THE IMPACTS OF PRIVATIZATION ON DISTRIBUTIONAL EQUITY

The Chilean case, 1985–9

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INTRODUCTION

Following several decades of a closed economic strategy with a high degree of state intervention, in the mid-1970s Chile undertook a new economic development strategy, based on free markets and an open economy.

One of the key aspects of this policy was the privatization of state-owned companies, which ushered in a wave of private-sector participation in the economy. Within a period of five years—from 1974 to 1978—approximately 600 companies were privatized. Simultaneously, an open economy was established and conditions were created which were conducive to the active participation of the market and private enterprise in the allocation of resources. These policies resulted in a substantial level of growth, and the world spoke of the 'Chilean miracle'.

Nevertheless, in the early 1980s, Chile's economy suffered a reversal in the face of a strong recession, and the state once again intervened in a significant portion of the nation's productive and financial activities.

This paper analyses a set of policies implemented to overcome the recession: the privatizations realized between 1985 and 1989 and their effects on employment and the distribution of income. Given that Chile engaged in its privatizations well ahead of other Latin American countries, the nation offers a case study which may shed useful light upon this important process, currently under way in a variety of developing nations in the Americas and around the world.

This paper begins with an analysis of the general economic policies implemented during the 1985–9 period. Subsequently, specific privatization programmes and the strategies followed in their implementation are explored. The final section of the paper examines the impact of such privatization processes—including different aspects of the country's development—and suggests some lessons that can be learned from the Chilean case.

THE ECONOMIC PROGRAMME

In early 1985, Chile's economic situation remained difficult, despite the tireless efforts by government officials to implement policies aimed at accelerating growth. Unemployment affected 16 per cent of the workforce (or around 24 per cent, if those participating in special government programmes were counted among the unemployed.)[1] Chile's foreign debt was $19.48bn., representing 121.4 per cent of GDP.[2] In order to confront these problems a so-called 'structural adjustment' programme was conceived, which consisted of three main elements.

First, an effort was made to restore macroeconomic equilibrium, which would allow steady growth. This meant taking steps to eliminate the public deficit, stabilizing the balance of payments and devising a monetary policy compatible with the goals of reducing inflation and allowing for healthy growth. The results of the programme are shown in Table 12.1. By 1988 the public deficit had been practically eliminated, monetary expansion reacted to the growing demand for money, there was a significant accumulation of reserves, and the export:foreign debt ratio had returned to reasonable levels.

Table 12.1 Data on the Chilean economy, 1984–9

Second, macroeconomic policies were adopted which were intended to allay fears among economic actors and to increase the efficiency of economic operations. In particular, free-market policies designed to foster Chile's integration into the international market-place were introduced. Moreover, in 1985 a privatization programme was launched. Legislation was approved to set prices at efficient levels. The trend of improved export figures, shown in Table 12.2, is an indication of the good results of the policies.

The third set of measures were long-term policies aimed at sustaining growth and a significant reduction in poverty. In particular, domestic savings had a boost, and there was a tax reform to correct the 'anti-savings' bias inherent in Chile's income tax schedule.[3] Table 12.3 shows the favourable results.

Table 12.2 Exports during 1983–9

Table 12.3 Savings, investment and employment, 1984–9

Clearly, these policies were a success. The economy achieved sustained growth,[4] inflation was brought under control, unemployment was reduced,[5] and the social conditions of the poor improved.[6]

THE PRIVATIZATION PROGRAMME

Table 12.4 illustrates the degree of involvement of the state in Chile's economy, in 1985. Nearly 9 per cent of Chile's GDP was accounted for by companies that lacked clear property rights, and 17 per cent of GDP was in sectors in which development was severely limited as a result of fiscal indebtedness.[7] If we examine in greater detail the industries in which the state was directly or indirectly involved, it is clear that all of them required large capital contributions. Therefore privatization was an approach which was not only consistent with a free and open market economy, but was a central instrument for accelerated growth. Efforts were focused on moving towards developing a nation of property owners, in an effort to achieve greater social stability.

