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Methods and sequencing of privatization : what post-socialist countries can learn from Chile

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METHODS AND SEQUENCING OF PRIVATIZATION
What Post-Socialist Countries Can Learn from Chile

by

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I. Introduction*

The economic transformation of post-socialist countries can hardly be mastered if production and investment decisions remain within the domain of the state. However, large-scale privatization in Central and Eastern Europe appears to be rather difficult and time consuming [Inotai, 1992, pp. 170ff.]. Privatization has to proceed under unfavourable circumstances, e.g. uncertain property rights, institutional deficiencies, non-existent capital markets and insufficient savings. This renders it difficult to speed up the privatization process and to avoid major policy failures by drawing on the experience of previous privatizations in other countries. The experience of Western market economies is of limited value because privatization was confined to selected enterprises. Moreover, the major impediments to privatization in post-socialist countries are largely absent in advanced market economies. In principle, the same arguments may be raised against using the experience of developing countries as a reference case.[1] However, there is one notable exception, namely the large-scale privatization of state-owned enterprises in Chile since 1974.

The Chilean experience has been largely neglected in the current discussion on privatization in Central and Eastern Europe. This paper will critically review the achievements and pitfalls of privatization in Chile and evaluate the lessons for post-socialist countries. The analysis proceeds as follows: Section II reveals that major privatization issues which are currently discussed in the East European context figured prominently in Chile

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1 For an overview on privatization in developing countries, see Berg, Shirley [1987].

as well. Similarities refer to (i) possible trade-offs between objectives to be achieved by privatization, (ii) the pros and cons of different privatization methods, and (iii) the sequencing of privatization under conditions of macroeconomic instability and distorted market structures. The Chilean experience with different privatization phases during the 1970s and 1980s is analyzed in Section III. The paper concludes by assessing which insights can be gained from the Chilean experience for the privatization process in Central and Eastern Europe (Section IV).

II. Privatization Issues in Eastern Europe and Chile: Basic Similarities

It is frequently argued that privatization in Eastern Europe has to be rapid and comprehensive to make the economic transition irreversible, to foster allocative and adaptive efficiency, and to render macroeconomic stabilization more credible.[1] The idea to restructure and revitalize state enterprises in the first step, before transfering them to private owners, is rejected by those who expect greater efficiency and adjustment flexibility from rapid privatization. To speed up the privatization process, it has been suggested to sell state-owned enterprises at open auctions to the highest bidder.[2] Firms for which a buyer cannot be found within a predetermined time span should be closed down to prevent a further waste of public resources.

Various objections have been raised against rapid and comprehensive privatization schemes. Critics emphasize possible trade-offs among different privatization goals. The public support of the transformation process as a whole may be undermined if rapid

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[1] For a more detailed discussion on the goals to be achieved by rapid privatization, see e.g. Blanchard, Layard [1992]; Hinds [1990]; Schmieding [1992]; Nunnenkamp, Schmieding [1991]; Roland, Verdier [1992]; Winiecki [1990].

[2] For the proposal to create independent holding companies or privatization agencies for managing the sale of state enterprises, see Schmieding, Koop [1991].

privatization results in an unequitable distribution of wealth and ownership.[1] Political opposition against the transformation of centrally planned economies into market economies might be reinforced if unemployment problems mount due to rapid privatization of overstaffed state enterprises. Another concern is that public sector accounts may be affected negatively. Large-scale privatization is expected to add to serious fiscal problems because of depressed selling prices in the presence of low national savings and rudimentary capital markets. Furthermore, privatization is considered an insufficient condition for creating competitive market structures and, thereby, containing transition problems. It is expected to boil down to the replacement of state monopolies by private monopolies if state-owned conglomerates were not broken down into smaller and independent units before privatizing them [Bonin, 1992; Newbery, 1991].

The sequencing of privatization in the economic transition of Central and Eastern Europe is heavily debated on theoretical grounds. Some authors, e.g. Lipton and Sachs [1990], conclude that privatization should only be the third step of economic transformation. In their view, it must be postponed until after macroeconomic instability and distorted incentive systems have been removed, in order to reduce the uncertainty about the future economic development and improve the informative value of relative prices. In sharp contrast, authors such as Lewandowski and Szomburg [1989, p. 257] consider "property reform as a basis for social and economic reform".

The persistent controversies on the pros and cons of rapid and comprehensive privatization are difficult, if not impossible, to overcome on purely theoretical grounds. Surprisingly, the Chilean

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[1] Public resentment is most likely if state managers take undue advantage of the institutional vacuum in the early phases of economic transition and enrich themselves by acquiring state assets. For empirical evidence on the so-called "spontaneous" privatization in Poland and Hungary, see Grosfeld [1990, pp. 147ff.]; Economist [1990, p. 16]; on the political economy of privatization, see Winiecki [1992].

experience has been largely ignored in the current discussion on the appropriate design and implementation of privatization programs in Central and Eastern Europe. In contrast to other privatization episodes, the case of Chile reveals remarkable similarities to the present situation in post-socialist countries:

- First, privatization involved about 600 enterprises. In 1973, the state enterprise sector accounted for almost one half of gross domestic product [Nankani, 1988, p. 18]. State enterprises were not only dominant in services such as public utilities, transportation and communication, but also in the financial sector and in mining. Their share in manufacturing output reached 40 per cent [Saez, 1991, p. 5]. Though this is significantly below the respective figures for post-socialist countries,[1] the overall task of the privatization in Chile was not too different.

- Secondly, the case of Chile may provide valuable insights into the trade-offs and inconsistencies between different privatization objectives. As presently in Eastern Europe, privatization was motivated by a variety of goals, ranging from microeconomic efficiency and enhanced competitiveness to the consolidation of public sector accounts and a more equitable distribution of wealth.

