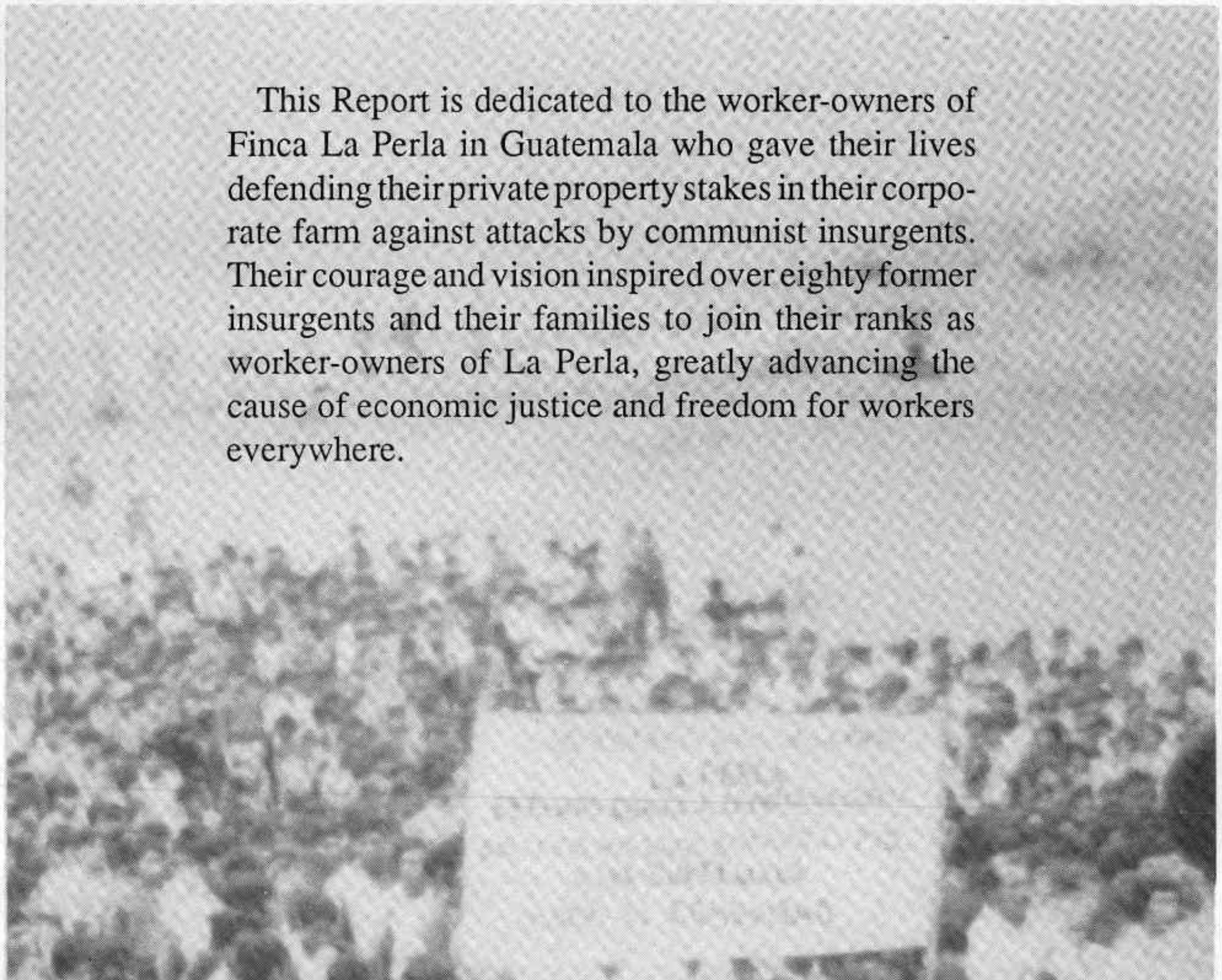
HIGH ROAD TO ECONOMIC JUSTICE

U.S. Encouragement of Employee Stock Ownership Plans in Central America and the Caribbean

Report to the President and the Congress
by the
Presidential Task Force on
Project Economic Justice

October 1986

This Report is dedicated to the worker-owners of Finca La Perla in Guatemala who gave their lives defending their private property stakes in their corporate farm against attacks by communist insurgents. Their courage and vision inspired over eighty former insurgents and their families to join their ranks as worker-owners of La Perla, greatly advancing the cause of economic justice and freedom for workers everywhere.



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EXECUTIVE SUMMARY

The nations of Central America and the Caribbean are in the grip of a recession longer than the Great Depression of the 1930s and with no relief in sight. Widespread poverty, a plummeting standard of living and despair offer a fertile breeding ground for Soviet adventurism.

Inefficiency, economic mismanagement, an overly large public sector, and a staggering debt burden create conditions that make recovery, at best, uncertain in a number of these countries.

So rich in resources yet so poor in its standard of living, this region is desperate for a solution. The danger is that in their desperation nations in the region will succumb to the false promises of Marxism.

The President's National Bipartisan Commission on Central America (the "Kissinger Commission") identified the problem of poverty; we focus on the source of the problem with recommended solutions based on free market, private property principles. Whereas others have focused on the security threat we turn our attention to the economic threat, and to the economic reforms that must be implemented to counter the security threat.

Economic freedom is the region's greatest untapped source for abundance and social gain, and our recommendations embrace the President's stance on this overdue regional reform. Yet we go beyond that. Without economic justice, economic reforms cannot long endure, flight capital will not return, and fledgling democracies will remain ripe for revolution.

Economic justice requires widespread access to private property ownership of the means of production. Thus, the central theme of our Report concerns the widespread use of financing techniques designed to expand capital ownership -- particularly through the privatization of state-owned enterprises and through a new, more workable model of land reform.

This Nation's strength is our values and our traditions. Our close proximity insures that our actions will have a major influence over the trend of events in this nearby volatile region. We propose a new direction for U.S. foreign policy, a direction that provides a specific way in which to apply those values and traditions we know are sound. By so doing, we can offer our beleaguered neighbors a new hope and a new beginning.

RECOMMENDATIONS -- AN OVERVIEW

The purpose of the Presidential Task Force on Project Economic Justice is to develop a plan for the expanded use of employee stock ownership plans (ESOPs) in development efforts of the United States in Latin America and the Caribbean.

PARASTATAL PRIVATIZATION THROUGH DEBT FOR ESOP EQUITY SWAP. The privatization of parastatals (state-owned enterprises) is an essential first step in restoring economic efficiency and growth. Parastatals should be sold to their employees through swapping U.S. bank debt for equity in the parastatals and then selling that equity to the employees through an ESOP.

CAPITAL MARKETS. To lay the groundwork for the private sector development of capital markets, ESOP financing should be widely used in development efforts in the region. ESOPs can serve as many mini stock exchanges, their in-house swapping of blocks of stock with each other (to diversify employees' holdings) laying the foundation for creating a real national stock exchange -- from the ground up.

CONDITIONALITY OF FOREIGN ASSISTANCE. U.S. foreign assistance should be conditioned on reforms consistent with private sector development and, to the maximum extent possible, development financing should be provided through ownership-expanding techniques of finance.

LAND REFORM. Whenever possible, U.S.-supported land reform efforts should be organized along the lines of Guatemala's La Perla, enabling farmers in the region to gain a joint ownership stake in estate-sized agricultural operations, retaining the benefits of economies of scale, and private sector technical, marketing and other services.

TRADE REFORM. Products of ESOP companies in the region should be exempt from U.S. quotas. Tariffs collected on products imported from such companies should be rebated to the host country in return for providing infrastructural reforms which encourage market-oriented solutions linked to expanded capital ownership. A multilateral certification board should be established to set standards for certifying regional firms as ESOP companies.

INVESTMENT INCENTIVES. PL-480 local currency funds should be utilized to underwrite the private sector establishment of an Employee Ownership Investment Insurance Corporation in the region to encourage the flow of investment to and among private sector, employee-owned companies in the region by issuing guarantees against political risk, carrying out promotional activities, and encouraging sound investment policies.

EDUCATION AND ADVOCACY. Personal ownership is the strongest motivator for economic education. We recommend A.I.D.-sponsored education initiatives for workers, educators, development personnel and political leaders -- with an emphasis on the benefits of ownership-broadening techniques of finance.

TABLE OF CONTENTS

FOREWORD

> "Could there be a better answer to Karl Marx than millions of workers individually sharing in the ownership of the means of production?"
>
> \- Ronald Reagan (1975)

Task Force Mandate: The purpose of the Presidential Task Force on Project Economic Justice is to develop a plan for the expanded use of employee stock ownership plans in development efforts of the United States in Central America and the Caribbean.

The United States now faces one of the most severe threats of its existence. Because of its location and its economically deprived condition, the Caribbean Basin is a magnet for adventurism from the Soviets and their proxies. Yet that external threat would not take hold were it not for the economic malaise of mismanaged economies in which parastatals now own more than 50 percent of productive capacity.

Our neighbors to the south -- Mexico, Central America and the Caribbean -- are ripe for Communist expansionism. If Mexico is a political bomb on our border, then Nicaragua is the fuse. Although others (e.g., the President's Commission on Central America) have identified the problem, we identify the economic source of the problem. And whereas others have focused on the security threat, we turn our attention to the economic reforms that must be implemented to counter the security threat.

Nations of the region must assume responsibility for their own economic problems. Military assistance, though necessary, is not the answer. No amount of military assistance can secure peace and stability in the region; that requires a restructuring of the economic institutions that are largely to blame for bringing to the region such economic malaise.

In a landmark speech delivered on Washington's Birthday 1983, President Reagan repeated his call for "a fundamentally new direction in American foreign policy." This new policy initiative would help create a "peaceful, prosperous and humane international order" by focusing on "the minds, hearts, sympathies, fears, hopes and aspirations, not of governments, but of people."

The President acknowledged that "to be an effective force for peace," America has a "responsibility to work for constructive change, not simply to try to preserve the status quo." To achieve that goal, he suggested that future economic assistance "must be carefully targeted, and must make maximum use of the energy and efforts of the private sector."

Noting that "economic freedom is the world's mightiest engine for abundance and social justice," the President concluded:

> "Developing countries need to be encouraged to experiment with the growing variety of arrangements for profit-sharing and expanded capital ownership that can bring economic betterment to their people."

In the words of Daniel Webster, "Power naturally and inevitably follows property." The banning of private capital ownership inevitably leads to totalitarianism. Under collectivism, the State is the only owner and the only employer. Thus, all the power associated with the ownership of wealth-producing enterprises and other modern means of production flow into the hands of a tiny non-accountable bureaucratic elite. Consequently, everyone's income and each person's dignity of work depends on the will of those who run the State.

The American experiment in individual liberty, free enterprise and republican self-government can only succeed where power is widely distributed. And since in any nation, social and political power flow from economic power, wealth and property should be widely diffused among those who comprise a nation.

In our view, the best route to economic justice lies through the widespread ownership of property, including productive capital. These ideas form the basis of the Congressional commission to our Task Force.

Ambassador J. William Middendorf, II, Chairman

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* * *

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I. INTRODUCTION

Our Congressional commission directs the Task Force "... to develop a plan for the expanded use of employee stock ownership plans in development efforts of the United States in Central America and the Caribbean...."

Employee stock ownership plans (ESOPs) are an important method for addressing economic, social and political problems in Central America and the Caribbean. (ESOPs are described in Chapter VI.) We see these as a useful tool, however, not a panacea. Moreover, we recognize that any approach of this sort must be adapted to the special circumstances and conditions of each country in the region.

ESOPs are a technique of finance designed to ensure that the employees of a company become company owners as that company meets its financing needs. Whether that financial need is for expansion or for the transfer of existing assets, ESOP financing is a method for such financing to create an ownership stake for the company's employees.

Although that ownership stake (i.e., stock) suggests that the company must be organized as a corporation, that is not the case. It is the concept of encouraging a company to borrow funds on behalf of its employees that is at the heart of the ESOP as a financing technique. That simple concept can be adapted to a broad range of organizational forms.

The problems in this region have been analyzed at length in the Report of the President's Commission on Central America (January 1984) and need not be repeated here except to note that the Commission's call for equality of opportunity and better income distribution acknowledges the need for "... expanded access to ownership of productive land and capital." Our recommendations complement, and should be used in conjunction with, the recommendations of that Commission.

The crisis of these neighboring nations has a major strategic dimension; yet beyond this, we also share a concern for urgent human needs. The people of Central America and the Caribbean are our neighbors and they need our help. We are inescapably interdependent. The question is not whether or not we will be involved, the only question is how. Their crisis is ours.

Their vitality is matched by their vulnerability. Thus, the future of this region is a responsibility we share, a responsibility based on common needs and common principles. We share the responsibility of encouraging economic and social development that fairly benefits all. We share the principle of democratic self-determination. And we share the need to cooperate in meeting threats to the security of the region.

Freedom and democracy in this region will always be fragile unless economic development is accompanied by economic justice. It is justice we must pursue if it is peace we mean to ensure.

Economic justice includes those principles that guide us in the design of our social institutions. Those institutions determine how each individual economically maintains himself and his family.

Although the principles of economic justice are described elsewhere (Chapter VI), the lack of economic justice is recognizable in the economic conditions that all too often prevail in the region. Those conditions include governmental interference in the affairs of individuals, corruption, and economic intrusions that cause capital flight, capital that is desperately needed in those economies to create the jobs on which a foundation for economic justice can be built.

A Great Opportunity

Now is a moment of great opportunity. Thanks to a rising tide of political democracy, Central America and the Caribbean are today regions ripe with fresh hope. People sense a tomorrow that can be better than today, and a future in which their children can have a better life. It is that hope that must be turned into a reality if economic and social development are to endure.

We are convinced that such development will only endure if it is equitable and just. Economic justice is the best foundation on which stable, prosperous democracies can be built.

Congressman Michael Barnes, chairman of the House Foreign Affairs Subcommittee on Western Hemisphere Affairs, reacted to a proposal for expanded capital ownership in El Salvador by recalling the words of Salvadoran President Duarte:

> "If my people believed that tomorrow would be better than today, that their children would have a better life than they have had, then the communists could ship in all the guns they want. There won't be anyone to pick them up and use them."

Congressman Barnes added his own footnote:

> "There's more wisdom in that single statement than in everything our government has had to say on the issue in the past two years." (February 3, 1983)

The Foreign Assistance Act of 1961 states that the overall objective of U.S. foreign aid is: "(T)o create conditions in the world under which free societies can survive and prosper."

Economic justice is one of those essential conditions. Without it, nations cannot sustain the dynamism and vitality of development.

The widespead use of ownership-expanding techniques of finance (such as employee stock ownership plans) can make a major contribution toward creating those conditions.

Senator Richard G. Lugar, Chairman of the Senate Foreign Relations Committee, summarized that point:

> "A new constituency must be created who are for free enterprise and against collective and state ownership of industry and agriculture. To create that new constituency, the fight for freedom and democracy must be reinforced with economic justice, and economic justice must be built on four pillars: free labor, free markets, private property in the means of production, and expanded access to corporate equity ownership and profits." (November 7, 1985)

Indigenous reform is not for us a security threat. What threatens us is the intrusion of aggressive outside powers exploiting local grievances to expand their own political influence and military control. Yet even a fought-for peace will be elusive and fragile unless the resulting political, economic and social conditions are widely perceived as equitable and just.

Congressman Phillip M. Crane, ranking minority member of the International Trade Subcommittee of the House Committee on Ways and Means, summarizes the issue as follows:

> "If we are to prevent the Soviets and their proxies from achieving success in Central and South America, as well as in other parts of the world, it is imperative that we seize the high ground in the ideological battle being waged. Expanded capital

ownership provides us with a weapon that will put us on that high ground." (June 4, 1985)

A Positive Alternative

We must set our sights on a positive goal, a positive good that can be realized and preserved. Our goal must be the attainment of a just result, a result that will endure.

It is not enough to promise a better future. Other outside powers do that and do it well. It is time to deliver.

What is needed is a concerted effort to harness and accelerate the effects of the financial and organizational forces of the modern private sector. And to harness those forces in such a fashion that they promote both progress and equity.

As our chairman pointed out in a February 1985 address in Costa Rica:

> "Without a dynamic free enterprise system, governments can neither stimulate nor sustain economic growth nor diversify their economies to foster economic development."

At the same time, as chairman of the U.S. delegation to the 14th annual General Assembly of the Organization of American States (OAS), he introduced a resolution echoing the President by calling for a study of "... the growing variety of arrangements for profit-sharing and expanded capital ownership now available for the promotion of economic justice with a view to identifying operational mechanisms and sources of funding for cooperative efforts with (multilateral and international) agencies that may be implemented in the framework of the OAS." This Report is such a study.

What is needed is applied justice. That means an opportunity for employees in industrial and agricultural enterprises to gain a stake in the success of their economic system.

Through the application of expanded ownership financing techniques (such as ESOPs), democratic leaders in the region can break through those rigid patterns that have for too long restricted ownership to a small class of people, and can do that in a way that both respects and strengthens private property and individual responsibility.

What we offer in this Report is a bold and innovative strategy for action, a strategy that incorporates the ESOP concept into a long-term strategy for promoting economic justice in this unnecessarily impoverished region.

American Traditions and Wealth Creation

To think about the powerful ideas of the American tradition requires finding ever new practical equivalents for what, in different circumstances, worked so well in the past.

In a sense, part of the effort of our Task Force is to recover potent traditional ideas. But another part is to discover contemporary, future-oriented social devices to do today in other countries what, by other methods, our Founding Fathers achieved in a different context in the past.

Our most fundamental conviction is that the soundest possible base for democracy and for economic dynamism is the widespread ownership of capital -- in homes, possessions, land, small businesses, and shares of the enterprises in which citizens work.

This is the best way to enliven the inborn practical intelligence of all people to sustained economic activism and, thus, to empower them to better their condition and that of their children in tangible, measurable progress from year to year.

When the wealth of individuals increases, the wealth of the entire nation increases. The root cause of the wealth of nations is the awakened practical intelligence of its own citizens. Our inquiry has consisted in seeking out practical and systemic ways to do that.

Our hope is that our efforts bear fruit among the poor among our neighbors to the south, whose fates are so inextricably intertwined with ours.

We hope that we bring to this issue a new way of thinking -- a new way of analyzing seemingly intractable problems, and a new way to seek a solution to ills that have gone unattended for far too long.

As Secretary of State George Shultz acknowledged in describing the future of American foreign policy:

> "... our ways of thinking must adapt to new realities; we must grasp the new trends and understand their implications.
>
> But we are not just observers; we are participants, and we are engaged. America is again in a position to have a major influence over the trend of events -- and America's traditional goals and values have not changed.

> Our duty must be to help shape the evolving trends in accordance with our ideals and interests; to help build a new structure of international stability that will ensure peace, prosperity, and freedom for coming generations. This is the real challenge of our foreign policy over the coming years." (January 31, 1985)

A Model for Economic Justice

Although this Report has as its focus Central America and the Caribbean, we believe that the principles and the concepts of expanded capital ownership are also applicable elsewhere because they show how democracy can build a firm social foundation for economic cooperation and growth.

Because the Task Force has 16 members, there obviously are issues in this Report to which individual members would have assigned different weight, or which they would have interpreted or phrased somewhat differently. Such is the nature of a Task Force. But these differences were personal, not partisan. This report represents what each of us found to be a remarkable consensus on a novel way to build a sound foundation for a peaceful future in the region.

II. THE CASE FOR EXPANDED OWNERSHIP

Marxist collectivism is at odds with the central idea that gave birth to this nation: that under the ultimate sovereignty of God, government sovereignty begins with the sovereignty of the individual, in community and in cooperation with others.

Governments are necessary, good and yet potentially dangerous instruments granted limited powers in order to promote and protect certain rights, including the right to life.

Collectivism opposes that view. These opposing views have been on a collision course for over a century, the inevitable confrontation manifesting on two fronts: the military and the ideological. In recent years, this Nation's response has been too often defensive -- engaging their military offenses with our reactive defense. We have yet to put our best foot -- our ideological foot -- ahead of our military foot.

More than two decades and billons of dollars after passage of the Foreign Assistance Act of 1961, we have yet to meet its mandate "to create conditions in the world under which free societies can survive and prosper". Often, we have relieved conditions of impoverishment, but far too seldom have we created conditions designed to economically empower those we aim to assist.

By not providing people with the means to become true partners in their nation's economic progress, we have failed to get the best use of our always-limited foreign assistance budget. And we have failed to create the conditions in which economically free democracies can survive and prosper.

A development strategy focused on widespread property ownership has great promise for enabling the U.S. to take the ideological high ground. This fundamental idea is natural to humans, and a crucial link in the "system of natural liberty".

Basic Values and Private Property

We believe that the opportunity to acquire ownership of productive property is a vital component of --

* Social Cooperation -- Respect for property follows from respect for personal dignity and its free expression.

Coercion is ruled out. Only cooperative action based on free consent is legitimate.

* <u>Individual Liberty</u> -- Personally-owned property affords day-to-day protection in the ordinary affairs of life. Political rights presuppose that individuals and private groups have the will and the means to act independently. Alexander Hamilton warned that "the control over a man's subsistence amounts to a control over his will" -- an intolerable condition for those who believe in the principle of self determination.

* <u>Human Dignity and Self Respect</u> -- techniques of finance designed to expand participation in ownership of the means of production bring with them a new approach to fostering economic autonomy. As an individual's personal success expands, his personal growth expands also -- his self-respect, his personal dignity and his independence.

* <u>Wealth Production</u> -- The opportunity to acquire the ownership of property motivates an individual to apply his best efforts to increase his productive skills and those of his coworkers. Ownership is a proven stimulus to industry, honesty, thrift and foresight. Expanding the ownership of property means that the benefits of property ownership, such as property income, increased value and collateral value become available to more people, including especially those of present low incomes who often contribute to the production of wealth without an opportunity to accumulate wealth.

* <u>Natural Instincts</u> -- Human beings have a natural instinct to improve their condition, and that of their family and their community. Policies not in alignment with that instinct restrain improvement in the general welfare by suppressing the drive to succeed. This trait was well summarized by Soviet Premier Nikita Kruschchev: "No one is born a Communist.... In the Soviet Union, farmers keep on looking in the barn for their horses even after they have given them to the collective."

* <u>Responsible Democracy</u> -- Those who own property, and thus are subject to a broader range of government taxation, are more likely to be active, involved and responsible citizens than those who own nothing. Similarly, they are more likely to insist on prudence and good management in public affairs. In addition, the widespread ownership of property ensures a perpetual

diffusion of political power, an essential element in the preservation of liberty.

* Respect for Law -- In acquiring property ownership, an individual comes to understand the workings of the law -- across generations and on an equal basis for all. Property ownership breeds respect for law, since property cannot exist without it. Rights to property secure rights to personal freedom and freedom of expression.

* Patriotism -- Property is a social reality, instructing each that their personal well-being is linked to the common good. In the first century B.C., the Greek historian Diodorus Siculus pointed out the obvious, "It is absurd to entrust the defense of a country to people who own nothing in it."

Law, Property, and Economic Dynamism

Economic justice is the principal theme of this Report. We believe that in Central America and the Caribbean it is by taking the "high road" -- the road that leads to the pursuit of economic justice -- that we will best serve the long-term interests of both the United States and the peoples of the region.

James Madison, in *The Federalist Papers*, put it thus: "Justice is the end of government, it is the end of civil society, it will be pursued either until it be obtained or until liberty be lost in the pursuit."

In politics, in other words, justice is the primary motivating factor. It is in the pursuit of justice that new nations emerge, and existing nations evolve into something new.

The existence of property implies the existence of law and a just social order. In fashioning the U.S. Constitution two centuries ago, the founders of the United States placed upon the Seal of the United States the words: *Novus Ordo Seclorum* -- the New Order for the Ages.

The fundamental idea was novel for that time. It was to be a new conception of community and political economy alongside a new conception of the role of the individual. It was to be the world's first system designed to maximize cooperation among free persons by allowing maximum autonomy to each.

The challenge was to do two things at once: to form a Union, and also to liberate every single citizen within that Union. Individuals had never been so free, and so protected from encroachments by the state. And never before did human beings respond with a greater sense of public cohesion and love for the commonwealth that trusted them in liberty.

From the beginning, the United States was conceived as an experiment in justice. In promising "liberty and justice for all", it embodied a powerful social ideal. It hoped to become, par excellence, "a land of opportunity."

This experiment worked. The United States was to become the first of the world's developing nations. Two hundred years later, it is the oldest of the world's constitutional democracies. Hundreds of millions have sought here, and found, not only opportunity but an abundance beyond their individual deserts.

This abundance -- like the nation's founding idea -- has two sources. One is social. Without the laws, habits, and institutions of the Republic, individual citizens could not today enjoy the blessings of a system of natural liberty. The other is the use individual citizens, in cooperation with multitudes of others, have made of their liberty.

Today, the world has need of fundamental concepts of order. Many developing nations (a majority of the world's nations) speak of "a New International Order." "Order" is the key word, the talisman. But justice determines whether that order is humane and liberating or inhumane and oppressive.

Yet most of the world neglects the secrets of successful economic orders -- today shared not only by the United States but also by some two score of other free and dynamic social systems.

In particular, the leadership of most of the world's nations have forgotten fundamental concepts of the fruitful relation between capital and labor -- between property and people.

Law and Property -- The American Tradition

The link between justice, liberty and property is a link acknowledged by those most responsible for founding this Nation.

John Locke's formula of fundamental rights -- life, liberty and property -- was well known to Thomas Jefferson and his revolutionary contemporaries. Jefferson confidant and fellow Virginian, George Mason, crafted a rephrasing of Locke as his conceptual cornerstone in authoring the Virginia Declaration of Rights, enacted less than two months prior to July 4, 1776:

> "That all men are by nature equally free and independent and have certain inherent rights, of which, when they enter into a state of society, they cannot, by any compact, deprive or divest their posterity; namely, the enjoyment of life and liberty, with the means of acquiring and possessing property, and pursuing and obtaining happiness and safety." (May 15, 1776)

The Massachusetts Declaration of Rights, penned by John Adams four years later, was practically identical in form and content. At a time when land was the most prevalent form of productive capital, Adams saw widespread ownership as a necessity for the proper and lasting diffusion of power:

> "... we may ... affirm that the balance of power in a society accompanies the balance of property in land. The only possible way, then of preserving the balance of power on the side of equal liberty and public virtue, is to make the acquisition of land easy to every member of society.... If the multitude is possessed of the balance of real estate, the multitude will have the balance of power, and in that case the multitude will take care of the liberty, virtue, and interest of the multitude, in all acts of government." (1780)

To Jefferson, "legislators cannot invent too many devices for subdividing property." Indeed, although Jefferson did not advocate the abandonment of property qualifications for voting, he did favor extending the vote to freeholders possessing a quarter of an acre in town or 25 acres in the country, and coupled with this the proposal that government grant fifty acres of land to every person of full age who did not already own that much land.

Philosopher Mortimer J. Adler suggests that the famous rephrasing of Locke in the United States Declaration of Independence (i.e., "life, liberty and the pursuit of happiness") reflects Jefferson's attempt to give the Declaration of Independence a universality and scope that could not otherwise have been achieved.

Jefferson did this by insuring that the Declaration was open to whatever new insights about enabling means for the pursuit of happiness that governments might subsequently discover in their effort to provide the conditions needed for their citizens' welfare. Jefferson later advised Lafayette not to include the right to property in the French Bill of Rights.

With the abolition of slavery and feudalism, the United States has insured that no person will ever again become the property of another. At the time, however, according to George Mason's account, Jefferson (despite being a slaveholder) believed that slavery was an abomination, and that property rights in people should not be condoned -- either in the newly formed United States or in post-feudal France. For Jefferson, while access to property was sacred, rights of property were not unlimited and are subject to higher laws.

In 1803, President Jefferson's approval of the Louisiana Purchase set the stage for the first widespread governmental involvement in promoting expanded capital ownership: Abraham Lincoln's Homestead Act of 1862, providing settlers an opportunity to become property owners in return for "homesteading" a parcel of land for 5 years.

The Homestead Act did much to open the prime farmland in America's Middle West to independent farmers in the years after the Civil War, an area that became one of the great cradles of American inventiveness and wealth in subsequent generations. The success, and the resulting productive abundance stemming from this government initiative, helped to fuel the Industrial Revolution of the next three generations.

As Lincoln pointed out during a campaign speech in 1860: "I don't believe in a law to prevent a man from getting rich. It would do more harm than good. So while we do not propose any war upon capital, we do wish to allow the humblest man an equal chance to get rich with everybody else."

Between the American Revolution and the Civil War, the case for expanded capital ownership was perhaps argued most elegantly by Daniel Webster in an 1820 address to the Massachusetts Convention:

> "The freest government, if it could exist, would not be long acceptable, if the tendency of the laws were to create a rapid accumulation of property in a few hands, and to render the great mass of the population dependent and pennyless.... In the nature of things, those who have not property, and

> seeing their neighbours possess much more than they think them to need, cannot be favorable to laws made for the protection of property. When this class becomes numerous, it grows clamorous. It looks on property as its prey and plunder, and is naturally ready, at all times, for violence and revolution."

Similarly, Alexis De Tocqueville, that astute observer of Democracy in America, observed in his famous 1840 text:

> "Nations are less disposed to make revolutions in proportion as personal property is augmented and distributed among them, and as the number of those possessing it is increased."

Free Enterprise and Private Property

Our Founding Fathers saw widespread individual ownership as an indispensable element of a dynamic democracy. Subsequent legislators have agreed.