Table 12.4 Involvement of the state in the economy (% of GDP)

The goals were prioritized in different fashions within the three key areas of the programme which were introduced: privatization of banks and pension fund administrators in which the state had intervened; privatization of the 'odd sector' —companies indirectly controlled by the government; and privatization of traditional state-run firms.

The financial sector

As of December 1984, the banking system as a whole showed losses in its nonreserve supported assets in the order of 200 per cent of the capital plus reserves, or 18 per cent of GDP. Twenty-two institutions came under administration, or were shut down; this represented a reversal of the privatization process, in a sense. Nearly 68 per cent of pension funds were also subjected to state control.

In the case of banks, privatization was part of a global policy which included the rehabilitation of the financial system.[8] This was achieved by increasing capital through old and new shareholders, liquidating non-viable projects, and modifying legislation affecting the industry to avoid a recurrence of similar difficulties in the future.8 In the case of the two largest banks, new shares were issued at book value, which in essence were underwritten by individuals.[9] In order to reconcile the real economic value of the newly issued shares with the placement price, and to diversify property ownership, very attractive purchase conditions were offered to the public. These stimuli consisted of long-term credits, a cash down payment requirement of just 5 per cent together with a 30 per cent discount on timely payments, as well as tax incentives. The system was open to people in compliance with their tax obligations. Acquisitions made in this fashion could never exceed 2 per cent of the shares tendered for sale, however.[10] Implementation of this programme involved legislation and a substantial campaign aimed at placing shares among the public.[11] Three years later, the banks were reprivatized. Their ownership had been divested and their creditworthiness had been recovered, as can be seen in Table 12.5.

Table 12.5 Bank statistics, 1984–7

In the case of the reprivatization of the pension fund administrators, an effort was made to spread ownership among a broad range of shareholders, while allowing for the participation of a single controlling stockholder. The goal was to ensure that contributors would participate in the ownership of the companies controlling the system, as well as to transfer management—as quickly as possible—to qualified groups, given the economic significance of these activities and the limited experience in Chile with a social security system base on individual capitalization.

To distribute ownership, favourable credit conditions for small shareholders (provided that they were active or retired contributors to pension funds) were offered. Similarly, a number of shares allowing for corporate control were offered, which were acquired by foreign investors.[12] In addition, nearly 14,000 'popular capitalism' stockholders participated in these privatizations.

The 'odd sector' companies

The 'odd sector' came about as a result of the economic crisis and the government's control of the country's primary conglomerates. The companies included in this category accounted for a high proportion of GDP, as already mentioned, but additionally comprised an important portfolio of investment projects which were essentially oriented toward the export sector. Decision-making was restricted as a result of uncertainty over property rights to these companies: some were owned by investment societies which had failed to service the credits granted to them by requisitioned banks, while others were firms which had been unable to repay loans made to them directly. The executives assigned to these companies, for the most part, were experienced business and administrative managers selected by the government as temporary trustees, who were charged with overseeing daily corporate operations. Consequently, these executives were hesitant to make long-term decisions, an impairment which substantially hampered the operations of the affected companies, threatening their efficiency and impeding the recovery of the economy as a whole.

As noted earlier, high priority was attached to the rapid recovery of the economy. Thus, in the case of these reprivatizations, resolving the problems of ownership and initiating divestment was considered decisive. To this end, a series of share packages were sold off through the stock market. As legal issues were resolved, packets were tendered for sale under normal—rather than special—conditions. Some thirty companies from different sectors were sold, being acquired, primarily, by local businessmen.[13] Several of these companies have subsequently entered into investment agreements with foreign businessmen. Around $640m. was the market value involved in this privatization over a four-year period.[14]

State companies

In this case, the general goals mentioned earlier were complemented with specific goals aimed at creating a wide variety of pension fund investment opportunities, obtaining resources for fiscal requirements, and enhancing the efficiency of state-run companies.[15]

