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LATVIA PRIVATIZATION ASSISTANCE

FINAL REPORT

SEPTEMBER 30, 1992

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DELIVERY ORDER #4
LATVIA PRIVATIZATION
ASSISTANCE

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DO #4

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SECTION I

Summary of Activities and Accomplishments
May 11 through August 31, 1992

A. Report Organization

The report identifies objectives, discusses accomplishments and compiles the documents prepared during the reporting period May 11 through August 31 under Coopers & Lybrand Indefinite Quantity Contract EUR-0014-C-00-1058-00, Delivery Order No. 4. Chemonics International, subcontractor to Coopers & Lybrand under the IQC, provided significant technical input during the reporting period.

Section I discusses the objectives and work accomplished. Section II provides a compilation of major papers and reports completed under the Workplan for the reporting period. Section III provides a compilation of monthly reports submitted to AID and Section IV includes the Workplan for Delivery Order No. 4 and a draft Workplan for the follow-on Delivery Order No. 9 for the period September 1, 1992 through June 30, 1993. The Annexes compile the Latvian laws translated into English and the contacts made by the team during the reporting period.

B. Project Objective and Activities

The project objective is to develop appropriate strategies and work plans for the Latvian Ministry of Agriculture to privatize four agroindustry sectors and to privatize one enterprise in each of these sectors on a pilot basis.

The specific activities for the reporting period included:

1. Develop working relationships with Latvian officials and other Latvians involved with privatizing agroindustry enterprises.

2. Review and comment on enabling legislation guiding agribusiness privatization in Latvia for the processing and service subsectors.

3. Review and comment on the progress of collective and state farm privatization and develop an acceptable model for dairy producers' associations.

4. Determine the economic relationship between dairy producer's associations and state owned central processing companies.

5. Assess the status of phase II implementation of collective and state farm privatization and make appropriate recommendations.

6. Develop guidelines for the management and control of state enterprises in a partially privatized environment.

7. In conjunction with the Ministry of Agriculture, identify four priority subsectors within which model privatizations will take place.

8. Develop a detailed workplan for the follow-on period September 1, 1992 through June 30 , 1993.

C. Status of Planned Activities

At the start of the period it was expected that enabling legislation governing privatization of agricultural processing and service industries would be enacted by the end of August 1992. This would provide the basis for the actual start of privatization activities by September. For various reasons this did not occur.

The Latvian government placed major emphasis on the dairy industry during the reporting period (as reflected in the above activities which were taken from the workplan -- see Section IV). Consequently, there was no progress by Latvian authorities on developing enabling legislation for other agricultural processing subsectors and for agricultural services. As a result, the team was unable to complete planned activities regarding the agricultural service sector (activity 2 above.) The MOA requested that these activities be carried forward and incorporated into the Phase I activities of Delivery Order No. 9. (See letter from Minister Gegers in Section IV.)

All other planned deliverables were completed on schedule (Activity 1, and activities 3 through 8 above). Papers for activities 3 - 6 are included in Section II. Valuable contacts and working relationships were developed during the period (activity 1) which will facilitate follow-on technical privatization and training activities and industry facilitation and preparation studies for the other priority subsectors.

By the end of the reporting period, three separate pieces of privatization enabling legislation were being formulated: one for dairy processing, one for processing of other agricultural commodities such as grain, flax and sugar beets, and one for agricultural services including tractor and machinery hire. Enabling legislation for the dairy processing subsector is now expected by mid October. The schedule for the remaining subsectors remains unclear.

The team devoted a significant block of time to the English translation of Latvian Laws affecting privatization and to translating the several drafts of the dairy processing privatization law. Detailed comments were made on each draft. These, and technical documents compiled in Section II were translated into Latvian. Many of the suggestions made were incorporated into subsequent legislative drafts. Several Latvians commented that we were the only expatriate team taking sufficient interest in the process to read and

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comment on their legislation. As a result of this effort the team was able to gain valuable insight into underlying objectives of the various players and to provide additional insights and guidance to Latvians responsible for writing the enabling legislation.

Working in conjunction with the Ministry of Agriculture the following four priority agroindustry sectors (Activity 7) were identified as targets for privatization under Delivery Order No. 9.

- dairy processing
- meat processing
- grain milling
- machinery and tractor services

To implement the MOA priority emphasis on the dairy subsector as reflected in the workplan, the team visited more than 25 central, regional and local dairy processing plants and collecting stations during the period. Many small scale and large scale farmers were also visited. Numerous conversations with Government and private sector individuals were held regarding agricultural and agroindustry privatization in general and dairy industry privatization in particular. Information on the cost structure of milk production and processing was gathered and evaluated. These contacts and data provided the basis for completing analysis and recommendations required in activities 3 - 6. The discussions gave the team information required to develop a short list of dairy processing plants to be privatized, and assisted in educating industry and government officials in the privatization process.

D. Implications of Work Accomplished

Privatizing enterprises in the dairy industry will be a unique experience. There are two interrelated reasons:

a. Unlike other agroindustry sectors farmers have expressed an interest in acquiring ownership of state assets to be privatized. This interest was forcefully expressed in the Resolution of the Latvian Supreme Council (April 15, 1992) setting out the terms and assumptions for privatizing the dairy processing industry. Under this Resolution, majority control of assets were to be allocated to dairy producers through membership in dairy producer associations.

b. Farmer organization into producer cooperatives will require major effort during the dairy processing privatization process. The C&L agroindustry privatization team will not be directly involved with this effort as it is outside the project scope of work. But, full completion of enterprise restructuring from the state to the private sector will depend on successful organization of farmers into the required associations.

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The dairy processing industry is highly inefficient as presently organized. There is a high level of underemployment and disguised unemployment at all levels. Many processing plants are operating at less than 70 percent of maximum capacity. Milk production has been on a downward slide since the peak year of 1988. The processing industry will face major plant restructuring and closings either during the privatization process or in the subsequent next few years. At the end of the reporting period, this issue was under intense scrutiny by the Parliament and it is not clear whether the emerging legislation will support restructuring during enterprise transformation from state to private entities or defer it to the post privatization period as was done with collective farms. Latvia does not yet have a workable bankruptcy law to guide enterprise liquidations.

The resolution of the above issues can have important consequences on the privatization of the dairy industry. But, it should not materially affect plants targeted for model privatizations, **if economic efficiency is used as the primary plant selection criteria.** Using economic efficiency as the primary criteria for plant selection will ensure plant viability after privatization.

Under the Resolution all but ten large central plants (subsequently reduced to six) were to be privatized during phase I. The plants exempted by the Resolution were to be privatized during phase II. In practice this means that more than 140 individual plants are scheduled for privatization during phase I. Most are organized into local and regional geographic/economic units with the smaller plants having administrative, financial and marketing ties with larger regional and central plants. The separation of plants into two groups effectively breaks up the existing structure whereby regional and local plants are considered cost centers for the larger central plants. Under the existing structure profit and loss are calculated only for the complete entity (the Kombinat) and not for individual plants. For project privatization purposes, all local and regional plants privatized under phase I will be evaluated as self-contained profit centers.

Based on work to date the team suggests that up to five phase I and a similar number of phase II plants be shortlisted for selection as model privatization sites. One shortlisted firm should be selected for Phase I model privatization and one for Phase II. Phase I technical privatization activities could begin as early as the first part of November. Phase II privatization, if undertaken, is most likely to start after the new year.

Phase I and Phase II plants have different organizational financial, employment and marketing attributes. Most viable plants to be privatized in phase I hire from 50 to 150 employees, have an annual processing capacity of 40,000 to 80,000 tons but have only a limited opportunity for foreign investment. Capacities for Phase II plants are larger (80,000 to over 200,000 tons, annually), employment is greater (150 to 400 workers), the milk collecting area is larger, and the potential to develop western niche markets and attract foreign investment may also be present.

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In both cases, to meet project objectives, **the primary selection criterion must be a high potential for short and long term individual plant economic viability within the developing market economy of Latvia and the NIS.** Since there is but limited, if any, potential to interest foreign investors in the plants to be privatized during phase I, this does not need to be an important selection criteria. However, **the potential to attract western foreign investment should be a second criterion for the selection of a larger central or specialized plant for model privatization.**

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II. PAPERS AND REPORTS

Comparison of Privatization Methods

Privatization of Latvian Agriculture: Preliminary Description and Analysis

The Supervision and Control of State-Owned Enterprises in Latvia

A Model for Privatizing Dairy Processing Plants in Latvia

Current Status of Collective and State Farm Privatization and Models for Dairy Producers Associations in Latvia

METHODS OF PRIVATIZATION
IN
CENTRAL AND EASTERN EUROPE

I. OBJECTIVES OF PRIVATIZATION

- A. Improved ownership
- B. Fair/equitable
- C. Speed

II. SALE (Germany, Hungary)

- A. Difficult to find good owners
- B. Slow
- C. Drain on private capital
- D. Fair

III. VOUCHERS (Czechoslovakia, Lithuania, Mongolia)

- A. Widespread ownership
- B. Complicated
- C. Fair

IV. INSTITUTIONAL OWNERS (Poland)

- A. State influence/control
- B. Slow

V. GIFT TO WORKERS (Russia, Yugoslavia)

- A. Encourages worker support
- B. Poor ownership
- C. Not fair

VI. "BOTTOM UP" OR SPONTANEOUS PRIVATIZATION (Czechoslovakia)

- A. Fast
- B. Unpredictable
- C. Encourages worker/manager support
- D. Unfair

R. Anderson (May 18, 1992)

PRIVATIZATION OF LATVIAN AGRICULTURE:

PRELIMINARY DESCRIPTION AND ANALYSIS

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Coopers & Lybrand
Washington, DC

23 May 1992

INTRODUCTION

This paper presents a preliminary analysis and description of the Latvian privatization program for the agricultural sector. It is based on a limited number of interviews with government officials, agricultural experts, and managers of agricultural enterprises and farms and a review of laws and other background material. The views and conclusions expressed here are entirely those of the author, are tentative, and may prove to be incorrect upon further detailed analysis.

