PUBLIC SERVICE PRIVATISATION AND CRISIS IN ARGENTINA

Introduction

In the 1990s, during the administration of Carlos S. Menem, Argentina implemented sweeping economic reforms aimed at the complete revamping of the productive and administrative structure of the nation. The aim was to put behind years of macroeconomic instability and sluggish growth through the introduction of market incentives and the retrenchment of state activity in the economy. Meticulously applying many of the policies of what came to be known as the Washington Consensus, the Menem administration was lauded in the international press, by G-7 governments and international financial institutions (IFIs), as a champion of effective government to be emulated by developing nations worldwide. Indeed, the policies initially appeared to work exceedingly well. A program of macroeconomic stabilisation known as the Convertibility Plan, the brainchild of Economic Minister and Harvard graduate Domingo Cavallo, rapidly brought down inflation to levels common in developed industrial nations, and did so without sinking the country into a deep or prolonged recession. Deeper structural reforms supplemented the macroeconomic stabilisation package. Privatisation, deregulation and trade liberalisation proved extremely effective in attracting new capital flows to the country, promoting the rapid modernisation of the economy. Argentina was living proof that the swift implementation of market-oriented reforms could rapidly erase decades of misguided state intervention, setting nations on the path of sustained growth.

The mirage did not last long. In 1995, as a result of the crisis of the Mexican peso, GDP declined by 3% and unemployment reached 16%. The so-called Tequila effect should have served as a warning of the vulnerability of the Argentine economy to external shocks. Although the period 1996-1998 saw the
reestablishment of vigorous growth rates, a series of external shocks led to a prolonged recession matched only by the Great Depression of the 1930s. The severe crisis suffered by Argentina holds important lessons for the academic and policy-making communities. Given the dramatic collapse of an economy widely advertised as a model to be emulated by other developing nations, the reforms enthroned as dogma during the 1990s ought to be carefully examined. Such a task necessitates methodical research on the role that market oriented policies played in the turn of events in Argentina.

This article discusses the role of privatisation in the economic reforms and the subsequent economic crisis afflicting the country. We start with an analysis of the function that privatisation played in the macroeconomic stabilisation and overall reorganisation of the Argentine economy followed by a description of the macroeconomic context of the Convertibility Plan. Finally, the relation between the pricing of public services in the hands of private enterprises and the macroeconomic crisis faced by Argentina are explored. We conclude that the macroeconomic and regulatory context within which privatisation took place played a very critical role in undermining the ability of the Argentine government to respond to external shocks that resulted in a prolonged recession and balance of payments crisis. Significant productivity gains in many privatised firms indicate that a microeconomic rationale existed for the privatisation of several sectors. However, the failure to pass some of these gains to the public in general can be attributed to a lack of political will and/or political inability to prevent the excessive concentration of economic power in a few groups. Given that the politics of privatisation cannot be radically extricated from the economics of the process, other nations should be advised to pay special attention on the impact of privatisation on the balance of economic and political power between diverse groups (including foreign investors) and the national government.

The Theory and Practice of Privatisation in Argentina

Privatisation in Theory

For economic theory, the main attraction of privatisation is the promise of greater microeconomic efficiency when an enterprise is transferred from bureaucratic administrators to private control. The improvement in efficiency is said to come from the difference in incentives faced by political appointees to the incentives faced by business managers. The former must make decisions based on a variety of goals including but not limited to the financial soundness of the enterprise. They are not free of political considerations regarding the number of employees, investment decisions, setting service rates, etc. The latter can be a lot more single minded regarding the operations of the enterprise, focusing on cost cutting and revenue expansion as strategies to maximise the shareholders' return of investment. The expected outcome of privatisation is a better-run enterprise, able to generate
profits at the same time that quality is improved and prices are reduced. However, there is no guarantee that these results will materialise. The market structure and regulatory environment within which the newly privatised firm will operate will be extremely important in determining outcomes. If a recently privatised firm must operate in a tightly regulated environment where it enjoys very little ability to make decisions, conditions of production may see practically no change. On the other hand, if a firm is privatised into a monopolistic market, with great freedom from government interference, the focus on profit maximisation is likely to result in important cost saving measures and significant increases in prices to consumers. In other words, a gain in economic efficiency cannot be taken as a forgone conclusion of privatisation.

Many advocates of market oriented reforms claim that privatisation also holds a promise to improve the macroeconomic outlook. (Williamson 1990) In cases where SOEs have made significant contributions to government deficits, privatisation seems like a natural solution to their reduction. The sale of SOEs would not only directly contribute to government revenue through its proceeds, but also eliminate future budgetary needs such as operating costs and capital investment of the enterprise.

Empirical evidence for this claim is less than scant. In a study of privatisation in Latin America, Pinheiro and Schneider (1995:769) find that "it is not reasonable to expect significant short-term fiscal gains from privatisation." In their view, privatisation cannot be considered a serious tool for deficit reduction. Politicians find the theoretical link between deficit reduction and privatisation useful as a signal of their commitment to economic reforms. Pinheiro and Schneider also warn that a privatisation process directed to the goal of deficit reduction can have a detrimental effect on economic efficiency.