Although each privatized company followed its own procedures, some general criteria were applied to the privatization process. During the first two years (1985 to 1986), CORFO and participating companies made an important effort to disseminate their economic results and capabilities.[16] This was chiefly done through the specialized communications media and the offering of small packets of shares from the companies to be privatized on the stock market.[17] Moreover, a majority of companies was initially authorized to divest 30 per cent of their stock. This amount was tendered primarily among company employees through the direct sale of shares (at the market price in effect as of the close of negotiations). Such sales were bolstered through a variety of creative mechanisms, such as allowing employees to make use of a significant portion of employer-guaranteed indemnities (retirement funds, etc.) to acquire shares. Workers received assurances that if, at the time of retirement, their shares were worth less than the purchase price, the company would make up the difference. In other cases, privatization took place through shares granted as bonuses or as part of a collective bargaining process.

In 1985, pension funds were authorized to acquire shares of companies which, by virtue of their liquidity and profitability, had been selected by a Commission on Classification and Approval of Investments established in accordance with the new Chilean social security system. State companies were included in the system if they had undergone privatization and diversification, and so long as they made at least 30 per cent of their shares available to AFPs for investment.

The sale of shares to employees has been called 'labour capitalism', while the process of selling to pension funds has come to be known as 'institutional capitalism'. Once the sale of the initial 30 per cent had been completed, the sale of packets of nearly 19 per cent of corporate capital commenced (sales were made in different combinations to employees, pension funds and small stockholders). At this stage, some groups of employees obtained direct loans from financial institutions in order to buy shares, the shares themselves serving as collateral.

Subsequently, the full privatization of the companies was announced and the sale of larger share packets on the stock market ensued. At this point, acquisition by foreign investors gained increased relevance. Nonetheless, it is important to note that the level of participation by foreigners was only moderate, given the total volume of resources involved in the privatization process. Table 12.6 shows the participation of foreign investors in some of the more prominent sales.

Table 12.6 Participation of foreign investors, up to 1988

In 1989, the privatization programme was completed, marking the transfer to the private sector of approximately 14 per cent of GDP. This figure is particularly important when compared to similar processes undertaken in the West. For example, the British Conservative government, led by Margaret Thatcher, reduced the size of the state sector from 11.5 per cent to approximately 6.5 per cent of GDP.[18] The most relevant aspect of the privatization process may well be in qualitative (rather than quantitative) terms, given the role played by key companies in the export and public utility industries in fostering the overall expansion of the economy. Nonetheless, it is useful to bear in mind that— notwithstanding the privatizations effected as of the mid-1970s and those conducted between 1985 to 1989 (as analysed in this paper), which encompassed a large number of state companies—the Chilean state sector remains quite large. State-run industries currently account for some 12 per cent of GDP in Chile, vastly more than the 6 per cent norm common in the developed nations of the Western world.[19]

IMPACT AND RESULTS OF PRIVATIZATION

The impact of the privatization process in Chile was profound and generated a vast array of results. This section provides an overall review of some of the most important impacts on employment and on distribution of income.

The impact on employment

One of the most acute problems facing Chile in the wake of the foreign debt crisis was the nation's exorbitantly high unemployment rate. Some observers ventured to suggest that privatization might well make the situation even worse. Unfortunately, memories were still fresh of the high unemployment rates which had coincided with the privatization efforts undertaken a decade earlier. In fact, quite the opposite occurred; companies increased their employment by 10 per cent after privatization, as illustrated in Table 12.7. The unemployment rate dropped from 15 per cent in 1985 to 6.5 per cent in 1990, the increase in employment in privatized companies being the result of both the overall headway achieved throughout the economy in those years and an escalation in investment by these firms. For example, in the case of the telecommunications industry, the increase in investment can be measured in a variety of ways, including the increase in urban services, as shown in Table 12.8.

The results of the privatization process in the electrical industry also show a surge in investment. The data on Enersis, the Chilmetro holding company, indicate that during the three-year period preceding privatization, average annual investments totalled $13m., while for the period 1987–9 the average was some $33m. Data for Chilgener serve to confirm the trend, with an increase in investment of 270 per cent over a similar time period, while investment by CAP, the steel company, for the period 1987–9 (following privatization) was 564 per cent higher than for 1984 to 1985. Furthermore, Soquimich, the privatized nitrate company, increased its annual level of investment by some 196 per cent. The global increase in investment is shown in Table 12.9.