In discussing the privatization program, it is useful to divide the agriculture sector into five subsectors since a different approach to privatization may be used for each. These are:

- land
- former collective and state farms
- service industries that provide inputs into farming (for example, fertilizer, chemicals, animal feeds, equipment supply and repair);
- small scale processing industries closely connected to the state/collective farms (for example, grain drying and storage, local sawmills, milk collection); and
- large scale processing industries (for example, dairy processing, flour mills, bakeries, flax processing, meat processing).

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*A team of consultants from Coopers & Lybrand and Chemonics have begun a long term program of technical assistance to the Latvian Ministry of Agriculture under a contract with the US Agency for International Development. This technical assistance is to support the Government of Latvia's program of privatization for the agriculture sector.

ORGANIZATION OF THE PRIVATIZATION PROGRAM

The Latvian Supreme Council has enacted a number of laws concerning privatization and more are anticipated. In contrast to most other central and eastern European countries (CEE), privatization is not centralized in a single government agency. In Latvia, there is a Ministry of Economic Reform that coordinates the overall process and recommends legislation, but implementation seems to be the responsibility of various sectoral ministries such as the Ministry of Agriculture.

With regard to a general privatization program for all enterprises, the Supreme Council on 3 March 1992 enacted a resolution that set forth certain broad principles of privatization and a timetable for the enactment of other laws that would implement these principles for each sector of the economy. Though further legislation has been proposed, the Supreme Council has not yet specified the details of the general privatization program.

PROGRESS OF AGRICULTURAL PRIVATIZATION

In contrast, agricultural privatization seems to have proceeded on a faster and separate track from the rest of the economy. In fact, privatization of Latvian agriculture may be more advanced than in any other CEE country. It seems that both land and farms have already been privatized to a great extent.

A number of laws have been enacted to carry out agricultural privatization. The two most important to date appear to be:

- a law on land reform enacted on 7 October 1990 which specified how land is to be privatized; and

- a law on agricultural enterprises enacted on 21 June 1991 which specified how collective and state farms are to be privatized and broken up into smaller units.

Laws concerning the privatization of agricultural service and small scale processing enterprises are being developed by the Ministry of Agriculture. It appears that the privatization of large scale processing enterprises, however, will be carried out under the general privatization program along with other large industrial enterprises. As noted above, legislation for the privatization of industrial enterprises has not been enacted by the Supreme Council.

Any program of agricultural privatization and restructuring in CEE countries is likely to be complicated and difficult to implement. Furthermore, this privatization in Latvia is taking place in the middle of the movement for independence from the former Soviet Union, the liberalization of price controls on agricultural products, and a severe economic recession caused by the fragmentation of the former CEE market. It is remarkable that Latvia appears to be so successful thus far.

REASONS FOR SUCCESS

There are two possible reasons why agricultural privatization has proceeded so rapidly compared to the rest of the economy:

- almost all farmers and rural workers are ethnic Latvians. This avoids some of the problems in urban industries where a majority of the workers and managers may be ethnic Russians. Privatization of the industrial sector may not be possible until the basic question of who qualifies for Latvian citizenship is answered;

- the basic principle of agricultural privatization seems to have been accepted politically. This principle appears to be that the agricultural sector should be returned to its former owners and structured initially in the same way that existed prior to about 1940 when Latvia was "occupied" by a foreign power, namely, the Soviet Union.

Because of this basic principle, agricultural privatization has emphasized:

- the restitution of land and other assets to the original owners or their heirs;

- the break up of the large collective and state farms created under the Soviet system; and

- the joining together of the new smaller private farms in various forms of producer cooperative associations which existed prior to 1940 (for example, cooperatives that owned the service and small scale processing enterprises).

The following will describe the progress to date and plans for privatization in each of the subsectors identified above.

LAND

Prior to the land privatization program, roughly 10 percent of agricultural land was used by private farmers (including small garden plots worked by collective and state farm employees) with most of the balance being under the control of collective and state farms. Thus the privatization of land is linked to the privatization of the state/collective farms, and the two programs must be integrated and consistent.

The laws on land privatization envision that privatization would occur in two phases:

- local land commissions would allocate state land including the land now used by state/collective farms to new users according to various priorities established by law; and

- beginning in 1993, actual title or ownership of the land would be transferred or sold to these new users.

The priorities or methods for allocating land among competing claimants is not entirely clear, but first priority is given to the owners of the land in 1940 or their heirs. Over 100,000 former land owners or their heirs requested land. To the extent possible, the actual land previously owned is to be returned. If a new structure (for example a cow shed owned by a collective farm) has been constructed on the land, substitute land is provide. Alternatively, the law permits monetary compensation in the form of securities which can be used to purchase other state property. It appears that most former owners have received the same land or substitute land. Second priority seems to be expansion or creation of private farms and garden plots. Third, the balance of the land remains under the control of the existing state/collective farms.

This process is not complete, and we have not seen statistics on the final land ownership pattern. It is clear, however, that the size of state/collective farms will be reduced perhaps from an average of about 3,500 hectares per farm to about 1,500. When the state/collective farms are themselves privatized, this remaining land will pass into private use and eventually ownership.

Originally, the land privatization law envisioned that claimants, in particular, former owners, would actually have to farm the land by 1996 before they would be given clear ownership. In submitting a claim to the land commission, the claimant had to provide a use plan showing when and how the land was to be farmed. Until the new owner actually begins to farm the land, the state/collective farm would continue to farm the land and may continue to use the land indefinitely if the claimant did not begin to farm the land by 1996.

There seems to be a proposal to change this land use requirement so that ownership would pass to the previous owner regardless of whether this person actually farms the land. This has created some concern and uncertainty for the state/collective farms since this would reduce their use of land even more.

Though the use of the land is allocated to private farmers in the first phase of the privatization, the law seems vague about how or under what conditions legal ownership (title) will be transferred in the second phase. The previous owners will not have to pay for the land returned to them, but the law seems to permit the state to charge for the land allocated to new owners. What this price may be is unclear. In the meantime, the state charges a token rent to the users.

Compared to farmers in Western countries, farmers in Latvia seem to be unconcerned about their lack of clear ownership of the land which they now use. This may reflect decades of socialist thinking where right to use was more important than legal ownership since the state owned almost everything. The ability to sell and mortgage land, however, is essential for the functioning of a private market system, and the ownership of the land should be clarified as soon as possible.

Some experts suggested that the land commissions gave out too many small plots resulting in inefficient sized farms and that many previous owners do not have the ability or interest to actually farm the land restored to them. Legal ownership and thus the ability to sell land allows the size of farms to be rationalized and ownership transferred to those who are the best able to use the land. In the meantime, anecdotal evidence suggests that private farmers are leasing or even selling the right to use the land amongst themselves. In other words, a private market for buying and selling land already exists.

STATE/COLLECTIVE FARMS

Prior to privatization and restructuring, the typical state/collective farm was a large operation with an average size of about 3,500 hectares, 300 employees, 2,500 animals, 45 tractors, and 55 combines. It also operated various service and processing facilities such as grain drying and storage, machinery repair, saw mill, potato cellar, and so forth. It also owned flats and houses used by the employees and sometimes factories unrelated to farming such as those manufacturing clothing or candy.

In order to restore the structure of Latvian agriculture prior to 1940, the goal is to break up these large farms into smaller units with no more than a few owners each. This break up is called "personification" in contrast to "collectivization" reflecting the belief that private farms with no more than a few private owners will result in a more productive and efficient agricultural sector. This, however, is a giant task given that there are over 600 of these farms to be restructured and the break up of each farm is likely to be complicated.

The large scale of state/collective farms and the need to restructure them is not unique to agriculture. Many industrial enterprises in the CEE also are too large to be efficient and require restructuring. There is an ongoing debate about whether these industrial enterprises should be restructured and broken up prior to privatization. Alternatively, it is argued that they should be privatized with their current structure and the new private owners allowed -- but not required -- to restructure them. The new owners could decide if restructuring is necessary.

Latvia has adopted a unique approach to this problem with regard to agriculture. The state/collective farms are first privatized with their current structure, but the new owners are required to then restructure them after privatization.

This process of privatization followed by mandatory restructuring begins with the transfer of ownership of the state/collective farm to a new private corporation. The new corporation is owned by the current workers, retired workers, and individuals whose property (other than land) was taken over by the farm when it was created. Each owner is given shares in the new corporation with no payment required according to rules established by law.

The two basic rules for determining the allocation of shares seem to be that:

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- farmers (or their heirs) whose property was taken over by the collective are given shares in the new corporation as compensation. Note that this property does not include land since the land is to be restored to previous owners under the land privatization law discussed above. The property including here is primarily buildings, equipment, and animals. No more that 51 percent of the shares in the new corporation can be distributed to former private farmers.

- the balance of the shares are to be distributed to existing or retired workers of the farm according to years of service and salary.

It appears that some workers could receive shares under both categories since they contributed property to the founding of the state/collective farm and have worked for the farm subsequently. Naturally, we heard complaints that these rules are unfair to one group or another. We are not certain how many state/collective farms have been converted into corporations thus far.

As part of the conversion into a corporation, the assets of the farm (excluding land) are valued primarily based on some variation of accounting or book value. The par value of each share in the corporation is then set so that the total value of the shares just equals the total value of the assets. As is discussed more below, this valuation is now much too low because of subsequent inflation and, in any event, it can be argued that it was not necessary to put any value on the shares.

The subsequent restructuring or breakup of the new corporation is for all practical purposes made mandatory by a special provision of the law. This provision says that any holder of shares in the new corporation can claim ownership of some of the real assets of the corporation. This shareholder can propose to trade his shares at par value for real assets with the same book value. The corporation then has 30 days to permit another shareholder to make a higher bid. The real assets are then to be distributed to the highest bidder.

The consequence of this provision seems to be that a minority of shareholders can force the breakup of the former state/collective farm even if a majority would like to continue to work for this large organization. Also the allocation of part of the land of the state/collective farm to other users as part of the land privatization program also forces a restructuring of the farm since the farm has too many animals, employees, and excessive equipment for the land available for its use. We visited two former collective/state farms that have begun the process of breaking up. We understand that no such farm has been completely broken up, but these two farms were the most advanced.

