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PRIVATIZATION IN MEXICO: GOOD, BUT NOT ENOUGH

INTRODUCTION

Mexico has undergone many positive changes since President Carlos Salinas de Gortari assumed office in December 1988. A program of market-oriented reforms has been instituted, and the economy shows signs of improvement. Inflation has fallen from 159 percent in 1987 to 19.7 percent in 1989, and the rate of growth has risen to 2.9 percent. All in all, Salinas has generated new hope for Mexico's future, and he has secured the public trust.

The most encouraging aspect of Salinas's modernization program is its concern to reduce government participation in the economy and give the private sector a primary role in revitalizing growth. As a result, privatization of Mexico's huge state-owned sector has become a key factor in the government's approach to economic reform.

Salinastroika. President Miguel de la Madrid began a privatization program to alleviate a mounting fiscal deficit and to combat runaway inflation. Yet the impact of the program has been marginal. In contrast, Salinas has taken bold steps to privatize important companies traditionally reserved for exclusive state ownership and control. In 1988, the government privatized the nation's largest airline, *Mexicana de Aviacion.* In 1989, the telephone corporation TELMEX was put up for sale.

In May 1990, Salinas reprivatized the state-run banking system and allowed private full (and partial) majority ownership of the eighteen national banks. The decree has since received congressional approval, and a new set of banking and finance regulations has been formalized. Salinas's bold initiative was necessary to stimulate the financial system, bring back expatriate capital from abroad, and generate the confidence required to attract new foreign investment.

Note: Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

The process of privatization in Mexico has not occurred in a vacuum. Many other reforms have been made to complement privatization and stimulate growth. Trade liberalization has continued, and an aggressive program of deregulation has been pursued – notably in the truck and automobile industries, secondary petrochemicals, and agriculture. In addition, cumbersome restrictions limiting foreign investments have been lifted, and an open war against corruption has been waged. Also, Salinas has decided to enter into formal negotiations with the United States to craft a free-trade agreement. These are all positive signs of a shift to a market economy.

Deeply in Debt. A host of difficulties remain, however. The country is deeply in debt, externally and internally. The foreign debt stands at $93 billion – the second largest in Latin America. The domestic debt totals more than $65 billion, and its interest payments alone absorb almost 80 percent of expenditures to service the debt. A substantial portion of budget costs are generated by the need to finance the losses of the so-called "strategic and primary" industries, such as electricity, the Agricultural Supply Commodities Board (CONASUPO) and the railroad company. Mexico is in urgent need of direct investment, but it is doubtful it can attract long-term commitments and recapture flight capital abroad under the unstable conditions caused by debt.

Salinas is conscious of the need to create a climate of confidence. More aggressive reforms are required. Two factors have hurt recent privatization processes. First, the government has failed to implement the kind of institutional changes which successful privatization requires. The present juridical framework, for example, stifles freedom of exchange and condones government interference in virtually all sectors of economic life. Second, the government has yet to adopt the strategies needed to make privatization a lasting success. A "spread the wealth" approach of popular capitalism, while suited to Mexico, remains an unexplored possibility.

A far more reliable test of Salinas's commitment to the free market lies less in his limited privatization programs than in whether he radically reforms the present system and allows private ownership of "strategic and primary" sectors. Among other top priorities are privatizing the *ejido* rural plots, as well as repealing the overly protectionist Foreign Investment Law enacted in 1973. These changes would consolidate his acclaimed but as of now overrated image as a champion of economic freedom.

In essence, the privatization processes undertaken in Mexico thus far do not go far enough to eliminate the root causes of Mexico's crisis. The Salinas administration must make more systemic changes if it intends to reap the rewards of a successful program of privatization. Salinas should:

- **Repeal the Foreign Investment Law.** This would help to restore financial stability and attract new flows of foreign investment capital for newly transferred corporations to private owners. It would also ameliorate current problems by finding potential buyers willing to purchase and modernize inefficient state-owned enterprises with outdated equipment.

- **End the "Pacto."** A government-business-union "pact" of price controls has been in place since 1987. It is impossible to assess real progress toward a free market until this freeze is lifted. Success in transferring companies from the public to the private sector is unlikely to occur in the absence of an uncontrolled market climate, based on the free interplay of supply and demand.
- **Extend ownership to "strategic and primary" sectors.** The privatization of huge and wasteful state monopolies is essential to preclude a resurgence of hyperinflation and to activate sustained economic recovery. The reprivatization of the banks, a strategic sector, was a courageous and commendable decision. It should be followed up by privatization of other important state enterprises: oil, primary petrochemicals, electric power, railroads, and others.
- **Juridical reforms.** Many juridical changes are needed to accelerate privatization, from local legislation to constitutional articles. A free and competitive atmosphere must be created for recent privatizations to work in stimulating growth.
- **"Popular Capitalism."** The current strategy of using privatization only as a method to "rationalize" the government's role in the economy should be replaced by a broader program aimed to supply the vast majority of Mexicans with a real opportunity to share the wealth. This will neutralize popular discontent with "crony capitalism" and unleash suppressed productive forces. It will also supply a popular alternative to introduce a sorely needed system of private property rights in areas like the agrarian sector.

The U.S. should pressure the Salinas administration to deepen internal adjustments. Also, it should stimulate awareness of the positive social and economic benefits of privatization and the market economy. This fundamental aspect of a sound policy of privatization is underplayed by the Mexican program's current approach.

THE MEXICAN CRISIS AND BEYOND

Few countries have experienced such pronounced decline in economic development and standards of living in such a short time as the crisis suffered by Mexico in the past eighteen years. Prior to 1970, the nation enjoyed three decades of sustained growth and stability. The economy averaged annual growth rates of 6 percent. Also, per capita revenue and real wages rose at steady paces. Inflation was stable, and the peso was a "respectable" 12.5 to the U.S. dollar.

The Results of Rectorship. In 1970, under Luis Echeverria, the Mexican government assumed a self-appointed role of economic "rector," and began to practice economic interventionism on a wide scale. This new shift in public policy was justified on the grounds that it would enable Mexico to attain national sovereignty, economic independence, and an equitable distribution of wealth.

The ensuing years witnessed a progressive growth of government intervention: public spending rose, state-owned enterprises multiplied, and overall economic ac-

tivity became heavily regulated. To finance its many public programs, the government borrowed heavily from abroad, and used monetary expansionism as a mechanism of growth. So far, the results of "rectorship" have been disastrous: per capita revenue has fallen and real wages have lost 47 percent of their original purchasing power since 1970. The inflation and devaluation rates since 1970 have been higher than the total accumulated rates in the preceding 150 years. Today the peso averages a dismal 2,900 to the U.S. dollar. To boot, foreign debt skyrocketed from a manageable $4 billion to a staggering $107 billion.

Not surprisingly, the structural imbalances brought about by widespread intervention in the economy squandered financial resources to wasteful ventures and destroyed confidence in the economy. This generated a massive flight of domestic capital. To date, estimates indicate that more than $80 billion are deposited in overseas accounts.[1]

Rectorship Redefined? Salinas inherited a weakened and impoverished economy. His practice of broad-based reform reflects a commitment to reduce the size of government, curtail federal spending, and give the private sector the main burden in achieving "stability without inflation." So far the evidence is positive: this year inflation was expected to fall to 15 percent[2] and growth to surpass the 3.5 percent mark. Further, the public deficit in 1989 was 6.3 of the gross domestic product — 66.9 percent less than the projected deficit for that year, 43.7 percent less than in 1988, and a full ten points less than in 1987.

There are reasons, however, to view these figures with skepticism. Public authorities claim that privatization has played an important role in stabilizing the economy and that these encouraging signs are proof of a sustained effort to limit government intervention in the productive private process. Both claims are unwarranted. The results obtained in revamping public finances owe less to structural change and state divestitures than to precarious short-term measures: the debt-relief renegotiation reached in July 1989, an ensuing fall in domestic interest rates, and fiscal revenues accrued from the 2 percent tax on corporate assets levied in January of the same year.

The hard fact is that the main source of stabilization experienced in Mexico continues to be the economic regime of price and exchange controls first imposed in December 1987 under the name "Economic Solidarity Pact." This freeze in wages and prices was renewed in 1988 at the outset of Salinas's presidency, under the new heading of "Pact of Stability and Economic Growth." Thus far the expiration dates on this "New Pact" have been extended on three occasions. The most recent

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1 This figure is taken from a 1988 study by Morgan Guaranty Trust Co. Recently, at a public address in Mexico City, MIT economist Rudiger Dornbusch estimated that overseas accounts could be as high as $200 billion. However, the estimate of $80 billion is widely regarded as more credible.

2 This goal will not be met. The inflation rate reached 21 percent in September. Now, new estimates for the annual rate range from 23.5 percent to 30 percent. Analysts concur that this implies yet another postponement of the Pact of price controls, especially in view of the upcoming congressional elections in mid-1991.

one, in June of this year, strongly suggests the critics' worst fears: if the controls were lifted, inflation would shoot up, and the peso could devalue by as much as 20 percent. To suppress inflation fails to offer more than artificial temporary relief. It can also prove devastating in the short run.