Privatisation has also been advocated as a solution to corruption in government. SOEs present abundant opportunities for corrupt officials to line their pockets through rigged bidding processes for contracts, over-invoicing of costs, preferential provision of services, etc. Clearly, these practices can also take place under private control, but it is commonly assumed that shareholders have a stronger incentive and greater capacity to claim transparency from business managers than citizens have over appointed bureaucrats. However, we should recognised that privatisation opens up ample opportunities for graft. The transparency of the bidding process, the make up of a regulatory framework and the pricing mechanism for public services have an enormous impact on the potential profitability of a privatised firm. Prospective investors and new owners alike have large incentives to seek advantages for their firms through all sorts of illegal practices. Once international capitals are involved, the magnitude of the problem can potentially reach dimensions impossible to imagine in the case of SOEs with much smaller budgets. Unfortunately, privatisation theorists and advocates have generally chosen to overlook these dangers and their potential repercussions. For example, Krueger (1990) points out the advantages of private economic activity over government intervention, placing emphasis on the
potential for rent-seeking present in SOEs, but failing to mention even once the potential for corruption under private ownership. Repeatedly expressed by prominent economic theorists and policy-makers (Krueger was pivotal at the World Bank during the 1980s and currently works for the International Monetary Fund), such views carried significant weight among IFIs and governments seeking effective economic reforms.

Since the 1980s, IFIs such as the World Bank (WB), the Inter-American Development Bank (IDB) and the International Monetary Fund (IMF) have been unconditional supporters of privatisation in developing nations. Not only have they advocated privatisation as an essential component of structural adjustments, on several occasions they have made privatisation a condition of renewed lending. In many cases, lending has been extended to support the administrative overhaul, severance payments and early retirements associated with privatisation. During the early 1990s the standard WB prescription regarding privatisation was that it had to take place as rapidly as possible in order to prevent the organisation of pressure groups that may be able to effectively oppose it. Unfortunately the rush to privatise not only undermines the possibility for popular participation in the process; it is also likely to result in terms unfavourable to the state and a weak regulatory environment. Greater attention to questions of reform sequencing has called attention to some of the flaws in the policy prescriptions of IFIs.

**Economic Reforms and Privatisation in Argentina**

During the military regime of 1976-1983, relatively cheap and easily available external credit was liberally used to finance large fiscal deficits. Although some of the funds went to finance infrastructure and the expansion of physical capital of SOEs, much was used to support a failed monetary scheme and undetermined military expenditures (including the violent repression of political dissent that resulted in somewhere between 9,000 and 30,000 disappeared).

Throughout the 1980s, the Argentine economy suffered bulging government budget deficits. Often financed with credit from the Central Bank, these deficits had severe inflationary consequences. Facing bloated foreign debt payments, largely the result of excessive government expenditures under the military regime of 1976-1983 and the nationalisation of private debt, the administration of Raúl Alfonsin, was unable to bring down government expenditures. In an effort to placate inflationary pressures, Alfonsin placed caps on the prices charged by state owned enterprises (SOEs) in key sectors of the economy such as energy and public utilities. SOEs were also suffering from the excessive borrowing that had taken place during the easy credit period of the 1970s. To make matters worse, many of these enterprises had an additional political mandate, absorbing labour that had become redundant in other sectors of the economy to keep unemployment rates low.

The use of SOEs as tools of macroeconomic policy, a practice common in prior administrations as well, severely weakened their ability to undertake necessary capital investment and sustain an adequate quality of services. As the practice
continued, their ability to provide services deteriorated, in some occasions resulting in substantial losses to the state and widespread discontent among users.

With service rates below average costs of production SOE deficits represented up to 4% of GDP in the 1980s. (Galiani and Petrecolla 2000:82)

In 1989 the economy experienced repeated hyperinflationary episodes, forcing an early transition to the Presidency of Carlos S. Menem. The critical macroeconomic conditions faced by the Menem administration required swift action. Fiscal deficits and hyperinflationary expectations had to be addressed immediately. Privatisation rapidly emerged as a cornerstone of policies aimed at stabilisation and deep structural reform. First, privatisation was promoted as a deficit reduction measure.

SOEs had contributed to the fiscal deficits for several years, and the proceeds from privatisation could help shore up government revenue and/or reduce interest payments on debt. Second, privatisation provided a strong political signal of Menem's commitment to market oriented reforms. He had won the Presidency as the candidate of the Partido Justicialista (Peron's old party), a party traditionally associated with populism and state intervention. In order to ease domestic and foreign investors and gain the favour of IFIs, Menem sought to establish credentials as a staunch reformer. Finally, privatisation could be used to attract new foreign direct investment and thereby help re-establish growth. At a time of crisis the drawbacks of such policy seemed minimal. Although worker unions objected to privatisation, the most powerful unions as a result of their close links to the Peronist Party. In any case, macroeconomic conditions were so adverse that emergency measures were widely accepted as necessary. The large deficits and decline in quality of SOE services during the 1980s had also created an atmosphere favourable to privatisation among the general public.

