when these banks faced failure it was because of a great many of their sizeable subsidiaries operating in the industrial sector. Two sizable bank subsidiaries, for example, were COPEC (gasoline distribution) and CCU (a brewery).

This area that was privatized, then renationalized, and as we will see, ultimately reprivatized, is referred to as the "strange area" or "odd sector" ("area rara"). Its magnitude was considerable as is revealed by the percentage of government loans involved as stated above, and by the fact that it represented \$1.3 billion U.S. dollars of book asset value.

A word should be said here about the always important issue of employee redundancy. During this period, 1973 to 1982, overall employment was basically stable, declining only 4% by 1982 to 2,825,000 persons. During the same period, employment in state-owned enterprises declined from 161,000 to 90,000. Fifty-nine percent of this decline was simply to get the state-owned enterprise number of employees back to the 1970 level, i.e.

undoing what had been done during the Allende regime. Employee redundancy termination pay had much earlier been set up by law to be one month for each year of employment with various maximum ceilings at various times of twelve to twenty years. This burden was paid and it of course added to the government's privatization costs.

That overall employment did not decline is a reflection of the overall economic improvement during the period, notwithstanding the set-back of the 1981-82 depression. It seems that the fortunate overall results in redundancy were due more to the country's generally improving economic condition than to improved efficiencies resulting from transfers to the privatized sector, at least during this early stage. Further to this point, the employment statistics in those enterprises that were still state-owned by the end of the period in 1985, had shown even greater decline than decreases in the combined private and privatized sector. This is because in all areas pressure for efficiency was on from the government. In our experience it is surprising for government pressure for improved efficiency to be this successful.

#### 5. Summary of the First Period of Privatization

Three general conclusions will serve as a summary of this first period:

- a. Chile's privatization program, however happenstance its first phase appears, got in full gear and was, despite many mistakes, some of them important ones, rolling along by the end of the period.
- b. By the same token, while there was a lot of privatization activity, by the end of the period not a great deal of first rate economic importance had happened in terms of whole industries being completely privatized. This is quite common and typical of the early stages of developing country privatization programs. Below are repeated the statistics quoted above in Table I and they are compared to an updating as of 1981 shown below in Table 2:

TABLE 2:

SHARE OF STATE OWNED ENTERPRISES AND GROSS OUTPUT (%)\*

<u>Sector</u>	<u>1965</u>	<u>1973</u>	<u>1981</u>
Mining	13.0	85.0	83.0
Industry	3.0	40.0	12.0
Utilities	25.0	100.0	75.0
Transport	24.3	70.0	21.0
Communications	11.1	70.0	96.3
Financial	n.a.	85.0	28.0
Public Percent of GNP	14.2	39.0	24.1

\* Source: see footnote page 41

By 1985, therefore, similar comparative statistics show that

- state owned enterprises still represented over 20% of GNP compared to 14% in 1970;
- of the 50 largest companies in Chile, 35 of them were still state owned, including six of the top ten in size and they represented 60.3% of the assets of these top 50 companies.

c. In some of the state owned sectors there was a lot of privatization activity underway, vigorous but undisciplined, with a lot of micro-results, but not too much in the way of macro-results.

#### D. SECOND PHASE OF PRIVATIZATION 1985 TO PRESENT

As will be developed further below, during the second phase a systematic approach to privatization replaced the unsystematic approach of the earlier period.

##### 1. Sequence of Events

In 1985, the President issued an explicit order to the military to proceed with privatization. As a direct consequence of this "clearing of the air," the sanctity of a "strategic sector" was importantly breached and the bastion of military

resistance to privatization all but disappeared. At the beginning of the period, I have been told that people literally lost their jobs for suggesting that certain enterprises should be privatized; by the end of the period they were being privatized.

During this period two AFP's were made independent entities. AFP's are private pension funds in the standard United States' sense of the words, except that they are always private independent entities rather than enterprise-owned.

These two largest pension funds were parts of the operation of the two largest bank groups from the "area rara". They were separated from their bank ownership and separately privatized. In each case they were sold to foreign investors, one to Bankers Trust and one to Aetna Life Insurance. At least in the case of Bankers Trust, they have admitted that even at the time of purchase they contemplated eventual resale at a profit. This objective could be a hangover of attitudes prevailing during the first phase.

During this second period, foreign investment came enthusiastically and importantly into the privatization market.

These new departures in program (and perhaps their very success) brought on increasingly vocal political opposition to acquisition of nationally owned assets by foreigners. A transfer of assets to foreigners admittedly changes the balance of national wealth but in reality the underlying objection was that sales to foreigners became a political whipping boy. In our experience, this strong an opposition to sales to foreigners is less prevalent in Latin America than might be popularly supposed. Governments are often able to accommodate opposition with surprising ease. It is possible that the very dogged determination of the administration without accommodation to political reaction has made this more of an issue in Chile than would otherwise be the case.

The "area rara" was reprivatized. "Popular capitalism", as further described below, was invented as a new program to appeal to a new class of investors. It grew out of a program to reprivatize the banks in the "area rara," a special program that was set up in 1984. While "popular capitalism" terms of sale and the concept and program survive, the specific provisions of the

original program were initially scheduled to run for five years but were terminated early, in 1986 due to the excellent initial results of the program.

SOQUIMICH, the nationalized nitrate fertilizer company that had unsuccessfully tried to partially privatize on the stock exchange earlier, was offered on the stock exchange in late 1986. By this time it had become a highly profitable company and 100% of it was successfully subscribed.

In 1988 it was also announced that IANSA, a sugar refining company, would be 100% privatized through the stock exchange. It had been partially privatized earlier, and Continental Bank currently owns 31.5% of this company.

In this second phase, public auction was proportionately more prominent as a marketing method. COPEC, the former bank subsidiary engaged in gasoline distribution, was bought in public auction by one of the industrially prominent Chilean families to the extent of 60%. Later half of their interest was sold to New Zealand interests.

In July 1988 it was announced that 15% of the national airline, LAN-CHILE, would be offered to the public on the stock exchange. There are two aspects of this proposal worthy of general note:

- a. This is at least the first major instance in Chile, and possibly the only one, where the operating company was relieved of a sizeable amount of its debt. LAN is now, as a result, cited as profitable, thereby enhancing its market attractiveness. Creating this profitable image has been privately stated as one of the reasons for its debt forgiveness. LAN had formerly incurred large losses with substantial government subsidization. Assuming this is the correct interpretation, it raises the question why, especially in the phase one period, when potential buyers were hard to come by, there was not more debt forgiveness or debt transfer in order to enhance the absolute net sales price and to attract a wider range of buyers.
- b. Several national airlines have been privatized successfully in other countries. Nevertheless, the sale of a national

airline is a tricky proposition. It often involves national pride, highlighting the question whether the government is "giving away the national patrimony". This is a subject that politically aware governments approach with extra caution. Under these circumstances, it is remarkable that the ideological determination of the Pinochet government has again triumphed over political caution in that the airline is now being offered for sale at a time almost concurrent with the national plebiscite to determine whether under a "yes" or "no" vote the present government is to survive. It is interesting to note that there will be heavy employee participation in the share offering.

It is entirely possible that "national pride" in LAN may well be exceeded by national pride in LADECO, which is primarily a domestic airline that is and has been all along 100% private and has been gaining in market share on LAN. The Center political opposition states that it will try to make a political issue of the privatization of LAN and it expects a favorable public opinion response. Other observers say that a lively response is not likely.

## 2. Magnitude and Direction of Effort

The words characterizing the first privatization period have been cited as "reactive" and "ideological". The effort during the second period has been much more "systematic" and much more "efficient".

