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INTELLIGENCE MEMORANDUM

SOME POLITICAL AND ECONOMIC PROBLEMS ARISING FROM STATE ENTERPRISE IN LATIN AMERICA

DIRECTORATE OF INTELLIGENCE
Office of Current Intelligence

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CENTRAL INTELLIGENCE AGENCY
Office of Current Intelligence
15 January 1965

INTELLIGENCE MEMORANDUM

Some Political and Economic Problems Arising From State Enterprise in Latin America

1. The economic and political problems arising from Latin America's experience with state enterprises bear closely on US concerns about the effectiveness of foreign assistance policies. Assistant Secretary of State Thomas C. Mann has pin-pointed the deficits of Latin American state enterprises as a major cause of "chronic, galloping inflation" and as a drain on domestic savings urgently needed for development purposes.

2. In all the larger Latin American countries, as well as some of the smaller ones, the state has assumed a major role in economic sectors that were largely operated by private enterprise 30 years ago. The state, for example, now dominates most forms of public transporation. Practically all the common carrier railroads are nationalized, with the exception of a few short lines in Central America and one segment of the rail system in Peru. The state is the principal owner-operator of commercial airlines and maritime fleets and has a substantial stake in coastal and river shipping in some countries.

3. Governments also dominate in the fields of fuels and power, operating national petroleum monopolies (or virtual monopolies) and generating most of the electricity. In addition, the state is a large investor in mining enterprises (especially coal, iron ore, tin, and copper) and has a monopoly or major position in telecommunications facilities in several countries. Other sectors in which the state plays an important role include steel production, commercial and investment banking, insurance, natural gas distribution, shipbuilding, and consumer monopolies such as salt, beer, tobacco, and alcohol.

4. Both political and economic considerations contributed to the origins and expansion of state

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enterprises. National pride has been a factor in the establishment of certain state economic agencies and has virtually made "sacred cows" of such enterprises as oil and mining complexes, rail systems, merchant marines, and steel mills. In addition, there is widespread acceptance in Latin America of the philosophy that the government should have a monopoly of certain "social" services and provide these to users without consideration of production costs. In many countries, the absence of a dynamic entrepreneurial class has left an investment void for the state. In some cases, private capital has recognized that it could not survive under government policy and regulation and has sought a negotiated sale of its assets to the state.

5. The chronic deficits accumulated over the years by most state economic agencies support the allegation that they have a built-in trend toward bankruptcy. Public subsidies provide a seemingly inexhaustible means of financing public inefficiency in spheres where private mismanagement or mistakes would have led to liquidation. In the exceptional cases where state enterprises are well managed, they have often had to incur heavy deficits because of government policy preventing them from charging prices that keep pace with rising costs.

6. Programs to improve the efficiency of state enterprises in Latin America have usually been postponed because of political risks or undermined by administrative and labor elements with vested interests in the status quo. Uninformed about the economic costs of wasteful state enterprises, the general public places considerable value on their status as symbols of sovereignty and tends to be vehement in their defense.*

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*Because of the diversity of the area and the complexities of the topic, generalizations in this paper must of course be qualified or refined to fit particular countries. It should also be noted that there are many gaps and inconsistencies in the available statistical data on the performance of state enterprises. [redacted] 25X1
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ORIGINS AND RATIONALE OF STATE ECONOMIC ACTIVITY

7. Prior to achieving independence, Spanish America was subjected to three centuries of colonial rule characterized by strict government economic control and regulation. During the first century of independence, the state continued to exercise a generally strong influence over economic affairs, despite the growing prestige of liberal economic thought stressing laissez faire, especially in connection with the import of foreign capital from Western Europe and the United States.

8. The rise of nationalism in the early decades of the twentieth century brought a renewed emphasis on state participation in economic life. State interventions since 1900 have often been designed to eliminate or reduce the predominant position of foreign capital, which in many countries pioneered the development of basic sectors of the economies. These included rail and other forms of public transportation, electric power generation and distribution, petroleum resources, mining and smelting, telecommunications, and investment and commercial banking. Many state enterprises were founded to carry on the functions of private companies which were nationalized.

9. The dissemination of Marxist theory and the establishment of Communist and socialist parties in the hemisphere after 1920 tended to popularize statist ideas. These political groups provided in most of the countries a nucleus of articulate supporters for nationalization of private investments and for increasing state involvement in economic activity. Mexico's state economic programs during the peaceful phases of the Mexican Revolution and its generally successful record in growth and diversification have probably had a measure of influence on the rest of the hemisphere as an example of economic promotion by the state.

