

OED Précis



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Privatizing Argentina's Public Enterprises

*Restructuring and privatizing major public enterprises entail high risk. But when reforms are backed by strong government commitment and grounded in careful sector work, they can achieve substantial results. Argentina's large-scale privatization of the early 1990s, recently audited by OED, provides a striking example.**

The World Bank's \$300 million Public Enterprise Reform and Adjustment Loan I to Argentina helped finance one of the most far-reaching public enterprise reforms ever carried out by any country. But for the Bank the loan was highly risky. At the time of loan appraisal, Argentina was in the midst of a severe economic crisis and the country had a history of unfulfilled reforms. To reduce the risk, the Bank insisted that the government show its commitment to reform by privatizing the state telecommunications utility before loan approval. Thus assured, the Bank swiftly committed significant financial and staff resources to the reform program. The government's commitment and ownership, coupled with the Bank's quick and substantial response, produced important results: All three sectors reduced their costs, expanded their output, improved the quality of their products and services, rationalized their prices, and experienced increased competition (albeit more in some sectors than in others).

Other factors were also important in the success of the reforms. Most notably,

the government's quick actions prevented opponents from mobilizing opposition. And the lessons learned from the initial rounds of privatization were used to improve subsequent rounds (see box).

Background

By the mid-1980s, a large, inefficient public enterprise sector was widely seen as a major reason for Argentina's disappointing economic performance in the postwar period. Although attempts were made to reform and privatize public enterprises, they were not far-reaching and two of the most ambitious efforts—reform of the national airline and telephone companies—had to be abandoned because of strong congressional opposition. By the end of 1989, federal public enterprises employed nearly 300,000 people and generated a huge operating deficit. Costs were high because of overstaffing, procurement from overprotected domestic industries, and uneconomic activities undertaken for political reasons. Price controls and indirect taxes created distortions, and inadequate investment led to severe shortages, obsolete technology, and poor service.

Macroeconomic conditions deteriorated so badly toward the end of 1989 that a new administration took office five months earlier than

scheduled. Shortly after elections, the new government sought Bank assistance in articulating and implementing reforms to restructure and privatize the public sector. Emboldened by public discontent with the crisis, the new government introduced plans that went deeper and were more ambitious than any the Bank had proposed, calling for the privatization of virtually all public enterprises.

Project goals

The \$300 million Public Enterprise Reform and Adjustment Loan I (PERAL I, approved in 1991 and closed in 1993) was the first of several Bank adjustment loans (totaling \$1.5 billion) to help Argentina restructure its economy. The loan's objectives were to help restructure and privatize public enterprises in three major sectors: telecommunications, railroads, and hydrocarbons. The loan also proposed repealing legislation that required public enterprises to fa-

**Performance audit report, "Argentina: Public Enterprise Adjustment Loan," Report No. 14809, June 1995. Performance audit reports are available to Bank executive directors and staff from the Internal Documents Unit and from Regional Information Services Centers.*

Factors contributing to success

Argentina's success story in privatizing public enterprises illustrates the importance of several factors:

- The administration's strong political will to proceed with largely economically justified proposals.
- A careful analysis and clear understanding of sector issues and options.
- A strategy and clear objectives for sector reform.
- An open, transparent privatization (bidding) process.
- Comprehensive privatization, so private firms in a sector do not have to compete with state-owned companies.
- A constant dialogue with vested interest groups and close

cooperation with the legislative branch.

- An appropriate legal and regulatory framework, relatively free of interference from special-interest groups, with rules perceived as fair and consistent with international practice—rules that favor benchmark competition and discourage vertical integration and dominant players in the market.
- A financial structure that prudently combines leverage and equity, to allow room for future indebtedness (for growth).
- Good, competent political and technical managers supported by adequate consultancy resources (in this case, financed largely by the Bank through PEREL and the Gas Utilization Loan).

vor domestic suppliers, to reduce the public-enterprise staff by more than 35,000, to draw up plans to privatize three other public enterprises, and to sign performance agreements with four public enterprises. To support PERAL I, the Bank also made a parallel \$23 million technical assistance loan, the Public Enterprise Reform Execution Loan (PEREL).

PERAL I entailed high risk for the Bank, not only because of the severe macroeconomic crisis, but also because Argentina had a history of unfulfilled reform commitments. To reduce the risk, the Bank insisted the government show its commitment to reform by privatizing ENTEL, the state telecommunications utility, before loan approval. Thus assured, the Bank invested a higher than average amount of staff resources to the reform program.

