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# Privatization in Chile

## An Economic Appraisal

Dominique Hachette
and
Rolf Lüders


International Center for Economic Growth

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# Contents

## Contents of the book *Privatization in Chile*

# Preface

Since the mid-1970s Chile has undergone a massive privatization program, transferring more than 550 state-owned enterprises from the public to the private sector. *Privatization in Chile*, from which this executive summary is taken, is the first study to provide a detailed and rigorous account of the economic impact of this unprecedented wave of privatization. Here Dominique Hachette and Rolf Lüders examine exactly what privatization has meant for efficiency, employment, government revenues and expenditures, the capital market, and savings and investment in Chile.

Privatization may be an idea whose time has come, but its net effects are often difficult to determine and obscured by preconceived notions and biases. On the one hand, critics of privatization claim that it causes unemployment and leads to disparity in capital ownership. On the other hand, proponents claim that it increases economic efficiency and strengthens capital markets. In this study Hachette and Lüders take on both sets of assumptions, showing that ultimately the effects of privatization depend on how the process is carried out.

Based on Chile's experience with privatization, unique in its scope, Hachette and Lüders extract policy lessons that are essential for anyone who works on or studies the privatization of state-owned enterprises around the world.

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Panama City, Panama
December 1992

# Summary of Conclusions

Dominique Hachette and Rolf Lüders analyzed Chile's privatization process from 1974 to 1989. Their conclusions include the following:

1. The Chilean experience with privatization seems to indicate that successful privatization is possible for a middle-income developing country. Between 1974 and 1989—that is, under Chile's military government—more than 550 of the largest state-controlled enterprises were divested. In addition, more than 50 percent of the arable land, the administration of the social security system, a high proportion of the health-care and education systems, and several other significant activities were transferred to the private sector.

   - Although markets are more imperfect in developing countries than in developed countries, the Chilean experience confirms that they can function well enough to generate fair transfer prices and to induce relatively efficient operation of the privatized enterprises. Free internal markets, competition—made possible to a large extent by opening up the economy to international trade—and effective regulation of natural monopolies seem to have been enough to generate a socially useful private sector in Chile.

   - The resources for privatization always exist, even in a developing country. State-owned enterprises (SOEs), for instance, can be divested by giving shares to private citizens or by divesting companies to foreigners. In most countries poor in liquid assets, there is a tendency to divest by granting credit to purchasers of SOE shares. Chile's experience in this respect was a disaster and points to the pitfalls of debt-led privatization.

2. The Chilean experience suggests that a wide range of enterprises and activities can be privatized. Chile privatized most public utilities (public transportation, electricity generation and distribution, telephone and other communication services, some ports and most port services, gas distribution and some gas-producing operations, some water-distribution services, garbage collection, and many others), as well as a substantial proportion of social services (including education, health care, pensions, and housing). State land was also divested. In the case of some public utilities (natural monopolies) and social services, the Chilean experience suggests that adequate regulation and control, together with the right economic policies, are essential for achieving the desired results in terms of efficiency and resource allocation.

3. Privatization in Chile suggests that a number of conditions, in addition to those already mentioned, must be met for the successful implementation of privatization policy. These are mainly political and institutional in nature.

   - *Leadership.* Most successful privatizations have been led by a person or a small group of people determined to implement the policies at almost any price.

   - *Initial political support.* Even under an authoritarian regime, the desire of the leaders to privatize, no matter how strong, is probably not enough to achieve as wide and deep a process as prevailed in Chile. Public support from opinion leaders and interest groups is essential.

- *Means of gaining additional support.* A government must take a number of steps to insure continued support for privatization over the long term. Divestiture transactions should be transparent and sequenced appropriately. The institutional and policy environment must be favorable. Chile also used labor and popular capitalism, making many workers and citizens into stockholders, to achieve sustained support.
- *Institutional investors.* The Chilean privatization process was accompanied by the spectacular development of the capital market. The development of large, competitively managed pension funds made a decisive contribution to the development of the capital market and thereby made divestiture of significant packages of stock in some of the largest Chilean corporations possible through the stock exchanges.