- Thirdly, heavily debated issues such as the restitution of expropriated owners, the valuation of state enterprises, and public acceptance of privatization schemes figured prominently also in Chile. The valuation of firms was impeded not only by institutional weaknesses, but also by the overstaffing, use of outmoded technology and outsized plants of state-owned enterprises. The perceived underpricing of sales was a prominent feature in the public debate on privatization.

[1] Until recently, the private sector (excluding the shadow economy) contributed typically less than 10 per cent to gross domestic product [Schmieding, Koop, 1991, p. 6]. The major exception was Poland with a share of about 20 per cent. In many cases, the dominance of state enterprises was even more pronounced in industrial production.

- Fourthly, different modes of divestiture were applied in the various phases of privatization in Chile, including bidding mechanisms, stock market auctions, direct sales to workers, and widespread distribution of shares among the public ("popular capitalism") [Nankani, 1990]. The privatization programs of East European governments encompass a similarly wide spectrum of options. The ongoing discussion of the pros and cons of different privatization methods may benefit from the empirical evidence available from Chile.

- Fifthly, "most of the Chilean privatizations took place while the economy was in the midst of a rapid and drastic structural reform, from a highly unstable, intervened and protectionist economy, to a relatively stable, open market economy" [Lüders, not dated, p. 1]. Hence, Chile provides an interesting reference case on how to integrate privatization into a comprehensive scheme of economic transformation in Central and Eastern Europe.

- Finally, structural and institutional deficiencies, which are frequently stressed as important impediments to privatization in post-socialist countries, were also prevalent in Chile. The national savings rate was particularly low before privatization started (1972/73: about 10 per cent [Edwards, 1985, p. 239]). The capacity of the domestic financial market was very limited [Larrain, 1988; Marshall, Montt, 1988]. The regulatory framework of financial intermediation and the supervision of financial institutions were weak or non-existent.

In retrospect, the economic transformation of Chile was quite successful. After the economic crisis of the early 1980s, real gross domestic product increased by an annual average of 5.4 per cent [ECLAC, 1991, p. 37].[1] Between 1985 and 1990, private investment recovered most impressively in Chile (by 130 per cent) within a sample of 35 developing countries [Pfeffermann, Madaras-

[1] This figure was high by world and developing country standards where it was below 4 per cent in 1984-1989 [IMF, 1991].

sy, 1992, p. 4]. However, privatization was not an undisputed success story from the very beginning. The strengths and weaknesses of the Chilean approach towards privatization are analyzed in more detail in the subsequent section. The privatization methods changed significantly since 1974, and so did the economic environment in which privatization proceeded during the 1970s and 1980s. This provides the opportunity to draw on empirical evidence in discussing appropriate methods, the sequencing and the possible trade-offs of privatization in Central and Eastern Europe.

III. The Chilean Experience

1. Institutional Setting and Privatization Methods

In September 1973, when the army overthrew the Allende government, the new regime inherited about 600 state enterprises.[1] Most of them were controlled by CORFO (Corporación de Fomento de la Producción de Chile) and acquired during the socialist era. CORFO had been the most important developmental public agency to create, acquire and manage firms. Since its establishment in 1939, it had come to possess a strong influence in such different sectors as electricity, telecommunication and steel. Since 1973 CORFO became the main institution entrusted with the privatization of public enterprises. It was expected to possess the best experience on the working of public sector firms and, thus, to be able to privatize them[2] better than any other government organization.

Within CORFO, three institutional bodies had to carry out the privatization of state enterprises, viz. (1) the Council, (2) the Privatization Committee and (3) the Normalization Unit.[3] The

[1] Depending on the definition of nationalization or takeover, this number differs from one source to another [see e.g. Nankani, 1988, p. 18; Yotopoulos, 1989, pp. 685 and 690].

[2] Including the state enterprises which were under the direct control of ministries and other government departments.

[3] Before 1976 known as Enterprise Managership.

Council functioned also as the board of directors of CORFO and was finally responsible for privatization. The proposals for privatizations came generally from the central government. In the cases of small enterprises they originated sometimes from within CORFO. Supervisory work of the implementation was done by the Privatization Committee. The actual administration of the divestiture program was carried out by the Normalization Unit. However, this division of labour was kept flexible to accommodate the necessary deviations from this procedure [Nankani, 1988, p. 24].

Besides institutional arrangements, the success of privatization programs depends also on the appropriate choice of buyers, timing, methods and terms of financing. The Chilean government tried from time to time several privatization methods and their combinations. Changes in privatization methods were largely due to the perceived failure of earlier approaches. The most important of these methods were the following.

Return to previous owners: One year after seizing power, the military government started returning to their previous owners the firms which were nationalized by the Allende regime. Most of these enterprises were denationalized during the first privatization phase (1974-1975). This restitution did not involve any payments for either of the parties [Nankani, 1988, p. 27]. Restitution in Chile did not create major problems. The time elapsed since nationalization was not very long, and old owners were easily identified. Therefore, restitution presented a viable solution in Chile. By contrast, conditions for restitution are very difficult in Central and Eastern Europe. Property titles are badly recorded and previous owners, wherever identifiable, have lost their managerial qualifications due to the long time span since nationalization. Consequently, in cases of property claims financial compensation of previous owners is a superior alternative in post-socialist European countries. This would remove uncertainties with respect to property rights and the ensuing delay of investment activities.

