

Public service privatisation and crisis in Argentina

Leopoldo Rodríguez-Boetsch

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

Introduction

In the 1990s, during the administration of Carlos S. Menem, Argentina implemented sweeping economic reforms aimed at the complete revamping of the country's productive and administrative structure. The aim was to overcome macro-economic instability and sluggish growth through the introduction of market incentives and the retrenchment of state activity in the economy. Meticulously applying many of the policies of what came to be known as the Washington Consensus, the Menem administration was lauded in the international press, as well as by G7 governments and international financial institutions (IFIs), as a champion of effective government to be emulated by developing countries worldwide. Indeed, the policies initially appeared to work extremely well. A programme of macro-economic stabilisation known as the Convertibility Plan, the brainchild of Minister of the Economy and Harvard graduate Domingo Cavallo, rapidly brought down inflation to levels common in developed industrial economies, and did so without sinking the country into a deep or prolonged recession. Deeper structural reforms supplemented the macro-economic stabilisation package. Privatisation, deregulation, and trade liberalisation proved effective in attracting new capital flows, promoting the rapid modernisation of the economy. Argentina was living proof that the swift implementation of market-oriented reforms could rapidly erase decades of misguided state intervention and lead to sustained growth.

The mirage did not last long. In 1995, as a result of the Mexican peso crisis, GDP in Argentina declined by 3 per cent and unemployment reached 16 per cent. The so-called

'Tequila effect' should have served as a warning of the vulnerability of the Argentine economy to external shocks. Although the period 1996–1998 saw the restoration of vigorous growth rates, a series of external shocks led to a prolonged recession matched only by the Great Depression of the 1930s. The severe crisis suffered by Argentina holds important lessons for the academic and policy-making communities. Given the dramatic collapse of a developing economy that had been widely advertised as a model to be emulated, the reforms enshrined as dogma during the 1990s ought to be carefully examined. Such a task necessitates methodical research on the role that market-oriented policies played in the turn of events in Argentina.

This article discusses the role of privatisation in the economic reforms and the subsequent economic crisis afflicting Argentina. We start with an analysis of the function that privatisation played in the macro-economic stabilisation and overall reorganisation of the Argentine economy, followed by a description of the macro-economic context of the Convertibility Plan. Finally, we explore the relation between the pricing of privatised public services and the macro-economic crisis faced by Argentina. We conclude that the macro-economic and regulatory context within which privatisation took place played a critical role in undermining the ability of the Argentine government to respond to external shocks that resulted in a prolonged recession and balance-of-payments (BOP) crisis. Significant productivity gains in many privatised state-owned enterprises (SOEs) indicate that a micro-economic rationale existed for the privatisation of several sectors. However, the failure to pass these gains to the public in general can be attributed to a lack of political will and/or political inability to prevent an excessive concentration of economic power in the hands of a very few. Given that politics is an inherent part of the privatisation process, other countries should pay special attention to the impact of privatisation on the balance of economic and political power between diverse groups (including foreign investors) and the national government.

The theory and practice of privatisation in Argentina

Privatisation in theory

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

Many advocates of market-oriented reforms claim that privatisation also promises to improve the macro-economic outlook (Williamson 1990). In cases where SOEs have contributed significantly to government deficits, privatisation seems like a natural solution to their reduction. The proceeds from selling off SOEs would not only directly contribute to government revenue but also would eliminate future budgetary needs such as operating costs and capital investment. Politicians find the theoretical link between deficit reduction and privatisation useful as a signal of their commitment to economic reforms. Empirical evidence for this claim is, however, less than scant. In a study of privatisation in Latin America, Pinheiro and Schneider (1995:769) found that 'it is not reasonable to expect significant short-term fiscal gains from privatisation'. In their view, privatisation cannot be considered a serious tool for deficit reduction, and warn that a privatisation process focused on such a goal can have a detrimental effect on economic efficiency.