Salinas should strive to slash the federal budget far more than he has done so far. The public sector continues to be an overwhelming burden on the national economy. Its share of the total external debt is over 75 percent. Public expenditures, as a percentage of the GDP, fell from 17.7 in 1988 to 16.8 in 1989. Mexico must beware of the precedents set by Brazil under the Plan Cruzado and Argentina under the Plan Austral, where failure to adopt strict disciplinary measures in fiscal policy occasioned a resurgence of hyperinflation and stagnation.

PARADOXES OF MEXICAN PRIVATIZATION

An ideal step would be to extend privatization targets to the primary parastatal (state-owned) enterprises that absorb massive federal subsidies. In general, the large-scale privatization of Mexico's inefficient and wasteful public areas represents a good opportunity to divest unprofitable concerns, alleviate foreign and domestic debt burdens, channel new investments, and bring back a sizeable portion of domestic flight capital. This would enable Salinas to meet the goals set in the National Development Plan, as well as the broader objective to modernize the economy.

In essence, a sound program of privatization combines three fundamental features into a single process: 1) a negative problem-solving adjustment in current economic imbalances; 2) a positive growth-based shift to a "consumer"-dominated economy; and 3) a non-abrupt transitional period of structural change. Unfortunately, government officials do not understand that privatization must be part of an ongoing political process before it can generate economic progress.

Awkward Approach. This failing is no more obvious than in the original purpose of the program to "disincorporate parastate entities" initiated under Miguel de la Madrid. The program was officially drawn up as part of the "conditions" imposed by the World Bank, the International Monetary Fund, and other creditor institutions, in exchange for substantial debt relief. Two crucial flaws impeded demonstrable success. The main objective was confined to introduce "more efficiency" in the public sector and "rationalize" government interference in the "macroeconomic scene." However, this did not imply a shift away from central planning and towards a market-based system. Consequently, disincorporation was limited to small parastatal companies (many of which existed only "on paper"). The main monopolies were left completely untouched.

The Mexican Ministry of Budget and Programming reports that vast numbers of parastatals have been "disincorporated": from 1,155 in 1982 to 377 by the end of 1989. An official reduction to 250 entities is planned by 1994. This is expected to bring further removal of state participation from four of the thirteen economic sec-

tors now operating under the government's control. The future goal is to retain partial or complete control in nine areas.

The wide array of divested sectors include airport and airline services, coffee and sugar, mines and steel mills, fishing and forestry, truck and auto parts manufacturing, tourism and hotel services, cement industries, urban transport, and stock-exchange houses. A large number of smaller areas (eg., refreshments and private mail) have also been freed from direct state control. In 1989, 49 cases of disincorporation were concluded, which reportedly generated substantial savings. The Ministry scheduled an ambitious agenda for 1990. It expected to finalize the sale of CANANEA, a huge and highly inefficient mining enterprise, along with two other mines, TELMEX and ASEMEX.

Unimpressive Numbers. These results are significant in comparison to previous years. However, behind the official numbers lie less than impressive accomplishments. The persistent policy of insulating the strategic industries from private ownership has been costly and counterproductive. They represent the vast bulk of Mexico's parastatal sector. The 778 divested companies account for less than 15 percent of government assets (excluding TELMEX, the steel mills and the banks, whose sale remains to be finalized). The remaining portion is almost entirely exhausted by strategic state-owned monopolies. These are meager in number and yet operate at astronomical losses, thus requiring constant federal funding. In 1989, they were responsible for 91.6 percent of the public sector deficit. The parastatal deficit for the same year was reported at approximately $175 million. The agricultural supply monopoly, CONASUPO, and the Federal Electricity Commission currently finance up to 55 percent of their annual expenses with government transfer subsidies. Other money losing enterprises include the steel parastatal, SICARTSA, the fertilizer parastatal, FERTIMEX, the railroad FERRONALES, in addition to many small enterprises which form part of the bureaucratic machine.

Not surprisingly, the savings obtained by Mexico's privatization program are less than impressive: an approximate $1.5 billion during an eight-year period. This is negligible compared to the $700 million in subsidies needed to finance the losses of the remaining state-managed companies in the first quarter of last year alone. The five gigantic parastatal companies listed above absorbed 92 percent of the total sum of government transfers assigned to the parastatal sector.

The matter has turned from bad to worse in 1990. So far government transfers for the first six months of the year have surpassed the $1.6 billion mark. This represents an increase of 9.2 percent in relation to 1989. Some 94 percent of the assigned resources were absorbed by five entities alone: CONASUPO and the Federal Electricity Commission, FERTIMEX, FERRONALES and the Mexican Social Security Institute, IMSS. Further, the government projects that $2.2 billion will be required to service the outstanding debts of all the aforementioned companies.

Disincorporation vs. Privatization. This finding reflects the misplaced basis of "disincorporation." Privatization is really just a special case of disincorporation. The official description of the term is: to "restructure and rationalize" inefficient

parastatal entities by means of four different techniques: 1) the "sale" of parastatals to the private or social sectors; 2) their "transference" to state or local governments; 3) "extinction" or "liquidation" of bankrupt entities; 4) the "fusion" of two or more state organisms.[3]

Falling Short. Here privatization figures only as an option. A process of disincorporation need not coincide with the goals of privatization. In fact, these techniques often fail to meet the criteria of genuine cases of privatization: transference of assets and managerial control from the public to the private sector. This is even true of sales to private owners, where transactions sometimes involve special corporate privileges and conditions which compromise competitive economic activity. For instance, under the transference approach, inefficient enterprises are restructured into smaller ventures run at the local level. But this does not imply an end to political control, nor does it correct the problem of underperformance. Thus, these techniques fall short of privatization.

The practice of liquidation (the most commonly utilized method of privatization) has also shown some significant shortcomings in disincorporating important public entities. Mexico's government recently announced the liquidation of the primary sugar-processing parastatal AZUCAR S.A., along with several affiliate farms known as *ingenios*. The decision was prompted in part by the prevailing embarrassing inefficiency of Mexico's sugar sector.[4] Yet it plans to form a new company with the capital remains of sugar farms, where it will retain majority shareholding. The same procedure has been set for TABAMEX and IMECAFE: state-managed regulatory bodies will be instituted with the proceeds obtained from extant productive units. In both cases the form has changed, but the substance remains intact.

Officials assert that this approach is necessary to "fortify" the role of these and other agricultural companies in servicing the needs of the rural classes. The phrase "fortify, not privatize" has become a standard motto used by public authorities to describe the "reorganization" of these state entities. Yet, it reflects a common failure to appreciate the fact that privatization constitutes the best means to truly "fortify" economic performance.

CONASUPO. In October of 1989 the government expressed its intention to "restructure" the agricultural supply monopoly, CONASUPO, as part of a general program to modernize the vast and chronically underdeveloped agricultural sector. The decision has been interpreted as an attempt to privatize the company, and hailed for that reason in international circles.

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3 See Oscar Verra Ferrer, "La Privatizacion en Mexico: Causas y Alcanzes", in *Privatizacion: El Inevitable Sendero del Gigante Decreciente* (Mexico D.F.: Centro de Estudios en Economia y Educacion, 1988), pp. 109-113.

4 Mexico has the potential to be a leading sugar exporter, yet the government was forced to import 800,000 tons of raw sugar in 1989 in order to meet domestic demand. This figure is expected to rise to 1,000,000 tons in 1990.

CONASUPO should be privatized. Its dismal financial record and perpetual lack of performance make it the state-owned entity that consumes the most of the state budget. Its total expenditures in 1989 exceeded $2 billion. For every peso it spent the company required 53 cents in the form of transfer subsidies.

Dubious Rationale. The government unveiled a broad-based program to eliminate "generalized" subsidies for CONASUPO and to restrict them to the "neediest" areas. To meet this objective it planned to sell 163 storage facilities, auction off 589 super-markets and nine food-processing plants, and shut down operations in "higher-bracket" zones. The plan also stipulated fixed reductions in the commercialization of basic foodstuffs, from ten to two. But behind this plan lies a dubious rationale: to reduce the company's participation in urban sectors in order to "fortify" and expand it in rural sectors. Once again, the substance changes, but the form remains the same.

In effect, the government has not expressed its intention to privatize and relinquish managerial control of CONASUPO. Nor does it contemplate substituting the collectivist agricultural system with a market system. Evidence corroborates this finding: projected outlays of CONASUPO for 1990 are 43 percent higher than last year; for every peso it expects to spend it will require estimated federal transfers in excess of 60 cents. In the first half of this year it has already absorbed subsidies in excess of $800 million. The figure is 44 percent higher than the amount assigned in the first half of 1989 and constitutes over 50 percent of all transfer subsidies assigned to the state sector for the first six months of 1990.

Mexico's program of disincorporation falls short of being a free market-based program of privatization. According to Oscar Verra Ferrer, a leading specialist in privatization, the fundamental problem is that disincorporation "lacks a well-defined conceptual scheme to orient it" and to replace the current model of centralized "rectorship."[5]

METHODS OF DISINCORPORATION

The Mexican Ministry of Treasury and Public Finance has released figures which indicate that from December 1982 to December 1989 more than 800 state-owned companies were authorized for disincorporation. Thirty percent of them are scheduled to undergo the process. The liquidation approach has been the method most used but also the one which exhibits the slowest rate of change: 34 percent of the authorized total of 292 remain in process.

Information Issues. The four techniques of disincorporation — liquidation, extinction, fusion, and transference — are comparatively easy to monitor. However, sales are far harder to assess. No detailed official information is released by the government prior to many sales, and the information that is made available is

5 Ferrer, *op. cit.*, p. 142 (translation by Roberto Salinas).

often contradictory and presented in confusing terms. This has been a major problem in the past, which still remains to be corrected.