The process used by these farms to carry out an orderly restructuring seemed to be to divide themselves up into 20-30 operating units (refereed to as "objects" in Latvian.) Some units would include part of the land and necessary facilities and animals to make a viable economic farm, for example, a pig farm. Other units might include part of the service or processing facilities, for example, a saw mill, potato cellar, or equipment repair shops. Also some of the animals and pieces of equipment were to be sold individually to shareholders in exchange for shares. The flats and houses were also sold for shares to their occupants.

It seems that the more ambitious or adventurous workers of the state/collective farm either individually or jointly with other workers would try to carve out a farm or business from the collective assets. For example, they would bid for one of the economic units, for individual pieces of equipment and animals to go with the unit if necessary, and for a flat or house to live in. The shares in the new corporation can be freely bought or sold among the existing shareholders (it does not appear that outsiders can buy shares). For example, younger workers might buy shares from retired workers who do not want to begin farming again.

One famous case was described where a high government politician happened to be a worker at one of the state/collective farms and ended up trading shares for a valuable clothing factory operated by the farm. Though there seems to have been questions raised about the transaction, it appears that he purchased enough shares from his fellow workers at freely negotiated prices so that he could buy the factory.

There is a lot of concern that the value of the shares and the assets are too low because of inflation. But since the shares can only be used to buy the assets of the corporation, the overall level of share value and asset value is not important though it would be desirable if the total share value did match the total book value of the assets. Only if auctions are permitted in which outsiders bidding with rubles are in competition with shareholders bidding with shares does the par value of the shares become important.

There are two important relationships between the land privatization law and the laws on the privatization of state/collective farms. First, the shareholders who trade their shares for an operating unit of the former state/collective farm can obtain the right to use some of the land of the farm if that is included as part of the unit. Like all other farmers, the state/collective farm does not own the land it is using and thus can not sell the ownership of the land. It can only transfer the right to use the land. As with other land allocated to new users, the former shareholders will want to obtain clear ownership of this land obtained from the former state/collective farm and may be concerned about the possibility that they may be asked to pay for the land in the future.

Second, under the land privatization law, a considerable proportion of the land previously used by the state/collective farms was transferred to other owners. Thus the state/collective farm became land poor relative to its equipment, facilities, and animals. Meanwhile, the new owners of land previously used by the state/collective farm need equipment and animals. For example, shareholders who wish to buy the state/collective farm's cattle raising unit may not be able to obtain enough land from the state/collective farm to support the cows included in the unit. The new owners need either to sell cows to other farmers or to buy land from other farmers. How this will all be sorted out is unclear though it emphasizes again the need for land to be freely transferrable.

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It seems to be an almost overwhelming task for the new shareholders to carry out such a drastic restructuring of the former state/collective farm. The former workers with little experience with Western business methods have suddenly become the shareholders in a corporation whose first activity is to break up the corporation. This would be a daunting task for the owners and managers of a Western corporation much less for the inexperienced new owners of a former state/collective farm. One only hopes that this restructuring does not disrupt farming activities leading to possible food shortages and high prices.

The major advantage of this approach, however, is that restructuring is to be carried out by those individuals most familiar with the operation of each farm, namely the former workers and managers rather than government bureaucrats. In effect, the farmers are allowed to determine their own future within the parameters of the law. If successful, this privatization and restructuring could be a model for other CEE countries.

PROCESSING ENTERPRISES

The basic philosophy of the privatization of small scale or first level processing enterprises is to restore their ownership to producer cooperatives. A decree has been issued that mandates this form of ownership for small satellite dairy processing facilities. No law has yet been enacted to implement this philosophy for other types of processing enterprises though a draft is being prepared by the Ministry of Agriculture.

The belief is that producer cooperatives had a major role prior to 1940 in owning and operating facilities that processed farm produce. These cooperatives are to be recreated and ownership of processing facilities transferred to them. It is unclear whether the transfer will be free or a payment required.

If for whatever reason, a producers cooperative does not come forward to claim ownership of the processing facility, then the concept is that the workers at the facility could become the owners. If they are not interested, then the facility could be sold any other interested investor.

It seems that large scale processing facilities were not historically owned by cooperatives and are likely to be privatized in the same way as other large industrial enterprises. As noted above, the government has not yet developed a strategy for privatizing large industrial enterprises including large agricultural processing facilities.

SERVICE ENTERPRISES

As with processing enterprises, the philosophy of the government seems to be that ownership of those enterprises or facilities that provide inputs into farming are also to be transferred to producer cooperatives. In the existing privatization laws for state/collective farms, cooperatives created by former workers of the farm are to be given priority in exchanging their

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shares for the service facilities of the farm. A new law, however, will be needed to transfer ownership of service facilities not owned by a state/collective farm.

COOPERATIVE OWNERSHIP

The emphasis on the recreation of cooperative forms of ownership raises a number of issues that need further analysis:

- are farmers interested in creating producer cooperatives? There is a feeling among at least some farmers that cooperatives are similar to the type of collective ownership that existed previously in CEE countries and they do not wish to repeat this experience.

- even if farmers are interested in creating producer cooperatives, are they able to do so in the near future? For the time being, they are likely to be preoccupied with the break up of the former state/collective farms and the creation of new privately owned farms. One expert suggested that the privatization of processing and service enterprises should be delayed giving the farmers more time to organize cooperatives.

- is the type of ownership structure based on cooperatives that existed in 1940 the best structure fifty years later?

- if cooperatives prove not to be a successful form of ownership in Latvia, is it possible for ownership of processing and service facilities to be transferred to other types of owners (individual proprietorships, corporations, limited liability companies, partnerships, etc.). In other words, will the new ownership structure based on cooperatives be allowed to evolve and change if necessary.

CONCLUSION

The program for privatization of the agricultural sector in Latvia is innovative and has progressed faster than privatization of other sectors. The privatization of both land and state/collective farms seems well on its way to completion though there are problems that could still block the process. The privatization of the agricultural service and processing industries has just begun. The emphasis on cooperative forms of ownership for these industries raises important issues that need further analysis.

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THE SUPERVISION AND CONTROL OF STATE-OWNED ENTERPRISES IN LATVIA[1]

INTRODUCTION

The Latvian government is likely to continue to own a number of enterprises until they can be privatized. Because the time necessary to privatize these enterprises is uncertain and some enterprises with special characteristics may never be transferred to private ownership, it is necessary for Latvia to develop a system for the monitoring, supervision, and control of these enterprises. Hereafter, these enterprises will be referred to as "state-owned enterprises" (SOEs).

There is considerable experience in other countries with the supervision and control of SOEs. This paper will survey and analyze this experience and will make tentative recommendations for Latvia.

In brief, this paper recommends that the government of Latvia should adopt a relatively "hands off" approach to the supervision and control of SOEs and have only limited involvement in their management. Instead primary responsibility for the management of an SOE should rest with a board of directors appointed by the government. Such a board of directors should consist only of experienced managers from other enterprises, private businessmen from Latvia, and foreign businessmen. The board should not include either government officials or managers of the SOE under the supervision of the board.

The objective of the board of directors is to assure that the enterprise is as efficient and profitable as enterprises not owned by the government. These enterprises should not be given social or political objectives that conflict with this primary objective. In other words, the SOEs should have the same commercial or profit-oriented objectives as a company wholly privately owned.

PUBLIC SECTOR EXPERIENCE

While these enterprises remain in the ownership of the government of Latvia, it is important that they be made as efficient and profitable as possible. This will increase revenues to the government since these enterprises should be expected to pay dividends to its owner, the government of Latvia, just like enterprises not owned by the state. This will also reduce the need for the government to subsidize loss making enterprises. Also, SOEs that are profitable will sell for a higher price to private investors when the decision is made to privatize these enterprises.

There are four important conditions that must be satisfied to create an environment that will encourage SOEs to be efficient and profitable:

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[1] R. Anderson, July 6, 1992

1. Competition. A major incentive for an enterprise to be efficient in all countries is competition from other enterprises selling the same products and services. The difficulty in many countries is that the managers of SOEs often argue that the government should protect them from competition. They argue that competition will force them to lower prices and thus reduce their revenues and profits. As a result, governments often give their state-owned enterprises a monopoly on the sale of certain products and services by prohibiting domestic enterprises from selling the same products and by putting high tariffs on imported products. The end result, however, is often an inefficient and money losing state-owned enterprise that the government must continue to subsidize, and the public must pay excessively high prices for lower quality products.

2. Hard Budget Constraint. Another common problem with SOEs in other countries is that the government gives these enterprises access to easy or soft credit. When the SOE loses money and can not pay its workforce, it has access to bank loans on favorable terms often from banks also owned by the government. The past practice in the Soviet Union was for the central bank to create financial credits which the state-owned banks then lent to state enterprises. Though in theory these loans were supposed to be repaid by the enterprises, the enterprises often did not invest the money in new capital or improving or expanding the operation of the enterprise. Instead the money was often spent simply to pay for current operating expenses including salaries for employees. Thus these enterprises will never be able to repay these loans. Though called loans, they are in fact subsidies to money losing enterprises.

3. Separation of Commercial and Social Objectives. A basic problem faced by all countries in creating a system to monitor and control SOEs is how to deal with the conflicting commercial and social objectives that are sometimes given to these companies. These social objectives might include hiring more employees than are necessary, refusing to lay off or fire surplus workers, keeping prices low for some classes of customers, investing in certain regions of the country, and so forth. These social objectives reduce the profitability of SOEs and often result in them losing money. As a result, the government has to cover their losses by subsidies from the budget or in indirect ways such as providing soft loans or credits.

This conflict between commercial and social objectives makes it difficult for the State to monitor and assess the performance of an SOE. For example, an SOE may be losing money because of incompetent managers and inefficient operations or because it is pursuing costly social objectives that either increase its costs or reduce its revenues. For example, is a state-owned bakery losing money because it has outmoded equipment and an excessive number of employees or because it is required to charge a low price for its bread? Because of the difficulty in judging the performance of such an enterprise and thus its managers, there is less incentive for the managers to improve performance.