This second period has been characterized by a number of innovative programs, the most well known of which is "popular capitalism". As stated, this grew out of the desire on the part of CORFO to refloat the "area rara" companies on an emergingly important public stock market. It was concluded that in order to make an offer of these shares appealing, it would be necessary to create a new class of shares and market them with wide distribution to a new class of owners. Whether the concept of "popular capitalism" in fact emerged out of the challenge of this large proposed offering or whether the concept of broadened ownership arose first is an interesting question.

"Popular capitalism" has as an important part of its distinctiveness, special new tax and loan concessions. Tax

credits, with certain limitations, were allowed for subscribers to offerings under "popular capitalism". These tax benefits are (for details see Exhibit II):

1. Tax credit up to 10% of three-year average income tax liability;
2. Dividends tax-free

Loans up to U.S. \$6,000 (indexed) per person were made available by the government which also on occasion made available liberal loans to the subject companies. As an inevitable result, preference in purchases accrued to individuals of greater financial substance.

"Popular capitalism" is therefore an investment-oriented, market broadening, slogan appeal designed to reach at least as far down as the middle and low-middle class.

#### c. Details of Second Phase Privatization Program

##### **a. Prioritization**

One gets some sense of prioritization in this second period although still not the feeling that there was a clear laid out sequential plan.

##### **b. Legal and Legislative Clearance**

There has been some feeling that the companies being disposed of, now of increasing importance, should not be disposed of by decree, but should be disposed of by the same legal processes that created them. This point relates especially to those companies of the "second category" that were created as nationalized institutions by law. (For the distinction in Chile between a decree and a law, see Exhibit IV) The opposition hopes to make political capital of this. Whether this will be a popular issue remains to be seen, but it is an instance of opposition to privatization coalescing as the privatization program gains in importance and momentum.

**c. Valuation**

Only recently has there been a program of the state's independently arriving at a fair market value for the state owned enterprises that it offers for sale. However, in this second phase, there has been an increased number of instances where privatization has been channelled through the increasingly active stock market. In these cases, and particularly where foreign buyers have been involved, respected domestic and foreign investment bankers have been the intermediary determining the sales terms, and there is no suggestion that this has been done on anything other than a fair and objective basis.

By whatever method of transfer, a general impression, backed up to some degree by statistical studies, indicates that the earlier "bargain" prices that may have prevailed in the first phase are no longer the case in the second phase and that full value is being received by the government.

The amount of value received and the times when it was received have been as follows:

- through 1982, expressed in 1984 dollars, \$1.2 billion had been received;
- Since 1985 about \$918 million has been or will be received by the end of 1988, including about \$300 million received in each of 1985 and 1986. In 1987 the government received about \$150 million and 1988 is estimated at approximately the same amount.
- Adjusting all these numbers very roughly for inflation indicates that the government has received a total in current dollars of something well over \$1 billion, or well over \$2 billion in values prevailing at that time.

**d. Marketing**

As stated, the privatization program experienced accelerating momentum during the second phase.

The method of offering up the companies changed substantially during this period. The most common method of privatization was bidding at auctions. Most of the companies from the "area rara" were put up for auction. Direct sales on a "best offer" basis were much less prevalent than in the first phase.

The companies sold under "popular capitalism" were, especially initially, often sold at auction, but as the period moved on, this sector and some others as well were increasingly handled by public offerings of stock.

**e. Negotiation**

Increasingly during this period, sales were handled by brokers or by investment bankers whether they were put through the public stock market or not.

As successive offerings were made, inevitably the necessity to make a decision on majority control by government of the companies arose with increasing frequency. Passing each of these milestones in control was faced and dealt with without special concern on the government's part.

**f. Terms of Sale**

As foreign buyers became more interested in investing in Chile, the country pioneered in retiring some of its foreign debt by invention of the debt/equity swap. This was tied in, in an increasing number of important instances, to privatization. The average amount of discount earned in a debt/equity swap during this period has been about 30%. This, of course, represents, to a buyer from a hard currency country, a discount over other bidder competitors not so situated, of approximately that amount. Whether the government is truly experiencing a discount in its sales is open to question, since one has to assume that the market-determined discount on Chile's debt represents the likelihood that the full amount of face value will not be repaid. If the market assumption is correct, then the current discount on the price obtained is a discount that will occur anyway, although later in time.

Of course, not all of the debt/equity swaps were in conjunction with privatization.

As stated above, "popular capitalism" was originally conceived of as a means of reprivatizing the bank shares and AFP's from the "area rara" and the shares of their former subsidiaries. Of necessity, a new class of owners was preferred and necessary. "Popular capitalism" offerings have all been stock market offerings to the general public. The amount of subscriptions allowed per individual has been proportionate to the individual's average tax payments over the preceding three years. Therefore, there is some weighting in subscription ability in the direction of the more moneyed interests. Most of the sales were allowed on credit, as described above. Except for this, during the second phase all of the important sales (and of course those that went through the public stock market) were for cash.

#### 4. Specific Aspects of the Second Phase and Conclusions

The objectives of the first phase of privatization were:

1. to react against the Allende regime policies and reverse its "statist" orientation
2. to raise revenue
3. to improve efficiency by returning management to the private sector.

In the second phase, while there was no wavering in the idea that transfer to the private sector was desirable, there was less insistence on the idea that privatized operations were automatically going to be more efficient. This attitude probably evolved because efficiency improved in state owned enterprises as well as in privatized companies and moreover there was considerable disillusion about the results of the private operations of the banks in the "area rara".

Instead, the principal new philosophy in the second phase of privatization has to do with broadened ownership. Most of the slogans and programs that were developed had as their fundamental purpose broadened ownership: "popular capitalism" discussed

above, "labor capitalism" which is employee stock ownership, and "institutional capitalism" which represents the fact that the newly constituted banks and the AFP's became, along with mutual funds, important investors during this period.

"Labor capitalism" has had impressive results if on a somewhat occasional basis. It has been in most cases the relatively conventional designation of a moderate proportional quantity of total shares being publicly offered to be reserved for workers, often with some purchase discounts. This program has not accounted for a massive number of shares but it is an impressive pioneering effort. This program is discussed in the body of the report under the section on ESOP's.

#### 5. Administrative and Organizational Structure for Privatization

The government's administrative and organizational structure was simpler than in most privatizing countries, essentially having been guided in large part and implemented almost completely by CORFO. A council of relevant ministers, who also serve as CORFO's board of directors, provided policy guidance. Undoubtedly, this absence of complexity and lack of organizational cross-current was a result of the GOC's consistent approach that excessive political caution and the need for transparency as political protection could be largely dispensed with.

The organizational set-up within CORFO is described in Exhibit V.

#### E. EVALUATION OF THE GOVERNMENT OF CHILE'S TOTAL PRIVATIZATION PROGRAM

This is an evaluation of all phases of the program.

##### 1. Points of Similarity; Points of Difference for Chile Compared to the Experience of Developing Countries

- a. The first phase of the government's privatization program was conducted in much more of a hurry than is ordinarily the case. The second phase was much more deliberate. In the

first five years of Chile's program, a large number of transactions were accomplished, but considering the number and economic importance of the state owned enterprises that still existed, not too many privatizations of first rank importance were completed. This slowness in accomplishment for the first several years of a country's privatization program is a frequent occurrence.

b. It is typical for countries developing privatization programs to reserve out from the program critical companies or industries designated as "strategic sectors" and this was done during the first phase of Chile's program. There developed, however, a substantial loosening of this reservation, finally resulting in almost complete discard of the concept with certain individual exceptions. This is atypical.

c. This issue is related to the initial resistance of the military to any major privatizations which was finally overridden by President Pinochet. It is certainly quite common for the military to object to privatization; it is our understanding that by now the majority of the military has been won over to the program.

