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**A Review of Chilean Privatization Experience**

**Patricio Meller  
CIEPLAN, Chile**

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# **A Review of Chilean Privatization Experience**

by  
Patricio Meller

## **Introduction**

Chile has had two reprivatization and one privatization processes; however, prior to both the Chilean economy went through a dramatic questioning and attacking of the basic principle of private property during the 1970–1973 period. This highly conflictive political experience led to the nationalization of industrial firms and banks, foreign investment (mainly in CODELCO), land reform, and other state intervention and expropriation measures (for a review of this period, see Larrain and Meller 1991). During 1973, public enterprises' share of GDP reached 39 percent; public firms' gross output share of mining, financial, and public utilities sectors was greater than 85 percent; it reached 70 percent in the transport and communication sectors; and it was 40 percent in manufacturing (Larroulet 1984).

The military dictatorship, 1973–1990, implied a complete reversal of the ideological conception that prevailed from 1970–1973. Private property and the private sector are the basic pillars of the present Chilean economic development model. Even Chilean socialist leaders do not nowadays question private property, the free-pricing market system, or the private sector as the main agents and engines of the economy. Moreover, the concept of private property is neither mentioned nor is it on the agenda of any Chilean political party (including the Communist party; which received 6.9 percent of the vote in 1992). The current political debate is focused on questioning not privatizing any of the ten or so remaining public firms and includes the rationale for not privatizing CODELCO.

This paper reviews the reprivatization and privatization processes implemented in the Chilean economy during the 1970s and the 1980s. Given the fact that Chilean privatization was carried out in 1986–1987, it is possible to examine some preliminary results achieved by privatized firms with respect to their profitability and employment performance. Finally, a few paragraphs are devoted to regulation, as it is a new problem for which there is not much experience. Recently privatized natural monopolies such as electricity generation have even questioned the concept of

regulation, claiming that the state should abstain from regulating even natural monopolies, because such regulation is equivalent to a rebirth of the old role of state intervention.

### **The Process of Destatization of the Chilean Economy**

The deep political, institutional, economic, and social crisis of 1973 was used as the frame of reference for a complete reversal of the development strategy and the role of the state in the Chilean economy. From 1973 on, the state and the public sector were considered the main generators of most of the problems of the Chilean economy; therefore, the smaller the size of the state and the smaller its degree of intervention, the more improved would be social welfare.

The many stabilization and structural reforms implemented during the military regime—like privatization and reprivatization, state and fiscal reforms, liberalization, deregulation, and the opening of the external sector (table 1)—have had as a goal the reduction, and eventually the elimination, of policies and mechanisms available to the state that might allow it to modify optimal economic growth generated by market forces. This type of environment was to give incentives to the private sector to become the engine of growth. The explicit economic philosophy during the 1973–1990 period was that in a *laissez faire*, free market system, the fundamental role of the state was the maintenance of law and order. This implied, among other things, protection of private property and enforcement of legal contracts.

Other objectives complemented the foregoing: (1) modernization of the state structure, which implied a reduction and simplification of red tape, and elimination of many existing public control measures; moreover, the efficiency of the public sector had to be improved; (2) the maintenance of an equilibrium in the macroeconomic environment, with stable and permanent rules, became the main responsibility of the state; in this way, the private sector would be able to perform a correct microeconomic evaluation of its investment projects; (3) the state should not be involved in the *production* of goods and services (including social goods like housing for the poor, health, and education).

In the implementation of the Chilean *laissez faire*, free market system, it is useful to distinguish state reforms implemented in the 1970s and in the 1980s.

### **State Reforms in the 1970s**

A schematic overview of the 1970–1973 Chilean economic situation may lead to a better understanding of the deep reforms implemented by the military regime during the 1970s. During the Unidad Popular government (1970–1973), the state assumed a large economic role. In the productive sphere, there was a massive transfer of real assets from the private to the public sector; the mechanisms that were used included nationalization of large copper mines, agrarian reform, nationalization of the banking system, and creation of the so-called social property area (which implied public control of the most important productive firms). Sharp increases in public expenditure through augmentation of public employment and real wages occurred; in addition, there was a large expansion of social expenditures. Control mechanisms, for example, generalized price controls, credit allocation and interest rate controls, foreign exchange and import controls, became the main tools of economic policy. It should be pointed out that these control mechanisms existed prior to 1970, but their use was considerably intensified during the Unidad Popular government.

In 1973 the overall public sector deficit reached 30 percent of GDP. There was a proliferation of black markets and economic changes, and the inflation rate reached 60 percent (a level of inflation unknown before then).<sup>1</sup> This seriously deteriorated economic situation constituted the basis for implementing drastic changes.