4. Effective Monitoring of Enterprise Performance. The government as owner of an SOE must put in place a system to monitor, supervise, and control the managers of the enterprise to make certain they are doing their utmost to improve the efficiency and profitability of the enterprise. Without such supervision by the owner, the managers may exert little effort to improve the enterprise or grand themselves excessive salaries and other benefits.

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Various countries have attempted to create these four conditions necessary for efficient and profitable state-owned enterprises. This has proven to be very difficult and most countries have had only limited success. As a result, SOEs in many countries continue to be very difficult and most countries have had only limited success. As a result, SOEs in many countries continue to be inefficient, high cost, and loss makers requiring large subsidies from the State. This has resulted in the trend around the world towards privatization whereby SOEs are transferred to private ownership. As long as enterprises remain in state-ownership in Latvia, the government of Latvia must attempt to create these conditions for improved performance of state enterprises. In most cases, the final objective, however, should be privatization.

The following reviews the experience in other countries which have put in place systems for the management of state enterprises and makes recommendations for Latvia.

PAKISTAN

Pakistan has a centralized and highly quantified approach to measuring and rewarding performance by managers of SOEs. The government of Pakistan owns 70 SOEs. The SOEs report to a Ministry of Production. An Experts Advisory Cell in the Ministry has a key role in developing an elaborate and complicated system for measuring performance by the managers of each of the SOEs. This system is called the Public Enterprises Performance Information System (PEPIS).

Using both domestic and foreign management experts, Pakistan took over six years to develop the PEPIS system. Its use is described in a 600 page manual. Under this system, targets are set for the managers of each SOE in consultation with the Ministry of Production. Managers can earn a bonus up to four months salary for achieving the highest targets.

Initially it was planned that PEPIS would evaluate managers according to the "public profitability" of their enterprises. Public profitability is meant to encompass both private profitability and also the benefit of achieving various social objectives. Thus managers would be rewarded according to how they achieved both the commercial and social objectives assigned to the enterprise.

In practice, this proved impossible and instead the primary criteria is private profitability but with various adjustments to account for the social objectives that each enterprise is required to achieve is these objectives reduce profitability. The system evolved considerably over time. The end result was a centralized and somewhat mechanical system for rewarding managers.

AUSTRIA

Austria has placed all of its SOEs under the ownership of a large state-owned holding company. This holding company, Austrian Industries AG (OIAG), accounts for approximately 20 percent of industry in this country. The OIAG in turn owns about 70 individual SOEs.

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The organization and management of OIAG has gone through two distinct phases that provide important lessons for Latvia. From the end of the Second World War to about 1986, OIAG was an important instrument for achieving national economic and social objectives and was under strong political influence. For example, the political affiliation of the members of the boards of directors had to follow the party representation in parliament. Even top managers were chosen for their political or party affiliation. Under this form of organization, OIAG was losing money and required large government subsidies.

In 1986, the Austrian parliament enacted legislation that fundamentally changed the OIAG. Most importantly, OIAG was brought under private corporate law which eliminated any obligation of OIAG to achieve social or political objectives, and greatly limited the influence of the government over its operations.

The key to the new structure is that the board of directors of OIAG is primarily composed of private businessmen rather than government officials or politicians. The parliament's involvement is limited to receiving an annual report on the performance of OIAG.

The supervision and control of the individual SOEs owned by OIAG is carried out along two paths. From the top, the OIAG sets targets to be achieved by individual SOEs. These targets are primarily the rate of the return on investment and the dividend to be paid by the individual SOEs.

From the bottom, the individual SOEs prepare business plans and budgets that show how they will achieve these targets. These are consolidated and incorporated into the overall business plan and budget for OIAG.

KOREA

The 24 SOEs in Korea account for about 10 percent of the nation's gross domestic product. This is approximately the same ratio as in India and Pakistan.

As in Austria, the Korean system of managing and controlling its SOEs had two phases. Prior to 1984, the day to day management of the SOEs in Korea was heavily influenced by the government. Many executives were selected according to political criteria rather than management ability. Various government agencies had conflicting and overlapping responsibility for the performance of SOEs. As a result, the SOEs had a much lower average rate of return on capital invested compared to enterprises that were privately owned. Many were losing money and required large government subsidies to stay in operation.

In 1984, legislation established a new system for managing Korean SOEs. Through the SOEs still report to sectoral ministries in the Government, much of their authority was transferred to a new Management Evaluation Council. The new legislation requires that the sectoral ministries guarantee the managerial autonomy of their subordinate SOEs. The sectoral ministries do still appoint the members of the board of directors of each SOE at the recommendation of the Chairman of the Board.

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As in the case of Pakistan, monitoring and control of the SOEs seems to be centralized in the newly created Management Evaluation Council. In controlling the SOEs, the Council relies primarily on a complex management evaluation system that can award bonuses to managers up to three times their monthly wage.

The Council is composed of 11 government ministers and a number of experts form the private sector. The Council is assisted by a special government agency (The Public Enterprise Evaluation Bureau). In addition, a Performance Evaluation Task Force is created to assist with the management evaluating system and is composed of experts form universities, private businesses, and accountants.

The new system seems to have been a success. By one estimate, the SOEs have been able to achieve cost reductions of about 13 percent over three years since the introduction of this system.

ITALY

Italy has a large State-owned holding company, IRI, which is structurally similar to the Austrian holding company. The Italian system for monitoring and controlling IRI, however, is different from Austria and may provide a useful model for Latvia.

As in Austria, IRI owns a total of more than 300 individual SOEs. In some cases, the SOEs are only partly owned by IRI, have substantial private ownership, and their shares are traded on the Italian stock exchange. Total sales of IRI companies is over $40 billion and accounts for about 3.3 percent of total value added in Italy.

The most interesting feature of IRI is that it is expected to achieve the social objectives of the Italian government but in a way that does not impair its profitability or economic viability. The most important social objectives have been:

- to invest in the economically underdeveloped parts of Italy, primarily in the south;
- to preserve employment and support sick private enterprises in depresses areas of the country; and
- to invest in strategic industries which are judged to be important to the nation's overall economic development.

IRI receives guidance as to these social objectives from the Minister of State Holdings.

Italian law, however, makes it clear that IRI must not sacrifice its profitability in order to achieve these social objectives. If the achievement of a social objective would reduce profitability, the Italian government is required to compensate IRI in the form of a direct payment to IRI set out in the government's budget. In this way, the cost of achieving these social objectives is transparent and not hidden in the operations of IRI.

This policy is consistent with a directive of the European Economic Community (Directive No. 80/723, 25 June 1980). This directive requires that member States assure that the public receives adequate information about the cost incurred by SOEs in pursuing non-commercial or social objectives.

Another interesting feature of IRI is its relationship with the Ministry of State Holdings. The primary legal responsibility of IRI is to safeguard the value of the State's investment in IRI, in other words, be as profitable as possible. With this objective in mind, there is a close working relationship between IRI and the Ministry concerning the IRI's plans and investment projects. The Ministry provides guidance and comments on the key policies and major decisions made by IRI. In the end, however, the Ministry can not require IRI to follow any particular policy. The Board of Directors of IRI must make its own decision having regard to its legal responsibility to safeguard the value of the State's investment.

IRI submits both its annual business plan and its annual financial reports to the Ministry for comment and review. During the year, IRI also submits information about any major new investment projects or significant revisions or its business plan.

A weakness of the Italian system, however, is the excessive oversight of Parliament. A number of Parliamentary committees are charged with oversight of IRI's operations resulting in numerous and often overlapping committee hearings.

NEW ZEALAND

Prior to about 1986, various government departments and agencies of New Zealand carried out commercial business activities (airlines, railroads, film productions, telephones, electricity, oil and gas, and so forth). Because these enterprises operated under an unclear mixture of social and commercial objectives, it was difficult for the government to monitor their performance. Consequently, most of these business activities were large loss makers.

In 1986, the government decided to reform its management and control of commercial business enterprises owned by the State. These enterprises were first converted into about 15 business joint stock companies and given a financial and management structure similar to a private enterprise. Instead of falling under the jurisdiction of various sectoral ministries, the control of these enterprises was given to a single agency reporting to the Minister of Finance.

The Minister of Finance then appointed experienced businessmen and managers to sit on the boards of directors of these new companies. Government officials, politicians, or representatives of special interest groups were not appointed to the boards of directors. The government believed that appointing anyone other than experienced businessmen or managers would only introduce social and political objectives into the management of the enterprises.

A law was passed establishing the new legal framework for these SOEs. In particular, the law required that these SOEs be as efficient and profitable as companies not owned by the government. Also if the government were to require these SOEs to pursue social objectives that would reduce their profitability, the government had to give the enterprise a subsidy to pay for the cost of this objective. This way nothing was hidden and the cost of the social objective was made public in the government's budget.

The board of directors was given the primary responsibility to assure that the SOEs were as efficient and profitable as possible. The boards had broad authority to control and supervise the enterprise.

In order to encourage greater efficiency, the government eliminated most barriers to competition and required the SOEs to compete against both domestic and foreign enterprises producing the same products and services. Also the enterprises were forced to raise capital through private sources such as banks and were not provided with any capital or subsidies from the government.

The government, however, did monitor the performance of the enterprises and had the authority to replace the boards of directors if they did not appear to be performing satisfactorily. The enterprises were required to submit a business plan to the Minister of Finance at the beginning of each year including financial and performance targets to be achieved over the year. The targets were published so that the parliament and the public could judge whether the enterprises were being well managed. At the end of the year, the SOEs had to publish financial statements that showed their profitability and whether they achieved their performance targets.

Though this system did substantially improve the efficiency and profitability of SOEs in New Zealand, the government concluded that private ownership would still be superior. As a result, the government has subsequently privatized most of the SOEs through sale to private investors from around the world.

RECOMMENDATIONS

The supervision and control of an SOE is complicated by the need to (i) clearly establish the relationship between the government and the SOE company and (ii) determine whether the SOE will be expected to pursue social objectives in addition to normal commercial objectives. Based on the above review of experience with SOEs, the following recommendations are offered for consideration.