Consequently, this Nation has a long history of legislative enactments encouraging the independent ownership of homes, farms, and various forms of business enterprises. These include abolishing the feudal remnants of primogeniture and entail, thus assuring a wider distribution of ownership in the inheritance of landed estates -- a fight led by Jefferson while a Virginia legislator.

Other enactments include the Preemption and Homestead Acts of the 19th Century, the Federal Farm Loan Act of 1916, the Home Owners Loan Corporation, the National Housing Act and the Bankhead Jones Farm Tenant Act of the 1930s, the Small Business Act of 1953, and the special impact provisions of the Economic Opportunity Act (1966).

In addition to numerous Federal agencies designed to promote individual ownership (e.g., the Farmers' Home Administration, the Small Business Administration, the Farm Credit System, etc.), the U.S. has numerous tax measures ranging from the deductibility of home mortgage interest payments to favorable tax treatment for self-employed retirement plans, individual retirement accounts, profit-sharing and stock bonus plans and, most recently, employee stock ownership plans (ESOPs).

President Reagan has long been committed to governmental encouragement of expanded capital ownership. For example, in a July 1974 address to the Young Americans for Freedom, he explained the historical roots of his suport for expanded capital ownership and ESOPs:

> "Over one hundred years ago, Abraham Lincoln signed the Homestead Act. There was a wide distribution of land and they didn't confiscate anyone's already-owned land. They did not take from those who owned and give to others who did not own. It set the pattern for the American capitalist system. We need an Industrial Homestead Act....
>
> I know that plans have been suggested in the past and they all had one flaw. They were based on making present owners give up some of their ownership to the non-owners. Now this isn't true of the ideas that are being talked about today.
>
> Very simply, these business leaders have come to the realization that it is time to formulate a plan to accelerate economic growth and production and at the same time broaden the ownership of productive capital. The American dream has always been to have a piece of the action."

In a February 1983 speech to the American Legion, President Reagan explained his vision of how expanded capital ownership can help create a world that lives in peace and freedom:

> "For too long, our foreign policy had been a pattern of reaction to the offensive actions of those hostile to freedom and democracy. We were forever competing on territory picked by our adversaries, with the issues and timing all chosen by them....
>
> Too many of our policy makers had lost touch with changing world realities. They failed to realize that to be an effective force for peace today, America must successfully appeal to the sympathies of the world's people -- the global electorate. We cannot simply be anti-this, and anti-that. We cannot simply react defensively to the

political proposals of others, sometimes criticizing them, sometimes accomodating them, without positive alternative solutions to basic human problems.

At bottom, they ignored our responsibility to work for constructive change, not simply to try to preserve the status quo.

Fortunately, the American people sensed this dangerous drift and, by 1980, a national reawakening was under way -- a reawakening that resulted in a new sense of responsibility, a new sense of confidence in America and the universal principles and ideals on which our free system is based....

Our (foreign) economic assistance must be carefully targeted, and must make maximum use of the energy and efforts of the private sector....

Economic freedom is the world's mightiest engine for abundance and social justice.... Developing countries need to be encouraged to experiment with the growing variety of arrangements for profit sharing and expanded capital ownership that can bring economic betterment to their people."

Bipartisan Support of Expanded Ownership

Both political parties have been blessed with outspoken champions of expanded capital ownership. Senator Russell Long (Dem., Louisiana), the principal Congressional sponsor of ESOP legislation since 1973, explains the foreign policy implications of his proposals as follows:

"If we continue to rely solely on traditional techniques of finance, those techniques will continue to allocate productive credit primarily to the already rich. With that approach, the concentrated ownership of newly-created capital is virtually assured; and the rich-get-richer legacy of capitalism will continue unabated.

That would show a great failure of foresight on our part, because ... we (would) continue to have a form of capitalism unsuitable for imitation abroad.

We need a working model of what we would advocate for other nations. We need to be able to show people all over the world how our increasing prosperity spreads out and reaches Americans in all walks of life."

In a similar vein, Senator Hubert Humphrey, a Democratic Presidential candidate, explained his support of expanded ownership:

"Throughout my career as a public servant, I have viewed full employment as a top priority goal for this country. And I continue to do so. But I recognize that capital, and the question of who owns it and therefore reaps the benefit of its productiveness, is an extremely important issue that is complementary to the issue of full employment.

I see these as twin pillars of our economy: full employment of our labor resources and widespread ownership of our capital resources. Such twin pillars would go a long way in providing a firm underlying support for future economic growth that would be equitably shared."

Similarly, Walter Reuther, former President of the United Auto Workers and one of this Nation's foremost labor leaders, expressed his support:

"Profit sharing in the form of stock distributions to workers would help to democratize the ownership of America's vast corporate wealth. If workers had a definite assurance of equitable shares in the profits..., they would see less need to seek...increases in basic wages."

Private Property and Privatization

On the domestic front, the Reagan Administration continues its search for methods to promote private property and free enterprise in ways that broaden the base of capital ownership. For example, privatization -- the transfer of public assets, infrastructure and service functions to the private sector -- has been adopted by the President as a means to reduce the size of government while stimulating private ownership.

Framing the issue clearly, the President notes:

> "Traditionally, governments supply the type of needed services that would not be provided by the marketplace. Over the years, however, the Federal Government has acquired many commercial-type operations. In most cases, it would be better for the Government to get out of the business and stop competing with the private sector."

Thus, on February 25, 1982, President Reagan signed Executive Order 12348 establishing a Federal Property Review Board as part of the Executive Office of the President. The purpose of this board is to identify surplus real assets and assist in their privatization. In addition, the President's Private Sector Survey on Cost Control (the Grace Commission) produced a privatization report that included recommendations projected to save the Federal government $28.4 billion over 3 years.

Also, on August 4, 1986, Constance Horner, Director of the Office of Personnel Management, proposed the Federal Employee Direct Corporate Ownership Opportunity Plan (FED CO-OP), an alternative contracting out approach designed to enable employees to become shareholders in existing contractors under a new privatization plan.

On the foreign front, the Administration's privatization policy is being advanced abroad through the Agency for International Development's Center for Privatization, with a goal of involving the Agency in privatization activities in 40 countries during fiscal year 1987.

We believe that privatization offers a fruitful area in which economic justice can be pursued in Central American and the Caribbean. Each of the nations in the region has an economy with government-owned companies which could be candidates for privatization. Many of the economies are dominated by parastatels (state-owned enterprises).

Privatization accomplished through the application of ownership-expanding financing techniques (such as employee stock ownership plans) would provide a dynamic new element to this long-needed reform. Thus structured, this reform could promote economic justice while providing a needed stimulus to the private sector.

Techniques for expanding capital ownership hold great promise for merging U.S. interests -- and American traditions -- with the interests of the people of the region.

As Secretary of State George Shultz acknowledged in describing the future of American foreign policy:

> "... our ways of thinking must adapt to new realities; we must grasp the new trends and understand their implications.
>
> But we are not just observers; we are participants, and we are engaged. America is again in a position to have a major influence over the trend of events -- and America's traditional goals and values have not changed. Our duty must be to help shape the evolving trends in accordance with our ideals and interests; to help build a new structure of international stability that will ensure peace, prosperity, and freedom for coming generations. This is the real challenge of our foreign policy over the coming years." (January 31, 1985)

III. CENTRAL AMERICA: CULTURE AND ECONOMY

Barriers to Prosperity

Despite an abundance of natural resources, substantial portions of Central America and the Caribbean are mired in poverty. Although there are signs of hope for renewed economic growth and, indeed, prosperity, there are also numerous inhibiting factors, many of which will be difficult to overcome if a policy of widespread property ownership is to become a reality.

Any effort to develop ESOPs in the region must take these factors into account. It should be noted, however, that while the following observations are offered generally, it is essential to distinguish between countries where these characteristics apply to a greater or lesser extent, and among the former British, the former French, the former Dutch, and the former Spanish-speaking countries in the region, whose histories and traditions have often been quite different.

The following political, social, and economic characteristics of the region would seem to be especially important to the prospects for success of ESOPs in the region:

* Economic Underdevelopment and Poverty. -- Protracted underdevelopment and widespread poverty make the success of any new program difficult at best.

* Entrepreneurial Skills -- The perennially short supply of entrepreneurial and risk-taking skills make any private sector program difficult to implement. The economic environment is often hostile to these skills, training is often non-existent, and many times this scarce talent (like the capital that fuels it) has fled the country.

* Workforce Skills -- Low levels of skills (and literacy), limited employee training, and the limited managerial background of mid-level personnel serve to retard economic growth. These limitations may also result in behavior that would be different were participatory ownership implemented among a more literate workforce.

* Resistance to Change -- There may be little interest in new, experimental programs requiring change and, thus, risk -- particularly in the present uncertain

economic circumstances. With no history of experience with ESOP-type programs, there may be reluctance to chance a new idea.

* Regulation -- Many of the economies suffer a variety of economic restrictions, including over regulation, centralization, protectionism, exchange controls, investment limitations, excessive government intervention in the production and pricing of industrial and agricultural goods, high taxes, hostility to foreign investment, labor regulations (particularly covering separation practices), import and export restrictions, privilege, and other barriers to successful business operation.

* Capital Shortage -- With many U.S. companies leaving the region, there may be a shortgage of available capital with which to fund ESOPs. With fiscal austerity in the U.S., foreign assistance funding could be scarce. If the capital is provided from the outside, that is also problematic. Also, with the region in such disarray and with attractive, safe investment opportunites available elsewhere, many economies in the region have experienced extreme capital outflows.

* Business Perception -- Business incentives may be characterized as "crony capitalism" or "Yankee imperialism" and viewed as exploitative and oppressive, a perception with some merit in the historical experience of some in the region. Free enterprise institutions and incentives may be recharacterized as a means for an elite to further enrich themselves through special privilege. A negative attitude toward profits may also be an inhibiting factor.

* Companies for Sale. Established owners may be unwilling to sell their firms to their employees. The privatization of parastatals may be viewed as a way for corrupt political leaders to sell nationalized properties to their friends. Such "crony capitalism" is a not uncommon experience. In addition, the likely parastatal candidates for ESOP conversion may be losing money, thereby all but guaranteeing that ESOP companies thus created will face great difficulties.

* Statism -- Many economies have a heavily statist capital base, with the state-dominated sector accounting for as much as 70% of GNP. This may make it difficult for ESOP companies to compete. Or the company's success may depend not on its own efficient production but on concessions and the "good will" of the State. Patronage employment in parastatals is widespread, saddling such firms with excessive and politically-appointed workers, a practice difficult to change and expensive to end (due to widespread generous severance pay requirements). Such "losers" may be the only available candidates for privatization.

* Ownership Security -- Several of these nations have histories of extreme political volatility, rendering security of ownership often tenuous. Even the more stable economies may have insufficient legal systems.

* Money and Banking -- Unsound money is a constant peril in some areas. Banking restrictions are common. Interest rates may be controlled. The inflation rate is often high. Regulations may limit funds available for certain types of investments. Government-imposed collateral requirements may limit those eligible for lending.

* Tax Systems -- High marginal rates are commonplace; tax administration is often inadequate and evasion widespread. Taxes on property income often have high exemption floors. The combination of exemption floors and widespread evasion results in a common pattern of inequitable tax burdens and politicized tax administration. User charges, particularly for water, sewers, power and transportation, rarely cover costs and the supply of these services must be financed in part from tax revenues. The most direct limitation to the implementation of employee stock ownership plans (following the U.S. model of income tax incentives) is widespread dependence on indirect taxes (e.g., taxes on imports and exports) rather than on direct taxes which are more difficult to administer (e.g., income or consumption taxes). (See discussion in Chapter VI.)

* Capital Markets -- The lack of sufficient capital markets, including secondary equity markets for stock distributed to ESOP participants, creates

potential -- though not insurmountable -- problems for the liquidity of employee shares.

These factors provide barriers that must be addressed realistically if ESOPs are to be successful.

Policy Implications of Cultural Barriers

Thus, policy implementation should focus on identifying truly viable companies and concentrating on those best able to survive changes in government control. Employee stock ownership works best in those companies not dependent on governmental favoritism and in those that can weather changes in government.

Policy dialogue to assist in removing the impediments to privatization should be a focus of policy implementation. When possible, existing structures should be used (e.g., church groups, labor organizations, etc.) for policy implementation rather than creating new ones.

SIGNS OF CHANGE

Although ESOP-type organizational structures remain a rarity in the region, signs of change are emerging that hold great promise for the future of economic justice in Central America and the Caribbean. We summarize three such signs.

Solidarity Associations

The first sign of change is the steady growth of Solidarity Associations and their support of employee ownership in the region. U.S. labor representatives challenge whether Solidarity Associations adequately and independently represent the views of workers. They also charge that such Associations are being used by management to inhibit free and democratic trade union movements.

However, Task Force Member William Doherty, executive director of the American Institute for Free Labor Development, AFL/CIO, indicates that "... the AFL/CIO is generally favorable to the concept of employee ownership." Thus, although the free labor movement in the region often stands in opposition to

Solidarista Associations, they agree on this core issue. That is a change for the better.

Today, Solidarista Associations are active in Costa Rica, Guatemala, and to a lesser extent, in Salvador and Honduras. With over 1,000 associations, a total membership of more than 140,000 and a combined capitalization in excess of $25,000,000, the Solidarista movement is expanding in many areas, including banana plantations, manufacturing facilities, multinational corporations, and government bureaucracies.

Begun in 1947 at the inspiration of Alberto Marten Chavarria of Costa Rica, the objectives include widespread individual access to private property and the means of production, free markets and limited government. Marten believed these were the necessary preconditions to elevating the dignity of the individual.

At the operational level, the movement has as its principal goals better employee-company relations, the promotion of social and economic justice for the working class, educating workers on how a market economy works, increasing savings and investment, and promoting capital formation. The founders, including Marten, have recently criticized the Solidarista movement for not moving more aggressively in promoting expanded capital ownership for workers.

In the typical Solidarista Association, the employee contributes 3 to 5 percent of pay and the company matches that. The funds are typically invested in real estate, bonds, loans and housing programs.

In the past 5 years, more companies with employee associations are beginning to sell their own stock to the associations. For example, approximately 20% of LACSA, the national airline of Costa Rica, is now owned by its employees. Similarly, one of the largest chains of department stores in Central America, La Gloria, is 30% owned by employees.

The same concept is becoming more widespread in Guatemala, where approximately 50 companies have employee associations, including some large U.S. multinationals.

In both Guatemala and Costa Rica, non-political Solidarity federations now represent both Solidarity Associations and owners. In October 1984, the Solidarity federation of Costa Rica established a merchant bank, with an expressed goal of utilizing ESOP-type financing to promote the purchase of stock by workers in those companies that have employee associations.

Testimony received by the Task Force on behalf of the Solidarista movement of Costa Rica expressed strong support for employee stock ownership plans as a technique for privatizing State-owned businesses. The testimony also indicated that the "Debt for Equity ESOP Swap" (described in Chapter VII) has great potential for rescuing for employees viable companies that will otherwise eventually disappear.

In an address before the Third National Solidarity Congress in Costa Rica, Costa Rican President Louis Alberto Monge expressed his evaluation of the Solidarista movement:

> "I am deeply moved by the continued growth of the Solidarity movement and its efforts to promote and consolidate employer-worker harmony. It is an effort which has my total support. The Solidarity movement has already demonstrated with concrete action and progress its efficiency in promoting the general welfare of the working class. The Solidariy movement has taught us all that the revolutionary goals of protecting individual liberty, while striving for the common good, need not exclude one at the expense of the other. Solidarity offers a way to obtain both through peaceful means rather than through armed insurrection."

La Perla Project

The second sign of change we report is the emergence in the region of working models of economic development utilizing the concept of employee stock ownership plans.

The first such organizational model is La Perla Project. La Perla is a 9,000-acre coffee and spice plantation in northern Guatemala with 500 full-time employees and 1,500 family members. In September 1984, the owners transferred to an employee association 40% of the plantation's stock -- to be paid for out of the future earnings of the plantation plus employee and employer contributions averaging 3% of pay.

Located in the volatile Ixil region of Quiche Province, one of the primary areas of insurgent activity, La Perla is the area's only major farm still in production. All of the other large estates have for the most part been abandoned due to the danger. La Perla's owners reasoned that if they are to protect the estate, they must build loyalty into the estate's employees.

They were also aware that land tenure in Guatemala, at present, is inherently provisional, and that at some point they could be subject to government-enforced land reform. They knew what had happened nearby in El Salvador and Nicaragua.

On March 1, 1985, 120 armed insurgents attacked La Perla and for several hours took control of the estate. Then 200 of the new employee-owners banned together to drive the insurgents off the estate. People were killed on both sides.

This ownership-sharing initiative on the part of the original owners worked to their advantage -- and to the advantage of the workers. La Perla's employee association version of an ESOP grants employees access to the ownership of land without dismantling the estate into small, uneconomic parcels -- the end result of most land reform efforts.

This gradual transfer of ownership -- while retaining the economies of scale realized by an estate-sized operation -- enabled La Perla employees to gain an ownership stake (the object of land reform), along with the technical, organizational, financial, and marketing skills essential to successful modern agriculture. Under the more typical land reform, those services are provided by the government in a more costly and generally less effective way.

The owners are committed to selling a majority of the operation to the employees. With partial employee ownership, supplemented by regular profit-sharing, the owners anticipate higher productivity. Thus, they hope the value of their remaining stock will increase prior to that sale. Employees are allowed to vote their shares on a one-man-one-vote basis.

The aftermath of this ownership initiative is instructive. The week following the attack on La Perla, the estate's new worker-owners petitioned La Perla's original owners for additional weapons to defend against future insurgent attack, volunteering to pay for them.

Also, among the estate's residents, there are now many former insurgents and their families. They have seen where the promises of the insurgents have led -- to hunger, death, and separation from their families -- compared to the real promises made and delivered by this new model of economic justice at La Perla, where today the workers are in fact co-owners of the estate.

Catholic Social Thought

"If you want peace, work for justice."

- Pope Paul VI

The third sign of change we wish to report comes from the pen of modern Catholic clergy. Because Catholicism is the dominant religion in Central America and the Caribbean, Church pronouncements on the issue of economic justice carry great weight in the region. Both historically, and now ever more frequently, the employee ownership issue is working its way into Catholic theology.

Catholic theologians have for many years supported the concept of expanded capital ownership. Recent church documents continue a tradition of papal writing on the subject that has evolved over the last century, as the world passed through three distinct periods of crisis in the sphere of work.

Pope Leo XIII's 1891 encyclical, "The Condition of Labor" -- "Rerum Novarum" -- was published during the first crisis of work, the Industrial Revolution, and raised for the first time the social question of the just relation between industrial employer and employee. In addition to affirming the dignity of the individual worker and supporting humanitarian improvements in the scandalous working conditions of that period, the Pope explained:

> "(It must be) assumed and established as a principle, that the right of private property must be regarded as sacred.... The law ought to favor this right and, so far as it can, see that the largest possible number among the masses of the population prefer to own property."

Commemorating the 40th anniversary of "Rerum Novarum", Pope Pius XI, in 1931, issued an encyclical, "On Reconstructing the Social Order" -- "Quadragesimo Anno" -- which adapted Leo's doctrines to the second crisis of work, the Great Depression. He recognized that the right to private property is limited by the requirement of the common good, and stated that "the right ordering of economic life cannot be left to a free competition of forces."

Despite his reservations about totally laissez-faire capitalism, Pius was as vehemently opposed to collectivism as his predecessor Leo, proclaiming: "no one can be at the same time a good Catholic and a true socialist." While rejecting class struggle and communal property, Pius reiterated the Church's teaching on the rights of workers, and called for a more equitable distribution of property in society.

In 1961, in "Mater et Magistra" -- "On Christianity and Social Progress" -- Pope John XXIII advocated the balancing of economic development and social progress. In order to achieve that goal, he called attention to "one very important social principle":

> "Economic progress must be accompanied by a corresponding social progress, so that all classes of citizens can participate in the increased productivity.
>
> ...
>
> From this it follows that the economic prosperity of a nation is not so much its total assets in terms of wealth and property, as the equitable division and distribution of this wealth.
>
> ...
>
> Experience suggests many ways in which the demands of justice can be satisfied. Not to mention other ways, it is especially desirable today that workers gradually come to share in the ownership of their company, by ways and in the manner that seem most suitable."

The most recent Church statement on this social question is Pope John Paul II's "On Human Work" -- "Laborem Exercens". Written 50 years after "Quadragesimo Anno" and in commemoration of the 90th anniversary of "Rerum Novarum", it addressed today's conditions of work, a period in which:

> "We are on the eve of new developments in technological, economic and political conditions which, according to many experts, will influence the world of work and production no less than the industrial revolution of the last century."

Focusing on the dignity of man and its relationship to work, this encyclical emphatically makes the point: "The Church's teaching on ownership diverges radically from collectivism as proclaimed by Marxism and "rigid" capitalism. The primacy of the person over things (can be restored) through joint ownership of the means of work."

In this most recent Church endorsement of expanded capital ownership in general, and employee ownership in particular, this outspoken Pope indicates that Catholic social teaching supports "proposals for joint ownership of the means of work, sharing by the workers in the management and/or profits of businesses, so-called shareholding by labor, etc."

Confirming the right of workers to form labor unions as an "indispensable element" of modern society and as a vehicle "for the struggle for social justice," the encyclical goes on to cite the "need for ever new movements of solidarity" and suggests that union demands "can and should also aim at correcting -- with a view to the common good of the whole of society -- everything defective in the system of ownership of the means of production or in the way these are managed."

Proclaiming that this approach "diverges radically from the programme of collectivism as proclaimed by Marxism," the encyclical recommends "associating labour with the ownership of capital, as far as possible" and concludes on a revealing note of advocacy:

> "Every effort must be made to ensure that in this kind of system also the human person can preserve his awareness of working 'for himself'. If this is not done, incalculable damage is inevitably done throughout the economic process, not only economic damage but first and foremost damage to man."

In the context of this latest pronouncement by the Catholic Church, the moral aspect of President Reagan's call for "expanded capital ownership" in the region takes on a new dimension -- and a new urgency -- for those concerned with economic and social justice.

IV. U.S. POLICIES TOWARD CENTRAL AMERICA

As with the President's National Bipartisan Commission on Central America (the Kissinger Commission), the members of our Task Force found that the more we learned, the more convinced we became that the crisis in this region is real and acute, and that the U.S. must act boldly to meet it. The stakes are enormous, not just for the U.S. and for our neighbors in this hemisphere but also, and most importantly, for the people of Central America and the Caribbean.

Although the U.S. has made mistakes in the past, we see reason for hope in the foreign policy now being implemented in the region. We are convinced that our recommendations can prove to be a valuable supplement to the President's policies.

Historical Perspective

The United States has been involved in the affairs of Central America and the Caribbean for more than a century. Our record is a mixed one.

It is difficult to fairly characterize 200 years of political relations in a summary fashion. However, the chief focus of U.S. policy in the early 1900s was the promotion of stability and solvency of local governments so as to keep at bay the intervention of extra-hemisphere powers, in keeping with the Monroe Doctrine.

Franklin Roosevelt's Good Neighbor policy, though designed to signal the end of U.S. intervention, resulted (during the Second World War) in identifying the U.S. with established dictatorships, a trend that continued until the mid-1970s.

Similarly, the importance of U.S. involvment in local economies (e.g., in Costa Rica's banana industry) left a memory of "Yankee imperialism" that still persists among some in the region.

In the past, the U.S. has too often supported economic policies more supportive of our needs than those of our neighbors. Similarly, we have too often remained complacent when confronted with injust and even cruel political leadership. We are likewise guilty of providing parastatal aid in return for political support, often with short-term advantage but to the long-term peril of both our interests and the interests of those we intend to assist.

In addition, land reform efforts supported by the U.S. have not always worked out as well as hoped. In El Salvador, for example, years after the U.S. support of government expropriation of large estates, the new owners have had difficulty securing valid title, previous owners have experienced delays in being effectively compensated (due primarily to lack of government funds or secured credit). Also, government's phase out of control over management and technical services (due to continued civil conflict) has resulted in inefficiencies and a misallocation of resources in the agricultural sector.

The U.S. has often done a less than credible job in helping our neighbors in a proper manner. Ignoring what has made our economy a beacon of hope for those wanting to raise their standard of living, we have failed to argue strongly enough against their centralization of economic decisions, their diversion of inordinate private resources to government infrastructure, and the adoption of political (rather than market) models of resource allocation.

Rather than counselling them on how to liberate the private sector's engine of economic growth, we have all too often supported government-controlled redistribution of existing resources. And foreign assistance has too seldom been conditioned on private sector development. In addition, U.S.-supported development bank policies frequently reflect a commitment to centralized development planning, overshadowing the few successful attempts to make loans conditional upon adoption of nonstatist policies.

Likewise, we have been active partners in the region's steady overindulgence in foreign debt and now find both their and our interests imperiled by the insistence on growth-sapping austerity programs. With the beginning of the international debt crisis, many of these nations lost their already-limited access to the international commercial banking market. Trade finance lines were often cut, and public and private sector borrowers were unable to raise new funds, further compounding debt-service problems.

We have been particularly remiss in failing to provide guidance in how to unleash the creative talents of their people -- their greatest productive asset. And all too often, restrictive U.S. quotas and tariff barriers affect their ability to find markets for what they are able to produce.

Their best hope lies in a reinvigorated and vastly expanded private sector. It is clear that those economies which have over-extended the role of the public sector and restricted the operation of the private sector have experienced sluggish growth, burdensome budget deficits and stifling debt burdens. The growing political awareness of that fact is a major reason U.S policy in the region now shows signs of a new beginning.

The Ingredients of a New Beginning

Despite our failures in the past, we also achieved some measure of success, and the likelihood of future success appears bright.

The Kennedy-inspired Alliance for Progress, for example, was a force for modernization and development (though it is criticized for conditioning financial and technical assistance on national planning schemes).

U.S. assistance programs have made and continue to make an important contribution. And whatever the mistakes of the past, private U.S. investment in the region now plays a vital and constructive role. Similarly, the U.S. has embraced a wide array of reforms financially supported by resources from the United States, the newly created Inter-American Development Bank, the World Bank and other aid donors.

The U.S. is also attempting to do its part through stronger growth, more open markets, sounder fiscal policies, and lower interest rates. In addition, the Caribbean Basin Initiative provides improved access to U.S. markets and enhanced investment incentives for U.S. investors.

Throughout this development process, justice plays a crucial role, as acknowledged by the Commission on Security and Economic Assistance:

> "Human well-being must also include individual freedom, equality of opportunity and justice, without which lasting political, economic and social stability are difficult to maintain." (1983)

Recent developments building on these themes include an Agency for International Development (A.I.D.) policy initiative, "Private Enterprise Development," in which Administrator M. Peter McPherson builds upon research conducted by the President's Task Force on International Private Enterprise (1984):

> "A society in which individuals have freedom of economic choice, freedom to own the means of production, freedom to compete in the

> market place, freedom to take economic risk for profit and freedom to receive and retain the rewards of economic decisions is a fundamental objective of the A.I.D. program in less developed countries." (March 1985)

Another positive development is McPherson's recent establishment of an A.I.D. Center for Privatization (September 1985):

> "...to provide technical assistance to A.I.D. missions, host governments and the private sector to promote the concepts of divestiture and privatization."

Particularly welcome is the recent A.I.D. privatization policy statement indicating:

> "A.I.D. encourages the introduction of employee stock ownership plans (ESOPs) as a method of transferring a parastatal to private ownership." (June 1986)

An A.I.D. mission directive indicates the Administrator's goal to be involved in an average of at least two privatization activities in each of 40 countries by the end of fiscal year 1987. Government divestiture to employees is emphasized as one way to maximize private sector participation in privatization.

The recommendations of the President's Commission on Central America are another bright spot in U.S. foreign policy concerning our southern neighbors. The primary economic principle adopted by the Commission espouses the "encouragement of economic and social development that fairly benefits all" and calls for "... an end to the callous proposition that some groups will be 'have nots' forever. Any set of policies for the hemisphere must address the need to expand the economies of its nations and revive the hopes of its people."

Similarly, the Commission acknowledges a pressing need to seek not just economic progress but also equity:

> "We recognize that it is unlikely that the social inequities and distortions that have accumulated over the last five centuries will be corrected during the next five years. But the groundwork for recovery should be laid as soon as possible. The costs of not meeting the challenge in Central America would be too

great, today and for generations to come."
(January 1984)

In addition, while the Commission's primary short-term economic recommendation encourages "the greatest possible involvement of the private sector in the stabilization effort," its long-term recommendation acknowledges the attendant need to "substantially improve the distribution of income and wealth."

It is particularly heartening to the members of this Task Force that the Commission suggests:

> "The goals of equality of opportunity and better income distribution require expanded access to ownership of productive land and capital. This is also crucial for social and political progress."

The "Program for Sustained Economic Growth" put forward by Treasury Secretary Baker in October 1985 is also a hopeful sign in offering a framework for cooperative action to encourage and support debtors' efforts to improve their prospects for economic growth while continuing orderly servicing of their debts.

The Program has three components: (1) the World Bank and the other international development banks would provided an additional $9 billion to participating debtors over the next three years, raising their lending $27 billion; (2) over the same period, commercial banks would provide $20 billion in new money, a yearly increase of approximately 2.5 percent over current exposure, and (3) the debtors themselves would be required to undertake fundamental structural adjustments.

These measures are seen as laying the groundwork for sustained economic expansion that will allow the developing world to "grow" out of its debts. The U.S. Treasury compiled a list of 15 potential participants, including nations in the region.

