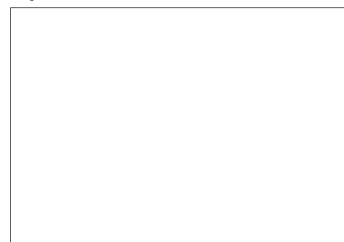




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Argentina: Reforming State-Owned Enterprises

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An Intelligence Assessment

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*ALA 87-10004
January 1987*

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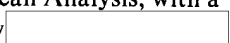

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Argentina: Reforming State-Owned Enterprises



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An Intelligence Assessment

This paper was prepared by  Office
of African and Latin American Analysis, with a
biographical contribution by 
Office of Leadership Analysis. It was coordinated
with the Directorate of Operations. 

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**Argentina:
Reforming State-Owned
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Key Judgments

*Information available
as of 18 December 1986
was used in this report.*

President Alfonsin is attempting to reduce the drain on the economy from Argentina's 350 state-owned enterprises (SOEs), whose inefficiencies are contributing to inflation and persistent economic stagnation. Progress is slow, but even modest cuts in SOE expenditures will indirectly promote economic stability and reduce the need for new foreign loans, thereby promoting a better relationship between Argentina and its international creditors. We believe, however, that Alfonsin's reforms are insufficient to end the country's economic malaise or to create major new opportunities for US exporters or investors. Furthermore, if his program unravels, Alfonsin's credibility with creditors would be weakened. Any such setback would only complicate matters for a government facing the challenge of institutionalizing democracy.

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The freeze on new government hirings implemented by Alfonsin in 1985 marked, in our view, a significant break with the populist approach to economics that had long characterized the President's Radical Party. Alfonsin has made reform of the unwieldy public sector a major element of his campaign to modernize Argentina's political and economic institutions. He has obtained a World Bank loan to improve SOE management and efficiency and has introduced legislation in Congress that would grant him more leeway in privatizing the parastatals. Moreover, he recently announced plans to speed the introduction of efficiency-enhancing measures to the major SOEs by centralizing them in a semiautonomous holding company run by senior private-sector executives, and pledged to further reduce the central government work force through a voluntary early retirement program.

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Notwithstanding Alfonsin's commitment to change and the potential for progress in certain areas, we doubt he will implement sweeping reforms in Argentina's parastatal system. For example, we believe that Alfonsin's most recent initiatives underscore his reliance on promoting efficiency in—rather than divestiture of—parastatals. While polls indicate that the public is becoming more receptive to privatization and reform, Argentina's nationalistic interest groups—including the Peronists, organized labor, the bureaucracy, and even sectors of Alfonsin's party and the business community—oppose the selloff of parastatals and other actions that involve layoffs, control by multinational corporations, or a major reduction in the state's role in the economy. The President, in our view, has concluded that antagonizing these powerful sectors might jeopardize his highest priority, the consolidation of democracy in Argentina.

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Alfonsin, in our view, will make some progress in restructuring SOEs during the remainder of his term. He has invested considerable political capital in his reform campaign, and will not jettison his program easily. Moreover, we concur with the US Embassy's judgment that, given the depth of problems at the SOEs, relative gains in efficiency could produce significant savings. We expect Buenos Aires to use noncontroversial methods such as a hiring freeze, a voluntary retirement program, and cutbacks in public investment. The savings thereby generated may, in our view, help narrow Argentina's budget deficit and decrease its need for additional foreign loans. They will not, however, generate surplus capital to repay principal on the foreign debt or produce significant economic growth over the next several years. Parastatal losses, although reduced, will continue to drain the treasury, and the temptation to cover them by printing money will keep inflationary expectations high. [redacted]

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Nevertheless, we are guardedly optimistic regarding the longer term consequences of Alfonsin's initiatives. The administration's goal of relocating Argentina's capital to a small Patagonian city and shifting many SOE headquarters to the provinces by 1989, will, if implemented, decentralize the public sector and permit significant work force reductions through attrition. Moreover, Alfonsin's efforts to rehabilitate some free-market concepts are changing the rhetoric—and more slowly the reality—of Argentine economic decision making, thus laying the groundwork that may enable a more politically secure administration to take bolder actions at a later date. [redacted]

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There is about a 1-in-4 chance, in our judgment, that Alfonsin will become impatient with his current economic game plan and abandon even his truncated reform program in favor of short-term, growth-oriented policies aimed at job creation through public investment and expanded SOE employment. In our view, the results of such a strategy, especially if pursued aggressively, would be uniformly negative. After a brief, consumption-led boom, inflation would soar and Argentina would almost certainly lose its sources of foreign financing, forcing the President either to turn to another round of austerity measures to halt an inflationary spiral or to face an economic crisis of a magnitude sufficient to threaten his tenure in office. [redacted]

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Figure 1
Selected State-Owned Enterprise Infrastructure



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**Argentina:
Reforming State-Owned
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Introduction

A review of Argentine economic statistics suggests that many of the ills plaguing Argentina's economy stem from inefficiencies associated with the country's mammoth public sector, specifically the multitude of state-owned enterprises (SOEs). Buenos Aires's persistent recourse to foreign borrowing and printing of money to cover the losses by these parastatals has contributed to its \$50 billion external debt and endemic inflation. The public companies' dampening effect on competition has also helped prolong economic stagnation—Argentina has averaged zero annual GDP growth over the past decade. Most observers agree that reinvigorating the economy will entail—along with deregulation and trade liberalization—extensive reform of state-owned enterprises. [Redacted]

aspects of the economy, from the utilities and basic industries, such as chemicals and steel, to airlines, television and radio stations, hotels, and banks. [Redacted]

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US Embassy reporting as well as academic studies point to the fact that successive Argentine governments—like many other Third World countries—have used their control over major corporations to pursue a variety of social and economic policy goals. Featherbedding in public enterprises, for instance, has helped keep Argentina's combined unemployment and underemployment—13 percent as of October 1985—at a remarkably low level for Latin America, while simultaneously enabling the state to spend little for social welfare or unemployment compensation. In addition, Buenos Aires has sometimes used SOEs to temporarily dampen inflationary pressures by allowing the prices for public services to lag behind changes in the consumer price index. [Redacted]

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President Raul Alfonsin appears to recognize the importance of reforming the public sector and has taken some steps in this direction, but he faces major roadblocks to significant change in the status of the SOEs. Since most parastatals are chronic money losers, few Argentine investors have the desire or the capital to buy them. Moreover, organized labor, the Peronist opposition, the state bureaucracy, and even sectors of Alfonsin's own Radical Party oppose the massive layoffs needed to restore SOE solvency and will fight sales of the firms. This paper examines the current condition of the SOEs, discusses President Alfonsin's evolving policy toward their reform, analyzes key interest-group attitudes toward the question, and reviews the implications of these developments for Argentine economic performance and for the United States. [Redacted]