1. Corporate State Enterprises. The first step is to convert the SOEs into joint stock companies or corporations. This process is often called corporatization. The shares of stock in the new companies would be owned by the government of Latvia. This conversion will help the SOEs to establish organizational forms similar to companies in Western countries. A board of directors will be the supreme controlling body of the SOE. It has the authority to hire and replace the senior managers and executives of the company, approve all expenditures, establish salaries for all employees, and in general approve the business plans and policies of the enterprise. The board of directors has the primary responsibility to assure that the enterprise is as efficient and profitable as possible and to represent the interest of the owner which is the government of Latvia.

2. Create a State-Enterprise Agency. The government of Latvia should create a special State-Enterprise Agency (SEA) whose function is to monitor and supervise the performance of SOEs. The SEA can be thought of as a holding company that "owns" the SOEs on behalf of the government of Latvia. It is desirable that this office report to a single senior government minister who will be responsible to the rest of the government and the parliament for the management of SOEs. The SEA should have a staff with knowledge of accounting, finance, and business management. This can be supplemented with foreign consultants.

3. Role of the State-Enterprise Agency. The SEA should be the representative of the government of Latvia as owner of the SOEs. Most importantly, the SEA has the owner's right to appoint the boards of directors of the SOEs and to replace them if their performance is unsatisfactory. In turn, the SEA should be responsible for reporting on the performance of the SOEs to the minister responsible for SOEs and to the parliament. The SOEs themselves should not be responsible for reporting to the government or the parliament except through the SEA.

4. Objectives of the State-Owned Enterprises. The primary objective of the SOEs under the control of the SEA should be to maximize the value of the government's investment in those enterprises. In other words, the SOEs should have the same commercial objectives as private enterprises not owned by the State.

If the government should require an SOE to achieve some social objective that would reduce its profitability, the government should provide a direct payment to the SOE to cover the higher costs or reduced revenues that would result. In this way, the cost of achieving social objectives is transparent and included in the budget of the government for public review. If possible, this principal should be established in legislation so that it is legally binding on the government, the SEA, and the management of the SOEs. In all other respects, the SOEs should be subject to same corporate laws that will apply to all private enterprises in Latvia.

5. Monitoring the Performance of the SOEs. Though the SEA should not become involved in the detailed or day to day management of the SOEs, she SEA should:

- require all boards of the directors of SOEs to prepare an annual business plan and financial budget showing how the company will be managed and operated during the coming year. This plan and budget should be reviewed and approved by the SEA;

- require all boards of directors of SOEs to develop financial and performance targets which the SOE will be expected to achieve by the end of the year. These targets should be made public in the form of a "Statement of Corporate Intent" so that the public an determine whether or not the SOEs are achieving their targets.

- over the course of the year, the SEA should receive periodic reports on the performance of the SOEs; and

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- at the end of the year, the SOE should publish financial statements showing its performance over the year including whether it has achieved its performance targets announced at the beginning of the year.

An alternative approach is that used in Korea and Pakistan. Under this approach, the role of the board of directors is reduced. Instead a centralized system of measuring and quantifying the performance of the SOEs and managers is coupled with substantial bonuses for managers.

This approach, however, seems to have a number of disadvantages for Latvia. Most importantly, these systems are complicated and require a great deal of time to design and implement. The approach recommended above is easier and quicker to implement. Over time, the SEA can evaluate the more complicated systems used in such countries as Korea and Pakistan to determine whether they can be adapted for use in Latvia.

6. Financial Structure, Dividend Policy, and Borrowing Policy. An important issue in improving the efficiency and profitability of the SOEs is their ability to raise new capital through borrowing or credit supplied by the State. A serious problem with the management of SOEs in other countries and with enterprises in Latvia has been that they have not been subject to a "hard budget constraint." In other words, they often could rely on receiving an injection of capital from the State or were permitted to borrow from State-owned banks. As a result, SOEs had little incentive to improve their efficiency and profitability.

In order to create a hard budget constraint, two policies are necessary. First the SOEs must be required to borrow from private or state Banks only under commercial terms and conditions. In other world, they must demonstrate to lenders that they have a sound plan for operating the business and that they will be able to repay the loans. Review and oversight by lenders is a major factor encouraging enterprises to improve their efficiency and profitability.

Second, any government subsidy to enterprises should not be in the form of a bank loan. In the past, the government gave credit to enterprises often in the form of a loan from a state bank simply to permit the enterprise to pay salaries and avoid firing workers. If a government subsidy is necessary to support an enterprise, it should not be done through a "soft" loan from a state bank that is likely never to be repaid. Instead the budget of the government should specifically provide for these subsidies and the subsidies should be in the form of a direct payment or grant form the government to the enterprise. At least in this way, the government and public will know the full extent of the subsidies required to support the loss making SOEs.

The second policy concerns the equity capital component of the financial structure. An SOE increases its equity capital in two ways: (i) by retaining some of its profits instead of paying dividends and (ii) injections of new equity capital supplied by the owner, in this case, the State. The SEA must critically review both the payment of dividends and new capital injections from the State. In order to provide a hard budget constraint, the SOEs and the SEA must follow strict policies with regard to the SOEs paying dividends or in providing new equity capital.

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It is recommended that the SEA should review the business plans and budgets provided by the SOEs to determine their need for new capital. If new capital is needed, the preferred option is for the SOEs to borrow the funds from private or state banks on commercial terms and conditions. If that is not possible, and the SOEs can make a convincing case that new capital is needed, then the next option is to permit them to retain more of their profits instead of paying dividends. If retained earnings is still not adequate to supply the capital needed, then as a last resort the SOE and the SEA can consider supplying new equity capital or government loans.

CONCLUSION

Monitoring and controlling SOEs in Latvia is a large and complicated task for the government to undertake. The strategy recommended here is to delegate a large part of this task to a board of directors established for each SOE. These SOEs should be placed under the control of Boards of Directors composed of the best and most experienced business managers that can be recruited in Latvia. Such managers are most likely to have the necessary skill and expertise to improve the efficiency and profitability of the SOEs. The government of Latvia will simply not have the necessary number of staff with the right experience and skills to carry our this task if it is centralized in the government.

Furthermore, the policy should be clearly established that these SOEs have the same profit oriented, commercial objectives as a private company. Any requirement that they pursue social objectives must be accompanied by an explicit payment from the government to compensate for the reduction in profits that will result. If this policy is not followed, it will be almost impossible to create incentives for the SOEs to increase their efficiency and profitability.

This is not to say that the government of Latvia should play no role in the management and control of the SOEs. As in the case with SOEs in other countries, Latvia should create a special agency (the State Enterprise Agency) which should review and criticize the business plans and budgets of the SOEs, agree on annual financial targets, and evaluate whether the SOEs have achieved those targets at the end of the year. If the board of directors of an SOE does not seem to be able to meet reasonable targets, then the SEA may have to appoint new board members.

Finally, the government should eliminate the soft budget constraint that results when the government provides loans and credits through the banking system that can never be repaid. Such credits simply subsidize loss making and inefficient SOEs and postpone the day when these enterprises will have to undertake needed reforms.

August 23, 1992

A Model for Privatizing Dairy Processing Plants in Latvia[1]

A. Background

- Government has identified more than 50 milkeries and creameries to be privatized during Phase I

- Most of the above enterprises have smaller creameries and local collecting and separating stations attached to them. The total number of physical plants that may be privatized under Phase I exceeds 140.

- Government has identified 10 additional large milkeries and specialized processing plants to be privatized in Phase II

- Government policy is to transfer assets to milk producers in plants to be privatized under Phase I. Assets in plants privatized under Phase II can be distributed to milk producers, current and past processing plant employees and to other investors.

- It is the intent that assets of all state owned dairy processing enterprises to be privatized in Phase I and will be transferred to the private sector. In Phase II some assets may be retained by the state. Some assets are transferred at no cost while other assets are sold at prices yet to be determined.

- To receive assets, farmers must be organized into producers associations in accordance with the Law "On Cooperative (Joint Activity) Companies and the "Model Charter of a Dairy Producers Cooperative Association"

- Milk producers must be organized into producers' associations to qualify for assets transferred from milkeries and creameries to the private sector.

- Privatizations of state dairy processing enterprises are managed by Privatization Commissions appointed for this purpose.

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[1] Prepared by Conrad F. Fritsch, USAID Agro-industry Privatization Project. The purpose of this paper is to provide a conceptual basis for discussion of procedures and approaches for privatizing dairy processing plants in Latvia. As such, it does not represent the views of the Government of Latvia, USAID, Coopers and Lybrand or Chemonics International.

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B. Proposed Approach to Conduct Model Privatizations of Milkeries and Creameries

Step 1: Forming Dairy Producers' Associations

One or more dairy producers associations are formed. They include all interested producers delivering milk to the processing plant(s) to be privatized or to associated collecting stations. Farmers not now delivering milk are not eligible for membership. The Agricultural Consultant assigned to the area served by the enterprise to be privatized will assist producers to organize into associations. In many cases, producers' associations may be formed around local level collecting stations and then joined into Unions to represent farmers at the operating plant level.

Step 2: Forming the Privatization Commission

Voting and non-voting members are appointed to the Commission.

Voting Members:

1. A **Commission Chairman** is appointed by the Ministry of Agriculture. This individual should be knowledgeable about the dairy processing industry, have good interpersonal and group management skills and have no personal interest in the outcome of the work of the Privatization Commission. He should not be a public sector employee in the pagast or agricultural district where the plant to be privatized is located.

2. The **Chairman of the pagast** (or his designate) where the plant to be privatized is located. This member becomes the permanent **Deputy Chairman of the Commission.**

3. Representative(s) **of the Dairy Producer's Association(s)** (or **Union of Producers' Associations**) whose members deliver milk to the enterprise being privatized or to satellites of this plant. They are elected by the general meeting of the dairy producer's association(s).

4. The **manager of the enterprise** to be privatized (or his designate).

5. A **non-management employee of the enterprise** being privatized. The representative is elected at a meeting of all non-management employees of the enterprise.

6. A **representative of the Office of the District Agricultural Director** in the district where the enterprise to be privatized is located.

7. A **consumer representative** from the pagast where the plant to be privatized is located. The individual is appointed by the Management Board of the pagast.

