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PRIVATIZATION AND FISCAL REFORM IN EASTERN EUROPE: SOME LESSONS FROM LATIN AMERICA

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PRIVATIZATION AND FISCAL REFORM IN EASTERN EUROPE:

SOME LESSONS FROM LATIN AMERICA

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1. INTRODUCTION

Since two decades ago, and for a plethora of reasons, all Latin American countries have made at one point or another economic reforms, attempting, with varying success, to stabilize and liberalize their economies. More recently, and in a much more dramatic fashion, the former socialist countries of Eastern Europe have turned the wheel 180 degrees and have embarked on drastic reforms to transform their systems into capitalist economies.

Although the initial conditions in both regions were radically different, it is natural to ask how the Latin American experience can be of use for Eastern European reformers. That such question is meaningful is well illustrated by the companion papers in this volume. Our paper joins them as a complement to, in particular, the excellent analyses made by Janos Hoos and Vratislav Izák of the Latin American and Eastern European experiences on, respectively, privatization and fiscal reforms.

The privatization of state-owned enterprises is an essential component of the transformation of the Eastern European economies. Private ownership is crucial for providing the incentives for efficiency to firms in market economies. It is also likely to be one of the most difficult aspects of the institutional and policy reforms underway in those countries. In Section 2, below, we address some of the privatization issues that we think are relevant in light of the Latin American experience. In Section 3, on the other hand, we focus on another essential component of any economic program: the fiscal side. Although by a fiscal reform is commonly meant only a tax reform, we also take the opportunity in that section to comment, albeit briefly, on other fiscal issues. We conclude in Section 4 with some qualifications, and further comments, on the Eastern European economies and their transition from socialism.

2. PRIVATIZATION

Drawing lessons, relevant lessons, for Eastern Europe from the Latin American experience with privatization is not an easy task. In spite of the large and increasing role played by the state in the production of goods and services since the Great Depression of the 1930's, there have always been in Latin America a private sector and well-defined property rights. Moreover, capital and stock markets, although imperfect and shallow, were already operating prior to the privatization programs initiated in the second half of the 1980's, and, despite several policy shifts, there was a long experience in dealing with foreign investors. Furthermore, none of the Latin American economies (with the exception of Cuba, of course) was ever structured on the basis of large vertically and horizontally integrated state-owned monopolies.

For one thing, those differences imply that the privatization effort in Eastern Europe will last longer than the programs carried out in Latin America. In particular, the divestiture of medium to large enterprises in manufacturing will have to be done at a much slower pace, and the transfer of public utilities will probably have to wait until a first round of privatizations and reforms is consolidated and an institutional framework for their regulation is in place.

Those differences notwithstanding, one can find several commonalities arising in both the Latin American and the Eastern European privatization processes. Janos Hoos has pointed out most of them, and here we try to complement his exposition.

2.1. The Sequencing of Privatization

The complexity of choosing a sequence of reforms is stressed in Hoos's paper. We mostly agree with the ideas he puts forward: start with small enterprises and residential assets, and then move on to large industrial enterprises. In the latter case, start with the tradeable sectors, rather than with the sectors more isolated from foreign competition due to natural or trade policy barriers. Nevertheless, given the magnitude of the changes that are currently being introduced in the Eastern European economies, the reforms will have to move simultaneously on several fronts. As it has been already apparent during the last few years, there will not always be enough time in those countries to wait for the consolidation of a specific policy change, or for progress in the divestiture of certain types of productive assets, before moving to the next step.

2.2. Who Owns the State-Owned Enterprises?

One important privatization issue that tends to be forgotten is, as emphasized by Tirole (1991), the clarification of whether the state is the sole owner of the enterprises. As a rule, Latin American governments were in full control of the enterprises prior to their divestiture. For instance, as the government in Chile was initiating a privatization effort in the 1970's, one of the first actions taken was to re-enforce control over the state-owned firms to proceed then to reduce the difficulties in having the agents (the managers) follow the goals of the principal (the government). Opposition to divestiture will not only come from workers that feel they have claims to ownership, but also from interest groups that obtain benefits from the state-owned enterprise or use it to provide favors.

2.3. Industrial Regulation

It is likely that public utilities will not be privatized in Eastern European countries in a first or even perhaps a second phase of divestitures. A possible exception could be telecommunications, although this sector may be privatized through the expansion of private investment rather than divestiture. Therefore, regulatory issues involving natural monopolies are not yet as relevant as in Latin America.

