Lessons from Privatization in Eastern Europe and Latin America

by

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This paper draws some conclusions from the experience with on-going privatization programs in the emerging market economies of Central and Eastern Europe. The experience of these former members of CMEA, the disintegrating communist economic block, is the most relevant for Cuba, also a member of CMEA, with an economy modeled on the central planning and state ownership once dominant in Eastern Europe. Although privatization is only now beginning to gather steam in Central and Eastern Europe, much can be learned from this initial experience. Insights can be obtained on the obstacles in the way to privatization and regarding alternative approaches to the sale or transfer of assets. However, because of the short duration of their efforts with privatization and the incipient development of a market economy, the CMEA experience has important limitations. Drawing some lessons from the longer experience of many Latin American countries with privatization enriches the analysis. Furthermore, the mixed economic systems in Latin America provide a varied framework for an assessment of the approaches to privatization.

Privatization involves the transfer of economic activity from the public to the private sector. In its more widely practised form, it involves the sale of state enterprises and other public assets to individuals or private firms. In CMEA countries privatization is also understood to encompass the entry of <u>new firms</u> into sectors of activity previously reserved to the state, an important phenomenon in low-capitalization firms that operate in the light manufacturing and service sectors. In Latin America, privatization has largely involved the sale of state companies in the industrial and public utility sectors to private domestic or foreign interests, and, to a lesser extent, the granting of leases and other concessions from the public sector to private firms. However, there has been only limited entry of new firms into activities controlled by state firms because the state in Latin America largely has concentrated its involvement in capital-intensive sectors such as mining, steel and telecommunications.

I. Objectives of Privatization Programs

Privatization programs aim to accomplish a number of major economic objectives. Foremost among these objectives is the increase in economic efficiency at the firm level derived from improved and more flexible management. Because profits and other efficiency criteria have been largely absent from the management of state-run firms in CMEA countries and as a result of the large distortions in an arbitrary price system, state companies generally operate at cost conditions well above international levels or produce goods and services of inferior quality. For many, if not most firms, redressing this uncompetitive structure may not be feasible in the short run. Plants may not have access to raw materials at a competitive cost, or the cost of replacing and refurbishing the capital equipment may be higher than the cost of a greenfield plant. Hence in many cases, the best course of action may be to liquidate the companies, which is a form of privatization. In the absence of liquidation, restructuring of the firm should be undertaken. Although restructuring would start under state ownership and management, privatization will become a central part of the restructuring process. Important questions arise as to the most appropriate mechanism to carry out the restructuring before and after privatization.

A second related reason for privatizations in socialist economies, is that private firms, whether privatised or newly established, bolster an emerging market economy. Firms with independent managers are more likely to react flexibly to market signals than are state-owned companies, which more likely have to satisfy objectives other than profit maximization and cost efficiency.

The need to strengthen the fiscal position of the government has provided a major rationale for privatizations in Latin America and also in Eastern Europe. The transition to a stable macroeconomic framework in a liberalizing economy requires progress towards fiscal balance. Privatizations can boost the public finances in two major ways. First, the sale of firms and other state assets has a direct revenue-generating impact, whether classified as capital gains or other extraordinary revenues. In addition, privatization will generally be accompanied by the elimination or reduction of operating and investment subsidies. Among operating subsidies that are eliminated are direct transfers to the firm from the central government, its agencies or state banks. Indirect subsidies to be eliminated include those provided to the state enterprise by other state firms in the form of inputs priced below their economic cost. Obviously, if firm valuation is low, as apparently is the case with many state enterprises in East Germany (GDR), the fiscal benefit from privatization can be negative. That is, subsidies are likely to exceed income derived from the privatization process.

A fourth objective of privatization programs is to facilitate relief on the country's external debt. The conversion of foreign debt instruments at a discount into equity of state enterprises can be used to reduce the country's external debt to banks and other institutions. This mechanism has been utilized in Latin America, most notably in Argentina, but substantially also in Brazil, Chile, Mexico and Venezuela. In Eastern Europe, privatizations have not been utilized yet in a major way as a mechanism to obtain relief on the external debt.