These were conditions far from desirable to carry out an orderly privatisation. Under pressure from IFIs and in need to establish reformer credentials, the Menem administration rushed the process. Budget strains encouraged the use of short-term revenue-improving criteria at the expense of long-term efficiency-enhancing outcomes. The process was broad and swift. Based on the Law of State Reform passed soon after the arrival of Menem to office in 1989, the vast majority of SOEs were sold to private investors or dismantled between 1990 and 1994. In just five years the National Telecommunications Enterprise (ENTEL), the air transportation company (Aerolíneas Argentinas), the state oil enterprise (Yacimientos Petrolíferos Fiscales), most state electric generation and distribution enterprises, state petrochemical firms, steel mills, radio and TV channels, the state natural gas company, ship yards, and many others, were privatised. In the years to follow a few public services that remained under government control were also targeted including the postal service, the regulation of airwaves and the issuance of passports. The result was a privatisation experience noted for its shortcomings regarding competition and regulation. A common observation is the prevalence of monopolistic markets in privatised sectors, even in instances when more competitive structures could have been created. Another is the delay in the establishment of a
regulatory framework and independent regulatory agencies to constrain the monopolistic power of privatised enterprises. (Gerchunoff and Canovas 1996) Monopoly power was essentially traded for higher bids in an effort to boost short-term revenue establish Menem’s credentials as a reformer.

Efforts at ownership dispersal were also absent. Entry to the bidding process was limited to a few conglomerates that could prove enormous financial resources and administrative capabilities. The winning conglomerates were invariably composed of powerful local business groups associated with foreign financial institutions holding Argentine debt and multinational enterprises. Practically no effort was made to sell shares to the general public, reserving no more than 10% for unions and employees in the best of cases. Galiani and Petrecolla (2000:86) describe the process as "a form of take-over of state enterprises by a powerful coalition of national holding companies, international financial investors, and some foreign operators of public services." Basualdo et. al. (2002) point out that the privatisation process brought together local business groups and international creditors, interests that had opposed during the 1980s. The result was an unprecedented concentration of economic and political power outside the grasp of the state.

In order to make SOEs even more attractive and boost bids service fees were often increased prior to privatisation. In the ten months prior to the privatisation of ENTEL the US dollar price of a telephone pulse was raised by 711%. Between 1992 and 1993, the average price of a cubic meter of natural gas increased by 23% in real terms; the service was privatised in January 1993. (Aspiazu 2002:12) The higher fees were intended to guarantee a comfortable level of revenue to the new owners, but labour costs were also slashed. In 1990, at the beginning of the privatization process, seven SOEs in the telephone, mail, air transportation, water and sewage, electricity, rails and natural gas sectors employed 222,800 workers. By 1994 only one SOE remained and 32 privatised firms had emerged from the other six, employing in combination 99,000 workers, equivalent to a decline of 55.6%. By 1998, when all SOEs in the initial group had been privatised into 33 enterprises, employment among these firms stood at only 75,800. If we consider the period 1985 to 1998 for the same group of firms employment declined by 68.9%. (Duarte 2002:73) The drastic reductions in the payroll of SOEs prior to privatisation made extensive use of voluntary retirement plans and severance pay. Considering the delicate fiscal position of the government during the early 1990s these outlays would have been impossible had the WB not stepped in with generous funding. A total of 86,274 employees 'voluntarily' retired from SOEs providing public services. The cost of these retirements reached US$1.3 billion in 1992-1993. Largely covered by WB loans, this figure represents about US$20,000 per retired worker during that period. (Duarte 2002:81)

The shedding of labour by SOEs would have a significant impact on overall unemployment levels. Prior to the prolonged recession that would hit the country from 1998 to 2002, the unemployment rate showed a clear upward trend that coincides with privatisation and the rapid and unilateral liberalisation of trade. According to IMF figures unemployment stood at 6% in 1991; climbed to 12% by
1994 and jumped to 16.6% by 1996. Official government figures show an even more
dramatic increase in unemployment during the same period. Duarte (2002) estimates
that at least 2% of the unemployment rate recorded in the late 1990s can be directly
linked to SOE layoffs.

Privatisation also resulted in lower demand for domestically produced inputs. As
subsidiaries of foreign-based corporations, many privatised firms switched
suppliers from local firms to the parent company resulting in the reduction of
manufacturing employment in Argentina.

Evaluating Privatisation in Argentina

There can be little doubt that privatisation served as an excellent instrument to
signal Menem's commitment to market-oriented reforms. Large capital inflows
during the early 1990s are evidence of its success in this arena. However, the
privatisation process in Argentina failed to accomplish the three primary economic
benefits attributed to it. Perhaps, as Pinheiro and Schneider (2000) would argue, this
failure is a result of the high costs of using privatisation as a political signal.