Privatisation has also been advocated as a solution to government corruption, since SOEs present abundant opportunities for corrupt officials to line their pockets through rigged contract bidding processes, over-invoicing of costs, preferential provision of services, etc. Clearly, these practices can also take place under private control, but it is commonly assumed that shareholders have a stronger incentive and greater capacity to demand transparency from business managers than citizens have over appointed bureaucrats. We should recognise, however, that privatisation also presents ample opportunities for graft. The transparency of the bidding process, the nature of the regulatory framework, and the pricing mechanism for public services have an enormous impact on the potential profitability of a privatised firm. Prospective investors and new owners alike have large incentives to seek advantages for their firms through all sorts of illegal practices. Once international capital is involved, the magnitude of the problem may potentially reach dimensions beyond all imagination in SOEs with much smaller budgets. Unfortunately, privatisation theorists and advocates have generally chosen to overlook these dangers and their potential repercussions. For example, Krueger (1990) points out the advantages of private economic activity over government intervention, emphasising the potential for rent seeking present in SOEs, but failing to mention even once the potential for corruption under private ownership. Repeatedly expressed by prominent economic theorists and policy makers (Krueger was pivotal at the World Bank (WB) during the 1980s and currently works for the IMF), such views carried significant weight among IFIs and governments seeking effective economic reforms (Dominguez 1997).

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

Economic reforms and privatisation in Argentina

During the military regime of 1976–1983, relatively cheap and easily available external credit was used liberally to finance large fiscal deficits. Although some of the funds went to finance

infrastructure and the expansion of SOEs' physical capital, much was used to support a failed monetary scheme and to cover undisclosed military expenditures (including the violent repression of political dissent that resulted in between 9000 and 30,000 disappeared).

Throughout the 1980s, the Argentine economy suffered bulging government budget deficits.

Often financed with credit from the Central Bank, these deficits had severe inflationary consequences. Facing bloated foreign-debt payments, largely the result of excessive government spending under the military regime and the nationalisation of private debt, the administration of Raúl Alfonsín was unable to reduce government expenditure. In an effort to calm inflationary pressures, Alfonsín capped the prices charged by SOEs in key sectors of the economy such as energy and public utilities. SOEs were also suffering from the excessive borrowing that had taken place during the easy credit period of the 1970s. To make matters worse, many of these enterprises had the additional political mandate of absorbing labour that had become redundant in other sectors of the economy in order to keep unemployment rates low.

The use of SOEs as tools of macro-economic policy, also a common practice in prior administrations, severely weakened their ability to undertake necessary capital investment and sustain an adequate quality of services. As the practice continued, their ability to provide services deteriorated, on some occasions resulting in substantial losses to the state and widespread discontent among users. With service rates below average costs of production, SOE deficits represented up to 4 per cent of GDP in the 1980s (Galiani and Petrecolla 2000:82).

In 1989 the economy experienced repeated hyperinflationary episodes, forcing an early transition to the presidency of Carlos S. Menem. The critical macro-economic conditions faced by the Menem administration required swift action. Fiscal deficits and hyperinflationary expectations had to be addressed immediately. Privatisation rapidly emerged as a cornerstone of policies aimed at stabilisation and deep structural reform. First, privatisation was promoted as a deficit-reduction measure. SOEs had contributed to the fiscal deficits for several years, and the proceeds from privatisation could help shore up government revenue and/or reduce debt interest payments. Second, privatisation provided a strong political signal of Menem's commitment to market-oriented reforms. He had won the presidency as the candidate of the *Partido Justicialista*, the Peronist party traditionally associated with populism and state intervention. In order to ease domestic and foreign investors and gain IFI approval, Menem sought to establish his credentials as a staunch reformer. Finally, privatisation could be used to attract new foreign direct investment (FDI) and thereby help re-establish growth. At a time of crisis the drawbacks of such policies seemed minimal. Although labour unions objected to privatisation, the most powerful unions acceded because of their close links to the Peronist Party. In any case, macro-economic conditions were so adverse that emergency measures were widely accepted as necessary, while the large deficits and decline in quality of SOE services during the 1980s had created an atmosphere favourable to privatisation among the general public.

These were far from optimal conditions in which to carry out an orderly privatisation. Under IFI pressure and needing to establish its reform credentials, the Menem administration rushed the process. Budget strains encouraged the use of short-term revenue-improving criteria at the expense of long-term efficiency-enhancing outcomes. The process was broad and swift. Based on the Law of State Reform passed soon after the accession of Menem to office in 1989, the vast majority of SOEs were sold to private investors or dismantled between 1990 and 1994. In just five years the National Telecommunications Enterprise (ENTEL), the airline company (*Aerolíneas*), the state oil enterprise (*Yacimientos Petrolíferos Fiscales*), most state electricity generation and distribution enterprises, state petrochemical firms, steel mills, radio and television channels, the state natural gas company, shipyards, and many others, were privatised. In the years to follow, the few public services that remained under government control were also targeted, including the postal service, the regulation of airwaves, and the issuance of passports.