Competitive bidding: This was the most common method adopted during the second phase of privatization (1975-1983).[1] It involved the setting of bid conditions and issuing notification usually through media advertising. Following an auction for which there were only a few qualification criteria, CORFO negotiated the terms of agreement with the most qualified bidder. The purchasers were generally large firms. Sometimes smaller domestic firms and employee cooperatives participated in the bidding. Up to one-tenth of the agreed price had to be paid immediately.[2] The balance could be financed through a loan from CORFO, usually with a maturity of 8 to 15 years and a real interest rate of 8 to 12 per cent.

According to Nankani [1988, p. 27], 47 firms were sold to domestic and 10 to foreign buyers through competitive bidding between 1975 and 1978. Most of them landed into problems shortly after privatization. They were either declared bankrupt or rescued by the government when a deep recession hit the country in the early 1980s [ibid]. This unfavourable outcome of privatization through competitive bidding has frequently been attributed to an inadequate screening of buyers with regard to their financial, technical and managerial capabilities. Moreover, the debt-led financing of privatization through government loans resulted in high debt/equity ratios and rendered the privatized firms financially very unstable [Saez, 1991, p. 23].

Bidding as a technique of privatization was not given up by Chile in later years. But the assessment of earlier privatization episodes resulted in several adjustments, e.g., in the selection of potential buyers and the financing of privatization operations. In order to avoid concentration of privatized firms in fewer hands, bidding was now restricted to prequalified investors.

[1] In those cases, where the share of ownership of CORFO was less than 10 per cent the shares were auctioned through the stock market [Saez, 1991, p. 243].

[2] In case of the privatization of banks, there was a minimum downpayment of 20 per cent [Saez, 1991, p. 23].

Interest rates charged were lowered. Conglomerates had to make a 100 per cent cash payment. Large companies were no longer privatized fully at a time. Shares were rather sold in various instalments to avoid an overburdening of financial markets. Furthermore, other privatization methods gathered momentum.

"Popular capitalism": This method implies an allotment of shares to a large number of small investors. It was sought as an improvement over the bidding method which had been blamed for excessive concentration of property without ensuring efficient management. Sizeable portions of the assets of two banks (Banco de Chile and Banco de Santiago), two pension funds (Santa Maria and AFP Provida) and a major electricity company (ENDESA) were reprivatized through this technique during the third phase (1985-1986), after the government had taken over their control during the economic and financial crisis of the early 1980s.

Shares were sold by CORFO directly and not through the stock exchange. For this purpose loans at zero real interest rates with a maturity of 15 years were granted up to 95 per cent of the sales price. In addition, the buyers could claim 20 per cent of the investment as credit against their future income tax liability and benefited from a 30 per cent reduction of amortization payments if the loans were repaid in time. "Popular capitalism" thus involved considerable subsidization in the context of privatization.

"Labour capitalism": Worker participation in ownership and management was promoted as another means to achieve a wider distribution of share capital. It was realized through sales to worker associations or individual workers.[1] Initially confined to the workers of the company concerned, worker participation was extended later to public sector employees in general, including

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[1] The price to be paid was generally fixed on the basis of the stock market price of the preceding period and was lower than the trading price on the day of offer [Saez, 1991, p. 35].

the army [Saez, 1991, p. 34]. None of them was allowed to hold more than 20 per cent of the share capital of an enterprise except in the case of employee buy-outs. Workers could use 50 per cent of their retirement funds for payments of share purchases or as collateral for loans from CORFO. The interest rates for such loans were usually below market rates. In some cases, workers were even entitled to return the shares at their original prices if they did not prove profitable later. As in the case of "popular capitalism", the risk for the participants was kept to the minimum. About one-third of the public work force participated in privatization programs by the middle of the 1980s [Nankani, 1988, p. 30].

In addition to the above methods, shares were sold to pension funds after the state-run retirement pension schemes were replaced by privately run financing societies in 1980. Pension funds are estimated to have bought around 15 per cent of the share capital of privatized public enterprises. Their participation was particularly strong in the case of public utility companies [Nankani, 1988, p. 32]. Furthermore, the engagement of foreign investors in the privatization of state enterprises was encouraged more strongly than in the earlier phases. Favourable conditions were offered in the context of debt-equity swaps which enabled Chile to reduce its foreign debt through privatizing state enterprises (see also Section III.3.).

It is an open question whether the alternatives to competitive bidding adopted in Chile during the 1980s show the correct way to privatization in post-socialist countries. The evidence that competitive bidding caused "excessive concentration" is rather weak.[1] The effects of concentration on the degree of competition and economic performance are highly ambiguous on both theoretical

[1] Yotopoulos concluded [1989, p. 696]: "The reduction in the number of firms seems to be well established, while its cause, whether the elimination of inefficient producers or the increasing monopolization to which privatization might have contributed, is more difficult to determine".

and empirical grounds. They depend, inter alia, on whether concentration takes place in the production of tradeables or in the non-traded goods sector. Negative effects for tradeables can be avoided if import competition is sufficiently strong.

The alternatives to competitive bidding need not necessarily result in less concentration in the longer run. Widely distributed shares may become heavily concentrated in a few hands if the public is not interested in holding them and trading of shares is allowed. Upper limits imposed on individual shareholdings can be circumvented by purchases through "strawmen". Moreover, a wide distribution of ownership involves trade-offs. It may seriously impede the effective control of the firm's management by private owners.[1] In Chile, principal-agent problems were aggravated by offering shares to the public at highly concessional terms. The subsidization of "popular" and "labour capitalism" reduced the risk of individual shareholders and further weakened their incentives to monitor and control the management. In the case of "labour capitalism", both efficiency and equity objectives are unlikely to be fulfilled. Incentives to reduce the typical overstaffing of inefficient firms are minimized. Equity criteria are violated because the wealth effects depend on the vastly different economic shapes of firms and because other population segments do not benefit at all.