In our view, however, the economic cost of Argentina's parastatals is high. The SOEs are steady money losers, with deficits of about \$3.9 billion in 1984 and \$3.3 billion in 1985, according to our calculations. Transfers from the central administration to cover SOE losses caused half of the total government budget deficit in 1985. Statistical studies show that the state oil company is one of the few major oil companies in the world that consistently loses money. One of the greatest drains on the Argentine treasury comes from the state railroad, which loses about \$3.0 million a day, and whose gross sales income covers only 63 percent of personnel costs, according to the press. [Redacted]

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The Weight of the State Sector

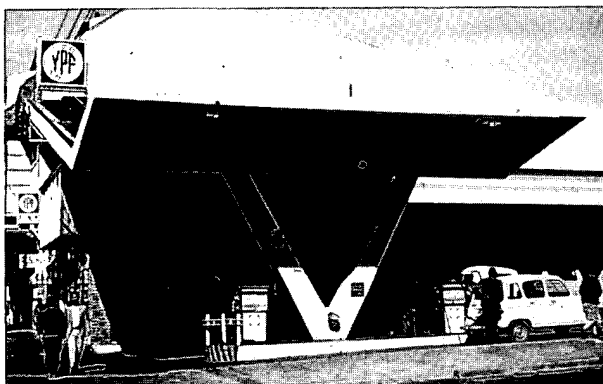
Public-sector spending dominates the Argentine economy. It accounts, according to government statistics, for 46 percent of GDP, of which two-fifths—18 percent of GDP—is generated by about 350 public corporations.¹ These firms participate in myriad

These losses have contributed to two of Argentina's most intractable economic problems: inflation and debt. In our judgment, Buenos Aires's printing-press financing of SOE expenditures has helped fuel annual inflation rates that did not dip below triple digits

¹ This assessment addresses only these 350 firms in which the state has sole or majority interest. In addition, 168 companies have minority state participation. See appendix for a survey of the state sector and several of the key parastatals. [Redacted]

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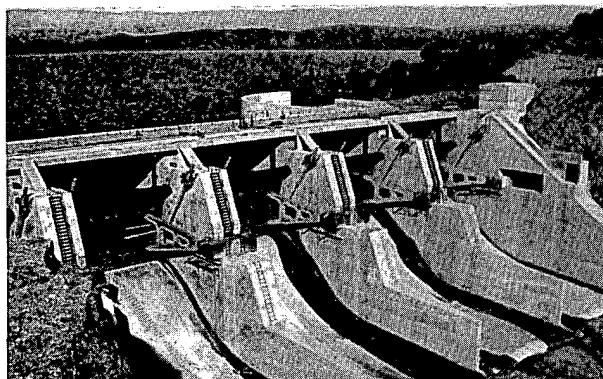
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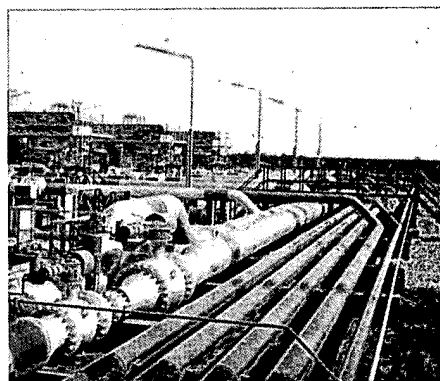
YPF. 33,725 employees ... gross income: \$3.4 billion ... losses: \$675 million ... market share: 80 percent.



Argentine Airlines. 10,303 employees ... gross income: \$471 million^a ... market share: 70 percent.



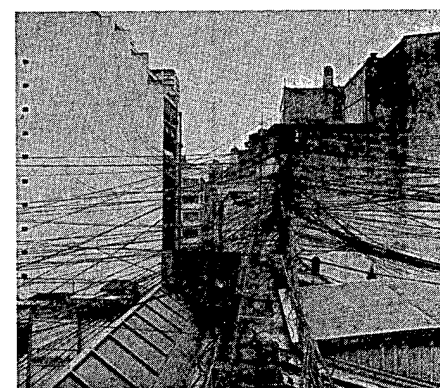
Water and Electricity. 11,249 employees ... gross income: \$424 million^a ... market share: 27 percent.



State Gas. 10,238 employees ... gross income: \$937 million ... losses: \$644 million ... market share: 90 percent.



Argentine Railways. 107,837 employees ... gross income: \$403 million ... losses: \$1.1 billion ... market share: 99 percent.



National Telecommunications. 48,158 employees ... gross income: \$702 million ... losses: \$24 million ... market share: 90 percent.

Figure 2. Major State Enterprises

Sources: International Monetary Fund, the US Embassy, and press.

^a 1983; all other figures for 1984.



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between 1975 and 1985. In addition, government statistics indicate that SOE borrowing is responsible for one-fourth of the \$50 billion foreign debt. The public enterprises, in our view, have also played an indirect role in Argentina's economic stagnation by thwarting competition and stunting private-sector growth in key sectors of the economy—such as transportation and energy. [redacted]

Alfonsin's Push for Parastatal Reform

When he became President in 1983, Alfonsin, according to the US Embassy, shared the statist and anti-free-market bias of his Radical Party (UCR). Largely ignorant of and uninterested in economics, the President left policy formulation in the hands of party stalwarts who increased real wages and the number of government jobs. Although Alfonsin paid lipservice to reforming the public sector, the Embassy reports that he shifted responsibility for the undertaking from ministry to ministry and made few substantive changes during his first 18 months in office. [redacted]

The ensuing economic chaos—by June 1985 the budget deficit equaled nearly 13 percent of GDP and inflation was averaging over 25 percent per month—caused Alfonsin to shift gears and implement the Austral austerity plan (see inset). In our view, the program's freeze on most new government hirings marked the President's first serious move to grapple with SOE reform and represented a significant departure from past Radical Party positions. Alfonsin subsequently centralized responsibility for restructuring state enterprises in two new administrative bodies:

- The Secretariat for the Promotion of Growth, tasked with increasing private-sector participation in areas dominated by SOE monopolies.
- The Secretariat for the Control of Public Enterprises, charged with overseeing all parastatal activities and devising ways to stem their losses. [redacted]