4. Privatization takes time, although not always necessarily as much as in the case of Chile, whose privatization process lasted seventeen years. More often than not, countries with a significant entrepreneurial sector also have heavily protectionist and interventionist economic policies, so that privatization, to be successful, must go hand in hand with sweeping institutional reforms. Preparing SOEs for privatization is usually a time-consuming and difficult task. In Chile, this preparation was accomplished for all practical purposes as a by-product of general policies designed to make the whole economic system more efficient. The government forced most SOEs to operate with a hard budget, like private enterprises. By making the whole system competitive, Chile virtually forced its SOEs to operate efficiently.
5. Empirical analysis of the Chilean case suggests that the change in ownership associated with privatization does

not affect employment levels per se but that the drive to increase efficiency levels, of which privatization might be a tool, does. SOEs and private enterprises in Chile were subject to nearly the same rules of the game after the military takeover in 1973. As a result, SOEs adjusted their employment levels downward faster, if anything, than privatized enterprises, to establish normal productivity levels, after the abnormal years of the Allende regime (1970–1973). Although privatization might tend to reduce employment to its optimum level per unit of output, instead of maintaining the excess employment levels common in SOEs, this does not imply that such a policy will increase overall unemployment in the economy.

6. Privatization can lead to an important degree of worker participation in ownership of capital and control of divested SOEs. Through labor and popular capitalism, many workers have become shareholders in privatized SOEs. In some cases, workers have become so enthusiastic about these investments that they have gone into debt in order to purchase stock packages beyond those to which they were entitled by the privatization system itself. Of course, the significant capital gains obtained since privatization and the high dividend rates of return on their initial investments, which occurred in the second half of the 1980s, have helped. It remains to be seen how these worker-capitalists will react when macroeconomic conditions change.

7. The issue of gains or losses in government wealth resulting from privatization has drawn a great deal of critical attention in Chile. In fact, the issue seems to have been a subject of concern almost everywhere governments have privatized. The Chilean experience shows that even in a country poor in liquid capital, shares of privatized firms can be divested at fair market values as long as there is private sector confidence in

the economy, the right institutions are created and developed, and foreign investment is welcomed. The Chilean case also shows that the final effect on wealth depends on government expenditure policy. If the funds collected from privatization are consumed by the government, privatization will almost by definition be associated with a loss of government wealth. If the funds are totally reinvested, the final outcome can in principle range all the way from a significant loss of wealth to a gain equivalent to the national gain resulting from the increase in internal efficiency.

8. Privatization can affect government revenues in several ways. First, the process alters the timing of revenues. This is most evident in cash sales, in which, assuming relatively well-functioning capital markets, governments anticipate the future cash flows they might have received from SOEs. In addition, revenues tend to increase if the privatized SOEs are expected to be run more efficiently by the private sector, assuming these enterprises are divested at fair market prices. Revenues tend to diminish, however, if sales proceeds are consumed by the public sector or invested in non-revenue-producing projects. In the Chilean case, divestiture did reduce expected government revenues, if one takes a sufficiently short view. If one takes a longer view, however, the answer is not so clear. Privatization has relieved the government of the net investments it made in its SOEs.

9. The case of Chile suggests ways to avoid policy reversals with regard to privatization. Chile suffered the reversal of many of the most important privatizations of the 1970s. The reason is that debt-led privatizations, together with the auctioning of stock, yield relatively high stock prices. In this situation capital-poor purchasers tend to take high risks in order to pay installments, and their low capital base is fragile. In a business

slump, the number of privatized enterprises that go broke is large, making government investment perhaps desirable. In Chile, this scenario occurred during the recession of the early 1980s, when management of a relatively large number of previously privatized enterprises was indirectly taken over by the government. Economic and political conditions were such that these enterprises were soon privatized again, but this may not always be the case.

10. Econometric evidence from this study does not definitely show whether privatization leads to more efficient enterprises. One important reason may be that in Chile SOEs and private sector enterprises were operating under a similar general framework, and therefore important behavioral differences between these two categories of enterprises cannot be expected. This does not mean that ownership is irrelevant or that the form of the framework is independent of the ownership structure. It is likely that in the long run the legislature and other public officials will tend to alter an SOE regulatory framework like the one existing in Chile during the 1980s in order to grant political favors such as employment and goods and services at subsidized prices.