The most prominent recent sales include the *Nacional Hotelera* hotel chain, the copper mining establishment *Mexicana de Cobre*, the two airlines *Areomexico* and *Mexicana*, in addition to many small chemical, textile and agricultural concerns. A highly publicized sale in 1989 was Diesel Navastar, a large truck manufacturer. The fact remains, however, that a great majority of transactions have been conducted with too much secrecy. This has hurt the credibility of the method of disincorporation, which is the most representative of all privatization methods. It has also tainted the popular image of privatization as "crony capitalism."

A case typical of this harmful trend occurred in August 1989, when the sale of 23 entities was reported in the news media based on information supplied by government agencies. Only 15 of these 23 enterprises had been authorized for sale. The remaining one-third were not known to be the property of government. The specific terms of sale and the actual prices at which companies were obtained were also unavailable to the public. To boot, many transactions took place in a clandestine form. More generally, there are numerous cases where the specific conditions under which particular private bidders purchased an "authorized" company are completely unknown. These include *Ceramica y Ladrillos* (a cement block factory), *Avantram Mexicana* (a wools manufacturer), *Nueva Nacional Textil Manufacturera del Salto* (a textiles concern), and *Productos Quimicos e Industriales del Bajio* (an industrial deodorant and insecticide complex).

Assessments. Opinions diverge on how many state-owned enterprises have been disincorporated. The government has released data which seem to suggest a notable improvement in reducing the burden of parastatal expenditures on the federal budget. The public sector deficit (as a percentage of the GDP) has fallen from 11.3 percent in 1988 to 6.3 percent in 1989. This, however, has not been the result of cuts in federal expenditures, but of a substantial amplification of the fiscal base through increased tax revenues. Still, expected outlays for 1990 (which include debt-servicing payments) are lower than outlays in previous years. Also, transfer payments have declined over the past three years.

A study released by the *Instituto Tecnologico Autonomo de Mexico* (ITAM), the leading technocrat institution in the country and the national analogue of MIT, affirms that, with the exception of TELMEX and the two airlines, privatization has had a mild impact in healing public finances. The budget transfers have yet to diminish in substantial amounts. The study points out that only small firms have been privatized, which have not been an excessive burden on the federal budget. Thus, the ITAM study concludes that little has been done to solve the problem.[6]

Naturally, part of the problem is that major programmed divestitures have not yet begun. The government expects to raise more than $20 billion from the sales of

6 The study is reported *El Univeral*, October 12, 1989, p. 43. It was released prior to the sale of the banks.

TELEMEX, all eighteen banks, CANANEA copper mine, the vast steel holdings and other minor enterprises. The financial impact of this is positive, but will not be felt in the near term.

For instance, the government has set a price of $6 billion for the sale of TELMEX. It is seeking investors willing to inject $4 billion, which together with projected earnings for the next four years will yield the estimated sum of $10 billion needed to modernize the company by 1994. The process of selling the firm began in August of this year. The final set of buyers is scheduled to be formally announced in December. According to Jacques Rogozinski, head of the Office for Privatization, potential bidders include four national groups and six international ones – among them Grupo Alfa and Desc, U.S. West and Southwestern Bell, and Telefonia Espanola. Yet Banco Internacional, the institution charged with the sale and divestiture of TELMEX, has reported that the process may be postponed until mid-1991, owing to lengthy and cumbersome auditing procedures to determine the value of its assets. Similarly, plans exist to disincorporate important companies like FERTIMEX, SICARTSA, and ASEMEX, but this has not happened.

Future progress remains to be seen. However, there is reason to be optimistic. An important series of steps have already been taken. Yet, it would be wrong to conclude that all is well. An examination of the aims and claims of Mexico's privatization program reveals certain shortcomings which strongly suggest that it must undergo some fundamental changes in order to afford notable and lasting benefits.

MEXICAN PRIVATIZATION IN PERSPECTIVE

Unfulfilled Criteria. The Center for Privatization in Washington D.C. identifies four factors that must be present in any feasible program of privatization[7]:

1) A firm commitment by the host government.

2) Reasonably priced enterprises with short-term profit potential.

3) A "spread the wealth" approach to broaden equity ownership.

4) A creative strategy to quell internal discontent with privatization.

At present, none of the outlined criteria are fully met by Mexico's privatization program. The conditions obviously overlap. For example, failure to satisfy the last two criteria casts doubt on a genuine commitment to privatization.

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7 See Peter Young, *The Enterprise Imperative* (London: The Adam Smith Institute, 1988), p. 13.

A fifth prerequisite should be added as well. In Mexico, privatization represents "the tip of the iceberg" in the structural change required to produce a healthy and growing economy. Here too, despite recent achievements, the program has yet to satisfy the basic criterion for a successful privitization program.

Pragmatic Liberalism. Arturo Damm Arnal, Professor of Economics at the Panamericana University, characterizes the Salinas administration's approach to privatization as a case of "pragmatic liberalism"; it has a sufficient degree of liberalization to attract new investment capital and prevent internal collapse, but insufficient to infer a principled commitment to a free-market and the "structural transformations" which the shift to the latter implies.[8] Damm Arnal states that a set of difficult steps must be taken for the government's program of internal reform to succeed:

They are to: 1) extend privatization to sectors legally restricted to the exclusive management of the state, such as the petrol, electricity and railroad industries; 2) repeal articles 27 and 28 of the Mexican Constitution, which detail criteria for "strategic and primary" sectors and prohibit any form of private ownership of them. On the one hand, it seems clear that Salinas is simply not willing to go this far. In his first Presidential Address in November 1989 he stated that state ownership of strategic sectors, including PEMEX, CONASUPO, FERRONALES and electricity, are "irreversible." On other occasions he has described these same sectors as "untouchable," citing both constitutional articles 27 and 28 in support of his decision.

On the other hand, there are important indications that this trend might change. The decree to reprivatize the banks required congressional and senatorial approval to amend article 28 and thereby restore the constitutional text to its original, pre-1982 form. This initiative was essential to supply legal credibility to the presidential decision and set a positive precedent for future possible changes. In the process of ratification Salinas was able to form a coalition between members of the PRI and the moderate right-wing party PAN. There was minor quibbling about the details of reprivatizing the banks, but approval came without any significant political mishap.

It would be wrong to suggest that the sale of other "strategic" concerns are next. Nevertheless, the possibility of joint ventures in oil and electricity are currently being considered. The Federal Electricity Commission is the second leading money-losing parastatal, behind CONASUPO. It absorbs massive amounts of state transfer payments and suffers a significant lack of productive investment. In the first six months of 1990, the electricity commission required federal transfers in excess of $290 million, which is 20.3 percent higher than the subsidies consumed in 1989 for the same time. Similarly, bureaucratic obstacles plus continued mismanagement have been responsible for sharp declines in the productive investment of PEMEX, the petroleum enterprise. For example, investment in

8 Personal interview with Arturo Damm Arnal.

petrochemical exploration and exploitation has decreased 75 percent during the last eight years. For every dollar obtained through all petrol-related sales, only 0.03 cents is destined towards technological investigation, innovation, and improvement. Thus, though PEMEX is one of the ten most important oil companies in the world, it has suffered a constant decline in productivity: from 3 million barrels per day in 1982 to 2.5 million in 1989. The Mexican Petrol Institute claims that PEMEX requires $4 billion in new investments for upkeep and modernization. Without it, Mexico might become a net importer of crude by the middle of the next decade.

These factors have persuaded the Salinas administration to pursue the possibility of joint ventures in oil and electricity with domestic and foreign private investors, despite the substantial "political" risk involved. So far offers for investment in the oil sector have been extended to Alfa, Cydsa, Mitsubishi, Dow Chemical, and Shell and Exxon. This is good. It is a far cry from privatization, but the absence of private ownership and voting power does not necessarily imply that this form of joint venture represents a fund-raising gimmick masked as authentic economic reform. On the contrary, the advent of private participation in these sensitive areas could function as a prelude to future privatization. Nonetheless, the motivation is clearly and purely "pragmatic," arising out of the financial need to channel productive investments in these sectors.

Legal and Economic Restrictions. In general, then, it is uncertain whether Salinas's government has demonstrated a full and firm commitment to privatization. An examination of primary achievements in this field seems to supports this conclusion. The two most talked about cases of disincorporation in 1989, Mexicana and TELMEX, contain crucial legal and economic restrictions on ownership and entrepreneurial direction. In the former case the government has retained 40 percent equity which it intends to sell to a consortium of investors called "Grupo Falcon," once the pre-set three-year trial period of "capitalization" of $500 million expires. Yet the government has also reserved rights to keep its partial ownership in the event that it considers it necessary. This arrangement is less than expected from genuine privatization.

An equally questionable arrangement afflicts the privatization of TELMEX. The company is in dire need of restructuring. It is one of the most inefficient yet most expensive telephone companies in the world. Demand is overwhelming and supply is scarce. TELMEX is now unable to service almost two million applications for new telephones. Twenty-year waits for telephones have been reported. There is one telephone for every 10,000 people and over 10,000 villages have no phone system at all. Some $10 billion in capital investment will be needed to modernize the national telephone service.