Historically, overall resistance to the program has been about normal or perhaps a little more than normal.

d. Chile's privatization program has been a very bold program and one that has persevered despite setbacks of some importance. This has clearly primarily been due to the personal resolve of President Pinochet. It is interesting to speculate why he has exhibited this resolve. It seems in part to be his nature and in part it is because of the unique elements of strong and even emotional reaction to the Allende regime.

e. In addition to using valuation experts and investment banking and other implementing services, most privatizing countries have used general consulting services available from other countries that have already had experience. Chile's experience occurred at an early date, but it is still remarkable that it was done without overall outside help. When a country can accomplish what Chile has and can

do it all alone, this is doubly effective and doubly impressive.

- f. Organization of the government's privatization program has been relatively decentralized. The Ministry of Finance and the Ministry of Economics both have responsibility, with a degree of division between them that is unclear. CORFO, owner of many of the state owned enterprises, is an independent ministry that also shares important responsibility.

This decentralized organization is most frequently found where there is not a detailed master plan, as has also been the case in Chile. The existence of a master plan and the creation of a centralized "czar" for privatization occurs more often than not in privatization programs of countries adopting such programs more recently.

- g. As strategic sectors are transferred to private ownership in country privatization programs, regulation of their now-privatized industries has been an important issue in many countries. It is, for example, one of the principal issues in Great Britain. Regulation has existed continuously in Chile but industries have not been as vigorously regulated as has usually been the case in industrial countries.
- h. Throughout the period, the general pattern of reduction in state ownership has been piecemeal and for most individual companies has featured gradual successive steps of reduction rather than all at once.

## 2. Favorable Results of the Program

- a. The government's resoluteness and sense of urgency about the program have been extreme by any comparative standards, and this has been admirable.
- b. On balance, the prices received by the government for privatized enterprises have been adequate. In the first phase of privatization there is some evidence that prices were too low but the combination of being at a low point in the business cycle, high interest rates, and the existence of heavy debt and debt service (which was indexed) would make

one moderate this claim. In the second phase, prices have appeared to be adequate.

- c. As detailed above, during the program overall employment has evened out about level despite there having been two recessions. As cited, employment in the state-owned enterprises that were privatized decreased as it did in state owned enterprises that were not privatized. An important component in both cases was to eliminate "disguised unemployment". This refers to the Allende government's insistence that state-owned enterprises hire people in excess of those needed in order that unemployment statistics be reduced. It has been estimated that in state-owned enterprises on the average this amounted to as much as 25% over-employment or about half of all the decrease in employment experienced in the sector subsequently privatized.

As with many of these points, a full assessment of the economic effect of privatization is difficult due to the fact that there was a total government program with a variety of important influencing economic factors of which privatization was only one part.

- d. Profit performance of state owned enterprises, which had aggregated a loss, has been good lately, both in the privatized sector and in the still non-privatized sector. Return on book equity is still not impressive but given the increase in values in the stock market, return on investment (i.e. return on the equity market value) has been excellent for privatized firms. The magnitude of this improvement is shown by the fact that in 1975, state-owned losses (excluding CODELCO and ENAP) were \$2.3 billion, whereas they are now much nearer break-even.
- e. Despite fear that privatization would result in monopolies being perpetuated, the privatization program increased the exposure to competition for all sectors (private, privatized and state-owned). Despite many cases of continued

predominance of monopoly, consumer prices have not risen; they are down in real terms.<sup>2</sup>

- f. The broadening of ownership that occurred to such a substantial degree especially in the second phase of privatization is unique outside of some of the privatization programs in Western Europe, especially in Great Britain. This broadening of ownership was accomplished both by conventional and unconventional means, with some of the latter innovative programs, popular capitalism, labor capitalism, and institutional capitalism continuing.
- g. The linking of privatization to debt/equity swaps is a brilliant Chilean invention. As a consequence of this debt/equity program, foreign debt has held level.

### 3. Unfavorable Results of the Privatization Program

- a. Up through at least 1982, despite ten years of intermittent effort by the present regime, the privatization program in its first phase was executed unsystematically:
  - 1. Too many companies were sold too quickly. This suggests that too low a price was achieved, which is supported by some evidence.
  - 2. Too many of the companies were sold early on in an unprofitable state. Our experience elsewhere strongly suggests that deferring privatization on the grounds that state-owned enterprises will be improved is very that performance of state-owned enterprises will be improved is very often an illusory and mistaken concept. But Chile's experience with those companies

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<sup>2</sup> These were fears with some basis. In 1985, of the thirty-five SOE's included in the fifty largest companies previously cited, thirteen were judged to be monopolies, seven were judged to be semi-monopolies or oligopolies, and fifteen were judged to operate with a reasonably competitive structure. In more instances than not, this condition continues to some degree.

that continue to be state-owned suggests that improvements would have occurred, and that a better price might have been achieved by waiting.

3. Each offering or series of offerings was very much a random mixed bag. The only exception to this (as set forth in the Case Histories section) was the power segment. It should be noted that this lack of systematic approach occurred despite the fact that quite a number of economists trained in the University of Chicago School were working on the program, possibly, therefore, applying more enthusiasm than system to their work.
- b. The initial customers purchasing state-owned enterprises were the wealthy and privileged class. No fair price was established by the government for the enterprises and there was initially not enough competitive bidding. Instead, in many cases, a single "best offer" was entertained and there were frequent resales later to other owners at a profit for the initial acquirer. Monopoly conditions had been prevalent and were to a considerable extent perpetuated.

A fair question is whether selling the state-owned enterprises relieved of debt would have achieved better prices net for the government.

- c. Especially in the first phase of the program, excessive credit for the sales was allowed. In the case of the privatized banks in the "area rara" sector this resulted in the pyramiding which may have helped cause and certainly deepened the 1982 recession.
- d. Was regulation, especially of companies that were in the "strategic sector" but were still eventually privatized, and in the case of successor private monopolies vigorous enough? Regulatory bodies exist but we are not sure whether adequate control was exercised. As companies were privatized, some regulatory restrictions were removed from their investment programs. Moreover, the administration of regulation changed drastically in the leniency of interpretations allowed. Especially in the case of banks, that normally

require special regulation, the almost complete absence of effective regulation was inadequate.

- e. Most governments take excessive pains to make sure that the trail laid by each privatization is transparent. Especially in the first phase, some of the sales were not transparent enough nor was there sufficient factual information available to prospective buyers and to the general public.
- f. In many countries experiencing a pattern of creating a development bank and then finding it has been used to make excessive and uneconomic loans, an important plank in a later privatization program has been providing for the liquidation of the bank, or at least terminating its borrowing power. This also establishes a policy of intent to make privatization irreversible. No liquidation of CORFO has been provided for. As the current privatization program draws to a close, perhaps CORFO has largely outlived its usefulness. Admittedly, liquidation of such institutions doesn't prohibit subsequent governments from starting up some profligate program again, but it makes it a little harder.
- g. Despite the fact or at least the impression that privatization programs initially involve contraction of employment, during this period overall debt increased. A large part of the reason was the necessary rebuilding of capital from a starved base.
- h. The effect on savings of the privatization program has apparently been negative, due to the need of all sectors to catch up on both fixed capital and working capital deficiencies.

#### 4. Conclusions

- a. Chile's privatization program has been remarkable for its resoluteness and follow through, all the more so since it occurred during a period of tremendous economic reaction and change, and with the upheaval of two recessions. By the standards of other country experience, at least in its latter stages it has been speedy.

- b. The privatization program occurred in two phases, 1974-1982 and 1985-present. During the first phase, the basic themes were reaction against the statist orientation of the immediate past, the necessity of revenue raising, and the belief that the private sector would be more efficient. In the second phase these objectives continued, the last one with somewhat less emphasis, but an important new objective of broadening private enterprise ownership to include the investing public was introduced.
- c. The errors that took place in the program were significant. They occurred partly because of the initial hurry to accomplish privatization, partly due to a laissez faire attitude and partly due to just a simple lack of thinking things through. Nevertheless, and importantly so, it is remarkable that Chile, as a pioneer in privatization, didn't make more errors. None of its errors were crippling and the country avoided many of the mistakes that are still being made by others.
- d. The program has to be judged overall as an economic success, brilliant in some respects even though flawed in some ways. Chile accomplished it all alone.