Of key importance to this Program will be the success of policies designed to enhance domestic savings, encourage increased private investment, stimulate the return of growth capital, and privatize state-owned enterprises. Each of these aims would be advanced by economic development policies designed to promote expanded capital ownership.

Add to these recent initiatives President Reagan's February 1983 statement urging developing countries to "experiment with the growing variety of arrangements for profit sharing and expanded capital ownership" and you have the ingredients for a hopeful new tomorrow in Central America and the Caribbean.

V. PRIVATIZATION AND PARASTATALS

The Task Force believes that the privatization of parastatals (state-owned enterprises) should be a central thrust in any strategy designed to promote economic justice in Central America and the Caribbean. Privatization is an essential part of an agenda for genuine liberalization, decentralization, and separation of economic affairs from government.

Employee stock ownership plans (ESOPs, described in Chapter VI) are a viable and promising vehicle for accomplishing that objective. If, on the other hand, privatization in the region means private ownership within a statist system where a handful of owners receive special protection and privileges from the government, little is gained. The goal should be privatization linked to expanded capital ownership in a competitive market economy.

Overview

State ownership has grown steadily since World War II. Latin American countries are suffering from ever more stifling bureaucratization of their economies. Government intervention -- often buttressed by nationalist and/or socialist ideologies -- has resulted in substanial increases in:

- state ownership of economic activities in, for example, extractive industries, manufacturing, financing, and international trade and commerce;

- regulation of private economic activity via money, credit and exchange controls, licensing systems, and price and wage controls;

- the state's consumption of gross national product; and

- government investment expenditures -- often now more than half of national capital formation.

In addition, state-owned enterprises often are competing unfairly with U.S. industries -- their operations posing a well-documented threat both to free trade and free enterprise.

Parastatals are now a world-wide problem. In Western Europe, for example, state-owned enterprises now represent almost half of the industrial sector; the steel industry is predominantly goverment owned. This politically perilous and economically debilitating pattern is now widespread in the Third World, not only in avowedly Marxist countries but also in those that reject Marxism. In South Africa, for example, there are now more than 300 parastatals.

This unhealthy trend has gained a strong foothold in Central America and the Caribbean where parastatals are becoming an increasingly dominant force. In Mexico, for example, there were only 84 government enterprises in 1972. By 1982, there were 760. During the same period, total government spending as a percentage of Mexico's gross national product increased from 23% to 46%. And, of course, the international debt crisis began in August 1982 when Mexico failed to make interest payments on its borrowed funds.

The ill effects on development efforts are widespread and growing. For example, because government deficits attributable to losses from inefficient parastatals are often financed through the country's central bank, this high-powered money is far more inflationary than the financing of private enterprises' losses through commercial banks.

In Argentina, for example, where government owns more than 50 percent of industrial production (353 firms employing 350,000 and accounting for 35 percent of government spending), the government used its printing presses to finance losses from those industries. That approach, according to a study, has an inflationary effect 10 times more powerful than the effect would be with traditional private sector financing of private sector industrial losses. Argentina's annual inflation rate reached 1200 percent before its recent monetary reforms.

Due to the accompanying over-regulation and bureaucratization in the region, the informal, "underground" economy is expanding apace. For example, in government-dominated Peru, despite the tremendous handicap of operating illegally (e.g., lacking access to the facilitative aspects of the law, and to credit and insurance), the informal economy now accounts for 60% of Lima's garment industry, 50% of housing construction, and even a good part of public transportation.

Nothing could do more for the economies and the peoples of the region than to reverse this misdirected trend.

Economic Justice and Efficiency

Fortunately, policy makers throughout the region are realizing that privatization offers an opportunity to deliver the same goods and services at lower costs, raise revenues for current operating budgets, reduce and control future budgets, put unused and underused public assets in private hands (and on the tax rolls), and loosen the grip that public sector employees often have on budgets and, ultimately, on taxpayers. Whether adopted out of a sense of opportunity or out of desperation, privatization offers a hopeful road toward private sector alternatives.

With the exception of public goods such as national defense, public safety, monetary policy and the enforcement of contracts, further government involvement in an economy follows largely from the belief either that a market cannot be established or that the result of market decisions will lead to socially unacceptable outcomes.

State-owned enterprises, of course, also serve as agencies for dispensing political patronage, particularly in the form of jobs for the politically loyal. Yet while it may seem that parastatals create jobs, in truth they are a principal cause of unemployment.

Not only does their typically inefficient use of resources act as a drag on the economy's job-creating capacity but also their prevalence is closely correlated with capital flight, and without private sector investment capital, jobs simply are not created in the private sector. Costa Rica, for example, with more than $2 billion in outstanding foreign debt, has citizens with $1.9 billion invested in the United States. Privatization would do much to entice that capital back home.

In certain cases, such as natural monopolies, goods with important externalities and merit goods (described below), a government may determine that public involvement in production or distribution is important to achieve social objectives.

But, as A.I.D. confirms in its Private Enterprise Development Policy Paper:

> "...it is clear that less developed countries which have over-extended the role of the public sector and restricted operation of the private sector have experienced slow growth, heavy budget deficits and rising debt burdens." (March 1985)

What is need is succinctly described by Secretary of State George Shultz in a speech appropriately titled, "Democracy and the Path to Economic Growth":

> "I am calling here for the reversal of state ownership and anti-import policies. These policies have placed stifling controls on private agriculture and industry. They have made them dependent on restricted markets. They have built costly protectionist barriers at national frontiers. And they have produced inefficient state enterprises that divert resources from more productive activities.
>
> I call, instead, for a development strategy that works through an open economy, one that rewards initiative, investment, and thrift." (December 6, 1984)

PRIVATIZATION THEORY: AN ISSUE OF PROPERTY RIGHTS AND INCENTIVES

Understanding the rights of private property is the key to understanding the behavior of private versus public employees, and understanding the performance differential between private versus public enterprises.

In the case of private enterprise, its assets are privately owned, and those private owners are free to use or transfer their assets as they judge wisest (within the confines of moral principles and the law). Also, in the case of private enterprise, there is a link between the use of private assets and wealth.

For example, when these owners discover how to produce goods and services that consumers desire at a cost lower than the market price, profits are generated, and their personal wealth increases. Their discoveries, in turn, benefit the whole of society -- in lower prices, in new investments elsewhere, and in increased employment.

On the other hand, while owners may reap part of the gains, they also bear a large part of the costs. Thus, if losses are realized, the value of their assets declines and their personal wealth diminishes. It is this private property linkage, and the incentive that this linkage provides, that accounts for the bulk of the difference in the behavior and the performance of private versus public enterprises. This undeniable linkage also strengthens the case for broadening ownership so as to include every worker in the firm.

Ownership and Behavior

Private owners have a strong personal incentive to monitor the behavior of private-enterprise managers and employees so that they will supply what consumers desire, and do so in a cost-effective manner. Thus, that private property linkage to the enterprise puts in place incentives that generate efficient, cost-conscious behavior.

Public enterprise lacks that linkage. The nominal owners, the "taxpayer-owners," cannot buy and sell assets of the enterprise. Nor do improvements in efficiency necessarily increase their wealth. If those improvements are, in fact, realized (e.g., through tax reductions), they are spread over many other "taxpayer-owners". Thus, they tend to be quite small.

In addition, the "cost" of obtaining these modest benefits -- acquiring information, monitoring public employees, and organizing the political force often required to improve their behavior -- is very high relative to the small, diffused benefit that can be realized.

The consequences are predictable. The "taxpayer-owners" have little incentive to monitor public employees. And because those employees can neither suffer the loss nor legally reap the gain from their decisions, they have little incentive to maximize the efficiency of the public's assets.

The costs of inefficiencies are borne by the taxpayers while any gains in efficiency accrue largely to the public employees, often in the form of more leisure time and/or higher pay.

Similarly, public managers responsible for setting wages do not have strong incentives to drive tough bargains in determining wages and benefits because they are not bargaining with their own wealth. Private owners, because they are bargaining with their own wealth, tie wage gains to productivity gains. The result is quite different behavior -- as the evidence indicates.

Similarly, whereas private enterprise makes plans based on what they expect consumers to demand and what they expect costs to be, the planning for public enterprise is done by those who neither bear the costs of their mistakes nor legally capture the benefits attributable to their foresight. Thus, private and public employees can be expected to behave in different ways and, as a result, private enterprise is typically more efficient than public enterprise.

A state-owned enterprise has little incentive to be efficient or profitable and, therefore, seldom is. It can afford to accumulate losses because it can sell its products below cost, at taxpayers' expense. Moreover, when a nationalized company plans for expansion, it is not necessarily for the purpose of meeting consumers' needs or for making a profit. Its goal may be to keep its workforce employed, or to hire more employees, or to gain influence within the government, capture strategic markets, or acquire hard currency.

Nationalized enterprises have the added advantage of direct access to the national treasury and can draw on help from other government agencies or banks. The state ownership of financial institutions, like the state ownership of industries, creates similar barriers to optimum economic performance.

The State Ownership of Financial Institutions

By blocking the use of market price signals and thwarting the profit incentive, state-dominated financial institutions: (1) fail to attract an appropriate volume of savings, and (2) fail to allocate savings to their most productive uses.

Guided by prices, the profit motive in private lending (as in private production) penalizes substandard performance in the allocation of resources -- loanable funds in the case of banks. Poor loans mean bank losses and a reduction in wealth for bank owners.

Pricing, in the case of financial institutions, allocates income between the present and the future, between consumption today versus increased consumption tomorrow -- through today's increased savings, investment and capital formation. That pricing is accomplished through the interest rate.

In the case of lenders, the interest paid to savers reflects the balance between their perceived present and future needs. Thus, interest paid is a reward for relinquishing present income in favor of future income. By holding interest rates below a level that would otherwise attract savers, state-owned banks argue that they are helping the economy (i.e., with lower than market-determined interest rates). Yet the effect is quite the contrary (e.g., loanable funds leave the country in pursuit of higher returns elsewhere).

Instead, this artificial shortage of loanable funds stifles development in two ways. First, this shortage means loanable funds available must be allocated among competing borrowers -- with state-favored, inefficient public companies generally standing first in line for allocations made by public employees.

Second, unofficial, unsanctioned lending markets generally arise in which intermediaries typically cannot offer much security to savers. Consequently, borrowers must pay higher interest to those lenders as a premium for that lack of security. As a result, the state-imposed low official interest rate -- contrary to its professed aim -- makes credit more expensive to all but a few, typically the inefficient few, with both short and long-term costs to the economy.

The flexibility of private ownership and market-pricing, on the other hand, provides a framework for the development process that allows the financial system to adapt itself to the real needs of a developing economy.

PRIVATIZATION EVIDENCE: PROPERTY RIGHTS CREATE INCENTIVES

Both economic theory and common sense suggest the linkage between personal property rights and productive performance.

For example, public enterprises in some European countries produce everything from pots and pans to cars and trucks. They even run hotel chains. As the theory suggests, these public enterprises perform quite differently than their private sector counterparts. For example, production and sales per employee are lower for public firms, as are taxes paid per employee. Sales per dollar of investment are lower and sales per employee grow at a slower rate. Per dollar of sales, both operating expenses and wages are higher.

Western Europe's experience is consistent with the theory: property-rights are not a neutral matter. It matters, and matters a great deal, who owns productive enterprises. Differences in the mode of ownership -- public versus private --

are a crucial factor in determining the efficiency of public versus private enterprises.

The evidence from U.S. experience bears this out. For example, the President's Private Sector Survey on Cost Control (the Grace Commission) discovered in their evaluation of the Federal government's custodial services that the General Services Administration employs about 17 times as many people, and spends about 14 times as much as private firms, to deliver comparable building maintenance.

Similarly, in a comparison of privately-owned firms with the U.S. government-owned railroad, Amtrak, studies disclosed that Amtrak repaired 182,955 railroad ties with an average work crew of 69, while the private firms repaired 684,338 ties with an average crew of only 26. Amtrak removed 71.8 miles of rail with an average crew of 129, while the average removed by the private firms was 344 miles with an average crew of 77.

In a similar vein, a survey of refuse collection costs in 1400 communities revealed that for cities over 50,000 population, private collectors were 30% less costly than public ones.

Public housing projects are typically run-down and epitomize urban blight in the U.S. and Europe -- a visible reminder of the effects when the incentive linkage of personal property is missing. A 1980 study found that the construction costs of such housing is 25% higher than comparable private housing.

Similar results are found in public versus private bus lines. In Australia, for example, private urban bus systems are 50% more cost effective than public ones. Even services generally viewed as natural monopolies (e.g., fire protection and wastewater treatment) are now being provided at significant cost savings.

The evidence of inefficiency is equally compelling in the case of state-run financial institutions. Tax-funded, public sector financial institutions -- as opposed to privately-funded, private sector financial institutions -- are not held rigorously accountable for the misallocation of their loanable funds. Low-quality loans -- loans which yield little or even nothing -- may have little or even no effect on the quantity of funds available for lending.

For example, in one Asian developing country, the repayment rate on the government's development bank loans is only 14 percent, with little or no penalty placed on borrowers for loan delinquency. Such "banks" are actually making grants, not loans. Not only are the nation's scarce development resources thereby squandered, but the "loan" criteria are such that opportunities abound for corruption, an opportunity similarly available in government-rationed credit markets, where state-controlled banks grant loans at below-market interest rates. Likewise, government banks generally incur high overhead costs, due to overstaffing and bureaucratization -- in addition to their high costs of absorbing bad loans.

PRIVATIZATION IMPLEMENTATION

Two approaches are available to implement privatization: the indirect approach and the direct approach. The indirect approach urges public employees to privatize those operations that would be more cost effective in the private sector, whereas the direct approach mandates privatization.

The indirect approach is flawed because the public employee has little incentive to apply private-sector efficiency techniques. The sale (privatization) of the public assets provides him no direct benefit. Indeed, not only is his personal wealth not increased by the sale, it may be reduced since his job security and personal income may be tied to retaining public assets and continuing the public production of goods and services.

The direct approach bypasses these considerations by, instead, mustering the political will to require privatization.

Of course, gaining that political reform may be a slow process. It cannot, should not, be imposed from abroad. And it must be adjusted and accomodated to the practices and institutions of countries of the region.

Privatization activities must recognize the difficulties and sensitivities involved. For example, everyone acknowledges that parastatals are bloated, often inefficient, prone to corruption and badly in need of reform. Yet such institutions also may serve significant social and political functions that cannot be ignored (e.g., using patronage jobs to create political loyalty).

The danger lies in destroying established institutions before new ones have been created, leaving an institutional void and increasing the very instability we hope to avoid. Reform, like finance, is a process accomplished over time.

As a recent A.I.D. cable to its Mission Directors advised:

> "Any strategy for privatization must take into account the groups whose interests may be harmed if divestment is successful. These may include labor groups and current managers of the firm, bureaucrats whose positions and power may be eliminated, political groups that favor public enterprises, local private enterprises that will suffer competition if the sale is to non-nationals, and enterprises which are protected from competition through their relationship with the public institution. A divestment program must include strategies to deal with these opposing groups." (June 19, 1986)

Other governments struggling with this dilemma (e.g., Japan) have deflected much of this opposition by creating advisory bodies that bypass the bureaucracy, appointing pro-privatization presidents to these companies, urging private firms to hire public enterprise employees made redundant by privatization, and appealing to the public through the mass media.

Protecting the Poor

In gaining support for privatization policies, advocates should be alert to false arguments. For example, opponents often argue that the poor cannot afford the cost of privatized goods and services. That falsely states the issue. The forces of free enterprise have created in the U.S. a broad choice of goods at prices that have brought us a high standard of living. If the poor cannot afford a good or service that government now provides, direct government finance can be provided, such as cash payments or vouchers.

Protecting the poor concerns a choice between public or private finance, and how best to mobilize the demand for consumer-needed goods and service. That issue should not be confused with the choice between public or private ownership and how best to supply those consumer-useful goods and services. If private supply is the most cost-effective, it should be utilized. And if the poor require assistance in buying those privately-produced goods and services, direct government finance (e.g., vouchers) provide a workable solution.

Politics and Pricing

A political issue related to politically-mandated privatization concerns price controls. Price controls are a primary reason why many goods and services originally supplied by private enterprise are now supplied by public enterprise.

Conversely, undue government protection of a privatized enterprise (e.g., via licenses, subsidies or import restrictions) can convert the privatized company into a ward of the government, unable to be an effective competitor. However attractive in the short-run, the long-run effect is to damage consumers, the country as a whole, and even the protected enterprise.

Similarly, imposing price controls on privatized firms lays the groundwork for eventual renationalization. This occurs because after price controls, the privatized firm often finds that it must reduce quality to maintain its profit margin (for example, if the firm is forbidden to raise nominal prices in response to mandated service improvements or inflation). Then, as service declines, the public demands that government take over the firm in order to provide more reliable service.

Price controls on private sector food production have destroyed agricultural self sufficiency in a number of countries in the region. Our PL-480 program -- the Food for Peace program (providing U.S. agricultural commodities to countries in the form of grants) -- likewise discourages domestic production.

An analogous danger threatens the successful privatization of financial institutions. Price (i.e., interest) controls would make privatization financially infeasible for truly private sector lenders. The freedom from government-mandated loan rates is crucial to the efficient rationing of scarce loanable funds.

Regulation and Banking

Similarly, the freedom of bank deposit rates is crucial for attracting into the financial system: (1) the savings of the non-wealthy (e.g., out of hoarding) and (2) the savings of the wealthy (e.g., back from other economies).

Likewise, open entry into banking is a necessary component of effective privatization. Otherwise, transferring a highly concentrated banking system from government to private ownership may simply replace a public cartel with a nominally private cartel. Similarly, open entry promotes an effective and spontaneous specialization, with moneylenders, pawnbrokers, shopkeepers, middlemen and others in the informal economy allowed the opportunity to develop and expand their practices within financing structures as formal as they find appropriate.

In addition, the non-regulation of bank portfolios is a necessary component of an efficient and thriving private banking system. Privatization is a mockery if -- whether under rigid regulations or under "official guidance" -- the institutions are required to hold stipulated quantities of government bonds, or are required to limit their lending to special classes of borrowers.

Thus, deregulation is an important element that should accompany privatization activities. Market-determined supply and demand (i.e., prices) are the most reliable, the most fair, and the most cost-effective means for ensuring the successful provision of most goods and services -- including the providing of loanable funds.

If, for political reasons, market-determined prices are deemed too high for certain groups, then public finance -- through vouchers -- should be utilized to fulfill that public purpose. Price controls should be avoided; it is the exposure to market forces that will best advance the interests of consumers, especially the poor.

Flexibility - A Foundation for Success

Gaining and retaining flexibility by the new owners of a former state entity is also crucial to the short and long-term success of privatization activities.

As pointed out in an A.I.D. cable to mission directors:

> "The new owners of a former state entity, and the managers employed by them, must have the right or freedom to undertake actions they deem important to respond to competitive conditions in a timely manner, including restructuring of the firm, altering the firm's product and its price, changing lines of activity, using subcontractors, and expanding some activities while closing down others. Other areas in which the owners should not be restrained are employment and compensation decisions, sourcing, production and engineering, cost structure, financing,

investment, and innovation. Such flexibility comes with private sector ownership and control. It is rare under public ownership." (June 19, 1986)

Qualified Buyers

A critical issue associated with the privatization of a parastatal is who is allowed to buy the enterprise. A certain suspicion about privatization is understandable among those who see it as a process for handing state-owned enterprises over to nominally "private" associates of authoritarian rulers. Recent experience provides unsettling evidence of the potential for such abuse, and clearly such practices must be protected against.

For a variety of political and social reasons, many governments exclude certain groups from purchasing government-owned enterprises. For example, foreign-owned businesses and multinational corporations are routinely excluded, often for fear of increased foreign influence in the economy.

That issue can be addressed by utilizing ESOP financing as the sale mechanism so as to build ownership into local employees. An employee ownership approach would also help in building a constituency for privatization -- often a precondition to mustering the political will essential to achieving a sale.

In addition, employee ownership would address one of the major impediments to privatization -- employee opposition (i.e., due to feared job losses in what most recognize as a swollen workforce). Governments tend to be most sensitive to the fiscal and employment aspects of privatization. ESOP financing (see description in Chapter VI) has the potential for reducing the subsidy burden (of the parastatal) without seriously undermining current levels of employment. Success of the privatized company would hinge, in large part, on the ability of employees to make the enterprise profitable.

Governments may condone minority participation in such privatizations by foreign-owned businesses or multinationals provided local employees gain a substantial ownership stake as part of the sale. Such a combination has certain advantages. For example, participation by a multinational could bring to the transaction financial strength that may otherwise be lacking.

Multinational participation may also serve as a much-needed source of technical skills (e.g., management, marketing, engineering, etc.). In addition, the government could require, as a condition of approving such participation, that ESOP financing be used to buy out the multinational's stake within a prescribed period of time.

TECHNIQUES FOR PRIVATIZATION

Privatization strategies should be creative, flexible and realistic. A variety of factors in the host country influence the country's privatization strategy as well as the privatization techniques chosen.

These factors include: (1) purpose for undertaking the privatization; (2) business climate; (3) commercial viability of public enterprises; (4) availability of capital (locally or internationally); (5) availability of local managerial and technical talent; (6) side effects (such as displaced labor); and (7) social and political environment of the country.

Privatization can take a variety of forms, some of which involve change of ownership status and transfer of decision-making authority from the public to the private sector while others entail only the transfer of decision-making authority (e.g., through the establishment of management contracts or the contracting out of service delivery).

The transfer of both ownership and control should be the goal; the transfer of decision-making authority only should only be utilized as part of a longer-term process leading to complete divestiture. A.I.D. privatization policy recognizes the problem in striving for only marginal improvements:

> "It should be recognized ... that enormous amounts of donor funds committed to help state-owned enterprises meet the goal of greater efficiency have been largely unsuccessful. There is no reason to believe that new A.I.D. resources will be better spent for that goal unless the process is linked clearly to both making the state-owned enterprise more responsive to market forces and actual divestiture." (June 16, 1986)

The growth of parastatals should be regarded by countries in the region as a priority problem, a problem intimately related to the debt crisis. Indeed, credit-starved governments often forced these state-owned enterprises to borrow foreign exchange they did not need. That relationship suggests a search for a privatization technique that acknowledges this relationship. We offer such a technique: Debt for ESOP Equity Swaps (described below).

Debt for Equity Swaps.

The region's debt crisis cries out for imaginative approaches; thus far the crisis is being managed, not solved. "There is little hope of the region emerging from recession until it can stop transferring resources abroad, as it has had to do for four consecutive years" according to the 1986 annual report on the region's economic progress prepared by economists at the Inter-American Development Bank.

Fortunately, the market's pricing mechanisms suggest an alternative to outright default. That alternative involves an acknowledgment of the obvious: much of the Latin debt is now trading at a discount (e.g., in London's secondary debt market). For example, as this Report was being written, bank loans to Brazil were trading in this market at 74 cents on the dollar, those of Mexico at 58 cents, Argentina's at 66, and Peru's at 23. These prices suggest loans in need of repair.

As a result, some creditor banks are selling their loans at a discount that is attractive to another bank or investor. Some banks -- including large U.S. banks with substantial loan exposure -- are buying those loans and seeking investors, typically multinational companies with operations in the debtor country.

The investor then arranges for the debtor government to buy back the loan in local currency (disbursed over a period of years). In return, the investor agrees to keep the money invested in the country for a period of years (converting foreign dollar debt into domestic currency debt).

Thus, the debt holder gains liquidity (albeit at a discount), the multinational increases the capital of its subsidiary at a favorable exchange rate, and the government reduces both its foreign debt and its interest payments (along with the need to send dollars out of the country) -- enabling it to use more of its export earnings for domestic investment or imports.

For many companies, such a swap is a less expensive way to make an investment it had to make anyway. For example, a company needing to install or upgrade equipment might be able to make a $10 million investment for $8 million by purchasing a discounted loan and exchanging it at the host country central bank for currency equal to the face amount.

For foreign lenders, such an approach offers a method for spreading their risk -- by converting their debt into foreign equity investments while also shifting some of their receipts from interest to dividends (although typically restrictions are placed on the repatriation of dividends in the early years of the conversion).

For debtor governments, the transactions reduce the number of banks holding debt to those wanting a long-term relationship. To prevent an undue increase in the host country's money supply, the central bank limits the magnitude of conversions.

Politically, it may be difficult for an outside investor to make the necessary changes to convert a state-owned company into a profitable entity, whereas a motivated employee-owner workforce could make the adjustments necessary to protect the value of their company. Many options are open for reducing an often bloated workforce. For example, job-sharing may be feasible. Or discrete operations could be sold off as separate employee-owned companies (e.g., a railroad's repair facility or the truck transport capacity of a mining operation).

With more than $380 billion that Latin American debtor nations owe foreign lenders, this technique is not likely to solve the debt crisis -- there are not enough investors willing or able to absorb that amount. Indeed, we do not wish to overestimate the benefits or minimize the complexities involved, yet this strategy clearly can serve as a model that can be adapted throughout the region.

Free Enterprise and Banking

If the U.S. intends to be taken seriously in its advocacy of free enterprise principles in the region, it should allow those principles to begin to work their will on the regional debt held by U.S. banks.

For example, accounting practices typically require banks to declare loans as "non-performing" if, after 90 days, interest due is not paid. Once this occurs, banks must write off these loans and incur losses. To avoid this, banks have taken to rescheduling loans (often, as a condition of rescheduling, requiring debtor countries to incur additional, new indebtedness).

When foreign countries are unable or unwilling to service their loans, the International Monetary Fund (I.M.F.) typically makes bridging loans. Thus, since the U.S. government is the largest source of I.M.F. capital, it is U.S. taxpayers (vs. bank shareholders) now underwriting these loans. Recent efforts to address the debt crisis have increased the role of such multilateral agencies.

Sound banking practices would not have extended loans of this magnitude. By the end of the 1970s, for example, the face value of Latin loans exceeded stockholders' equity. Similarly, free enterprise principles would not permit government-sponsored, taxpayer-financed bailouts of bad private sector loans.

At present, so long as the loans are "performing", banks carry those assets on their books at face value, overstating both assets and profits -- as is evident by the deep discounts on Latin debt now being traded abroad.

Since markets are a more reliable source of valuation data than accountants, a formal, secondary market could be organized, with banks required to periodically adjust their balance sheets based on that market's evaluation of their loans, thereby forcing banks to maintain more realistic capital levels.

The required write-down of banks' over-valued foreign loans may, of course, mean that banks which exercised poor banking practices would be required to reduce dividend payments and otherwise adjust until they were managed on a sound financial footing. Although the adjustment period may be difficult, the market indicates that adjustment is overdue. Yet the secondary "ripple effects" of such adjustment in the U.S. and elsewhere may be too severe to accomodate market principles.

Our neighbors to the south are being required to adjust. And U.S. taxpayers are being required to underwrite U.S. banks' reluctance to adjust. The difficult question is determining when and how U.S. banks will begin that adjustment process.

Debt for ESOP Equity Swaps

A logical extension of this concept suggests an adaptation of the debt for equity swap, an adaptation that could have profound consequences for restoring economic efficiency in the region, while laying a foundation for economic justice.

Market-based logic suggests that debtor nations should be treated like debtor companies -- particularly when the debt incurred was utilized to capitalize state-owned companies. If debtors cannot service their loans, traditional banking practices require (as part of the loan contract) that those debt claims be converted into equity.

Under the typical loan agreement, the bank would foreclose on the property pledged for the loan -- typically the company itself. Since most countries in Central America and the Caribbean hold vast portfolios of nationalized industries, such debt-for-equity swaps could be accomodated.

Some nations in the region may not welcome foreign lenders owning a substantial interest in their currently state-owned companies for any substantial period of time. Thus, our adaptation suggests a more politically palatable solution. We suggest allowing debt-burdened state-owned companies to be privatized and converted into employee-owned businesses. This would be accomplished by enabling foreign lenders to exchange non-performing government loans in state-owned companies for equity in those enterprises.

The foreign lender would then sell that equity to an ESOP established by the newly-privatized parastatal. (ESOP financing is described in Chapter VI.) The equity could be sold outright, requiring a new, renegotiated loan to the company. Or the ESOP could acquire the equity over time -- with the lender transferring its equity ownership as payments are made.

To secure the lender and, thus, induce such a transaction, A.I.D. could guarantee a portion of the debt. Foreign lenders (perhaps in conjunction with host countries) could capitalize an ESOP buyout insurance corporation. At the host country's option, the foreign lender could be allowed to retain a partial equity interest, thereby ensuring the privatized company's long-term relationship with a financially strong (and financially committed) outside investor. Similarly, foreign investors (e.g., mutlinational corporations) could buy a portion of the equity (as in the more conventional "debt for equity swap" described above).

The ESOP, utilizing earnings of the privatized company, would pay for the equity over time (on terms reflecting the value of the debt exchanged for that equity). Over time, employees of the parastatal would become equity owners of a newly privatized company, their success determined largely by their ability to make the company profitable.

Thus structured, this financing technique offers a method for vesting a share of the national patrimony in these parastatals in the workers themselves. Indeed, because the citizens of countries in the region are, in effect, the ultimate guarantors of this debilitating debt burden, it is only fair that they should benefit from the privatization. Previously, their benefit was shared collectively; ESOP-financed privatization would enable many of them to benefit individually.

The non-ESOP "debt for equity swap" approach to privatization results in foreign ownership -- not a pattern that is widely replicable. Nor is it an approach likely to endure, politically. Charges of "Yankee imperialism" are certain to be heard. Nor is it an approach well-designed to motivate the employees of those enterprises.