Nevertheless, under the terms of disincorporation, the government will retain 25 percent equity and entrepreneurial control of the company. Also, external ownership is limited to 49 percent and new investors will only hold "non-voting" shares. The arrangement also contains a disturbing and very ambiguous juridical clause which re-affirms the government's role as "rector" over "normativity of the telecommunications sector." This proviso was allegedly introduced to guarantee

the contracts of the company's 50,000 employees (it has a bloated average of 12 workers per 1,000 lines; Bell Atlantic has approximately 4 to 5 per the same number). However, it can be easily be interpreted in many ways, one under which the government retains effective and complete control of the company. This is not encouraging.

These two instances of partial privatization underscore free-market advocate Edgard Mason's harsh but poignant accusation that the current policy of disincorporation is merely seeking to "privatize without privatizing" – that is, to reap the rich financial and capital-gathering rewards which normally accompany the sale of wasteful public concerns without surrendering control of the enterprises. This strategy of financial pragmatism is detrimental to the free-market goals of real privatization. It is also apt to discourage several potential investors.

Selling the Banks. The presidential initiative to sell the banks is probably the most welcome economic reform made by the Salinas administration so far. The advent of a free - trade agreement with the U.S., the need for a constant flow of investments, and the parallel need to lure flight capital back home, convinced authorities to return the banks to the private sector. The immediate-run impact of the announcement has been extremely positive: an estimated return of almost $3 billion in domestic capital, and the inflow of $5 billion in fresh foreign investments, for 1990.[9]

Unfortunately, an evaluation of the structure and terms of sale of the eighteen banks reveals that the initiative is yet another disappointing case of quasi-privatization. A new block of bank and financial legislation was enacted in June 1990 to regulate the process of selling the banks and their future behavior within the national financial system. Nevertheless, the legislation contains severe restrictions on the nature of ownership and distribution of assets, which buyers and analysts feel is bound to delay the privatization of the banks. The principal problem, as usual, is that the regulations enable government to retain rectorship and roundabout control of assets and administrative decision-making.

The structure of TELMEX's equity will be partitioned. A series of stocks (so-called A-type) will be sold exclusively to Mexican persons or groups through an auction system; it will represent 51 percent of ownership and define control of the bank. Another series of stocks (type B) with a limit of 49 percent will be sold through the stock-market; their acquisition is open to the controlling owners, but not to foreigners. Finally, a C-type series will be sold in international markets and are exclusive for foreign investors.

9 A corollary benefit of privatizing the banks was that it repaired the obvious anomaly that, owing to continued expansion in commercial trade, future private banks could operate in Mexico. These banks would be owned by foreigners, whereas domestic ownership would remain prohibited. Further, it also corrected the related anomaly that Mexicans could be free to pursue minority stock ownership in banks abroad, but not in their own home land.

The government intends to sell A-type stock to national financial institutions and stock-brokerage houses, who will be able to control 100 percent equity. The rules state that the sale of C-type stock is optional, depending on the discretion of the controlling group. Moreover, a maximum limit of 5 percent has been placed on individual equity ownership. The penalty for exceeding the limit is tremendous: compulsory sale of equity back to the bank, at half the price, with revenues to be collected by government. The latter will also exercise discretionary power over board appointments in the form of a veto power.

In essence, the new bank legislation and the terms for the reprivatization of the banks contain five drawbacks, most of which originate from the governments's unwillingness to relinquish *de jure* control of the national banks. They are:

1) **The terms of sale contain a judicial clause similar in letter and spirit to the one in TELMEX's terms of sale ,which states that the government will retain "rectorship over normative behavior of the banks."** In fact, the banks are being "concessioned" back to the public according to article 28 of the Constitution. There is no reliable guarantee of property ownership under these conditions of "rectorship."

2) **The legislation is exceedingly restrictive.** Individual investors must tolerate a 5 percent limit on stock ownership with no voting rights and government control over managerial decisions. Also, they must cope with bureaucratic discretion over their commercial association with other investors. It is bound to scare many interested buyers away because the discretionary power of authorities may interpret two investors with a business association as officially "one," thereby having formal grounds to expropriate their assets and impose a penalty. The legal ambiguity of this rule, and the possibility of arbitrariness, compromise the goal of a genuine case of bank reprivatization.

3) **The legislative restrictions on foreign investment and ownership are illogically harsh.** Pedro Aspe, the Minister of Finance, has categorically denied any foreseeable revision on the 30 percent limit, claiming that enough capital exists in "the domestic private sector" to purchase remaining majority percentages. Nonetheless, spokesmen for interested foreign banks have stated that in the absence of a modification in the new legislation to allow more than 5 percent individual ownership and more than minority participation, the inflow of foreign capital is very unlikely. Representatives of Morgan Guaranty Trust, Bank of America and Rothschilds & Co. concur that more realistic rules are required to achieve an internationally respectable financial system. The measure to sell the banks is welcome, but the process of divestiture betrays the spirit of privatization in its failure to inspire ownership confidence and attract much-needed investment.

4) **The government will not surrender all control over the national bank system.** First, it intends to continue its role in so-called "development banks" (eg., Nacional Financiera) and "regional banks" (eg., BANRURAL and BANPESCA). These institutions finance "primary" projects in industrial and rural sectors of the economy. They total more than fifty altogether. None has been authorized for privatization, despite their prevailing and notorious inefficiency. Second, the

government seeks to fashion a financial system of mixed participation and does not plan to sell all 100 percent of the banks. In fact, authorities have revealed that it intends to retain majority ownership in the country's three largest banks (BANAMEX, BANCOMER and SERFIN) to "prevent preferential practices and avoid the concentration of financial power." These two factors suggest that the "reprivatization of the banks" is, once again, a case of partial privatization.

5) **The new legislation does not foster a competitive banking system.** Only new "regional" banks can be established. Also, the regulations prohibit competition by foreign banks. They may set up offices to undertake "international operations," but they will be unable to practice standard banking activities. This set of serious failings suggests a lack of commitment to rid the state of public companies. To privatize, one must privatize completely.

Pricing Problems. Another serious problem blocking efforts to enlarge the program of disincorporation is a lack of commercial interest in the enterprises put up for sale. The Salinas government has been able to privatize one of 70 parastatal companies put up for sale in the first year of its administration – the 25 percent sale of Mexicana equity to the Falcon consortium. And it has only finalized the sale of 35 out of 88 scheduled companies. All of these were small entities, averaging a price of $10.6 million each.

The reported reasons for this failing are twofold: 1) the economic "inviability" of state companies, and 2) their status as underdeveloped entities with highly obsolete equipment. FERTIMEX, the fertilizer company, though a prime target for privatization and huge in size, falls in both categories. It suffers salient technological backwardness and is a leading recipient of state subsidies. In the first half of 1990 it consumed more than $160 million of federal funds. This is 39.4 percent higher than the transfers assigned during the same period in 1989. Thus, the company lacks short-term attraction for investors. This pushes prices of such entities downward.

The lack of profit potential hinders efforts to disincorporate public sector companies. A characteristic example is the complicated sale of CANANEA, Mexico's largest copper mining concern. It was nationalized in 1982. It was put "back" on the auction block in 1988. All attempts to sell the firm failed until August of this year. It has been recently acquired by copper magnate Jorge Larrea, amid public charges of favoritism, obscurity, and rent-seeking.

The problems in selling CANANEA were almost inevitable. It is extremely inefficient and uncompetitive (the costs of production for one pound of copper is 90 cents, 30 percent higher than standard international costs). The company has also suffered acute labor unrest. In August of 1989 Salinas declared it bankrupt. Two months later the mine was reopened with half of the original staff. It remained on the selling block for nine months with no firm offers in sight. The purchase price was reset at approximately $400 million, 50 percent less than what the government sought to sell it for in 1988. The company's bleak financial prospects and its highly turbulent labor history discouraged several interested buyers, some of which

claimed that the government should have paid investors to take over the mine. It was finally sold for $475 million, after lengthy and complex pricing procedures.

Major Problems. Two salient cases of poor profit potential are SICARTSA and AHMSA, the state-owned steel holdings. The disincorporation of both entities presents problems of major proportions. Each company requires enormous sums of capital investment in equipment and modernization. For example the construction of new steel industries requires an estimated sum of $100 million to $200 million. Yet, the capital required by SICARTSA alone is twentyfold. Furthermore, both parastatals are leading recipients of government transfers. Not surprisingly, no immediate investor interest has followed the announcement of the disincorporation of SICARTSA and AHMSA.

An attractive but underplayed option to lure new buyers and increase the demand for state-run concerns is debt-for-equity swaps. *Mexicana de Cobre,* once an inefficient copper mine, was privatized in 1986 through a swap involving $1.36 billion in foreign debt in exchange for equity in the amount of $680 million. A debt-equity swap is contemplated for the terms of sale of the steel mills. Swap operations were suspended in late 1987, but recently reinstated in April of this year. They constitute an effective tool to remedy the pressing lack of interest in Mexican state companies. More leniency in foreign investment regulations would function as an ideal complement.

The principal difficulty in price and valuation mechanisms is the system of price and exchange controls. It is impossible to determine the fixed market value of current candidates for privatization without a price system based on the free interplay of supply and demand. The liberalization of wages and prices is indispensable to accelerate the sale of unproductive enterprises. Similarly, market-set exchange rates would open access to foreign credit, making long-term investment more plausible.