The central prize of privatisation from an economic perspective, efficiency
gains, were not attained economy wide. The drastic drop of labour among privatised
firms had a strong positive impact on productivity in all the enterprises in question.
Fewer workers, the intensification of the labour process and new physical capital
resulted in an average increase in labour productivity of 16.9% per year between
1993 and 1998. However, the benefits derived from higher labour productivity were
not transferred to workers in the form of wage increases, nor were they passed on to
consumers as fee declines. Instead, as we shall see below, the firms captured these
gains in the form of extraordinary rates of return (monopoly rents). Although the
privatised firms significantly improved cost efficiency in public services, society at
large hardly saw any benefits.

A second goal, the long-term improvement of fiscal accounts, also failed to
materialise. Efforts to enhance short-term government revenue from privatization
resulted in a net increase in debt. Between 1990 and 1994 the privatisation process
generated US$ 10.4 billion in cash receipts and US$15.1 billion in debt reduction at
nominal value (the market value of the debt was substantially lower). Debt-for­
equity swaps represented a little over US$13.5 billion in debt reduction. The
additional US$1.6 billion was debt transferred to the newly created private
enterprises operating in the gas and electricity sectors. In the same period the
Argentine State absorbed an estimated US$20 billion of SOE outstanding debt,
delivering debt free enterprises to the private sector. This represents a net increase in
debt held by the state of US$6.5 billion. (Basualdo et. al. 2002) In other words,
current revenue was temporarily increased reducing budget deficits during the early
1990s, but future budgets were compromised by the increased indebtedness.

Finally, privatisation and the consequent reduction of state intervention in the
economy did not result in a reduction of rent-seeking activities as predicted by
economic theorists and policy-makers employed by IFIs. On the contrary, the privatisation process opened up unprecedented opportunities for rent-seeking activities by local and foreign business groups, particularly in the context of a rushed process lacking adequate regulatory framework. The privatisation process in Argentina created monopoly rents that dwarf by magnitudes of thousands those that previously could have been obtained from import licensing, the original target and source of inspiration of rent-seeking theory. (Krueger 1974) Allegations of widespread corruption for hundreds of millions of dollars and the enormous concentration of power among a reduced group of business conglomerates indicate a rise in the prevalence of rent-seeking activities during and after the privatization process.

The Macroeconomic Context of Convertibility and its Crisis

In 1991, Harvard trained Domingo Cavallo became Minister of Economics and rapidly implemented a radical anti-inflationary program. Fixing the exchange rate of Argentine pesos to US dollars at one to one, and linking the supply of pesos to amount of dollars held in reserve by the Central Bank, Cavallo intended to re-establish confidence in the ability of the peso to function as a store of value. In theory at least, the Central Bank no longer had discretionary power over monetary policy. The money supply was to be determined by a rule: one dollar in reserves, one peso in circulation. If reserves were to increase by one US dollar, the supply of pesos would increase by one peso times the money multiplier (determined by the required reserve ratio), but if dollar reserves were to decline, the supply of pesos would have to experience an equivalent decline. The Central Bank was mandated to convert pesos into US dollars at the rate of one to one. The Convertibility Plan proved extremely successful, causing inflationary expectations to plummet and leading to a rapid decline in the inflation rate between 1991 and 1994.

A key element complementing the Convertibility Plan was the rapid and broad liberalisation of trade. The unilateral elimination of import licensing and the sharp reduction of other trade barriers allowed foreign goods to enter Argentina practically unimpeded. This facilitated the function of the fixed exchange rate as a price anchor. If the prices of domestically produced goods were to rise faster than the US dollar prices of the same goods produced abroad, the influx of imported goods would place a check or even pull these prices back down. However, not all goods and services are traded across international borders. Trade liberalisation is effective on tradable goods and services, but may have little or no deflationary impact on the prices of non-tradables such as public services.

The early 1990s certainly were an auspicious time to implement pro-market reforms. The effervescent mood of international financial markets in face of the break-up of the Soviet Union and extremely low interest rates in industrial nations generated an atmosphere propitious for significant capital flows to developing nations and transition economies. With inflation under control, and a massive
program of privatisation and liberalisation in place, Cavallo and Menem were praised internationally. Argentina became an exemplary case of successful market reform to be emulated by other nations. Financial capital readily flowed into Argentina, seeking a slice of the much-lauded 'emergent market.' The inflow of funds facilitated an impressive economic expansion in the period 1991-1994, providing the Central Bank with adequate reserves to expand the money supply and accommodate economic growth.

The Mexican peso crisis of 1994-1995 was the first warning sign that Argentina was becoming excessively dependent on often finicky international capital flows. Although the key economic indicators in Argentina did not show signs of distress prior to the crisis, international investors withdrew funds from Argentina on the heels of the Mexican moratorium. The resulting balance of payments difficulties threw the Argentine economy into a significant recession in 1995. By 1996 robust growth had been re-established and any cautionary lessons from that crisis were thrown to the wind by Argentine authorities as well as international financial community.