As already pointed out, the policy reforms were supposed to lead toward a permanent diminution of the economic role of the state. In the productive sphere, there was a massive transfer of real and financial assets toward the private sector through reprivatization and privatization.<sup>2</sup> Fiscal reform included a significant reduction of public expenditure and a tax reform. These measures generated important fiscal surpluses at the end of the 1970s. Economic liberalization and deregulation, that is, elimination of almost all existing (economic) controls, took place.

Table 1 provides a synthesis of the economic reforms implemented during the 1970s.<sup>3</sup> Table 2 provides the intertemporal sequence of the implementation of these reforms; the lower part of table 2 provides values for inflation, unemployment, and growth, the macroeconomic environment prevailing during the reforms. In this essay I will examine only the reprivatization process.

The first reprivatization process occurred in 1974; 257 firms and around 3,700 farms that had been illegally seized or intervened by the state (or by the workers) were quickly returned to the old owners. This reprivatization process did not involve any

monetary transaction; former owners were asked not to start any legal or judicial action against the state, and they were also required to absorb existing debts.

**Table 1. Chilean Major Structural Policy Reforms of the 1970s**

<i>1972–1973</i>	<i>Post-1973</i>
	<i>Privatization</i>
More than 500 commercial firms controlled by the state	By 1980, only 45 firms (including and banks one bank) remained in the public sector
	<i>Prices</i>
Price controls	Market-determined prices except wages and exchange rate
	<i>Fiscal Regime</i>
"Cascade" sales tax	Value-added tax of 20 percent
Large public payroll	Public employment reduced
Large fiscal deficits	Fiscal surpluses in 1979–1981
	<i>Trade and Exchange Rates</i>
Multiple exchange rate system	Homogeneous, unified exchange rate
Prohibitions and quotas on imports	Flat import tariff of 10 percent (excluding automobiles)
High tariffs <sup>a</sup>	Absence of other trade barriers
Prior deposits for imports	
	<i>Domestic Financial Markets</i>
Controlled interest rates	Market-determined interest rates
State ownership of banks	Reprivatization of banks
Control of credit	Liberalization of capital markets
	<i>Capital Mobility</i>
Total control of capital movements	Gradual liberalization of the capital account <sup>b</sup>
Government was the main external borrower	Private sector is the main external borrower
	<i>Labor Regime</i>
Unions played a large role and had considerable bargaining power	No unions and no collective bargaining power
Worker dismissals prohibited	Relaxation of prohibition on dismissals
Mandatory wage increases	Relaxation of mandatory wage adjustments and severe cuts in real wages
High and increasing nonwage labor costs (40 percent of wages)	Reduction of nonwage labor costs (to 3 percent of wages)

<sup>a</sup>The average tariff was 105 percent and the maximum was 750 percent.

<sup>b</sup>Movements of long-term capital were liberalized in 1981, and those of short-term capital in 1982.

Table 2. Phasing of Chilean Reforms during the 70s

	1974	1975	1976	1977	1978	1979	1980	1981
Price Liberal	■	▨						
Privatizat.	■	■	▨	▨	▨			
Fiscal Reform	■	■	■	▨	▨			
Trade Reform	■	■	■	■	■	■		
Dom. M <sup>k</sup> Lib.		■	■					
K <sup>o</sup> Acc. Lib.						■	■	■
L-Reform						■	■	

	1974	1975	1976	1977	1978	1979	1980	1981
Inflation (%)	369	343	198	84	37	38	31	9
Unemployment (%)	9	16	19	18	17	17	17	16

There was another reprivatization process from 1974–1978 which included specific monetary transactions. This involved the dismantling of the "social property area" created under the Unidad Popular government. At the end of 1973, more than five hundred firms and banks were under state control; by the end of the 1970s, only forty-

five firms (including one bank) belonged to the public sector; the rest had been "reprivatized."

The 1970s reprivatization process occurred in the middle of a deep recession (in 1975, GDP declined 12.9 percent). At that time, Chile also had a very small domestic capital market. Thus only a few private agents were able to participate in the reprivatization process. This situation led to an acute concentration of property and the formation of a few conglomerates ("economic groups"), which dominated the economy through the ownership or control of the main firms and banks. The state received US\$543 million from the sale of banks and firms (see Larrain [1991] for details). It has been estimated that there was a 30 percent subsidy given by the state in the form of the underpricing of reprivatized banks and firms (Foxley 1982).<sup>4</sup> Most of these firms were acquired with an initial down payment equivalent to 10–20 percent of the total costs; CORFO (a public institution) provided the credit for the remaining part. Property concentration of reprivatized firms was a deliberate goal of the economic authorities, and it was achieved through the sale of large share packages, up to 100 percent, of a given firm or bank. It was believed that this procedure would result in higher prices for reprivatized firms (and banks). Many of these reprivatized firms and banks went bankrupt during the 1982–1983 recession. They were then intervened and rescued by the state and underwent a second reprivatization during the mid-1980s.