11. Chile's experiences raise the question of whether a massive privatization is possible in a developing country only under an authoritarian political regime. The answer to this question lies in the realm of opinion. Chile's program probably could not have been carried out under a regime of a different nature. At the time, no developing country, with the possible exception of Bangladesh, had any experience with massive privatization, and it was still generally accepted in Latin America that public utilities and basic infrastructure enterprises had to be run by governments. Chile was therefore breaking new ground. Democratic regimes are by nature conservative, and institutional change is

slow. Today, however, democratic conditions in Chile probably reduce the possibility of a reversal. This does not mean that today massive privatization cannot take place in developing countries or emerging democracies under democratic regimes. In Central Europe, privatization is part of the process of democratization itself, and in Latin America ideological conditions have changed radically. The examples of Costa Rica and Great Britain have demonstrated that privatization is possible in a Western-style democracy.

# An Overview of
# *Privatization in Chile*

Chile's experience with privatization has been unique in both scope and diversity. Between 1974 and 1989, Chile privatized some 550 state-owned enterprises (SOEs; see Table 1). In that period, SOE participation in gross domestic product (GDP) fell from 39 to 16 percent. Because of the unusual nature of this massive privatization, Chile's experience offers numerous lessons to developing countries who are embarking on a path of privatization.

## The Economic Framework in Chile, 1973–1989

The successes and failures of privatization in Chile are closely related to certain features of the country's general economic development. Privatization in fact took place in two rounds that were clearly tied to two different phases of Chilean economic evolution.

The First Round, which began with a major recession in 1975 and ended with an even deeper one in 1982–1983, took place during a period of substantive institutional adjustments, a major drive to re-establish macroeconomic balances, and painful stabilization efforts. During the two years of recession that followed that hectic period, about fifty of the most important privatized firms came back under the control of the government in the wake of a massive disruption in the financial sector. A period of recovery, adjustment, and consolidation of the main institutional developments of the 1970s ensued, followed by a boom starting in 1984 and lasting until the present. Firms that had been managed by the state during the downturn returned to the private

TABLE 1 State-owned and State-managed Enterprises in Selected Years, 1970–1989 (number of enterprises)

| | 1970 | 1973 | 1983 | 1989 |
|---|---|---|---|---|
| Enterprises related to CORFO | 46 | 571 | 24 | 24 |
| Subsidiaries | 46 | 228 | 23 | 24[a] |
| State-managed enterprises | 0 | 325[b] | 0[c] | 0 |
| Banks | 0 | 18 | 1 | 0 |
| Other state-owned enterprises | 20 | 22 | 21 | 18[a] |
| Other financial institutions | 2 | 2 | 2 | 2 |
| National Copper Corporation (CODELCO) | 0[d] | 1 | 1 | 1 |
| Total | 68 | 596 | 48[e] | 45 |

NOTE: CORFO is the State Development Corporation.
a. Between 1983 and 1989 14 new enterprises were created by splitting existing enterprises.
b. This does not include state-managed companies (*compañías intervenidas*) in which CORFO had only a minority interest. Those firms are counted as subsidiaries.
c. After September 1973, 350 state-managed enterprises were returned to their owners, most of them during 1974.
d. Although CODELCO did not exist, the state owned 50 percent of the big copper companies. It acquired this percentage when it invested in foreign-owned companies during 1970 as a result of the Chileanization process.
e. This does not include more than 50 "odd sector" enterprises indirectly managed by the state, which fell into government hands during 1983 as a result of government intervention in some financial institutions and which were privatized before 1979.
SOURCE: State Development Corporation (CORFO).

sector and a Second Round of privatization took place, which ended when a new president assumed office early in 1990.

The government of Salvador Allende (1970–1973) tried to revamp the Chilean economy as part of its political agenda. Among the measures it took were significant income redistribution and extensive state control of the means of production. By the end of 1973, however, Allende had created a legacy of deep macro- and microeconomic disequilibria. In 1973, the deficit exceeded 20 percent of GDP. In August of that year, official inflation was an unprecedented 300 percent per year; only two months later, it rose to around 1,000 percent. Since the sources of revenue necessary for control of the means of production were dwindling, nationalization or expropriation were soon replaced by government requisition or outright seizure of firms. Fair compensation was awarded in only a few instances.

The military government that took power in September 1973 initially aimed to eliminate serious and pressing macroeconomic disequilibria. In the long run, however, its three main goals were the following:

1. to secure a high and stable rate of economic growth, which, in the government's view had been seriously jeopardized in previous decades by a combination of a faulty development strategy and an inadequate choice of instruments
2. to eradicate extreme poverty and achieve full employment through highly productive activities
3. to achieve both price and policy stability

To achieve price stability, the government pursued a combination of restrictive fiscal and monetary policies and use of the exchange rate to control expectations for most of the period. It also adopted mandatory wage adjustments in the first few years to hinder the growth of aggregate demand.

