

March 1996

# BUDGET ISSUES

## Privatization Practices in Argentina







United States  
General Accounting Office  
Washington, D.C. 20548

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Accounting and Information  
Management Division

B-271291

March 19, 1996

The Honorable Scott Klug  
House of Representatives

Dear Mr. Klug:

This report responds to your request that we continue our work on privatization practices in other nations with a review of the divestiture experiences of Argentina. Specifically, we examined issues relating to (1) the privatization process, (2) the valuation and preparation of the assets for sale, and (3) the use of the sale proceeds. In common discourse, the term “privatization” can refer to contracting-out, public-private partnerships, vouchers, and franchising or the awarding of concessions, as well as the actual sale—divestiture—of government assets and operations. Our review focused on the last activity, the transfer of ownership from the government to the private sector. In our earlier report Budget Issues: Privatization/Divestiture Practices in Other Nations,<sup>1</sup> we examined the divestiture experiences of the governments of Canada, France, Mexico, New Zealand, and the United Kingdom. For our work on Argentina, we again focused on policies and procedures for the divestiture of entities. We also examined the policies and procedures used to award concessions—the process by which the government provides a private firm the right to operate a government entity. We chose to include concessions as well as divestitures because of the significant role they have played in the privatization process in Argentina. Between 1990 and 1993, over 50 percent of the privatizations occurred through the awarding of concessions.

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## Results in Brief

The privatization process in Argentina was less centrally controlled than in the other countries we have studied. A central executive unit did not oversee or coordinate the privatization process. Instead, special privatization committees—generally within the Ministry of Economy and Public Works and Services or the Ministry of Defense—were established for each privatization. As with many of the other countries we have studied, however, private sector financial advisors, technicians, and consultants assisted the privatization committees throughout the sale process.

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<sup>1</sup>GAO/AIMD-96-23, December 15, 1995.

The Argentine government engaged in some limited restructuring of entities prior to sale. For example, the government generally retained the liabilities or obligations, including debt, of the entities being privatized in order to enhance their sale price and, in some cases, to ensure that they would sell. The government also broke industries into their component parts—for example, generation, distribution, and sale in the case of electric power companies—and converted the components into distinct business units. Generally, the government did not, however, significantly restructure the entities beyond this. As in all of the other countries in our earlier study, the government believed that the private sector could do a better job of investing in and improving these enterprises. While the government generally broke up industries in an attempt to foster competition, some of the component parts remained natural monopolies<sup>2</sup> and required the creation of a regulatory framework. The Argentine government did not have a well developed regulatory scheme when it began its privatization initiatives at the end of 1989 and has been working to develop the regulatory capacities of the country.

The Argentine government was required to value the assets of an entity prior to the entity's sale and, like the other governments we have studied, used a combination of valuation techniques to complete these valuations. The government used the proceeds from privatization primarily to reduce the country's internal and external public debt.

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## Background

Argentina President Carlos Menem came into office in 1989 with the broad goal of restructuring the economy and reducing both annual fiscal deficits and the external public debt. The public sector was extensive at that time and most public enterprises were money losers. Publicly owned enterprises had historically been one of the primary sources of chronic budget deficits in Argentina. In the 1980s, the national government owned the 17 companies that produced minerals, petroleum, natural gas, and refined fuels, as well as those that were involved in the provision of public utility services, including telecommunications. The government also owned approximately 40 military-related enterprises, which ranged from weapons to timber, petrochemicals, strategic minerals, and construction. It also owned 100 smaller enterprises, including radio and television stations, hotels, and several airlines; and owned and operated the national railroad, which included freight and passenger services.

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<sup>2</sup>A natural monopoly arises when the entire output of an industry can be most efficiently produced by a single firm, for example, when the firm has significant economies of scale. For this reason natural monopolies are often regulated or government run. Statutory monopolies are monopolies where an exclusive right to sell is granted by law, and may include natural monopolies.