Table 12.7 Employment in privatized companiesa

Table 12.8 Growth in telecommunications servicea

Table 12.9 Gross domestic investment (% of GDP)

Impact on distribution of income

Given the lack of concrete data on the impact of the privatization process on redistribution, it is simply not possible to analyse this topic in depth. Nonetheless, some initial conclusions as to the probable effects of this process can be drawn.

In the case of banking privatization, the sale prices used were based on book value. However, this value was considerably higher than the corresponding market value, due to the unusual situation of the banking system mentioned earlier. Consequently, it was necessary to offer favourable credit and tax conditions in order to reduce the gap between these appraisals. Critics argued that, given the companies' book value, this adjustment constituted a huge subsidy. To them, the profits obtained by the shareholders of the newly privatized banks served to confirm their thesis. Nevertheless, these evaluations took place after the fact and were based on an extraordinarily short time-span.

The most relevant aspect of this situation, and one that is well worth looking at more closely, is why the combination of sale prices, credit and tax conditions and discount rates applied to the private banking market in 1984 failed to serve as a strong incentive for attracting new shareholders. In any case, the incentives were limited to credible taxpayers, who were authorized to acquire only a small number of shares. Moreover, through the privatization of both the banking system and the pension fund administrators, the state sought to redistribute ownership. This goal was successfully fulfilled and helped to stimulate the participation of non-traditional investors in the stock market.

Second, in the cases of privatization of companies in the 'odd sector', no incentives were provided and divestment took place through transparent and broadly advertised market mechanisms.

Third, in the controversial privatization of state-owned companies, the majority of transfer capital was not offered under special sale conditions, and the stock market was used to conduct such operations. Incentives were granted solely to employees. Of these, the most relevant was the authorization for employees to use advance severance pay to purchase shares. Furthermore, in the case of larger companies, public sector employees were also allowed to make use of their severance pay to acquire shares. For privatization processes requiring a large volume of capital, employees and small stockholders were granted the option of making payment by instalments.[20] Sales to employees were conducted directly on the basis of benchmark prices quoted on the stock market at the time of the transaction.

Sales to pension funds were carried out exclusively through the stock market and included strict procedures to guarantee transparency. A similar approach was taken with the small packets of shares placed on the market gradually. Table 12.10 shows the participation of the main shareholders in a select group of privatized companies. It confirms the high level of workforce participation.

Some studies on the privatizations conducted in 1985 and 1986 have alleged that resources were transferred from the state to the buyers, in implicit subsidies.[21] Were this true, the transfer would have primarily served the interests of labour—that is, the employees of the privatized firms and participants in the social security system in general—rather than large capital holders, because the majority of the shares sold in that period were bought by workers and pension funds.

Another aspect that should be analysed is the role that foreign capital played in the privatization process. Although foreign capital was important in allowing Chile, the pioneer of foreign debt conversion in Latin America, to return to the international financial markets, it had no real significance in privatization. Around $500m. in acquisitions were made in this fashion, of which just over half were used to acquire public firms sold by CORFO. The remainder was used in the purchase of 'odd sector' companies, in which there were also no significant transfers in favour of foreigners.

It is interesting to observe what occurred in this period with the distribution of income in the country. As shown in Table 12.11, the poorest 30 per cent of the population increased their participation in the national income.

Thus we may initially conclude that the privatization process did not have negative repercussions for the redistribution of income, but rather that it enhanced access to capital among sectors of society which did not traditionally engage in such investments. In other words, the privatization process resulted in a redistribution of assets. For example, in the case of the privatization of the two largest banks, shares were sold to some 37,356 individuals. The situation of the Banco de Chile is a case in point: prior to privatization, through 'popular capitalism', ten shareholders accounted for 34.2 per cent of the bank's stock. Following privatization, those shareholders held just 3 per cent of the bank's paper. The case of the Banco de Santiago is even more impressive. Here, the percentage of ownership of the top ten shareholders plummeted from 98.1 per cent to a mere 8 per cent.