Crony Capitalism. The methods of privatization employed in the Mexican program are amateurish and counterproductive by most international standards. There is a substantial lack of awareness of the "social" value of privatization and the opportunity it brings to widen equity ownership via techniques designed to democratize national wealth. On the contrary, privatization is perceived by some Mexicans as anti-revolutionary capitalist exploitation.

There is some basis to these accusations. The secrecy and absence of open information which have characterized numerous transactions has damaged the reputation of privatization. A sorry precedent was set in the 1987 sale of minority shareholdings in BANCOMER and BANAMEX, the two largest nationalized banks. Equity shares were sold to a privileged clientele with close political ties to

government agencies at undervalued prices. Those people thereafter made enormous profits in stock-market trading.[10]

The precedent has not been reversed. For example, with the sale of Mexicana shares, serious misgivings were expressed in the Mexican news media about the government's unwillingness to disclose concrete information about the bidders who competed against the Falcon Group for 25 percent ownership of Mexicana. The implicit message is that political patronage again played a role in the selection process. More recently, the sale of CANANEA was marred by accusations of cronyism, preferential treatment, and widespread obscurity in process of acquisition. In June 1990 the company was awarded to the industrial group ICA. A month later the decision was declared null and void and a new date for auctioning was set. In August the company was awarded to Jorge Larrea on the basis of a better offer: $7 million more in cash plus a guarantee to invest $300 million in the mine's productive infrastructure. In the meantime, another offer was issued by SINTEMEX group, for $600 million. Yet, the offer was ruled out. The reasons remain unclear, but the presiding judge claimed the offer was "extemporaneous." This has provoked charges of "obscure negotiations" and political favoritism from spokesmen for ICA and SINTEMEX.[11] Larrea reportedly has close ties with the government. He now controls 95 percent of copper production in Mexico and 5 percent worldwide. The critics contend this is no coincidence.

The similar lack of information in the sales of several small enterprises has meant the irreversible loss of a good opportunity to give privatization a positive image from the outset of the program. However, after seven years of flawed "antidemocratic" strategies, it is harder to form a popular consensus in support of methods such as employee buyouts and individual stock-offerings. Many critics construe these options as embellished descriptions of methods designed to enrich powerful labor leaders and corporate cronies, and hence to keep the wealth only for the few.

Nevertheless, a spread-the-wealth approach of popular capitalism remains available. It has been successfully used and marketed in Chile. In Mexico it could prove beneficial to the vast majority of underprivileged citizens, enabling family members to become rightful owners of their property. It is also a strategy that would short-circuit the long entrenched hostility to foreign influence and corporate exploitation.

An ideal place to test popular capitalism and give many an opportunity to "share the wealth" is the extraordinarily backward agrarian sector. It has become standard practice to describe it as "chaotic." Food productivity suffered a sharp fall of 66 percent in 1989. Corn and bean production fell 87 percent and 72 percent

10 See Young, "Privatization in Mexico: Robust Rhetoric, Anemic Reality," Heritage Foundation *Backgrounder* No. 611, October 22, 1987, p. 6.

11 See, for example, Luis Gonzalo Berna's editorial "Minera de Cananea", *Uno Mas Uno*, July 13, 1990.

respectively. Misery is pervasive: 90 percent of the estimated 3.4 million rural peasants earn a salary below the minimum wage, a daily income of less than $4.00.

Widespread poverty and unproductivity are the principal causes of the huge flow of illegal immigration into the U.S. and of the massive flow of rural people into urban centers, notably in Mexico City. The fundamental blame belongs to the collectivist system of "agrarian reform," which has prevailed for more than 70 years. This system has destroyed the foundation of a thriving rural economy: private property rights. It has redistributed six times the amount of arable land in Mexico. The *ejido* farm terrains cannot be bought or sold. They total 26,000 and must be shared by millions of native farmers. The lack of juridical security in property titles has signified social and economic chaos. It has also produced an excessive dependence on food imports. In 1988 the government spent $3.5 billion on imported food. This staggering amount will grow to $4.5 billion in 1990.

A good way to resolve the problem would be to privatize the *ejido* plots and to extend private ownership titles to the peasant community. A well-designed plan would accomplish two ends in one step: it would unleash much needed productive initiative and give many farmers a priceless opportunity to own and farm land as they saw fit. The great majority of them would surely welcome this change with enthusiasm.

This illustrates how privatization can generate social well-being. Unfortunately, the policy of using land reform for political rather than economic purposes has clouded the judgment of public officials opposed to rural privatization. The private sector has exerted much pressure on the Salinas administration to implement these policies in the agricultural economy, but so far to no avail. Internal political forces remain deeply opposed to market-oriented reforms.

Unpopular Capitalism. Many political obstacles to privatization have undermined the progress of the Mexican program. This problem reflects a lack of creative strategies to appease popular discontent with privatization. Salinas has defended the current program by stressing that divesting money-losing enterprises will enable the state to channel financial resources to enlarging basic services like health, housing and education. This is laudable but unlikely to gain immediate popular support. More effective options, like stock-employee ownership plans, are being considered for the sale of small parastatals. However, they have yet to receive the attention they deserve.

The present approach to privatization is not well-founded. It has to be revised to guarantee long-term success. The social value of privatization has been greatly underestimated. This has produced uncreative and clumsy policies which have done more harm than good. The lack of popular strategies structured to "spread the wealth" reflects an unduly narrow concern on the need to eliminate pressing financial problems, whatever the consequences. The source of this "no other way" approach has been aptly described by analyst Raul Conde:

> The policy of disincorporation constitutes a pragmatic solution to financial pressures, rather than an effort to democratize the property of state-run entities and

liberalize the market. The owners change, but the economic policies remain the same.[12]

Partial Support. The success of privatization in other regions of the world owes much to the conviction that prosperity and economic well-being requires a system of private ownership and free competition. Thus, well-defined goals and principles have accompanied privatization programs in order to ensure their success. An essential component of these programs has been to supplement privatization with yet other market-oriented changes. In this way, newly privatized companies can function amid a competitive atmosphere free of excessive legislative restrictions.

The Mexican program has failed to heed this fundamental ingredient of successful privatization. The deregulation efforts have not been sufficient to rid the economy of forces hostile to both privatization and a competitive market. The foreign investment revisions of May 1989 are a good example. The 1973 Foreign Investment Law places a 49 percent restriction on foreign stock ownership. The new procedures permit 100 percent ownership in certain nonstrategic areas of the economy, notably tourism. They also allow minority ownership in the "secondary" petrochemical industry. This represents a step forward, but it is not enough. The recently programmed sales of AHMSA and SICARTSA are unlikely to occur without foreign participation in view of the vast amounts of fresh capital required to modernize the two steel mills. The same applies to FERTIMEX, the fertilizer concern. However, these areas fall under the rubric of "strategic," where foreign ownership is prohibited by law. Without further modifications in foreign investment legislation, scheduled privatizations will fail to attract the interest of foreign investors.

Sound privatization procedures presuppose a mature and safe financial market. In Mexico, progress in this area has been impeded by wasteful spending practices and eight years of a government-owned banking system. The announced privatization of the banks has helped to restore a climate of confidence. Now, the challenge is to accelerate their sales to strengthen and perpetuate confidence, and to bring spending practices under strict control. This is needed to recapture flight capital deposited in overseas accounts, safe from inflation and expropriation, and thereby to ease future privatization efforts by luring would-be investors to invest in projects at home.

Many critics complain that the disincorporation program merely succeeds in shifting unwanted monopolies from public to private hands. This harbors some truth. A proper climate of free competition must exist to avoid "private monopolies" and stimulate sustained commercial growth. Much progress has been made in economic liberalization, particularly in trade. However, Mexico remains a long way from becoming a free and competitive economy. This has blocked the free-market goals of privatization as well as specific attempts to sell important state-run companies, such as TELMEX and CANANEA.

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12 See his op-ed article "De Monopolio Publico a Monopolio Privado? V," in *Novedades*, November 10, 1989.

A recent embarrassing case was the unsuccessful attempt to sell PIPSA, the government newsprint monopoly, in October of last year. Salinas offered national newspaper publishers the opportunity to purchase PIPSA as a symbol of his commitment to freedom of speech. The proposal contained a proviso to lift restrictions on newsprint imports after the sale became final. The offer was declined because no publisher wished to purchase an unprofitable and inefficient business that would have to compete unfavorably in the international market with more advanced firms.

Since 1989, however, Salinas has taken the steps to put priorities in proper order. In April he decreed the liberalization of the newsprint paper market, thereby ending the government's monopoly on producing and importing paper. Permits are no longer required; and imports will be subject to a standard 15 percent tariff. This constitutes a step forward in creating a much needed competitive market in this area, and in facilitating the sale of PIPSA.

No Sound Privatization. The five demands of sound privatization have not been met. The government should seek international expertise in reshaping its program and in constructing a politically feasible alternative. This could function as a decisive factor in removing present obstacles and extending the program to important areas of the economic infrastructure, such as the oil and electricity industries.

OBSTACLES TO PRIVATIZATION

In Mexico there is much resistance to privatization and the ideological position it represents. Major political and intellectual opposition has forced public officials to adopt a purely pragmatic "no other way" approach to privatization. This sharp resistance stems from fear of "exploitation" and bitter memories from the past, when foreign intervention in railways, petrol, and electric power was strong, and wielded much political influence.