The development of domestic capital markets is an important complementary objective of privatization. Capital markets in Central and Eastern Europe and in Latin America are either practically non-existent in the former, or illiquid and largely short-term in the latter. New share issues can help boost the liquidity of stock markets. Stocks of privatized companies are the most widely traded in the Mexico City and Santiago de Chile stock exchanges.

A well designed privatization program can also help foster foreign investment through direct sales to foreign investors and by providing core facilities that attract complementary foreign capital. Concessions to foreign firms for the development of natural resources controlled by the state can also play an important part in bringing foreign capital, skills and technology. The granting of management contracts to qualified foreign firms can also pave the way for future inflows of direct and portfolio investment. Attracting foreign investment in a socialized economy will require the sale of some state assets to foreign investors, in addition to the establishment of joint ventures, management contracts and marketing arrangements.

Privatization can also aim to widen equity ownership among the population, thus cementing support for the difficult and very costly process of restructuring the economy. Chile in 1982-87 was very successful in placing a majority of the equity of large state companies in the retail market through qualified institutional fund managers. The recent Mexican experience with the privatization of commercial banks is also relevant in this regard.

Privatization programs often have generally not been well focused. In many of the programs in Latin America, for example in the earlier Mexican experience during 1984-87, the importance given to fiscal objectives meant that privatizations not always were carried out with careful consideration of the proper restructuring of the company's assets. This delayed the gains in efficiency that can be derived from the process. The rush to privatize either because of fiscal, foreign debt or other reasons has often not been consistent with the development of an adequate institutional framework to support the operation of private companies. Private utilities, for instance, require a regulatory framework which will assure stable and balanced contracts between producers and consumers or among suppliers.

The presence of multiple objectives does not mean that they are mutually exclusive. Many of the objectives of privatization programs listed above can be attained simultaneously. For example, fostering foreign investment is consistent with the goals of boosting the public finances and increasing company efficiency, and, at the same time, through well coordinated offerings of shares in domestic and foreign markets, privatization could help with the development of a domestic capital market.

II. The Mechanics of Privatization

The placement or distribution of equity in existing state enterprises in Central and Eastern Europe and in Latin America has been carried out under a variety of mechanisms. Most of them involve the sale of shares to residents or non-residents under established rules. Some Central European countries, notably Poland and Czechoslovakia, are beginning to experiment with schemes for the free distribution of shares among wide groups of the population.

The main mechanisms used in the placement of shares are the following: a) direct sales to an investing group by the government; b) auctions or other competitive bidding; c) spontaneous privatization by state companies; d) free distribution of shares to the public; e) profit and equity sharing with employees of the firm; f) retail sales to the public; and g) selling blocks of shares in foreign stock markets.

Direct Sales to an Investing Group

Direct sales to an investing group through a two way deal under a clear set of rules is one of the fastest routes to privatization. If done properly it can also bring complementary capital, technology and management skills from the acquiring group. In CMEA countries, direct sales have been of two types. In one widely practised form in Poland and Hungary, direct sales to a management group have taken place. This management buyout has the advantage of familiarity with the firm and the market, but are unlikely to attract substantial investment capital or bring much new technical knowhow to the firm. Direct sales to multinational companies have also been employed widely. These have involved some of the best known examples of privatization in Eastern Europe and in Latin America. The acquisition or joint ventures with foreign companies of Skoda in Czechoslovakia, Tungsten in Hungary and the GDR's banking system are among the best examples in the CMEA area.

Direct sales of assets or associated joint ventures, are used by critics of privatization as examples of hasty action. Much of this criticism extends to the valuation process. Hero Brahms, deputy president of the East German privatisation agency (Treuhandanstalt) acknowledged recently that his agency did not initially have the experience to value companies properly. Mr. Brahms added that the Treuhandanstalt still has problems "with reliable valuation information. Profit and loss accounts, are, for example, often unreliable".