#### G. OUTLOOK FOR PRIVATIZATION

The outlook for a continuing privatization program in Chile depends entirely on under what political scenario these later acts are played out. Will the present regime continue or will it be replaced?

The political means of resolving this question were established by the 1980 constitution. First of all, there will be a plebiscite, "yes" or "no", on the present government. This is set for October 5th. If the plebiscite results in a "yes" vote by however narrow a margin, the executive branch of the present regime can continue in power for eight years, but supplemented by a popularly elected legislature after one year. If the plebiscite vote is "no", then there must be a national election for president and a simultaneous congressional election after a little over one year.

The political spectrum comprises the present government, militarily oriented and appointed and as its opposition an amalgam of some twenty parties ranging from right to left but of such broad spectrum that the question arises as to the conviction of any one candidate to carry the flag. The far left is now of relatively little influence except in the event of some split of the other parties more fractionating than presently contemplated. Present polls, with their reliability not in disrepute but not verifiable, say that the result is too close to call and will be determined by the as yet "undecided" votes. If there is a hidden vote it probably is in the "no" sector. There is a split in support with cities likely to lean toward "no", rural areas likely lean toward "yes". Given an outcome not dramatically different from the above indications of a close vote, a military coup, while possible, appears unlikely.

1. Outlook under the Present Government

The most important aspect of the government's current privatization program is that it is almost completed. Table 3 below shows that of some 60 enterprises which includes all of the most important state owned enterprises that existed at the beginning of the program, 58% of them have either been privatized or there is some indication that they will be in whole or in part. For 30% no plans have been announced and the assumption for most of these is that they will not be further privatized. Examination of this category shows that for well over half of them a reasonable case for continued government ownership can be made. For 12% future intentions are unannounced or unknown to us. Compared to other countries this is a very substantial achievement.

TABLE 3:

DISPOSITION ACCOMPLISHED OR INTENDED FOR  
MAJOR STATE OWNED ENTERPRISES\*

100% disposition completed	16	
Government minority, disposition announced	3	
Some disposition under study or announced	4	
Government majority, some disposition planned	<u>12</u>	
	35	58%
Government majority, no plans known	18	30%
Status unknown	<u>7</u>	<u>12%</u>
	60	100%

\* Source: see Exhibit I

Exhibit VI sets forth all the major state owned enterprises in this period showing the time sequences in which they were partially or wholly privatized. Note that the overall sequence, historically, appears to be

1. no major divestitures of these companies prior to September 1985;
2. 1986 features: complete or partial divestiture of power companies; partial offerings of some other companies with majority control retained;
3. 1987-1988: most of the power companies divested; majority control elsewhere surrendered except in transportation and mining.

Exhibit I sets forth the major enterprises that are still state owned and in most cases their intended disposition showing which ones are concretely pending action, which ones, in our opinion and with some indication from the government, appear still to be candidates for privatization, and which ones apparently will not be privatized.

As of now, the most notable characteristic of the government's privatization program is the degree to which it continues to push ahead vigorously. In our experience, no matter how pro-privatization most governments are, most of them slow down their activity, particularly controversial activity, about one to one and a half years before an election. Logically, the impending plebiscite should be no exception, but the fact is that the government has shown no sign of slackening its privatization activities. In fact, one part of its latest proposal (announced in July with the election in October) is that privatization of LAN, the national airlines, should commence. In our experience, privatization of airlines is one of the most controversial topics a government can tackle, since questions of national pride and national patrimony arise. Nevertheless, the government, in its persistent fashion, has been pressing ahead.

The above material and exhibits set forth the disposition of the candidate companies remaining on the agenda. The question arises what new candidates might be added to the list of

privatization candidates. Our speculation on this is in part the result of discussions with government officials.

Candidates that have been specifically scheduled for privatization are the port authorities and an airlines terminal. It has been pointed out that these activities and several others can be dealt with as separate and detachable pieces to be privatized either in toto or piecemeal. Various alternatives are under study.

Beyond this, the next area appears to be the area of services. Two specific service areas have been alluded to in government remarks. One is the area of health care. Most hospitals in Chile are private but other aspects of health care, for example day care centers, are possibilities for privatization. Another area is technical education. It is discussed in the body of the report that there is a great need in Chile for technical education and the possibility of privatizing it is being considered.

In these services, as in all services, the possibility of contracting out is logical. There may possibly be some contracting out of other services, such as municipal waste disposal and other services, providing of water, etc. On the other hand, it can be argued that given both alternatives, contracting out is a less complete procedure than full privatization.

## 2. Outlook for Privatization under an Opposition Government

The opposition government assumed is a coalition of Center parties.

The attitude of the Center parties as revealed through interviews with them and through general discussions. It indicates that they view the whole subject of privatization as "tricky". They have hope that a favorable political issue for them is cumulatively developing. They object to foreign sales; they object to their contention that privatization has been to the benefit of the privileged and they rely on a historically prominent feeling that at least "strategic sectors" should be nationally cared for and nationally administered.

Nevertheless, it appears that the privatization movement has gone too far, there is too much vested interest established in it, so that a Center government will not undo what has been done and may even add to it, but much more modestly than the present government would do and undoubtedly administered with an increase of caution and red tape. While the program may continue, it would not be surprising to see the fire go out of it.

The Center opposition hopes to make a political issue of the privatization of the national airline LAN. It is our opinion that attempts to make this a popular issue are likely to fail.

Recently 13 of the 20 parties of the Center issued a generalized statement condemning what they viewed as the excesses of privatization. Nevertheless, all of these Center parties are splintered as to their different attitudes, privatization being no exception, and the degree of passivity or reaction of a successor Center government may well depend on which splinter parties, leaning left or leaning right, would dominate.

#### H. CASE HISTORIES

This next section goes into somewhat more detail on four industries:

1. Electric Power Generation and Distribution
2. Communications: CTC and ENTEL
3. Banks and AFP's (pension funds)
4. Steel

When looked into in additional detail, each of these cases tells an interesting and representative story giving detailed examples of some specifics on privatization.

##### 1. Electric Power Generation and Distribution

In the post-World War II period, CORFO was given responsibility for creating a rational network for the electric power industry. In the initial phases of this program large components of the industry were not government owned. The pattern that eventually emerged was one in which ENDESA, in

itself a power generating company, served importantly as the middleman. Somewhat over-simplified, power generation companies sell to ENDESA and ENDESA sells to the distribution companies. Control over the industry, but especially over ENDESA, permitted the government (even before nationalization) to embark on creating a rational nationwide structure in which it was decided that the nation should convert from thermal to hydro-electric and, because of the relatively cheap costs of hydro-electric power, that nuclear energy should be rejected.

During the Allende regime almost all of the industry, a few cooperatives excepted, was nationalized. This was accomplished by the government's buying up power companies' shares. It did not, however, do so in an open market: all share prices were, in any case, depressed, given the economic outlook for the new regime. And there certainly was some intimidation enforcing sale.

Under the Pinochet regime, a privatization program for the electric power industry was developed. The essential unique feature in this case was that, unlike so many other industries where privatization was an unplanned series of events, there was something of a rational plan developed for the electric power industry. Its guiding principles were as follows:

- a. Distribution companies would be privatized sooner and without some of the reluctance that later attended privatization of power generation.
- b. There would also be privatization of power generation but in general this would follow behind power distribution.
- c. ENDESA represented the nerve center of the industry and in fact was therefore a "strategic sector" all on its own that would not be privatized (as with so many other industries in Chile this was later relaxed and ultimately completely reversed).
- d. The initial privatization priority sequence set up was a very pragmatic one: those distribution companies that were profitable and therefore likely to be commercially appealing and that were legally the least trouble to divest would be the first be privatized.