10. Further stimulus for state enterprise sprang from the disruption of Latin America's trade during World War II, especially the interdiction of the normal flow of manufactured imports and the liquidation or seizure of European investments. As

a consequence governments were encouraged to launch industrialization programs and to promote self-sufficiency.

11. More recently, government price policies and other regulations, as well as nationalization, have led to further liquidation of private investment, particularly in public transportation and electric utilities. In still other spheres, the state as a matter of policy or in order to satisfy popular aspirations has established monopolies--for example, the oil industry in Mexico, Chile, and Brazil. The state has also stepped in to replace or substitute for private capital in sectors which cannot attract private funds. On the other hand, Latin American governments have generally had access to sizable foreign and domestic credits and other assistance to finance the programs of state enterprise, except perhaps in oil exploration.

12. In any event, a major role for the state in economic activity is widely accepted in Latin America--as in other developing areas of the world--and endorsed by influential leaders. Some of the principal reasoning is synthesized by Raul Prebisch, former executive secretary of the UN Economic Commission for Latin America, whose ideas have had a pronounced influence on government economic policies in the past decade and a half. He asserts that, even if private enterprise in Latin America could be transformed into a dynamic force,

> there would be weighty reasons for state action in our countries. Some of these reasons have to do with economic development. There are cases in which the state has had to undertake activities in these strategic areas of the economic system, or make investments which have not proved attractive to private enterprise. In other cases, state action has had the virtue of building up a technical capacity that would have been difficult to achieve otherwise.
>
> Apart from these development considerations, there are other considerations

that in Latin America's experience are generally important: the avoidance of an excessive concentration of economic power in private hands, with the consequent political danger; and the taking over by the state of enterprises that by their nature are monopolistic or activities that can operate in other ways through international arrangements that restrict competition.

POLITICAL BACKING FOR STATE ENTERPRISE

13. State enterprise draws upon a number of sources for its strong political support. Probably the majority of the influential economists in government subscribe to a large or expanding role for the state in economic activity as the best means for accelerating economic growth. The faculties of the schools of economy in Latin American universities in recent years have been almost completely dominated by professors of Communist or Marxist orientation and their students often adopt a similar philosophy.

14. Most political parties and pressure groups of the center and left-of-center subscribe to a large state-operated sector of the economy, including the Christian Democratic parties and their labor and student affiliates. For example, President Frei of Chile advocates "Chileanization" of the foreign-owned segment of the copper industry, which apparently means extensive control over prices and marketing as well as government ownership of a partial equity interest in the operating companies. Communists and pro-Communists, often joined by extreme nationalists of both the right and the left, support state enterprises and nationalization of private foreign investments.

15. Political support for state enterprise is reinforced by the inadequacies of the private sector. Business is usually oriented toward limited risk of capital, low volume production, and high profit margins. The private sector is composed in large part of family enterprises and closed corporations, which are in perennial pursuit of governmental favor and protection--usually in the form

of administrative, tariff, and tax privileges--and various administrative devices to quell or restrict more efficient competition, foreign and domestic.

SOME ECONOMIC COSTS OF STATE ENTERPRISE

16. Reliable data are often not available to measure precisely the operating costs of state enterprises. Financial statements of these enterprises often do not include adequate allowances for depreciation and depletion; interest charges on debt; a realistic allowance for a return on the public capital invested; and the ever-mounting financial burdens of pension and other employee benefits.

17. However, the financial statements do reflect the heavy expenditures for labor. To a large degree, a number of state economic enterprises serve as public works projects in an area where underemployment and unemployment rates have been high in recent years. Both management and work force are generally in surplus on a minimum average of 30% to 35%. For example, the National Motor Company of Brazil in 1962 produced 1,178 vehicles with a work force of 3,800 persons. The affiliate of the Ford Motor Company produced 14,000 vehicles of comparable make with about the same number of employees. State oil entities provide a further illustration of this pattern. From 1959 to 1964, employment in the Brazilian state oil enterprise Petrobras trebled while production rose only about 5%. Mexico's oil agency PEMEX, which employs more workers than the total of several private oil companies in Venezuela--each of which has its separate administration and operations force--has production equal to about 12% of Venezuela. Featherbedding is rampant in such agencies as the Argentine, Brazilian, and Bolivian railways and the Bolivian state mining enterprise COMIBOL. Government policy and regulations, however, largely prevent the discharge of surplus workers by management.