Development policies involved eliminating price controls and multiple exchange rates; liberalizing the capital market and ending interest rate ceilings; eliminating most taxes, subsidies, and prohibitions that fostered discrimination among sectors; and liberalizing foreign trade.

Finally, the government attempted some redistribution of income, through increased and more tightly targeted social expenditures and the creation of a public work program.

In 1982 and 1983, however, Chile underwent a deep economic and financial crisis. Although the depressed international economy may have sparked this recession, domestic management of the exchange rate and certain features of the financial market only worsened the situation. In response the government set exchange rates to encourage exports and limit imports. Tariffs on imports were doubled from 10 percent to 20 percent, and other measures were taken to put financial institutions and other enterprises back in solid positions. As a result, in 1984 there was a fundamental shift in the trend of the main aggregates, and the economy began to recover.

When privatizations were resumed in 1984, recovery from the crisis was far from complete. The government worked to gain additional foreign credit and to stimulate savings and investment. These steps paved the way for the economic boom of the late 1980s.

## The Ideological and Economic Objectives of Privatization

Privatization in Chile took place as part of a sweeping process of institutional reforms undertaken by the military regime, which was convinced that its goals of economic growth, full employment, and the elimination of extreme poverty could not be achieved within the existing institutional arrangement. The regime further held that effective economic decentralization was a necessary condition for attaining efficient democratic organization.

**Restoring economic freedom.** State-owned enterprises generated about 39 percent of GDP in 1973. Central government subsidies to these SOEs helped cause runaway inflation in that year. The nationalization and intervention policies of 1971–1973, which took place within a chaotic social and political context, generated an image of the state as an extremely inefficient entrepreneur, which intended to use economic power to establish a totalitarian regime. This perception became the basis of support for the military takeover and provided the government's fundamental political legitimacy, explaining to a large extent the speed and depth of the privatization process in Chile. The divestiture of SOEs therefore was an instrument of the military regime designed to decentralize and spread economic power in the country, an objective considered essential for establishing a viable democracy. At the same time, it may have played an important role in granting the government the power it found necessary to keep public order and at the same time produce revolutionary structural reforms.

**Economic objectives in the 1970s.** Although the Chilean privatization process, like the British process, pursued political objectives, in the final analysis, its main objectives were economic. Like privatizations everywhere, the Chilean privatizations during the 1970s were expected, above all, to help finance the public sector deficit. At the time of the military takeover in 1973, central government expenditures had reached about 50 percent of GDP, and only half of expenditures were financed through taxes and other income. Therefore, divestiture modes were chosen that would maximize public sector revenues.

Of course, privatizations in Chile were also expected to contribute to economic efficiency. Officials continually stressed this point, and they created an environment in which both public and private enterprises had incentives to be efficient. In the 1970s and early 1980s, therefore, all enterprises were subject either to strong competition or to special regulations based on marginal cost pricing; public enterprises were obliged to become self-financing with no further subsidies and were allowed to charge market rates for their products; and the government stopped interfering with SOE management. In addition, SOEs were obliged to distribute a high percentage of their profits to the state in dividends, and new investments were allowed only after careful project evaluation. These measures raised the rate of return on SOE net worth during the early 1980s to close to that of private enterprises.

**Lessons from the 1970s and new objectives for the 1980s.** The government learned several lessons from the First Round of privatizations that caused it to adopt new modes of divestiture from 1985 onward. During the First Round, it had attempted primarily to maximize revenue and efficiency. To this end it offered controlling stock packages to investors, expecting in this way to receive better prices per share than by spreading ownership widely. Since there was little capital in the Chilean private sector at that time, it provided credit and did not require purchasers to prove ownership of any level of net worth. Some of these ideas proved to be wrong. During the economic and financial crisis of the early 1980s, the highly indebted conglomerates failed and the enterprises they controlled fell again into the hands of the state (becoming known as "the odd sector").

In 1985, therefore, the list of objectives was expanded to include the following:

1. the normalization of the financial and productive institutions of the odd sector

2. the generation of resources for public debt repayment and necessary investment in public services and general economic infrastructure

3. a strengthened financial position and increased investment in SOEs

4. an increase in the availability of investment instruments, especially for the pension funds, and a strengthening of the capital market in general

5. the spreading of ownership, through the offering of favorable purchasing conditions

**Implicit privatization objectives.** Although the explicit privatization objectives of the Pinochet regime were always clearly stated, the constant modification of the government's goals regarding the percentage to be sold in the various SOEs during the Second Round was unexplained by the expressed objectives. These modifications probably reflect objectives that were not explicitly stated.