The first candidate was a power distribution company serving Santiago and Valparaiso, CHILMETRO; it was profitable. For it, and for each company in turn, legal clearance was first established and then some rationalization of organizational relationships, especially with ENDESA, were established so that each company could be both free standing and have a clear relationship to ENDESA. Thereafter, privatization of other electric power distribution companies proceeded. In some cases there were squabbles with communities (without necessarily any legal justification); the localities felt that they "owned" the local power distribution facility. Later in the sequence, ownership in power companies was opened up to foreign investment.

The government was more cautious about privatizing companies engaged in power generation. This was considered much more of a "strategic sector". Privatization of power generation companies began later in time and much more frequently the offerings were initially partial, as the government worked up only gradually to surrender of majority control.

The industry privatization program also opened up the way for privatization of the third area in this industry: those companies that consisted of hydro-electric power plants only. Some of these also were privatized; for those that have not been privatized, the reason given is that more investment is needed and they are therefore remaining in government hands. This reasoning has not been further investigated but on the face of it, is questionable.

As described above, the "jewel in the crown" in the industry is ENDESA. ENDESA was the last sector to admit of any privatization, with 20% being sold in 1987. A second offering occurred later in the year and the intention has just been announced to make a third offering that will bring government ownership up to the brink at 51%. It has been stated that ENDESA will be completely privatized.

The first offering of ENDESA was made through the stock market as an outright sale to the public as part of "popular capitalism". As such it was broker-priced and investment-bankered by Rothschild and a local bank, BICE, in what would stand as a model exercise in privatization offerings. A new class of shares was created and the classic pattern of "broadened

ownership" under "popular capitalism" was applied: loans up to 15 years for the purchasers, tax credits up to 10%, dividends tax free, maximum tax forgiveness with a ceiling of \$6,000 per person. A small proportion of the stock was reserved for employees and was offered at a small discount. Foreigners were also permitted to buy into the industry.

Tariffs and other regulatory matters have been handled all along by the National Commission of Energy. Since the privatization program for this industry started, the strictness of administration by the National Commission of Energy has eased considerably. Unlike formerly during the first days of privatization, the commission now takes into account such conditions as marginal provision of power and peak loads of power with resulting price adjustments allowed.

When privatization of ENTEL is completed, the industry will be completely privatized excepting only a few outlying regions where the government feels service can not be supplied on satisfactory commercial terms and must therefore in effect continued to be subsidized by government operation, Easter Island, for example.

## 2. Communications: CTC and ENTEL

CTC is the telephone company; ENTEL handles microwave, audio, video, and international telephone. ENTEL sells its products both to CTC and to private users. It is the mechanism for hooking into International satellites.

As of 1973, the telephone system was still predominantly nationalized with some alternate local privately supplied areas.

CTC was nationalized by the Allende regime. It had previously belonged to ITT. It was nationalized without compensation but in restoring it to private hands the Pinochet government paid ITT compensation of \$25 million. Since ITT had already been reimbursed by expropriation insurance, they donated their subsequent Chilean compensation to a fund (Fondacion Chile) matched by the government, thereby totalling \$50 million with the objective of pursuing wide-ranging R&D in Chile. This R&D is not related to communications; among other things it has been substantially involved in fisheries and fruit growing. If these

enterprises become commercially successful the fund is set up to be self-liquidating but continuing.

Telephone instruments have always been purchased from abroad and this continues to be the case. Under national ownership there was a bad wait of five to eight years. This has now been eliminated and in fact a significant independent business of telephone brokerage has sprung up. CTC essentially continues as a monopoly, although two new private companies have been created. These were created to fill geographically local gaps in telephone coverage that ex-employees of CTC were knowledgeable about and proceeded to set up and service.

The government's first move in preparation for the privatization of CTC was to sell off the non-core businesses, stripping the business down solely to that of providing telephone service. This meant selling off a variety of component and support businesses.

There ensued several stock offerings of CTC. The most sizeable one was conducted by an auction with competitive bidding. In the second round of stock sales, employees were offered a limited amount of the shares at a preferred price. A number of telephone companies, mostly foreign, bid on these offerings but 35% of the company was sold to the highest bidder, the Bond Group of Australia. In return for a commitment of \$250 million of investment by a certain time in 1988, it was committed that the Bond Group share could rise to 45% and this transaction is now underway in the summer of 1988.

ENTEL, which can be looked at as a more sophisticated extension of the communications field, has from the beginning been state owned. It has been sold off in public offerings in at least four separate offerings. A preferred price for a limited number of shares was offered to employees. The government now has 51% ownership.

### 3. Banks and AFP's

AFP's (Administradores de Fondo de Pensiones) are pension funds, which began operations in May 1981 as a new law was enacted which allowed their existence. They originally belonged to their funding bank groups. All major AFP's have now been

privatized as separate profit making institutions. As independent cash reservoirs they have played an important role as an investment source for the second round of privatization. The two largest AFP's were bought by foreigners: Bankers Trust and Aetna Insurance. In Bankers Trust's case, they have been frank to admit that their purchase of their AFP was an investment on which they planned to turn a profit on resale at some future unidentified date.

The largest bank to be privatized in the early first stage of privatization was the Banco de Chile. The Banco de Santiago, the second largest, was created in 1974 by the country's largest financial group. Both of these banks and others as well were purchased almost entirely on credit with installment payments. Most but not all of these payments were made over several years in the late 70's and early 80's. Once released from government ownership, the banks proceeded to compound their credit and used this borrowing power to become investment conglomerates. Severe pyramiding took place and often the alleged collateral for an industrial company that one of the banks wished to buy (the acquisitions were designated parts of a "bank group" and consisted of conventional industrial companies) was stock of a previous acquisition that had been acquired with borrowed money not yet repaid.

It must be recognized that this extreme pyramiding took place in a period of prosperity. Following the 1975 recession, a boom was on and both institutions and individuals went heavily into debt on the theory that the sharp upward increase in values was going to continue indefinitely. It did not; a severe recession set in 1981 and 1982. If not brought on by these excessive credit and pyramiding activities, the recession was certainly worsened by the practice. By the end of 1982, these banks were on the brink of bankruptcy.

Banks had by law been subject to regulation, with requirements, for example, of specific ratios of assets to borrowings, but subsequently no regulation at all was applied to the "groups" and in most cases it was these subsidiary groups that accomplished the acquiring of other groups.

As the whole structure was about to come crashing down, the government stepped in and renationalized Banco de Chile, Banco de

Santiago and three other banks and therefore all of their subsidiaries. These included some very sizeable enterprises including CODEC (gasoline distribution) and CCU, a brewery. These two companies and other industrial subsidiaries were subsequently separated from their owning banks so that they could be sold as independent entities.

The government was especially sensitive to the idea that ownership of the five banks that had to be renationalized and then reprivatized should not revert to the same ownership that had created their failure. They therefore recapitalized each of the companies with a new "Class B" stock. With new stock and a search for new ownership, the concept of "popular capitalism" was born. Whether the concept of broadened ownership was born out of this necessity or whether it was conceived somewhat independently is hard to tell.

An important characteristic of "popular capitalism" was that appeal to new stock owners in an emerging stock market had to be enhanced by the use, once again, of credit. CORFO arranged for loans covering 75% of the stock, with the purchaser required to repay it only over a 15-year period. The loan amount allowed was \$6,000 per purchaser with the repayments to be indexed.

In addition, there were tax benefits as a further inducement. Any purchaser received a tax benefit of 10% of his taxable income averaged over the last three years. In addition, dividends from the companies were to be tax free.