Likewise, the more common direct sale approach to privatization fails to expand capital ownership, because only those of already substantial means are able to participate in such transactions. Realistically, in order for the employees of a state-owned enterprise to acquire any substantial stake in that enterprise, they must be extended credit to make the acquisition. Otherwise, only foreign investors or already-wealthy local investors will be able to buy the enterprises, thereby missing an excellent opportunity to advance economic justice in the region.

In order to increase the economic viability (and, thus, the credit worthiness) of such companies, the U.S. should also consider extending import relief to products of ESOP privatized parastatals. (See recommendation 5 in Chapter VII.)

A CHALLENGE THAT MUST BE MET

The greatest challenge facing the international financial system is the design of a workable arrangement for debt service. I.M.F. austerity measures fail to get to the root of the problem, and are widely perceived as a way to squeeze interest payments out of poor countries for the benefit of large U.S. banks -- banks which behaved irresponsibly in the 1970s (albeit at the I.M.F.'s urging) by making vast sums of credit available to countries which were becoming ever less credit worthy.

Real wages have fallen drastically in some countries, and per capita consumption has dropped below already meager levels. The cutback in social services due to debt service is highly regressive, hitting hardest those already struggling economically.

This belt-tightening has fallen on investment as well. Investments are not made in order that interest can be paid. Yet it is the supply side in the region that must eventually generate the exports with which to earn foreign exchange to repay the loans. This requires higher rates of investment and productivity. ESOPs can contribute to both these objectives.

The clock is ticking on this problem. It is not a problem we can turn our backs on. This internal threat, left uncorrected, will cause external threats to prosper.

It should also be recalled that financial crises are not new for Latin America. For example, since 1828, Latin American nations have defaulted at least seven times on U.S. loans, most recently in 1931 when economic conditions were remarkably similar to those they now endure. Default has happened before; the conditions are ripe for it to happen again. The choices are clear. Either economies in the region can continue to shrink -- with obvious risks both to us and to them in increased instability. Or we can work together toward a more equitable solution.

Reform, like the finance that fuels it, takes time. Yet our available time is rapidly slipping away. Further delay only further endangers both us and our neighbors to the south.

POSTSCRIPT: the Private Delivery of Public Services

The conventional approach to providing many services is for government to collect the revenues needed to support the service and deliver the service as well. The premise is that local public services are all "public goods" -- i.e., goods or services that can only be produced, delivered and paid for collectively. Yet many of these services (such as transit or garbage collection) can be privately provided.

Natural Monopolies. Even in the case of services historically considered natural monopolies (such as the generation and distribution of electric power, telecommunications and some forms of transportation), there is considerable room in most economies to manage the function in a profitable or at least a cost-minimizing fashion. The implementation, construction and management of the public good can often best be undertaken by the private sector with public oversight, as in the case of regulated public utilities. Also, with today's technological advances creating substitutes (new sources of energy, new modes of communication, etc.), it has become increasingly more difficult to define a natural monopoly.

Goods with Externalities. An externality is associated with a particular good or service (e.g., immunization against infectious disease) whenever some individuals cannot be excluded from benefitting from (or being harmed by) the providing of a good or service to other individuals. Pricing is particularly troublesome (e.g., even those not immunized benefit from the immunization of others).

Merit Goods are goods which society argues are good for individuals and should be distributed in amounts greater than the individual would purchase in a free market. Education is a classic example. Society's interest is advanced by expanding the supply and utilization of education for the benefit of all.

Many activities in the fields of public health and education provide good illustrations of true externalities and merit goods. In such matters, governments rightly provide a higher level of service or set a lower price than what would prevail under free market conditions.

In many economies in the region, however, governments have unnecessarily linked natural monopolies, externalities and merit to a variety of other goods and services and, in the process, have damaged their economy's market mechanisms.

There are two circumstances in which privatization should not be attempted:

(1) where the government forbids a private sector alternative and the parastatal is not likely to perform competitively, and

(2) where the function being served by a parastatal is to provide truly public goods.

Yet even in those situations, there is the option of seeking to change the policy environment to allow for competition by persuading the host government to: (1) eliminate subsidies and barriers to market entry (2) reduce government monopolies, and (3) force its parastatals to operate more like private entities in a free and competitive market environment.

There are costs incurred and benefits delivered in the public provision of any good or service. The challenge is balancing the two and looking for ways (consistent with market pricing) for the private sector delivery of the good or service. In many cases, people have costs imposed on them for goods received by others. Where possible, the costs should be directly borne by those who most directly benefit.

VI. EMPLOYEE STOCK OWNERSHIP PLANS

Widespread personal ownership of the means of production must become a key feature of U.S. development efforts if this Nation is to create conditions in the world under which free societies can survive and prosper. Employee ownership is an important element in that policy, an element that can be advanced through a variety of organizational forms. In the U.S., that policy is reflected most dominantly through the corporate form, and through incentives for corporations to establish employee stock ownership plans.

Employee stock ownership plans (ESOPs) are a technique of finance designed to ensure that the employees of a company become company owners as that company meets its financing needs. Whether that financial need is for expansion or for the transfer of existing capital assets, ESOP financing is a method for such financing to create for employees an ownership stake.

Although that ownership stake (stock) suggests that the company must be organized as a corporation, that is not the case. What is important is the ESOP as a concept: encouraging a company -- however organized -- to borrow funds on behalf of its employees. And to repay those funds with the income generated by the assets acquired.

That is the heart of the concept: granting employees access to their employer's credit to buy income-producing capital assets. That concept can be adapted to a broad range of organizational forms.

Due to the quite different tax systems in many countries in the region, it may be impossible to recreate the same mix of ESOP incentives as now exist in U.S. law. However, what is most important about ESOPs is ESOP financing as a concept, and that concept can be tailored for application to laws and practices in the region.

ESOPS -- THE CONCEPT

The purpose of ESOP financing is to link productive property to people, and to ensure that as productive property is financed, more people have an opportunity to own such property. Most such property (the productive assets of enterprises) is acquired with one of three financing techniques -- each of which create additional capital ownership for existing owners.

For example, when a traditional business loan is repaid, it is repaid on behalf of existing owners. That type of financing can result in the creation of more capital, or it can result in a transfer in ownership of existing capital -- but in neither case does that type of financing create any new capital owners. Instead, existing capital owners become the owners of more capital.

Similarly, if the profits of an enterprise are used to buy more capital assets, those assets will be owned by already-existing owners. No new owners are created.

Likewise, if the government provides tax benefits for business financing, those deductions, credits, exclusions, etc. create no new owners. For example, when computing taxable income, the income tax system of most nations allows an enterprise to reduce its otherwise taxable income with deductions designed to allow the owners of the enterprise to replace the assets used to earn that income. Often, incentive deductions are allowed for capital financing in addition to those sufficient to recover the actual replacement cost.

The "Closed System" of Finance

The net effect of relying on these three traditional sources of finance -- loans, profits and tax benefits -- is to create a "closed system" of finance, a system in which the economy expands and income-producing assets change hands, yet few new owners are created.

If the enterprise is state-owned, it grows into a larger state-owned enterprise. If it is privately-owned, its owners increase their privately-owned wealth. In neither case does property ownership become more widespread when financing is accomplished through these three most prevalent financing techniques.

There is also a fourth source of finance. In the case of corporations, funds can be raised through the sale of new stock -- that those with savings can buy. However, these "new equity issues" are seldom a significant source of net new financing (e.g., annually averaging only 3-7% in the U.S.). And, realistically, that avenue to capital ownership is most accessible to those with significant discretionary income -- comprised primarily of those with significant capital incomes (i.e., those already within that "closed system" of capital finance).

ESOP financing acknowledges that expanded capital ownership will always be an elusive goal unless financing techniques can be devised to create more widespread capital ownership. It simply will not happen within the current "closed" system.

In addition, ESOP financing recognizes that it is this "rich-get-richer" legacy of traditional free enterprise financing that collectivists deride. It is for opening this "closed system" that the ESOP financing concept was devised.

The purpose of enterprise finance is to enable a company to acquire assets before it has the funds to pay for them. The purpose of ESOP finance is to utilize that commonplace business practice and adapt it to create widespread capital ownership.

This approach puts the concept of savings in a new and more workable context. Capital ownership is still attained by the individual in lieu of consumption. Only now the income generated by newly acquired productive assets is saved and applied to repay the debt incurred for its acquisition. The key ingredient in access to capital ownership is access to credit utilized to acquire income-producing assets, assets whose income-producing potential can then be preserved by depreciation reserves set aside to replace the assets as they wear out or become outmoded.

Louis Kelso, an investment banker, is the originator of the ESOP financing concept. Russell Long, a U.S. Senator from the State of Louisiana, is responsible for originating the legislation allowing that concept to become a reality. Yet it is not the ESOP incentives of U.S. law that are most important. Rather, the importance lies in the principles on which those incentives are based -- because the principles can be applied to formulate incentives in any type of economic system.

Principles of ESOP Financing

Without principles, we are left without a yardstick to measure the economic justice of policy proposals. And, thus, policymakers in the region are left without guidance on which proposals to embrace and which to reject. Also, with a set of easily understood principles, the fashioning of specific applications of the ESOP concept becomes more apparent.

Participation is the core principle of the ESOP concept, the center around which the secondary principles of distribution and limitation revolve:

Participation (or the democratic principle) holds that a just economic policy must ensure widespread participation in the economy so that everyone has an opportunity to earn a living. That means not only an opportunity to be a productive factor in the economy (e.g., via a job) but also an opportunity to own a stake in the productive factors of the economy (i.e., capital ownership).

Distribution (or the private property principle) holds that each person should receive income according to their input. In the case of labor inputs (i.e., a job), that means a full day's pay for a full day's work. In the case of capital inputs (i.e., productive assets), that means a payout by the enterprise of the profits on those privately-owned inputs (as represented by stock in the case of a corporation). In other words, each participant in production is rightfully entitled to receive the wealth he produces: wages in the case of labor, and company profits -- as the "wages" of property ownership.

Limitation (or the anti-monopoly principle) holds that no one has the right to so use his property that it endangers or damages another; the rights to property must never be exercised to the detriment of the common good. Thus, no one has a right to so extensive an ownership of income-producing property that it injures others by excluding them from even that minimum degree of participation in property ownership which would enable them to earn a viable income from such property. One danger of the current "closed system" of corporate finance is that it assures the additional accumulation of income-producing property by those already so awash in assets that those accumulations may only be used to acquire additional income-producing assets. Justly financed, the productive property that embodies a culture's technology can support a broad base of those whose culture gave rise to that technology.

Applied Principles of Finance

The U.S. law providing incentives for ESOP financing applies these three principles by:

(1) Requiring that a large percentage of an ESOP company's employees are eligible to participate in the ESOP,

(2) Encouraging ESOP companies to distribute to their employees -- as stock dividends -- the profits earned on their ownership in the company, and

(3) Limiting the benefit that any invidividual can receive from the ESOP incentives.

ESOPs and Corporate Property

Employee stock ownership implies joint ownership of part of a corporation -- its stock. Yet the ESOP concept can also be applied to other organizational forms (e.g., cooperatives and employee associations). But it is the corporation that is the most prevalent organizational form -- and with good reason: it has been shown to be an extraordinarily effective social invention for organizing the production, marketing and distribution of goods and services.

The corporation provides its individual owners with a definable link to private property and, thus, decentralizes economic power. In contrast, collective ownership offers no definable individual stake and, thus, concentrates ownership in whoever runs the collective (e.g., the government in the case of state-owned enterprises).

Also, the corporation form shields its individual owners (i.e., its stockholders) from personal liability. Thus, for example, if an ESOP company finds it cannot repay its ESOP loan, the lender's recourse is against the company's assets, not the personal assets of the individual stockholders. Also, a corporation can live in perpetuity, its individual owners leaving or dying and others taking their place.

Property is the primary social link between an individual and the process of producing and distributing wealth. Property rights determine who has the right to share in the profits generated by that property. If Daniel Webster is correct that "power naturally and inevitably follows property", then democratizing ownership is an essential element in democratizing power.

In the economic world, property performs the same power-diffusion function that the ballot does in politics. Actually, it does more because property makes the ballot-holder economically independent of those who wield political power.

Property is also an essential element in income distribution because it is not only power, but also income, that follows property. Karl Marx recognized that. His solution: "The theory of Communism may be summed up in a single sentence: Abolition of private property (in the means of production)."

The ESOP concept similarly acknowledges that ownership is a key element in determining income distribution patterns. But rather than transfer that ownership to the government and then distribute income based on ever-shifting, inherently arbitrary government-determined standards of "need" -- ESOP financing instead encourages the steady, voluntary expansion of capital ownership, along with the income associated with that ownership.

Property rights operate like circuitry in electronics or hydraulics in plumbing -- directing income to whoever owns the productive inputs embodied in that property. If that property is owned by the government, then it is the government to whom that income will flow. If it is owned by only a few households, then the bulk of property income will flow to those few. If, instead, income-producing property is broadly owned, then property rights will operate to broadly irrigate the economy with purchasing power.

A market economy ensures that income distribution patterns follow input distribution patterns. The Marxist principle of "to each according to his need" is a guiding principle of charity, the necessity for which will always be with us, but the widespread need for which will be reduced to the extent that economic justice operates to ensure more widespread private ownership of the means of production.

The principles of economic justice suggest that it is not government's job to appropriate to itself the ownership of property. Rather, it is government's job -- as society's "institutional architect" -- to advance the widespread use of financing techniques that ensure the steady, perpetual diffusion of property ownership.

Similarly, beyond a modest social safety net to protect against true poverty, government officials should not be the ones to determine what is a "just" income. Instead, government should work to make available widespread opportunities to work, plus widespread opportunities to acquire income-producing property, and allow market forces to distribute income as men apply to that property their ambition and their talent.

Thus, ESOP financing operates simultaneously on several levels. In addition to advancing economic justice, it provides a way for government to fulfill its duty to its citizens by lifting barriers to private property ownership in the means of production -- while building a political constituency for a free market economy.

ESOPS: THE FINANCING TECHNIQUE

As a technique of finance, ESOPs are thus far a uniquely American experiment. The U.S. tax system relies primarily on an income tax system, and ESOPs are a part of that system. The following overview of U.S. incentives for ESOP financing provides a look at one nation's approach to applying principles of economic justice.

The ESOP Structure of U.S. Tax Law

ESOPs operate through a regulated trust device, a tax-exempt employee benefit trust similar in many ways to profit-sharing or pension trusts. The trust arrangement is a "spendthrift" trust -- employees in an ESOP generally cannot receive their stock until they terminate employment. This trust arrangement enables employees to accumulate capital on a tax-free basis.

In order for the sponsor company to qualify for the ESOP tax benefits (described below), the sponsor company must operate its ESOP in compliance with rules designed to ensure that ESOP tax benefits -- provided by all U.S. taxpayers -- are utilized to benefit a broad cross-section of employees, and not just those that are highly paid.

With certain exceptions (e.g., employees under a certain age and those employed for only a short period), all employees must be eligible to participate. Employees covered by a collective bargaining plan cannot be forced to participate.

Participation in the plan cannot discriminate in favor of officers, shareholders or highly-paid employees. Similarly, the plan must not be operated so as to disproportionately reward that group.

Participants in an ESOP receive allocations of stock to their personal accounts. If the ESOP has been used to borrow money, a block of company stock is held by the trustee and each year and, as the ESOP loan is repaid (from employer contributions to the plan), the trustee allocates to each employee his share of that year's portion of the total. In making those allocations, ESOPs can allocate on the basis of pay, on the basis of pay and length of service, on a per capita basis, or on any combination of the above -- so long as such allocations do not discriminate against rank-and-file employees.

Each year, the employer may contribute up to 25% of pay to each employee's ESOP account and claim a deduction for that amount against the corporate income tax. In the case of a "leveraged" ESOP (i.e., one that borrows to acquire stock), the result is that an ESOP company can service debt at a lower level of company revenue. The reason for this has to do with the deductibility of ESOP contributions.

In the traditional loan, a company is allowed, as a business expense, a deduction for its interest costs on that loan. Loan principal must be paid with "after-tax" company dollars. With an ESOP loan, however, a company can claim an income tax deduction for its payments of both interest and principal -- because the employer's ESOP contribution (used to pay both interest and principal) is treated as a business expense: an expense of funding an employee benefit plan (i.e., a "leveraged" ESOP).

Thus, each payment simultaneously finances both capital stock acquisitions for employees and capital asset acquisitions for employers. It is the logic of simultaneously financing both that justifies the company's sharing the use of its credit with its employees -- because both are benefitted.

ESOPs must invest primarily, not exclusively, in employer securities -- generally the employer's best class of common stock if the employer is not readily tradable on an established securities market. ESOPs sponsored by traded companies may invest in any type of employer common stock. Employees must be allowed to direct the trustee how to vote the stock in their accounts -- on all issues for publicly traded ESOP companies, and on major issues for those not traded.

Once stock is contributed to an employee's account, it must "vest" within a prescribed period of years (generally 5 to 7 years). Thus, if an employee in an ESOP with a graded 5-year "vesting" schedule (i.e., 20% each year) leaves after 3 years, he would be entitled to 60 percent of his account balance.

When an employee leaves, the employer must commence distribution of his account balance within five years (or earlier if he has reached retirement age). Once the ESOP participant receives the stock, the employer (unless the stock is publicly traded) is required to buy the stock back if the employee "puts" the stock to the employer (i.e., exercises his option to sell the stock back to the company).

Non-public ESOP companies have a "right of first refusal" to ensure that they have the option to buy back the company's stock before it can be sold to someone else. Companies whose charter or by-laws mandate that they be substantially employee-owned may require employees to sell their stock back to the company (i.e., to enable the company to remain employee owned).

Upon distribution, employees pay tax on the cost of the shares in the plan. If received in a lump sum after age 59-1/2 on account of separation or due to death or disability, that tax is computed based on a formula that treats the income as though it were received over a 5-year period. Any gain in value on the stock remains untaxed until sold.

ESOP Incentives in U.S. Law

In addition to the corporate income tax deduction allowed an employer for contributions to an ESOP and the tax deferral on amounts allocated to employees' accounts (described above), U.S. law includes several incentives unique to ESOPs. These include:

> Dividend Deduction. ESOP companies are allowed a deduction for dividends paid on ESOP-held stock, whether paid out to employees as current ownership income or applied by the plan to repay an ESOP loan.
>
> Tax Deferral on Sale to an ESOP -- Stockholders selling to an ESOP may defer tax on any profit on their stock sold to an ESOP or a worker-owned cooperative provided: (a) after the sale, the ESOP or coop holds at least 30 percent of the company's stock, and (b) the

seller's proceeds are reinvested in the securities of another business.

Lender Interest Exclusion -- To encourage ESOP financing, commercial lenders (e.g., banks and insurance companies) may exclude from income 50 percent of the interest they receive on ESOP loans. Because lenders are willing to compete for this tax-favored financing, ESOP companies are able to borrow at lower rates of interest than conventional borrowers. This exclusion is also available to mutual funds, thereby encouraging mutual fund investors to participate in ESOP financing.

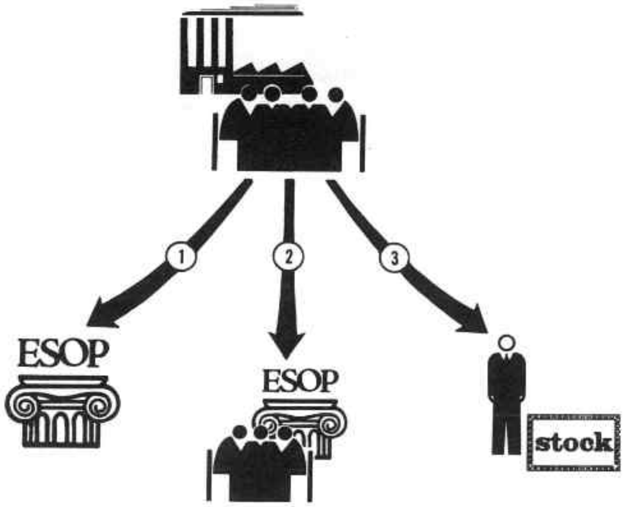
Estate Tax Relief -- Two ESOP provisions provide estate tax relief. The first provides an exclusion from an estate (and thus a reduction in estate tax) for 50 percent of the proceeds realized on an estate's sale of stock to an ESOP or to a worker-owned cooperative. The second provides that the liability for estate tax may be assumed by an ESOP or a coop in return for a transfer from the estate of stock of an equal value, provided the ESOP company guarantees payment of the tax and agrees to pay the tax due on an installment basis over a 14-year period (interest only for the first 4 years).

Tax Credit ESOP -- This provision permits ESOP companies to claim a credit against corporate income taxes of up to one-half of one percent of payroll, provided the tax savings are used to buy stock for employees in an ESOP. This "PAYSOP" (payroll-based tax credit ESOP) originated in 1975 as a credit based on the amount of investment undertaken by the employer. That one percent "investment tax credit ESOP" was amended in 1976 to include an additional one-half percent credit for employers, provided employees contributed a matching amount to the plan. The investment-based tax credit ESOP was replaced in 1982 with the payroll-based tax credit ESOP which expires at the end of 1986.

ESOP proposals approved by the Senate but not enacted into law include: (a) a provision permitting contributions to an ESOP to be treated as contributions to a charity for income, gift and estate tax purposes, and (b) a provision permitting employees to exclude from their taxable income up to $2500 per year provided the amount is invested in employer securities in an ESOP.

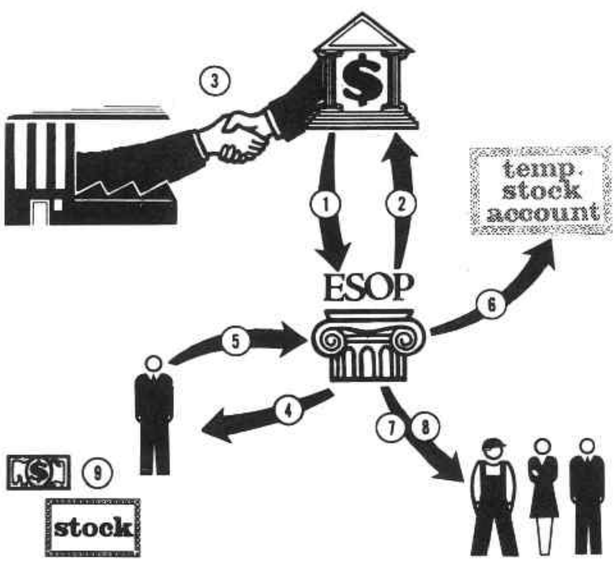
Areas of concern include valuation, expense and repurchase liability. ESOP companies whose stock is not readily tradable on an established securities market are required (at the

STAGE 1:
STOCK CORPORATION FORMS ESOP



1. Board approves ESOP.
2. Appoints ESOP trustees.
3. Approves purchase by ESOP of seller's shares.

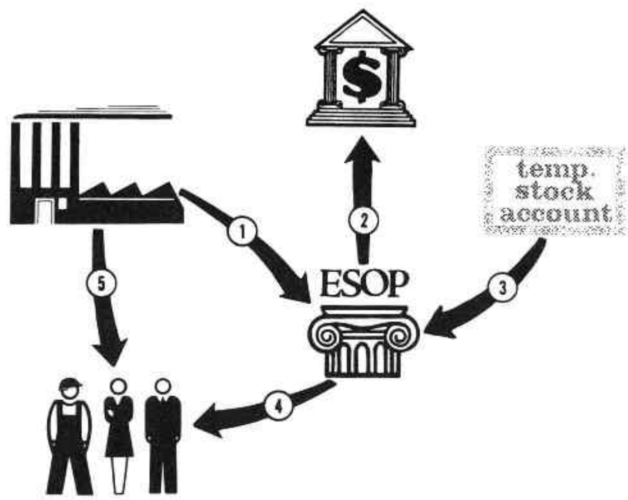
STAGE 2:
EXISTING STOCK PURCHASED WITH LOAN TO ESOP



1. Bank loans money to ESOP at reduced interest rates.
2. Trust signs note to bank.
3. Corporation guarantees to make contribution to ESOP to repay loans.
4. ESOP pays seller for shares.
5. Seller transfers shares to ESOP.
6. Shares pledged as collateral or held in suspense account.
7. ESOP accounts set up for each employee.
8. Credit purchase requires no cash or guaranty by employees.
9. Seller avoids capital gains taxes by buying new shares.

STAGE 3:

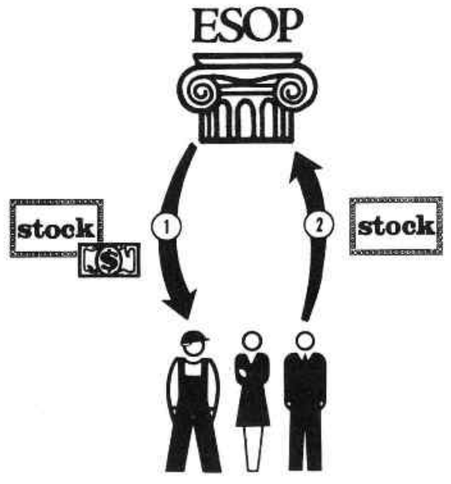
COMPANY PAYS OUT PROFITS FOR REPAYING BUYOUT LOAN, BONUSES, AND DIVIDENDS AS NEW EMPLOYEE BENEFITS



1. Company makes annual contribution and dividends to ESOP for loan repayment (tax deductible).
2. ESOP pays annual principal and interest due on loan.
3. Shares released for annual allocations.
4. Released shares allocated and held in ESOP accounts of participants (non-taxable).
5. Distribution of monthly and annual cash bonuses and dividends, if available.

STAGE 4:

DISTRIBUTION OF VESTED SHARES UPON RETIREMENT OR TERMINATION



1. Distribution of cash and ESOP shares (taxable).
2. Sale of distributed shares at appraised fair market value.

outset and annually thereafter) to value their stock using an independent appraiser. Thus, ESOPs can be more expensive than other types of employee benefit plans (e.g., those that invest in publicly traded companies).

Also, because ESOPs require expertise in corporate, tax, labor, securities and employee benefits law, professional fees are involved. In addition, employers must plan for the deferred liability that they may be creating by encouraging employee ownership.

Unless the employee has a market for his stock, the law requires that the employer provide that market (i.e., through a "put option" to the employer). Thus, the tax and cash flow advantages in the early years of ESOP financing can be partially offset by the need to generate cash in the later years to buy back the stock of departing employees. On the other hand, companies may find that the stock repurchased from departing employees can be "recycled" to new employees by recontributing (and claiming a tax deduction for) that stock, thereby lessening the repurchase burden.

What ESOPs are Not

Because many countries embrace some type of worker participation plan, the ESOP concept is often confused with other arrangements. ESOPs are not, for example, Western European-type codetermination plans. In those plans, workers are granted representation on a company's board of directors. Generally there is no ownership interest associated with codetermination, only managerial oversight through board membership. Although ESOP companies may include employees on their board of directors, U.S. law does not mandate it.

Similarly, ESOPs should not to be confused with Western European collective investment funds (such as Sweden's "Meidner Plan" concept or Denmark's Wage Earner Investment Funds). These arrangements are typically government-mandated and require companies to use a portion of their annual profits to buy for their employees shares in other companies. The funds are often managed by a labor union. In the U.S., establishing an ESOP is voluntary; employee stock ownership is not mandated. Each employee has an individual (vs. collective) account primarily invested in employer securities. ESOPs are managed by company-appointed trustees who have fiduciary responsibilities to the employees. Although ESOPs are often established in companies with unions, it is not the union which manages the plan (though union members may serve on the ESOP advisory committee).

Nor are ESOPs employee stock "option" plans. Typically, such plans are limited to highly-paid management employees, enabling them to acquire company stock on favorable terms. ESOPs are required to cover a broad, nondiscriminatory class of employees and no "option" is involved.

Similarly, ESOPs are not profit-sharing plans. Although the ESOP company's earnings and profits are used to fund the plan, profit-sharing plans typically do not create a company ownership interest for employees but, instead, allow employees (usually at management discretion) to share in company profits. Often ESOPs are combined with profit-sharing, in some cases employees agreeing to work for less than normal wages -- sharing in profits on a regular basis to make up the shortfall. Some ESOP companies have found this approach important for providing employees with immediate "feedback" concerning the benefits and responsibilities of ownership.

Nor are ESOPs necessarily "pension plans" as that term is generally used. Pension plans (generally termed "defined benefit" plans) are funded on a collective basis and invest broadly in order to underwrite an employer's promise to pay a formula-determined (i.e., "defined") benefit at retirement. If the investments do well, the employer profits by contributing less to the plan. If the investments do poorly, the employer must contribute more.

In addition, employers sponsoring such plans are required to pay an annual fee to a government pension guaranty agency to insure, up to a maximum, the benefit promised by the employer. Also, the agency may levy against an employer's assets to pay its pension liabilities. ESOPs, on the other hand, are "defined contribution" plans under which the employer contributes an amount to each employee's individual account. The ESOP must invest primarily in employer securities. No government-mandated underwriting fees (or liabilities) are involved. If the investments do well, the employee does well; if the investments perform poorly, the result is reflected in the employee's account.

Nor are ESOPs worker cooperatives. Worker cooperatives operate on the basis of one-man-one-vote whereas corporations operate on the basis of one-share-one-vote. No person outside the cooperative can obtain an ownership position, whereas in a corporation employees may be but one of several groups with an ownership stake. Profit or loss in a cooperative is generally allocated on the basis of pay or hours worked, whereas corporate profits are allocated based on stock ownership.