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Non-voting members:

Technical experts are assigned to the Commission by the MOA (by state or district officials) as needed, to conduct technical analysis and provide expert opinion. One technical expert, most likely an economist or a person with similar training or experience is appointed as a permanent non-voting member of the Commission. This individual is responsible for taking minutes of the meeting and coordinating the activities of the other technical advisors.

The staff member of the Agricultural Consultancy Service assisting with the organization and development of the dairy producer's associations is also a permanent non-voting member of the Commission.

Step 3: Implementing a Formula to Distribute Assets of the Enterprise

Because of the large number of enterprises to be privatized procedures for allocating assets must be fair, easy to understand and easy to administer. The approach is discussed here and presented in Figure 1.

Action 1:

All assets of collecting stations become the property (free of charge) of the dairy producers association made up of members who deliver milk to the collecting station.

Action 2:

A special restitution asset pool is set up to cover claims of former owners that have not been met by distributing assets of collecting stations under the standard formula.

Action 3:

Thirty five percent of assets remaining after action 1 become the property (free of charge) of the dairy producer's association (if only one association represents all producers at the main plant level) or the Union of associations if such a Union has been formed [2]

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[2] If only one association has been formed to represent all farmers, shares are transferred to this association in the name of all it's members. These funds form the basic and additional shares held by producer-members of the associations. Otherwise assets are owned by individual associations making up the Union. Assets can be distributed in proportion to milk delivered and form the basic and additional shares in the Union.

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Action 4:

Thirty five percent of assets remaining after action 1 become the property (free of charge) of management and non-management employees of the enterprise being privatized. A variable number of equal shares is allocated to individual employees based on a common formula that includes both length of time employed by the plant and total earnings received. (Employees may choose to hold stock shares as individuals, sell them or pool them in mutual stock or pension funds, etc.)

Action 5:

The remaining thirty percent of the assets to be privatized (minus those held in reserve in the restitution pool) are distributed or sold based on the following priority quotas:

a. Ten percent is offered to the management staff of the enterprise group being privatized. The option to purchase must be exercised within one month from the time the sale offer is made.

b. The remaining twenty percent (plus the value not purchased by management staff within the allotted time) is offered to dairy producers' associations (or unions). The option to purchase must be exercised within two months from the time the sale offer is made. After the time to purchase stock by the first two priority groups has expired, the remaining stock is offered to any individual or group of management or non-management staff. The option to purchase must be exercised within two months from the time the sale offer is made.[3]

Action 6:

Any remaining stock is sold to the public at large.

Step 4: Transforming State Enterprises into the Private Sector

The following technical activities are started immediately after formation of the Privatization Commission and are carried out concurrently with activities described under steps two and three above. Decisions to purchase shares offered for sale on a priority basis may use information obtained from analysis conducted under this set of activities.

[3] This offer can be made at the same time that the priority block of stock is offered to management staff. Assets held against claims by former owners which are not distributed to them will become part of the pool available to Producer's Associations.

Action 1:

First Asset Valuation

As required by Latvian law, an initial valuation of all assets controlled by the state enterprise within the jurisdiction of the Privatization Commission is performed according to laws governing asset valuation. Valuations are made for each separate geographic/economic unit, eg. collecting stations, milkeries, and creameries comprising the group of enterprises being privatized. The activity is undertaken by an economist or economic accountant. The legal counsel acting on the instructions of the Commission and the laws of the Latvian Republic prepares legal documents identifying land and non-land assets to be included within the scope of the enterprise group being privatized and draws up documents certifying the value of each geographic/economic unit.

Action 2:

Transforming Collecting Stations into Cooperatives

The legal counsel prepares documents transferring ownership of each collecting station to the respective dairy producers' association.

Action 3:

Business Review and Analysis

A business review and financial analysis is done for the system of processing plants being privatized. The purpose of the analysis is to determine short run profitability. It includes determination of gross margins by product lines, employment levels, inventory turnover, debts and debt structure, condition of productive assets, accounts receivable and accounts payable. Operational efficiency is calculated by comparing industry cost and return data with those in a comparative subsector from an industrialized economy. The analysis is undertaken by an economist/financial planner.

Action 4:

Transforming the Accounting System

Government accounting systems do not accurately portray private enterprise profit or loss status. Existing accounts are transformed using accounting principles and procedures governed by the appropriate Laws of the Latvian Republic. This activity is started simultaneously with the business review and analysis evaluation. It is conducted by a certified accountant or a financial economist with an accounting background. (Note: The Agrarian Economics Institute, along with the Economics/Accounting Dept at Jelgava Univ. is preparing a model accounting format using the Danish accountancy system.)

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Action 5:

Prepare a Model Business Plan

A model business plan is prepared using information from the business review and analysis. It provides a best initial estimate (BIE) of long term profit potential based on realistic price and market conditions. This work is conducted by an economist/planner.

Action 6:

Second Asset Valuation

A second market based asset valuation is completed using an appropriate market based asset evaluation approach. The results are used to estimate the market value of assets using results from the model business plan. Government decisions relating to forgiveness of debt are incorporated into the business plan. The second asset valuation is conducted by a financial analyst/ accountant.

Action 7:

Enterprise Restructuring or Liquidation

Private sector restructuring is initiated only for those plants or groups of plants where the business review and model business plan indicate that the enterprise can be profitably restructured into the private sector. If, based on the previous analysis, the Commission determines the enterprise to be economically viable it is restructured into private ownership. If it is not economically viable alternative options include retaining them as state enterprises or entering into bankruptcy proceedings.

C. Discussion

Step 1: Forming Dairy Producers' Associations

Forming dairy producers' associations may be the most challenging activity of the dairy plant privatization process. Latvia has had no experience with western style cooperative associations for almost fifty years and the former Soviet style cooperatives do not provide an appropriate model. An annex to this paper provides general information on the role and purpose of cooperatives in the Latvian dairy industry.

The cooperative form of business ownership is the most appropriate organizational form for ownership of collecting stations. This is also the level at which most claims by former owners are likely to be made. So, to simplify the process of settling claims all assets at this level are transferred to legally formed, renewed or new producers' associations.

While all producers should remain free to join or not to join a cooperative, the advantages of the cooperative form are greater when a larger rather than a smaller number of producers are members. But, there are costs involved in joining and maintaining a cooperative. Consequently, it is appropriate that producers be given incentives to join.

An individual must invest in shares of the cooperative and usually pay a membership fee. Dairy plant assets transferred free of charge can cover these initial costs and at the same time make each member a part owner of the plant for as long as milk deliveries continue. When no longer delivering milk he has the right to redeem accumulated shares for cash.

The primary purpose of a cooperative association is to reduce costs of services provided to members or to secure and maintain markets. It is a commercial business organization and is an ideal structure to promote improved business practices among small scale farmers with limited business experience. It provides experience and training in group decision making processes. On-the-job examples and formal teaching methods can be used by Agricultural Consultants and other specialists to develop farmer management and decision making skills.

Cooperatives have authority to raise working or investment capital by imposing a charge on producer-members in proportion to milk delivered. This is an important feature in Latvia where a commercial credit and lending system is not yet in place. By raising working capital through patronage deductions (which are usually repaid sometime in the future) the organization has a source of capital at much lower cost than if it was borrowed on the open market. Producers, managers and employees of the plant can all benefit from this approach to raising capital funds.

The following suggestions are made to promote formation of local level producer cooperative associations needed to begin the dairy plant privatization process:

1. Staff of the Agricultural Advisory Services should be trained in cooperative principles and in the practical actions required to organize, develop and manage farmer cooperatives at local levels. Outside donor support should be mobilized for this effort.

2. Local and district representatives of the Agricultural Advisory Services should place priority emphasis on the organization and development of local level producer associations for the next two years.

Local Agricultural Advisors have an extremely important role in cooperative development activities. It is essential that farmers continue to see them as representatives of farmers interests and not as official representatives of the Ministry of Agriculture.

Step 2: Forming the Privatization Commission

Membership in the Commission should be composed of individuals with a direct stake in the outcome of the process and balanced by individuals in a position to take a more objective and

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longer view of the outcome. The Commission also requires access to technicians to conduct specialized analyses and provide expert opinion to assist the Commission in reaching it's decisions.

The committee chairman should be an individual with no vested interest in the outcome of the process and should have good interpersonal and group communication and leadership skills.

The Pagast Chairman is recommended as the Deputy Chairman of the Commission because of his local knowledge. He is usually once removed from actual management or leadership in the enterprises being privatized but can assist the Chairman from his position as an important member of the local community.

Since the purpose of the process is to transfer ownership and management from the state to the private sector it is important that the existing government leaders be represented on the Commission, but not in their usual formal leadeıship roles.

The plant manager has the most technical knowledge about plant production and marketing operations and to can develop working relationships with new owners while serving on the Commission.

Non-management employees often have views and interests which differ from those of the management. Since they are major beneficiaries of the process they should have direct representation.

A consumer representative is needed to provide a broader community perspective on Commission deliberations.

In most cases farmers should be represented by only one Producers' Association or Union of associations since. Commission deliberations will become hopelessly confused and muddled if farmers are represented by numerous individuals. Moreover, it is not in the long run producer interest to have fragmented and divisive leadership structures. The option to form local level producers associations around collecting stations is included to give producers the maximum opportunities to define how they will relate, become part of, or maintain a separate identity from the newly emerging private sector structures.

Some farmers may want to form their own local association and then process and sell milk apart from the larger group. By gaining access to collecting point assets free of charge, they have the right and the opportunity to do this. They will need to be represented on the Commission on a part time to negotiate the transfer of assets. In some cases the system being privatized has several functioning creameries or cheese making plants in addition to the collecting stations and a larger central plant. The option to form associations around these mid level plants should be available.

In other cases, producers may decide to form an association around several or even all collecting points and smaller processing plants. In the latter case, this one association is in a position to represent all farmers. In the former case, further negotiations are required. Some local associations may want to join the larger association for representational purposes or with associations
delivering to another plant. They are free to do so while still retaining their separate identity.

The approach requires that private and household farmers reach an accommodation with producers from former collective farms (joint stock companies) regarding representation on the Commission. Since there are more private and household farmers than there are joint stock company members, the cooperative form will generally ensure that the private and household farmers form the majority in any association with former collective farm employees.