From these terms, one can predict the class of ownership for which this instance of "popular capitalism" would have a special appeal. The liberal financing terms meant that almost anyone who wished to purchase could afford to do so in a true broadening of ownership. On the other hand, the tax concessions and benefits meant that the appeal would be skewed towards those wealthier individuals who paid significant income tax in the first place.

As part of the offerings, 10% to 15% of the stock was reserved for employee purchase. It was offered at a small discount and employees were allowed to subscribe one month in advance of the offering.

#### 4. Steel

The Pacific Steel Company (CAP) is Chile's only steel manufacturer and distributor of any consequence. The present company was created just after World War II when the steel mill, in the Concepcion area, was built with loans from the United States Export-Import Bank. The Bank's willingness to finance was not easily attained and it only agreed to advance the funds providing the majority of the company would be in private hands. This was accomplished, 22% came from foreign investors, the rest of the majority private ownership came from an insurance company and other local investors. The minority balance was purchased by the government through CORFO.

Construction of the steel mill was a turnkey operation provided by Koppers. As a consequence, for several years, a large contingent of foreign assistance and advisors were present getting the mill and the company started. One of the financial advisors felt that it was unsound to have the workers' pensions (one month per year of service with ceilings at various maximums that have been reduced over the years) entirely a liability of the company and therefore conditional on its continued prosperity. He persuaded the company that in effect it was borrowing the workers' money in an interest-free loan which ought to be used more to the workers' benefit. A plan was installed whereby workers of a certain number of years' service could borrow funds for the purpose of buying a home with an up to ten year pay back (indexed). Later, this program was expanded so that after buying a home, an employee could elect to take down further loans from this fund for financing seven years of intermediate and higher education for the employee's children.

These programs were very successful. 96% of CAP employees now own their own homes, and 40% of them have children who go through college. Employee turnover is something just over 20 years. Significantly, employees became used to the idea of borrowing funds which were both tax-free and interest-free.

CAP was in a tax-free status scheduled to end in 1970. The public board members prevailed over the private board members in extending this status in return for a doubling of capacity, which expansion proved to be ill-advised. The state was the sole

subscriber to the new share issue required to finance this unneeded expansion.

On assuming power, the Allende regime bought out almost all of the private ownership of CAP but at unfair terms that were biased against any wealthy owners. Shares were bought at full market but only up to a certain low maximum number of shares after which the price paid declined progressively in value so that large holdings were paid for as low in value as 1/100 of their market value. Each stockholder had 10 days in which to sell and had the option of selling all or nothing. The stock was paid for in unindexed bonds so that in practical effect the company was expropriated without compensation. At the same time the government fixed steel prices and ran the company in a manner that almost immediately started a train of losses.

With the coming of the Pinochet regime, Chase was asked to value the company, with the result that a price of \$150 million was established. At the same time, the military identified CAP as "strategic" and specified that only 40% of the company could be privatized. Chase looked for both domestic and foreign buyers and while there were some negotiations, there was almost no foreign interest. Inflation eroded the value of the company so that at one point its value was as low as \$3 million. Successive managements attempted unsuccessfully to sell the permitted minority of the shares. By this time up to 30% would have been allowed to private investors but in fact these investors did not materialize.

The present management concluded that they could only sell the company to buyers who had a special interest in and affection for the company, namely, suppliers, customers, or employees. The company undertook to sell these shares for 25 cents per share at a time when the market value for the small number of shares still remaining in private hands was 12.5 cents per share. The government gave permission that 49% could be so sold, very likely this liberal because they thought obtaining this premium was not possible. Employees were permitted to borrow against the loan fund for their purchases. This type of borrowing had long since become a tradition. Payments were to be made either indexed in installments over eight years or paying at retirement, which is what most of the participating employees elected. This, of course, caused a cash drain on the company, but it was against a

fund which by now was looked upon as belonging to the workers anyway.

The next crucial step, from 49% private ownership to 52%, was permitted by government after the 49% had been reached, on the grounds that all of the next critical issue was to go to employees. Once private ownership was in a majority, the rest of the government's minority holding of stock was sold very rapidly in several issues over only a four-month period.

Over the first one and a half years, a 10% employee participation had accumulated and the market had gone up to 24 cents per share. Cash was accumulating within the company and the government wanted to drain the cash off by issuing bonds favorable to it. It was persuaded instead to capture the cash by selling its shares in return for additional tax concessions forgiving tax on half of any dividends if the shares were held for two years. This sale, and the increasing popularity of employee ownership, has by now worked up to the point where 37% of the capital is owned by employees. Out of 7,000 employees, 5,500 now participate with 1,500 not doing so, mostly for ideological reasons; this category of employees has proven more likely to leave. Over a period of time for the participating majority of the workers, given the booming stock market, employee ownership has been a resounding financial success.

Company profits recently have increased dramatically from around \$5 million in 1983 and in 1984 (which was also the average annual profit in the pre-Allende era) to \$31 million in 1987 and with a further increase in store for 1988. General consensus is that the principal cause of increased earnings is related to the overall increasingly healthy condition of the economy.

With the improved fortunes of the company, resulting dividends have become increasingly significant for employees. In 1986 for the average employee annual dividends represented half a month's pay. In 1988 they will represent 3.7 months' pay.

The company cites four results of privatization of CAP, resulting particularly from the form of partial ESOP they have adopted:

1. They believe private ownership makes the company much easier to manage because everyone, almost without being told, knows that the central focus is on profits.
2. The principal restrictions that the company felt were inhibiting under government ownership were a lack of decision on access to adequate fixed capital requirements and government unwillingness to let the company expand by diversifying.
3. They feel very strongly that their experiences have made them more "progressive" than companies who had a more routine history of constant private ownership and they believe that the privatized sector is the logical candidate to lead the way into a new era.
4. They believe fervently in their employee stock ownership plan and would like to see it legally established universally or at least legally encouraged for all companies.

ELECTRICITY DISTRIBUTION

EXHIBIT - I

DISPOSITION OF MAJOR STATE-OWNED ENTERPRISES

NAME	PRODUCT OR SERVICE	DISPOSITION	
		CODE	DISPOSITION
<u>FIRST GROUP: CORFO HOLDINGS</u>			
CHILECTRA	Electricity generation	1	
CHILECTRA V	Electricity distribution	1	
CHILGEN	Electricity generation	1	
CHILMETRO	Electricity distribution	1	
CHILQUINTA	Electricity distribution	1	
COLBUN	Electricity generation	4	
COQUIMBO	Electricity distribution	1	
CTC	Telephones	2	Full Disposition planned
ECON	Computer services	1	
EDELNOR	Electricity distribution	5	
EDELAYSEN	Electricity distribution	5	
EDELMAG	Electricity distribution	4	
EMEC	Electricity distribution	1	
EMEL	Electricity distribution	1	
EMELAT	Electricity distribution	1	
ENDESA	Electricity generation	4	Statement that there will be complete disposition
ENTEL	Telecommunications	4	
FORESTAL-MADERERO	Forestry	4	
IANSA	Sugar refining	2	
INTEROCEANICA	Shipping	4	Complete disposition announced
LAN-CHILE	Airline	4	Partial disposition announced
LAB CHILE*	Pharmaceuticals	4	
PILMAIQUEN	Electricity generation	1	
PEHUENCHE	Electricity generation	5	
PULLINQUE	Electricity generation	1	
SACOR	CORFO's land administration	5	
SAIP	Easter Island utilities	5	
SASIPA	Easter Island services	5	
SOQUIMICH	Nitrate fertilizer	1	
TELEX CHILE	Communications	1	
TRANSMARCHILAY	Maritime transportation	6	
CAP	Steel production and sales	1	
COFOMAPA	Forestry and timber	6	
EMA	Zinc and lead mining	6	
ENACAR	Coal mining	4	
LOTA-SCHWAGER	Coal mining	4	