Reliance on external financial flows cannot be considered a significant offence, particularly in the case of developing nations experiencing rapid growth. However, a dangerous and sinister process was well in motion by 1995, and continued after that year's crisis. With the nominal exchange rate fixed at one peso for one dollar, the peso had become overvalued in real terms. Between 1991 and 1994 Argentine rate of inflation was significantly higher than in the US, making Argentine goods and services relatively expensive. This naturally translated into growing current account deficits (primarily the result of rapidly growing imports and sluggish exports) which required substantial capital account inflows to maintain the balance of payments. The period of economic recovery that followed the 1995 recession carried indications of this real exchange overvaluation. Even though rapid GDP growth was re-established between 1996 and 1998, the unemployment rate did not drop below 12%. A significant jump in the current account deficit from US$6.8 billion in 1996 to US$14.5 billion in 1998 indicates that the recovery relied heavily on capital inflows. A shock to the capital account would require a significant devaluation in order to reduce the current account deficit or the reduction of domestic prices in order to restore the price competitiveness of Argentine exports.

In the fourth quarter of 1998 the Argentine economy entered a four-year depression. GDP declined by 3.5% in 1999, shrunk by 0.5% in 2000, contracted by 5.5% in 2001, and dropped by a record 12.5% in 2002. Growth was re-established in 2003, but only after a sharp devaluation and the largest default on external obligations in history. What turned a buoyant economy, the pride and glory of advocates for market reforms during the 1990s, into a severely depressed basket case? Much of the blame lies on the vulnerability to a balance of payments crisis created by market-friendly policies adopted throughout the 1990s, a flawed privatisation process being no stranger.

Starting in 1998, Argentina faced a series of severe external shocks. The South East Asian crisis of 1997 sent shock waves through international financial markets,
drying up capital flows to so-called emerging markets. Aware of the vulnerability to
the Argentine economy to contagion from far away financial crises -a lesson learned
in 1995- the government sought to inspire confidence through the establishment of
an Extended Fund Facility of US$2.8 billion with the IMF. Nevertheless, contagion
from the Russian and Brazilian crises resulted in reduced capital inflows and rising
domestic interest rates. The economy inevitably shrunk as consumption and
investment declined. With privatisation having run its course, the Argentine State no
longer had assets at its disposal to attract foreign capital. In any case, the mood in
international financial markets did not favour further investment in Argentina.

The slow down of capital inflows did not constitute the only external shock. In
the same period the effective real exchange rate of the Argentine peso rose. Several
events contributed to the reduced price competitiveness of Argentine products
among its main trade partners. The sharp devaluation of the Brazilian Real in early
1999 made Brazilian goods extremely inexpensive in Argentina at the same time
that Argentine goods became prohibitively expensive in Brazil. Inevitably, the trade
balance with Brazil turned sharply into a deficit. Shortly thereafter the US dollar
started to appreciate against the newly launched Euro. Europe was Argentina's
second largest trade partner after Brazil, so the consequent appreciation of the
Argentine peso against the Euro further deteriorated Argentina's trade accounts. To
make matters worse, rising interest rates drove up payments on large public and
private debts accumulated in the early and mid-1990s, and the repatriation of profits
and royalties by foreign subsidiaries -among them many privatised public services-
caused a further deterioration of the current account.

Facing dual shocks to the capital and current accounts, Argentina was hard
pressed to find solutions to the growing balance of payments disequilibrium. Having
no control over capital inflows, interest rates on US dollar loans, or the repatriation
of company profits, Argentina was forced to increase exports of goods and services
and reduce imports. In the meanwhile, IMF assistance became indispensable to meet
external obligations and IMF-style adjustments were rapidly implemented. The
solution devised was standard IMF fare minus the devaluation. The trade surplus
would be generated by austerity measures such as reduced government expenditures
and rising taxation. The contraction of consumption would reduce imports and free
resources for their transfer to the export sector. Normally the forceful contraction of
consumption would be accompanied by the devaluation of the currency. However,
in the Argentine case this was practically impossible. First, the Convertibility Law
required an act of Congress to lift the parity to the US dollar. Congressional debate
on the issue would immediately result in massive capital outflows and the virtual
collapse of the financial system, exacerbating the crisis rather than solving it.
Second, the Argentine economy was highly dollarised, with a large amount of
contractual obligations denominated in US dollars. The devaluation of the peso
would have put in peril the financial soundness of the entire productive apparatus as
well as large segments of the middle and upper income groups. Finally,
Convertibility was associated in the minds of most Argentines with the defeat of
hyperinflation and constituted the inviolable promise of a stable currency. Changing the parity to the US dollar would have amounted to political suicide.

The impossibility of devaluation meant that the entire burden of reducing imports and expanding exports had to fall on the contraction of consumption. As previously discussed, the overvaluation of the real exchange rate during the early 1990s and the re-valuation of the effective real exchange rate in the late 1990s reduced the price competitiveness of Argentine products. The contraction of consumption would have to be severe enough to drive domestic prices down and restore the price competitiveness of Argentine goods and services -effectively depreciating the real exchange rate. The adjustment sought a reduction in wages forcing prices to drop and restoring international price competitiveness. In other words the policy response to external shocks was to be deflation.

