GOVERNMENTS AND THE HANDLING OF PURCHASED INPUTS AND MARKETED OUTPUTS

THE ART OF PRIVATIZING AFTER DECADES OF CENTRAL PLANNING

Robert L. Ross*

Privatization of state enterprises had become commonplace in developing countries long before communism's demise and much experience has been accumulated. Much of this experience has been acquired in Latin America where the role of the state and of parastatal enterprises had dominated economic policies in many countries following World War II. However, few Latin American countries ever formally abandoned the structure of a market economy. Only Cuba created a completely centrally planned economy. Nicaragua is probably the country whose conditions most closely parallel those of Central and Eastern Europe and its reforms are less than 2 years old.

The Nicaraguan economy under the Sandinistas was totally controlled by the central government, but most of the economy remained legally in private hands. The Chamorro government began the process of privatizing state enterprises shortly after taking power in April 1990. Since then, some seventy-five state enterprises were privatized or returned to their former owners, and another twenty-five were liquidated. The Nicaraguan approach was to handle each case separately and no attempt at a massive privatization was made.

Each state enterprise was treated as a unique case. Although workers at these enterprises generally supported the principle of privatization, they argued that the enterprises should be turned over to them for free. The government resisted this and agreed to sell the workers up to 25 percent of the shares. The government financed the purchase at a low interest rate and attached a percentage of workers' salaries to assure repayment.

Agriculture was treated differently. The government gave state-owned land to demobilized soldiers and contras as part of the peace process. Once land titles were granted, the new farmers have gradually been forming small farming enterprises or cooperatives.

Some land was sold to peasant organizations, some was sold to agricultural technicians on credit and, where feasible, land was returned to former owners. In all cases, the government required the new owners to farm the land under threat of reexpropriation.

Agroindustries were sometimes sold on credit to their suppliers. One state-owned slaughterhouse was sold to a large number of small cattlemen. A grain feed mill was sold to a group of sorghum farmers.

Although the government negotiators had reservations about the managerial capability of small farmers to manage an agroindustrial enterprise, they found it counterproductive to raise the issue and proceeded with the sale without making nay provisions for professional management. The negotiators hope that competitive pressures from other agroindustries will eventually promote efficient management.

In order to facilitate the sale, the government negotiators undertook to clean house as much as possible. Unnecessary labor was let go and indemnified. A title search was undertaken to assure that no former owners had any claim to the land and a credit check was made to ascertain any outstanding

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* Robert L. Ross represents the Latin American Agribusiness Development Corporation.

unrecorded debts. At the time of the final sale, the government issued a legal title and financial certificate protecting the buyer against unrecorded liabilities.

In general, the privatization process in Nicaragua seems to be progressing well with a minimum of red tape on a case-by-case basis. It took place simultaneously with new legislation undoing the Sandinista legislation and favoring market forces. It was done with great political sensitivity because of the effective power that the Sandinista retain as a not-very-loyal opposition. Nicaragua has proven to be most adept at developing the art of privatization.

Prerequisites for a Successful Privatization Program

First of all a consensus must exist in the population on the long-term benefits of privatization and to accept the sacrifices necessary to reform the economy. Without such a consensus, the reform process will not sustain itself, particularly in a democratic environment. Privatization will produce winners and losers, and the latter will use their political clout to protect their interests. Periodic elections will give the losers a chance to strengthen their position and slow the privatization process (witness Poland).

Second general laws must be passed and enforced that make clear the rights of private property and in general spell out the rules of the game to the economic players. Foremost among these rules are those covering competition, fiscal and tax policy, the operation of the banking industry, foreign trade and, most important of all, the functioning and independence of the judicial system.

Third specific laws must be passed and rules approved covering the scope of the privatization program and the method of carrying it out. This is the area I would like to focus on.

Privatization Programs

The rhetoric of privatization has long since outstripped reality. The euphoria of communism's demise brought brave public statements from the new democratic leaders about creating market economies and merging with the European Economic Community (EEC). Since then, much has been done to liberalize the economy, to limit the role of the state, and to encourage private entrepreneurship. However, privatization itself has proven to be the most difficult area to come to grips with.