The economic costs inherent in the Chilean approach suggest that post-socialist countries should consider different ways to buy political support for privatization. A fair and equitable distribution of benefits of privatization is not precluded by competitive bidding [Schmieding, 1992]. The revenues from direct sales to the highest bidder may be distributed through flat per-capita transfers or compensating tax cuts. Alternatively, the public may be offered shares in independent holding companies (or priva-

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[1] For a discussion on the effects of different modes of privatization on corporate governance, see Frydman, Rapazynski [1992]; Schmieding [1992, p. 103].

tization agencies) which control the state enterprises and manage their privatization.

Notwithstanding, the shortcomings of the bidding process in Chile during the 1970s have to be avoided. This applies above all to the financing of enterprise sales. The extension of government loans in the absence of basic solvency laws and supervisory bodies encouraged privately owned conglomerates to acquire more firms than they could manage. Financial fragility was not considered a major problem, probably because the conglomerates anticipated government bail-outs in order to prevent major bankruptcies and avoid far-reaching macroeconomic consequences. This expectation proved to be correct in the early 1980s. The financing of privatization in its debt-led phase had as a consequence that a significant part of private investors' risk remained with the state.

It is unlikely that the drawbacks of financing privatization by public loans can be avoided by better screening of private investors. This is even more true for Eastern Europe than it was for Chile. Governments lack the relevant information and experience for assessing the financial and managerial capabilities of individual investors. It is rather advisable for post-socialist countries to adopt the well established laws on basic solvency and portfolio criteria of a more advanced market economy. Moreover, privatization must be financed in a way that disposes the state of microeconomic risks and avoids moral hazard by private investors.

2. Privatization, Stabilization and Structural Reforms

Appropriate methods of divestiture alone do not guarantee the success of privatization. Failure may also result from an inadequate sequencing of privatization in the economic transition to a market economy. Privatization is particularly difficult under conditions of pronounced macroeconomic instability and distorted market structures. It was exactly in such an environment that

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privatization was initiated in Chile. Consequently, the Chilean experience may help in deciding whether instabilities and distortions should be removed before privatization is undertaken.

During the Allende government, the Chilean economy suffered from excessive public control of agriculture and industry, huge budget deficits, high tariff and non-tariff protection, overvalued exchange rates, high inflation, negative real interest rates, price and wage controls, etc. In 1973, the military government shifted emphasis from state intervention to free market policies. It started with a comprehensive reform program encompassing macroeconomic consolidation and far-reaching structural changes to improve efficiency and stabilize the economy. The reform program envisaged large-scale privatization from the beginning. By 1978, most of the companies under CORFO's control were denationalized.[1]

Privatization in Chile was accompanied with liberalization and structural reforms. Foreign trade was freed from quantitative restrictions soon after 1973. Import tariffs were reduced from about 94 per cent on an average to a flat rate of 10 per cent in 1979 [Saez, 1991, p. 8]. At the same time, export subsidies were eliminated. Restrictions on external capital movements were removed. The financial sector was greatly deregulated. This involved lowering of reserve requirements, removal of government interference in credit extension with regard to both the selection of borrowers and the amount of credit, freeing of interest rates, etc. Private financial companies were allowed to be formed liberally without any control on debt to asset ratios. In order to stabilize the economy, the government adhered to monetarist policies and got rid of fiscal deficits. Price controls were lifted. Loss of power by trade unions resulted in a de-facto deregulation of labour markets. The social security system was privatized in 1981. Enterprises which remained under government

[1] However, some of the remaining state-owned enterprises were among the largest in terms of net worth [Yotopoulos, 1989, p. 691].

control reduced redundant labour and improved their performance in terms of savings, tax payments and transfers to the government budget.

The economic policy of the military government had remarkable success until the recession in 1982-1983. For example, the inflation which was marked by nearly 500 per cent in 1973 and 1974 was reduced to 20 and 10 per cent in 1981 and 1982 respectively. The budget deficit amounting to nearly 25 per cent of GDP in 1973 was turned into surplus by 1979. The inflow of foreign capital increased. GDP registered an annual growth of 4 to 10 per cent between 1976 and 1981 [Yotopoulos, 1989, Tables 1 and 2].[1]

Some of these achievements were nullified by the recession. GDP growth became negative, unemployment rose, so did the budget deficit. The recession was aggravated by worsening international economic conditions, e.g. high inflation, steeply increasing interest rates, declining commodity prices and the debt crisis. However, the major blame for the Chilean economic crisis has been put on domestic policy failures that materialized in the early 1980s. The reform program suffered from serious inconsistencies. The exchange rate was fixed to the US-dollar in June 1979, while backward wage indexation was maintained and capital inflows were not sterilized [Corbo, 1985; Edwards, 1991]. The result was a significant real appreciation of the local currency which eroded Chile's international competitiveness.

Some critics go further in claiming that the crisis was due to too many reforms in too short a time. Particularly the sequencing of privatization is regarded as inappropriate [Meller, 1990, p. 83]. According to this view, excessive privatization is reflected in the fact that by 1983 about 70 per cent of the firms privatized during 1975-1978 either went bankrupt or were brought under

[1] However, economic reforms were accompanied with a steep rise in the unemployment rate in the early years of the transformation process. The rate decreased from its 1976-peak in the subsequent years, but remained substantially above the level of the early 1970s.

state control again. More than 50 enterprises and banks belonged to the latter category [Nankani, 1988, pp. 27-28]. The textile and metallurgic industries which had traditionally been highly protected and were not able to withstand competition after the liberalization of foreign trade were very highly affected.