Alfonsin followed these initiatives with further moves in the same direction. In a major policy address in February 1986, he announced plans to privatize the wholly government-owned steel producer, SOMISA, as well as to sell government majority or minority interests in five petrochemical firms. Several months later, the President submitted legislation to Congress

The Austral Plan

During the first half of 1985 the Argentine economy spiraled downward and inflation reached an annual rate of over 1,000 percent. President Alfonsin responded with a new economic program—the Austral Plan—that froze prices and wages, created a new currency, halted government hiring, and included a pledge by the government not to print money to finance deficits. [redacted]

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The plan won Alfonsin wide popular support and rapidly stabilized the Argentine economy, reducing inflation to a monthly average of 3 percent during the second half of 1985. The plan also shrank the government deficit as a percent of GDP because of increased real tax receipts due to the decline in inflation, stepped-up tax collection efforts, higher charges for government services, and a "forced savings plan" that required businesses and individuals to loan money to the government. Buenos Aires signed agreements with the IMF and commercial bank creditors to roll over portions of its \$50 billion debt and obtain \$5.6 billion in new lending. [redacted]

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We believe that the Austral Plan was initially an emergency measure to overcome hyperinflation and maintain political stability, rather than a well-conceived project to reform Argentina's economy. The first policy supplements to the Austral Plan—loosening, then retightening, price controls and an export promotion program that has been partially offset by an overvalued exchange rate—represented, in our view, incremental changes tailored to the Argentine statist mindset. Nevertheless, more recent addenda—highly positive real interest rates and a state enterprise reform—appear to indicate the beginning of a shift toward addressing structural issues. [redacted]

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Figure 3. President Alfonsín: "Madam, permit me to privatize you."

that would supersede existing restrictive laws and grant the executive branch greater leeway in selling off SOEs. In addition, Alfonsín recently announced plans to speed the introduction of efficiency-enhancing measures to the major SOEs by centralizing them within a semiautonomous holding company staffed by senior executives from the private sector. He also pledged to standardize public-sector wage scales and to cut central government employment through a voluntary early retirement program. The administration is now considering a variety of supplementary approaches to SOE reform:

- **Selling on the Stock Exchange.** The press reports that Buenos Aires is examining the possibility of privatizing some SOEs by selling shares on the stock exchange. The major exchange, however, is a thin and highly speculative market, listing only 250 stocks. The government is taking preliminary steps to deepen the market by reducing the current securities transfer tax from 0.75 to 0.50 percent and requiring that firms that receive industrial promotion tax breaks be quoted on either the national or the smaller local stock exchanges.

- **Breaking Up the State Oil Company.** Buenos Aires is considering dividing this enterprise into separate entities responsible for exploration and production, refining, transportation, and marketing, according to press reports. If implemented, such a scheme could bring about specialized, more efficient management and encourage private-sector participation.
- **Outside Management Contracts.** Buenos Aires is actively seeking outside management assistance for at least one important parastatal. Argentine Government officials have approached at least two foreign steel firms about managing SOMISA, according to the US Embassy. Alfonsín may believe that competent outside management will make SOMISA more attractive to purchasers at a later date.
- **Decentralizing Government Employees.** President Alfonsín has publicly pledged to move the capital of Argentina to Viedma, located in the underdeveloped southern region of the country. Moreover, he has announced plans to move the administrative offices of several large SOEs—including the state oil and coal companies—to other small southern cities. Alfonsín probably believes this is the least politically painful way to cut the size of government, as thousands of workers are expected to quit rather than move from Buenos Aires.

A Gradual Approach

Alfonsín has publicly made SOE reform and privatization a key item on his economic agenda. While progress has been slow to date, Alfonsín has chalked up several concrete accomplishments. The hiring freeze—which reduced SOE employment by 6.3 percent during the year ending June 1986, according to government statistics—is, in our view, Alfonsín's most important achievement in this area. In addition, Alfonsín pared the total deficit of SOEs from 6.3 percent of GDP in 1983 to 4.4 percent in 1985. He also returned a medium-sized steel tubing manufacturer to the private sector and privatized the National Atomic Energy Commission's Special Alloys Factory.

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Key Figures Involved in Parastatal Reform



Juan Vital Sourrouille
Minister of Economy
(since February 1985)

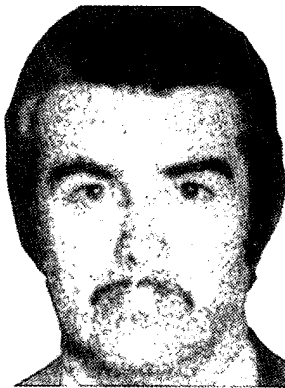
Respected technocrat . . . key economic official in Alfonsin administration . . . perceives public-sector reform efforts as way to invigorate the Austral Plan, the "economic shock" program he masterminded in 1985 . . . was secretary of planning from 1983 until appointed to current post . . . served as adviser to several international and national economic commissions during the 1970s . . . relative newcomer to the Radical Party . . . 46 years old. [redacted]



Pedro Agustin Trucco
Minister of Public Works and Services
(since July 1986)

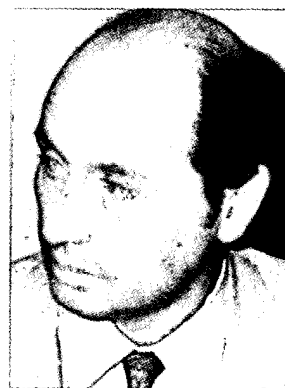
Earned portfolio through energy and dedication displayed in previous job as under secretary for river and marine transport . . . thought to be close to Economy Minister Sourrouille . . . has taken an aggressive stance on parastatal reform . . . promised to speed up privatization programs and reduce government influence, especially in maritime sector . . . youngest member of Cabinet (37) . . . not in public life until 1983. [redacted]

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Enrique Jose Olivera
President, Executive Board of State-Owned Enterprises
(since November 1986)

Harvard-trained business executive and banker given task of spurring parastatals' productivity . . . appointment reflects Alfonsin's desire to apply private-sector expertise to unwield public enterprises . . . has held variety of posts with Fiat Company in Argentina and abroad, including stint in Italy (1976-77) while that country was pursuing a reorganization of its public holdings . . . now director of the River Plate Bank of France and chairman of several companies . . . 46 years old. [redacted]



Norberto Bertaina
Secretary of Secretariat for Promotion of Growth
(since February 1986)