Nor are ESOPs "quality of worklife" schemes or "participative management" programs in which companies work with their employees to enhance the work experience and solicit employee input into the decision-making process. Although both can make major contributions to the workplace, and both can enable employees to make the fullest possible use of their creative capabilities, neither are mandated by ESOP law.

U.S. ESOP law is intentionally flexible, enabling ESOP financing to adapt to a wide range of organizational and operational philosophies. For example, some ESOPs operate on the cooperative principle of one-man-one-vote. The law accomodates that principle for ESOPs and also extends to worker-owned coops many of the ESOP's tax incentives (e.g., the "ESOP rollover" and the estate tax relief provisions). Similarly, managers (whether or not in ESOP companies) are finding that quality of worklife and participative management programs are worthwhile. The evidence indicates that ESOPs tend to create a workplace context in which such programs are more likely to emerge.

Tapping the Intangibles

One aspect of employee ownership deserving of a brief note is its potential for accessing the untapped potential reservoir of human energies, resources and commitment -- the root source of quality, creativity and productivity in any enterprise. Particularly in an economic environment (as in the region) where capital investment comes only at a premium, companies need a time-proven method for fully enlisting the interest, drive, enthusiasm and intelligence of their workforce -- as an alternative to capital investment.

Shared values are the most powerful factor underlying the superior performance of the most excellent firms. Employee ownership summons up a common determination to succeed and insures that the company's success is shared with those on whom that success will largely depend. The ESOP provides for employees a mechanism for "harvesting" the increased value created through improved performance.

This is an area in which ends and means are the same: higher productivity is achieved by improving the quality of life in the workplace itself. When people are better educated, more humanely treated, more involved in decisionmaking, and better rewarded for their efforts, then they are empowered to achieve a better quality of life generally.

When improvement comes from those who know best where improvements can be made (i.e., the workers), the result is both a higher level of improvement and a lower level of alienation. When many micro-problems are solved by workers, the result is macro excellence for the enterprise.

With a genuine commitment to the concept, a free flow of information within the firm, and consistent "feedback" concerning performance targets (e.g., on-time delivery, quality, service response time, etc.), companies can break the complacency barrier and, by encouraging workers to "work smarter," raise the firm's performance potential.

Thus, such programs can have a beneficial effect not only on productivity but also on job satisfaction, individual dignity, general mental health, and community cohesiveness.

Implementing this new approach to management systems may require the development of a support capability in-country. A useful analogy: the support provided American farmers by the land-grant colleges and county agents established by the Morrill Act of 1862, along with the Homestead Act.

ESOP MODELS

ESOP financing can be adapted to a wide range of situations. As a technique of finance, ESOPs can be used to finance new capital, to refinance existing loans, to buy out existing stockholders, to acquire other companies, and to sell off portions of a parent company.

For example, at his confirmation hearing before the Senate Finance Committee, Treasury Secretary-designate Donald Regan explained how Merrill Lynch and Company used an ESOP to divest itself of the Lionel-Edie Company. Rather than sell the company to someone else, the former chief executive explained:

> "We used an employee stock ownership plan, letting them buy it, and they have prospered as a result of that. I am definitely in favor of that."

Three examples provide an overview of how an ESOP can be used to meet differing situations:

Weirton Steel Company

Weirton Steel Company is one of the largest ESOP companies in the United States. Utilizing ESOP financing to save a beleagured steel mill and over 8,000 jobs marked Weirton Steel as one of the most dramatic ESOPs to date.

In 1982, the parent corporation, National Steel, announced its intention to substantially reduce its investment in the marginally profitable steel industry. Weirton employees and their management were faced with the option of either an employee buyout or a substantially reduced workforce (Weirton had once employed more than 12,600 in a valley of about 60,000 population). The employees, represented by an independent steelworkers union, joined with management to form a study committee to evaluate the possibility of an ESOP buyout.

The joint study committee hired a consulting firm to undertake a feasibility study to apprise them of what would be required to make the buyout possible. The cost reductions essential to the profitability of the firm required a 20% pay cut which employees voted to approve in order to save their jobs -- and their communities.

The buyout was completed in September 1983 and profitability has been sustained ever since. Under the buyout agreement, once the company reached $100 million in net worth, employees would begin sharing in profits in order to recoup some of their necessary wage cuts. That benchmark was reached at the end of the second year, and in March 1986, 8400 employees shared one-third ($20.8 million) of their company's 1985 profits. Employees will share in one-half of the profits when the company's net worth reaches $250 million.

Weirton's top management have a strong commitment to employee participation and participation teams have been established throughout the enterprise. The stock is allocated according to relative salary; voting follows the one-man-one-vote principle. The board of directors has 3 labor representatives, with the remaining nine outside directors chosen by Weirton's financial advisors. Employees will be able to elect a majority of the board in 5-7 years, as their buyout debt is repaid.

Weirton's adjustment to their new status as an independent company was accomplished with aplomb. Although marketing is now their own responsibility (vs. National Steel's), they have steadily expanded their customer base. Employment (down to below 7,000 by the date of closing) is now over 8,500. They recently announced their 10th consecutive quarter of profitability and enjoy the highest profit per ton in the industry.

Fastener Industries, Inc.

Fastener Industries, Inc. is a manufacturer of nuts, bolts and fasteners for automobiles and appliances. Family-owned since 1905, the last family member retired in 1979 at which time the company profit-sharing plan was converted to an ESOP and used to buy part of the company. The company then borrowed money (i.e., utilized a leveraged ESOP) to buy the remaining shares from the family.

Now operating as a 100% ESOP-owned company, all 125 employees participate in the plan and vote their shares. Stock is allocated according to pay; no one employee has more than 4% of the company stock. Plant managers meet with employees monthly about machinery purchases and other company decisions. Each employee meets regularly with the company president. During downturns in the economy, the company builds up inventory rather than laying employees off. Retiring employees are given a half day of free legal advice on how best to plan their investment strategy.

The Lowe's Companies

The Lowe's Companies is a building supply retailer with 14,000 employees in 295 stores operating in 21 states. The company is 20% ESOP-owned and 5% owned by a company profit-sharing plan; the balance of the publicly traded firm is widely held.

Lowe's founder began a profit-sharing plan in 1957 to which he periodically sold blocks of his stock. When he died in 1960, the profit-sharing plan bought the company's stock from his estate and then made a public offering of Lowe's stock to help repay the loan incurred to buy the stock. The profit-sharing plan retained a 48% interest.

During the 1970s, several employees retired with enormous profit-sharing accounts: $400,000 to $3,500,000. The profit-sharing plan diversified its investments and the percentage of Lowe's stock held for employees fell to 17 percent by 1977. In 1978, management introduced an ESOP to rebuild employee ownership of the company.

Stock is allocated according to pay; Lowe's generally contributes between 12% and 15% of payroll annually. Employees vote their shares. Board members are elected by shareholders. Each of Lowe's stores elects a representative to an ESOP advisory committee which hears management reports and makes recommendations.

Stores hold employee meetings monthly. Lowe's has experienced record-breaking growth with employee ownership, growing from six stores in 1957 to 295 today. Lowe's sales per employee are generally two to three times that of their competitors. Sales reached $2.1 billion in 1985.

ADAPTING THE ESOP CONCEPT TO THE REGION

Any consideration of ESOP financing in Central America and the Caribbean must include a consideration of the unique institutional barriers existing in each country. Adapting the ESOP concept may require flexibility and creativity. Yet it is not the ESOP form -- as found in the U.S. -- that is important. Rather, it is the ESOP concept: structuring financings to grant access to ownership to those normally denied access.

For example, a lack of capital markets need not be a barrier. Indeed, the widespread use of ESOPs in a country can lay the foundation for the establishment of more formal capital markets. ESOPs can serve as "mini" stock exchanges, their in-house trading of blocks of stock with each other (to diversify employees' holdings) paving the way for creating a real national stock exchange -- not from the top down but from the ground up.

ESOPs provide a formula for reform, but a formula that needs to be carried out gradually and cautiously. This type of reform cannot be imposed from the outside but must be embraced from the inside; the reality of different cultures and different social institutions will require adjustment and accomodation. Prudent, far-sighted reform must reconcile itself to that reality.

Although ESOPs in the U.S. rely largely on incentives built into an income tax system, those incentives are not essential to application of the ESOP financing concept in the region. Countries in the region can adapt the concept to fit incentive systems particular to their economies.

For example, as part of the government loan guarante provided the Chrysler Corporation in 1980, the U.S. government required that 15 percent of the loan guarantee amount be financed through an ESOP. Similarly, in conjuction with an additional infusion of government funds into Conrail, the government-owned railroad, Congress required that 15 percent of the company stock become owned by employees through an ESOP.

Similarly, U.S. trade adjustment assistance legislation provides a preference for ESOP companies in the granting of loans and loan guarantees to firms adversely affected by foreign competition. Also, legislation was enacted ensuring that the financial assistance provided by government to small businesses could be provided through the ESOP financing technique. In addition, the legislation authorizing the privatization of Conrail directed the Department of Transportation to give priority to an employee buyout of Conrail should no other bidder make an acceptable bid to acquire the railroad as a unit. (See Chapter VII Recommendations, "Conditionality of Foreign Assistance".)

VII. INGREDIENTS OF A U.S. POLICY -- RECOMMENDATIONS

Our Congressional commission directs the Task Force "... to develop a plan for the expanded use of employee stock ownership plans in development efforts of the United States in Central America and the Caribbean...." The recommendations in this chapter comprise that plan.

What U.S. development efforts do not need is another report gathering dust in someone's little-used library. What our development efforts need is action. We believe that these recommendations comprise the framework for a course of action that would much improve the quality of such efforts.

RECOMMENDATIONS -- AN OVERVIEW

Note: The recommendations fall into 7 general categories; this overview is followed by detailed descriptions, plus areas for additional study.

(1) PARASTATAL PRIVATIZATION THROUGH DEBT FOR ESOP EQUITY SWAP. The privatization of parastatals is an essential first step in restoring economic efficiency and growth. Parastatals should be sold to their employees through trading U.S. bank debt for equity in the parastatals and then selling that equity to the employees through an ESOP.

(2) CAPITAL MARKETS. To lay the groundwork for the private sector development of capital markets, ESOP financing should be widely used in development efforts in the region. ESOPs can serve as many "mini" stock exchanges, their in-house swapping of blocks of stock with each other (to diversify employees' holdings) laying the foundation for creating a real national stock exchange -- from the ground up.

(3) CONDITIONALITY OF FOREIGN ASSISTANCE. U.S. foreign assistance should be conditioned on reforms consistent with private sector development and, to the maximum extent feasible, development

financing should be provided through ownership-expanding techniques of finance.

(4) LAND REFORM. Whenever possible, U.S.-supported land reform efforts should be organized along the lines of Guatemala's La Perla, enabling farmers in the region to gain a joint ownership stake in estate-sized agricultural operations, retaining the benefits of economies of scale, and private sector technical, marketing and other services.

(5) TRADE REFORM. Products of ESOP companies in the region should be exempt from U.S. quotas. Tariffs collected on products imported from such companies should be rebated to the host country in return for providing infrastructural reforms which encourage market-oriented solutions linked to expanded capital ownership. A multilateral certification board should be established to set standards for certifying regional firms as ESOP companies.

(6) INVESTMENT INCENTIVES. PL-480 local currency funds should be utilized to underwrite the private sector establishment of an Employee Ownership Investment Insurance Corporation in the region to encourage the flow of investment to and among private sector, employee-owned companies in the region by issuing guarantees against political risk, carrying out promotional activities, and encouraging sound investment policies.

(7) EDUCATION AND ADVOCACY. Personal ownership is the strongest motivator for economic education. We recommend A.I.D.-sponsored education initiatives for workers, educators, development personnel and political leaders -- with an emphasis on the benefits of ownership-broadening techniques of finance.

RECOMMENDATIONS -- DETAILED DESCRIPTION

(1) PRIVATIZATION OF PARASTATALS.

-- PRIVATIZATION OF PARASTATALS THROUGH DEBT FOR ESOP EQUITY SWAP. Parastatals (state-owned enterprises) should be sold to their employees through trading U.S. bank debt for equity in the parastatals and then selling that equity to the employees through an ESOP. See description in Chapter V.

-- A.I.D. PRIVATIZATION ACTIVITIES. -- A.I.D. should require that ESOPs be considered as an option in all A.I.D.-assisted privatization activities. A.I.D. should consider as candidates the two privatization activities projected for each A.I.D. mission in fiscal year 1987. A.I.D. technical assistance should aid in developing an understanding in the region of the long-term benefits of such privatization, and A.I.D. should rapidly develop the resources necessary to provide technical assistance for ESOP privatization activities.

(2) CAPITAL MARKETS.

-- A Foundation for Capital Markets. To lay the groundwork for the private sector development of capital markets, ESOP financing should be widely used in development efforts in the region. (ESOPs are described in Chapter VI.) ESOPs can serve as many "mini" stock exchanges, their in-house trading of blocks of stock with each other (to diversify employees' holdings) laying the foundation for creating a real national stock exchange -- from the ground up.

-- Secondary Equity Markets. The resources of the International Finance Corporation, a component of the World Bank, should be utilized in assisting to establish internal capital markets and stock exchanges to help create domestic capital sources and to provide a market for stock interests created for employees through ESOPs. Multilateral lending institutions should designate capital markets a crucial element of regional infrastructures and direct their resources to facilitate the development of that infrastructure (i.e., those institutions should assist in developing markets in the underwriting, trading and brokering of securities).

(3) CONDITIONALITY OF FOREIGN ASSISTANCE.

-- The Foreign Assistance Act of 1961 states that the overall objective of U.S. foreign aid is: "(T)o create conditions in the world under which free societies can survive and prosper." Thus, expanded capital ownership should be included as an explicit goal of U.S. foreign assistance efforts by adding the following new paragraph to section 102(b) of the Act:

> "(17) United States policy recognizes that the widespread and realistic opportunity to enjoy the human right of private property ownership is essential both to a productive, competitive free enterprise economy and to the establishment and strength of democratic institutions. United States assistance policies should therefore seek to encourage the secure possession, productive use and free exchange of private property, and to create a wider distribution of capital ownership among the people of assisted countries."

-- Policy Conditionality and Policy Reform in U.S.-assisted Development Financing. Consistent with the Treasury Department's recommendations concerning U.S. participation in multilateral development banks (1982), such banks should introduce more policy conditionality and concentrate their lending where they will have the most policy leverage -- with a particular emphasis on ownership-expanding techniques of finance. Further, the allocation process of such banks should be based upon the economic and social priorities of the borrower government but only to the extent that their priorities are consistent with the principles of economic justice as set forth in this Report (Chapter VI). Such banks should emphasize lending policies and programs attuned to market signals and to greater financial participation by private sector lenders, private investors and other sources of private financing.

-- Inter-American Investment Corporation. The Inter-American Investment Corporation (of the Inter-American Development Bank) should designate a portion (e.g., $50 million) of its U.S. subscriptions for investment in employee-owned companies in Central America and the Caribbean. This could be accomplished by granting loans or by purchasing shares or convertible debt instruments, as well as through cofinancing, loan syndications, joint ventures and the underwriting of securities and participations. The Corporation's technical cooperation efforts should be expanded to include expertise in ESOP financing. These recommendations will strengthen the Bank's policies and enable it to be a more effective partner in support of growth-oriented structural reform.

-- International Finance Corporation. The Internatioal Finance Corporation (I.F.C.), a component of the World Bank, makes direct equity investments in private companies in the region. A substantial portion of its investments should be directed to companies that utilize employee ownership financing techniques.

-- Central American Bank for Economic Integration (C.A.B.E.I.). Consistent with the recommendations of the President's Commission on Central America, the Task Force believes that C.A.B.E.I. should be reinvigorated. To that end, a substantial portion of future U.S. contributions to the private sector development activities of C.A.B.E.I. should be set aside to guarantee C.A.B.E.I. loans to ESOPs and similar ownership-expanding financings in the region. In the case of those countries in the region with which the U.S. has a balance of payments program, the U.S. should negotiate an agreement by which a portion of local currencies would be set aside for the guarantee of ESOP-type loans.

-- The World Bank. The World Bank and other multilateral development banks should play a catalytic role in identifying investment opportunities appropriate for the application of ownership-expanding financing techniques. The Department of the Treasury should direct U.S. executive directors at multilateral development banks to consider ESOPs as an option in all privatization projects. The Bank should assist in identifying the options set forth in this Report to commercial banks, debtor and creditor governments and multilateral institutions.

Replenishments and proposals for general capital increases should be linked to assurances (from the International Monetary Fund, the World Bank and other multilateral development banks) that such institutions are adopting policies and realistic strategies for increasing private sector involvement in general and expanded capital ownership in particular, with a particular emphasis on policies and programs designed to encourage employee ownership. Each development project should be required to include an "Ownership Impact Report" detailing the extent to which assets being financed will be publicly or privately owned and, if privately owned, the extent to which employees in assisted enterprises will share in that ownership.

Replenishments and general capital increases should be conditioned upon receipt of an annual report detailing the specific steps that each such organization has taken to advance the goal of expanded capital ownership and employee ownership in the region. In addition, each such organization should rapidly develop the relevant technical assistance capacity both to advocate and to implement ESOP financings in their development strategies.

-- ESOP Company Loan Guarantees. -- Local currency resources generated through economic assistance should be utilized to guarantee loans structured to create employee ownership in companies operating in the region. Local currency resources are generated through Public Law-480 Agreements, through balance of payment loans or grants and other means. Agreements with the host country generally provide for joint programming of local currencies by A.I.D. and the recipient country, and the programming of credit arrangements in the private sector are common. The use of such funds to guarantee loans of this type should be a priority for A.I.D.

-- Cargo Preference for Foreign Employee-Owned Ships. -- The U.S. should grant an exemption for Central American/Caribbean merchant ships from the U.S. Public Law 480 cargo preference requirements provided the ships are substantially employee-owned. U.S. food assistance under Public Law 480 -- the Food for Peace Program -- provides U.S. agricultural commodities to countries in the form of grants. In the shipment of such commodities, a preference is granted U.S. flag ships. Our recommendation would encourage shipping by regional employee-owned vessels, thereby stimulating economies in the region while also advancing the concept of economic justice through employee ownership in ports of call around the world.

-- Cartagena Consensus Group. In response to the dramatic fall in the standard of living in Latin America and the increasing burden of debt repayments, in 1984 eleven Latin American nations formed the Cartagena Consensus Group which has issued a series of reports -- and warnings. In February 1986, the Group called for an urgent adjustment in interest rates "so as to distribute in a more equitable manner between creditors and debtors the burden of the economic adjustment." This communique made no mention of privatization efforts or proposals for expanded capital ownership. We recommend that the Group be informed of the debt rescheduling/privatization recommendations in this Report.

(4) LAND REFORM.

-- Strengthen and Reform Policy Implementation. The U.S. has a long history of promoting land reform, starting with the occupation of Japan in 1945. Some of these efforts, as in Japan and Taiwan, have been extremely successful while others, most notably the 1979 effort in El Salvador, have had mixed results. From long experience, A.I.D. has learned the essentials for successful land reform: a strong host country commitment; free market pricing and marketing of agricultural inputs and products; readily available credit at market-determined terms and interest rates; the reduction of barriers to agricultural imports and commodity exports; just and expeditious compensation and meaningful alternative investment opportunities for expropriated estate owners; security and marketability of land titles; economically optimum parcel sizes; and, if acquisition of estates by cooperatives is involved, freedom for the cooperative to run its own affairs with minimal government controls. These lessons were brought together in an A.I.D. Land Tenure Policy determination in January 1986. A.I.D. should continue its support of well-designed land reform programs in the region, in line with its 1986 policy determination, thereby strengthening and reforming the underpinnings of efforts to broaden land ownership. In addition, it should promote the development of private sector lending and mortgage institutions for financing voluntary transfers of land title on reasonable credit terms.

-- Stressing Optimum Results. Properly designed and effectively implemented, land reform can lead to a strong and productive agricultural sector and a broadened base of property ownership while simultaneously strengthening a nation's economic and political systems. Such strengthening can also result from converting large estates into partially or wholly employee-owned entities, as at La Perla in Guatemala. (See Chapter III.) A.I.D. should seek out opportunities for assisting in the replication of the La Perla model of land reform and other similar forms of ownership-expanding agricultural organization.

(5) TRADE REFORM

-- Quota Exemption for ESOP-originated Products. -- Products of ESOP companies otherwise subject to U.S. quotas (e.g., sugar, textiles and clothing) should be allowed entry to U.S. markets without regard to quotas.

-- Tariff Rebate for ESOP-originated Products. -- U.S. tariffs collected on products imported from ESOP companies in the region should be partially rebated to the country of origin in return for that country providing export tax relief on such products. Such export relief should be linked to structural changes leading to market-oriented policies, combined with programs designed to promote expanded capital ownership. By both opening our markets and reducing export costs, this approach should encourage companies in the region to make owners of their employees.

> Note: We acknowledge the compliance issues raised by our quota exemption and tariff rebate recommendations (e.g., a non-ESOP company passing title to its products through an ESOP-certified company). Nevertheless, we believe the problem is manageable with adequate review procedures and that the benefits sought (i.e., widespread private property ownership) are sufficiently compelling that the recommendation should be implemented on an experimental basis.

-- Multinational Certification Board. In order to certify regional export goods as originated by an ESOP company, A.I.D. should assist in the establishment of a Multinational Certification Board whose goal it would be to establish standards for certifying companies as "ESOP companies." Because our recommendations in this area include preferential treatment of regional companies structured to promote economic justice through employee ownership, it will be necessary to set standards and establish a review procedure for ensuring that such treatment is limited to those companies periodically certified as complying with those standards. The membership of such Board should include representatives of the private sector, including those representing the interests of business, finance, labor and agriculture.

> Note: In setting those standards, we recommend that the views of U.S. labor representatives receive due consideration. Because the preferred import of goods from the region may have an impact on U.S. jobs, labor representatives' views should be considered in determining what criteria of ownership should suffice in order for imports to be certified as originating from an ESOP company. For example, issues to be considered include what percentage of a company's equity is employee-owned and what aspects of company control accompany such ownership. Other relevant issues include whether there is a democratic organization or free union to negotiate the ESOP's design and whether a labor contract protects workers'

interests in other areas such as wages, bonuses, dividend rights, working conditions, and benefits.

-- Technical Assistance Fund. -- A portion of the tariffs collected on the import of products from ESOP companies in the region should be assigned to an employee ownership technical assistance fund to encourage employee ownership in the originating countries, including technical assistance to recommend infrastructure reforms necessary to implement ESOP-type financing.

-- Trade Credit Programs. Consistent with the President's Commission on Central America, we recommend that trade credit guarantees be made available to nations in the regions. The decline in the availability of trade finance critically affects imports. An A.I.D.-administered Trade Credit Program should be established similar to the one recommended by the Commission but focused on Central American and Caribbean ESOP companies, and with particular sensitivity to the export of U.S. technologies.

-- Reinvigorating the Central American Common Market. Consistent with the President's Commission on Central America, we support a multilateral approach to the economic development of the region and the reinvigoration of the Central American Common Market as a method for reviving intraregional trade and economic activity, though we would hope for a more open trading posture. Continued initiatives should be sought in support of expanded trade, both to improve living standards of the people in the region and also to enable debtor countries to earn foreign exchange.

(6) INVESTMENT INCENTIVES

-- Employee Ownership Investment Insurance. We recommend that PL-480 local currency funds be utilized to underwrite in the region the private sector establishment of an Employee Ownership Investment Insurance Corporation, replacing the Overseas Private Investment Corporation (targeted for privatization). Local currency proceeds from the sale of PL-480 commodities are applied to specified uses as agreed to by the host country and the U.S. in the sales agreement. Using such funds to capitalize such an insurance enterprise would provide a free enterprise, employee-ownership stimulus to regional economic development by insuring (with local currency) U.S. dollar investments in employee-owned enterprises in the region. Such insurance generally provides coverage against political risk, including expropriation and war or strife. We believe that such insurance could be offered at a discount (relative to the coverage available to traditional U.S. investment) due to the decreased likelihood of expropriation (or strife) where investments are structured to create widespread ownership by local residents.

-- Venture Capital. Consistent with the President's Commission on Central America, we recommend the formation of a privately owned venture capital company for Central America and the Caribbean. We recommend that such a company be encouraged to lend to private companies active in the region and that such lending be structured to promote expanded capital ownership and particularly employee ownership.

(7) EDUCATION AND ADVOCACY

-- Conference on Expanded Capital Ownership. -- An A.I.D.-sponsored region-wide conference should be convened on the topic of expanding the base of private property ownership in the region. The conference should be designed to educate leaders in business, academic, political and religious communities on the issues raised in this Report, with a particular emphasis on how employee ownership can advance economic justice in the region.

-- Workers' Conferences on Economic Justice. -- A.I.D.-financed conferences should be convened for workers in the region that, where appropriate, would be cosponsored by workers' organizations in the region. It is essential that workers achieve a greater understanding of the social, economic, legal and political foundations of democracy and free enterprise and their relationship to economic justice. The only way to accomplish that goal is through on-site conferences and sustained education initiatives.

-- Seminars for Professionals. -- A.I.D.-sponsored seminars should be convened in the region for attorneys, bankers, accountants, development personnel, policy administrators, and other professionals. The issues involved are often complex, bridging political science, law, labor relations, banking and other related specialties. Although the concept is simple, implementation involves appropriate, often complex adaptation to local conditions. Professionals are an indispensable element in advancing this concept; their education should be a top priority.

-- Exchange Programs. -- A.I.D. and the U.S. Information Agency should establish an active exchange program for workers and managers in employee-owned companies in the region to visit ESOP companies in the U.S., and vice versa. This people-to-people diplomacy in the name of economic justice is a powerful method for creating and sustaining the message of how workers can create for themselves conditions leading to widespread economic justice.

-- Technical Assistance. -- The technical assistance capacity of U.S. development personnel should be expanded to include a detailed understanding of how traditional development financing can be converted to employee ownership development financing.

-- Conference for Religious Leaders. -- The private sector should be urged to convene an ecumenical conference of religious leaders on social teaching, with a particular focus on applied economic justice. Due to the Catholic Church's endorsement of private ownership and employee ownership, an ecumenical conference of Church leadership (including spiritual leaders from Central America and the Caribbean) would prove a valuable avenue for raising regional awareness of these social issues.

-- Advocacy Process. -- An international advocacy process for economic justice should be established by the Executive branch, including designating a "Decade for Economic Justice" to heighten awareness of the ownership issues addressed in this Report. Potential components of this advocacy process exist in both the public and the private sector -- both in the U.S. and in the region. For example, political leaders in the region should be encouraged to develop comprehensive plans to encourage expanded capital ownership in their nations and should be encouraged to coordinate such plans with other nations in the region. The private sector should become involved in this process by establishing scholar networks and research centers and by convening conferences and workshops. Due to the interdisciplinary nature of this topic, colleges and universities should establish institutes for the study of economic justice to advance programs of research, teaching and implementation of democratic free enterprise in the region.

ADDITIONAL AREAS OF STUDY

> Note: Many promising ideas were proposed by Task Force Members on which we lacked sufficient information to formulate a consensus. Nevertheless, some Members of the Task Force felt that several additional subjects are deserving of serious study. Thus, we recommend additional study of the following subjects:

-- Central American Trading Corporation. -- We recommend a Treasury Department study of the costs and the benefits of creating incentives in the Internal Revenue Code for the establishment of Central American Trading Corporations. Under prior U.S. law, Western Hemisphere Trade Corporations were entitled to an income tax deduction which could reduce their tax rate by as much as 14%. Originally enacted in 1942, this provision (Sections 921 and 922 of the Internal Revenue Code) expired December 31, 1979. We recommend analogous legislation allowing a partial exemption from tax on repatriated earnings from investments in ESOP companies in the region. U.S. bank holding companies, for example, could establish such a corporation and qualify for preferred tax treatment on repatriated earnings from interest on loans to ESOP companies, thereby encouraging such banks to offer ESOP loans at less than the normal market rate of interest. Similarly, U.S. venture capital companies could use such corporations when repatriating taxable profits, provided the profits were generated from ESOP companies in the region.

-- Possessions Tax Credit. -- We recommend a Treasury Department study of the costs and the benefits in amending the Internal Revenue Code provision (Section 936) allowing U.S. corporations a tax credit for U.S. tax paid on U.S. possession source income (from Puerto Rico and the Virgin Islands). The amendment would modify the existing incentive to encourage such corporations to include their employees as stockholders of their employer corporation by requiring that a portion of the credit be utilized to acquire employer stock in an ESOP for possession corporation employees. The study should include the costs and benefits anticipated in extending similar treatment to U.S. corporations throughout the region provided such corporations structure their investments in the region so as to create employee stock ownership.

-- Investment Incentives. We recommend a Treasury Department study of the costs and the benefits of extending to

U.S. investors and lenders incentives for promoting private sector development in the region, particularly development structured to create employee ownership. In particular, we recommend an evaluation of: (a) favorable tax treatment of repatriated earnings from investments in ESOP companies in the region, and (b) permitting U.S. lenders a larger loan loss reserve for loans structured to create employee ownership in companies in the region.

-- Reverse PIK. We recommend a joint A.I.D./U.S.D.A. study of the use of U.S. food surpluses to strengthen the agricultural sector in the region, particularly ESOP estates. Past efforts to make use of U.S. commodity surpluses have been criticized for their price-depressing effect on local agriculture in the assisted countries. Although current A.I.D. policy provides that food aid programs may not introduce disincentives to local food production, it is difficult to design programs to meet this criterion.