Table 12.10 Distribution of shareholdings following privatization (1985–8) (percent)

Table 12.11 Chile: income distribution, 1985–90 (percentage of monetary income received by each decile)

In the pension funds industry, nearly 14,000 shareholders were incorporated into the two most important privatized administrators of pension funds, while two foreign investors with experience in the field acquired majority shares.

The priority given to the workers of the privatized SOEs, and to small shareholders, produced a significant change in the distribution of shares. Specifically, the number of shareholders in privatized companies increased by 40 per cent, from some 26,604 individuals in 1985 to nearly 200,000 in 1989 (see Table 12.12).

In addition, it is important to consider the increase in the number of shareholders resulting from the incorporation of administrators of pension funds into the market-place. Thanks to this mechanism, some three million employees have become indirect shareholders. For similar reasons, the level of dispersion among owners also rose, as can be seen in Table 12.13.

Table 12.12 Number of shareholders in privatized public companies

Table 12.13 Percentage control by ten major shareholders

The data clearly indicate that the labour force, whether employees of the privatized firms, the public sector or indirect beneficiaries (the three million people participating through the pension fund system), was granted one of the greatest opportunities in Chilean history to acquire shares and capitalize their savings. The magnitude of the process can be appreciated if we note that, in terms of aggregate value, the labour force increased its participation by approximately 2.2 per cent of GDP over a period of just five years.

CONCLUSIONS

As we have seen, the privatizations conducted during the second half of the 1980s were decisive among the policies implemented to avert Chile's crippling economic crisis. Recovery was successfully achieved, by the end of the decade. GDP was 35.2 per cent higher than in 1984.

Privatization contributed directly to economic recovery by increasing efficiency within companies and expanding the markets within which they operate. Furthermore, privatization brought new opportunities for investment. Indirectly, the process generated favourable expectations for growth, strengthened Chile's weakened capital markets, and enhanced the nation's image abroad. This impact on growth produced positive effects on employment and incomes.

The distribution of income improved over the period of the privatization process. The main explanation for this is the adoption of social policies that produced a concentration of public resources and programmes on the poorest groups in the country. The growth in GDP with its effect on employment and wages was another key element.

Chile's case is interesting because it provides an example of a concrete experience in which a radical privatization programme promoted a redistribution of shares, which produced a positive distributional impact. Perhaps the most important effect has been that resulting from the transfer of property ownership from the state to thousands of direct proprietors, including the employees of the privatized firms themselves. Attention must also be paid to the importance of the thousands of beneficiaries who have accessed the market indirectly through the pension funds system.

The magnitude of the assets privatized, both in terms of state-owned and 'odd sector' companies, was significant. As a result, a large number of people who were traditionally barred from property ownership (due to financial limitations, rather than outright discrimination) have been able to acquire shares in large, important companies.

NOTES

1 During the 1981–2 economic crisis, special employment programmes were created to confront the sharp rise in unemployment. The PEM *(Programa de Empleo Minimo)* commenced in March 1975 and concluded in December 1988. This employment scheme was established by the Ministries of the Interior and Finance and was implemented by the municipalities as a subsidiary and temporary programme with social welfare purposes. The programme focused on poorly qualified workers. The POJH *(Programa Ocupacional para Jefes de Hogar)* began in October 1982, by virtue of administrative policies adopted in accordance with instructions from the Ministry of the Interior, and ended in December 1988. Funding

for the later programme was allocated in the annual budget. This programme focused on more qualified workers.

2 The government intervened in a significant portion of the private sector during the period 1981–3; import duties were increased from 10 per cent to 35 per cent between 1982 and 1984; the fiscal deficit totalled 4.4 per cent of GNP in 1984. All of this was diametrically opposed to the official core policies of promoting the role of the private sector, opening the economy, and maintaining fiscal discipline, adopted as of the 1970s.

3 The new policy called for only funds withdrawn by the company's shareholders to be subject to income taxes. Initially, this was not applied to corporate taxes. The latter were incorporated in 1989. However, in 1990, the inclusion of corporate taxes was reversed.