The Mexican privatization program will not go very far unless these obstacles are overcome. These can be divided into three: ideological, juridical, and political.

1) **Ideological Obstacles.** The "ideological" opposition in Mexico to privatization has been consistently strong. Important intellectual circles are still influenced by the socialist model of economic statism, despite its marked unpopularity almost everywhere else. A widespread objection is that privatization constitutes an intolerable threat to "national sovereignty." The sale of strategic industries is perceived as generating an unwanted dependency on outsiders, placing those cherished enterprises at the mercy of foreign imperialism.

The Salinas administration has received constant criticism from the left for "selling out" domestic interests. The announced divestiture of the state steel companies was condemned by leaders of all the socialist parties, including the Democratic Revolutionary Front and the Popular Socialist Party. A similar condemnation followed the decree to reprivatize the banking sector. Consequently, any attempt to extend privatization to oil and electricity would likely meet with furious opposition. Salinas has declared these industries "untouchable." Yet all are

in dire need of development and massive restructuring. Privatization could fulfill these needs.

In Mexico, as elsewhere, cries for national sovereignty are accompanied with demands for exclusive state ownership. This has enabled a few to mask their personal and highly lucrative interests with handy nationalist rhetoric. The public good would be far better served by transferring state enterprises to the mass of private citizens and retaining a majority share of ownership. In fact, parastatal businesses are controlled far more by the government than by the private sector. Thus, the vested interests of a handful of high bureaucrats have been falsely equated with the public interests of the entire nation.

A popular complaint often lodged against privatization is that it causes unemployment. The standard response to this standard objection is that hard transitional adjustments may create short-run unemployment, but that the advent of a competitive and prosperous society eventually widens employment opportunities. In Mexico, this has not persuaded authorities and analysts who contend that potential unemployment constitutes a "social cost" higher than the economic cost of keeping state companies alive. This assertion is empty rhetoric. It ignores that money-losing state-run companies are often a leading cause of unemployment. They absorb massive amount of resources which could have been destined to productive job-creating ventures. The policy of subsidizing inefficient and wasteful enterprises, together with an explosive bureaucratic payroll, has signified the loss of two jobs for every needless "make-job" employee.[13]

2) Juridical Obstacles. An overlooked obstacle to privatization and free-market reform in Mexico is institutional and judicial barriers. The constitutional articles 27 and 28 prohibit foreign and domestic private ownership of all the national economic infrastructure. The "strategic and primary" sectors (namely, oil, electricity, railroads, primary petrochemicals, and so forth) are the sole and exclusive property of the government under these articles. They are a major barrier to privatization and the development of a market economy.

Some officials claim that these articles play a purely "cosmetic" role. This is both true and false. Some strategic industries have been put up for sale — notably the telephone company and the banks. The former was unconstitutional under article 28; the latter required deleting a constitutional clause introduced in 1983, seven months after President Jose Lopez Portillo expropriated the banks in September of 1982. Several declarations have been issued voicing this concern, including an official statement from dissident PRI members opposed to selling TELMEX.[14] This has forced the Salinas administration to compromise and seek measures to temper domestic discontent. Thus, the terms of sale for the telephone company contain a legal stipulation that the government shall retain "normative rectorship" over national telecommunications. The very same stipulation was introduced in

13 See Luis Pazos, *Hacia Donde va Salinas* (Mexico D.F.: Editorial Diana, 1989), p. 168.
14 See Julio Cesar Lopez Garcia, "Privatizacion," *El Financiero*, October 3, 1989, p. 42.

the terms of sale of the national banks. This gives government potential leverage to exercise full control over these two vital areas, thereby forestalling full privatization.

A more serious problem is the lack of clear and certain limits to what qualifies as "strategic" and "primary." This endows government officials with a tacit but arbitrary power to expropriate whatever concern they happen to conveniently regard under those categories (this is what happened in 1982 when the banks were nationalized in the name of "the public interest"). The main government rationale for disincorporating new entities is the idea that these no longer require "the presence of the state." Yet, future administrations may easily disagree. The lack of reliable constitutional private property rights and the possibility of overturning parastatal government "concessions" discourages long-term prospects for privatization.

The most disturbing juridical barriers to market reforms are the modifications of constitutional articles 25 and 26 introduced in February 1983, during Miguel de la Madrid's administration. The purpose of these new clauses was to elevate economic "rectorship" to constitutional level. Yet the term "rectorship" is a euphemism for authoritarian central planning. The amended texts contain sentences copied almost verbatim from articles of Soviet and Cuban Constitutions.[15] A free and competitive society is incompatible with a legal antecedent that binds government with a constitutional obligation, according to article 25, to "plan, conduct, coordinate and orient all national economic activity."

The current package of economic reforms is unlikely to bring long-lasting benefits as long as these constitutional articles remain unchanged. The Salinas government should revoke articles 25 through 28 of Mexico's Constitution. This would strengthen the causes of privatization in two important ways. It would increase prospective candidates for privatization with new and attractive targets. It would add impetus and credibility to the program of market-oriented reform and create a stable juridical climate hospitable to the changes brought about via structural change.

Unfortunately, the prospects for near-future juridical revision are dim, notwithstanding the successful amendment of article 28 to permit the reprivatization of the banks. It remains true that the PRI lost precious congressional seats in the 1988 November election and no longer enjoys the two-thirds majority in Congress required to modify the Constitution. An immediate option would be to seek an alliance with members of the PAN who now occupy congressional posts, similar in style and spirit to the coalition formed to guarantee legislative approval for Salinas's initiative to return the banks to the private sector. This would enable Salinas to obtain the two-thirds majority required to change constitutional articles.

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15 See the comparisons made in Luis Pazos and Carolina R. de Bolivar, "Economics, Politics and Culture in Mexico, in John Goodman and Ramona Martinez-Baden, eds., *Fighting the War of Ideas in Latin America* (Dallas: National Center for Policy Analysis, 1990), pp. 76-78.

But deep tension between the PAN and PRI is likely to short-circuit future attempts to construct a "successful" coalition.

3) Political Obstacles. Two political obstacles have damaged the national privatization program. Both have public and private sector origins.The policy of privatization does not enjoy strong political backing. Few transactions have gone without opposition from syndical forces and dissident PRI constituencies. The policy of handing out special concessions to organized labor leaders in order to secure political votes has created a status quo hostile to privatization. The privileges include rights to intervene in managerial operations. Thus, the shift in administration and entrepreneurial structure which occurs in a privatization scheme threatens vested interests. According to PEMEX Administrative Subdirector Ernesto Marcos Giacoman, the existence of well-entrenched syndical organizations is "a principal obstacle to disincorporation."

Similarly, privatization has provoked visible discontent within the PRI, where reactionary groups exert considerable pressure to structural changes and revision. For the most part the motives are insincere. Many members are simply unwilling to give up highly lucrative deals in the parastatal sector. Fraud and corruption have been rampant: clandestine partnerships and misappropriated funds have enabled a select few to enrich themselves for prolonged periods of time. For example, it is estimated that for every peso destined to the state-run agricultural areas, only 30 cents reach the companies involved. Many cases have recently been exposed, notably the massive frauds in BANRURAL and BANPESCA, two state-owned credit agencies which finance development projects in the fishing and agrarian sectors. Salinas has made heady and courageous efforts to fight corruption, but this continues to be a definite obstacle to privatization and economic reform.

The prevalence of special privileges is not confined to the public sector. Private businessmen enjoy many corporate concessions and exemptions. This has hurt privatization in two ways: it has encouraged not only rampant cronyism, but opposition to the follow-up reforms necessary to ensure competition and free entry to the market. While the majority in the private sector enthusiastically welcome the reprivatization of the banks, other minority groups are opposed. This is no surprise, since a return to a privately managed bank system is bound to trigger structural adjustments which certain businessmen in the private sector wish to avoid.

DEBT-EQUITY SWAPS

New attention has been focused on the role debt-equity swaps can perform in selling state-owned enterprises. A limited swap program existed from 1986 to 1987. It was suspended in November 1987. The date is significant: it was both at the height of Mexico's inflationary crisis, and barely prior to the commencement of the "pact" of price and exchange controls. The reasons for dropping the program were the familiar ones: supposedly swaps were inducing perilous inflationary pressures, and subsidizing investments that would have been made anyway.

The "Old" Program. Mexico's previous debt-swap program retired $3.8 billion in outstanding foreign debt. The amount equalled 56 percent of direct foreign investment made during the period in operation. Nonetheless, the program was abandoned.

Neither of the two cited reasons for suspending the program withstands analysis. A debt-equity swap need not produce inflationary pressures. The program in Chile, which has been combined with privatization of state-owned enterprises, avoids the potential danger of inflation by exchanging debt-notes for company shares instead of newly emitted local currency. Similarly, studies show that a consistent or "mature" swap program does not lack "additionality"; on the contrary, the continuity of a program eliminates uncertainty and works in attracting direct investments that would have been placed elsewhere.[16]

The "New" Program. The approach of the government's new scheme is designed to allay concerns with swaps and to repair the alleged failings of previous plans. It was activated in April of 1990. The new program was instituted as a result of a requirement in the debt-reduction agreements reached under the Brady Plan. It sanctions an annual sum of up to $1 billion in swap operations in the next three-to-four years.