From the beginning, the process of privatizing the large SOE public utilities and infrastructure enterprises was, to say the least, controversial, and the authorities had no way of knowing the force of the generalized negative reaction. The government may have believed that the favorable impact of these initially partial privatizations might create a favorable climate for broader privatization goals. It might have acted as well on the idea that moderate changes would produce a weaker political reaction. Stated differently, the variation in the privatization goals may reflect the fact that the government, after the crisis of the early 1980s, aware that it eventually might have to relinquish power to the opposition, tried to privatize the SOEs as fast as was politically possible, with the purpose of reducing the state's economic power to a reasonable minimum.

## The Privatization Process

**The First Round (1974–1979).** During the First Round of privatizations, the management of about 550 of the largest enterprises in the country was transferred back to the private sector; land expropriated under the agrarian reform of the late 1960s and early 1970s was allocated to private owners (generally former agricultural workers); and market forces and decentralization were introduced into the education, housing, health, and social security sectors.

Immediately after the military takeover in September 1973, the government appointed representatives in every state-controlled enterprise for the purpose of normalizing their operations. In 1974 the government returned 325 state-managed enterprises to their owners. Between 1975 and 1979, the government transferred 207 financial institutions, industries, wholesale distribution companies, and other corporations to private hands. These divestitures were carried out through liquidation, bidding at auction, or direct sale.

Privatization of the pension system was instrumental in the success of the entire privatization process. Until 1980, the pension system in Chile was financed on a pay-as-you-go basis and was managed largely by government-operated institutions. Fraud was rampant, service was inefficient, and costs were high. In 1980 the government instituted a new pension system based on three principles: a minimum pension for all Chileans, benefits based on individual capital accumulation, and private administration. The real novelty of the system lies in the fact that it is privately administered. Profit-seeking private pension fund companies compete for the right to manage individual funds on the basis of commissions and quality of service. Employees can freely choose among these companies and can switch from one to another if they like.

**The Second Round (1984–1989).** The Second Round of privatizations followed the deep recession and financial crisis of 1982–1983. In 1984–1985, the government divested companies belonging to the odd sector, which had come under its control during the recession. The government used a variety of privatization modes in this period. The productive companies of the odd sector were generally auctioned off. Since local investors were still undercapitalized, some of the larger reprivatized companies were acquired jointly by foreign and local interests. Some enterprises were sold through popular capitalism, in which the government offered new shares to the general public, granting an automatic long-term credit at zero interest to pay for them and offering an extremely generous investment tax credit.

Between 1986 and 1989 the government began to privatize a relatively small number of traditional SOEs, among them the large public service companies. The main modes used at this stage were labor capitalism (in which shares were sold directly to the workers of the enterprises to be divested), institutional capitalism (in which the shares were sold to institutional investors, particularly the pension fund companies), traditional capitalism (involving other forms of onerous divestiture), and in some cases popular capitalism.

**Overall accomplishments.** By early 1990, when the new civilian government took over, the military government had accomplished its objective of transferring to the private sector the property and management of all but a handful of the nearly 600 enterprises it had controlled in 1973. It can be argued that it accomplished significantly more than initially intended, since, at the beginning, it did not aim to privatize traditional public service or infrastructure SOEs created or intervened in through specific laws. Perhaps even more important, the privatization process, including that of the traditional SOEs created by law, came to be generally accepted. Privatization led the public sector to substantially reduce its participation in all economic sectors except mining (big copper and petroleum), making ample room for the private sector to become the engine of economic growth.

## Effects of Privatization on Government Revenues and Wealth

Privatization of public enterprises implies a transfer of public assets to the private sector, either domestic or foreign. The transfer may be unrequited or onerous. If onerous, the public sector receives cash, which it may use either to carry out current or investment expenditures or to redeem public debt. In other words, privatization can affect both the balance sheet and the income statement of the public sector.