Under a 1982 U.S. Department of Agriculture program, U.S. farmers who reduced their crop acreage were paid not in cash but in kind by obtaining a right to proceeds from the sale of government stocks of surplus agricultural commodities. This payment-in-kind (PIK) program was used to reduce government stocks while deterring further production. We recommend a joint A.I.D./U.S.D.A study of the prospects of a "Reverse PIK" program aimed not at idling cropland but at encouraging additional crop production in countries where hunger is endemic.

The "Reverse PIK" proposal would distribute commodity certificates to farmers in a participating country based (perhaps up to a ceiling) on their previous year's crop marketings. Such certificates would entitle each farmer to a share in a commodity reserve donated to their country under the existing authority of Title III of the Foreign Assistance Act ("Food for Development"), and in line with A.I.D.'s February 1983 Policy Determination for Programming Public Law 480 local currency generations.

The host country would determine marketing of the commodity reserve, buying certificates from farmers to enable it to carry out its plan. Thus, any price-depressing effect of additional commodities would be compensated for by cash or by in-kind payments to farmers from the sale of the certificates. The program would be aimed at all farm producers but especially at family farmers, independent cooperatives and employee-owned corporations.

U.S. rice exporters currently make use of an analogous marketing certificate program under Section 603 of the Food Security Act of 1985. When the world price of rice drops below the Commodity Credit Corporation's support price, the Corporation pays exporters the price differential in certificates redeemable in cash or in kind. Although the administrative mechanism in a less developed country would be more complicated, the problems should not be insurmountable.

-- Banking System Reforms. The Task Force received testimony on the advantages of a central banking system which offers a lower discount rate for bank notes representing loans to employee-owned enterprises. It is argued that such a system promises to accelerate the rate of capital formation in such enterprises. This concept was a feature of the U.S. Federal Reserve system when it was created in 1913. It may be possible to design such a system which avoids the risks of inflation and credit allocation raised as objections to earlier proposals.

We recommend that the Department of the Treasury, the Federal Reserve and the Council of Economic Advisers study and report to the Congress on the costs and the benefits of this proposal in light of the capital formation and ownership expansion needs of the region. We also recommend that the study include an analysis of a reinsurance entity to underwrite such ownership-expanding notes discounted by a central bank.

VIII. CONCLUSION

As Martin Luther King, Jr. put it so well:

> "True peace is not merely the absence of some negative force, tension or war, it is the presence of some positive force -- justice, good will, brotherhood."

Reform in this region can wait no longer. For far too long, this Nation has stood by while injustice and degradation created a fertile ground for insurgency and totalitarianism. Yet we have the capacity -- applying the principles we know are sound -- to transform this crisis into an opportunity.

The mandate of the Foreign Assistance Act of 1961 is clear: we are to "create conditions in the world under which free societies can survive and prosper". We have yet to meet that mandate in Central America and the Caribbean.

Our nearby neighbors, vital allies and vulnerable friends need our help now more than ever. We are partly to blame for their crisis. Thus, the responsibility for a solution is partly ours.

Yet it will not be outsiders who eventually decide the future of this promising region -- not us and not others. Principles of democratic self-determination forbid it, and we will not permit it.

The ultimate responsibility lies with the people of the region. They must want the needed economic reforms. If there is a failure, it is a failure of institutional design, a governmental failure to provide institutional support for an economic order designed to evoke the best that people have to offer. Widespread private ownership is the key to a dynamic economy, and the secret to stability and a democratic order.

The failure of collectivism is well-known and well-documented. It fails to deliver the standard of living it promises and it imperils those it pretends to protect. It fails to empower those most in need and usurps power to those who need it least.

Widespread capital ownership, on the other hand, is a development effort that can fairly benefit all, and an effort that all can support -- regardless of their political persuasion.

Secretary of State George Shultz suggests that U.S. foreign policy must "get ahead of history". We agree, and we believe that our recommendations provide a blueprint for positive, enduring change. Employee stock ownership not only increases the constituency for a private property, free enterprise economy, at the same time it undercuts the primary rationale for collectivism (i.e., concentrated private ownership).

But it is the people of the region who must be the ones to propose and implement the required changes. It is commitment to the concept that must come first. That requires education and a willingness to change. That commitment must then be translated into action -- applying the concept through locally appropriate means.

The fundamental struggle of our age is a struggle of ideas -- ideas concerning order, equality and justice. An image that occurs to us is as follows. An economic order in which a relatively small body of persons makes most of the daily economic decisions is likely to resemble a dinosaur, governed by a small brain. By contrast, when the numbers of owners and economic activists is multiplied, the cumulative sum of the practical intelligence embodied in each of them is likely to suffuse the entire economic order with a much higher degree of practical intelligence at every point in the social body.

Since the source of wealth of a nation is intellect and initiative, this more broadly spread and locally diffused intelligence is likely to generate a far more dynamic economy.

In addition to being more dynamic, such an economic order will also be more just. It will respect the dignity and the initiative of every economic agent. It will grant every person access to capital ownership and a role in decision-making.

Part of the effort of our Task Force has been to recover potent traditional ideas and values. But another part has been to discern contemporary, future-oriented devices to do today what, by other means, the founders of this Nation achieved in a different context in the past.

ESOPs are that device; they represent an innovative institutional response to an age-old problem: how government can best encourage widespread economic participation. They offer a new model for transforming new insights into concrete results. The concept is imaginative, the technique proven and sound. Its application requires only the political will to adapt the concept to local conditions.

A New Beginning

With creative and bold responses to the debt crisis, and to the crisis in economic stagnation, these countries can rekindle a fire of renewed hope among their people, a fire of opportunity, and a fire that can light the way for a new beginning in this long-beleagured region.

Our neighbors need our assistance, yet there are fiscal limits to our ability to help. Assistance can no longer mean simply sending aid, though aid will continue to be needed and aid must continue to be sent. U.S. assistance also means sending ideas; it means urging our neighbors to build on ideas that can endure for the future.

What this Report suggests is not a destination but a new direction, a direction that the people in this region must follow if they are to realize their full potential, and a direction that will open to them a whole new array of options, opportunities and outcomes.

Stable democracies require economic justice; that justice will require a process leading to reforms. Yet those needed reforms will take time to be implemented, and time to work. Democracy must be nurtured in those countries where it does not have a long tradition. There are no quick fixes.

Nevertheless, we are heartened by the ascendancy of democracy in the region. And we are secure in our belief that our recommendations are sound because they are based on principles history has proven sound.

As President Reagan reminds us in his oft-quoted Washington's Birthday 1983 speech:

> "By wedding the timeless truths and values Americans have always cherished to the realities of today's world, we have forged the beginnings of a fundamentally new direction in American foreign policy--a policy based on the unashamed, unapologetic explaining of how our priceless free institutions work and describing the social and economic progress they so uniquely foster."

APPENDIX A

THE TASK FORCE MANDATE

The mandate of the Presidential Task Force on Project Economic Justice is found in Section 713 of the International Security and Development Cooperation Act of 1985.

Sec. 713. Use of Employee Stock Ownership Plans in Development Efforts.

(a) Findings. -- The Congress declares that --

(1) employee stock ownership plans in industrial, farming, banking and other enterprises in Central American and the Caribbean can be an important component in achieving United States goals in Central America and the Caribbean; and

(2) employee stock ownership plans should be used as an instrument in financing growth and transfers of equity in the region, in reorganizing state-owned enterprises into viable employee-owned businesses, in expanding political and economic pluralism, and in stregthening democratic institutions in the region.

(b) Plan for Expanded Use of ESOPs. -- The President is urged to develop a plan for the expanded use of employee stock ownership plans in development efforts of the United States in Central America and the Caribbean, with an emphasis on policy and infrastructure changes needed to encourage voluntary employee stock ownership initiatives by multinational corporations and other private sector enterprises which have investments, are considering making new investments, or are interested in management contracts and joint ventures in the region.

(c) Task Force. -- To assist in this effort, there is established a Presidential Task Force on Project Economic Justice (hereinafter in this section referred to as the "Task Force"), which shall consist of individuals appointed by the President who are distinguished leaders of the private sector of the United States, including significant representation of union representatives of workers in successful companies with employee stock ownership plans and of nationally recognized experts in all phases of design, implementation, and operation of employee stock ownership plans. The President shall designate one of the members of the Task Force to serve as Chairman. The Chairman of the Task Force shall appoint a volunteer fund-raising committee, and all the expenses of the Task Force shall be paid without the use of public funds.

(d) Report. -- Not later than December 31, 1985 (subsequently extended), the Task Force shall prepare and transmit to the President and the Congress a report on the expanded use of employee stock ownership plans in the development efforts of the United States in Central America and the Caribbean, including specific recommendations on strategies for using employee stock ownership plans as a means of accelerating the rate of private sector capital formation in Central America and the Caribbean that is systematically linked to expanding ownership and profit-sharing opportunities for all employees.

APPENDIX B

COUNSELORS, FRIENDS AND PATRONS OF THE TASK FORCE

Counselors of the Task Force:

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Senator Russell B. Long

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Senator Steven Symms

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Congressman Phillip M. Crane

Congressional Staff:

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Robert J. Kurz, House Committee on Foreign Affairs, Subcommittee on Western Hemispheric Affairs.

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Richard Bissell, U.S. Agency for International Development.

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James Kelly, National Security Council.

Ambassador Alan Keyes, Assistant Secretary of State for International Organization Affairs.

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Foreign Officials:

President Oscar Arias, Costa Rica.

Former President Luis Alberto Monge, Costa Rica.

Rodrigo Madrigal Nieto, Foreign Minister, Costa Rica.

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Alberto Marten Chavarria, former Finance Minister and founder of the Solidarista Movement, Costa Rica.

Nathaniel McKitterick, Alexandria, Virginia.

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Robert Shaw, President, Allied Plywood Corporation, Alexandria, Virginia.

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PATRONS OF THE TASK FORCE

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Eastern Airlines, Miami, Florida.

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ACKNOWLEDGMENTS

The Task Force Members wish to thank the Members of Congress who made this effort possible. In particular, we thank the sponsors of the enabling legislation -- Congressmen Michael Barnes and Phil Crane, and Senators Richard Lugar, Chris Dodd, Russell Long and Paul Laxalt. Without their interest and their commitment, this Task Force could not have become a reality.

The Task Force extends its heartfelt thanks to the members of the Center for Economic and Social Justice for their inspiration and dedication in conceiving of and advocating the legislation leading to the creation of this Task Force. A particular debt of gratitude is owed to Norman Kurland, founder and President of the Center and Deputy Chairman of the Task Force, for his tireless energy, boundless enthusiasm and total personal commitment to the goal of economic justice through expanded ownership.

We are also grateful to Rabbi Herzel Kranz for his efforts in spearheading the governmental relations effort in Congress and the State Department. In addition, we applaud Joe Recinos for his courage and dedication in working to create models of economic justice in Central America, and particularly for his efforts in helping to create a new model of land reform at La Perla. Thanks also to Bruce Mazzie for serving as the able Executive Director of the Task Force; his efforts made this possible.

The Task Force is also indebted to the Task Force Members of the Drafting Committee: Bob Crane, Steve Hanke, Norman Kurland, John McClaughry and Howard Wiarda. We are also grateful to the many Task Force Members who shared so generously their time and their professional expertise.

In particular, we appreciate the contribution of Professor Steve Hanke of Johns Hopkins University for the analysis he provided of both the privatization issue and the debt for equity swap; the insights into the culture of the region offered by Howard Wiarda, Director of the Hemispheric Studies Center of the American Enterprise Institute; and John McClaughry, President of the Institute for Community and Liberty, for his work on land reform, trade advantages and the Reverse PIK.

We were also fortunate to have many witnesses testify before the Task Force, often travelling great distances at their own expense. We are particularly grateful to them for their commitment, their sacrifice and their helpful suggestions.

Also, a special thanks to Jeffrey R. Gates, counsel to the Senate Finance Committee, for writing the Report.

APPENDIX D

SELECTED READINGS

(1) President Ronald Reagan, Excerpt from an Address to the American Legion Conference, Washington, D.C. (February 22, 1983).

(2) Ambassador J. William Middendorf, II, "Free Enterprise: Key to Latin American Economic Revival" (State Department Current Policy No. 692), February 22, 1985.

(3) Ambassador Alan L. Keyes, "Latin America's Economic Challenge: The Democratic Response" (State Department Current Policy No. 840), April 23, 1986.

(4) "Peasants Fight and Buy Stock to Save Beleagured Plantation," by Robert England, Insight, June 16, 1986.

(5) "U.S. Banks Swap Latin Debt," by Eric N. Berg, The New York Times, September 11, 1986.

Ronald Reagan

Remarks at the Annual Washington Conference of the American Legion
February 22, 1983

(Excerpt)

The world's going through a period of great economic instability, one that poses significant dangers to world security. We and our allies must demonstrate the political courage to cooperate in undertaking the necessary remedies, particularly when these remedies require near-term sacrifices. Never has it been more true that we will all hang separately if we do not hang together.

A key element of our relationship with countries around the world is the economic link that unites us with trading partners. I'll not go into great detail today about the international economic and trade policies. But one point I want to make is that it is and will be our policy to oppose protectionism at home and abroad and to foster the continued pattern of ever freer trade which has served the world so well. And it must also be fair trade.

Closely related to the trade and economic component of our foreign policy is our relationship with the developing world. I'm convinced that the time has come for this country and others to address the problems of the developing nations in a more forthright and less patronizing way. The fact is that massive infusions of foreign aid have proven not only ineffective in stimulating economic development in the Third World; in many cases they've actually been counterproductive. That kind of foreign aid is nothing more than welfare payments on a global scale and is just as ineffectual and degrading.

Our economic assistance must be carefully targeted and must make maximum use of the energy and efforts of the private sector. This philosophy is reflected in the Caribbean Basin Initiative I announced a year ago. Its goal is to combine trade, aid, and incentives for investment into a balanced arrangement that encourages self-help for the people of the Caribbean Basin. Again and again, leaders of these countries have told me that they don't want a handout, only help to improve their own lives by their own efforts.

An important part of such help is exposure to the effective management practices and economic thinking that contribute so much to successful development in the advanced economies like our own. There is no more damaging misconception than the notion that capitalism is an economic system benefiting only the rich. Economic freedom is the world's mightiest engine for abundance and social justice. In our own country it has created more wealth and distributed it more widely among our people than in any other society known to man. Developing countries need to be encouraged to experiment with the growing variety of arrangements for profitsharing and expanded capital ownership that can bring economic betterment to their people.

Current
Policy
No. 692

J. William Middendorf II

Free Enterprise: Key to Latin American Economic Revival

United States Department of State
Bureau of Public Affairs
Washington, D.C.

Following is an address by Ambassador J. William Middendorf II, U.S. Permanent Representative to the Organization of American States (OAS), before the International Conference on Latin America sponsored by the Center for International Relations, San Jose, Costa Rica, February 22, 1985.

It is a pleasure for me to join the illustrious group here in the discussion of the conference theme: "Basic Freedoms in Latin America: Their Past, Present and Future Prospects." The fact that this historic conference is treating both the political and economic aspects of Latin America's situation is indicative of what Secretary of State George P. Shultz stated in his testimony before the Senate Committee on Foreign Relations, entitled "The Future of America Foreign Policy: New Realities and New Ways of Thinking" [Current Policy No. 650], January 31, 1985:

> The United States seeks peace and security; we seek economic progress; we seek to promote freedom, democracy, and human rights. The conventional way of thinking is to treat these as discrete categories of activity. In fact, as we have seen, it is now more and more widely recognized that there is a truly profound connection among them. And this has important implications for the future.

Secretary Shultz expanded on these points by saying:

> . . . it is more and more understood that economic progress is related to a political environment of openness and freedom. It used to be thought in some quarters that socialism was the appropriate model for developing countries because central planning was better able to mobilize and allocate resources in conditions of scarcity. The historical experience of Western Europe and North America, which industrialized in an era of limited government, was not thought to be relevant. Yet the more recent experience of the Third World shows that a dominant government role in developing economies has done more to stifle the natural forces of production and productivity and to distort the efficient allocation of resources. The real engine of growth, in developing as well as industrialized countries, turns out to be the natural dynamism of societies that minimize central planning, open themselves to trade with the world, and give free rein to the talents and efforts and risk-taking and investment decisions of individuals.

Private and State Sector Approaches to Development

It is becoming more and more obvious throughout the hemisphere that without a dynamic free enterprise system, governments can neither stimulate nor sustain economic growth nor diversify their economies to foster economic development. Too often in the past, one heard the truism that first must come a proper infrastructure, but this has led to vastly overblown bureaucracies of government-owned means of production far beyond such basic infrastructure requirements as roads, utilities, and communications. Without an efficient and limited public sector at a manageable economic cost—and without an overall environment conducive to sound investment—privately owned enterprises are unlikely to make their full contribution to development and commerce.

Economic development can no longer be financed externally through massive amounts of foreign aid or foreign borrowing, which were hallmarks of the 1960s and 1970s. Now growth, if it is to come, must begin with each country's climate to attract and keep in country local savings and to attract foreign savings, i.e., having a set of motivations and attitudes that are concretely expressed in the absence of civil conflict, a system of generally accepted and enforceable property rights, and the ability of individuals to enjoy the fruits of their labor without confiscatory systems of taxation or arbitrary seizure of property. If government controls too much of the means of production, as is the case in many of the high-debtor countries in our hemisphere, or if it is inefficient and ineffective or all of the above, or if it pursues policies that significantly distort free-market decisionmaking, the overall prospects for economic development suffer, and international commerce with it. As Secretary Shultz noted in the testimony I cited earlier:

> . . . recent experience has fueled a broad and long-overdue skepticism about statist solutions, central planning, and government directions.
>
> This intellectual shift is partly the product of the extraordinary vigor of the American recovery. The United States has revised its tax system to provide real incentives to work, to save, to invest, to take risks, to be efficient. We have reduced government regulation, intervention, and control. We have opened opportunities for freer competition in transportation, finance, com-

munication, manufacturing, and distribution. Last year's real growth in GNP [gross national product] was the sharpest increase since 1951; inflation was the lowest since 1967. The overall result was the creation of over 7 million new jobs in 2 years.

It is our sincere hope that the factors behind our present success in the United States will be emulated in Latin America because a return to sound economic policies in all of the hemisphere would be mutually beneficial and ultimately create a better standard of living for all. We are all one hemisphere, and what affects the Latin countries affects us all. Clearly, it is in my own country's trading interest, since we are running a $20 billion trade deficit with Latin America, largely as a result of its sharply curtailed imports from us. It is also in the interest of the world's financial institutions which have major loan exposures there. Finally, the ability of the hemisphere to withstand communist adventurism and narco-terrorism depends on sound economic policies for economic recovery.

As one who has worked with the Latins for 30 years, I don't think I can emphasize strongly enough my feeling that Latin America must work toward a better balance between government and free enterprise, which at present is so heavily skewed toward state ownership.

Unfortunately, we seem to be losing the semantic battle for the minds of Latin Americans when we extol the virtues of free enterprise. It is an unfortunate fact that Marxist teachers have infiltrated primary schools in many Latin American countries. From that key position, they take advantage of their young charges' formative years to make them feel that Marxism is the natural state of affairs of any society. Therefore, anyone who opposes it must be against humanity. Foreign private direct investment becomes "economic imperialism" in the Marxist-Leninist lexicon, and this economic imperialism opposes a "new international economic order" which calls for redistribution of the world's wealth. In the Marxist lexicon, we are in a zero-sum game where, if one group is to attain greater wealth (read "the exploiters"), another group must lose it. None of this helps to encourage the much-needed new capital to come in to create the jobs so desperately needed in countries with unemployment levels ranging up to 30% and 40%. In fact, one wonders if Marxists in countries with non-Marxist governments don't hope to keep unemployment levels high, in the hopes that the resulting unrest might help bring them to power.

The trend toward government ownership is clearly seen in Mexico, where, according to trend data, there were only 84 government enterprises in 1972. By 1982, there were 760. During the same period, total government spending as a percentage of gross national product increased from 23% to 46%. By 1982, following the bank nationalization, the great majority of Mexico's major industries were under government control, and the government's share of total capital formation had reached 45%. It is an interesting footnote that in the period 1957–72 (during most of which Dr. Ortiz Mena, now president of the Inter-American Development Bank, was finance minister), Mexico's compound annual rate of GDP [gross domestic product] growth was 6.6%, whereas during the period 1973–83, after the oil boom began, this GDP growth rate averaged 4.7%. Even in Brazil—where in 1979 President Figueiredo created a special ministry with the objectives of (1) selling government-owned enterprises to the private sector, where feasible; (2) restricting the indiscriminate growth of state-owned enterprises; and (3) strengthening the free enterprise system—little progress has been made and the spending of government and its companies approaches 50% of the gross domestic product.

A good sign for positive change is that some of the empirical research which has been conducted on the macroeconomic consequences of the statist "solutions" so long favored in most of Latin America is beginning to receive wider publicity and beginning to affect the thinking of high-level policymakers. Ke-Young Chu and Andrew Feltenstein, in their paper "Relative Price Distortions and Inflation: The Case of Argentina, 1963–76" (International Monetary Fund, *Staff Papers*, Volume 25, September 1978), for example, estimated that, in Argentina, government transfers to cover public enterprises' losses were proportionately 10 times as inflationary as the financing of private enterprises' losses through commercial bank borrowings, primarily because it is assumed that only in the former case are the losses translated into high-powered money through central bank financing of the government deficit. Because the state in Argentina owns the vast majority of its industrial production, and since most of these state-owned industries operate at enormous losses which only government printing presses can make up, the inflation rate there last year approached 700%.

Other equally devastating findings are discussed in *Public Enterprises in Mixed Economies*, by Robert H. Floyd, Clive S. Gray, and R.P. Short:

> For 25 developing countries for which data were available, Short estimates the average (weighted by GDP) overall public deficit, before reduction by government current transfers, at 5.5 percent of GDP during the mid-1970s. He further estimates that the overall deficit in developing countries increased by 2.5 percentage points of GDP between the late 1960s and mid-1970s.
>
> Defining the "budgetary burden" of public enterprises as the residual of government transfers and loans, less loan service payments by the enterprises, Short estimates this burden to average 3.3 percent of GDP for 34 developing countries, compared with a 4.4 percent estimate for the central government's overall budget deficit in these countries. In other words, public enterprises accounted for three-fourths of the central government deficit in the countries in question.

As I have witnessed during the last 30 years, the Latin American countries have suffered ever more stifling bureaucratization of their economies. Government intervention—often buttressed by nationalist and/or socialist ideologies—has resulted in substantial increases in:

- State ownership of economic activities in, for example, extractive industries, manufacturing, financing, and international trade and commerce, far beyond the traditional limits of infrastructure and often accomplished through expropriation without adequate compensation;
- Regulation of private economic activity via money, credit, and exchange controls, licensing systems, and price and wage controls;
- The state's consumption share of gross national product; and
- Government investment expenditure—typically more than half of national capital formation.

Informal Economy

In spite of these trends, which amount to a fight for survival on the part of free enterprise in many parts of Latin America, there are several countertrends. A good example of how the private sector can triumph in spite of governmental restrictions is revealed in the study by Peruvian businessman and economist Hernando de Soto. Because it takes a person 6 months to get government approval to set up a simple business in Peru, an informal economic system has grown to rival the more traditional business. According to de Soto, an informal economy developed and grew despite the tremendous handicap of being illegal.

De Soto's study estimates that the informal economy of Peru now accounts for 90% of Lima's garment industry, 25% of its furniture industry, 60% of housing construction, and even a good part of the automobile and truck industries. The informal Peruvian economy, says the study, has grown so fast that it now accounts for an estimated 60% of the total Peruvian economy, and almost none of this output is counted in the official $22 billion Peruvian gross domestic product. Perhaps most important is the free enterprise system's ability to create jobs: in Peru, an estimated two out of every three jobs are now in the informal sector.

Another factor Mr. de Soto's study points out is that South American economies often have two kinds of private sectors: one that is seriously burdened by excessive regulation and hampered by bureaucratic inefficiency but is officially sanctioned, and a second one which is far more in accord with free market principles but whose existence is barely acknowledged. This difference is made clear by an experiment documented by a study group from Mr. de Soto's Institute for Liberty and Democracy, in which it tried to set up a legal garment firm without easing the way with bribes. According to a *Wall Street Journal* article:

> It took a lawyer and three others 301 days of full-time work, dealing with 11 government agencies to complete the paperwork—which, when laid end-to-end, measured 102 feet. (One of the researchers then tried the same experiment in Tampa, Florida, and finished it in 3½ hours.)

Debt Crisis Management

As we all know, Mexico's extreme illiquidity in August of 1982 precipitated the "debt crisis." The response was a provision of immediate emergency assistance by the U.S. Government and other creditors which led to the development of a rescue package and an IMF [International Monetary Fund] stabilization program. By the spring of 1983, the U.S. Government had developed a strategy designed to deal with the liquidity problems, primarily of the major countries, and to encourage the adoption of needed stabilization measures. What has not been widely understood is that the strategy was not intended to be one of "solution" for the "debt crisis" but rather one of "management" of the crisis with the central purpose of preventing the liquidity problems from developing into a crisis of the entire international financing system.

I think it would be helpful to recall the elements of the U.S. Government strategy for management of the debt crisis as reaffirmed at the Williamsburg summit:

- Credible economic stabilization measures to be undertaken by the individual debtor countries;
- Sustainable economic growth in the OECD [Organization for Economic Cooperation and Development] countries, combined with the maintenance of open markets;
- Support from the IMF and other international financial institutions for economic adjustment; and
- The provision of bridge financing by creditor governments when needed.

I think we can all agree that, up to now, the strategy has succeeded in its central purpose of avoiding the development of a systemic crisis while, at the same time, supporting stabilization efforts in the debtor countries.

Not Yet Out of the Woods

I believe that, with what I have said up to this point, it should be clear that we are not out of the woods. In fact, I would agree with the testimony of Dr. Norman Bailey, former Assistant to the President for International Economic Affairs, before the Subcommittee on Western Hemisphere Affairs of the U.S. House of Representatives on January 29, 1985: ". . . Unfortunately, we have always been in the woods and the path out of them is obscure and easily lost." Agreement with this statement stems not from an attitude of pessimism but rather from an acute recognition that the real world is pregnant with danger—the economists' definition of the real world being "the nominal world minus inflation" notwithstanding.

One is led to this opinion by simple arithmetic. At the end of 1981, the Latin American countries owed approximately $297 billion. At the end of 1984, their external indebtedness amounted to about $371 billion. Despite the high visibility of U.S. banks in this situation, they, nevertheless, only hold one-fourth of this debt, the rest being held by foreign banks, multilateral lending institutions, and governments. After 3 years of crisis and austerity, Latin America, therefore, has increased its indebtedness by about $75 billion on which, by the way, interest is due. About $34 billion of the $75 billion was lent by commercial banks in countries reporting to the Bank for International Settlements, and of the $34 billion, $12.6 billion was lent by U.S. banks. During the period 1981–84, as a result of rescheduling agreements, the debt service ratio—i.e., interest and principle payments as a percentage of foreign exchange earnings (export earnings from goods and services)—of the debtor countries declined from 51.2% to 43.3% of merchandise exports. The ratio of net interest payments to merchandise exports declined somewhat to about 35% in 1984, demonstrating the sensitivity of these economies to both export growth and the changes in world interest rates.

From the point of view of the balance of payments, we have seen Latin America accumulate a $74 billion merchandise trade surplus in the period 1982–84 inclusive, but one which is apparently largely due to tremendous cuts in imports. The most recent estimates indicate that the value of Latin American exports in 1984 was still somewhat below 1981, although export volume showed an increase. During the same 3-year period, debt service payments amounted to $109 billion, and new money and the surplus on the trade balance amounted to about $148 billion, which I read to mean that approximately $39 billion was spent on services, fled the region, or was added to international reserves. Even under optimistic assumptions, the World Bank, the Inter-American Development Bank, and others have concluded that it will be the end of the decade before 1980 prerecession per capita levels of gross domestic product will again be achieved.

Major Uncertainties

There remain a number of major uncertainties which render the global economic environment pregnant with danger. Highest on my list of uncertainties is the debt crisis, where we are by no means out of the woods, despite a recent spate of news articles to the contrary.

One fact which is often overlooked is that the country with the largest external debt in the world is not Brazil or Argentina, it is the United States of America. By the end of June last year, foreigners had lent our treasury $171 billion, which was 15.6% of the total. The foreign debt of the American private sector at the end of June 1984 was estimated to be another $299 billion. It has been estimated that, by the end of May this year, the United States will become a net international debtor for the first time since shortly before World War I. Perhaps, when we bemoan the international "debt crisis," we should remember the words of John Donne: "Ask not for whom the bell tolls, it tolls for thee." Nevertheless, the size and growth of our economy, coupled with positive encouragement of free enterprise by President Reagan's policies, give us grounds for more optimism than in those countries where the parastatal, government intervention model predominates.

With regard to international debt prospects, Assistant Secretary of State for Economic and Business Affairs Richard T. McCormack posed two questions in a speech delivered last November ("The Medium-Term Outlook for the World-Economy," November 22, 1984, Current Policy No. 664):

> **First**, is our [worldwide] present success in reducing these [balance-of-payments] deficits based on a draconian depression of activity . . . that is not sustainable either socially or politically?
>
> **Second**, is the present outlook viable only under the most favorable assumptions and vulnerable to new shocks, such as OECD recession or higher interest rates?