Longtime activist in Radical Civic Union Party . . . may owe current post to close ties to Vice President Victor Martinez . . . advocates directing state resources to young industries rather than "mature" ones . . . [redacted] *. . . trained as a CPA, has spent professional career in government . . . approximately 50 years old.* [redacted]

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Political and practical considerations, however, are apparently forcing Alfonsin to shift emphasis from privatization. Instead, over the past six months he has publicly stressed the need to make the parastatals more efficient. We believe this tack, which placates traditionalists in his party, also reflects Alfonsin's appreciation for the many other obstacles to privatization. Submission of the SOE-related legislation, for example, was delayed several months because of internal UCR opposition. The current version contains many compromises—such as granting newly privatized companies import protection, tax exemptions, and preferential prices on goods and services purchased from other parastatals—which will hinder competition. Moreover, the bill contains a list of SOEs to remain in state hands that includes virtually all the largest money losers: the railways, Argentine Airlines, the state oil company, the telephone company, and most major utilities. Beyond these impediments, the high cost of privatization is a problem. Buenos Aires had to provide generous financial terms in order to enable an Argentine firm to buy the steel tubing manufacturer, and plans to assume the debt of Austral Airlines to attract buyers, according to press reports. [redacted]

Alfonsin's decision to bring private-sector executives into top positions within the SOEs has also been slow to take off. US Embassy reporting indicates that private-sector transplants to the Argentine public sector have often become frustrated by bureaucratic stonewalling and redtape. For example, Alfonsin's first Secretary for the Promotion of Growth, businessman Manuel Tanoira, quit in 1986 after only five months on the job, publicly claiming to have had difficulty obtaining even simple balance sheets for the parastatals. Alfonsin's recent efforts to recruit senior private-sector executives for jobs in the new parastatal holding company, however, suggest to us that the President may now realize he must create a critical mass of businessmen at high levels of the SOEs in order for their presence to have an impact. Even this development might be undermined; for example, an interministerial committee created to coordinate economic and price policy with the parastatal holding company could hamper the latter's ability to make changes in individual SOEs. This dilution of the

holding company president's authority was the reason Alfonsin's preferred candidate for the post declined the position, according to the US Embassy. [redacted]

Other key factors are dictating a slow, incremental approach to parastatal reform. Alfonsin has frequently publicly pledged to avoid the massive layoffs which, in our estimation, are needed to restore a measure of profitability to many state firms. A voluntary retirement program—the one he recently announced could easily be extended to parastatals in the near future—would bring only gradual reductions in SOE payrolls. In addition, the plan to relocate the Argentine capital and many SOE administrative offices will require, according to press estimates, over \$3 billion in public and private funds. The major sums involved will, in our view, necessitate a drawn-out transfer process. [redacted]

Interest Group Attitudes: Privatization Versus Reform

Opinion polls indicate that the Argentine public is becoming more receptive to SOE reform and privatization—a significant shift in attitude (see inset). According to academic studies, the Argentine public until recently strongly favored state ownership, seeing this as both a symbol of Argentine nationalism and a protection against foreign domination of the economy. We believe President Alfonsin has now begun to channel this sentiment in favor of upgrading the performance of SOEs. His task is complicated by the fact that Argentina's conservative parties—natural backers of market-oriented changes—are fragmented, uninfluential, and ill disposed to work with Alfonsin, according to the US Embassy. Moreover, the country's more important interest groups continue, for the most part, to favor statist and nationalist economic policies. [redacted]

The Radical Party. Alfonsin's Radicals have traditionally advocated considerable state control of the economy, and the party's national committee assented to the President's privatization proposals only after a difficult internal debate. [redacted]

[redacted] Alfonsin struck a compromise with the

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Argentine Attitudes Toward Privatization

Argentine public support for streamlining the public sector and privatizing some industries and services has grown steadily over the past few years. We believe the change has occurred primarily because of increasing frustration over the parastatals' inability to supply basic services at affordable costs. Over the longer term, however, we think the Argentine mindset may turn against traditional statist and nationalist economic nostrums that have left Argentina so far behind its economic potential. A poll of city dwellers sponsored by USIA in November 1985 revealed that the urban public now favors privatization of most SOEs, including TV stations, Argentine Airlines, and utilities such as the gas and telephone companies. A plurality continues to support state control over the oil company, largely, in our view, because of peculiar historical circumstances that have caused this company to become a symbol of Argentine nationalism for the general public.

Results of the poll are:

Do you approve or disapprove of the privatization of the following state enterprises? Percent

	Approve	Disapprove	Do Not Know
Public TV stations	54	23	23
The telephone company	50	27	23
The railroads	49	29	22
Buenos Aires subway	45	29	26
Electricity	44	33	23
The gas company	43	33	24
Argentine Airlines	40	35	25
State petroleum company	34	42	24

party's more statist members by promising to use the proceeds from divestiture to invest in up-and-coming sectors such as informatics and biotechnology, and with the understanding that utilities and many basic industries will remain in state hands, according to press reports. Ricardo Angeloz, the governor of Cordoba Province who harbors presidential ambitions,

openly repudiated even this position. Other Radical party leaders may come to conclude that the short-term economic and political dislocations of a major privatization effort outweigh the long-term benefits—especially as the November 1987 congressional and gubernatorial elections approach.

We judge that support for gradual SOE reform—as opposed to privatization—within the UCR is more widespread. For example, there has been little internal party resistance to Alfonsin's hiring freeze, probably because it is flexible enough to allow for new hirings when deemed politically expedient. In contrast, the press reports that the UCR has consistently opposed actions that would involve laying off government workers. Similarly, most UCR members probably would accept changes in the regulatory structure, but would not embrace a drive for deregulation.

The Peronist Party. Peronist philosophy remains highly nationalist and statist. Peronists, according to the US Embassy, regularly label privatization of industries over which they believe the state is naturally sovereign as “selling out” to private interests and the International Monetary Fund (IMF). Peronist-controlled local governments near the SOMISA steelworks and some of the petrochemical industries targeted by Alfonsin for divestiture have vowed to fight privatization. Furthermore, the Embassy and the press report that the Peronists will try to block or water down Alfonsin's privatization bill by inserting language to forbid the sale of parastatals at less than book value—effectively halting most offerings—or by adding other SOEs to the list of companies not to be privatized. The Peronists' public statements also oppose significant SOE reform—perhaps merely a reflection of the party's blindly countering all Alfonsin administration initiatives. Peronist organizational disarray, however, may force the party to conserve its strength for the major privatization debates, allowing Alfonsin greater leeway in addressing SOE inefficiencies through internal restructuring.