**Government revenues.** Maximizing government revenues was perhaps the single most important economic objective of privatization during the second stage of the First Round (1975–1979). In the short term, the Chilean government appears to have lost revenue. Although it obtained additional revenues from the private sector by privatizing public firms, the government lost tax revenues and dividends on the divested shares. In the longer term, however, it is not entirely clear whether the effects on government revenues were positive or negative. Leaving out the case of the Chilean national copper corporation, which has not been privatized, and taxes, which if anything are expected to generate large revenues from divested enterprises, the Chilean government had since the 1940s made net investments in its enterprises, taken as a group. Therefore, privatization has allowed the public sector to replace spending on public enterprises with spending on other programs, such as social programs and public works.

**Government wealth.** Estimates of the short-run effect on government wealth (before expenditure of revenues from privatization) were made on the basis of a sample of ten large traditional public enterprises divested during the Second Round. The total long-run impact was then estimated for each round on the basis of actual government expenditure policies.

The analysis suggests that, as a group, the ten public enterprises were probably sold at fair market prices, except for those shares sold to workers and popular capitalists, which were divested with an intentional subsidy to spread ownership and gain support for the process. Those who complain that the enterprises were sold at artificially low prices tend to compare divestiture stock prices from years ago with either book values or recent market prices, both of which are irrelevant for past market prices.

The final effect on wealth depends on government expenditure policy. During the First Round the government used divestiture revenues to increase social expenditures. During the Second Round revenues from privatization, somewhat diminished because of the giveaways and subsidies implicit in some of the divestiture modes used, were reinvested largely in public works. As a result the public sector loss of wealth was reduced to about the amount of the giveaways and subsidies.

### Privatization and the Capital Market

As part of the privatization program, the government divested a large number of banks and commercial, industrial, and financial institutions. These privatizations coincided with a deepening and broadening of the capital market. The mode of divestiture, however, may have had a negative effect on the development of the capital market during the 1970s. It helped push up interest rates and destabilized the capital market, evidence of which appeared in the financial crisis of 1982–1983. The authorities learned the lessons of this experience and designed divestiture modes in the 1980s that would deepen and broaden the capital market. Privatization of public enterprises also stimulated the capital market by providing investment opportunities for the newly privatized pension system.

### Privatization and Employment

Privatization does not seem to have had negative effects on the number of persons employed in Chile. Although the adaptation of all firms—private and public—to the rules of the market in the 1970s created unemployment, the sale of public firms to the private sector per se was not a contributing factor. In the 1980s, while relatively stable rules applied to both private and public firms, employment in privatized firms actually increased with divestitures.

### Privatization and Efficiency

Available evidence does not allow a definite conclusion on whether privatization leads to more efficient enterprises. No significant differences of behavior have been found among public, private, and privatized enterprises under similar sets of rules and regulations. Public firms adapted rapidly to changes in regulations, reducing their level of inefficiency and becoming more similar to private enterprises in the 1970s. Although the greater efficiency of these public firms was not intended as a preparation for a new round of divestitures, there is no doubt that it facilitated divestitures in the 1980s. It is useful to remember that public choice theory suggests that the similar rules operating in the private and public spheres may be unstable. In the medium and long term political pressure is likely to produce a change in the rules, which would allow public enterprises to be used for patronage and for supplying certain goods and services at "low" prices—in other words, to become inefficient.

## Two Polemic Cases of Privatization

Several privatization operations have been strongly criticized and remain controversial to this day. Two such cases are those of the Investment Steel Company of the Pacific (CAP) and the National Electricity Company (ENDESA).

**Investment Steel Company of the Pacific.** The Steel Company of the Pacific was established as a private stock company in April 1946. In July 1968 the government initiated a takeover of the company, gradually increasing its share of stock ownership from 41 to 99.6 percent. In 1981 the government authorized CAP to become a holding company and changed its name from Steel Company of the Pacific to Investment Steel Company of the Pacific.

In April 1980 the government had asked CAP to submit to a program of stock issues to reduce indebtedness and increase private sector participation in ownership. CAP stockholders agreed to sell about 260 million shares at a price of US$0.25 per share. But no investors were interested in buying at that price. In May 1983 the legal deadline for the sale was reached with only 0.4 percent of the issued shares sold.

In 1984 the company tried again to sell shares at a US$0.25 apiece. Once again, interest was scant. The price at that time in the stock exchange was US$0.12. The low market price was due to the high level of risk of investing in CAP, which had historically shown low profitability; the unfavorable macroeconomic conditions and the presence of other investment alternatives; and a world surplus in iron production. The price of US$0.25 per share, however, had been set by the CAP stockholders to last until late 1987.