There are a number of issues facing government policymakers. The first of these is the timing of the reforms. For example, should privatization be pushed before free markets and the necessary legislation are well established? There is, after all, little domestic capital to purchase state enterprises, there is no store of unemployed capable managers waiting on the sidelines, and the old Nomenclatura retains influence. Hungary, which started the move toward decentralization over 20 years ago, is still in no hurry to privatize. Romania is moving systematically toward a free market economy, but is also in no hurry to privatize.

As long as the countries continue to create conditions favoring a market economy where the price system and consumer demand encourage more efficient resources allocation, an argument can be made that privatization should be delayed.

The Wholesale Approach

If the political decision is taken to privatize, the next question is whether the state enterprises should be sold off *en masse*, such as through public auction, or to tailor make each sale, enterprise by enterprise.

Few people would argue against the wholesale treatment of small service establishments like retail stores and personal service businesses. They are too small and too numerous for individual treatment. Invariably, assets are sold rather than the enterprise. Public auction such as has taken place in Czechoslovakia is a suitable vehicle to accomplish this.

The issue becomes more controversial as the size and complexity of the business grows. So far all of the privatizations undertaken have been tailormade, usually involving a joint venture with, or a buyout by, a foreign corporation which contributed capital, technology, management, and markets to the deal. General Electric, General Motors, Volkswagen, Cargill, Gerber, and other household names have privatized state enterprises in three Central European countries. This process will continue for some years, but will not affect more than a small fraction of all state enterprises slated for privatization.

Wholesale privatization schemes are being debated in Czechoslovakia, Poland, and Romania, all of them involving the distribution of vouchers to the general public that can be converted into shares of states' enterprises or mutual funds acting on a fiduciary basis. It appears that Poland and Romania are favoring the formation of mutual funds run by professional management, while Czechoslovakia favors direct investment in individual enterprises. Agriculture is excluded from this plan, although many agribusiness enterprises are included. These plans call for the transfer of about 30 percent of the shares of the participating state enterprises.

The advantage of the mutual fund proposal rests entirely on the efficiency of the hired managers. It is expected that foreign investment houses will play a major role in their management. However, these wholesale approaches do not provide any new capital for the privatized enterprises, no new technology, no new management, and no new marketing skills. For these funds to become profitable, they will have to restructure and reorganize their investment portfolios one company at a time. In that sense, even the wholesale approach will have to face realities one enterprise at a time.

There are no precedents for this approach to privatization. Proponents of this strategy argue that the issue must be forced while there is still political support for privatization and that this will stimulate private entrepreneurship. The first argument is probably valid, because the public's support for fundamental economic reforms can be expected to decline in inverse relationship to the pain they cause. The second is wishful thinking. Financial analysts and portfolio managers do not breed entrepreneurs; they hire auditors and consultants.

The Czechoslovak approach provides for the sale of vouchers at a nominal price to its citizens who will then be allowed to bid on shares of specific enterprises. It is not yet clear how all of the mechanics of valuation will be worked out, but the intent is to permit direct investment by the citizenry. This is an attractive political solution, but I do not see how it will improve the efficiency of Czechoslovak enterprise. They will receive no capital, technology, management, or market access from the program. It should accelerate the creation of a stock market, but with no liquidity to support a secondary market, I suspect the new investors will see the value of their investments decline as people try to cash in their holdings.

The wholesale approach to privatization, in my opinion, does not address the basic weakness of the inefficiencies of the state enterprises. It does represent a major step forward in removing the state from business activities. Political realities may well force governments into bold steps that present high risks down the road, but these steps may be far preferable to doing nothing.

The Case-by-Case Approach

The most successful approach so far has been the individual sale of state enterprises to foreign corporate investors, but this only solves a few cases.

Attempts have been made to return businesses to their former owners. This approach has worked fairly well in Nicaragua, but the Sandinistas were only in power there for a decade. Most of the former owners are still around and anxious to go back into business. Two generations have gone by in Central Europe and nearly four generations in Eastern Europe.