Organized Labor. Like the Peronist Party—which the majority of its members support—organized labor opposes any policy involving worker layoffs. Moreover, strike patterns indicate that labor is stronger and

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Figure 4. Municipal labor union poster associates privatization with hunger and unemployment. [redacted]

more militant in state-run than in private-sector companies and probably sees privatization as a move by Alfonsin to erode its power base. To publicize its position, Argentina's main labor confederation held a major rally against privatization last April. [redacted]

Because of its large constituency among SOE bureaucrats, labor also opposes efforts to reform the parastatals. The unions, however, are amenable to monetary suasion, according to the US Embassy. During the late 1970s, for example, the military government effectively used generous severance packages and job retraining programs to minimize the political and social dislocations caused by its massive reductions in the number of railroad workers. Labor leadership is more militant now, and the economy more depressed, but we believe that a skilled politician such as Alfonsin could use similar programs to gain labor's acquiescence in reforming selected companies. [redacted]

The SOE Bureaucracy. This group, which perceives Alfonsin's proposed changes as a direct threat, is fighting reform tooth and nail, according to Embassy reporting. The handful of parastatal chief executives who are serious about streamlining the public sector have not been able to overcome bureaucratic resistance. Indeed, the bureaucracy has thwarted administration plans to encourage private-sector participation in sectors dominated by parastatals. The state telephone company, for example, warded off an attempt to break its monopoly on the installation of telephone lines by announcing in October 1985 its own drive to

install 1 million lines by 1989 at an average cost of \$1,100 each, effectively preempting private competition. [redacted]

Private and foreign participation in the oil industry—a reform trumpeted by the government as a decisive break with past statist and nationalist practice—provides another example of the SOE bureaucracy's ability to foil administration intentions. Ordered by Alfonsin to draw up a contract for energy companies interested in exploring for oil in Argentina, the state oil company, YPF, granted itself the option of becoming a 50-percent, joint-venture partner in any commercial finds discovered by private prospectors. Furthermore, the contract requires the companies to sell the oil to YPF, which has also reserved for itself those geographic areas with the highest potential for oil discovery. Only \$39 million in new investment was therefore committed during the 18 months following the government's opening up of the oil sector in March 1985. [redacted]

Private Business. Although the Argentine Chamber of Commerce has publicly endorsed privatization, we believe most businessmen are ambivalent on this issue. Many private companies depend on a particular SOE as their major or only customer. Alternatively, some businesses have formed anticompetitive partnerships with the state. For example, three major newspapers own a newsprint company jointly with the government. Protected by high tariffs on imported newsprint, this company dominates its field and has used its leverage to financially squeeze a fourth newspaper by refusing to supply it with paper, according to press reports. [redacted]

Since few local businessmen possess the capital to purchase the larger SOEs, the attitudes of foreign investors are vital to any progress in privatization. Multinationals, according to academic studies, are attracted by Argentina's wealth of natural resources and its skilled labor force, but experience difficulty operating in its highly regulated, nationalistic environment. Press reports indicate that the Honda Company, for example, is considering canceling plans to build a motorcycle factory in Cordoba Province because of onerous criteria imposed by Buenos Aires,

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such as heavy local content requirements, a specific export-import ratio, and retroactive payment of value-added taxes if production does not reach a set percentage of original planned production. In addition, three US pharmaceutical companies have pulled out of Argentina in the past few years because of price controls, lack of patent protection, and government policies that favor local companies. Moreover, the possibility of a return to power by the xenophobic Peronist Party raises investors' concerns. These factors have worked against an enthusiastic foreign response to Alfonsin's reforms; few new multinationals have entered Argentina over the past year. [redacted]

The Military. The armed forces have a major stake in SOE reform, since they administer Military Industries, a holding company for state firms whose products range from weapons to lumber and petrochemicals. The military, however, has been eased from top management of Military Industries by President Alfonsin and weakened by a 50-percent budget cut; as a result, in our view, it retains little influence with the government in this area. US Embassy reporting shows that the officer corps has passively accepted aspects of Alfonsin's program that affect Military Industries, such as the privatization of its petrochemical plants. We believe that the military nevertheless would strongly oppose the sale—particularly to foreigners—of companies it perceives as vital for national security, especially the arms industry [redacted]

[redacted] Alfonsin may soon take the first steps to reorganize or privatize Argentina's cumbersome defense industries, which are mammoth money losers and have consistently produced low-quality, overpriced armaments.² [redacted]

Outlook and Implications for the United States

We believe Alfonsin will make some progress on SOE reform during the remainder of his term. The President, having invested considerable political capital in this campaign, will not jettison his program easily. Moreover, we concur with the US Embassy's observation that, given the depth and breadth of problems at the parastatals, relative gains in efficiency could produce significant savings. We expect the administration to make its greatest gains through politically

[redacted]

neutral methods: continuation of the hiring freeze, a voluntary early retirement program, a buy-out program for younger employees, or cutbacks in public investment. [redacted]

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We expect the administration to implement some of the privatization proposals currently under study over the next year. Buenos Aires is likely to sell a few of the firms nationalized by previous regimes—the showpiece will probably be Austral Airlines—and may sell a few nondefense industries owned by the military. Since these divestitures will not involve the largest money losers, however, they probably will generate only limited savings. We note that the former military government sold off some 120 small firms without making a dent in aggregate SOE losses or increasing the net efficiency of the state sector. [redacted]

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Near-term prospects for radical restructuring of the public sector in Argentina, however, are bleak. Notwithstanding Alfonsin's commitment to change and the potential for progress in certain limited areas, we doubt that he will implement sweeping reforms. [redacted]

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[redacted] the President and Economy Minister Sourrouille were shocked by the near-double-digit inflation figure posted in August and have decided, at least for the present, to emphasize tight money, rather than fiscal discipline, to control inflation. This reliance on monetary policy and improved Central Bank efficiency—which has triggered bank failures and is already causing a variety of political headaches for the government—will almost certainly reduce administration interest in pushing the politically contentious SOE issue. Furthermore, the congressional and gubernatorial elections slated for November 1987 will, in our view, make the President even more wary of innovations—especially those involving foreign companies—that could provide ammunition for his rivals within the Radical Party or for the Peronist opposition. [redacted]

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Finally, the opposition of major interest groups to Alfonsin's proposals will continue to work against significant change. Alfonsin, in our view, is not prepared for a sustained battle with the recalcitrant bureaucracy or the statist sectors of his own party on

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this issue. Moreover, the President probably will also want to avoid worsening his already poor relationship with organized labor. We also expect the Argentine business community to remain ambivalent on this subject, and see little prospect of an influx of foreign capital. [redacted]