### **State Reforms in the 1980s**

State reforms in the 1980s consolidated and deepened the reforms of the 1970s; that is, there was further reduction of the role of the state in the economy. The reforms of the 1980s included (1) in the productive (and financial) sphere, a second reprivatization process and a widespread privatization of traditional public enterprises; moreover, there was a social security reform under which the old "equal for all" pension system (administered by the public sector) was replaced by a personal capitalization system administered by the private sector; (2) new tax reform oriented toward a reduction in the size of the public sector; and (3) the establishment of the autonomy of the Central Bank. I shall examine the privatization and reprivatization processes in only a schematic way in this paper; the next sections will deal with specific issues related to these processes.

There were some lessons learned from the first reprivatization. That process was really debt-led, where the newly reprivatized firms started with quite large debt/equity

ratios, which generated a highly unstable financial position (Larrain 1991). The high concentration of property and interlocking decisions of firms and banks also made most of the Chilean private productive and financial structures depend on the appropriate management of the two largest economic conglomerates.

The second reprivatization process (1984–1987) included firms, banks, and financial institutions that were rescued from bankruptcy in 1982–1983. The net stock value of these enterprises has been estimated to be US\$1.1 billion (equivalent to 6 percent GDP; Hachette and Lüders 1988) (see table 3). In this second reprivatization process, distinct sale procedures were used: "popular capitalism,"<sup>5</sup> stock exchange, and bidding among prequalified buyers. All of these transactions (except those in the popular capitalism program) required 100 percent cash payments; in this way, the previous debt-led reprivatization problem was avoided. Moreover, this time there was

**Table 3. Second Reprivatization Process 1984–1987**

<i>Firms &amp; Financial Institutions<sup>a</sup></i>	<i>Reprivatization Mechanism</i>		<i>Book Value of Assets (Sept. 1987) (US\$ millions)</i>	<i>Number of Shareholders (Sept. 1987)</i>
	<i>Private Auction</i>	<i>Popular Capitalism</i>		
COPEC	X		310	15,922
Banco de Chile		X	285	39,179
Banco de Santiago		X	156	15,919
INFORSA	X		85	3,447
Pesquera Coloso			47	6,340
INDUS	X		45	5,158
Banco de Concepción	X		44	6,110
AFP Provida	X	X	18	7,909
AFP Santa María	X	X	13	6,062

*Source:* Hachette and Lüders (1988).

<sup>a</sup>See Hachette and Lüders (1988) for the complete list of reprivatized firms and banks; the list shown here includes those having the largest asset book value figures.

a specific objective for the dissemination of property. From a political point of view, this would ensure the irreversibility of the whole reprivatization process.

The privatization of public enterprises began in 1986. Divestiture of public enterprises (all of them created by the state) included public utility firms (electricity, telephones and communications, gasoline distribution) and other firms like the national airline (LAN), the steel company (CAP), and nitrate and coal companies. The total value of the stock assets of the programmed divestment process (excluding CODELCO, the large state copper mines) has been estimated to be US\$3.6 billion (Hachette and Lüders, 1988).

Different procedures were used for the divestiture of Chilean public enterprises:<sup>6</sup> institutional capitalism, through which the new privately administered social security firms (AFP) were able to acquire restricted amount of shares; "employees' capitalism," in which workers of divested public firms received special incentives (through price subsidies) for buying shares of the companies in which they worked; "traditional capitalism," which consisted of the sale of packages of shares to qualified buyers through direct auction or through the stock exchange. The sale of divested public firms generated US\$1.1 billion. The subsidy implicitly provided by the government in this divestiture process was higher than 50 percent (Marcel 1989). Again, all these privatization transactions required cash payment of 100 percent of the total cost. Furthermore, there was the explicit purpose in mind of disseminating property, to include investors and workers, people in general, without any discrimination between domestic and foreign investors.

Given the fragility of the Chilean financial system and its bad performance during the 1970s, several regulations and changes were introduced during the 1980s:<sup>7</sup> (1) the Superintendency of Banks introduced a rating system of a given bank's loan portfolio according to the degree of risk; then, a specific bank was required to provide reserves according to the default risk of its loan portfolio; (2) a restriction was established on the level of loans a bank could provide to a client related to the owners of the bank; in this respect, all loans provided to distinct enterprises that belong to the same group of shareholders would be considered as one loan and therefore subject to the loan limit established with respect to total bank assets; (3) the Superintendency of Securities and Insurance established new rules for joint-stock corporation with respect to the disclosure of transactions between related companies, sales and purchases of stocks by important shareholders and managers, requirement of consolidated financial

balance sheets, and penalties for publication of false or misleading information; moreover, a risk rating of all securities issues by private (and public) firms was introduced; also, a law established the definition of a conglomerate and of a controlling group of shareholders; (4) mutual funds and insurance companies now have requirements about portfolio diversification that specify limits on investment in securities of one issuer or related issuers; in addition, there are requirements related to information disclosure, net worth, and technical reserves.