Indeed one issue that has slowed the privatization process dramatically has been the rights of former property owners expropriated under the Communists. Most of the owners have passed away and any surviving rights have accrued to their heirs. Many beneficiaries live abroad. Some had cooperated with the Nazis. Some belong to ethnic minorities. Some had signed documents legally transferring their property to the state (or, as was often the case, to a cooperative). Some titles had disappeared as had some property registries. Memories of events did not always coincide with documents. Most of the properties had been improved since expropriation and the question arose as to who would pay for any improvements. Property claims are typically emotional as beneficiaries seek to right a perceived wrong two generations ago. Some claimants of agricultural land can show family ownership going back over 400 years.

The rights of former property owners are usually treated more on the ground of civil rights rather than economic efficiency. In the case of Romania, the government there, with little prior study, granted property rights of up to 3 hectares to each member or worker in the collective and state farms. Those rights extend to both prior ownership as well as to entirely new property rights. In some cases, individuals, fed up with the cooperatives, simply reclaimed their land on their own initiative. The entire process has created considerable confusion as to property rights and this is a major reason why agricultural production has declined in Romania since the revolution.

Another reason for the decline in food production has been a lack of credit, capital, technical, and marketing assistance for the new small farmers. This closely parallels the experience of agrarian reform in Latin America, where the real goal was to destroy the power of the large landholders. The new small farmers received inadequate assistance and production declined.

My own observation of Romanian farms is that many seemed to be well managed from a production point-of-view, but that their marketing needed strengthening. Many of them were integrated into industrial processing. By focusing its attention on broad ownership, the government runs the risk of breaking up efficient units. An argument could be made that the marketing of agricultural products should have been privatized and improved before redistributing land in the case of Romania. Political pressures forced the issue perhaps prematurely. The country is in no position to provide credit to a new class of small farmers and in even less of a position to provide technical and marketing assistance. For the new structure to work will require an entirely new system of services to small farmers. Some observers hope that the Romanian small farmers will eventually evolve like their Western European counterparts into voluntary cooperatives.

In the case of Lithuania, privatization of farm land began with little or no legal framework, but with the tacit approval of a new independence-minded government. Cooperatives have begun to spin off plots of land to selected members, presumably with some understanding that ownership will follow when political realities permit. Sometimes other assets of the cooperatives would end up on the farm that had been spun off. Nationality considerations played a role in determining who benefited from this arrangement. It is not at all clear how the new small farmers will obtain credit, or market their production, but they are organized and can count on a sympathetic government. The assumption here is that the new farmers will make up in sweat equity what they lack in experience. Again from personal observation, the Lithuanian cooperatives appeared less focused on the products than their Romanian counterparts and also less efficient. Perhaps the new arrangement will improve production through hard work, but it will also narrow the options of restructuring the cooperatives as productive enterprises.

The Russians, without any planning and out of economic necessity, have embarked on a novel course. With few laws and almost no privatization, productive enterprises are banding together in a myriad of commodity exchanges, which are really barter houses. While they certainly lack sophistication, nevertheless, they are effectively privatizing the distribution channels. Many of these exchanges will probably transform themselves into wholesale houses or private traders. This transformation should simplify the process of privatization when it starts.

The Art of Privatization

From the above discussion, it should be clear that the art of privatization is balancing off the conflicting demands of political reality and compromise with those of the marketplace. It is not possible to debate the most appropriate road to privatizing state enterprises without first coming to grips with politics. The issues at stake are fundamental to any society; there are no major winners and losers and expectations are high. The specific realities will vary from one country to the next: it is the rights of former property owners (all of the countries); the need to pacify the country (Nicaragua); nationality issues (Romania and Lithuania); a desire to force movement in the face of a recalcitrant legislature (Poland); rearguard operations by the Nomenclatura (Hungary and Romania); and pressure to spread ownership among the population (Czechoslovakia, Poland, and Romania) among others.

The art of privatizing agriculture is a further battle of pushing reform, of partially recognizing the rights of former land owners, and of maintaining production levels. Considering the effect of pending reform on production in the Soviet Union, the Central European countries (except for Romania) have been relatively successful at keeping farm production going and even increasing (Poland).

If there is one concern I have in agriculture, it is that political pressures will force governments to turn over land for whatever reason in small parcels to a large number of small farmers. Unless they subsequently regroup as companies or voluntary cooperatives, there is a risk of creating a class of minifundio farmers who will be too small to utilize new agricultural technology and who will demand government support through high prices or subsidies to remain competitive, much as has happened in the European community.