Debt-swaps are now limited to privatizations, tourism, agriculture, and infrastructure development projects already approved in the annual budget. In this way, potential inflationary effects are neutralized, as the government will not need to print new currency to redeem debt notes acquired in the secondary financial market.

The scheme sets strong restrictions on admissible debt swaps. The operations have a "ceiling" of $3.5 billion in the three-to-four-year period set for the program. Public authorities claim that if the program shows signs of success, the government may extend it beyond 1993, with higher ceilings for swap investments. At present, investors are only allowed to exchange debt for 50 percent of acquired assets. The rest must be financed with direct cash. This restriction was placed in order to guarantee the flow of new hard currency, and hence secure additionality. Also, discounts on acquired debt may not surpass 35 percent of nominal value.

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16 See Melanie Tammen, "Energizing Third World Economies: The Role of Debt-Equity Swaps," Heritage Foundation *Backgrounder* No. 736, pp. 6-8. Mexico's Finance Minister Pedro Aspe has been a fierce critic of debt-equity swaps (although he himself proposed "viable" debt-for-assets swap scheme in March of 1989 at the annual meeting of the Interamerican Development Bank.) Analysts persuaded by Aspe's continued criticism that swaps fuel inflation have failed to explain the counterexample of Chile. Chile is Latin America's nation with the most aggressive swap scheme yet with the lowest levels of inflation. Also, the criticism was really an attempt to find a scapegoat for blaming inflation on other factors unrelated to excessive government spending. Mexico's inflation rate in 1987 was 159 percent, its highest in history. The true cause of this was an exorbitant monetary supply rate of 129 percent provoked by the need to cover a huge public deficit. On this point, see Sergio Sarmiento's op-ed piece, "El Retorno de los Swap," in *El Financiero*, December 11, 1989.

Finally, access to swap operations will now be open to domestic investors. A substantial sum of expatriate capital is expected return via swap investments.

Swap operations are being considered for many companies targeted for sale to the private sector. They include TELMEX and the steel mills SICARTSA and AHMSA, CANANEA, PIPSA, and CONASUPO supermarkets in urban areas. An auction system will be used for state-owned companies obtained through swaps. No majority ownership will be open to foreign investors. This year 27 operations were approved from a total of 359 applications. A total of $860 million will be retired in debt in exchange for investment projects in infrastructure, agriculture, and tourism. The swaps approved for privatizations were minimal, as were the number of operations licensing new foreign investment.

The new swap program is encouraging in many ways. It is a clear improvement on the previous program in linking swaps with privatization and in substituting conventional swaps of debt-for-currency with debt-for-assets techniques. Nevertheless, the program also has important limitations. Many foreign observers complain that the sanctioned annual amounts of $1 billion are severely limited. The actual amount of investments channeled through swaps are less than the already low ceiling, in view of the 35 percent discount on foreign debt. This means that only $650 million per year have to be allocated among several different areas. Some of these, such as tourism and infrastructure, require very large amounts.

Similarly, the 50 percent restriction in swapping debt notes for equity shares acts as a disincentive for potential investors unwilling to pay the remaining half in hard cash. The most troubling flaw with the new scheme is its low debt-reduction import. By 1993, it will retire only half the sum cancelled through the swap scheme in Chile. This is even lower in GDP terms, since Chile's represents only 15 percent of Mexico's GDP. In effect, the total savings to be obtained over a three-to-four-year period equal the annual savings in debt-servicing costs reached through the foreign debt-relief agreement finalized last February. Mexico needs a far more aggressive debt-swap scheme to bolster sorely needed investment and retire substantial sums of its still gigantic foreign debt.

A Creative Alternative. A large and aggressive swap program could help in important ways to fix the various pricing problems which have persistently hurt efforts to sell state-owned companies. However, critics contend that this would be detrimental to the nation and would leave it at the mercy of excessive foreign economic domination. It is often said that swaps "discriminate" against domestic investors. This merely masks an underlying "fear" that swaps contribute to the loss of economic independence. Again, this turns an economic (and financial) issue into an emotional or political debate about "national sovereignty."

This view, while misplaced, is pervasive. There are innovative alternatives which could work to nullify it. A study done in the Mexico City-based Center for Free Enterprise Research suggests that the government could institute a type of "domestic debt-swap" program by exchanging internal debt notes in the form of privately held treasury bills with voting in three banks and other large parastatals. This move has several advantages: it would transfer money-losing parastatal

COMPANIES SLATED FOR PARTIAL OR FULL PRIVATIZATION		
PARASTATE COMPANIES	ESTIMATED SALE PRICE (In trillions of pesos)	INTERNAL DEBT (March 1989)
BANCOMER	25	
SERFIN	10	
COMERMEX	7	
TELMEX	52	
MEXICANA	2	
FERTIMEX	5	
SICARTSA	7	
AHMSA	5.3	
TABAMEX	5	
TOTAL	118.3	118.3

enterprises to private hands, thus removing a main source of inflation and inefficiency; it would eliminate the need to extend huge sums in transfer subsidies to the public sector; it would help modernize Mexico's financial market by attracting important amounts of domestic investment capital; it would encourage the repatriation of flight capital; it is appropriately "nationalistic"; and it is feasible.

The principal virtue of this proposal is that this type of aggressive "domestic swap" program would eliminate a very large portion of Mexico's pernicious internal debt, together with all debt-servicing costs in one single step. This would generate a huge savings. Mexico's internal debt represents a far more serious obstacle to alleviating public finances and revamping growth than its external debt. It has soared above the $65 billion mark, and is roughly equivalent to 25 percent of the GDP. In 1989, for every peso spent in servicing debt-payments, the government allocated 77 cents towards internal interest-payments and only 23 cents to foreign debt payment. The same amounts are projected for 1990. The debt-servicing outlays for internal debt now constitute 42 percent of total federal expenses. This comes as a result of the government's need to finance payments of interest rates on treasury bills and other securities, rates that must be kept extremely high to attract investments. The interest rate on 28-day treasury bills called CETES now stands at 30 percent.

A policy of domestic debt-swaps would solve the problem occasioned by a fast-rising internal debt, and eliminate the need to finance unproductive activities with domestic debt - contraction. The CETES and other securities choke the public sector with abnormally high interest-payments and make money markets soar. These could be exchanged for shares in certain important parastatal companies. Luis

Pazos, General Director of the Center for Free Enterprise Research, has proposed a list of companies for privatization (see table on previous page).[17]

All these companies have been programmed for partial or full privatization. The internal debt has since risen to $152 trillion. Two options remain plausible. First, the additional amount could be exchanged for other state-owned entities. The swaps would not involve discounts over the nominal face value of CETES and other debt certificates. Nonetheless discount options could be offered to encourage investors reluctant to participate in the swap program. Second, a "partial" swap scheme could be instrumented, involving the exchange of stocks in TELMEX, the two steel concerns and the three banks for internal debt-certificates. In this way over 60 trillion pesos could be cancelled in internal debt, that is, roughly 40 percent of debt outstanding.

The government's current failure to take such proposals seriously reflects lack of creativity in bolstering privatization together with aggressive and plausible debt-reduction techniques. Moreover, this kind of swap scheme would not have inflationary impacts, because it involves debt-for-assets swaps. On the contrary, the proposal has a strong anti-inflationary component in its outright elimination of the principal cause of deficit spending: internal debt-contractions and enormous debt-servicing costs.

TOWARD A "MODERN" MEXICO

The Salinas administration has made concrete efforts to reverse the state interventionist trend initiated and sustained by his predecessors. Many market-oriented initiatives have been undertaken, including some viewed as unimaginable just a few years ago. These welcome changes are an essential ingredient in the general program to modernize the national economy and return Mexico to the pre-1970 days of stability and growth.

Conviction or Convenience? Mexico nevertheless needs more changes to guarantee "modernization." Salinas's sustained onslaught on what he calls "statal giantism" is a step forward. His moves to privatize major state enterprises reflect a serious intention to reduce the size of government. But this is not enough. Economic democracy and consumer sovereignty are needed as well to ensure that Mexico grows and prospers and that the success and social benefits of privatization are realized. A purely "pragmatic" motive is both precarious and insufficient.

RECOMMENDATIONS

To "modernize" means to improve, revise, and show willingness to make the required changes. A set of fundamental reforms should be made to consolidate the

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17 See *Hacia Donde va Salinas*, pp. 171-173. A "small" version of this domestic swap scheme is currently under consideration for the partial sale of equity ownership in some of the more indebted and less "rentable" banks.

war against "statal giantism" and give privatization a fundamental role in revitalizing the economy. Thus the Salinas Administration should:

- **Undertake Juridical Reforms.** A necessary condition for long-term successful privatization is an institutional framework which protects private property. The Salinas administration should fashion radical reform in the nation's legal system, and provide a constitutional foundation to changes made and already underway. A top priority should be to revoke or substantially modify constitutional articles 25 through 28, which give the government exclusive prerogative to own "strategic" areas of the economy, and manage "primary" activities, under the role of "rector" and official planner. Another priority is to deregulate the economy and introduce a more competitive system in various sectors of the national infrastructure. These reforms are required to vitalize the package of privatizations structured by the Salinas government and take the program to "its last consequences" by targeting industries such as oil, electricity, and railroads as possible candidates for private domestic ownership.[18]

- **Revise foreign investment legislation.** The 1973 Foreign Investment Code is a major barrier to privatization. It allows only a 49 percent foreign minority ownership of all domestic businesses. This has discouraged many potential foreign investors from participating in scheduled privatizations. A serious problem with the current program is the inability to find buyers willing to invest massive capital in the technological innovation of underdeveloped companies. A large part of this problem could be solved by legally allowing majority shareholding in corporations like FERTIMEX, SICARTSA, AHMSA, and TELMEX. The Salinas administration has corrected many of the follies made by its three presidential predecessors. The more open policy toward foreign investment is a welcome initiative, but requires revision of the 1973 provision to make it more than a temporary, short-lived measure. Salinas could do this by forming a political coalition with the PAN party, similar in style to the strategy to repeal the constitutional clause which prohibited private ownership of the banks.