Solutions

I believe these questions remain valid, but for these questions to be given favorable answers in a historical sense, the "debt crisis" must be genuinely resolved. And for a genuinely favorable resolution, the solution must be sought in the reform of the domestic economies of the debtor countries of the hemisphere themselves.

The economic policies necessary to achieve such a reform are relatively easy to summarize. In terms of monetary policy, there must exist positive inflation-adjusted interest rates, realistic exchange rates, economically sound measures to control inflationary pressures, and measures to induce the return of flight capital. In terms of fiscal policy, the governments of our Latin American neighbors must rein in parastatal enterprises—which, for the most part, are deficit-ridden and a major source of inflation—reform their taxation and tax collection systems, and reduce subsidies. Simply put, they must put their own houses in order by creating clear and stable rules of the game for economic activity—clear rules which encourage productive activity by offering a secure climate for investment, both domestic and foreign.

What is needed was succinctly defined by Secretary of State George P. Shultz in his address of December 6, 1984, entitled: "Democracy and the Path to Economic Growth" [Current Policy No. 641].

> I am calling here for the reversal of state ownership and anti-import policies. These policies have placed stifling controls on private agriculture and industry. They have made them dependent on restricted markets. They have built costly protectionist barriers at national frontiers. And they have produced inefficient state enterprises that divert resources from more productive activities.
>
> I call, instead, for a development strategy that works through an open economy, one that rewards initiative, investment, and thrift.

Maintaining an Open Multilateral Trading System

The world economy continues to be involved in a process of adjustment. Simply put, this adjustment involves converging the levels of consumption and production. During the 1970s, many countries lived beyond their means, as reflected in their unsustainable balance-of-payment positions. This situation must now be corrected by either increasing the "means" or living more modestly or both. While this process is not cost free, it is inevitable and has as its ultimate goal the restoration of sustainable noninflationary global economic growth.

A key element in this adjustment process is the maintenance of an open multilateral trading system, which is essential to position the countries of the hemisphere for servicing their external debt and for enabling the export and import sectors of all our economies to make their contributions to domestic economic recovery and growth. I also want to make three further points.

First, protectionism poses a serious threat to the prospects for a medium-term recovery in the world economy. Virtually all economic projections are predicated on open trade. If the assumption about the maintenance of open trading policies is removed, the medium-term outlook for the world economy becomes bleak.

Second, protectionism poses a fundamental threat to the strategy that has fostered development since 1945. International trade is a powerful engine of growth. The experience of the 1960s and 1970s demonstrated that countries with "inward-looking" development strategies—characterized by liberal import regimes, adequate incentives for producers, and the maintenance of realistic exchange rates and prices as well as positive real interest rates—have performed better than countries with "outward-looking" development strategies. Protectionism would threaten the viability of the "outward-looking" strategies with far-reaching consequences for economic efficiency and world trade.

The postwar strategy in many Latin countries of industrializing through import substitution, with its high tariff barriers, has been disappointing. It has fostered dual economies, crippled development in the agricultural sector, resulted in frequent balance-of-payments crises, and contributed to rapid urban growth and political instability. Studies by the OECD and the World Bank both recognize that a substantial relaxation of import restrictions coupled with moves toward appropriate exchange rates are necessary to expand exports and overcome the shortage of foreign exchange that most developing countries (except for some of the oil exporters) seem to face.

It should not come as a surprise that the development strategies based on import substitution have produced such poor results. Import substitution carried to excess is a little like a soccer team that plays only itself. Competition hones the skills and tactics of a soccer team, and, by definition, Brazil could never have won the world soccer championship if it had not been willing to play against foreign teams. Moreover, import substitution policies often also violate the law of comparative advantage since they amount to a *dirigiste* attempt to outguess the marketplace.

For these reasons, developing countries are urged to use great caution in applying import-substitution measures, and such countries are encouraged to focus more actively on the possibilities which exports offer their economies, while striving to keep our markets open to those exports. Since the 1970s, many of the more successful developing countries have been pursuing precisely such a strategy. The economic success stories, such as Taiwan, South Korea, and Singapore, have all adopted policies which emphasize exports as a means of promoting rapid industrialization.

In recent years, these and other countries have shifted toward more liberal trade and payment regimens. Often, these moves have not been as rapid nor as encompassing as we might want. But overall, particularly in East and Southeast Asia, there has been a clear tendency of the more economically progressive and successful countries to move in the direction of liberalizing trade barriers and adopting policies aimed at stimulating exports. The U.S. Mission to the OAS has recently chaired meetings of the ambassadors of the ASEAN [Association of South East Asian Nations] countries with the Andean OAS ambassadors, with the thought that fellow "developing countries" along the Pacific rim might compare notes so that the most successful features of each economic system might be examined.

Third, protectionism is, by definition, "anti-adjustment." It is an administrative way of delaying adjustment to changes in competitive positions stemming from changes in technology and productivity. We must jointly and severally rise to the challenge of structural adjustment rather than run away from it. Renewed growth and the reinvigoration of all our economies demand it.

I would like to note here that the U.S. commitment to an open multilateral trading system remains firm, as was demonstrated yet again in President Reagan's call for a new round of trade negotiations under the GATT [General Agreement on Tariffs and Trade] in his State of the Union Address. It has been contended that no country has an entirely open system. In this imperfect world, however, the United States is still the most open market among the major trading nations, as witnessed by our recent horrendous trade deficits. What is needed in the new trade round is a rededication to work toward perfecting the multilateral trading systems so that opportunities for fair trade can be increased for all participants. By fair, we mean that the goal posts should be the same width for each side. If ours is 20 feet wide and our trading partner wants his to be only 2 feet, we're going to lose a lot of games, and nobody believes that's fair.

Vast Capital Needs

Latin America still needs vast amounts of capital for progress or, indeed, to maintain present living standards. According to an Inter-American Development Bank study, between now and the year 2000, Latin America and the Caribbean will have to create 100 million new jobs, since half of the population is under 20, and birth rates are running at 3% (with Mexico's at 5.8%). The average cost for creating one new job in the region is estimated at $12,500, leading to an approximation that $1.25 trillion in capital will have to be generated in the next 15 years—a figure perhaps twice the amount of all transfers of funds to the hemisphere in the past 15 years, which includes the huge borrowing splurge of the 1970s.

For Latin America, if the decade of the 1960s can be considered as the decade of official aid from the developed countries (including the Alliance for Progress) and the decade of the 1970s as the decade of commercial bank lending (nearly $300 billion), then the decade of the 1980s must be the decade of foreign direct investment. Why? Because, regarding future prospects for official aid, it would be prudent not to expect that support via the International Monetary Fund, the World Bank, and other multilateral lending institutions will be a replacement for private sector lending—and I stress the word replacement—for a number of reasons.

First, the sums needed are simply too large.

Second, virtually all industrialized country governments, including that of the United States, are grappling with the issue of controlling their own government deficits.

Third, it is unlikely that industrialized country central banks will be as accommodating toward these deficits as they were in the 1970s.

Further, it is now widely recognized that Latin America will not receive even remotely the same high level of borrowed capital from the banking systems to which it became accustomed during the 1970s, particularly in light of debt servicing problems on existing loans.

Of course, borrowing is only one of the three types of international monetary transfers—the other two being direct aid, either government-to-government or multilateral, and foreign direct investment. It is obvious to all that foreign direct investment, if it can be gotten, has the advantage over the other two of providing management knowhow, technical skills, and technology transfers resulting in a high degree of export potential and, therefore, of being a source for valuable foreign exchange.

In order to attract this scarce and needed capital—in competition with other countries also aggressively seeking it, such as members of the OECD and the Pacific Basin countries—the climate for investment must be much more conducive in Latin America. The best test of this is found where local investors themselves find it attractive to reinvest their own funds and where there is no capital flight.

Capital Flight

Just at the time when Latin America needs so much more new capital, there has been the reverse trend of hemorrhaging capital outflows through flight capital.

Henry C. Wallich, member of the Board of Governors of the U.S. Federal Reserve System, in a recent incisive paper entitled, "Why is Net International Investment So Small?," made the following comments:

> There seems little doubt that substantial capital exports have taken place from the countries that were borrowing. Unfortunately, one must assume that in large part this represents capital flight. The assets, thus acquired, probably do not produce income and taxes from the capital-exporting country, and probably are not available to strengthen its foreign exchange position and its economy generally. In other words, given economic and political conditions of the capital-exporting countries, these foreign assets are not likely to play the same constructive role for the home countries that capital exports from developed countries have ordinarily played. To be sure, changes in the politics and economic policies of the respective countries, giving adequate protection to the owners of capital and a positive real return on domestic assets, may change that situation. They may convert what today is flight capital into an important resource for the country.

The irony of this situation is that, in fact, Latin Americans own plenty of capital. It is just not located inside Latin America—the amounts in Swiss and Miami banks and in San Diego condominiums probably far exceed the liquid funds in the home countries. Indeed, generations of Latins claim they have been brought up to get their money out into "safer" havens as soon as they make it. This trend has to be reversed if Latin America is to grow at all.

Henry Wallich further states:

> For the [world's] eight largest [non-U.S.] borrowers over the years 1974–1982, . . . calculation[s] show an increase in debt (equity and direct investment included) of $317 billion, while the current account deficit adjusted for changes in official reserves, amounts to only $207 billion. Thus, there seems to have been a capital outflow of $110 billion. The degree to which borrowing financed this capital outflow differs among countries. For Brazil, only 12 percent of the inflow was compensated by outflows; for Mexico, 45 percent; for Venezuela, almost the entire inflow was absorbed into outflows.

Nearly 100% capital flight? Clearly, with a change in domestic policies away from the parastatal-import substitution approach to economic development, there is reason to believe that this money could be attracted back to Latin America, which would, of course, be a major contribution to a lasting solution of the debt crisis and job creation.

In his February 8, 1985, address, "The International Debt Situation in an American View: Borrowing Countries and Lending Banks," Henry C. Wallich states further:

> Unfortunately, one must assume that a large part of the borrowed money went for consumption, in the form of excessive im-

ports of high-priced oil and various consumer goods. Frequently this spending was financed through government budget deficits, caused by subsidies and other unproductive expenditures, including purchase of weapons. A worldwide shift from negative real interest rates to significantly positive real rates, and the consequent rise in debt service, also used up some of the funds borrowed.

In adding up incremental investment, capital flight, and increased outlays (in nominal terms) for consumption, there is a danger of over-explaining the absorption of borrowed funds. The best judgment seems to be that the borrowing countries experienced a substantial increase in their income and debt-carrying capacity and that these benefits of added investment could be enhanced in future, if measures are taken to induce flight capital to return.

It may be that this audience will find itself closer to the Henry Wallich school of thought on flight capital than the point of view expressed to me recently by a prominent Argentine economist that, at least in the Argentine case, the term "flight capital" was misleading and that more accurate terminology would be "portfolio diversification."

Other Solutions

While it is relatively easy to diagnose the ills resulting from excessive governmental involvement in our economies, it is far more difficult to find constructive solutions. In many of the countries of our hemisphere, the state-owned sector is so large, relative to the domestically owned pool of private capital, that a simple sale of those state enterprises that are running the largest deficits would be difficult (who would want to buy them?), and attracting foreign capital for this purpose also would be difficult, for well-known political reasons. Indeed, there are still many in Latin America who would view selling off parastatals to "transnationals" in the same way as they view foreign direct investment—selling off their "national patrimony." There have been ideas floated that some debt could be exchanged for equity in the parastatals. Brazil considered this for a time, but may have given up on the idea, at least for the present.

However, I believe that there are other potential and feasible solutions over the long term, for, as President Reagan has said, "Developing countries need to be encouraged to experiment with the growing variety of arrangements for profit-sharing and expanded capital ownership that can bring economic betterment to their people." One such method of expanded capital ownership is advocated by Dr. Louis O. Kelso and Patricia Hetter in their book, *La Economia de los Dos Factores: Un Tercer Camino.* The plan involves employee stock ownership plans, which are nothing less than having the employees of the corporation also become the stockholders, i.e., owners. There are now approximately 8,000 corporations in the United States using these plans, and the experience with them has been quite good—productivity goes up, worker income is linked to profitability, etc. While they are only one form of expanded capital ownership, the point I am trying to make is that there are alternatives to state ownership, and they should be explored and adapted to the conditions existing in each of the countries of our hemisphere. Indeed, Costa Rica and Guatemala have rapidly increasing employee stock ownership plans.

But the benefits of expanded capital ownership go far beyond the economic, as has recently been demonstrated in the La Perla project in Guatemala. La Perla is a 9,000-acre coffee and cardamom plantation in northern Guatemala. It has 500 full-time employees, about 1,500 family members, and approximately 4,000 other people dependent on the economy of the estate. In September 1984, the farm's owners set up a trust in which they allocated 40% of the stock. The stock will be paid for out of the future profits of the farm, but upon the signing, full voting rights were passed through to an employee association.

Early this year, 120 insurgents attacked the estate and actually took control of the center. The insurgents, however, were then attacked and driven off the farm by 200 armed workers, and a number of workers and insurgents were killed. In the week following the attack, the estate's 300 unarmed worker-owners petitioned the owners for additional rifles to defend against future insurgent attacks and volunteered to help pay for them through a payroll deduction plan. As Joseph Recinos (a representative of the Solidarity Union of Guatemala, a movement aimed at expanded capital ownership as a means of economic and social reform), has stated:

> We can more clearly see what the true message of ownership and of vested interest in the free enterprise system means in viewing the La Perla model. There is no greater significance to the concept of defending the free enterprise system than a worker laying down his life to defend the company in which he is co-owner.
>
> If we want to prevent further Nicaraguas or El Salvadors, the American Government must address the problem of economic and social justice in Central America. Promoting broad capital ownership as an alternative to Marxist philosophy in Latin America, if they are actively pushed now as foreign policy objectives, can go a long way in giving people a vested interest in protecting the free-enterprise system.

Norman Kurland, one of the founders of the Center for Economic and Social Justice (a group whose goal is the promotion of employee stock ownership plans) stated in a *Washington Times* interview last September:

> To win over Marxism-Leninism you have to go beyond the military. Of course, you have to be militarily strong. On the other hand, there is an ideological battle. Marx and Engels stated that you could sum up the entire philosophy of communism in a single sentence: Abolish private property.
>
> The entire case of Marxism-Leninism disappears if we prove to the world that private property is essential for providing economic and social justice, and for providing human dignity to people in the Third World.
>
> Marx was wrong. However, we cannot simply attack him on the basis of the problems he was focusing on but rather on the basis of the means that he would use. The solution is not to make enemies of the owners but to make owners out of the nonowners.

Foreign Direct Investment

Over the past 4 years, it has been made clear to me, in visits to every country in the hemisphere, that private foreign direct investment can play the key role in future trade and commerce. Indeed, it is the catalyst for economic development and international economic integration through the world trading system, as well as being perhaps the only remaining source of capital, technology, and management know-how on a scale needed for economic survival.

It seems intuitively obvious that the high-debtor countries of our hemisphere must take strong steps to court foreign direct investment as the most attractive alternative to new bank financing. Foreign direct investment has the advantage of not requiring fixed interest payments. Earnings are repatriated only if the investment is profitable. Local enterprises are able to sell to multinational companies and often gain access to new markets and distribution channels, both nationally and internationally. Finally, and most importantly, foreign direct investment creates real jobs as opposed to state-funded make-work jobs.

Unfortunately, the trend has been in the other direction. In 1950, U.S. direct investment in Latin America accounted for nearly 50% of the total U.S. investment overseas. By 1970, this figure had dropped 17% in Latin America and was 3% in Asia and the Pacific. At the end of 1982, the stock of U.S. direct investment was down 15% in Latin America and had doubled to 6% in Asia and the Pacific. In a time when total flows of U.S. foreign investment were declining, flows to the Far East rose sharply.

I am encouraged by the increasing recognition of the importance of internal factors for the revitalization of Latin American economies now being expressed by prominent Latin Americans. Brazilian Senator and former Planning and Finance Minister Roberto Campos stated the issues succinctly in his speech, "The New Demonology": "The United States has become the magnet for European and Japanese investors precisely because they have two things we lack—a strong currency and stable rules of the game."

The prominent Argentine economist, Marcos Victorica, has also addressed these issues. Mr. Victorica estimates that Argentine capital abroad amounts to about $27 billion and that much of this capital left the country during the early 1980s, despite the fact that real interest rates in Argentina amounted to about 20%—double U.S. real interest rates—and he has ascribed these developments to a lack of confidence. Regarding policies affecting foreign direct investment, Mr. Victorica has noted one of the key difficulties (such as exchange controls): "No one will come in [to invest] where a way out is forbidden."

Argentine Presidential Secretary General German Lopez recently spotlighted this problem in comments reported on the Buenos Aires government radio network, when he stated that, "President Alfonsin is determined to modernize the country and that, to this end, there is no alternative but to resort to foreign capital so that the investments that will contribute to Argentine development are made." The only way to make up for the time lost, Lopez states, is to urgently attract investments, adding that:

> I want to say that the past 10 years have been very dramatic for Argentina and that I consider that in reviewing, in weighing our responsibilities, we are sometimes unfair. We have made mistake after mistake for virtually 50 years. We have practiced a sort of political cannibalism destroying each other. [Therefore] President Alfonsin is firmly determined to modernize Argentina in order to put it at the level of efficiency asked by public opinion.

Recently, the newly elected President of Uruguay, Julio Maria Sanguinetti, said that "those of us who historically defended a greater role for the State now have to say that we must reestablish equilibrium and that as a result our direction will be to reduce to the maximum extent expenditures of the State, and to encourage as much as we can private production."

I am pleased to see that some leaders of Andean Pact countries are taking a new look at their investment policies. During his recent visit to the United States, President Belisario Betancur of Colombia addressed a number of our business leaders on April 2. He said:

> The Latin American experience of the past 10 years shows that self-sustained development is not stable if it is mainly dependent on a growing foreign debt. The development effort should be based on domestic savings and productive investment, supplemented by foreign loans. . . . From these considerations you may well understand why I said that . . . it was better to have more partners and fewer creditors.
>
> We have made a proposal to the member countries of the Cartagena agreement to modify Decision 24 providing more flexible terms in keeping with foreign investment needs. The idea is to allow new investment in certain areas to be 100% foreign when the recipient country decides that its development needs so warrant.

It is now generally recognized by potential investors that one of the difficult impediments to foreign investment in Latin America has been the Calvo Doctrine. Many countries in the hemisphere incorporate the doctrine and other restrictions in their constitutions, in other laws, or in multilateral agreements, such as the Andean Pact decision 24. With regard to decision 24, I am pleased to note that there is increasing recognition on the part of member governments of the pact that more flexibility is required by member governments on foreign investment policies. This was one of the principal causes for Chile's withdrawal from the pact in 1976. Moreover, under the dynamic leadership of Craig Nalen, the Overseas Private Investment Corporation (OPIC) recently signed agreements with Colombia and Ecuador. These agreements were the result of countless hours of patient and persistent negotiation between Lorin S. Weisenfeld, Assistant General Counsel of OPIC, and various officials of Colombia and Ecuador, and it is to be hoped that other Andean Pact countries will follow.

While the United States rejects the Calvo Doctrine on the theory that the investor's government has an independent interest in fair treatment for its nationals, the Calvo Doctrine has unquestionably had a negative impact on the ability of foreign governments to provide diplomatic protection in the event of a miscarriage of justice. This doctrine had its origin in the early part of this century as a reaction to perceived abuses of protection by the United States and European powers on behalf of their investors and traders in the last century.

In countries that subscribe to the Calvo Doctrine, the foreign investor is considered to have agreed that all disputes—including those relating to expropriation—will be definitively resolved through local legal processes, and to have renounced any right to invoke the diplomatic protection of his home government in the event those processes give rise to a miscarriage of justice following expropriation. In the 1960s and 1970s, there were over 300 major expropriations in the hemisphere (excluding the $1.85 billion in thousands of unsettled expropriation claims of former U.S. investors in Cuba) where compensation was not arrived at through international arbitration and was often grossly inadequate or delayed in many cases. Corporate boardrooms around the world have long corporate memories, and as Cicero said to Atticus, "It is the right given to any man to err, but to no one, unless he is a fool, to persist in."

Another negative consequence of this policy is that potential U.S. investors are constrained from obtaining OPIC insurance coverage because of requirements limiting possible litigation to local courts, and of a prohibition of direct subrogation.

The United States has long favored an open international investment system. A major U.S. goal in the 1980s is to reverse the trend toward government-induced distortions in the investment process through international understandings and voluntary guidelines leading to a more open investment climate in which investment flows are able to respond to market forces.

Recent Positive Steps

As part of continuing efforts in this area, the U.S. delegation to the 14th annual General Assembly of the OAS introduced a resolution entitled "Promoting Ecomonic Justice Through Strengthening Private Direct and Indirect Investment in Latin America and the Caribbean." The operative part of the resolution reads as follows:

> To instruct the General Secretariat to conduct a study of requirements necessary for the creation of economic and regulatory environments conducive to attracting and fostering direct and indirect investment in the countries of Latin America and the Caribbean. This study should identify the various private and official, multilateral and national agencies involved in the promotion of investment while also considering and evaluating

the growing variety of arrangements for profit-sharing and expanded capital ownership now available for the promotion of economic justice with a view to identifying operational mechanisms and sources of funding for cooperative efforts with said agencies that may be implemented in the framework of the OAS.

While the resolution did not come to a formal vote, the U.S. delegation was able to secure agreement, as noted in the rapporteur's report, that these topics would be taken up by the Permanent Executive Committee of the Inter-American Economic and Social Committee of the OAS in 1985. I view this agreement as a major achievement and a major step forward for Latin America, not because U.S., Japanese, or other OECD investors have any shortage of opportunities to invest at home or abroad, but because of the potential benefits to our own hemisphere that foreign direct investment brings in terms of improving standards of living.

The Reagan Administration is actively pursuing two programs in Central and South America which aim to improve the investment climate: the Caribbean Basin Initiative (CBI) and bilateral investment treaties. The CBI, by granting various products access to the U.S. market, provides important incentives for the private sector. Bilateral investment treaties offer important protection for investments. The intent of both programs is to stimulate additional foreign investment.

As you know, the key elements of the bilateral investment treaties are:

- New and existing investment to be granted national treatment or most-favored-nation treatment, whichever is more favorable, but both sides are allowed to list exceptions to national treatment in specified sectors of economic activity;
- Conditions for expropriation which accord with international law principles, including payment of prompt, adequate, and effective compensation;
- Unrestricted transfer of capital, returns, compensation, and other payments into and out of the host country; and
- Dispute settlement procedures involving third-party arbitration both for disputes between the host country and a national or company of the other country and disputes arising between the governments.

While these treaties are generally reciprocal in their provisions, the major inducement for the developing country is the assurances such a treaty offers a foreign investor.

As a result of the leadership of Bill Brock of USTR [U.S. Trade Representative], several countries have negotiated such agreements with us. In this hemisphere, we signed treaties with Panama in 1982 and with Haiti in December 1983. We are also very close to agreement with Costa Rica, and we have had negotiations with Honduras and El Salvador.

While the treaties mentioned above are laudable achievements for the parties concerned, in all candor, much remains to be done for our hemisphere to realize its full economic potential.

Conclusion

I titled my remarks today, "Free Enterprise: Key to Latin American Economic Revival." I would like to end on a positive note. Simon Bolivar said 150 years ago that Bolivia was a beggar sitting on a throne of gold. In an expanded sense, this is still true for resource-rich but extremely poor Bolivia and for several other countries in Latin America. The hemisphere is so rich in natural resources and populated by men and women of such talent and good will that there is no reason that our hemisphere cannot have a bright economic future. All that is needed is for the economic and political leadership of Latin America to reembrace the wisdom of their own founding fathers, Simon Bolivar and San Martin. These men of vision, along with our own Founding Fathers, were swept up with the liberalizing writings of Locke, Rousseau, Hume, and Adam Smith, which called for a separation of political and economic power and emphasized the sanctity of private property. Similar wisdom can be found in the words of Muhammad Ibn Khaldoun, the 14th century Arab jurist, historian, and statesman: "When incentive to acquire and obtain property is gone, people no longer make efforts to acquire any. This leads to destruction and ruin of civilization." ■

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Latin America's Economic Challenge: The Democratic Response

United States Department of State
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Following is an address by Ambassador Alan L. Keyes, Assistant Secretary for International Organization Affairs and chairman of the U.S. delegation, before the 21st plenary of the Economic Commission for Latin America, Mexico City, Mexico, April 23, 1986.

The past 10 years have witnessed the triumph of democracy in Latin America. A decade ago, only 10 Latin American countries had freely elected governments. Today, there are 25. Currently, over 90% of the people of Latin America and the Caribbean live under democratic political systems. All over the region the people have declared their passion for liberty. They are determined to have governments that respect the inviolable dignity of the human person, governments whose form and composition are commensurate with the innate human capacity for self-government. Thanks to the rising tide of political democracy, Latin America and the Caribbean are today regions of dynamic hope, stages upon which the drama of mankind's best aspirations are each day being played out. It is a drama of pride and rising self-confidence, a drama of leaders who understand the importance of justice for all the people and of people who accept and respect the need for highly motivated leadership.

In place of the bitter resentments and antagonism that for decades have divided the governed and the governing, a spirit of reconciliation has arisen. Within and among the countries of Latin America and the Caribbean, people of different classes, backgrounds, and conditions are becoming reconciled to their dependence upon one another, reconciled to the need to respect in one another the dignity, capacity, and aspirations of their common humanity. In this reciprocal confidence between and among the people and their duly elected leaders, we can see the outline of a new social contract taking shape in countries throughout the region. It is a new contract of freedom, in which the right of the people to choose their government is respected. It is a new contract of equity, in which the incentives and rewards of leadership and labor are granted without resentment. It is a new contract of justice, in which the good of the whole community is acknowledged to be the responsibility of all and the exclusive possession of no one group, class, or division of society.

The rising tide of democratic freedom in Latin America flows toward a future of great promise. Yet in the minds of many, the prospect of that future is overshadowed by the realities of the present economic situation. Latin America may well be going through the most trying economic period in its history. The 1982–83 recession required painful adjustments. Despite these difficult efforts, economic growth remains slow. The external debt of many Latin American countries remains a serious problem.

This problem has been in part the result of inappropriate domestic economic policies, which have motivated extensive capital flight. Many observers believe that at least $100 billion has left Latin America since 1980. Much of the region's borrowing did not finance productive investment. The same policies that led to this financial hemorrhage generated the large demand for foreign credit in the first place. They included overvalued exchange rates, low domestic real interest rates, low confidence in the security of domestic investment and in the legal protection afforded to personal property, restrictions on labor market mobility, restrictions on the international flow of goods and services, the burgeoning of public sector enterprises, and overly expansive fiscal policies.

Many have expressed fears that favorable democratic trends in Latin America may be undone by instability resulting from the economic situation. These observers suggest that persistent net outflows of capital could deprive Latin American countries of desperately needed resources for investment. They argue that stagnating economies could give rise to skyrocketing unemployment, shortages of basic goods, and uncontrollable inflation. According to this view, masses of people without work or hope, their industry negated by adverse trends, their savings consumed by ever-increasing prices, could become the kindling for ugly social conflagrations.

There is concern that, inflamed by economic deprivation, the deep divisions and rivalries between classes and groups might erupt into conflict, fueled and armed by forces unfriendly to democratic freedom. These observers believe that military dictatorships of the right or the left could stride forward, promising to mend shattered peace and order, or else realize, through grim regimentation, desperate dreams of egalitarian social progress.

The specter of such a future inspires deep anxiety in the minds of many sincere friends of democratic freedom throughout Latin America. They believe that to preserve democracy, governments must find means to resolve the current economic difficulties. My delegation believes, however, that the same democratic principles which have restored hope and energy to the politics of Latin America can bring growth and vigor to its economies. The same confident partnership between free peoples and motivated leaders can unlock the latent potential of its population. The new social contract of freedom, equity, and justice can assure the foundations of a lasting but dynamic economic equilibrium.

The New Contract of Freedom

In the economic as in the political sphere, choice is the basis of democratic freedom. Choice implies competition among alternative conceptions, products, and tastes. It implies a system in which these ingredients can interact without undue interference to determine the society's pattern of production, distribution, and consumption. Competition and a free market for economic transactions are, thus, the implied economic bases of the new contract of freedom.

The experience of many countries, both industrial and developing, has confirmed that emphasis on these institutions contributes to economic growth. Nations that have avoided policies which interfere with the market test of competition have generally enjoyed better economic performance. The competitive pressure of the market is the force that leads to greater efficiency and accelerates economic growth. The market cannot achieve this efficiency without policies that allow the price system, including appropriate exchange rates, to allocate resources efficiently. One recent study concluded that a major impediment to investment in Latin America is widespread price controls. Though often viewed as a way to protect the purchasing power of the poor, usually just the opposite occurs. Price controls inhibit investment, resulting in reduced production, shortages, and, eventually, higher prices than would have prevailed without the controls.

An unfettered price system provides the framework for rational economic choices by producers and consumers alike. To protect this framework, fiscal discipline is essential, as well as efforts to control inflation. Fiscal deficits are financed either by inflationary money creation or by heavy borrowing. A large deficit can temporarily boost the economy, but the high soon wanes, leaving only high inflation. High inflation eventually brings low growth due to massive economic disruption.

Where the framework for choice is well established, the stage is set for healthy competition. Such competition cannot take place, however, where individuals or enterprises are mere appendages of state power or where economies are walled in by protectionist measures from reciprocal interaction with the outside world. Privatization and an open trading system are the keys to economically effective competition. Privatization is a creative process designed to shift whole areas of economic activity from the politically dominated and generally unprofitable state sector to the consumer-dominated, profit-oriented private sector. It requires that governments open inefficient state monopolies to private competition. It requires, as well, relief from the crushing burden of excessive economic restrictions.