Although the interests of each producer group may be different it is important that these interests be addressed and resolved at the start of the process. The freedom of association built into the formation of producer associations around local collection points and mid level processing plants offers maximum opportunity to create workable coalitions among individuals and associations or to form smaller economic units and start on their own. It is at this point that the role of the local Agricultural Consultants Service representatives takes on major importance in
the success of the privatization process. These individuals will be a major resource in guiding farmers decisions.

Step 3: Implementing a Formula to Distribute Assets of the Enterprise

As noted in the previous discussion procedures for redistributing assets must be fair (and actually seen to be fair by all participants), and they must be easy to understand and administer. Moreover, the process needs to be open by involving the active participation of all interested parties.

The proposed formula for distributing assets of state enterprises is designed to meet the tests of clarity, openness and ease of administration. Most prior claims of former owners will have been met through asset distribution from collecting points. Consequently, the remaining group of former owners are mostly individuals. Their claims should constitute no more than 10 percent of the total assets available for distribution. The reserve pool will easily accommodate these claims. The Commission, just after its formation, should develop procedures to accommodate these claims within a reasonable period not to exceed four months duration.

Since producers are the only owners at the collecting point level the cooperative form is the most appropriate. However, additional owners are brought into the structure at the creamery

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and milkery plant levels. It is recommended that a joint stock company (JSC) be formed to accommodate this.[4]

Producers' associations and unions of associations can hold stock a JSC in the name of their members. Voting rights are in proportion to the total value of shares owned. It is seen from the formula used to distribute assets that producers' associations or their unions can attain majority control by purchasing additional shares, either from the priority pool or from employees directly. In some cases adding assets from collecting stations to the thirty five percent allocated from the remaining assets may result in a near or absolute share ownership.

The ability of cooperatives to raise working and investment capital through patronage deductions also introduces the option of exchanging these funds for additional stock in the JSC or obtaining interest from the remaining shareholders for use of the funds.

Employees can be granted stock as individuals or as members of an employee association. In some cases employees of several plants may pool their shares to achieve greater returns and some individuals may decide to sell shares to other employees, managers or to producer associations. Many options are available that do not require Commission involvement. The important point is that the initial distribution process be clear, easy to administer and seen to be fair.

It is useful to give current managers an option to increase their holdings (and chances for profit) as they remain one of the most important groups of people in guiding the newly privatized enterprise. While producers and non-management employees may own the majority of the assets, success or failure of the privatized business depends on the quality of the professional management staff. Giving them a larger stake in the ownership can improve their operating effectiveness. In some cases they may want to pool their shares with employees or even with producers' associations. Again, these options can be exercised outside the direct administration of the Commission.

Step 4: Transforming State Enterprises into the Private Sector

These activities comprise the work of the technical experts. Long and short term expatriate consultants with the Agro-industry Privatization Project working with Ministry of Agriculture colleagues are responsible for most of this work. The actual time for conducting the

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[4] A cooperative could be an appropriate ownership form for the larger milkeries or creameries if they were to be the only owners of plant assets. But, in correcting for the excesses of the previous system, the doctrine of fairness used to privatize assets of former collective farms leads to the conclusion that employees of these milkeries and creameries also have historical ownership rights. This is a major reason for recommending the joint stock company form.

analysis is estimated at about eight weeks. The total elapsed time will be longer depending on progress made by the Commission in addressing the substantive components of its responsibilities.

The role of the Privatization Commission is to facilitate the process of transferring asset ownership from the state to the private sector. In the process it ensures that the newly structured enterprises are in the best possible position to survive in a competitive environment.

Step 5: Terminating the work of the Privatization Commission

The work of the Privatization Commission is complete when:

a. new, potentially viable private sector business organizations have been legally formed and state assets have been properly transferred to private sector groups or individuals representing the new ownership structures; and

b. non-viable units have been transferred to appropriate authorities to carry out liquidation processes or have been retained by the state for further action.[5]

In the event that new owners are not found for all available state shares they can be held at the pagast level and be made available for sale following procedures developed by the Privatization Commission before it is disbanded.

[5] It is not the role of Privatization Commissions to guide the liquidation process. They do not have expertise for this set of activities.

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Annex I
The Role of Dairy Producers' Cooperatives[6]

A cooperative can be defined as "a user owned and democratically controlled business in which benefits are received in proportion to use." Four common principles of cooperative business associations are:

- service provided at cost
- financial obligation and benefits proportional to use
- limited returns on financial equity
- democratic control

A. Service provided at cost

Cooperatives are generally not formed to increase profits, but rather to reduce the cost of services provided to members. Cost reduction to cooperative members is possible because of savings available when services are provided on a large scale. This means that cooperatives work better when there are more members than when there are fewer members.

Dairy cooperatives may also bargain with milk processors or government over milk prices, or their representatives may work on behalf of producers in finding new markets and holding them. If producers' associations actually own the assets of processing plants members may expect to receive profits now going to the state or to other owners. But, as discussed below, they are likely to be disappointed if they join cooperatives with the idea that income will increase greatly as a result.

B. Financial Obligation and Benefits Proportional to Use

In discussing the advantages and disadvantages of cooperative ownership of dairy processing plants, it is necessary to recognize that a cooperative is first and foremost a business organization. While operation of formal cooperatives may, at first, seem similar to the informal concept of rural cooperation among neighbors sharing machinery or delivering milk to the processing plant there are important differences. As with any business, it is necessary that owners invest some of their money in the cooperative in order to realize benefits.

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[6] Based in part on publications of the USDA Agricultural Cooperative Service publications: "Cooperatives in Agribusiness", Information Report No. 5, "Dairy Cooperatives", Information Report No. 1, Section 16, and "How to Start a Cooperative", Information Report No. 7.

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1. Proportional Returns

Dividends returned to members are proportional to the use made of the cooperative. For example, a cooperative providing machinery services, pays dividends proportional to the amount of services purchased or used. A dairy cooperative pays dividends proportional to the amount of milk delivered. Of course, in some

cases, returns are too low to provide dividends. In these cases losses are also shared proportional to use.

In some cooperatives individuals may hold more shares than others. Share dividends are, of course based on the number of shares held. But, unlike joint stock companies cooperatives do not raise most of their capital through sales of stock. Some cooperatives do, however, sell stock to non-members.

2. Proportional Cost Sharing

A unique aspect of cooperative businesses is that the amount of capital invested by members (apart from the required minimum stock ownership and membership fees) is roughly proportional to the use made of cooperative services. While all members usually buy at least one share of stock and may have to pay initial membership fees these sources usually do not raise sufficient money to provide all investment and working capital needed to operate the business.

When additional operating or investment funds are needed cooperatives often retain a small percentage (a patronage retainer or deduction) from members accounts to raise the needed capital. In the case of dairy cooperatives, a percentage of the value of milk delivered may be retained for use by the cooperative in meeting it's business obligations. Funds are usually repaid after several years. These deductions operate like a revolving fund, with previous "borrowing" being repaid and new "borrowing" made. This permits the cooperative to raise capital at lower cost than enterprises who borrow from banks or other lending agencies. It is consistent with achieving services at lower cost. It is perhaps the major advantage of the cooperative form of agro-industry ownership at this time in Latvia, as the cost of capital is high and existing lending institutions are undercapitalized and inefficient.

C. Limited Returns to Equity

Members form a cooperative mainly to get services -- a source of supplies, markets for products or specialized services including tractor and machinery hire. Thus, increasing monetary returns is not a primary function of a cooperative. In the United States, for example, the special status of a cooperative is recognized by law which limits returns to members capital at 8 percent.

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In the case of dairy cooperatives, gaining access to processing plants may improve access to markets. But cost savings for processing milk may be very small. In addition, producers will become liable, through their organization, for maintaining long run plant efficiency. Setting producer milk prices too high may result in increased short term profits, but, may also result in losing market share to enterprises keeping consumer prices lower. Records of Latvian dairy processing plants indicate that the cost of milk delivered by farmers usually accounts for 85 percent or more of total costs of processing milk for sale to the consumer. This means that major production efficiencies may not be possible even though producers gain ownership of assets of processing plants.

D. Democratic Control

Cooperative members generally have one vote each at the general meeting of members, regardless of the number of shares owned or the value of patronage. Other incorporated business forms follow the principle that the number of votes is proportional to stock shares owned. The governing principle of one vote per member is especially important at local or primary levels where the majority of producers are in a position to retain direct control of the organization.

However, because it is a business most cooperative charters and by-laws recognize that day to day business decisions are best handled by professional managers rather than brought to the vote of the general meeting. Consequently, the members, acting through the general meeting usually limit their control over business matters to major policy issues, which include hiring and firing of operation managers (but usually not other operational or production staff), policies regarding market development and decisions on certain recommendations made by the Board of Directors.

E. Other Issues

There are several other issues of general interest regarding coöperatives.

1. Open Membership

Open membership is often considered to be unique to cooperatives. This is more the case in Latvia where there are limited opportunities to invest money than in industrial economies where there are many joint stock companies in which anyone can own stock. However, the issue in forming dairy producer cooperatives may be more one of encouraging a large number of producers to join the cooperative than in keeping prospective members out.

Current discussion in Latvia often centers around a small number of farmers joining together to form a cooperative. However, a cooperative of five or seven members, with everyone else on the outside is little different from a limited liability company. It does not serve the long run needs of the majority of dairy producers nor is it compatible with the democratic principles of cooperative ownership and control. In the case of a dairy cooperative expecting to

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receive sizable assets of existing processing plants the basis for forming a cooperative would be violated if ownership was retained by only a small proportion of members sending milk to the plant.

Holding some of the shares in trust by the state for future members is not an appropriate solution. Rather, ways must be found to encourage a large proportion of producers delivering milk to a particular plant to become members right at the start. For psychological reasons it is better not to require cooperative membership as a condition of delivering milk to a particular plant owned by the cooperative. Rather, incentives should be present to encourage producers to want to become members. Transferring plant assets free of charge to cooperatives and then using part of them to cover membership and initial share costs may provide such an incentive.