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Privatization was an important part of the broader goal of restructuring the economy, but it also enabled the government to reduce what had become an unmanageable level of external public debt. The government used the sale of state enterprises to generate cash as well as to conduct what are called debt-equity swaps. In a debt-equity swap, bank debt is replaced with an equity investment. For example, stock in an entity that is being privatized is exchanged for external public debt owed to a foreign creditor bank. This type of transaction enabled the government to retire its external debt directly. Based on our calculations, the cumulative proceeds from privatization from 1990 through 1994, including cash and debt reduction, equaled approximately 9 percent of Argentina's economy, or average annual gross domestic product (GDP), during this period. This exceeded the level of cumulative proceeds realized by Mexico from 1989 through 1992, which was 6.3 percent of Mexico's average annual GDP. However, New Zealand remains the country in our study with the highest level of cumulative sales proceeds as a percent of average annual GDP—at 14.1 percent from 1987 through 1991. Table 1 provides additional comparative detail on all of the countries in our study.

**Table 1: Types of Entities Privatized by Country and Industry**

Types of major industries fully or partially privatized		
Country	Agricultural services	Mining and construction
Argentina		Mining Oil
Canada	Fishing	Mining Oil
France		Oil
Mexico		Mining
New Zealand	Forestry	Oil
United Kingdom		Oil

Types of major industries fully or partially privatized				Cumulative sales proceeds as percentage of average annual gross domestic product <sup>a</sup>
Manufacturing	Transportation and public utilities	Finance, insurance, and real estate	Services	
Steel Petrochemical	Airline Rail Ports Toll roads Telecommunications Water Sanitation services Electricity Natural Gas	Financial services Buildings	Hotel Radio Television	9.0 (1990-1994)
Aircraft	Airline Trucking Telecommunications		Hotel	0.6 (1984-1990)
Petrochemical		Financial services Insurance		1.5 (1983-1991)
Automobile Steel Iron Cement Petrochemical Foodstuffs	Airline Trucking Toll Roads Telecommunications	Financial services	Hotel	6.3 (1989-1992)
Steel Printing	Airline Shipping Rail Telecommunications	Financial services Insurance	Hotel	14.1 (1987-1991)
Automobile Steel Ordnance Aerospace Foodstuffs	Airline Airport authorities Trucking Shipping Harbors Bus companies Telecommunications Water Electricity	Financial services	Hotel Public housing	11.9 (1979-1991)

<sup>a</sup>The source of the data on the cumulative proceeds for Canada, France, Mexico, New Zealand, and the United Kingdom is the Organization for Economic Cooperation and Development (OECD). We have derived the data pertaining to Argentina from the World Bank and the Argentina Ministry of Economy and Public Works and Services. We have not verified this information. The cumulative sales proceeds have been divided by the average annual GDP for the years indicated for each country.

## Scope and Methodology

We obtained our information on the privatization process in Argentina through interviews with government officials directly involved with privatization in Argentina, and through the use of academic and economic

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literature and official government material. We conducted this work in Washington, D.C., from January through March 1996 in accordance with generally accepted government auditing standards. World Bank experts on privatization and a privatization expert in Argentina reviewed this document, and we have incorporated their comments where appropriate. We did not verify the accuracy of all of the information provided to us nor did we evaluate the relative success of the privatization program in achieving national goals.

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## The Privatization Process

Four of the five countries we studied in our earlier report have parliamentary systems of government,<sup>3</sup> but Argentina, like the United States, has a presidential system, with an executive branch, a judiciary, and a bicameral legislature. In Argentina, the executive branch had primary control over the privatization process, while the congress maintained an oversight role. Two laws were passed in 1989 which facilitated privatization: the State Reform Law and the Emergency Law. According to the World Bank, the State Reform Law gave the executive branch sweeping powers to reform the state. The State Reform Law established objectives and procedures for privatization, and the Emergency Law suspended subsidies and removed barriers to foreign investment. We were told that the State Reform Law specified which enterprises were subject to privatization: Additional privatizations required congressional approval. The State Reform Law also created a bicameral legislative oversight commission on reform and privatization, which was composed of members from the majority and opposition parties.