The argument is also made that speedy sales prevent proper restructuring of companies that would enhance their value. This assumes that the agency in charge of privatization has the managerial and technical ability to proceed with a restructuring, which even in Germany has proven to be difficult to acquire.

Auctions and Other Competitive Bidding

This is the most widely used mechanism for privatization. It has been employed in all privatizing countries in Eastern Europe and Latin America. In the latter, it has been associated with domestic and foreign offering of shares to competing groups sometimes accompanied by the underwriting or placement of shares in major stock markets. The 1990-91 privatization of TELMEX, the mexican phone company, is probably the best example of a balanced bidding process involving both block sales to competing groups of investors and retail placements of stock in the domestic and foreign markets. In Eastern

Europe, auctions are being employed in Germany and Hungary under the close coordination of privatization agencies.

Spontaneous Privatization

This mode of privatization can involve either direct sales or auctions, except that instead of being closely guided by a central privatization agency such as the Treuhandanstalt, the State Property Agency (SPA) in Hungary or Corporación de Fomento de la Producción (CORFO) in Chile, it is done in a decentralized fashion by state companies themselves.

Spontaneous privatizations are initiated by private managers, subject to the approval of the privatization agency. The arrangements with investment banks, the valuation process, debt-restructuring and other preliminary steps needed prior to privatization are arranged largely by the company managers. This process can be swift. It was employed with some success by the Hungarians in 1990 as the modus operandi for their first privatization package. Hungary is currently trying a mix of both Spontaneous Privatization and SPA-directed efforts. The aim has been to execute the divestment of 5 to 8 percent of state property per year. The goal of Hungary's privatization program is to reduce state property from 90 percent in early 1991 to 40 percent by 1996.

Free Distribution of Shares to the Public

In such schemes shares in state enterprises are distributed among the adult population of the country free of charge or at nominal distribution cost. The most notable and sophisticated example of this is the proposal by the Polish government announced at the end of June 1991.

The Polish scheme would cover the privatization of 400 state-owned factories, representing 25 percent of the country's industrial sales and 12 percent of total employment. This would be a key element in the goal to sell companies representing 50 percent of GDP within three years. In the scheme, prepared by S.G. Warburg of London, 60 percent of the equity in the 400 companies would be transfered to up to 20 investment groups to be known as National Wealth Management Funds (NWMF). Management of these funds would be carried out by foreign fund managers under contract to the shareholders. The government will keep a 30 percent shareholding in the groups while employees will retain 10 percent of the equity.

Other schemes for free transferral of shares have been proposed in Czechoslovakia and Hungary. These "voucher schemes" have yet to be implemented on any significant scale in these two countries.

Profit and Equity Sharing with Employees of the Firm

This is a complement to other forms of privatization. It usually involves the sale or transfer of a minority shareholding to company employees. It can be done gradually through profit sharing, or it can be a component of a larger privatization package. The privatization of Mexican banks and utilities and the prospective privatizations in Venezuela have components of this form of privatization. Employee or management buyouts have also taken place in Poland and Hungary, although the earliest experience with this modality of divestment of state property in Central Europe took place in Yugoslavia in the 1970s.

Profit and equity sharing has limited value as a capitalization mechanism. It is also unlikely to contribute substantially to the improvement of management conditions, although often it can contribute to the betterment of morale among employees. Management buyouts have been the exception in recent privatization experience, but there is scope for such schemes particularly in skill and technology intensive industries, for example tool and dye making, pharmaceutical and biological companies.

Retail Sales to the Public

Efficient retail sales to the public require some prior development of the domestic capital market, but direct distribution to shareholders may prove initially successful. In the absence of a functioning stock market, however, shares will have poor liquidity, limiting their desirability and thus lowering their value. One of the ways of tackling this problem has been through the privatization of social security and pension funds, as illustrated by the experience of Chile beginning in the mid 1970s. In Chile, private pension funds provide considerable depth to the capital markets and have raised inmensely the returns received by participants in the plans. CMEA countries are not yet ready to operate with the same institutional arrangements as Chile. However, in a privatization horizon of 3 to 7 years, there would be sufficient time to create a domestic capital market capable of handling the widening of share ownership.