18. Apart from costs which appear or should appear in profit and loss statements, there are many indirect costs to the economy, such as the inflationary impact. The Brazilian Minister of Planning

reported last July that the operating losses of Brazilian state companies were equal to 80% of the central government deficit. The subsidies granted to four of these entities last year--the railroads, ports, airlines, and merchant marine--alone totaled about 57% of the deficit. Losses of state enterprises have run to about 30% of Chile's central deficits in recent years. The $300 million deficit of the Argentina state railroads for the fiscal year ending October 1964--and estimated 70% of the net of operational losses of all state enterprises--amounted to about 25% of the total government deficit. The US Embassy in La Paz stated in 1962 that the deficits of the state mining entity alone averaged between one-half and two-thirds of the value of the US aid program. An important cause of Mexican budget deficits in recent years has been subsidization of state enterprises which price their goods and services below cost. Operational deficits of state enterprises are also a major factor in central deficits in Uruguay, where subsidies to the state railroads and airlines alone will amount to more than one-third of the total in 1964. In all these countries but Mexico, large government deficits have contributed to steep inflationary spirals.

19. Another indirect cost of state enterprise in Latin America has been the adverse impact on private investment, domestic and foreign. Policy statements of leaders as well as national development plans formulated under the Alliance for Progress have recognized the need for a high level of private investment to complement the resources of the public sector. Nevertheless, governments have inhibited or reduced private investment in a number of countries through restrictive regulations, administrative practice, legislation, and price controls. These policies and measures have the effect of placing an increasing strain on limited public development funds. In some cases nationalization or the threat of its has aggravated balance-of-payments problems by frightening away potential foreign investment and by driving private domestic capital into safer havens abroad. Vagueness of official policy toward the private oil industry in Argentina, Venezuela, and Peru, the foreign-owned copper industry in Chile, the private mining sector in

Mexico, and the electric power industry in Mexico and Brazil in recent years are cases in point of serious deterrents to new investment in Latin America.

20. Another closely related indirect cost of state enterprise has been the loss of substantial revenues in the form of corporate income taxes, fees, import duties and royalties from private investments which might have entered or expanded in various spheres of activity. As one US businessman with extensive experience in Latin America testified in 1964:

> Inevitably /state economic interventions/ retard or prevent the formulation of new job-creating facilities in the private sector, due to the threat or the reality of competition from government enterprises not playing the same game of profits and taxpaying and to the fear of outright confiscation.

21. One of the heaviest drains of state enterprises has been the extensive use of public investment funds to expand or sustain operations which are essentially uneconomic. For example, in recent years, large sums of money have been invested in the maintenance of state rail lines in several countries which can no longer compete with parallel road transportation. [redacted] 25X1
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A comprehensive transportation study conducted in Argentina under the direction of the IBRD in 1961 recommended that over half of the state rail system be eliminated and that additional substantial trackage be studied for possible abandonment.

22. To the extent that losses of state entities have contributed to the need for Latin American stabilization loans, balance-of-payments assistance, and budget support, they have directly diverted such funds from more productive expenditures. The present depressed condition of agriculture in a region which continues to be heavily dependent on this sector for exchange earnings and employment can be traced in part to government emphasis on national prestige

projects, such as steel mills, coal mines, smelters, merchant marines, hotel chains, auto factories and the maintenance of other operations which are not economically viable by ordinary business standards.

PRINCIPAL SECTORS OF EXPERIENCE WITH STATE ENTERPRISE

23. Most of the larger countries in the area, including Brazil, Argentina, Mexico, Chile, and Venezuela, have had extensive experience with state enterprises, and two of the smaller ones--Bolivia and Uruguay--are virtually socialist in orientation. The governments of Colombia, Peru, and Paraguay are less deeply involved, but have also suffered financial drains from subsidizing state entities. In all of these areas the state is a major investor in, or director of, "mixed" corporations and has generally made available large credits for their operations. State and mixed agencies in each of these nations are among the largest business enterprises, from the standpoint of capitalization and total production.

24. In contrast, the governments of Central America and Panama have participated to a much lesser extent in their economies. Nationalization of private companies and state enterprise programs have not been important political issues. Costa Rica has been the most inclined among the six toward promotion of state enterprise, but its program too has been on a modest scale.