The motivation to sell off state enterprises quickly to reduce budget deficits [Vickers, Yarrow, 1991, p. 126] resulted in highly leveraged companies. They could not withstand the recessionary impact on demand. The failure of individual enterprises triggered serious contagion effects due to strong financial linkages among enterprises and between industrial units and banks.[1] Debt-led privatization before basic solvency and portfolio requirements were enforced was inconsistent with financial stability under conditions of recession. To contain the financial and economic crisis, the government took over the management of firms of public importance, especially banks, with a view to reprivatize them to new owners later.

In contrast to the earlier privatizations, this reprivatization (1985-1986) proceeded under conditions of macroeconomic stability and well established incentive systems at the micro level. Moreover, laws against ownership concentration were implemented. Large investors were no longer allowed to use the assets of an acquired state enterprise as collateral to buy another state enterprise. Related party loans were defined as one loan. For this purpose rules were introduced to define related parties, a conglomerate or a group of shareholders. Further, the privatized corporations were obliged by law to disclose their balance sheets, stock purchases or sales, and to distribute at least 30 per cent of their profits [Piñera and Glade, 1991, p. 23]. These measures were expected to increase the sustainability of privatization.

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[1] About half of the foreign debt of the entire financial sector was owed by the two largest conglomerates in December 1982 [Saez, 1991, p. 8].

After the reprivatization of corporations in the mid-1980s, the government was left with about 40 corporations which pre-dated the Allende regime and were mostly in the public utilities and mining sectors. The new rules also applied to their privatization. No investor was allowed to buy more than 20 per cent of the share capital [Piñera, Glade, 1991, p. 32]. The corporations were privatized in healthy conditions. In some cases, old debts were transfered to CORFO before enterprises were offered for sale. The divestiture was carried through successively according to the absorptive capacity of the market in order to avoid pressure on sales prices. Some of the large public enterprises were divided into subsidiaries to facilitate their divestiture successively. The privatization in Chile came more or less to an end in March 1990 when an elected government took office. It announced in 1991 to increase the private participation in the remaining large state-owned enterprises through additional investment in expansion, but not by selling the existing assets [Saez, 1991, p. 6].

The more cautious and gradualistic approach adopted in recent privatization phases is commonly understood as the result of the necessary learning process induced by the economic and financial crisis of 1982-1983. The Chilean experience indeed suggests that an appropriate sequencing is important for the success of privatization. The number of enterprise failures could have been reduced by more appropriate privatization methods, especially with respect to financing arrangements (Section III.1.). This underlines the earlier conclusion that large-scale privatization requires that a regulatory framework of basic rules and institutions supervising and enforcing such rules is established from the beginning.

Many of the enterprises sold to private investors in Chile in the 1970s were candidates for liquidation, rather than privatization [Nankani, 1990, p. 44]. Notwithstanding, it would be misleading to conclude from the bankruptcies and rescue operations that privatization must be postponed until after macroeconomic stability has been restored and microeconomic incentive systems have

been reformed. It is the transparency of the rules of the game which matters for stabilizing expectations and reducing uncertainty. Hence, it would be sufficient to announce clearly the future course of economic policy before privatization is initiated. As concerns macroeconomic stabilization, much depends on the credibility of announced fiscal consolidation. The Chilean experience indicates that the phasing out of government support for individual enterprises would be more credible if state-owned conglomerates were split up for the purpose of privatization. Politically, it is more feasible to impose harder budget constraints on smaller privatized enterprises because their failure would not trigger off far-reaching macroeconomic effects. As concerns structural reforms, the evidence from Chile suggests that it is most important to provide clear signals on future trade policy. The privatization of enterprises producing in sectors which have been highly protected so far would then no longer be based on wrong expectations of buyers for continued import protection.

Further, policy announcements must be consistent for privatization to be sustainable.[1] Major inconsistencies, for example between trade policies on the one hand and exchange rate and monetary policies on the other hand, undermine the transition to a market economy. In the case of Chile, inconsistent policies deepened the crisis of the early 1980s which, in turn, resulted in the failure of earlier privatization programs. This indicates that consistency is a major challenge for privatization to succeed in Eastern Europe.

3. Consequences and Sustainability of Privatization during Economic Transition

The sustainability of privatization may suffer not only from misconceived privatization methods and inconsistent policies during the transformation to a market economy. Additional strains

[1] For a more general discussion on consistency and credibility, see Funke [1991].

may come from short-term economic consequences of privatization which are difficult to avoid even under the most favourable circumstances. Major concerns relate to (i) increasing unemployment which may undermine the public support for privatization, (ii) deteriorating fiscal balances caused by large-scale privatization, and (iii) the capital market effects of privatization. The subsequent discussion on the Chilean experience in these respects reveals that it is extremely difficult to isolate the effects of privatization from other influences. Nevertheless, tentative evidence may help to assess the justification of the above concerns.

Employment: The rate of unemployment increased considerably in Chile after 1973 (Table 1). But this unfavourable development cannot be ascribed to privatization according to a detailed comparative study of a large sample of Chilean enterprises during 1965 and 1978 by Hachette and Lüders [1991]. The rise in unemployment was instead related with the introduction of efficiency rules in public enterprises and with structural changes which applied to both the public and the private sector.

After overthrowing the Allende government, the military regime asked the state enterprises to reduce redundant labour. Employment in this sector went down as a result of the government's determination to achieve fiscal consolidation by eliminating the heavy subsidization of inefficient state enterprises.[1] These enterprises were not privatized until the second half of the 1980s and some of them are still publicly owned.