Bank sector work carried out during the previous administration also proved invaluable in fleshing out the rapidly emerging Argentine reform strategy. In addition to privatization of ENTEL, project components included:

- strengthening sector regulation in telecommunications;
- privatizing part of the state railway freight business, terminating uneconomic intercity passenger services, creating a new enterprise to take over passenger service in Greater Buenos Aires, reducing the railway staff by 30,000, reducing government subsidies, and creating new regulatory agencies; and
- setting natural gas and crude oil prices at international levels, lifting trade restrictions on oil and gas, restructuring and privatizing parts of the state oil and gas companies, and creating new regulatory agencies for oil and gas.

Implementation and results

The loan was fully disbursed and closed ten-and-a-half months ahead of schedule. On the whole, loan covenants were complied with or exceeded. In all three sectors, state involvement in production ended almost fully, competition was enhanced as barriers to private entry and international trade were lowered, and the first

steps were taken toward creating independent regulatory agencies.

Telecommunications

After being split into two regional companies, ENTEL was sold in 1990 to consortia led by European telephone agencies; competition was permitted in nonbasic services; and a new regulatory agency was created. Because Argentina needed speedy reform, it adopted a "sell as is" strategy in telecommunication. As a result, the price of the sale was lower than it would have been with divestiture. Another reason for the low price may have been the high country risk perceived by investors at the time. Nevertheless, privatization produced rapid results (see table). The growth rate of the telephone network quadrupled (from 3 percent a year in 1989 to 12 percent in 1994); price distortions were reduced (although charges for commercial users continued to substantially subsidize those of residential users); internal efficiency and the quality of service improved; tax revenues increased; and private investors earned an attractive return on investment.

Railroads

Argentine railways were known for their inefficiency and cost. And competition from other transport modes had not spurred the state railway to become efficient or customer-oriented, but it seems to have had that effect on privatized firms. The monolithic state railway company was divided into several passenger and freight companies before privatization. As part of this process:

- Eighty percent of freight services were placed in private concessions. The result was a doubling of the amount of freight moved by rail, as prices fell 20 percent.
- All suburban passenger services in the Buenos Aires region, including the subways, were privatized.

In the months that followed, ridership in suburban rail and Buenos Aires metro increased 30 to 40 percent.

- Seventy percent of intercity passenger services were shut down and the rest placed under private or provincial control.
- Employment in the sector fell from 90,000 in 1990 to fewer than 20,000 in 1994, and labor productivity increased by a factor of seven or eight.

Investors fared moderately well, with some exceptions, but the biggest beneficiaries were the taxpayers, as privatization of the railways ended the single biggest drain on government funds. Federal subsidies to the sector fell to half what they had been (an annual \$700 million before privatization) and were projected to end altogether in ten years.

Oil and gas

Reform introduced a flurry of activity in hydrocarbons. Domestic prices began to track international prices, and restrictions on international trade in oil, gas, and hydrocarbon products were lifted. The government realized almost \$10 billion from the break-up and

privatization of the state oil company, Yacimientos Petrolíferos Fiscales (YPF), and the state gas company, Gas del Estado (GdE). Three refineries and miscellaneous assets belonging to YPF were sold, and what remained was divested through international public offerings. GdE was privatized as ten independent companies (two transmission and eight distribution systems), with restrictions on vertical integration. As a result of reform, the private sector (excluding privatized YPF) controlled more than half the reserves and production of both natural gas and oil; more than 25 international oil and gas companies entered Argentina; competition was introduced into oil and gas production and the refining and distribution of oil products; and labor productivity doubled. YPF is now a major private oil company, with shares traded in Europe, Japan, and the United States.

Competition

Reform was intended to encourage competition or to maximize its disciplining effect in all three sectors. Pockets of monopoly remained in hydrocarbons and railroads. But in varying degrees competition changed all three sectors. The oil and gas sector became far

more competitive as regulatory barriers to entry and competitive rivalry were lowered. Rail freight had already been exposed to fierce competition from trucking and suburban passenger service and, to a lesser extent, to competition from buses and cars; under privatization, rail service responded to that competition by becoming more customer-oriented. In telecommunications, by contrast, basic services were sheltered from competition in the short term. The government gave privatized firms exclusive rights in long-distance service for up to ten years, partly to make ENTEL attractive to potential buyers at a time when the government's reputation among investors was poor. In retrospect, a five-year monopoly would probably have sufficed.