25. Although the Mexican government has long been involved in economic activity through a variety of state enterprises, an aggressive private business sector is becoming increasingly a brake on further governmental inroads into its sphere. The government itself is showing an awareness of the need for greater efficiency from state enterprise and is tending to select managers on the basis of technical and professional competence, rather than to meet the demands for political patronage. Some Mexican state agencies are well managed, such as the national steel mill, and others, like the oil agency PEMEX, have demonstrated improving performance in recent years. Moreover, the state's investment banking activities have often assisted and stimulated the private

sector. The comparative vigor of the Mexican economy attests to the dangers of generalization on Latin America about the economic impact of state enterprises.

26. Where private foreign-owned companies still operate in Latin American utility, oil, communications, transportation and mining fields, the threat of nationalization is ever present in some degree. This is the case of the copper mining industry in Chile and the oil industry in Peru. Some government regulatory policies suggest that private capital is to be frozen in the status quo or eliminated by a gradual process leading ultimately to a negotiated sellout. The latter has occurred in Mexico in recent years in such diverse fields as electric power and motion picture exhibition, and the private mining industry there has long faced adverse regulation which points in the direction of greater government control. During the past two decades, Latin American government regulatory policies have been least restrictive toward private foreign investment in the manufacturing sector.

27. The principal contributors to state enterprise operating deficits have long been the national rail systems. This is true of Argentina, Mexico, Brazil, Chile, and Uruguay. State rail losses are also relatively heavy in Bolivia, Paraguay, Ecuador, Peru, and Colombia. During 1964, the combined operating losses of the Argentine and Brazilian state railways were estimated to be about $500 million, or 25% of the projected annual new investment from external sources under the Alliance for Progress. The financial records of other state transport entities have also been adverse, with few exceptions, but the size of the loss has generally been smaller.

28. State oil agencies, with the exception of the one in Chile, have been another drain on government funds. The history of PEMEX is highly controversial; its record is probably permanently buried under biased accounts both for and against this complex. PEMEX, which took charge of a modern and prosperous oil industry in 1938 with a capacity considerably above domestic requirements, had by

1958 incurred a substantial cumulative deficit. According to a study [redacted] PEMEX was heavily in arrears on tax payments to the Mexican government and outstanding debt was seven times its net worth. Moreover, Mexico may be approaching a deficit in its trade balance in petroleum products, in contrast to sizable exports in 1938. 25X1

29. Enterprises supplying electric power to the public in Latin America, both government and private, have been severely handicapped by government rate policies and depreciation allowances which impede their ability to accumulate internal funds for maintenance and expansion. Low returns have also prevented them from competing in the open market to raise capital. Low rates combined with inflationary conditions have in effect forced the liquidation of private companies. For example, American and Foreign Power (AMFORP) has negotiated the sale of its subsidiaries in recent years to government electric enterprises in Argentina, Colombia, Mexico, and Brazil. [redacted] The future of the remaining private sector in the electric power industry in many of the major countries appears precarious. 25X1 25X1 25X1

30. Private enterprise in domestic telecommunications (excepting commercial radio and television broadcasting) has met a similar fate. The enclaves holding out in various countries may be facing ultimate absorption by the state. For example, in Mexico, the government has purchased a major interest in the largest telephone company and may be considering eventual nationalization.

31. In mining and smelting, Bolivia's state mining enterprise COMIBOL is the prime example of deficit performance by state entities. State coal mines in Argentina, Venezuela, and Brazil have also placed heavy demands on public funds to cover operating deficits and capital requirements.

32. To carry out industrialization policies, governments have entered diverse manufacturing fields in recent years--iron and steel, chemicals and petrochemicals, fertilizer, rail car manufacture,

automobile production and assembly, aircraft, cement, and others. Steel industries, which have become prominent prestige symbols, have probably required the greatest amount of investment in this sector. Government experience is difficult to evaluate, in part because many manufacturing operations are conducted by so-called mixed corporations. However, few of these entities appear to be managed competently and to have become self-supporting.

GOVERNMENT CAPABILITIES FOR CARRYING OUT REFORMS

33. Many Latin American leaders acknowledge the need for reforms in the operation of state enterprises. However, governments have been largely preoccupied with other economic issues, such as adverse terms of trade throughout much of the period since the mid-1950's, trade barriers imposed by some of Latin America's principal customers, and the inability to attract larger amounts of foreign public and private investment funds--the so-called external bottlenecks to development. They usually consider these difficulties to be the fundamental causes of their economic ills.