4 Decree Law 600 regulating foreign investment was modified to establish more convenient conditions for project financing; at the same time, tax rates were readjusted to bring them into alignment with the reductions adopted in earlier years.

5 Based on national employment levels for the quarter October-December of each year.

6 At the beginning of the 1980s, major reforms in education were launched which decentralized public education and generated competition between private and public educational facilities. This reform was curtailed during the economic crisis.

7 The foreign debt of the public sector increased from \$6.6bn. in 1982 to \$13.7bn. in 1985, as a consequence of the state guarantee on private debt and an increased use of public indebtedness to meet balance of payments needs. For more information, see: Fontaine, J.A. (1989) 'The Chilean economy in the eighties: adjustment and recovery', in Edwards and Larrain (eds) *Debt, Adjustment and Recovery*, Oxford: Basil Blackwell.

8 Prior to privatization, debtor and banking system support programmes were implemented through the sale of portfolios to the Central Bank.

9 These were Banco de Chile and Banco de Santiago. The remaining banks undergoing privatization were Banco de Concepción, Banco Osorno and Banco Internacional, which were sold to corporate institutions without the added incentive of so-called 'popular capitalism'. In addition, Banco Colocadora Nacional de Valores was merged with Banco de Santiago, while other banks were liquidated.

10 See Valenzuela, M. (1989) 'Reprivatización y capitalismo popular en Chile', *Revista de Estudios Públicos*, no. 33, summer.

11 Law 18.401.

12 Bankers Trust acquired 40 per cent of AFP Provida, while Aetna Chile bought 51 per cent of AFP Santa Maria. Other smaller administrators were privatized through the stock market.

13 The most important were: in the energy sector, COPEC; in the forest sector, in addition to COPEC and its subsidiary Celulosa Arauco y Constitución, the company Inforsa; in the industrial sector, Compañía Cervecerías Unidas, Compañía Tecno Industria, Textil Viña, Industria de Radio y Televisión and Compañía Industrial; in the transport sector, the airline LADECO and part of Compañía Sudamericana de Vapores.

14 Labbé, F. and Llevenes, M. (1988) 'Evolución del proceso de privatización chileno 1973–1987', paper by the Centro de Estudios Públicos.

15 Thanks to policies implemented in 1974 which imposed a goal of maximizing profits, performing under competitive conditions by eliminating all privileges, with strict control on credit and investments, state companies were able to eliminate their losses and substantially improve their financial position within a six-year term. Nevertheless, from a long-term standpoint this behaviour was not likely to continue, given the structural problem inherent in public companies whereby the political goals set by government officials tend to increase inefficiency.

16 CORFO is a state holding organization and a development

bank which owns the great majority of Chile's privatized public companies. Through its upper management, this institution served as sales agent. Final decisions were adopted by the board, composed of four ministers and a representative of the President. An informal advisory team was formed which included representatives of the ministers of the economic sector who collaborated on strategic design. In addition, the services of a stockbroker were utilized to carry out sales in this market and to advise and support CORFO in these operations. Specialized financial institutions were utilized solely for the sale of large-scale assets and to conduct promotional activities in foreign countries.

17 It is important to note that, in the case of the power companies, use was made of a mechanism known as 'reimbursable financing', whereby an electrical distribution company was given the right to request that a client—to whom the company was committed to providing a timely supply of power—provide new monies in exchange for shares, bonds or other paper. Initially, these contributions were reimbursed through shares which, in the case of Chilectra, meant that some 10 per cent of the company was privatized between 1983 and 1985.

18 Vickers, J. and Yarrow, G. (1988) *Privatization: An Economic Analysis*, Cambridge, MA: MIT Press.

19 Lüders, R. (1991) 'Massive divestiture and privatization in Chile', *Contemporary Policy Issues*, October.

20 Such mechanisms were primarily used in the cases of CAP, Iansa and Chilmetro. Credit facilities were granted to privatize Endesa.

21 Marcel, M. (1989) *La Privatización de las Empresas Publicas en Chile 1985–88*, Santiago: Notas Tecnicas, CIEPLAN.