- **End the "Pacto."** A free and stable price environment is essential for business planning and the correct valuation of state-run assets. Privatization is an ongoing process of structural change whose chances of success feeds on supportive public policies. The labor-management-government "pact" of price and exchange controls inhibits the free market aims of privatization by preventing prices from finding their place in a free economy based on supply and demand. The "pact" should end and stricter monetary discipline should be adopted; sectorial solidarity is no substitute for monetary stringency. This would restore free and realistic economic climate, and hence stimulate the repatriation of

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18 See Noe Cruz Serrano's editorial "La Venta de Paraestatales, "Hasta Sus Ultimas Consecuencias," in *El Financiero*, September 25, 1990. The editorial describes an official document which details the government's plan to ultimately reduce state control of the economy to eight strategic entities.

flight capital together with a continued flow of new investments. Many privatization targets still on the calendar would thereby become feasible.

- **Support popular capitalism.** A broad-based program to expand the popular ownership of "family jewels" should be adopted. This strategy of popular capitalism has worked well in other less developed countries. Also, it is a politically effective way to divest state concerns. The Mexican program has proceeded in a piecemeal fashion where sales based on complicated and cumbersome valuation mechanism have tended to degenerate into insider deals and cronyism. This has given privatization a misleading and negative image. The government should replace its current strategy with a positive and popular alternative.

  Some recent progress has been made on this front. Eight small fishing parastatals will be sold off through the stock exchange market. This will help to set a precedent for other privatizations. In the industrial sector, employee-ownership plans remain an attractive possibility. In the agrarian sector, systems based on "social" vouchers could be used to establish property rights and facilitate the disinconception of companies like CONASUPO and FERTIMEX. In Mexico, a popular alternative plan would help neutralize demagogical cries of revolutionary betrayal, and give privatization a positive "social" value. A program based on broad ownership results in a convergence of individual interest and is essential to spread the free market message in countries where "capitalism" is often conflated with crony mercantilism.

- **Shift the focus of the privatization program.** The national program of privatization should be redefined from its current model of pure financial "pragmatism" to one embracing a general "spread the wealth" approach. The privatization of fields like the oil industry, electric power, railroads, education, social security, rural land-plots, and other "strategic and primary" concerns would thereby become a real possibility. This requires reorienting the role of the state as "economic rector" towards an institution responsible for guaranteeing the property rights and the free operation of the market. At present, the Salinas administration uses populist arguments to justify privatizations in process; namely, that the "disincorporation of parastatal entities" is necessary to "rationalize" the economic role of the state and to allow it to channel funds saved through the program towards "public needs" like education, housing and food. A more creative approach would be to fashion an "awareness" program designed to teach the lay public the positive social aspects of privatization, and the various methods whereby vital services can be efficiently supplied by mass

participation of citizens. An ambitious alternatives such as the privatization of large parastatals via domestic debt-equity swaps should be pursued.[19]

The U.S. has direct interest in seeing that this set of reforms is instrumented. It would help in considerable ways to neutralize a radical left-wing movement led Cuauhtemoc Cardenas, son of the revered hero Lazaro Cardenas who expropriated oil interests in 1938. This movement is very strong, calling for a return to central planning and full-scale protectionism. Furthermore, a reform of the present privatization program would help to ease the way towards economic integration and free trade with the United States. An obstacle to the bilateral free-trade agreement negotiations is the fear of massive structural dissimilarities in the two economies. A popular, full-scale program of privatization in Mexico would help allay this worry.

The U.S. could help Mexico fulfill the required set of reforms in the Mexican privatization program by pursuing the following policies:

- **Redefine the Brady Plan.** The debt-relief accord reached in February of this year has been hailed as a landmark debt reduction achievement. It reduced debt burden by 20 percent, and cut annual obligations by 3 billion for the next three to four years. While this is undoubtedly positive, the Brady Plan errs in locating foreign debt as the principal cause of economic backwardness in Mexico.[20] The Bush Administration should insist that debt-relief alone is insufficient to end stagnation in a structural fashion, and that the root of recovery lies in large-scale internal reform. A policy of debt reduction tends to perpetuate irresponsible monetary policy, and to delay required reforms such as privatization.[21]

- **Use free trade negotiations as leverage.** The advent of formal free trade between Mexico and the U.S. implies a good opportunity to convince the Mexican authorities of the need for a more open and market-oriented economy. The U.S. representative to the free trade agreement negotiations, Carla Hills, has sought to include constitutional and foreign investment modifications as a condition for the accord. This reflects the acute concern that reforms on this front, such as the May 1989 revision on foreign investments, have been a result of administrative decrees that lack legal permanence. Spe-

19 Other creative and realistic alternatives include privatization of education and social security-based voucher systems and the private provision of public services. This has had huge success in Chile, a country with a similar cultural background, social practices and economic structure. That is to say, there is ample precedent that these alternatives are feasible to a country like Mexico.

20 See Melanie Tammen, "Reducing Third World Debt: Private vs. Public Strategies," Heritage Foundation *Backgrounder* No. 699, April 10, 1989, pp. 11-13.

21 Huge parastatal companies such as CONASUPO and the Federal Electricity Commission continue to absorb massive amounts in federal subsidies, and should be privatized – if only for this reason. In fact, public spending as a percentage of the GDP rose 7.2 percent in 1989. The main danger of debt-relief is precisely that it tends to delay adoption of strict fiscal discipline and elimination of wasteful public concerns.

cial emphasis should be placed on lifting investment restrictions, liberalizing "strategic" sectors, and instituting reliable guarantees of private ownership. This would open up broader objectives for Mexico's privatization program.

- **Offer technical assistance.** A serious practical problem with the policy of disincorporation in the past has been the absence of a politically popular program.[22] The U.S. can and should help the Mexican government to frame a practical program fashioned to broaden equity ownership through stock and employee participation. The free-market objectives of privatization cannot be successfully transmitted amid the context of cronyism and rent-seeking. The Bush administration should extend technical expertise to correct this flaw, and replace the current system with a program which places emphasis on a public awareness of the social value of privatization.

CONCLUSION

Mexico's package of privatizations is one of the biggest in the world. The presidential initiatives to expand the program to "important" economic sectors, such as telecommunications, infrastructure, and banking, has won it enviable international acclaim. MIT economist Rudiger Dornbusch and British Prime Minister Margaret Thatcher have lauded the Salinas administration for its many privatization efforts and have commended its program of reforms as a model to emulate.[23]

Notwithstanding the good reputation that Mexican privatization enjoys, a detailed analysis of the program reveals that "publicity has outstripped performance."[24] It is necessary to restructure current policies to meet the conditions of successful privatization. It is vitally important to introduce solid private property rights and give constitutional permanence to the transference of assets from the public to the private sector.

Good but not Great. President Salinas has demonstrated commendable political courage in privatizing state companies considered "untouchable" just a few years ago. He now faces the new challenge to expand the program to "strategic" sectors and allow mass domestic ownership of the nation's most vital economic interests.

The key to extending the national privatization program in this fashion is political and popular will. It represents an invaluable opportunity to start anew, and revise the pro - gram in a way that meets the prerequisites of successful and profitable privatization. Further, large-scale privatization would remove obstacles

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22 See Young, "Privatization in Mexico," pp. 11-13.

23 A typical example of the arguably overrated image Mexico now enjoys for its "economic revolution" and its near-future transformation into an "economic powerhouse" is David Goldman's article "A Revolution you can Invest In," *Forbes*, July 9, 1990, pp. 48-51.

24 This phrase is taken from Daniel James's succinct comment on this issue in a letter to the editor, "Mexico Phobia: Fear of Open Market," *The Wall Street Journal*, April 24, 1990.

to sustained progress and open up new opportunities to pursue competitive trade and a smooth economic integration within expanding world markets.

Internally, a broad program of privatization would help alleviate the administration's lagging difficulty in balancing public finances and adopting sound monetary policies. In turn, this would engender a financial climate of stability, thereby facilitating the return of flight capital and continued flows of productive investments. The ambitious goals of $50 billion in investments and a 9 percent investment rate by 1994 would then become a realistic possibility.

The Salinas administration's record of privatization is good, but not great. A great deal has been done, but a great deal more remains to be achieved. Salinas should seek structural reform in the juridical system to guarantee private ownership; lift restrictions on foreign investments; expand the program to "strategic" sectors of the economy; end the extant regime of price and exchange controls; and formulate public awareness programs together with a policy of "popular capitalism" designed to expand equity ownership among the citizenry.

A basic ingredient for economic modernization and prosperity is market-oriented reform. In Mexico, the fundamental re-orientation of the national privatization program is essential to bring about a climate of sustained stability and economic growth. A free, modern and prosperous Mexico would then simply be a matter of time.

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