We believe that failure to substantially shrink and restructure the public sector will continue to generate economic problems. The modest curbing of SOE spending likely to result from the President's program may, in our view, help Buenos Aires narrow its fiscal deficit and somewhat diminish its need for new loans, but the savings will almost certainly be insufficient to generate the surplus capital needed to begin to repay Argentina's \$50 billion foreign debt. Parastatal losses, although smaller, will continue to drain the national treasury, and the constant temptation to cover them by printing money will keep inflationary pressures high. [redacted]

Over the longer run, however, we are guardedly optimistic regarding the consequences of Alfonsin's actions. His plans to move the federal capital to Viedma and SOE headquarters to various provincial cities will, if implemented, permit significant work force reductions through attrition. Even without this dramatic measure, Alfonsin's emphasis on some free market concepts is slowly changing the rhetoric of Argentine economic policy making. No longer exclusively associated with discredited military regimes, these ideas, as demonstrated by opinion polls, are attracting increased support from the Argentine public, although they have yet to gain wide acceptance among special interest groups. Thus, Alfonsin, in our view, has laid some of the groundwork that may enable a more politically secure administration to take bolder actions at a later date. [redacted]

We believe that even modest success in cutting SOE expenditures will also indirectly contribute to promoting economic stability in Argentina and fostering a less contentious relationship between Buenos Aires and its international creditors. The progress made in reducing the fiscal deficit will not, in the short term, significantly improve Argentina's ability to pay its foreign debt—17 percent of which is owed to US banks—but it may decrease the yearly sums of new money Argentina needs from its creditors, thereby easing the pressure on US banks to lend involuntarily.

These developments will also buttress democratic institutions in Buenos Aires, since economic stability would deny antidemocratic elements in the military and the Peronist party a key issue with which to rally public support against constitutional rule. [redacted]

There is a danger, however, that Alfonsin may lose patience with economic policies that are likely to generate little economic growth over the next two years. We see roughly a 1-in-4 chance that the President will abandon even his truncated reform program and opt instead for short-term, growth-oriented policies. The temptation to resort to such a quick fix will increase as the 1987 elections approach, especially if political factors—such as the exposure of any widespread corruption within the government or greater unity within the Peronist opposition—threaten the UCR's electoral prospects. [redacted]

[redacted]

The results of such a strategy—whether financed by the printing press or foreign reserves—would, in our view, be uniformly negative. Alfonsin might be able to generate a strong, temporary, consumption-led boom, but it would quickly dissipate as inflation mounted, foreign sources of finance dried up, and private investment slumped. SOE reform would most likely go by the boards. The President, in all likelihood, would eventually be forced to turn to yet another round of austerity measures to halt an inflationary spiral, thereby destroying any remaining public confidence in his economic policies. [redacted]

US interests would be undercut if Alfonsin reversed course and turned to the parastatals as part of a pump-priming strategy. The resulting high inflation and debt payments arrears would damage relations with Western governments and creditors. Alfonsin, in our view, might turn to measures such as stricter import controls, heavier government intervention in agriculture and industry, and even a debt moratorium to escape his economic quandary, thereby further harming US lenders, exporters, and investors. A crisis of this dimension would only complicate matters for a government facing the challenge of institutionalizing democracy. [redacted]

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Appendix

An Overview of the State Sector

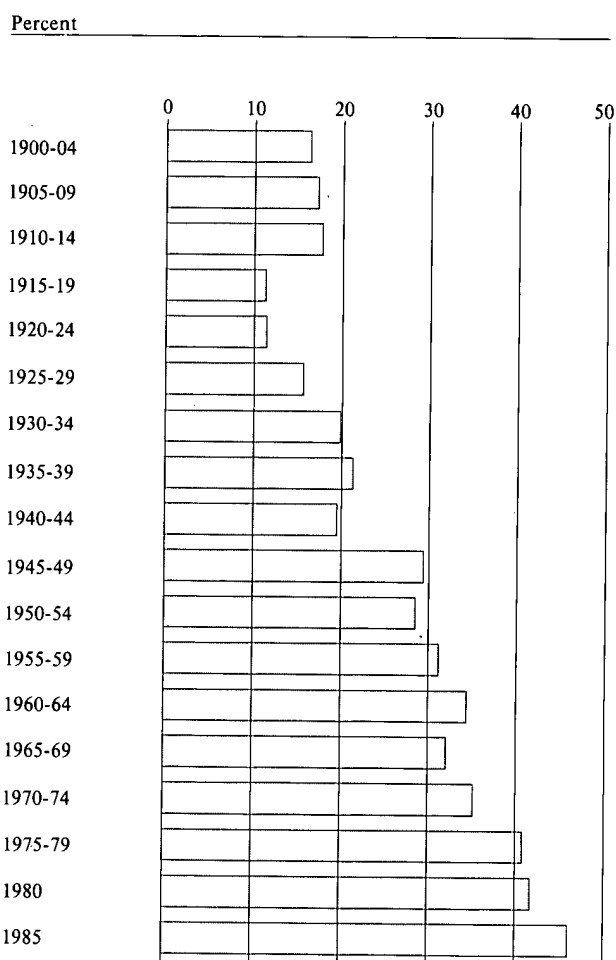
How the Government Got Involved

The Argentine Government's participation in the industrial and service sectors has expanded over time to satisfy a variety of economic, populist, and nationalistic objectives. During the 19th century the central government provided only the most basic services, such as mail, water, and some banking and railroads, in order to promote the growth and integration of the young republic, according to academic studies. In 1910 the government employed similar reasoning to enter the oil exploration business, laying the groundwork for what was to become the state oil company. During the depression of the 1930s low commodity prices and foreign protectionism disrupted international trade and spurred the government to assume a marketing role with the creation of the National Grain, Meat, and Potato Boards. A decade later, the desire to ensure the availability of strategic supplies during wartime led to the state's first direct intervention into industry: the creation of the armed forces-run Military Industries, which became full or part owner of 31 armed forces suppliers, largely in the steel and petrochemical fields. [redacted]

President Juan Peron—believing that national security was at stake and determined to end the dominant position of foreign-owned corporations in the Argentine economy—set the tone for the postwar years. Under the official slogan that Argentina was to be “socially just, economically free, and politically sovereign,” his government bought the railroads from the United Kingdom and the telephone company from the United States. Peron also established the national coal and gas companies, the state airlines, the chemical company ATANOR, and the steelmaker SOMISA, among others. [redacted]

State ownership grew in the 1950s and 1960s, with the increasing participation of provincial governments. Taking advantage of multilateral financing, the state placed new emphasis on large development projects, including dams, a nuclear power plant, and petrochemical production facilities. In 1970 a new

Figure 5
Public Spending as a Percent of GDP



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twist was added: the government began to intervene in bankrupt companies to preserve jobs, allowing them to continue operating under its administration. In this manner the state entered the sugar, textile, steel tubing, and cold-storage industries and took over Austral Airlines. The state also entered the telecommunications industry, expropriating the wire service TELAM, and, under the second Peron administration of 1973-76, acquiring 85 television and radio stations.