In the case of other monopolies on sale, however, there is a strong need for breaking them up prior to their privatization, and this for several reasons. To start with, as it happened in the case of some Latin American countries, it is not enough to rely only on trade liberalization to put pressure on monopolies or oligopolies because in a traditionally protected economy it will take time for the importers to set up distribution chains, and even in some cases the local producers will end up becoming the importers as well. Thus, the desired effect is far from immediate.

Another reason is that once property rights have been allocated it is very difficult to undo things. This is clearly shown by the Chilean experience with the privatization of regulated natural monopolies that caused problems such as the lack of separation into different companies of electricity generation and transmission, or the restitution by the hydro-power generator companies of the water rights they were privatized with. The breaking up of monopolies has to include the abolition of any rights or privileges that the enterprise may have been granted when owned by the state because, in the end, they become barriers to entry.

It is interesting to note that most Latin American countries have tended to overlook entirely the issue of industrial regulation and its relationship with privatization. For instance, a full-fledged antitrust commission was created in Mexico only after the privatization process was, for all purposes, already completed (in 1993). This behavior can be perhaps explained by the fact that monopolies can be sold at a higher price as single companies, a thought that can make politicians to be hesitant to break up the monopoly before selling it. This reasoning, however, obviously neglects the future social welfare losses that will arise from monopoly practices.

2.4. *The Emergence of Conglomerates*

The Latin American experience shows that the divestiture method that is used has consequences for market and ownership structures as well as for corporate governance. The privatization processes of the seventies in Chile, and of the eighties and nineties in Mexico and Argentina, led all to the formation of highly leveraged conglomerates: domestic investors acquired through public bids simultaneously both banks and enterprises.

In the case of Chile this proved to be disastrous in the early eighties. Since the conglomerates were using the banks to provide credit to their own enterprises, when the economy entered a recession in 1981 the conglomerates collapsed and the enterprises reverted to state ownership (see Bitran and Sáez, 1994). Certainly the issue is not the simultaneous ownership of banks and enterprises *per se*, but rather that their emergence as a result of privatization has consequences for economic stability and financial regulation, an issue to which we will return. But the question still remains: do you want to facilitate the formation of conglomerates by choosing a determinate method of sale, as was the case in several Latin American countries?

To avoid the concentration of ownership as an outcome of privatization, the use of retail sales of shares has been suggested, but this may have implications for corporate governance.

Not enough empirical research has yet been done in Latin America regarding the consequences of having a large number of small shareholders, through popular or people's capitalism, as opposed to one dominant owner; or having only one type of shareholder, as opposed to a combination of shareholders such as large domestic investors, foreign investors, institutional investors and small shareholders. In general, the vast majority of enterprises in Latin America were awarded to one dominant owner, or stable core to use Lipton and Sachs's (1990) expression. This had the advantage of alleviating the agency problem that would result by the lack of incentives for monitoring managers in the case of a very disseminated structure of shareholding.

2.5. Financial Regulation

A private financial system is now being developed in Eastern Europe, and, as is well known, the implicit government insurance on bank deposits creates a moral hazard and adverse selection problem that requires appropriate regulation. As noted earlier, the Chilean experience in the seventies can be used as a lesson on this matter. The existence of conglomerates and of joint ownership of banks and enterprises did not contribute, on their own, to the financial collapse of the early eighties. The problem was the lack of regulation of transactions between related parties, which lead to the abuse of self-lending. The lesson that can be drawn here is that appropriate prudential regulation must be in place before starting to privatize. Again, once property rights have been allocated and interest groups have developed, it is very difficult to regulate properly.

2.6. Investment Funds

In a related fashion, the government has also to provide the right incentives for the managers of investment funds to truly represent the goals of the ultimate owners of the firm. This may become an important issue in Eastern Europe considering that some countries are relying on these funds for the privatization of large enterprises. Investment fund managers should have in mind the maximization of long-run profits and not short-run profitability.

Furthermore, in the countries choosing voucher systems for the distribution of shares and investment funds for corporate control, policy makers should also consider the possible consequences of having fund managers (or board members elected by them) sitting, simultaneously, in several enterprise boards, because there is the potential for indirect horizontal or vertical collusion between these enterprises.

2.7. Transparency

Janos Hoos devotes in his paper some space to the issue of transparency. We agree that this is important for equity, fairness and political economy reasons. The impression that a privatization program may benefit or is benefiting specific and clearly identified groups linked to the administration in power, or past administrations, reduces the support for reform. As shown in Latin

America, the political economy of privatization is complex, and lack of transparency or legitimacy (real or perceived) makes it even more difficult. Voters in Uruguay rejected a privatization program in a plebiscite precisely because they had the impression that the sales would only benefit investors tied to the government. The rejection in Eastern Europe of "spontaneous" privatization by the managers of state-owned enterprises and the former *nomenklatura*, as described in Hoos's paper, shows that transparency is also an important issue in those countries.