[1] Government subsidies to state enterprises represented the most important source of the fiscal deficit of 25 per cent of GDP in 1973 [Lüders, not dated, p. 8]. Subsequently, transfers to state enterprises became the exception rather than the rule. Income tax concessions and import duty exemptions were also eliminated. The deficit of the public sector enterprises was reduced from 12.4 per cent of GDP in 1973 to 0.6 per cent in 1979 [Saez, 1991, p. 17].

Table 1 - Selected Indicators of Chilean Economic Conditions, 1971-1989

	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
Unemployment rate (per cent)	5.5	3.7	4.6	9.7	15.6	18.6	17.4	17.1	16.7	15.8	26.3	23.7	22.5	18.5	16.6	13.9	12.9	12.2	9.8
Real GDP growth (per cent)	9.0	-1.2	-5.6	1.0	-12.9	3.5	9.9	8.2	8.3	7.8	5.5	-14.1	-0.7	6.3	2.4	5.7	5.7	7.4	10.0
Public sector expenditure (per cent of GDP)	31.1	31.2	44.9	32.4	27.4	25.8	24.9	23.8	22.8	23.1	24.9	28.5	28.4	28.8	32.5	30.0	28.3	30.7	n.a.
Fiscal deficit of central government (per cent of GDP)[a]	10.7	13.0	24.7	10.5	2.6	2.3	1.8	0.8	-1.7	-3.1	-1.7	2.3	3.8	4.0	6.3	2.8	0.1	1.7	n.a
Government receipts from privatization (per cent of total government revenues)	-	-	-	0.9	10.4	4.6	4.4	3.3	3.2	1.0	1.4	0.3	n.a.	n.a.	0.2	4.9	5.8	10.1	n.a.
Credit to private sector (per cent of total credit)	28.5	22.2	18.6	15.2	15.9	15.6	37.7	50.6	54.7	68.1	81.1	83.0	80.8	79.8	83.4	84.1	82.9	83.7	n.a.
Real short-term lending rate (per cent)	n.a.	n.a.	-76.1	-36.9	16.0	64.3	56.8	42.2	16.6	11.9	38.7	35.1	15.9	11.5	11.0	7.5	9.2	7.4	11.8
Inflation rate (per cent)	26.7	108.3	441.0	497.8	379.2	232.8	113.8	50.0	33.4	35.1	19.7	9.9	27.3	19.9	30.7	19.5	19.9	14.7	17.0
External debt (Mill US$)	2618	3050	3275	4522	4762	4849	5884	7374	9361	12081	15664	17315	17928	19737	20384	21144	21502	19578	18241
Debt service ratio (per cent of exports)	36.8	15.6	11.9	15.1	31.2	39.4	43.9	44.6	41.2	39.6	64.2	64.4	65.7	60.9	65.4	57.1	36.5	36.5	37.5

[a] "-" indicates surplus.

Source: World Bank [1991]; Hachette, Lüders [1991].

The subjection of enterprises in the private and the public sector to market rules could be expected to result in an increase of transitional unemployment. Problems of economic transition are reflected in GDP growth figures which remained low or even negative in the mid-1970s, but picked up remarkably thereafter (Table 1). By contrast, employment did not recover significantly even if a lagged response of demand for labour is taken into account. Unemployment rates reached unprecidented levels in the early 1980s. This has to be attributed to adverse world-market developments and inconsistent internal policies, rather than to privatization per se. Among international factors, the second oil price hike, the worldwide recession and the international debt crisis stand out. The adjustment to external shocks became increasingly difficult because of policy inconsistencies (Section III.2.). Wage indexation resulted in an inflexible structure of real wages at a time when wage flexibility was required [Corbo, 1985, p. 899]. Moreover, it led to an automatic increase in real wages since 1977 as inflation was declining [Edwards, 1991, p. 31].

State enterprises which were privatized during the second half of the 1980s, have generally recorded an increase in employment [Saez, 1991, Table 9]. As the earlier rise in unemployment, this favourable trend cannot be linked directly to privatization. This period was marked by increasing growth rates (Table 1). Private and public firms had to employ more people to satisfy additional demand since they had no excess labour due to rationalization measures adopted since the 1970s. In summary, the Chilean example reveals that the employment effects of privatization are difficult to disentangle from other influences. There is no evidence, however, to blame privatization for giving rise to serious employment problems. The overstaffing of inefficient firms was unsustainable even if they had remained under state control.

Fiscal effects: Similar difficulties are encountered in identifying the fiscal consequences of privatization. Only the direct effects of enterprise sales on the budget can be measured easily. It is, thus, not surprising that attention in Chile was focused

on this aspect. The pressing need to reduce huge public sector deficits added to the short-term motivation to maximize sales proceeds from the privatization of state enterprises. Receipts from privatization represented 3 to 10 per cent of annual government revenues in the second half of the 1970s when the fiscal motivation of privatization was particularly strong (Table 1).

However, receipts from privatization have only an once-and-for-all effect on the public budget. Fiscal consolidation in Chile was sustained because of tax reforms and improved tax collection as well as significant cuts in government expenditures [Corbo, 1985, p. 916]. The elimination of subsidies to inefficient state enterprises helped to reduce the share of public sector expenditure in GDP from 45 per cent in 1973 to about 23 per cent in 1978-1980 (Table 1). This indicates that it is the hardening of the budget constraints of enterprises which matters most with respect to sustained fiscal consolidation.[1]

In principle, the elimination of soft budget constraints may be easier once enterprises are privatized [Nunnenkamp, Schmieding, 1991, p. 14]. The Chilean example suggests, however, that this is not necessarily so. It may even be argued that the earlier emphasis on the maximization of sales proceeds threatened fiscal consolidation in the longer run. High selling prices could be realized only through the provision of public loans to private buyers. This debt-led privatization resulted in financial fragility of large conglomerates. The government had virtually no choice but to rescue these enterprises in order to contain contagion effects. In so far as such a government behaviour was anticipated by the borrowing firms their budget constraints were not hardened effectively.