The Argentine privatization process was less centralized and more flexible than in the other countries we studied. Separate unique privatization committees were created for each privatization, and the planning and implementation of the privatizations occurred primarily within the committees. A subsecretariat for privatization was formed within the Ministry of the Economy and Public Works and Services several years after the Menem privatization initiatives began, but an expert on privatization in Argentina stated that the unit was created primarily to gather and disseminate information about privatization and to keep foreign investors informed about the status of the privatization initiatives. Most of the state-owned companies in Argentina were located within the Ministry of the Economy and Public Works and Services or the Ministry of Defense, and the Ministers of these units were responsible for appointing

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<sup>3</sup>Canada, France, New Zealand, and the United Kingdom.



the members of the committees within their respective ministries. The committees generally included representatives of the entity being privatized and staff from within either the Ministry of the Economy and Public Works and Services or the Ministry of Defense. The work of the committees was reviewed by the office of the auditor general, and the committees relied extensively on the expertise of consultants, private sector industry experts, and legal advisors to assist them with the sale preparations and transactions.

The Argentine government implemented its privatization program quickly—in 3 years, it privatized almost all of its state-owned enterprises. It began with large, complex entities, such as the telecommunications company and the state airline. We were told that the less rigid structure of the privatization process in Argentina facilitated this speed. The Menem government used the successful completion of privatizations to develop credibility for its far reaching program of economic change. The World Bank has reported that from 1990 through 1993, Argentina sold 34 enterprises and awarded concessions for 19 services.

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## Valuation and Preparation for Sale

In Argentina, the government was required to estimate the worth of an entity prior to sale as well as determine what level of improvements and investment should be required from the purchaser once it acquired the entity. The government used this information to establish a minimum bid. In most cases, the purchasers of all newly privatized firms were also required to invest a certain amount in the entity in addition to the purchase price, and each sale had to include specifications related to investment and improvements. We were told by a privatization expert in Argentina that the government used a variety of valuation techniques, including, in some cases, net present value analysis. We were also told that the government used a market based discount rate<sup>4</sup> for calculating the net present value of the entity.

The government generally retained the entities' liabilities, including debt, but did not attempt to improve the entities' efficiency in advance of their sale. The market price of an entity is reduced by the liabilities that come with it; the price may be reduced further by the risk premium associated with any contingencies. The Argentine government absorbed most of the known liabilities but let the market make decisions regarding the future efficiency of the firm. We were told by government officials that entities in

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<sup>4</sup>A market based discount rate reflects the cost of borrowing in the private sector. It is generally higher than the government borrowing rate.

poor condition offered the private sector an opportunity for improvement and profit, similar to “fixer-uppers,” where profits awaited those who could achieve efficiency improvements. Argentine government officials stated that the efficiency of the privatized firms has significantly improved. For example, we were told that freight productivity has increased and a greater annual volume is now shipped with fewer employees. According to a former government official, telephone lines of the former state telecommunications company have increased and waiting periods for repairs have decreased.

The government generally broke up state monopolies and sold the components separately in order to promote competition. Public enterprise assets, such as telephone networks, gas transmission systems, and electricity generation plants, were either sold or awarded through concessions to private sector bidders. The new owners were then required to create private sector corporations to control the assets of the privatized entities. In our earlier study, the countries we examined generally either privatized entities that were already in a corporate form or converted agencies into a corporate form prior to privatization. Sometimes they did this in order to increase the efficiency of the entity and help establish a track record for the entity as a commercial enterprise. In other cases, the governments used this as an opportunity to clean up the entity’s outstanding obligations prior to sale and thus facilitate the sale process. In Argentina, incorporation did not involve an operational restructuring of the entity; rather, it was a legal proceeding to allow the new owner to acquire the assets of the former government enterprise.

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## Effects of Privatization on Employees

Public sector employment was reduced significantly as part of the privatization process, but the government also provided generous severance packages, and a World Bank study and government officials have reported that many of the separations were voluntary. The Argentine government reported that, from 1990 through 1994, the number of employees working for public enterprises was reduced from about 348,000 to about 67,000, an 81 percent drop. Of this reduction, 40.8 percent was reportedly due to voluntary or compulsory separation, 41.5 percent to transfers to other levels of government or private firms, and 17.7 percent to normal attrition.