Some other method of divestiture had to be found. The solution, carried out in 1986, was a capital reduction operation in which CAP purchased shares from the State Development Corporation (CORFO) at US$0.25 a share. This operation meant that existing stockholders increased their share of ownership, while the share of state ownership declined. In 1987 CORFO started to sell CAP shares in the Santiago Stock Exchange, and the company was fully privatized in that year.

The privatization of CAP appears to have been largely successful in terms of profitability and efficiency. Yet criticism still centers on the capital reduction operation of 1986. Critics claim that the price of US$0.25 was too low, given that the price in the stock exchange at that time had risen to US$0.38. CORFO, these critics stated, was not getting a fair market price for the shares. However, a high level of demand for CAP shares may have developed as a result of the repurchase operation itself, pushing up market prices.

Another question concerns a small number of private investors who purchased shares at the set price of US$0.25 in March and April 1986, reaping profits later that year when the central bank authorized CAP to purchase some of its own debt at highly discounted market prices. Some have asked whether these investors were notified in advance of the upcoming debt-repurchase transaction. Unfortunately, the answer to this question is beyond the scope of this study.

**National Electricity Company.** One of the most interesting privatizations carried out in the late 1980s was that of ENDESA. ENDESA is one of the country's largest enterprises and the largest electric power producer, and the company had been state property since its creation in December 1943.

Preparation for privatization began in 1980, when ENDESA's electricity distribution units were transformed into independent companies and subsidiaries and gradually privatized. ENDESA itself was then privatized largely through labor capitalism, the least controversial mode of privatization. Preferential shares were offered to ENDESA workers at a low price on credit in 1987. After sales to workers, the divestiture process continued through sales to other investors, and by

1989 the privatization of the Chilean electric power sector was almost complete.

The privatization of ENDESA was criticized for two reasons. First, some believed that privatizing a traditionally public enterprise producing a basic public service would lead to higher tariffs that would hurt the poor. The error in this view lies in confusing ownership with who establishes tariffs and how. Second, critics pointed to the debt reduction operation carried out between CORFO and ENDESA in December 1986 to prepare the company for privatization. To improve its financial position, ENDESA floated shares for US$500 million, which were purchased by CORFO. To pay for the float, CORFO acquired ENDESA's debt for an equivalent sum. Critics of the operation argue that although the debt reduction amounted to US$500 million, the market value of the shares purchased by CORFO was lower at that time and that CORFO therefore sustained a loss of capital. In fact, the shares purchased by CORFO had a market value of 28.92 pesos per share, greater than any market price before or after the flotation except for February 1987, shortly after the operation. There is no doubt, however, that a US$500 million reduction in debt implies a similar increase in the value of the company for CORFO. But if the debt reduction operation had not been carried out, revenues from share sales when ENDESA was later privatized would have been lower than they actually were, because the company would have been more indebted and more financially risky. Moreover, the debt reduction operation reduced the likelihood of reverse privatization, which could easily have happened given ENDESA's high indebtedness. In short, criticisms of the debt reduction operation do not seem well founded.

## Conclusion

Chile's unique privatization process was on balance successful. It distributed property ownership; it stimulated the private sector to improve efficiency; it opened new investment opportunities and created new responsibilities for the private sector; and it helped reduce practical and psychological dependence on the powerful and pervasive public sector. The process was also successful in converting critical and antagonistic groups, convincing them of the benefits of privatization. In doing so, it reduced the risk of reversibility despite significant changes in the political setting when the military government transferred power, after elections, to a democratic government. The latter recognized the validity of the privatization process and is even following in the steps of its predecessor, though at a more modest pace.

Errors were committed in the process of privatization. Some were predictable; others were unavoidable; and still others, put forward by some critics, were nonexistent. The most repeated error—though not unique to Chile—appears to be the lack of transparency in divestitures. Although this problem does not seem to have affected the fiscal results of privatization, it provided ammunition to groups that felt they were not being given fair access to public enterprise stock being divested and to ideological groups opposed to any notion of privatization.

The success of privatization in Chile resulted from the political and economic environment and from the diversity of divestiture modes. A president who held power for seventeen years and was convinced of the economic and political significance of the process ensured relative constancy. The economic situation in the 1970s was favorable to the process. The large deficit and high level of inflation were convincing factors. Finally, the diversity of modes of privatization ensured that objectives as varied as maximizing government revenues and spreading property ownership—two important goals of both supporters and opponents—were met.

# About the Authors

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