The severe recession of 1999 enabled a reduction of wages and domestic prices, starting a slow process of deflation. The recession contributed to a reduction of the trade deficit in goods and services from US$7.5 billion in 1998 to US$5 billion in 1999. However, the current account deficit remained large at US$12 billion and the government deficit practically doubled. In 2000, Fernando de la Rúa became President and opted to continue abiding by IMF demands, by now adamant about a large reduction of the government deficit. De la Rúa's administration raised taxes to perilous levels and enacted an across the board cut in government salaries and pension payments of 13%. As a result a nascent recovery in 2000 was choked off. Urged by the IMF, de la Rúa also pushed through the Legislature a labour market flexibilisation law amid allegations of kickbacks from the Executive to members of Congress. The subsequent economic contraction reduced the balance of trade in goods and services to a deficit of US$2 billion. Nevertheless, the Argentine current account balance still registered a deficit of US$9 billion. In 2001, as the external accounts continued to slowly improve, domestic conditions rapidly worsened. In an effort to cut government expenditures, de la Rúa drastically reduced social assistance programs. The consequent decline in consumption drove the balance of trade in goods and services into a small surplus. However, unemployment climbed to a record 18% as the government's austerity program was disenfranchising people. Three years of deflationary efforts were slowly having an impact on external accounts, but their social and political cost had reached a boiling point.

In September 2001, the IMF, unsatisfied with progress in the reduction of government deficits, suspended financial assistance to Argentina. What capital inflows may have remained came to a complete halt and an imminent devaluation became possible. Domingo Cavallo, the original architect of Convertibility, had been resurrected to the Ministry of Economy after a five-year hiatus. In an effort to stem capital flight and prevent the collapse of the banking system, Cavallo froze all bank deposits, infuriating a middle class that was already suffering lower wages and high unemployment. After more than three years of recession and rising unemployment, many poor and unemployed were going hungry. By December food riots broke out in the outskirts of Buenos Aires, as mobs sacked grocery stores. The government attempted to restore order through police repression. On this occasion
the middle class, traditionally indifferent to the plight of low-income classes, poured into the streets of central districts of Buenos Aires and other major cities to demand the resignation of Domingo Cavallo. When De la Rúa replied with further police repression the population replied demanding the President's resignation. In the ensuing weeks debt payments were suspended and the peso was floated against the US dollar.

The Role of Privatised Public Services in the Economic Crisis

Privatised Public Service Enterprises (PPSEs) were not innocent bystanders in the prolonged process of economic, political and social deterioration that afflicted Argentina. Deflation is never an easy task. Not only does it place severe strains on the financial system and depresses investment, deflation also heightens political tensions as unemployment and social distress escalates. The monopolistic power and special contractual arrangements retained by PPSEs made matters worse. Just as austerity measures were implemented to drive prices down and recover international price competitiveness, the fees of many public services were rising. Rising prices of public services meant that the contraction in the consumption of other items had to be more severe, exacerbating the difficult conditions faced by the vast majority of Argentine households. Electricity rates, water and sewage fees, natural gas prices and transportation costs increase as incomes shrunk and unemployment exploded. While the economy sunk, PPSEs' profits grew. We must explore the pricing of public services post-privatisation in order to understand this seeming paradox.

The combination of trade liberalisation and privatisation had a profound impact on relative prices in the economy. The rapid and unilateral reduction of trade barriers kept low the prices of goods and services traded across international borders. Industrial and manufacturing firms originally established behind high levels of protection hardly had any time to adapt to the new competitive conditions. Dedicated to the production of tradable goods, many floundered in their struggle to survive, resulting in the significant enlargement of the files of the unemployed previously noted. On the other hand, the prices of non-tradables were largely unaffected by international competition and continued to increase in the midst of trade liberalisation. Public services represent an important proportion of non-tradables. Many of these, such as electricity, roads and telecommunications, are important inputs to the production of tradable goods and make up a significant proportion of essential household expenditures.

The lack of competition often inherent to the provision of public services is a result of economies of scale and their non-tradable nature. Regulatory authorities are generally established to determine reasonable prices for public services. A common pricing mechanism used by regulatory authorities is the price-cap system. This pricing method establishes a maximum rate that can be charged for a public service. The maximum rate is periodically adjusted to accommodate changes in input costs and factor productivity. The regulatory agency would dictate lower service fees if significant productivity increases were obtained or input prices declined in order to guarantee that gains from productivity increases are shared with the population at
large. In the case of an increase in input prices the regulatory agency would increase
the maximum rate to protect the earning of the public service provider. In principle
the price-cap mechanism would guide the regulation of public service fees in
Argentina. In practice virtually no downward adjustments of service fees took place
to distribute the benefits of large increases in productivity. Instead, the price-cap
mechanism was aptly utilised to obtain automatic rises in service rates through fee
adjustments to the US rate of inflation.