\*Status whether under CORFO not known

<u>NAME</u>	<u>PRODUCT OR SERVICE</u>	<u>DISPOSITION CODE</u>	<u>DISPOSITION</u>
<u>SECOND GROUP: Enterprises Created by Special Laws</u>			
ANAP	Saving and loans for housing	6	
ASMAR	Dry dock services and ships repair	3	Some disposition under study
CHILE-FILMS	Movie making and publicity	2	
CONAF	Forestation and reforestation	6	
CORFO	Project lending	5	
CORREOS	Post Office	5	
ECA	Agricultural supplies sales	4	
EMOS	Waterworks	3	
EMPORCHI	Port management	3	
EMPRENAR	Maritime transportation	5	
ENAER	Airplane production	5	
ENAEX	Explosives	1	
ENAMI	Mining and refineries	6	
ENAP	Oil & gas production & refining	5	
FAMAE	Military supplies	5	
FERROCARRILES	Trains & train transportation	3	
ISE	Insurance	4	
METRO	Subway	5	
POLLA	Lottery	5	
TV-NACIONAL	TV net work	5	
SAG	Pest and quality control	6	

THIRD GROUP: Large Enterprise

CODELCO	Copper & molybdenum mining and refining	5
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FOURTH GROUP: State Banks

BANCO CENTRAL	Chilean Reserve Bank	5
BANCO DEL ESTADO	Banking services	5

DISPOSITION CODE:

1 - 100% Disposition completed	4 - Government majority, some disp. planned
2 - Government minority, disposition announced	5 - Government majority, no plans known
3 - Some disposition under study or announced	6 - Status unknown

Source: U.S. Dept of State, American Embassy, Santiago  
 "Privatization of State Enterprises in Chile", March 27, 1987

**EXHIBIT II**

**COMPARISON OF EMPLOYEE OWNERSHIP PLAN FEATURES  
UNITED STATE AND CHILE**

<u>FEATURE</u>	<u>UNITED STATES</u>	<u>CHILE</u>
1. When offered	1. In connection with or as substitute for public offering.	1. Same, but to date has been in conjunction with privatization offerings of SOE's.
2. To whom offered	2. All employees, restrictions in accounts per individual based on salary, longevity or other factors.	2. All employees, no known restrictions.
3. Price	3. Frequently, although not always, at a discount usually modest.	3. Same.
4. Percent employee ownership	4. Has on occasion been 100% but minority percentage more customary.	4. Same.
5. Availability of purchase loans	5. Yes, from company.	5. Yes, from government. Repayments have been indexed.
6. Tax deductions (see also Exh.III)		
a. To employee	6a. Tax deferred until received or sold. Certain averaging permitted. Dividends tax free.	6a. Tax credit up to 10% of three years average income tax. Dividends tax free.
b. To company	6b. Principal and interest payments tax-deductible. Additional contributions or stock purchases have partial deductions or tax credits.	6b. No known benefits available.
c. To seller	6c. Tax deferred under certain circumstances.	6c. Has not arisen since seller has been government. Incentives in this area will be needed if private sector program is developed.
7. Employee representation on Board of Directors	7. Usually not except where 100% employee ownership.	7. Yes, usually one representative although more if employee share is more substantial and of course if 100% ownership.

### EXHIBIT III

#### U.S. TAX ADVANTAGES OF EMPLOYEE STOCK OWNERSHIP PLANS (ESOP's)

##### To the Company

1. ESOP loan payments are tax-deductible, principal payments (when made) as well as interest.
2. Company may contribute up to 25% of each employee's pay each year to his ESOP account and claim a deduction.
3. Dividends on ESOP stock are deductible regardless of whether paid out to employee or used to repay loan.
4. An ESOP company may claim a tax credit of 1 1/2% of payroll if these tax savings are used to buy additional stock for the ESOP employees (expired at the end of 1986).

##### To the Employee

5. Employees pay tax on cost of shares only on receipt. If received in lump sum after age 59 1/2 or due to death or disability, tax is paid as if were received over a five-year period. Any gain in value of stock is untaxed until sold.

##### To the Seller

6. Stockholders selling to an ESOP may defer tax on their profit if a) after the sale the ESOP owns 30% of the company's stock, and b) seller invests proceeds in securities of another business.
7. 50% of proceeds realized if an estate sells to an ESOP are excluded from the estate and therefore from estate tax.
8. ESOP may assume liability for any estate tax on any stock received if it pays on installments within 14 years. Interest ' payable for the first 4 years only.

##### To the Lender

9. Commercial lenders may exclude from income 50% of interest on the ESOP loan (assumption is that competition will result in lower rates to an ESOP borrower, although there is no requirement for this).

**EXHIBIT IV**  
**PINOCHET GOVERNMENT APPROVAL PROCEDURE**  
**LAWS VS DECREES**

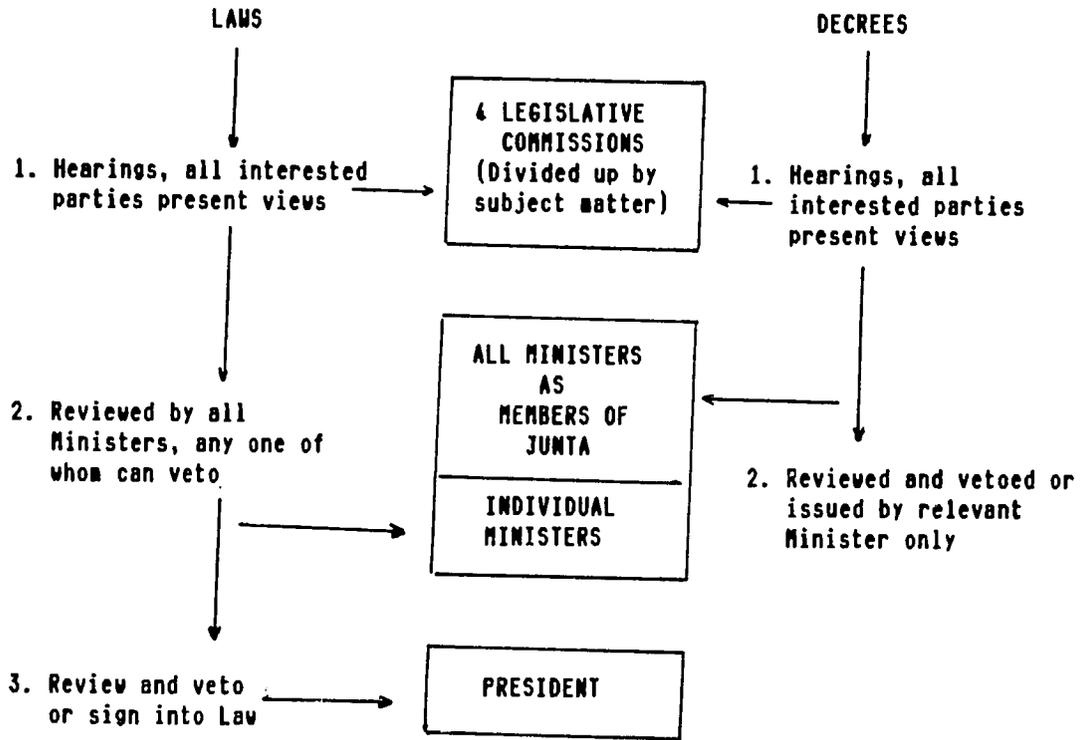


EXHIBIT V

ADMINISTRATIVE AND ORGANIZATIONAL STRUCTURE FOR PRIVATIZATION

An administrative structure for privatization was set up within CORFO in the early 1970s. As the entrepreneurial arm of the government, CORFO was considered the appropriate institution to oversee the divestiture of all state enterprises, including those directly under the ministries and other government agencies.