To conclude with this section, there are no simple guidelines for an optimal privatization program. The specific features of the divestiture efforts have to differ from country to country on the basis of the initial conditions of the enterprises, national idiosyncracies, political constraints, and the macroeconomic environment. Nevertheless, judging by the Latin American experience, a necessary condition for the success of any privatization program in Eastern Europe is that the rules of the game be clearly defined and respected, so that the high degree of uncertainty and noise already existing in their economies is not increased.

3. FISCAL REFORM

The most pressing fiscal issue that the Eastern European countries had to face from the beginning of their economic reforms was the reshaping of their tax systems. Since during the socialist period, and specially until the seventies, their taxes tended to be quite rudimentary (see Gray, 1991, for a review), this reform has been, and will continue to be for some time, one of the most important in the agenda. In what follows, we make some remarks on this and other fiscal issues, following the lead made by Vratislav Izák's companion paper.

3.1. Novel Tax Systems

Given that the tax systems in the Western world are themselves hardly optimal, one could ask whether the former socialist countries should not take the opportunity to adopt a novel system. In particular, one could wonder, following McLure (1992), if the time for some system based on cash flow taxation has not come.

The Eastern European countries apparently do not think so. And this for two very good reasons: Since several of them are looking forward to integrate economically with the rest of Europe (Hungary and Poland had already applied, when this was written, to become members of the European Community), a cash flow tax would be a headache to administer across borders, because it would not qualify as an income tax in the rest of the continent. Furthermore, a cash flow tax that exempts returns to savings and investment would yield less than an income tax (see Tait, 1992). Those two reasons are quite similar to the ones heard in Latin America when someone has suggested the adoption of such a system.

3.2. Value Added Taxes

Most countries in Eastern Europe have already introduced value added taxes (and a host of excise taxes). As described by Vratislav Izák, the VATs allow for multiple rates and exempt some services. Furthermore, the taxes are, wisely enough, mostly tailored after the ideal value added tax advocated by the European Community Commission. It is going to be interesting, no doubt, to learn in the future about the revenue collected through these indirect taxes; our own conjecture being that, in the sort-run, the most open and .administratively centralized countries will have the greatest success. There is, nevertheless, another point that deserves even more attention: The welfare impact of all those indirect taxes across the population. The analysis of this impact seems to us an important and urgent research topic. On this, by the way, Eastern Europe will do well in not looking for advise from Latin America, where there have been ver few serious studies at the household level of the impact of taxes, but from Western Europe.

3.3. Progressive Income Taxes

In all capitalist countries, the majority of economists (and of the people, for that matter) continue to endorse progressive personal income tax rates. Curiously enough, some important economists and policy-makers in former socialist countries are, in contrast, not quite enthusiastic about progressivity (the most illustrious case is Kornai, 1990). One possible reason for their dislike could be the belief that there is no need to be concerned about income distribution, since their societies are relatively more egalitarian than the rest of the world. To qualify this view, however, one can note that the redistribution of income in favor of the rich can be quite large during sustained periods of high inflation and/or stabilization, such as the ones that their countries are currently enduring. Moreover, the privatization process itself will lead to a redistribution of assets. On this, Latin America can provide many sobering examples.

3.4. Asset Taxes

Izák has drawn attention to the gross asset tax on firms implemented in Mexico in 1989, whose main purpose is to decrease evasion by taxing visible assets. Leaving aside the issue of whether or not this tax has been truly successful (see Urzúa, 1994, for a skeptical view), it is worth noting that similar taxes have been already tried and abandoned in other Latin American countries: Colombia, where a tax on wealth for both individuals and enterprises was implemented in the seventies (and has been recently abolished); and Bolivia, where a tax on net assets was tried in 1988 without much success (the main problem seems to have been that firms were able to decrease tax payments by exaggerating their liabilities). It is also interesting to note that most Eastern European countries used to have, during their socialist period, a tax on fixed assets, with the purpose of giving incentives to the efficient use of capital. Curiously enough, as described in Gray (1991), Poland has recently reintroduced a tax along that line.

3.5. Tax Compliance

Under socialist regimes, the shortage of goods and the abundance of bureaucrats used to make citizens distrustful of any government policy. Thus, it should come as no surprise Izák's remarks in his paper on the extent of tax evasion that currently prevails in former socialist countries. He has already mentioned some traditional medicines that will help to control the disease of tax evasion, but we would like to add one that should be as good as penicillin: Honesty from the part of the government. The authorities should try to gain the confidence of the citizens by being as clean as possible. Regarding this, Latin America can provide several examples of countries where widespread corruption from the part of the government is a big factor that discredits, *a priori*, any campaign against tax evasion.