During the 1980s prices and wages had been periodically and automatically
adjusted for inflation, transmitting past inflation into the future. The Convertibility
Plan declared all automatic adjustments of prices and wages null and void to
eliminate this source of cost-push inflation and reduce inflationary expectations. The
ban on price indexation included all privatised public services. However, since
public services were subject to regulated maximum rates, and these would no longer
be adjusted, this measure did not sit well with PPSEs and potential investors in
firms up for privatisation. In 1992, the contracts for telephone services were
renegotiated to allow the two telephone service providers biannual adjustments of
service fees according to the US consumer price index (CPI). The firms argued that
inputs to the industry were imported and service rates should be adjusted to a foreign
price index. Given the anchoring of the Argentine peso to the US dollar, they
claimed that such indexation could do no damage. The authorisation to adjust
service fees for US inflation clearly contravened the Law of Convertibility passed by
the Argentine Congress. Illegal or not, the Menem administration ceded to the firms'
request allowing for indexation to the US CPI. The privatisation process was only in
its early stages and Menem intended to give a clear signal that his administration
was vent on protecting the interests on foreign investors. Public services that had
already been privatised went through contract renegotiations to incorporate a clause
allowing fee adjustments to the US CPI. In later privatisations, indexation of service
fees to the US CPI became a standard feature.

The special treatment granted to privatised firms, albeit illegal, proved to be a
bonanza to foreign investors. Between January 1995 and June 2001, the Argentine
CPI declined by 1.1% and the Argentine producer price index (PPI) increased by
1.6%. During the same period the US CPI increased by 18.4% and the US PPI did so
by 9.8%. While the Argentine economy was experiencing severe deflation PPSEs
were allowed to increase service rates, causing further imbalance of tradable to non-
traded prices and slowing down any gains in the price competitiveness of
Argentine products.

In addition to the periodic indexation of service rates, some PPSEs were able to
negotiate additional rate increases and reduce their contractual commitments. For
example, Aguas Argentinas negotiated a fee increase of 13.5% in July 1994 even
though the regulatory framework stipulated no fee increases for ten years. By the
end of 1997, a new re-negotiation of contract postponed or eliminated diverse
investment projects that had been agreed to in the original privatisation contract. In
1998 the enterprise obtained an additional service rate increase of 5.1%.
Renegotiations of the contract in 1998 introduced the periodic indexation of fees to
the US CPI. Negotiations during De La Rua's administration resulted in 9.1% increase in service fees in 2001. Consequently, residential rates for water and sewage services increased by 88.2% between May 1993 and January 2002. In the same period the Argentine CPI increased by only 7.3%. (Aspiazu and Forcinito 2003:1-2) The repeated re-negotiation of fees and cancellation investment commitments by a significant number of PPSEs indicates that, contrary to the arguments of market reform advocates, opportunities for rent-seeking and corruption expanded as a result of privatisation.

With a captive market, the provision of public services under monopolistic conditions entails a modicum of entrepreneurial risk. Low risk in turn implies that rates of return, which, if fees are properly regulated, should be small relative to high-risk sectors. However, the lack of an appropriate regulatory framework and proper regulatory agencies guaranteed a higher than normal rate of return to PPSEs. In effect, profit margins for public services providers in Argentina were significantly higher than profit rates in other industries in the country, as well as profit rates obtained by public service providers in Europe or the US. Between 1993 and 1999, the largest 200 firms operating in Argentina generated nearly US$26 billion in profits. Of these, 54% went to 26 PPSEs, resulting in average profits of US$ 2 billion per year. In the same period the rate of profit to revenue among the top 200 firms was 10.8% for PPSEs and 6.4% for firms with ownership links to PPSEs. Firms in the same group but with no ownership links to PPSEs registered an average rate of profit of only 1.6%. (Basualdo et. al. 2002:37)

Other measures of profitability do not alter the picture significantly. Between 1994 and 1999 the average rate of profit relative to the firm's net assets was 15.4% for PPSEs, with road concessions and water and sewage services averaging above 20%. The only sector below 10% was electricity with 5.6%. The average rate of profit to sales for PPSEs was 12.3% for the same period and presented less dispersion between sectors. In comparison, in 1999, the largest 100 firms excluding PPSEs had an average rate of profit to net assets of 3.4%, and an average rate of profit to sales of 1.2%. (Basualdo et. al. 2002:38) Clearly, during the period under observation, investment in public services and associated non-tradable industries constituted an extremely profitable investment, whereas investment in manufacturing and other tradable sectors held little to no appeal. In view of this fact, it should come as no surprise that Argentina faced a very serious struggle trying to reduce its current account deficit between 1999 and 2001.