The organizational structure set up within CORFO for carrying out privatization, functioned as follows:

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CORFO'S COUNCIL a/

Composition:

President:	Minister of the Economy
Members:	Finance Minister Planning Minister (ODEPLAN) Minister Vice President of CORFO Additional member appointed by the Executive

<u>Function:</u>	Final responsibility for privatization strategies and decisions, as proposed by the Privatization Committee
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PRIVATIZATION COMMITTEE

Composition:

Members:	Planning Minister (ODEPLAN) General Manager of CORFO Enterprise Manager of CORFO Normalization Manager of CORFO
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Executive Secretary:	Normalization Deputy Manager of CORFO
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<u>Function:</u>	Link between the Normalization Units and the Council; supervises the implementation of actions approved by the Council
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## NORMALIZATION UNIT

### Composition:

The Normalization Unit is a Vice-Presidency within CORFO

### Function:

Carries out policies approved by the Council and implements the selected method; oversees the whole privatization transaction, including prior restructuring of SOE (if needed), selection of investment bank or other financial intermediary, screening of prospective purchasers, negotiations if required, and collection of proceeds from sales

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a/ Also functions as the Board of Directors of CORFO

- o The central government set the goals of the divestiture program as well as the SOEs targeted to be divested. On occasion, however, some proposals emerged from within CORFO (particularly with respect to small enterprises). Whatever their origins, these proposals were submitted to the Council of CORFO.
- o The Council made the final decisions on privatization. (It also functioned as CORFO's Board of Directors). Given that it consisted of powerful members within the government, decisions made by the Council were not ordinarily submitted to the executive branch for final approval except in very politically sensitive cases.
- o The Privatization Committee essentially served as the link between the Council and the Normalization Unit (see below). It was, in effect, the administrative arm of the Council. It also supervised the implementation of privatization proposals approved by the Council.
- o The Normalization Unit, which is a special, structured unit within CORFO, was created specifically to rationalize all government-owned assets, i.e., those under CORFO as well as those under various government bodies. It was the unit that carried out the policies approved by the Council and oversaw the whole privatization process. Its functions included restructuring enterprises, choosing investment banks, screening prospective purchasers, negotiating sales, and collecting payments from buyers after the sales. In

addition, together with the enterprises, it provided technical support to the Council and Privatization Committee. It has a special budget to enable it to perform these functions.

It should be noted that the procedures implicit in the above structure were not rigidly adhered to but were flexible enough to allow for variations based on the size and sensitivity of the enterprises being divested.

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Source: World Bank Report: "Techniques of Privatization of State owned Enterprises" Volume II: Selected Country Case Studies: Nankani

EXHIBIT VI

MAJOR SOE'S AND TIMING OF THEIR PRIVATIZATION

& GOVERNMENT OWNERSHIP AT VARIOUS DATES

<u>NAME</u>	<u>DESIGNATION</u>	<u>SEPT 85</u>	<u>JUNE 86</u>	<u>DEC 86</u>	<u>FEB 87</u>	<u>DEC 87</u>	<u>JUNE 88</u>
<u>POWER</u>							
EMEL	POWER DIST	100	0				
EMEC	POWER DIST	100	0				
EMELAT	POWER DIST	100	0				
CHILMETRO	POWER DIST	90	63	35	35	0	
EDELNOR	POWER DIST	100	100	100	100	100	
CHILQUINTA	POWER DIST	92	61	35	35	0	
COLBUN	POWER GENERATION	100	100	100	100	100	
CHILECTRA	POWER GENERATION	100	77				0
CHILGENER	POWER GENERATION	100	?	53	53	35	0
PILMAQUEN	HYDRO PLANT	100	0				
PULLINIQUE	HYDRO PLANT	100	100	100	100	100	0
SAS. PA	POWER & OTHER	100	100	100	100	100	100
ENDESA	CENTRAL POWER CO.	100	100	100	100	80	56
<u>COMMUNICATIONS</u>							
TELEX CHILE	TELEX	100	0				
CTC	TELEPHONE	93	90	89	89	75	37
ENTEL	TELECOMMUNIC`N	100	86	70	70	67	51
<u>INDUSTRIAL</u>							
CAP	STEEL	90	47	47	46	0	
SOQUIMICH	FERTILIZER	93	83	45	35	18	0
ENAEX	EXPLOSIVES	100	100	33	33	0	
<u>LABORATORIO</u>							
CHILE	PHARMACEUTICALS	100	70	70	70	51	51
IANSA	SUGAR REFINING	100	?	55	53	51	25
<u>TRANSPORTATION</u>							
LAN-CHILE	AIRLINE	100	100	100	100	100	100
TRANSMARCHILAY	MARINE TRANSPORT	100	100	100	100	100	
<u>MINING &amp; FORESTRY</u>							
COFONAP	FORESTRY	100	100	100	100	100	
EMA	MINING	100	100	100	100	100	
ENACAR	COAL MINING	100	100	100	100	100	
SCHWAGER	COAL MINING	100	100	100	?	57	57

Sources: U.S. Dept of State, AmEmbassy, Santiago - "Privatization of Enterprises in Chile - Progress Report", March 25, 1988  
 U.S. Dept of State, AmEmbassy, Santiago - "Sale of State Enterprises: Progress Report", June 26, 1986  
 (See also sources: Exhibit I and Table 1, page 40)

## PERSONS VISITED IN CHILE

### OFFICIALS OF THE GOVERNMENT OF CHILE

Jose Martinez Munoz - CORFO  
Jorge Asecio Fulgeri, Jefe Gabinete, Ministro de Economica  
Eduardo Novoa Castellon, Ingeniero Comercial - Ministerio de Economica  
Norman Bull de la Jara, Subsecretario de Economica

### SUPPORT ACTIVITIES - U.S.

Donald A. Clarey, Deputy Adimistrator - U.S. Small Business  
Administration, Washington  
Stanley S. Shepard, Press Officer - American Embassy  
Harry Barnes, Ambassador - American Embassy  
Paul Fritz, USAID Representative - American Embassy  
Carlos F. Capurro - USAID Office  
Carlos F. Singer - USAID Office  
Renato Hidalgo - USAID Office  
David L. Linowes, Professor - University of Illinois

### SUPPORT ACTIVITIES - CHILE

Hugo Yaconi Merino, Presidente - CODIGAS  
Jose Zabala de la Fuente, Presidente - USEC  
Rolf Lueders, Professor - Inst. de Economica, Universidad  
Catolica de Chile  
Alberto Armstrong V., Director - Escuela de Administracion,  
Universidad Catolica de Chile  
Pedro Larrain Tobar, Gerente Generale - Camara de la Produccion  
y del Comercio de Concepcion  
Jose Pablo Arellano, Director Ejecutivo - CIEPLAN  
Eugenio Ipinza Poblete, Gerente Depto - SOFOFA  
Jose Moreno Aguirre, Presidente - Soc. Nacional de Agricultura

### PRIVATE SECTOR - CHILE

Ernesto Ayala Oliva, Presidente - Papeles y Cartones, S.A.  
Jose Luis Bustamente y Rivera  
Bartolome Soler Ruiz, Gerente - Soler, Manaut y Cia, Ltda.  
Jorge Schaulsohn B., Attorney  
Eugenio Heiremans D., Presidente - ACHS  
Roberto de Andraca, Presidente - CAP

### INVESTMENT BANKING

Manuel Casanova D., Director - Banco de A. Edwards  
Segismundo Schulín-Zeuthen S., Gerente General - Banco de Chile  
Hernan Sonoso - Banco de Chile  
Alan L. Werlau, Vice President - Bankers Trust Company, Santiago  
Erwin Hahn Huber, Gerente General - Banchile