The existence of a large informal or underground economy in many, if not all, Latin American countries offers clear evidence of the inhibiting effects of artificially imposed restrictions. Without governmental limits on competitive economic activity, economies expand due to the inherent dynamism of private enterprise and entrepreneurship. In some countries, uninhibited informal sectors may account for well over half of the actual GNP [gross national product]. The aim should be to bring the entire economy into line with the dynamism of these informal sectors.

After World War II, many Latin American countries adopted an import substitution policy which led them to the establishment of a number of inefficient industries unable to compete on the world market. By contrast, the developing Asian countries emphasized export industries. Over the years, Latin America largely exhausted its prospects for import substitution while the Asian countries penetrated markets throughout the world. Asian exports boomed, enabling them to import as well, thus generating high growth. Moreover, much of their expansion was financed internally with relatively less recourse to external borrowing. Experience, therefore, shows that countries that have shifted from import substitution to more open policies have experienced better economic performance. This is particularly true for smaller countries that concentrate on a limited range of products in which they can achieve economies of scale.

Import substitution policies result in costly inefficiencies and useless, uncompetitive industries that are a net drag on the economy. They also result in higher prices for both imported and domestically produced goods, lower real incomes, and a lower standard of living for the people. The monopoly elements that are created in the process reduce production, boost prices, and make some people extremely rich at the expense of the rest.

Increased and diversified exports are of great importance to Latin America's economic future. Exclusive reliance on traditional commodity exports is unrealistic. To compete in world markets, the region's industries require the best and latest know-how, in the broadest sense. Yet these capabilities will not come in the face of restrictive import and foreign investment regimes. Unless a stable and predictable environment is created to attract investors, both foreign and domestic, competition in the international arena will be difficult. I hope that we can count on the support of your governments for the early initiation of a new, broad round of multilateral trade negotiations, which has as its purpose the enhancement of an open international trading system. The United States looks upon the countries of Latin America and the Caribbean as natural allies in the effort to break down further the barriers to exports which exist in the regimes of our trading partners.

The New Contract of Equity

The new contract of freedom promotes the scope for choice and competition essential for economic dynamism. But without a sense of equity, societies cannot achieve the stability needed to sustain this dynamism. In economics as in politics, equity is based upon mutual respect. The people must respect the need for incentives, without which economic leadership and initiative will falter. Popular participation and popular consumption, however, are vital to the success of a modern economy. Economic leaders, therefore, must respect the right of the people to rewards commensurate with their indispensable contribution to the economy's success. The interdependence of incentives and leadership, of rewards and popular participation, is, therefore, the basis of the new contract of equity.

The new contract of equity means an end to the compulsory redistribution of wealth by the power of the state. Economics need not be a zero-sum game. Respect for equity encourages appropriate incentives for economic leadership. Entrepreneurial activity ensures increasing opportunities for participation in the economy through rewarding employment. As a result, the allocation of goods in the society results from a dynamic process, an upward spiral of incentives and opportunity, participation and reward.

Nowhere is this more clearly demonstrated than in the experiments in expanded capital ownership taking place in some parts of Latin America. Through profit-sharing in the form of stock distribution, employees in industrial and agricultural enterprises gain a stake in the success of their economic system, which in turn leads to increased productivity. Through expanded capital ownership schemes, economic leaders break down rigid patterns of economic activity which restrict ownership to a small group or class of the people. But they do so in a way that respects and strengthens the principle of ownership, of private property and individual responsibility. Instead of narrowing the economy's base of support to an unstable few or concentrating its power unproductively in the state bureaucracy, this apporach broadens the economic foundations and diffuses economic power throughout the system.

We do not mean to suggest that the expanded capital ownership approach is a universally applicable one. However, it illustrates the principles and concepts through which democracy can build a firm social foundation for economic cooperation and growth. Ownership need not be a reality confined to the wealthy few or an all-powerful state. Through the operation of democratic principles, it can become an experience universally shared and understood.

The New Contract of Justice

The principles of democracy now advancing in Latin America and the Caribbean clearly offer practical foundations for addressing the region's current economic problems. Above all, however, they offer the paradigm for economic cooperation on a democratic scale. By this measure, successful economies must transcend sharp distinctions between beneficiaries and laborers, owners and workers, leaders and common folk. As individuals, all experience the benefits. As individuals, all take responsibility for success or failure. Governments need not be all-powerful mediators among irreconcilably hostile classes or groups. Freed from their fear of one another, people can live and work together with no need of an obtrusive government power to overawe their violent inclinations. Such are the fruits and the future of democracy. Such is the meaning of the democratic contract of justice.

It is especially this aspect of the democratic revolution in Latin America which provides a principle for the relations among states in the region, and especially for the relations between them and the United States. The future of our hemisphere is a shared promise and a shared responsibility. We shall all gain or lose by the strength of our mutual trust and cooperation.

Nowhere is this more clearly seen than in our approach to the difficult problem of Latin America's debt burden. Several Latin countries have made considerable efforts in the past several years to take the necessary stabilization measures to reduce their external imbalances, improve their export capabilities, and move their fiscal positions more into balance. Continued efforts are needed, however, to reduce domestic imbalances and inflation and to put in place structural reforms to improve prospects for future growth. One of the most important developments during the past year has been the emergence of broad agreement among creditor and debtor nations that improved growth in the context of further economic adjustment in the debtor nations is essential to any resolution of the debt problem.

The "Program for Sustained Growth" put foward by [Treasury] Secretary Baker in October 1985 offers a framework for cooperative action to encourage and support debtors' efforts to improve their growth prospects. This initiative aims to encourage determined efforts by debtor countries to adopt growth-oriented macroeconomic and structural reform policies which will permit them to take full advantage of improved opportunities in global markets, to strengthen the domestic foundations for growth in the longer term, and to provide for continuing orderly servicing of their debts. Of key importance will be policies designed to enhance domestic savings, encourage increased private investment, and stimulate the return of flight capital. The repatriation of flight capital would greatly reduce the need for new external borrowing.

In the spirit of Latin America's new social contract of democracy, the United States is doing its part through stronger growth, open markets, sounder fiscal policies, and recent trends toward lower interest rates. Many Latin American governments have begun to create a more positive climate for private investment, and I believe investors will respond to these improved conditions. These governments are shifting away from an antibusiness attitude, reducing excessive control and regulation, limiting the scope of state-owned enterprises, creating tax incentives for investment, and adopting growth strategies that emphasize equity financing rather than debt accumulation. These are policies that provide the basis for a partnership of freedom, equity, and justice between governments and the private sector, between the United States and the countries of Latin America and the Caribbean. On the basis of such a partnership, we may all face the future without fear, secure in the belief that through the principles of democracy we will forge lasting solutions to today's economic challenges. ■

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Peasants Fight and Buy Stock to Save Beleaguered Plantation

JOSEPH RECINOS

La Perla plantation militia boasts it has never lost a battle to guerrillas.

SUMMARY: After Marxist guerrillas killed the patriarch of a plantation, his sons struck back, selling stock to their workers and giving them a stake in the plantation's future. Now the Reagan administration wants to see if the rest of Latin America can profit from the idea.

In Guatemala, in the remote Ixil Triangle region of the nation's highlands, an 11,000-acre coffee bean plantation called La Perla (The Pearl) seems to be winning an economic, military and ideological war with Marxist guerrillas.

The idea that drives La Perla, the only plantation left in the Ixil area, is worker stock ownership. Since December 1984 the plantation has been 40 percent owned by its 500 mostly Ixchel Indian laborers.

It is no less than a competing model of economic and social justice for the region. It promotes the redistribution of wealth without seizing the property of the rich and without destroying the notion of private property. It is a vision in direct competition with the collectivist promises of the Marxists of Central America.

Social justice with private property rights intact? "Yes, yes, yes," says the head of La Perla, 37-year-old Enrique Arenas Menes. He has struggled since 1975 to save his family's plantation from being overrun by the Guerrilla Force of the Poor, Guatemala's largest antigovernment guerrilla army. According to Arenas, the peasant owners have kept the plantation going even though 25 to 30 of them have died in battles with the guerrillas since 1975.

President Reagan is one of the staunchest supporters of expanding workers' ownership of the firms that employ them. An owner, in the view of Reagan and others, has a sense of commitment that someone who is only an employee may lack. In impoverished areas of Central America, worker ownership may draw peasants away from subsistence farming into more economically productive ventures — and provide them with a stake in the economic system that will diminish the appeal of Marxist rhetoric.

A commission Reagan appointed a year ago to examine the potential of the idea for Central America, the Presidential Task Force on Project Economic Justice, will make its recommendations next month (see box, Page 26). No less an unyielding critic of the administration's Central American policy than Rep. Michael D. Barnes, a Maryland Democrat, says that the "La Perla project could produce a peaceful answer to the agrarian problems of Guatemala, and do so in a swift fashion."

For La Perla, the road to worker ownership has not been an easy one. Grave doubts about the future of the plantation began to emerge in 1975. A heavily armed band from the Guerrilla Force of the Poor came to La Perla and assassinated Enrique Arenas's father, Jose Luis Arenas Barrera, a Ladino from Guatemala City who first opened the fertile jungles of Ixil to coffee bean cultivation in 1941. According to Enrique Arenas, the guerrillas, who had operated in the area since about 1970 without violence, were seeking to spark a peasant revolt. Guerrilla attacks on neighboring plantations increased thereafter.

Besides the violence, the guerrillas waged a war of promises. Arenas says they told the campesinos they could own the land and become rich. "Campesinos who joined the guerrilla forces were promised Mercedes," says Jose Orive, a spokesman for the Guatemalan government who has visited the plantation. The violence and promises had their effect. By 1980 La Perla, still in the hands of six Arenas brothers, was the only plantation operating in the area. It was also increasingly vulnerable.

From 1981 to 1983 guerrilla activity increased dramatically in the nation. The strength of the Marxist forces, supplied by Cuba and Nicaragua, peaked at 6,000 to 10,000. Why did the peasants of La Perla ignore the call to join the Marxist cause and stay at La Perla in the face of guerrilla attacks? "Because of the Arenas family's long history of good relations with the workers," says Orive. The assassination of the elder Arenas shocked and horrified the workers as well as the family. It provided an emotional bond that has driven Enrique and the peasants to keep La Perla open.

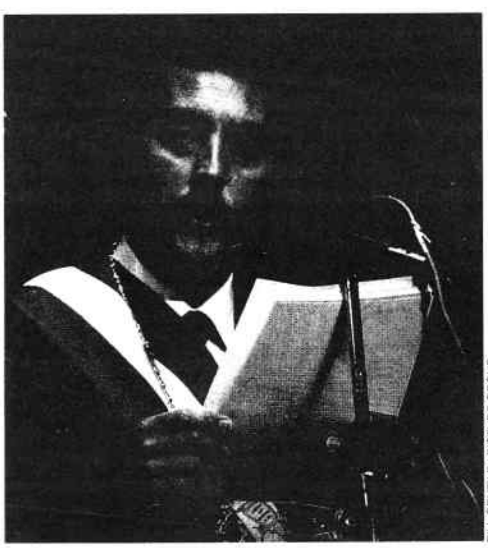
In 1982, La Perla decided it would have to close down if it did not begin to fight back — literally — against the guerrillas. The guerrillas had occupied parts of the plantation — including its two landing strips — burned a Cessna 185 aircraft and stolen the payroll for 300 workers. They had already blocked the primitive roads to the nearest villages, Nebaj, 25 miles away, and Chajul, 20 miles away, making air travel the only way in and out of the plantation. That led Arenas to ask the army's chief commander, Benedicto Lucas, for permission to form a civil defense militia.

An integral part of government counterinsurgency efforts, which often were brutal in their own right, had been the establishment of civil patrols. Since they first began under the junta led by Efrain Rios Montt, they have grown into a force of 800,000 out of a population of 8 million. The democratically elected, civilian government of Vinicio Cerezo, which took office in January, still supports them.

At first the army feared La Perla's peasants might join the guerrillas, but Arenas assured Lucas the "La Perla people were faithful to the government — if they had arms they would protect themselves without the army." The army reluctantly agreed.

Virtually shut off from the world, La Perla's workers bought their own weapons, which were delivered by air in December 1982. Arenas says they had only 18 guns the day the militia was formed. The very next day they were attacked; the civil defense militia drove the guerrillas back. "They have been very, very successful," says Arenas. The civil patrol has not lost a battle with the guerrillas since its formation, he claims. Today the civil patrol has 97 M-1 rifles and an assortment of 35 to 40 other guns. Two hundred La Perla workers are now members of the patrol.

Bringing a shaky peace and security to La Perla came too late, however, for a $2 million loan that the brothers Arenas had sought from the Central American Bank for Economic Integration, a bank set up by the Organization of American States with U.S. support. The loan had been approved in 1983, but the bank was then waiting for new funding. By the time funding had arrived, the increased intensity of the communist insurgency had cooled the bank's enthusiasm. The loan was canceled.


BILL GENTILE / PICTURE GROUP

President Cerezo backs civil patrols.


ALON REININGER / CONTACT PRESS IMAGES

This year's coffee harvest may bring La Perla workers their first dividends.

The Arenas brothers were then in desperate need of cash to keep the plantation operating. They considered selling it to other landowners. But Guatemalan economist Joseph Recinos, who had studied in the United States in the late 1960s and had become an enthusiastic proponent of worker ownership, encouraged the owners of La Perla to try the idea themselves. The Arenas brothers agreed to sell a sizable block of stock to the workers.

The idea was one with something of a pedigree — in theory at least — in Central America. In the late 1940s in Costa Rica, Alberto Marten Chavarria started a movement to fight against the notion of class struggle through worker ownership and profit-sharing by management-labor organizations controlled by workers. They were to be called *solidaristas*. The associations, as Marten envisioned them, would elect their leaders democratically, buy stock and fund profit-sharing plans from donations from workers and management.

The idea waned in Costa Rica after Marten tried to form a political party based on it. But stripped of partisan politics, the movement was reborn in 1971, when the Rev. Claudio Solano, a young priest who became director of the (Pope) John XXIII Social Science School in Curridabat, Costa Rica, began to promote the idea vigorously. Today the country has 1,100 *solidaristas* with 130,000 worker members, says Honorato Gonzalez, president of the Solidarity Union of Costa Rica. Comprising 18 percent of the labor force, it is the largest labor organization in Costa Rica. According to Arnoldo Nieto, a movement leader, it has reduced Marxist influence, which once threatened to eclipse the free labor unions, to a mere 7 percent of the labor force.

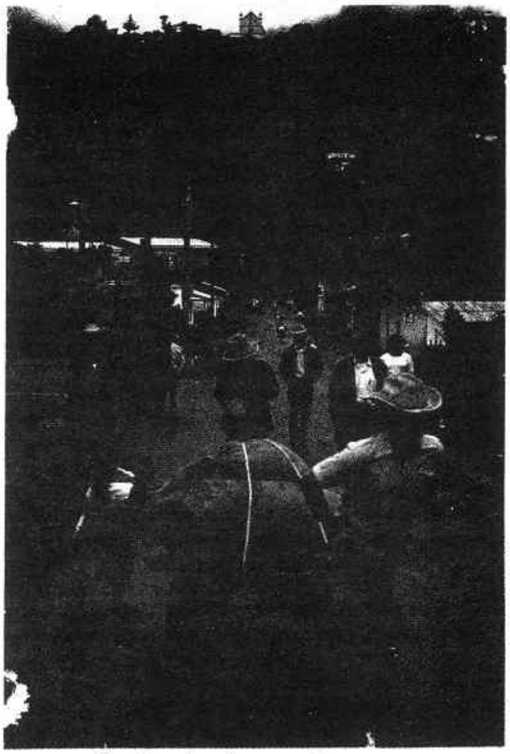
Recinos saw in Costa Rica a model for *solidarismo* in Guatemala and elsewhere in Latin America. It was particularly important, in his view, to demonstrate that the solidarity idea could be transplanted from an educated, middle-class nation like Costa Rica to the largely illiterate peasant masses of an impoverished nation like Guatemala.

La Perla is now one of some 50 *solidaristas* formed in Guatemala since 1983. They represent 10,000 workers in such industries as bananas, cement, shoes, hotels, grocery chains and banks.

The civil patrol has provided the security and worker ownership the motivation for La Perla to struggle to rebuild. The plantation had not had a profitable harvest since the day the elder Arenas was killed. In 1984 it managed to produce a meager 500,000 pounds of coffee beans. Last year, the first since employees gained their shares, production nearly doubled to 970,000 pounds, according to Enrique Arenas. This year he believes the plantation can produce 1.32 million pounds "if you Americans keep drinking coffee and the price of coffee stays up." This could produce the first profits and dividends for the workers. Arenas sees next year as an even better opportunity. If the plantation reaches its full capacity, 3.3 million pounds, it could be highly profitable.

Plantation workers earn slightly more than the average $1,200 per capita income in Guatemala. In addition, Guatemalan law requires plantation owners to provide housing and small plots for the workers to grow their own food. Some peasants earn more money by selling food from their plots.

At La Perla, the *solidarista*, headed by Avelino Soto, owns outright a general store that sells food and clothes on the plantation. The association also has exclusive rights



ANTOINETTE JONGEN / BLACK STAR

Guatemala: An agrarian economy

over about one-tenth of the plantation, where its members can grow whatever crops they wish and pocket the profits. The workers are paying for their shares in La Perla S.A. over a 10-year period through payroll deductions. They enjoy full voting rights and occupy nine of the 10 seats on the board that manages the plantation.

While the economic and military successes against the guerrillas have so far been considerable, the struggle is by no means over. Although the Guerrilla Force of the Poor's numbers have dropped below 2,000, according to the U.S. State Department, a powerful contingent remains camped across the Xaclbal River from La Perla. They have stepped up the frequency and strength of attacks on La Perla for more than a year.

With so much of the area in ruins, the guerrillas have focused more and more on attacking the comparative prosperity of La Perla. On Feb. 20, after the civil patrol burned the corn of the guerrillas in retaliation for an attack on coffee bean stores at the plantation, the guerrillas mounted what Arenas calls their biggest assault to date. In a half-day gun battle that began at 6 a.m., the civil patrol pushed back and defeated some 120 guerrillas who had surrounded them. Six of the workers in the militia and about 20 guerrillas died, according to the civil patrol.

Arenas expects another attack soon. The plantation is expanding the area it has under cultivation — planting corn in a far reach of its property — and the guerrillas will perceive that as a threat. "We're developing areas that used to be occupied by guerrillas," says Arenas. "They won't like it. They will attack."

The corn is being planted to feed 5,000 refugees who have flooded into the plantation over the past few years. Arenas says more than 600 former guerrillas and another 900 guerrilla sympathizers, along with their families, have taken up residence at La Perla. On May 24 a band of 83 refugees from guerrilla-held areas asked for refuge, the largest number in a single day.

As news of the struggle at La Perla has spread, support for the embattled worker-capitalists has begun to pour in. The Guatemalan government and a U.S. Christian organization, the Acts of Faith, are assisting in building a hospital there — the first in the zone's history. Payments made by the workers for their stock are helping to build the plantation's infrastructure. A road now connects two ends of the plantation, and two pickup trucks and a jeep have improved communications and defense.

Other landowners in Guatemala say they are watching La Perla closely. But they are unlikely to try worker ownership until they see favorable financial results. Says government spokesman Orive: "They have unpleasant memories of radical land reform" that was tried in the early 1950s.

Do the workers fully understand the nature of their ownership? "About two-thirds of the 500 worker-owners really realize that one day their participation will give them enough money to change their lives completely," Arenas says. "With the first profits all the people will finally be totally convinced of the goodness of this plan."

Enthusiastic supporters of the worker ownership movement plan to export the idea to Mexico and the rest of Central America, then to all of Latin America. The former U.S. ambassador to Costa Rica, Curtin Winsor Jr., says, "It may be the single most original and significant ideological contribution from Latin America" to the world.

Arenas, too, is hopeful about the future but realistic. "We have some hard years ahead. We are willing. We are not alone. The workers are with us."

— Robert England

Innovative Plan to Spread Wealth

The La Perla plantation, a showcase for worker stock ownership in Central America, served as a catalyst in the creation of the Presidential Task Force on Project Economic Justice. Headed by J. William Middendorf II, the group will present recommendations to President Reagan next month for spreading the wealth in Central America and the Caribbean.

According to an advance copy of the report obtained by **Insight**, the recommendations will include some sweeping and innovative approaches to the region's economies — changes Middendorf calls "the second revolution of the Americas."

The most daring proposal is to establish a "free market of the Americas" — the United States, Central America and the Caribbean, for the moment. Those countries that drop all trade barriers would have unimpeded access to U.S. markets. So would all employee-owned companies based in the region (excluding those in Cuba and Nicaragua), regardless of trade barriers their countries impose. The hope is that this would lure outside investment into these troubled economies.

The region's heavily nationalized economies will be encouraged to privatize through the sale of state-owned companies to their employees. State companies that are substantially employee-owned would also gain free access to U.S. markets.

In a two-edged stab at Latin American debts and what it sees as bloated state enterprises, the task force proposes that loans be swapped for equity in state-owned businesses, in two steps: A bank holding debts in Mexico, Central America and the Caribbean would trade the loan contracts for a share of the state-owned enterprises, then sell its equity to the workers via an employee stock ownership plan. Success would hinge on the ability of employee groups to make the enterprises profitable.

Employee stock ownership would be promoted vigorously in all the countries of the region. Each would set up its own Project Economic Justice. Finally, a two-tiered credit system would provide favorable lending rates for investments aimed at improving productivity. ■

Business Day

The New York Times
THURSDAY, SEPTEMBER 11, 1986

U.S. Banks Swap Latin Debt

Concerns Get Equity Stake

By ERIC N. BERG

When the Nissan Motor Company recently wanted to expand its Mexican subsidiary, it took a most unusual route.

First, Nissan went into the financial markets and bought $60 million in Mexican Government debt. Because Mexico is in financial trouble, Nissan paid only $40 million for the debt. It then resold the debt to the Mexican central bank for $54 million in pesos — which it then promptly invested in the Mexican subsidiary.

The result: Some $60 million in Mexican Government debt was wiped out; Nissan had more equity in its Mexican operation, and Citicorp, Nissan's investment banker, pocketed a fat fee.

Roughly about the same time, the Bankers Trust Company engaged in a similar deal, using its own money, rather than a multinational corporation's, to convert a $60 million loan to the Chilean Government into a 51 percent stake in a pension manager in Chile and a 97 percent stake in an insurance company there.

These are two of the many instances in which developing countries, working with foreign bankers, have found a new way to whittle their mountains of debt while, at the same time fostering investment in their private industry.

A handful of Latin American countries have shown themselves willing to pay off some of their debt — at close to face value — provided the funds are then reinvested in local businesses. In effect, the nations are facilitating a swap of their public debt for equity in private businesses. Thus, the name given to the practice: debt-for-equity swaps.

In some cases, such as the Bankers Trust deal, banks themselves have been willing to take and retain shares of foreign businesses. In other cases, such as Nissan's, banks have been able to find third parties, typically multinational corporations looking to expand their foreign local operations, to use those earmarked funds.

The approach does not appear to offer a wholesale solution to the third world's debt problems; there are too many limits on how much can be done.

For one thing, most developing countries are not in a position to redeem all of their debt at once. Furthermore, many nations have been unwilling to allow extensive ownership of domestic businesses by foreigners, but relax those restrictions to make these swaps work.

Practice Is Burgeoning

Nonetheless, the practice is burgeoning. In the last two years, for example, Mexico, in 23 debt-for-equity deals, has paid off $300 million in this fashion. That is out of a total of $97.3 billion in external debt. Chile, which has $21.5 billion in external debt, has paid off $280 million, in 26 deals.

While these figures, at first, may not seem impressive, debt specialists have estimated that Mexico alone could convert more than $10 billion of its debt into private-sector equity over the next decade.

Indeed, over the next 12 months, Mexico may "extinguish" another $1.2 billion of its debt using the new approach, and Chile, $900 million.

"It is very exciting," said Pedro-Pablo Kuczynski, a Latin specialist at the First Boston Corporation. "Debt-for-equity swaps reduce the interest bill of the country, and they bring in a significant amount of foreign exchange, as would new loans."

The countries gain because it offers them a way to attract new, and sometimes badly needed, investment for their private sectors at the same time they work down their public debt. The banks benefit, too, if countries find their debts more manageable.

In some cases, the banks are also profiting enormously by buying foreign debt at a discount from other banks and then redeeming it at close to face value. And investment bankers, at the banks and elsewhere, are earning sizable fees for their role as middlemen who arrange these complex transactions.

Banking analysts say the fees can be handsome indeed — as much as $1 million for every $100 million swapped. To many analysts, these fees explain the banks' fascination with swaps.

Not Their Own Loans

Ironically, most major American banks are not using the new approach to redeem their own loans; under accounting rules, if a bank sells a loan at a discount, it has to report a loss from the transaction on its earnings statement.

For the most part, only foreign banks, or banks with limited foreign loans, are willing to recognize such losses. The biggest United States banks, by comparison, such as Citibank and Bankers Trust, however, are actively involved as middlemen, buying these loans from other banks and then trading them in.

Whatever the limitations, however, such transactions have been multiplying: Citicorp, in one of many swaps, acquired 20 percent of the shares of the Celanese Corporation's Brazil subsidiary in a public-for-private sector swap. And the Bank of Boston arranged for its corporate clients in Argentina to buy Government debt and exchange it for australs, which the client used to invest in its own plant and equipment.

The process seems likely to gain further momentum still.

John S. Reed, Citicorp's chairman and chief executive, threw his weight behind this approach on several occasions in recent months, expressing his support for a proposal by the Mexicans last year that debt-for-equity swaps be undertaken on a large scale in their country. In a meeting with Wall Street analysts Aug. 14, he called the bank a strong advocate of debt-equity swaps with less-developed countries, as a way "of reducing the burden on the country and getting long-term permanent investments."

Experts called Citicorp's position highly significant, because it has exercised leadersip in foreign debt workouts. With more than $10 billion in loans to South America, it has more at stake than any other commercial bank.

Might Follow Cue

But other banks might follow Citicorp's cue, doing their own swaps, analysts said. The analysts predicted that the practice could be extended beyond Latin America, to troubled debtors in Africa and Asia.

In fact, Mr. Reed recently told the American Chamber of Commerce in Manila that he would like to do debt-for-equity swaps in the Phillipines.

"It's a fresh, visionary approach," said George M. Salem, the senior bank researcher at the Donaldson Lufkin & Jenrette Securities Corporation. "The wrong way to proceed would be to pile debt upon debt. You don't lend more money to a troubled borrower."

For the banks that choose to retain equity holdings in foreign companies, the question that now remains is how successful their new investments will be. In many of the countries in which they are investing, the banks have faced equally daunting problems recovering their loans from the private sector.

Still, bankers feel they have a better chance of getting repaid from private corporations than from the governments involved.

With a swap, "you are fostering a certain industry, a certain market, a certain project or company," said William P. H. Hoar, a specialist in debt-for-equity swaps at Bankers Trust. "If that company is export related, you build hard currency."

Richard L. Huber, a group executive at Citicorp overseeing swaps, commented: "We think everybody ends up a winner The country has its total foreign debt reduced. Investment funds are pumped into the economy. And the seller of the debt gets liquidity."

Except for Chile, most countries' laws are vague on how swapping may be done, if they have laws covering the practice at all. And a lot depends upon the fiscal philosophy of the local central bankers.

Law Still Developing

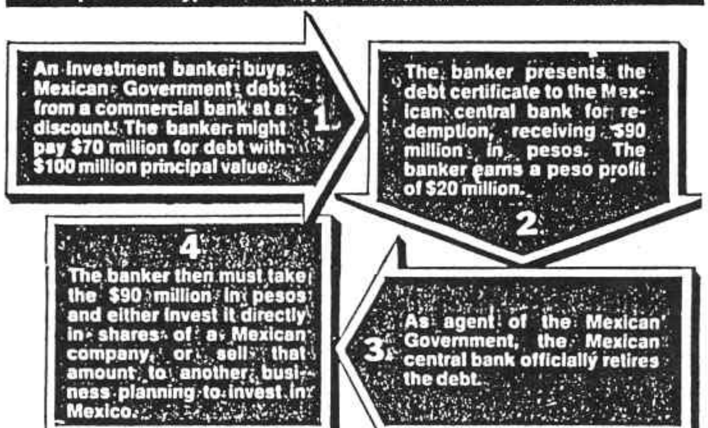
In Mexico, where the law is still developing, foreign banks or corporations cannot own more than 50 percent of a local business.

Even if banks and other corporaions never reached the 49 percent hreshold in Mexico, the idea of swaping on a grand scale would be atacked by left-wing political parties nd by other nationalistic factions in ..lexican public life, experts say.

What is more, if the swapping gets too heavy, experts fear, stock markets, which are small to begin with in Latin countries, might be disrupted.

How a Swap of Debt for Equity Works

Example of one type of deal



Two Countries Pare Their Debt

	MEXICO	CHILE
Total external debt*	$97.3 billion	$21.5 billion
Debt owed to commercial banks*	$76.1 billion	$14.3 billion
Number of debt-equity swaps**	23	26
Debt retired from swaps	$300 million	$280 million
Debt expected to be retired within next 12 months	$1.2 billion	$900 million

*As of end of 1985. **Within past two years.

Sources: Morgan Guaranty Trust Company; The Lagniappe Letter; Central Bank of Chile

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