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[1] The indirect fiscal effects of privatization and public enterprise reform can hardly be captured in quantitative terms. The cash flows from the government budget to enterprises, and vice versa, would have to be compared to the situation without reforms. Similar problems arise with regard to tax revenues which may be derived from additional income generated by privatization.

All in all, the case of Chile supports the view that the sale of state enterprises is no substitute for sustained fiscal correction [Blanchard, Layard, 1992, p. 30]. Governments in Eastern Europe should avoid a fiscal myopia and resist the temptation to achieve higher selling prices by sharing the risk of subsequent failure of privatized enterprises. The focus must be on the credible elimination of soft budget constraints to help sustaining fiscal consolidation. The widespread concern about "too low" selling prices neglects the less visible effects which privatization exercizes indirectly on public sector accounts.

Capital market development: The Chilean experience points out another drawback of high selling prices as a result of fiscal myopia and debt-led privatization, i.e., extremely high real interest rates. The real short-term lending rate on Peso loans soared to 64 per cent in 1976 and remained above 40 per cent until 1978 (Table 1). Again it is difficult to isolate the interest rate effect of debt-led privatization from other influences, such as the substantial undercapitalization of most firms after the Allende regime, the increase of credit demand induced by the lack of appropriate loan evaluation, and monetary restraint [Corbo, 1985, p. 899]. It is hardly to be disputed, however, that the financing of privatization during the early years of the military government had a significant impact on interest rates.[1]

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[1] The second hike in real interest rates in 1981-1982 has to be attributed to distress borrowing before and during the financial crisis. Since 1982, it became difficult to raise foreign loans. The financial crisis resulting in state intervention, direct government supervision or closure of privatized banks and other financial institutions, including pension funds, was a great blow to the Chilean capital market. Two banks and six other financial institutions were intervened by the government in December 1981. Later in January 1983 five more banks were added to this list, other three banks were closed and two were put under direct government supervision. These latter 10 banks accounted for 45 per cent of the capital and reserves of the whole financial system [Saez, 1991, pp. 9-10].

The high difference between real interest rates on domestic Peso loans and US-dollar loans (16-48 percentage points in the second half of the 1970s; Corsepius [1988, pp. 15 f.]) added to the detrimental effects of debt-led privatization. Low or even negative real interest rates on US-dollar loans induced heavy borrowing from abroad, once the limits on US-dollar loans were removed with the opening of the external capital account and the exchange rate risk was minimized by fixing of the nominal exchange rate [Corsepius, 1988; Yotopoulos, 1989, pp. 602 f.]. In practice, the access to cheap foreign loans was confined to a few conglomerates and large banks [see also Foxley, 1983, p. 112]. As a result, competitive bidding for state enterprises was biased in favour of large private investors with access to foreign financing. The effective discrimination of smaller investors in capital markets added to the concentration of risks during the earlier privatization phases in Chile.

The concentration of risks was further aggravated by the unfavourable structure of external financing. Foreign borrowing was favoured at the expense of foreign direct investment (FDI). In 1974-1979, FDI amounted to only two thirds of that in the period 1964-1968 [Yotopoulos, 1989, p. 695]. The ratio of debt inflows to inflows of FDI, which was below 5 in 1975, more than doubled in 1977-1981 [Corsepius, 1988, p. 12]. The weak participation of foreign investors in the privatizations of the 1970s had as a consequence that entrepreneurial risks remained mainly with domestic investors who were less able to bear them in times of crisis. A greater diversification of risks could have been achieved if privatizations had been financed to a larger extent by FDI.

The imbalance in foreign financing was reduced by the Chilean authorities during the reprivatization of government controlled enterprises in the 1980s. Especially some of the larger reprivatized companies were acquired jointly by local and foreign investors, which helped to avoid excessive indebtedness [Lüders, not dated, pp. 11 f.]. The participation of foreign investors was

mainly through debt-equity swaps. Chilean external debt certificates were bought by foreign investors on the secondary market at a 30-40 per cent discount on the face value [Meller, 1990, p. 83]. The certificates were then redeemed at par by the central bank, provided these funds were used to acquire state enterprises. The degree of subsidization of foreign investors involved in debt-equity swaps is open to question [Lüders, not dated, p. 12]. Benefits from secondary market discounts were reduced if competition among foreign investors raised the prices of the reprivatized enterprises. But such price increases would have led to the discrimination of local investors in the competitive bidding for state enterprises, unless local investors were offered similar incentives.

The emphasis placed on new privatization methods such as "popular" and "labour capitalism" in the 1980s stimulated domestic capital market development through the participation of small local investors. The new methods resulted in 127000 additional shareholders between 1984 and 1989 [Saez, 1991, p. 45]. The total value of transactions on the stock exchange increased by nearly 22 times, and the share of divested companies in these transactions rose from 6 to 66 per cent during the same period [Lüders, not dated, p. 25]. Also the bond market became heavily dependent on the divested companies. They issued about four fifths of all company bonds in 1989 and 1990 [Saez, 1991, p. 46]. A very important contribution to the growth of the Chilean capital market was from the pension funds which were allowed to participate in the capital transactions of privatized companies. By the end of 1990, they were holding influential portions of stocks of several privatized companies.