Selling Blocks of Shares in Foreign Stock Markets

This can only be done by sizable companies with an established operating record, and only after extensive restructuring and preparation by management, the government and investment bankers. It has been used in Latin America by a handful of large companies, among them telephone companies in Chile and Mexico (CTC and TELMEX), the leading Mexican cement company (CEMEX) and a few other large enterprises. In CMEA countries, major changes in operating procedures, financial and legal structure and accounting are necessary before this form of privatization and access to new capital can be employed. However, for companies with high international competitive potential, early restructuring could prepare the road for access to foreign stock markets within a few years. The establishment of a joint venture with foreign partners could be a way to accelerate this process.

III. Lessons from Privatization

After considering the objectives of privatization and the alternative mechanisms that have been employed in the light of the recent experience in Eastern Europe and Latin America, conclusions are derived that should help to structure the privatization process in state controlled economies.

The main conclusions that can be derived are the following:

1. From an efficiency point of view, the entry of new firms is the best mechanism for privatization.

Existing firms in CMEA countries have such deep structural problems that in many or most cases the organization of productive resources may have to start from scratch. The key question is how to foster and best support the entry of entrepreneurs into areas of activity heretofore reserved to state enterprises. A change in regime and the initiation of reform by itself can do much. By one estimate over 500,000 new firms were created in Poland in the first year after the installation of a democratic government in the country. But the absence of adequate financial markets, will mostly relegate new domestic companies to labor-intensive activities in the service sector. Companies with foreign capital should be allowed to operate at the outset, but not much will happen until property and legal rights are well established.

Encouraging new firms is highly desirable, but this still leaves the problem of the restructuring of the existing firms and the massive challenge of retraining and reemploying workers from the old state sector. For a number of years, the rate of job creation of new firms is likely to be well below the rate of employment contraction in the state sector. Hence, the focus would have to remain on launching privatized firms that can operate profitably within a reasonable time span.

2. Institutional Reorganization of the Economy Must Begin at Once

A major roadblock to privatization either through the establishment of new firms or through sales or transfers of existing state assets is the lack of clear contractual rights and relationships. Time can not be wasted in restablishing land and other property rights. Legal mechanisms that assure the validity of contractual relationships must be established.

A scheme to provide insurance for contractual relationships involving privatized firms or newly established companies could be helpful in attracting domestic and foreign investors. The insurance could cover titles and breach of contract under certain conditions. Fees would be assessed on the investors on a case-by-case basis. Insurance contracts could cover the title to the land of a privatized company, a guarantee from the government against expropriation or rights of access to natural resources. Insurance covering foreign investments possibly can be reinsured in international markets or could be covered by agencies such as the Overseas Private Insurance Corporation of the United States (OPIC) or similar agencies in other OECD countries.

3. Rules for Privatization Have to be Clearly Established

This applies to all forms of sales and transfers, direct sales to investor groups, auctions, transfers and spontaneous privatizations. One of the reasons for the widespread criticism of spontaneous privatization in Hungary has been the inconsistency of procedures relating to valuation, awarding of contracts, technical transfers and other arrangements. The main object of the rules is to guarantee a fair, transparent and speedy process for all parties involved in the privatization process. Obscure procedures will also lead to investor delays as they seek to protect their investment. The repeated delays in the privatization of Aerolíneas Argentinas, which took close to two years to complete, more than double the projected timetable, is an example of the problems that can arise when procedures relating to the investment (as well as contractual relationships) are not clear to participants.

4. Sales of Equity are Preferable to Voucher or Other Transfer Schemes

Although there is as of yet only a small amount of evidence regarding the workings of voucher schemes, the controversy surrounding the implementation of such programs in Czechoslovakia and Poland provide some warning about their practicality. The appeal of transfer schemes appears to be largely political rather than economic or managerial. While profit and equity sharing with workers could well work in the case of some enterprises, it appears that the generalized distribution schemes under consideration in CMEA countries will not help achieve most of the major objectives of privatization described in the first section of this paper. The main exception is that it would help to widen equity ownership among the population.