Regulatory reform

Regulatory reform was the government's Achilles' heel. The administration followed the Bank's recommendation to create an autonomous, industry-funded regulatory agency for telecommunications at the time ENTEL was privatized. But the agency did not function as hoped because the government was reluctant to delegate critical decisions about licensing or tariffs to a body insulated from political pressure. Regulation was also the major challenge for railroads. One challenge, for example, was to motivate concessionaires to maintain track and rolling stock in good condition. But freight concessionaires were reluctant to invest in track, not only because such investment was expensive but also because it would be unrecoverable if concessions were terminated for any reason. A new regulatory agency was created for gas, but as of late 1994, the one for oil had not been created.

Lessons learned

Considering how few precedents there were to learn from, Argentina's accomplishments in all three sectors were impressive. Al-

Telecommunications performance before and after privatization

Indicator	Telefónica de Argentina (south)		Telecom Argentina (north)	
	Nov. 90	Sept. 94	Nov. 90	Sept. 94
Total lines in service (000s)	1,915	3,013	1,571	2,624
Telephone penetration (lines per 100 inhabitants)	12.06	16.4	11.30	13.40
Waiting time for new lines (months)	27	2	27	4
Quality of service (% of calls completed)	(94 target)	(94 actual)	(94 target)	(94 actual)
Local	74	93	74	97
Domestic long-distance	64	91	64	93
Repair time delays (days)	6	1.7	6	4.4

Note: Privatization took place in November 1990.

most everyone benefited: taxpayers, investors, and to a lesser extent consumers, whose greatest gains are likely to come in the long run, as competition takes hold. And the reforms are unlikely to be reversed, not only because they have produced visible gains, but because the political costs of renationalizing these enterprises would be high. Moreover, the number of private firms with an interest in keeping the sectors open is growing, and the privatized firms have been able to raise money in domestic and international capital markets to fund growth and modernization. Among the lessons learned from the Argentine experience:

- Deep and speedy reform is possible only when a country fully "owns" that reform and is willing to make politically difficult decisions. The Bank can serve only as catalyst, providing advice and technical assistance, helping maintain program continuity, and lending international credibility to the government's reform efforts.
- Sweeping changes in ownership and regulation can be implemented fairly quickly if (1) the country has access to substantial technical advice and consulting resources. (In Argentina, the level of reforms called for an unprecedented amount of Bank staff involvement and risk-taking.) And (2) a good deal of preparatory work has been done beforehand.
- Speedy privatization makes it more difficult for opponents of the policy to organize and signals the country's resolve for reform. It can also lead to mistakes and flip-flops in strategy, a weakening of the government's bargaining power with buyers, and underpricing of firms. But when an economy needs dramatic action, as Argentina's did, the advantages of speedy reform clearly outweigh the disadvantages. As international experience accumulates, late-privatizing countries can learn from the mistakes made in earlier privatization efforts. And each country can use the lessons learned from one round of privatization in some sectors to improve subsequent rounds in others. The low price the Argentine government got for its state telecommunications company, for example, was more than offset by the much higher prices realized subsequently in the divestiture of the gas and oil companies, as the government's reforms gained international recognition.
- Different businesses and different situations call for different approaches to restructuring and reform. Businesses that face competition must be handled differently from those that enjoy monopoly power, and those with noncommercial goals must be treated differently from those that are commercially viable.
- Reformers must seize every opportunity to create competition where it does not exist or to unleash it where it is latent. Except in telecommunications, Argentina had more success doing this than many other countries, chiefly by breaking up monolithic state enterprises before privatization. In the railway and hydrocarbon sectors, the government did not fall into the trap of granting extended monopolies to improve the enterprises' selling price.
- Privatization of infrastructure and public utilities creates complex regulatory issues and challenges, and each sector poses special regulatory problems.
- It takes a lot more than laws and decrees to create effective regulatory institutions. The Bank must be as concerned about the *process and politics* of regulation as it is about regulatory *structure and techniques*. In that context, the Bank may want to compare the merits of creating autonomous regulatory agencies for each sector (as Argentina tried to do) with those of creating one high-powered economic regulatory agency (like the Mexican Fair Competition Commission).
- The Argentine government's desire to sell public enterprises to strong private investors restricted the set of potential Argentine investors to a handful of large business groups. Such concentration of economic power, where it is unavoidable, may result in problems to which governments should be fully alert.

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