### **Privatization Mechanisms of Public Enterprises**

Privatization of public enterprises (during the 1980s) implied a deepening and consolidation of the role of the private sector in the Chilean economy. Public enterprises were a key agent in the previous development strategy. They had been created to provide cheap intermediate goods and cheap public utilities to the import-substitution industries. Given indivisibilities and scale economies, some of these industries were quite large and, during the 1940s and 1950s, only the state was willing to invest in their creation. Therefore, divestiture of these public enterprises was really the final blow to the old development strategy. With the exception of CODELCO and a few other firms, the rest of the Chilean economy at the beginning of the 1990s was in private hands. Moreover, the privatization of CODELCO is now a hot issue. In 1972, all political parties fully agreed on the nationalization of CODELCO; today, the question many people ask is: What are the reasons for not privatizing CODELCO?

Table 4 provides a list of the public enterprises that were privatized during the 1986–1989 period, with the percentages of ownership that were sold. By 1990, around 30 public enterprises were almost 100 percent sold; these included a steel refining company (CAP, 7,000 workers); public electricity generation, transmission, and distribution utilities (ENDESA, 2,900 workers; ENERSIS, 2,500 workers; Chilgener and Chilquinta, 1,750 workers); telephone (CTC, 7,000 workers); telecommunications (ENTEL, 1,400 workers); a nitrate company (SOQUIMICH, 4,700 workers); a coal mine enterprise (Schwager, 2,300 workers); a sugar refinery (IANSÁ, 2,000 workers); and the national airline (LAN, 900 workers).

As was mentioned previously, different mechanisms were used in the privatization of Chilean public firms; these mechanisms were used even in the privatization of the same firm (see table 4). It was required that a public firm be transformed through a legal procedure into a corporation able to sell shares; its accounting and financial

operations would then become subject to the regulation procedures of the Superintendency of Securities and Insurance. Medium and large public firms were privatized by the sale of packages of shares. The buyers were domestic and foreign investors, pension funds (AFP), employees of the same firms, and the public in general. In the case of small public firms, a simpler procedure was used. All shares were sold in one package to a qualified buyer, who could be either a domestic or a foreign investor, or the firm's employees.

**Table 4. Privatization of Chilean Public Firms 1986–1990**

Public Firm	Activity	Privatization Percentage			Privatization Mechanisms				Book Value of assets (Sept. 1987) (US\$ millions)
		1986	1987	1990	AFP	Stock Exchange	Employees	Private Auction	
CAP	Steel refin.	52	100	100		X	X		679
COFOMAP	Forestry	n.a.	n.a.	100				X	
Chile Films	Movies	0	0	100				X	
Chilmetro	Electr. distr.	63	100	100	X	X	X		206
Chilgener	Electr. gener.	35	100	100	X	X	X		264
Chilquinta	Electr. distr.	63	100	100	X	X	X		52
CTC	Telephone	11	63	99	X	X	X	X	306
ECOM	Computer	100	100	100			X		
Edelmag	Electr. distr.	12	12	100		X	X		
Edelnor	Electr. distr.	0	0	16		X	X		
Elecda	Electr. distr.	n.a.	n.a.	98		X	X	X	
Eliqsa	Electr. distr.	n.a.	n.a.	98					
Emelari	Electr. distr.	n.a.	n.a.	96		X	X	X	
Emec	Electr. distr.	100	100	100		X		X	
Emel	Electr. distr.	100	100	100			X		
Enacar	Coal	0	0	16	X	X	X		71
Enaex	Explosives	0	100	100				X	
ENDESA	Electr. gener.	0	30	96	X	X	X		1,314
ENTEL	Telecommun.	30	33	99	X	X	X		93
IANSA	Sugar refin.	46	49	100		X	X		90
ISE Gen.	Insurance	0	0	97		X	X		
ISE Vida	Insurance	0	0	99		X	X		
Labor. Chile	Pharmaceutical	23	49	100	X	X	X		
LAN Chile	Airline	0	0	68		X	X	X	49
Pehuenche	Electr. gen.	0	0	100			X		
Pilmaiquén	Electr. gen.	100	100	100				X	44
Pullinque	Electr. gen.	0	100	100				X	
Sacret	Financial credit	0	0	100					
SOQUIMICH	Nitrate	55	100	100	X	X	X		102
Schwager	Coal	0	42	100	X	X	X		
Telex	Telex	100	100	100				X	8

Source: Marcel (1989); Sáez (1992); Hachette and Lüders (1988).