The result was a privatisation experience noted for its shortcomings regarding competition and regulation. A common observation is the prevalence of monopolistic markets in privatised sectors, even when more competitive structures could have been created. Another is the delay in the establishment of a regulatory framework and independent regulatory agencies to constrain the monopolistic power of privatised enterprises (Gerchunoff and Cánovas 1996). Monopoly power was essentially traded for higher bids in an effort to boost short-term revenue and establish Menem's credentials as a reformer.

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

In order to make SOEs even more attractive and so boost bids, service fees were often increased prior to privatisation. In the ten months prior to the privatisation of ENTEL the US dollar price of a telephone pulse was raised by 711 per cent. Between 1992 and 1993, the average price of a cubic metre of natural gas increased by 23 per cent in real terms; the service was privatised in January 1993 (Aspiazu 2002:12). The higher fees were intended to guarantee a comfortable level of revenue to the new owners, but labour costs were also slashed. In 1990, at the beginning of the privatisation process, seven SOEs in the telephone, mail, air transportation, water and sewage, electricity, railway, and natural gas sectors employed 222,800 workers. By 1994 only one SOE remained and 32 privatised firms had emerged from the other six, employing a total of 99,000 workers, representing a drop of 55.6 per cent. By 1998, when all SOEs in the initial group had been privatised into 33 enterprises, employment among these firms stood at only 75,800. Over the period 1985–1998, there was a 68.9 per cent drop in the number of jobs among the same group of firms (Duarte 2002:73). The drastic staff cuts in SOEs prior to privatisation were achieved through the extensive use of voluntary retirement and severance pay. Considering the delicate fiscal position of the government during the early 1990s, such outlays would have been impossible had the WB not stepped in with generous loans. A total of 86,274 employees 'voluntarily' retired from public service SOEs, at a total cost of US\$1.3 billion in 1992–1993, or about US\$20,000 per retired worker during that period (Duarte 2002:81).

The shedding of labour by SOEs was to have a significant impact on overall unemployment levels. Prior to the prolonged recession that hit the country from 1998 to 2002, Argentina's unemployment rate showed a clear upward trend coinciding with privatisation and the rapid and unilateral liberalisation of trade. According to IMF figures, unemployment stood at 6 per cent in 1991, climbed to 12 per cent by 1994, and jumped to 16.6 per cent by 1996. Official government figures show an even more dramatic increase in unemployment during the same period. Duarte (2002) estimates that at least 2 per cent of the unemployment rate recorded in the late 1990s can be directly linked to SOE layoffs. Privatisation also resulted in lower demand for domestically produced inputs. As subsidiaries of foreign-based corporations, many privatised firms switched suppliers from local firms to the parent company, resulting in the reduction of manufacturing employment in Argentina.

Evaluating privatisation in Argentina

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

Improved efficiency, the central goal of privatisation from an economic perspective, was not attained in the economy overall. The drastic drop of labour among privatised firms had a strong positive impact on productivity in all the enterprises in question. Fewer workers, the intensification of the labour process, and new physical capital resulted in an average increase in labour productivity of 16.9 per cent per year between 1993 and 1998. However, the benefits derived from higher productivity were not transferred to the workers in the form of wage increases, nor were they passed on to consumers as lower prices. Instead, as we shall see below, the firms captured these gains in the form of extraordinary rates of return (monopoly rents). Although the privatised firms significantly improved cost efficiency in public services, society at large hardly saw any benefits (Geldstein 1997).

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

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

The macro-economic context of Convertibility and its crisis

Cavallo became Minister of the Economy in 1991 and rapidly implemented a radical anti-inflationary programme. Pegging the Argentine peso to the US dollar at 1:1, and linking the supply of pesos to the amount of dollars held in Central Bank reserves, Cavallo intended to re-establish confidence in the ability of the national currency to function as a store of value. In theory, the Central Bank no longer had discretionary power over monetary policy.