Buenos Aires tried to reduce its participation in the economy during the late 1950s and from 1976 to 1982. During the latter period the military government liquidated 120 minor holdings, according to academic literature. Nevertheless, it also created new enterprises and took over others experiencing financial difficulties, so that there was probably a net increase in the state's participation in the economy, according to one researcher's estimate.

Size of the State-Owned Sector

Public-sector spending dominates the Argentine economy. It now accounts for 46 percent of GDP, according to government statistics, up from 16 percent at the turn of the century and 29 percent during the first Peron administration (1946-50) (see figure 5). Parastatals account for roughly two-fifths of public-sector spending, or 18 percent of GDP. Moreover, SOEs consumed 45 percent of public investment in 1984, up from 38 percent in 1980, according to IMF statistics. Investment in parastatals constitutes 20 percent of the total investment in Argentina.

Parastatal borrowing is responsible for one-fourth of Argentina's \$50 billion foreign debt, according to government statistics.³ In addition, transfers from the central government to cover SOE losses caused half of the total government budget deficit in 1985. Parastatal deficits have, however, decreased from 6.9 percent of GDP in 1982 to 4.4 percent in 1985 (see table 1). President Alfonsin hopes to pare 1986 losses to 3.1 percent, according to the 1986 budget.

³ A portion of this debt was, according to the US Embassy, actually central administration debt placed on the books of parastatals to circumvent foreign banking regulations against overconcentration of loans with one borrower.

The government employs 1.7 million people, or 16 percent of the Argentine work force as of 1980. Parastatals employ roughly one-fifth of the government total, the majority of whom work in the national, provincial, or municipal administrations. According to government statistics, SOE employment dropped 43 percent between 1960 and 1982, largely because of a 100,000 worker decrease in employment by the declining state railroad. During Alfonsin's first year in office, SOE employment rose from 312,000 to 324,000 workers. Since the end of 1984, however, the parastatal work force has dropped 7.7 percent to 299,000 workers, mainly because of the hiring freeze implemented under the Austral plan (see table 2).

The Major Parastatals

Although the state has total or majority control over 350 enterprises, its holdings are highly concentrated. The eight largest parastatals—YPF, State Gas, Greater Buenos Aires Electricity, the telephone company, Argentine Airlines, Water and Electricity, Argentine Railways, and Argentine Shipping Lines—produce about 70 percent of the sector's aggregate value and absorb more than 30 percent of total public-sector investment, according to the World Bank (see table 3).

YPF

YPF, the state-owned oil company, produces, refines, and markets oil for domestic consumption and export. YPF is responsible for 80 percent of Argentina's crude oil production, which totaled 168 million barrels in 1985. About 13 percent of this production was exported, earning Argentina \$640 million in foreign exchange in 1985. The remaining 30 percent of oil output is produced by private Argentine and foreign companies under contract with YPF.

Plagued with problems, YPF is one of the few major oil companies in the world that consistently loses money. YPF's troubles stem, to a large extent, from high production costs and political pricing decisions. According to an industry analysis reported in the press in the spring of 1985, YPF's production costs

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Table 1 *Percent of GDP*
Argentina: Operations of State-Owned Enterprises ^a

	1982	1983	1984	1985	Budget 1986
Current receipts	9.7	11.2	11.1	13.3	12.9
Current expenditures	13.6	13.8	12.6	14.5	12.6
Wages and salaries	2.2	3.0	3.4	3.0	2.8
Other goods and services	6.1	7.2	6.7	7.9	7.2
Interest	4.1	2.5	2.1	2.7	1.8
Of which:					
External	2.2	2.0	1.8	2.0	1.8
Other	1.2	1.1	0.4	0.9	0.8
Current account surplus or deficit (-)	-3.9	-2.6	-1.5	-1.2	0.3
Capital receipts	0.4	0.1	0.1	0.1	0.1
Capital expenditure	3.4	3.9	3.8	3.3	3.5
Total deficit (-) before transfers from general government	-6.9	-6.3	-5.1	-4.4	-3.1
Net transfers from general government	1.9	7.0	3.2	3.1	2.9
Overall surplus or deficit (-)	-5.0	0.7	-1.9	-1.3	-0.2

Sources: The International Monetary Fund and the US Embassy.

^a Because of rounding components may not add to the totals shown.

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Table 2 *Thousand employees*
Public-Sector Employment

Year	National Administration	SOEs ^a	Provinces	Municipalities	Total
1951	532	384	230	99	1,245
1960	549	486	315	125	1,475
1970	583	370	415	141	1,509
1980	557	315	648	179	1,699
1982	579	279	670	197	1,725
1983	529	312	706	160	1,707
1984	542	324	NA	NA	NA
1985—June	553	319	NA	NA	NA
1985—December	554	315	NA	NA	NA
1986—June	549	299	NA	NA	NA

NA = not available.

Sources: Press and the US Embassy.

^a State-owned enterprises.

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Table 3
State-Owned Enterprises: Selected Statistics ^a

Million dollars

	Gross Income (1984)	Gross Losses ^b (1984)	Foreign Debt (1985)	Number of Employees (1984)	Share (percent)
Total	8,591	3,924	13,268	324,000	
Government oil deposits (YPF)	3,428	675	4,684	33,725	80
State Gas Company	937	644	1,850	10,238	90
Greater Buenos Aires Electricity	876	189	725	21,053	55
National Telecommunications Enterprise	702	24	608	48,158	90
Argentine Railways	403	1,115	1,101	107,837	99
National Mail and Telegraph	191	173	7	42,843	85
Argentine Airlines	NA	NA	827	10,303	70
Water and Electricity	NA	NA	2,180	11,249	27
Other	2,054	1,104	1,286	38,594	

NA = not available.

Sources: International Monetary Fund, General Syndicate of Public Enterprises, and the US Embassy.