34. State enterprise is an extremely sensitive political issue throughout Latin America, largely because it is inseparably tied to national sovereignty and pride. Unstable governments in Latin America, concerned primarily with political survival, usually prefer to avoid the hazards of decision in this field. This hesitancy about taking action is reinforced by the fact that government economic enterprises in many cases have attained autonomous power which presents a latent challenge to the authority of the central government. Some have become empires within an empire successfully defying efforts to reform them. The state railroads of Argentina and the state mining corporation of Bolivia fall into this category. In Uruguay, the President of the National Council of Government recently advised the US Ambassador that state agencies were "little republics with independent disregard of the general welfare and governmental policy." No Mexican politician would question PEMEX's monopoly position or criticize publicly its administrative or financial record. Petrobras in Brazil is similarly sacrosanct, particularly since its management by tradition belongs to the military. The autonomous Brazilian transportation agencies--rails, merchant marine, and others--are almost outside of the control of their nominal coordinating body, the Ministry of Transport and Public Works.

35. There thus seems little likelihood of any extensive liquidation of state entities, although prospects are better in some countries for an elimination of certain uneconomic operations of these corporations. The chances also seem somewhat more favorable for a modicum of restraint in the further expansion of state economic activity, provided governments face up to a

sober appraisal of their past experience. Some governments, such as those in Peru, Ecuador, and Costa Rica, have in recent years considered divesting themselves of a few deficit state monopolies. Under present conditions, however, there is little reason to believe that private capital can again be attracted to share the burden of development in certain sectors--particularly in electric power, telecommunications, transportation, oil, and in some cases, mining and smelting.

36. The political chances are fair for a measure of progress in the election of management on the basis of professional and technical qualification rather than political affiliation, as is usually the case. Under these circumstances, management tenure would become tied to performance and less subject to frequent political shifts with the concomitant disruption of sound planning and investment programs. Recognizing this need, both Venezuela and Bolivia have contracted with skilled management to assist in obtaining better results in the operations of certain state agencies. However, the most skilled management is effective only to the extent that it has power to carry out wise operating and investment decisions. State enterprise directors and planners require the support of the government, political and labor groups, and public information media to implement politically difficult measures.

37. Central governments also appear to have within their power the enforcement of stricter controls over investments, budgeting, and accounting of state enterprises--a prerequisite for more economic operations.

38. The continuing adjustment of prices charged for goods and services of state enterprises to meet costs of production under inflationary conditions and to generate internally at least a portion of the funds for maintenance and modernization is still another essential to reducing deficits. This action along with a substantial reduction in employment are probably the <u>sine qua non</u> if state entities are to approach a break-even point in their operations. Such reforms are known to be politically dangerous, but often not to the degree asserted by incumbent governments in the area.

39. Any successful program to improve the efficiency of state enterprise over current levels would be more effective if accompanied by a more favorable government policy toward private capital. Such a policy would recognize the need to attract investment funds from a wide range of sources in an effort to obtain the maximum cooperation with the public sector in accelerated economic development. A changed attitude toward private investment by implication requires some abandonment of a doctrinaire approach to state enterprise and a clear definition by the state of those spheres in which investment can operate with a reasonable degree of security over the long run.

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State and Mixed Enterprise in Selected Countries and Sectors*

Country	Public Transportation			Telecommunications	Electric Power	Oil	Mining	Invest Banking	Steel	Other Industry
	Rail	Scheduled Airline	Merchant Marine							
Argentina	M	VM	D	M	VM	VM	D	D	D	H
Brazil	M	H	D	H	D	VM	D	D	D	H
Chile	M	VM	D	D	D	VM	H	D	H	H
Mexico	M	D	D	H	M	M	H	D	H	H
Colombia	M	S	D	M	D	H	H	D	D	H
Venezuela	M	D	D	M	D	S	S	D	D	H
Peru	H	S	D	H	H	H	S	H	D	H
Bolivia	VM	M	-	D	H	H	D	D	-	S
Uruguay	M	M	H	M	M	VM	-	D	-	H
Paraguay	M	M	D	M	M	-	-	D	-	H

*Symbols reflect a general relationship to the private sector in each country. They do not reflect monetary values of investments.

Key:
- M = Monopoly
- VM = Virtual Monopoly -- i.e., some private enterprise continues on a small scale
- D = Dominant position -- the state has the largest single investment and accounts for a minimum 35% of the production of goods or services for direct investment
- H = Heavy investment
- S = Small investment

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