Even though public sector employment was significantly reduced, World Bank reports indicate that the Argentine government met with limited resistance from labor during this period of restructuring. The World Bank

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stated that factors such as low public sector wages, the large number of employees holding more than one job, and generous severance benefits, may explain this limited opposition.

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## Type of Sale and Sale Process

The Argentine government privatized public enterprises primarily through divestiture and the awarding of concessions. A concession, or franchise, provides a private sector company with the exclusive right to provide services in a geographic area. A key issue in the Argentina privatization process was whether to sell or to award a concession. A privatization expert told us that there were no explicit criteria for awarding a concession as opposed to selling an entity but that there were implicit criteria. If an asset was considered strategically important to the nation, the government would not sell it. This has often meant that natural monopolies, or entities that have a strongly monopolistic infrastructure, have not been sold. The government awarded concession rights in the following areas: freight and passenger rail, ports, tollroads, water supply, and sanitation services.

In preparation to offer concessions for the railroads, the government separated rail into three components: freight, intercity passenger rail, and urban passenger rail, which included the Buenos Aires Metro. Intercity passenger services were then either transferred to provincial governments or closed. The government awarded 10-year concessions (20 years for the Buenos Aires Metro) for the urban passenger lines and 30-year concessions for freight services. The terms of the passenger concession agreement defined the tariffs to be charged, service levels and quality to be provided, and the capital improvements to be carried out. The winning bids were chosen based on the minimum cost to the government for the combined operating support and capital program costs. By contrast, freight concessions were awarded to the highest bidder, including an allowance for proposed capital investment and the number of existing employees to be hired by the concessionaire.

Most sales involved open, competitive bidding, for the controlling interest in the entity. The government generally retained a noncontrolling portion of the shares, typically about 39 percent, to be sold later in a public offering. It did this to ensure that it would share the benefits if the price of the entity's stock rose once the entity was established in the private sector. This procedure has similarities to the use of the "clawback" in New Zealand and the United Kingdom. (Clawbacks are stipulations, that under

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certain conditions, require the buyers to return a share of profits—or losses—to the government.)

The government also retained a portion of the shares for purchase by the employees that were transferring from the public enterprise to the new private entity. The employee share was generally close to 10 percent, although some privatizations reserved as little as 2.5 percent for employees. Worker-shareholders also had the right to elect a representative to the company's board of directors. The number of shares that each employee could purchase was determined by factors such as the employee's years of employment and salary level. Upon retirement, death, or employment termination, an employee's shares were sold back to the company.

There are few restrictions on foreign investors in Argentina. According to the Organization for Economic Cooperation and Development (OECD), foreign investors have full access to the local capital market. The World Bank and the OECD also have reported that there is a concentration of asset ownership in Argentina and that most of the public enterprises were sold to financial consortia, which were composed of several Argentine companies allied with international groups.

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## Competition and Regulation

Although the Argentine government generally tried to foster competition through the privatization process, it has experienced some problems promoting competition. One example of a problematic privatization involved the sale of Aerolineas Argentinas, the state-owned airline. When the airline was offered for sale in 1990, the only qualified bidder was a consortium that included the only other airline in the country. According to the World Bank, instead of disallowing the bid, the government allowed the sale to occur. Service was poor and losses continued, and in 1993, the government bought back approximately 30 percent of the airline's shares. As a result of this sale, the government now makes a greater effort to ensure that there is more than one bidder and that a regulatory framework is in place prior to the sale. The government ultimately sold the shares of Aerolineas Argentinas back to the private sector.

The government has had difficulty establishing a regulatory regime, as illustrated by the privatization of the former state telecommunications company, the first company to be privatized in Argentina. In some instances, the government preserved the monopolistic structure of the entity being sold to facilitate the attraction of private capital. A 1995 World

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Bank report<sup>5</sup> stated that the government in Argentina split the telecommunications market into two regional monopolies to increase the competitiveness of the industry, but we were told that the government also used the monopoly rights to increase the proceeds from the sale. Although a regulatory agency had been established to monitor the telecommunications industry, the government did not, according to the World Bank, develop clear regulatory processes prior to the sale. The government subsequently brought the regulatory agency under closer scrutiny and formed a plan for improving its regulatory framework. There have been improvements in the agency's performance, but a 1993 World Bank report<sup>6</sup> stated that the regulatory capacities in Argentina may take many years to develop. We were told by government officials, however, now that the government has experience with both regulated monopolies and with competition, that the government strongly prefers the latter.