^a Converted to dollars using Carta Economica parity exchange rate.^b Before net transfers from federal government.

averaged \$19 per barrel—more than double production costs in the United States—yet it sold oil to refineries for \$13.17. One press analysis concluded it would lose less money if it handed over its extraction business to the private sector and paid its staff to stay home. [redacted]

Other difficulties include revolving-door management and the YPF labor union. During the past 10 years, according to one academic analysis, YPF averaged one new chief executive per year, as well as frequent changes in its board of directors. The directors, typically political appointees, have little experience in the highly complex oil industry, and are not around long enough to learn through on-the-job training. The industry also supports two separate labor unions, one for YPF workers, and another for private-sector employees. YPF union members tend to oppose any initiatives that could negatively affect the ability of YPF to provide jobs, regardless of their potential to benefit the industry as a whole. [redacted]

In addition, YPF dictates terms to, rather than competes with, its “competitors.” Private oil companies may operate either directly for YPF or under contract to the state. Under the terms of the contract, the private company assumes the exploration risk—which is substantial in an industry where 19 of every 20 wells drilled are unprofitable—while YPF shares the reward, granting itself the option of becoming a joint partner in a commercial discovery. Moreover, YPF reserves for itself those geographic areas with the highest potential for oil discovery. The result is that, in a country with sizable underground reserves of 2.3 billion barrels, oil deposits are underexplored and underexploited. [redacted]

State Gas

The State Gas Company has sole responsibility for the transportation, distribution, and sale of natural gas in Argentina. State Gas does not, however, produce gas;

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instead, it purchases 85 percent of its gas needs from YPF and the remainder from Bolivia. State Gas sales have increased steadily since World War II and in 1984 equaled 14.1 billion cubic meters. [redacted]

State Gas ran up a \$644 million deficit in 1984, according to IMF statistics. Like most SOEs, State Gas is overstaffed, employing 10,238 people with sales of \$937 million. By comparison, New York Electric and Gas Company employs 4,215 people and has sales of \$993 million, according to press reporting. [redacted]

This parastatal's primary problem, however, is with its purchasing relationships. Since gas production is a byproduct of the oil industry in Argentina, the separation between YPF and State Gas is, in our view, artificial and damages gas exploration and production incentives. According to an academic study, YPF views natural gas as a necessary evil to be disposed of at the lowest cost. Between 1972 and 1984, YPF flared 37 billion cubic meters of gas, while the state imported 27 billion cubic meters of gas during the same period. In 1979 Buenos Aires issued a resolution to limit this wasteful practice, but YPF still flares almost 20 percent of gas production. [redacted]

State Gas pays YPF a relatively low price for natural gas, according to an academic study, and is constantly pushing to pay less. As a consequence, the price of gas is fixed at zero in most of the old oil exploration contracts YPF signed with private companies, according to an academic study, and at only 14 percent of the international price in the model contract more recently offered to the oil companies. More important, Argentina's proved natural gas reserves—which total 680 billion cubic meters—are even less exploited than its oil deposits. [redacted]

The purchasing relationship with Bolivia is also skewed against State Gas. Buenos Aires is under contract until 1992 to purchase natural gas from Bolivia—despite Argentina's excess gas capacity—in order to support La Paz's fledgling democracy. Under current terms, Argentina pays \$3.70 per million Btu (one-fourth in cash, the remainder paid in goods), far above the current world price of about \$2.20 per million Btu. Although Bolivian gas represents only 16 percent of the volume used by State Gas, it accounts

for 67 percent of its hydrocarbon costs, according to Embassy reporting. The political decision to support Bolivia is another major factor behind State Gas's voracious appetite for treasury financing. [redacted]

ENTel

The National Telecommunications Enterprise (ENTel) is responsible for 90 percent of Argentina's telephone service. The remainder is provided by two regional private-sector firms as well as several cooperatives. Argentina had 2.45 million working telephone lines in 1985, according to press reports, or eight lines per 100 inhabitants. By comparison, the United States has 70 telephone lines per 100 inhabitants; Australia, 70; Spain, 30; and Greece, 28. [redacted]

ENTel telephones are expensive and difficult to obtain. On average, ENTel charges \$3,264 for a one-line, one-telephone installation, and \$1,100 for a home installation, according to the press. Moreover, there is usually a several years' wait to have a phone installed. Telephones are considered such a luxury that some landlords impose a 17-percent surcharge for an apartment that has one. After installation, service is poor; for example, customers often have to wait a few hours to place an international call. [redacted]

ENTel's difficulties stem largely from overstaffing and poor management, according to academic studies. High personnel costs have left less money available for investment; as a result, much of ENTel's equipment is obsolete or in disrepair. Revolving-door, political management has caused lack of continuity in long-term planning and lack of coordination between key tasks such as laying cable and installing lines. [redacted]

ENTel has recently attempted to circumvent capital shortages and management deficiencies. In mid-1985 the company implemented MEGATEL, a scheme to install 1 million new phone lines by 1990, to be financed by monthly payments from line recipients in advance. Despite the prepayment requirement, customers quickly signed up to participate and the program has been highly successful, according to

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press and Embassy reports. In addition, the government hired a senior executive from the private sector to improve ENTel management. However, nationalists criticized the new executive for maintaining that Argentina did not need its own telecommunications satellite, and he was recently replaced. [redacted]

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Argentine Airlines

Argentine Airlines is the largest of five domestic airlines; two of the other lines are also owned by the government. Argentine Airlines possesses a modern fleet of seven Boeing 747s, 12 Boeing 737s, eight Boeing 727s, three Boeing 707s, and four Fokker 28s, according to press reports. It controls 70 percent of the air travel market. [redacted]

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Tight regulation helps thwart airline competition in Argentina. The National Transport Board for Air Commerce controls prices, regulates routes, and coordinates various activities of domestic airlines. The government also reserves intracountry travel and international air freight shipments purchased or sold by any government entity for domestic carriers. [redacted]

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Argentine Airlines is also plagued by overemployment. Pan Am flies 1,623 kilometers per employee; British Airways, 1,039 km; Air France, 806 km; Iberia, 669 km; and Argentine Airlines 570 km, according to press reports. In addition, absenteeism at Argentine Airlines averages 51 days per employee per year, not counting vacations and holidays. The airline's president has candidly stated that the airline could be run comfortably with less than half its current number of pilots. This executive took the opportunity of a recent airline pilots' strike to fire all the strikers and pare employment. Political pressure, however, forced him to hire them all back at their previous salaries. This incident exemplifies the difficulties involved in attempting to make the necessary changes to increase the efficiency of Argentina's state-owned enterprises. [redacted]

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