The money supply was to be determined by a single rule: one dollar in reserves, one peso in circulation. If reserves were to increase by one US dollar, peso supply would increase by one peso times the money multiplier (determined by the required reserve ratio), but if dollar reserves were to decline, the peso supply would have to experience an equivalent decline. The Central Bank was mandated to convert pesos into US dollars at the rate of one to one. The Convertibility Plan proved extremely successful, causing inflationary expectations to plummet and leading to a rapid decline in the inflation rate between 1991 and 1994 (Cavallo 1997).

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

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

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

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

In the fourth quarter of 1998 the Argentine economy entered a four-year recession. GDP declined by 3.5 per cent in 1999, by 0.5 per cent in 2000, by 5.5 per cent in 2001, and by a record 12.5 per cent in 2002. Growth was re-established in 2003, but only after a sharp devaluation and the largest default on external obligations in history (Basualdo et al. 2002). What turned a buoyant economy, the pride and glory of advocates for market reform during the 1990s, into a severely depressed basket case? Much of the blame lies with the vulnerability to a BOP crisis created by market-friendly policies adopted throughout the 1990s, to which a flawed privatisation process was no stranger.

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

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

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

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

The severe recession of 1999 enabled a reduction of wages and domestic prices, starting a slow process of deflation. The recession contributed to a reduction of the trade deficit in goods and services from US\$7.5 billion in 1998 to US\$5 billion in 1999 (Basualdo et al. 2002). However, the current-account deficit remained large at US\$12 billion and the government deficit practically doubled. In 2000, Fernando de la Rúa became president and opted to continue abiding by IMF demands, by now adamant about a large reduction of the government deficit. De la Rúa's administration raised taxes to perilous levels and enacted an across-the-board cut in government salaries and pension payments of 13 per cent. As a result, an incipient recovery in 2000 was choked off. Urged by the IMF, de la Rúa also pushed a labour market flexibilisation law through the Legislature amid allegations of kickbacks from the Executive to members of Congress. The subsequent economic contraction reduced the balance of trade in goods and services to a deficit of US\$2 billion. Nevertheless, the Argentine current account still registered a deficit of US\$9 billion. In 2001, as the external accounts continued to improve slowly, domestic conditions rapidly worsened. In an effort to cut government expenditure, de la Rúa drastically reduced social assistance programmes. The consequent decline in consumption drove the balance of trade in goods and services into a small surplus. However, unemployment climbed to a record 18 per cent as the government's austerity programme was disenfranchising people. Three years of deflationary efforts were slowly having an impact on external accounts, but their social and political cost had reached boiling point.

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

The role of privatised public services in the economic crisis

Privatised Public Service Enterprises (PPSEs) were not innocent bystanders in the prolonged process of economic, political, and social deterioration that afflicted Argentina. Deflation is never an easy task. Not only does it place severe strains on the financial system and depress

investment, but it also heightens political tensions as unemployment and social distress escalate. The monopolistic power and special contractual arrangements retained by PPSEs made matters worse. Just as austerity measures were implemented to drive prices down and recover international price competitiveness, the fees charged by many public services were rising. This in turn meant that the contraction in the consumption of other items had to be more severe, exacerbating the difficult conditions faced by the vast majority of Argentine households (Geldstein 1997). Electricity rates, water and sewage fees, natural gas prices, and transport costs increased as incomes shrunk and unemployment exploded. While the economy sank, PPSEs' profits grew. We must explore the pricing of public services post-privatisation in order to understand this seeming paradox.

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

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

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

stages and Menem intended to give a clear signal that his administration was bent on protecting the interests on foreign investors. Public services that had already been privatised re-negotiated their contracts to incorporate a clause allowing fee adjustments to the US CPI. Indexation of service fees to the US CPI became a standard feature of subsequent privatisations.

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

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

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

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

Comparison with rates elsewhere helps to place the exceptionally high rate of profits attained by PPSEs in Argentina within a global context. For example, in the USA, the UK, and France a normal rate of profit on net assets for water and sewage service providers is considered to be between 6 per cent and 7 per cent. As a result of repeated re-negotiations, the indexation of fees to the US CPI, a weak regulatory framework, and co-opted regulatory agencies, Aguas Argentinas received an average rate of profit on net assets of 23.3 per cent between 1994 and 1999. In the case of telephone services, Telecom Argentina generated an average rate of profit three times larger than its parent companies France Telecom and Telecom Italia, while Telefónica Argentina was twice as profitable as Telefónica de España (Abeles et al. 2001).