The speed and variable manner in which Argentina privatized may help to explain why the country's regulatory capacities are not more developed. A privatization expert told us that Argentina's decentralized privatization process allowed the government to privatize quickly and to formulate solutions for problems as they arose. While this speed and lack of a rigid structure may have had a positive effect on the ability of the government to sell enterprises and award concessions, we were told that these factors may have had a negative effect on the government's ability to create an adequate regulatory system within a relevant time frame.

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## Use of Proceeds

We were told by a government official in Argentina that the government is required to use the proceeds from privatization to finance the social security system or to buy down existing debt. According to OECD, by the end of 1992, debt-equity swaps enabled the government to retire over \$11 billion in external public debt, which represented approximately 5 percent of GDP in 1992. According to the World Bank, the government also received about \$8.5 billion in cash during this period.

Although it is difficult to determine the amount of net proceeds that Argentina realized from its privatization program, the World Bank and OECD have stated that increased tax revenues from the new corporations, as well as the savings from the discontinuation of subsidies to money

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<sup>5</sup>The World Bank, *Bureaucrats in Business: The Economics and Politics of Government Ownership* (Washington, D.C.: The International Bank for Reconstruction and Development, 1995).

<sup>6</sup>The World Bank, *Argentina's Privatization Program: Experience, Issues, and Lessons* (Washington, D.C.: The International Bank for Reconstruction and Development, 1993).

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losing enterprises, were more important to the economy than the privatization proceeds.

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## Conclusions

In our previous report, we noted that in the United States—as in other nations—divestiture raises the issues of how best to evaluate a proposal to sell, who should manage the valuation and sale processes, how to estimate future proceeds, how the sale should be structured, and how the proceeds should be treated in the budget. Although the experiences in the governments we examined suggested that often no single answer is widely applicable to all governments in all situations, we found that the information these governments provided may help the United States smooth the transfer of viable operations from the public to the private sector.

With respect to the privatization process, we noted that a centralized approach was common and offered a number of advantages. We suggested that the Congress assign responsibility for all divestitures to a central agency in the United States as a means of developing a consistent management process. With respect to treatment of the proceeds in the budget, we found widespread use of budget rules designed to prevent the use of one-time proceeds to finance ongoing spending. We also said that budget rules should not dominate the divestiture decision; the decision to privatize should be made on other grounds.

Although the Argentine government had—as did the other governments we studied—certain unique approaches to privatization, it also displayed a number of the common elements we identified in our earlier report. For example, the goals for privatization, which included reducing debt and restructuring the economy, were very important in determining the speed and scope of the privatization program and, like the other governments we studied, the Argentine government generally used the proceeds from privatization to reduce debt and thus interest costs. Unlike the other governments in our earlier report, Argentina did not centralize the privatization process. Instead, the government created separate unique privatization committees for each privatization and allowed the process to remain somewhat flexible. This allowed the government to privatize quickly but may have hindered its ability to establish a regulatory framework at the same pace with which it privatized the state-owned industries.

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We are sending copies of this report to the President of the Senate, the Speaker of the House of Representatives, and the Chairmen and Ranking Members of the House and Senate Budget Committees. We are also sending copies to the Director of the Congressional Budget Office, the Secretary of the Treasury, and the Director of the Office of Management and Budget. Copies will be made available to others upon request.

Please contact me at (202) 512-9142 if you or your staff have any questions. Barbara Bovbjerg, Assistant Director, and Hannah Laufe, Senior Evaluator, were major contributors to this report.

Sincerely yours,

A handwritten signature in black ink that reads "Susan J. Irving". The signature is written in a cursive style with a large, stylized "S" and "I".

Susan J. Irving  
Associate Director, Budget Issues

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