Comparison with profit rates in other nations helps to place in a global context the exceptionally high rate of profits attained by PPSEs in Argentina. For example, in the US, the UK and France a normal rate of profit on net assets for water and sewage service providers is considered to be between 6% and 7%. As a result of repeated re-negotiations, the indexation of fees to the US CPI, a weak regulatory framework and co-opted regulatory agencies Aguas Argentinas received an average rate of profit on net assets of 23.3% between 1994 and 1999. In the case of telephone services, Telecom Argentina generated an average rate of profit three times larger than its parent companies France Telecom and Telecom Italia, while
Telefónica Argentina was twice as profitable than Telefónica de España. Another telling example comes from the two companies in charge of natural gas transportation whose average rate of return was 40%; a reasonable rate of return for this sector is considered to be between 10% and 20%. (Basualdo et. al. 2002:39-40) The exorbitant profit rates obtained by PPSEs can only be interpreted as evidence of unchecked monopolistic power and the exertion of strong influence over regulatory agencies and government alike.

The evidence reviewed indicates that PPSEs contributed to the prolonged depression of 1999-2002 and the collapse of Convertibility in a variety of ways. PPSEs rising fees contributed to the overvaluation of the peso, diminishing the price competitiveness of Argentine products abroad; borrowed heavily in international markets, requiring foreign exchange to make debt payments; and repatriated their profits when growth prospects declined, placing an undue burden on the current account. We analyse each of these below.

First, the special treatment regarding the adjustment of fees granted to PPSEs undermined efforts to re-establish price competitiveness of Argentine products abroad between 1999 and 2001. Whereas the entire economy was submerged in a deflationary process for three years in a row, the prices of most public services continued to increase at the US rate of inflation, or even above in the case of some contract re-negotiations of the period. This not only slowed down internal price adjustments rendering Argentine goods less competitive; it also generated significant hardship among low and middle income households already suffering from declining wages and growing unemployment. Second, PPSEs borrowed extensively overseas during the early 1990s. In most cases, SOEs were transferred to private hands debt-free. PPSEs use their extensive assets as collateral in the acquisition of large debts. Interest and principal payments on this debt eventually required significant foreign exchange resources, with the subsequent pressure on the current account and the exchange rate. Given that PPSEs produce non-tradable services, the foreign exchange needed to meet their debt payments would have to be generated in the tradables sector. Finally, the sombre growth outlook between 1998 and 2001 led to the repatriation of profits to parent companies abroad, precisely at a time when the balance of payments faced severe difficulties. Like payments on PPSEs foreign debt, this contributed to recurrent current account deficits and placed pressure of the exchange rate.

Conclusion

The fall of de la Rúa was followed by a couple of weeks of political wrangling in Congress from which Eduardo Duhalde emerged as the new interim President. Duhalde added the abrogation of the Law of Convertibility, effectively letting the peso float against the dollar, to a payments moratorium declared shortly after de la Rúa's fall. The ensuing devaluation of the peso necessitated that all contracts, prices and fees previously established in US dollars be converted into pesos, including
deposits in the banking system and domestic debts. Furthermore, the special indexation privilege thus far available to PPSEs was summarily abolished. These emergency measures resulted in a severe dislocation of the economy, as the financial system tittered on the border of collapse and enterprises with foreign debts struggled to stay off bankruptcy.

Analysis of events since January 2002 is beyond the scope of this paper. Suffice it to state that the Argentine government has kept most public service fees frozen. Only in mid-2004 some energy sector fees were raised in an effort to curb fast growing demand for natural gas and electricity. Between 2002 and 2004, PPSEs have put pressure on the Argentine government to raise public service fees. From lawsuits at the United Nations international dispute resolution court, to lobbying of G-7 nations with influence in the IMF, and even veiled threats and actual interruptions of services, PPSEs have sought to re-establish the golden days by any means at their disposal. After much wrangling, the administration of Néstor Kirchner has apparently reached agreements with PPSEs in various sectors regarding the re-negotiation of contracts.

A rushed and flawed privatisation process that did not establish an adequate regulatory framework and the corresponding independent regulatory agencies is responsible for much of the disappointment surrounding PPSEs in Argentina. A privatisation process that concentrated wealth and power resulted in few or no benefits to society at large. Significant productivity gains in all PPSEs ought to have brought large benefits to consumers of public services, but for the most part these gains were seized by PPSEs exercising monopolistic power. Contrary to the Argentine case, privatisation should not represent the complete forfeiture of state authority over public services. Developing nation governments must pursue privatisation with extreme caution. A regulatory and legal framework that limits the activities of PPSEs and grants the state broad powers of intervention ought to be established prior to the transfer of state assets to the private sector. As the case of Argentina proves, swift privatisation for the sake of short-term expediency can carry enormous long-run costs.

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Abstract

This article discusses the privatisation of public services in Argentina in light of the severe crisis that afflicted the country between 1999 and 2002. An inadequate regulatory framework and the absence of effective regulatory agencies resulted in the exercise of monopolistic power over public service fees. The emergence of a series of external shocks, starting in 1997 with the SE Asia crisis, weakened the country's external accounts. In the context of a strict fixed exchange rate regime, rising public service fees and overseas obligations contracted by the privatized firms placed growing pressure on the balance of payments. Even though privatized firms were not directly responsible for the four-year recession or the balance of payments crisis, their actions contributed to the onset and prolongation of the difficulties faced by Argentina.