3.6. Social Security

In most economies of Eastern Europe, the tax burden of social security is sufficiently large to be quite worrisome. Among possible reasons for its magnitude are: an increasing share of old people, too generous benefits, bad administration, and, for some countries, the simultaneous use of social security contributions for both the pension system and the health care system.

Except for some platitudes, such as improving the administration of the funds and increasing the age of retirement, it is hard to say what to do to solve the problem. But one point seems clear: given the current state of their economies, the

Eastern European countries should not try to follow the road already taken by some Latin American countries and privatize their pension systems. Given the lack of suitable financial institutions in Eastern Europe, this policy would seem to be quite adventurous in the short and medium terms. Furthermore, in the case of the intertwining of the pension and health systems, any drastic reform of the social security system will have to wait until the mature development of a private market of health services (perhaps together with an independent public health system).

3.7. The Need for New Institutions

Tanzi (1993) has called attention to the very strong links between fiscal and monetary policies in the Eastern European countries. Links that make fiscal goals to be pursued through monetary policy (e.g., the monetization of the public deficit), because of the lack of *ad hoc* fiscal and financial institutions such as bond markets. Tanzi (1993, p. 26), in fact, dares to say that: "To a large extent the success or failure of the transformation process will depend on how quickly modern fiscal institutions can be created." We strongly agree, but to these fiscal institutions we would add the counterparts that are also much needed by the private sector: commercial banks and other financial intermediaries. Regarding the financial markets, of which the most cosmopolitan and glorified is the stock market, we think they are less important in the short and medium terms; although there are, of course, exceptions, such as the voucher market developed in the Czech and Slovak Republics during their privatization processes.

3.8. The Debt Burden

It almost goes without saying that most Eastern European countries suffer from "debt overhang", the same problem that has afflicted most Latin America since the eighties. The very high burden of foreign debt in the case of countries such as Hungary and Poland clearly leaves a very small room for fiscal maneuvering, even during this period of low world interest rates. The industrialized countries in the West are fully aware of that, and some minor help has been provided; but we are afraid that there will never be the political will to go beyond that (except, of course, for the case of Russia). What to do then? Here, we believe, several Latin American countries have a good lesson to offer: bargain, bargain hard with the private banks.

4. SOME QUALIFICATIONS AND FINAL REMARKS

Before concluding, it is perhaps worth to give two qualifications. The first is something obvious, but important: the Eastern European countries conform a very heterogeneous group, much more heterogeneous than the Latin American one. Furthermore, the initial conditions under which each of the Eastern European countries initiated her own economic transformation process differ markedly from each other (which, again, was not quite so in the case of Latin America). Thus, care has to be taken while drawing lessons even in a cross-sectional fashion. To give an example, the Czech and Slovak Republics started their transformation with a very low level of foreign debt, a fiscal balance, low inflation, and an insignificant private sector; while Hungary started with just the opposite initial conditions in all those four accounts.

The other qualification concerns the fact that some pressing issues in Eastern Europe are foreign to Latin America. An obvious case is the inter-enterprise debt problem, particularly in the states of the former Soviet Union (see, e.g., Rostowski, 1993), which constitutes a serious issue to be considered during the privatization process. Other cases are the fiscal coordination problems that are already arising in several Eastern European countries after their partitions in different states (see Kopits and Mihaljek, 1993), and the large proportion of their firms that were artificially surviving through public subsidies during the socialist period (see, e.g., Richet, 1993).

Instead of concluding summarizing our views, we make two final remarks that lie outside of the economic sphere. The first concerns the importance of social and cultural institutions. After reading about the stabilization processes undertook by most countries in Central Europe after the First World War, we were struck by the similarity of the initial conditions then and now for some of the countries (even though they were then capitalist!). For instance, the foreign debt owed by Czechoslovakia and the level of her inflation were then, just as now, quite small compared to the ones of her neighbors Hungary and Poland. What made then, and makes now, for those differences? Certainly not financial expertise, for Hungary, for instance, has always had a stronger financial sector than Czechoslovakia.

In a remarkably prescient conference given in 1990, which already described most of the issues that would become relevant later during the economic transformation of Eastern Europe, Arrow (1991) chose to conclude drawing the attention to the economic consequences of the fading importance of the Nation-State in our times. The recent fragmentation of several countries in Eastern Europe makes Arrow's message worth remembering. Countries can ignore international economic integration only to their own peril.

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