The advantages of sales over transfers of equity are clear in regards to other major objectives of privatization, in particular the likelihood of having access to improved management and technical expertise, enhancing competition among prospective investors and generating positive effects on the fiscal accounts or the external debt.

This does not mean that some form of discount sale of shares may not prove to be effective. For instance, it may be worthwhile to study the possible sale of shares in farm enterprises at some discount to workers and residents of agricultural communities. Still, practical considerations would probably make this approach difficult.

5. Privatizations are Highly Effective in Attracting Foreign Investment

There has been great success in this regard in Latin America as shown by the cases of Argentina, Chile and Mexico. Mexico has carried out some of the more sophisticated and well structured transactions involving the sale of common equity to foreign shareholders and to direct investors as well. It has been able, for instance, to sell important stakes in key companies such as Mexicana de Aviación and Telmex to foreign companies which will have a substantial say in management and operations. Mexico has also been able to attract large inflows of portfolio investment into shares of formerly state companies, even under still restrictive regulations that limit foreign holdings of voting shares.

In CMEA countries, foreign investment in state companies will have to be largely of the direct form since capital markets are still in an embryonic stage. But other mechanisms would have to be assessed. One mechanism which is very likely to be appropriate is the direct placement of securities with investor groups abroad. This has taken place already in Poland and Hungary among emigré groups, but it could well be taylored to other specific investor groups. A good example could be the placement of shares in tourism enterprises among companies in the same activity abroad. Ordinarily, direct placements tend to be most effective when the investors already understand well the business.

6. Fiscal Objectives Must Not Drive the Privatization Process

Fiscal balance is highly important and the privatization process must contribute to it. But centering the privatization process on the need to achieve specific revenue goals is likely to distort the process or to exert pressure to carry out transactions without proper preparation. One way to approach this problem is to budget conservatively the revenues derived from privatization, assigning the bulk of the revenues to a special fund earmarked for discretionary spending, preferably capital expenditures.

The reduction in net subsidies arising from privatization is a better criterion to guide the privatization process than are revenue goals. Realistic pricing must be restored to the economy. Privatization could become a key instrument in butressing the functioning of a proper price system.

IV. Comments About Privatization in Cuba

Cuba has probably the most rigid and distorted economy of any socialist country. Unlike some of the Eastern European countries, the process of reform and decentralization has not been started in any significant way. Management, technology, marketing knowhow and the productivity of Cuban firms are well below international standards. Because of this and the lack of a proper institutional framework, privatization of some firms through sales of assets in general may not be feasible. Manufacturing companies linked to Eastern European suppliers are not likely to be profitable. Liquidation of many of these firms will have to be accomplished in an orderly fashion.

However, a number of large firms with a dominant market position will be good candidates for early privatization. Typically this may involve cement, beverages, mining, petroleum, utilities, some chemical industries as well as others. Sugar mills and other agroindustrial plants are also early candidates for privatization since their cost structure could be aligned with international prices in the short-term. Opportunities for foreign direct investment will also be strong in the case of the larger firms and in the tourism sector.

Substantial entry of new firms can be expected in the service sectors. Retail activities are likely to be at the forefront of this process as would be firms offering personal services. The lack of capital will restrain firm formation largely to labor intensive activities.

Cuba's exile community offers major assets in the restructuring of state firms as well as in the formation of new businesses. The community's professional and managerial skills, capital and linkages to international markets and companies will be important boosters in the implementation of successful privatizations. But the great problems with privatization in East Germany illustrate the difficulties of the process under even stronger conditions of support from fellow citizens and the government of the Federal Republic of Germany. Cuba's relative advantage would be to learn from the trials of the privatization processes in Eastern Europe and Latin America and to be able to improve upon the design and implementation of such programs.