Especially the significant involvement of pension funds in the privatization process has contributed to enhanced stability and growth of capital markets in Chile. However, the favourable impact of new privatization methods on capital market development must not be seen in isolation. A wider spreading of shares may render the effective control of management by owners extremely

difficult. To resolve this conflict post-socialist countries should find out ways to promote capital market development without compromizing on corporate governance. The earlier suggestion to distribute widely shares in independent holding companies or privatization agencies, rather than in privatized enterprises, may be helpful in this respect. The trading of shares in holding companies provides the stimulus to widen the spectrum of capital market instruments and encourages active participation of the public. The privatization of enterprises through competitive bidding, managed by the holding companies, not only helps effective corporate governance. It also allows to attract FDI which can play a significant role in alleviating bottlenecks to privatization that result from poorly developed domestic capital markets.

IV. Summary and Conclusions

The empirical evidence on large-scale privatization programs to which governments in Central and Eastern Europe may refer in assessing the pros and cons of different privatization methods and alternative suggestions on sequencing is extremely limited. However, the Chilean experience with large-scale privatization in the 1970s and 1980s offers a most instructive reference case. The conditions under which privatization was initiated in Chile after the socialist Allende regime reveal remarkable similarities to the present situation in Eastern Europe. State enterprises dominated all important economic sectors. Privatization was motivated by a variety of goals which were at least partly in conflict with each other. Domestic capital markets were weak, and basic institutional and regulatory issues unresolved. The government tried various privatization methods with mixed results. Most importantly, the Chilean privatizations started while the economy was in the midst of a drastic stabilization and liberalization process. The achievements and pitfalls with regard to the methods and sequencing of privatization in Chile should, therefore, no longer be ignored in the discussion on appropriate privatization

schemes in Eastern Europe.

As concerns privatization methods, the first lesson from the Chilean experience is that privatization through competitive bidding is likely to fail if large private investors have easy access to public loans to finance the acquisition of state firms. Basic solvency rules need to be in place and enforced to enhance the financial stability of enterprises and banks. Furthermore, privatization should be financed in a way that disposes the state of entrepreneurial risks and contains moral hazard of buyers. Fiscal myopia must be avoided. Higher selling prices achieved only through public loans and risk sharing with the private sector undermine the sustainability of fiscal consolidation. Especially large borrowers anticipate government bail-outs in times of a financial crisis. The widespread concern about "too low" selling prices ignores the longer-term costs resulting from "too high" selling prices. Price concessions required for transfering entrepreneurial risks to the private owners should not be resisted because of equity considerations.

Once the drawbacks of debt-led privatization are avoided, competitive bidding seems to be better suited for the economic transformation of Eastern Europe than alternative privatization methods. The case of Chile indicates that the promotion of public participation in the privatization of state enterprises involves considerable costs in terms of subsidies and preferential sales prices. Given the current fiscal constraints, most post-socialist countries are less able to bear these costs than Chile in the 1980s. Furthermore, a wide distribution of shares impedes the effective control of the firms' management by the owners. Principal-agent problems are aggravated if enterprise shares are offered to the public at highly concessional terms. The second lesson is, thus, to consider other ways to buy public support for privatization without interfering with economic efficiency. A fair and equitable distribution of benefits of privatization can be achieved, for example, when revenues from direct sales to the highest bidder are distributed through compensating tax cuts. If

widespread shareholding is prefered, the public should be offered shares in independent holding companies or privatization agencies, rather than in individual enterprises.

Thirdly, the Chilean experience suggests that an appropriate sequencing is important for the success of privatization. Large-scale privatization requires that a regulatory framework of basic rules and institutions supervising and enforcing such rules is established from the beginning. The most promising way for East European governments to avoid delay in this respect would be to adopt the well established laws and regulations of a more advanced market economy, and to ask for technical assistance in institution building. From bankruptcies and renationalization of enterprises, which had been privatized in the early phases of Chile's economic transition, it cannot be concluded that privatization should be postponed until after macroeconomic stability has been restored and microeconomic incentive systems have been reformed. It is crucially important, however, to clearly announce the future course of economic policy when privatization is initiated. For stabilizing the expectations of buyers and reducing the uncertainty of private investors fiscal consolidation must be credible, signals on foreign trade policy and especially the phasing-out of import protection very clear, and policy announcements consistent. Otherwise, the sustainability of privatization will be at serious risk.

The fourth lesson also relates to the sequencing of privatization. The case of Chile does not support the view that privatization should be postponed in order to contain negative effects on employment and fiscal balances in the short run. It is not to be disputed that rising unemployment may undermine the political support for economic transformation. There is no evidence, however, to blame privatization for giving rise to serious employment problems once it is realized that the overstaffing of inefficient firms is unsustainable, even if they remain under state control. Transitional unemployment and the ensuing political problems should be alleviated by adequate social security pro-

visions, rather than conserving inefficient and inflexible production structures. Fiscal considerations must not be focused on the once-and-for-all effect of enterprise sales on the government budget. It is the hardening of the budget constraints of enterprises which matters most with respect to sustained fiscal consolidation. Privatization will help to eliminate soft budget constraints, provided governments in Eastern Europe resist the temptation to achieve higher selling prices by sharing the risk of subsequent failure of privatized enterprises.

The undercapitalization of state enterprises, weak domestic capital markets and the drawbacks of debt-led privatization suggest a final lesson on risk sharing. Foreign investors should be encouraged to participate in the privatization of state enterprises. This would not only add to the amount of investable funds in post-socialist countries, but also provide access to much needed managerial and technological know-how. Highly indebted countries in Eastern Europe may stimulate foreign direct investment through debt-equity swaps, as did Chile in the 1980s. To avoid a discrimination of local investors they should be allowed to participate in debt-equity swaps. Especially the engagement of institutional investors such as pension funds could enhance the stability and growth of domestic capital markets. This may also help to contain a public resentment to strong foreign influence in the domestic economy.

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