. Another telling example comes from the two companies in charge of natural gas transportation whose average rate of return was 40 per cent; a reasonable rate of return for this sector is considered to be between 10 per cent and 20 per cent (Basualdo et al. 2002:39–40). The exorbitant profit rates obtained by PPSEs can only be interpreted as evidence of unchecked monopolistic power and the exertion of strong influence over regulatory agencies and government alike.

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

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

Conclusion

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

Analysis of events since January 2002 is beyond the scope of this paper. Suffice it to say that the Argentine government has kept most public service fees frozen. Only in mid-2004 were some energy-sector fees raised in an effort to curb fast-growing demand for natural gas and electricity. Between 2002 and 2004, PPSEs have put pressure on the Argentine government to raise public service fees. From lawsuits at the United Nations international court for dispute resolution, to lobbying of G7 nations with influence in the IMF, and even veiled threats and actual interruptions of services, PPSEs have sought to re-establish the golden days by any means at their disposal. After much wrangling, the administration of Néstor Kirchner has apparently reached agreements with PPSEs in various sectors regarding the re-negotiation of contracts.

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

References

- Abeles, Martín, Karina Forcinito, and Martín Schorr** (2001) *El oligopolio Telefónico Argentino frente a la liberalización de mercado*, Buenos Aires: Universidad Nacional de Quilmes.
- Aspiazu, Daniel** (2002) 'Privatizaciones en la Argentina: la captura institucional del Estado', *Realidad Económica* (189):8–16.
- Aspiazu, Daniel and Karina Forcinito** (2003) 'Privatización del sistema de agua y saneamiento en Buenos Aires: historia de un fracaso', paper presented at the III World Forum on Water, Kyoto, 16–23 March.
- Basualdo, Eduardo, Daniel Aspiazu et al.** (2002) *El proceso de privatización en Argentina*, Buenos Aires: Universidad Nacional de Quilmes.
- Cavallo, Domingo** (1997) 'Lessons from Argentina's privatization experience', *Journal of International Affairs* 50(2):459–474.
- Domínguez, Jorge I. (ed.)** (1997) *Technopols: Freeing Politics and Markets in Latin America in the 1990s*, University Park, PA: Pennsylvania State University Press.
- Duarte, Marisa** (2002) 'Los impactos de las privatizaciones en el mercado de trabajo: desocupación y creciente precarización laboral', in Daniel Aspiazu (ed.) *Privatizaciones y poder económico*, Buenos Aires: Universidad Nacional de Quilmes.
- Galiani, Sebastián and Diego Petrecolla** (2000) 'The Argentine privatization process and its aftermath: some preliminary conclusions', in Melissa H. Birch and Jarry Haar (eds.) *The Impact of Privatization in the Americas*, Coral Gables, FL: North-South Center Press.
- Geldstein, Rosa** (1997) 'Gender bias and family distress: the privatization experience in Argentina', *Journal of International Affairs* 50(2):545–571.
- Gerchunoff, Pablo and Guillermo Cánovas** (1996) 'Privatization: the Argentine experience', in William Glade with Rossana Corona (eds.) *Bigger Economies, Smaller Governments: Privatization in Latin America*, Boulder, CO: Westview Press.
- Krueger, Anne** (1974) 'The political economy of the rent-seeking society', *American Economic Review* 64(3):291–303.

- Krueger, Anne** (1990) 'Government failures in development', *Journal of Economic Perspectives* 4(3):9–23.
- Pinheiro, Armando Castelar and Ben Ross Schneider** (1995) 'The fiscal impact of privatisation in Latin America', *Journal of Development Studies* 31(5):751–776.
- Williamson, John (ed.)** (1990) *Latin American Adjustment: How Much has Happened?*, Washington, DC: Institute for International Economics.

The author

Leopoldo Rodríguez-Boetsch is Assistant Professor of Economics and International Studies at Portland State University, Oregon. His areas of speciality include Latin American political economy and economic development. Contact details: PO Box 751, Economics Department, Portland State University, Portland, OR 97207, USA. <leopoldo@pdx.edu>