2. Continuing Member Education

An important consideration in forming cooperatives in Latvia is providing farmers with the opportunity for sharing information, becoming educated on business practices and improving general agricultural knowledge. This is especially important at local or primary levels among farmers who have had limited previous opportunity to work together in formal groups to make decisions based on commercial reality. To achieve maximum use of this potential, formal and informal training programs on business management as well as other topics need to be organized on a regular basis.

3. Cooperation Among Cooperatives

Individual associations can gain additional advantages by cooperating together in areas of mutual interest. Such cooperation may be formal or informal. Informal approaches can include joint training meetings or other occasions where common problems and issues are discussed.

Formal cooperation can include formation of secondary level cooperative unions in which the local or primary associations formally merge into another legal organization able to represent a larger number of members on business matters of mutual interest.

In the case of dairy producer cooperatives, unions of primary cooperatives would be in a position to become full or part owners in regional or city processing plants. Ownership of local plants would still be held by the primary association.

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August 31, 1992

Current Status of Collective and State Farm Privatization and Models for Dairy Producers Associations in Latvia[1]

Executive Summary

This paper addresses Implementation Tasks IV A., VI B. and IV C of the Latvia Agro-Industry Privatization Project No. EUR-0014-I-00-1058-00 (Delivery Order No. 4). Section A reviews major privatization affects on collective and state farms. Section B develops alternative models for producers cooperatives to support privatization of dairy processing plants. Section C discusses the economic relationship between dairy producers' associations and state owned regional and central dairy processing companies.

A. The Status of Collective and State Farm Privatization in Latvia

Latvia chose to privatize it's collective and state farms using a spontaneous privatization approach. The long run goal was to breakup collective and state farms into smaller and more efficient units with minimal interference from the state. State and collective farms were transformed into joint stock companies (JSC). Many rural Latvians consider this to be a temporary ownership form. The operational idea guiding the privatization process seems to be that in all cases the existing and newly formed small scale farms will be more efficient than the new joint stock companies restructured to take advantage of the emerging market economy. This concept should be reevaluated using objective farm economics criteria.

1. The broad policy goal of farm privatization should be to achieve efficient economic units through restructuring of former collective and state farms and commercial growth of small scale farms. To achieve this goal:

   - Farm management research is needed to identify optimum farm sizes under alternative technology and pricing options. This information can form the basis for educational programs for government officials, Agricultural Advisory Services (AAS) staff and farmers so that the on-going farm privatization process will result in economically sized commercial farming units.

   - The AAS should be expanded and additional donor support secured to promote rapid growth over the next few years. It should investigate possibilities for providing appropriate business management skills for both small scale and large scale farming enterprises. JSC managers also require improved personnel management skills. The broad goal of the AAS should be to serve as a bridge between small and large scale farmers rather than to further divide them.

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[1] Prepared by the USAID Latvia Agro-industry Privatization Project

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2. Land laws should be amended, if required, and procedures and educational services developed to encourage new land owners to lease land to JSCs and other commercial farmers rather than keep land in sub optimal agricultural uses. Progressive land taxes should be considered as a policy instrument to achieve improved agricultural land use.

3. To promote interfirm competition and a market economy, widely disseminated producer, wholesale and retail market prices are needed. Public sector data collection and dissemination programs should be developed for this purpose. Donor support, including provision of computers, should be secured to implement such a program.

B. Models for Dairy Producers' Associations in Latvia

Government policy is to allocate assets of local and regional plants free of charge to farmers through producer cooperative societies. In central plants assets will also be distributed to employees and other groups and individuals. At this level assets will be sold at discount to producers and employees. This option may be available to larger regional plants at the option of the enterprise Privatization Commission.

1. Cooperatives are the most suitable business organizational form for privatizing assets of collecting stations and small scale processing plants -- if economic analysis indicates that they can be viable business entities. Assets distributed free of charge can be used to cover initial membership fees and required minimum stock purchases. Membership should include only producers delivering milk to the plant or plants being privatized.

2. Joint stock companies are the most suitable organizational form for privatizing assets of regional and central plants.

3. Organizing producers into functioning cooperatives may be the single most difficult activity of the dairy processing plant privatization process. Latvian farmers do not have experience in making decisions affecting the economic welfare of the group rather than just the individual.

4. Staff of the AAS should be trained in cooperative principles and farm and agribusiness management techniques, including double entry bookkeeping. They require training in the practical aspects of group dynamics and organization. Outside donor support should be mobilized for this effort.

C. Economic Relationship Between Producers' Cooperatives and Regional and Central Dairy Processing Plants

In Latvia, farmers cooperatives are important business entities because there are no other private sector supply and marketing enterprises available. However, if farmers cooperatives simply inherit the existing inefficient state dairy processing system, the cost of restructuring the

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industry will become the responsibility of producers -- unless of course the state continues to subsidize excess production at prices above those that would prevail in a market system.

Unlike most western countries which used subsidies to promote self sufficiency, Latvia dairy producers have already achieved this status. Latvia's needs are to rapidly create an efficient production and processing industry that can respond to existing domestic and export demand. The major policy consideration is how to recapture a major share of eastern markets lost over the past few years, supplemented by new niche markets in selected western countries.

1. The ultimate goal of privatization is to improve enterprise and industry efficiency. Fairness considerations suggest that asset ownership be divided free of charge, among producers and employees. Competitive considerations suggest that neither cooperatives or employees should gain absolute control over the industry through free asset distribution. After free share distribution is completed remaining assets may be sold, preferably at auction, to establish a market value for shares distributed free of charge.

2. Full cooperative ownership of all dairy processing plants is likely to restrict necessary industry restructuring required to create an efficient dairy processing industry.

3. At regional and central levels government should promote joint stock company structures including producers, employees and management.

4. Government should minimize it's share of assets retained in privatized enterprises. The goal should be to transfer full asset ownership to the private sector at the time enterprises are restructured. Transferring all state enterprises to cooperatives with no regard for efficiency may be simply setting up another monopoly enterprise while shifting the cost of restructuring to producers.

5. To minimize negative political reactions, foreign investors should be brought into ownership only after assets have been distributed or sold to new Latvian owners. Their investments will expand enterprise equity capital.

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August 31, 1992

Current Status of Collective and State Farm Privatization and Models for Dairy Producers Associations in Latvia[2]

This paper addresses Implementation Tasks IV A., VI B. and IV C of the Latvia Agro-Industry Privatization Project (Delivery Order No. 4). Section A reviews major privatization affects on collective and state farms. Section B develops alternative models for producers cooperatives to support privatization of dairy processing plants. Section C discusses the economic relationship between dairy producers' associations and state owned regional and central dairy processing companies. Conclusions and recommendations are provided at the end of each section.

A. The Status of Collective and State Farm Privatization in Latvia

Collective and state farm privatization was designed to rapidly breakup existing large collective and state farms into smaller, more efficient units owned by former collective farm workers or individuals with legitimate claims to assets illegally nationalized after 1940.

1. Phase 1 Collective and State Farm Privatization Activities

The first step in the privatization process was the return of agricultural land to former owners or their heirs. Remaining land could be claimed by individuals presently working it. Phase I land privatization was initiated with the law on Land Reform in Rural Areas (November, 1990). During this phase former owners and other claimants received use rights to land. Present land users and individuals requesting land under restitution rights presented requests for land allocation before June 20, 1991. All claims were to be reviewed and use rights to land assigned by January 31, 1992. Administrative records show that, by August 1992, decisions had been handed down on 96 percent of all claims filed.

Phase II provisions are contained in the Law On Land Privatization in the Rural Areas (June, 1992). Beginning in September, 1992 ownership rights to individuals granted use rights are transferred over a period of three years. Land not distributed remains under the jurisdiction of the municipality (pagast) in which the farm is located and is retained as part of the agricultural land base for former collective and state farms.

Non-land farm assets were privatized under the Law of Privatization of Agricultural Enterprises and Collective Fisheries (June 1991).

At the start of Phase I, Privatization Commissions were formed for each state and collective farm. Objectives for this phase included: 1) identifying individuals with rights to

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[2] Prepared by the USAID Latvia Agro-industry Privatization Project

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receive non-land assets, 2) determining asset share values for eligible individuals, 3) issuing certificates transferring non-land asset ownership rights, and 4) forming and registering new joint stock companies (JSC). This phase ended March 15, 1992.

Privatization Commission members were elected at a general meeting of workers on each farm. These commissions had three objectives:

- Dividing physical assets of the farm into approximately 20 geographic/economic units per farm.

- Determining the current book value of assets contained in each geographic/economic unit and allocating total asset value to workers and former owners in the form of share certificates based on common criteria.

- Transforming the collective or state farm into a JSC to manage the farming operations and the further transformation of the farm assets into smaller operating units owned mostly by former members of the collective or state farm

a. Dividing Farm Assets into Geographic/Economic Units

Economic/geographic units were formed around distinct economic activities such as machinery services, meat processing, grain milling and drying units, housing and other social assets, milk production units, pig production units, etc. When identifying agricultural production units it was not always possible to allocate sufficient land to support the unit. Moreover, there seems to have been no systematic criteria used to determine the "optimum" size combination of assets to carry out the expected production or service activities. Consequently, few of these "privatization units" can be transformed into viable economic entities without additional resources.

b. Determining Book Value of Assets and Allocating Shares to Legitimate Claimants

Book values as of July 1, 1991 were estimated for all itemized assets. Formulas were developed to allocate assets to former owners and former and current workers. The current value of assets of former owners was used to determine total value of assets to be returned to this group. The percentage of total value distributed to each successful claimant was calculated using this total. (A legislated ceiling of 50 percent of total asset value to be distributed was placed on this group.)

The labor share value for each eligible worker was calculated by taking total individual earnings while employed for the collective as a percentage of total earnings paid by the collective or state farm since it was founded.

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The calculated percentage for restitution and labor shares was applied to the total asset base. Share certificates bearing the asset value (as of June 1991) were then issued representing the individual share of total assets to be privatized.

c. Transforming Collective and State farms into Joint Stock Companies

The final activity of the Privatization Commission was transforming farms into the JSC form with ownership residing in all individuals holding asset value certificates. The Commission presided over the election of new corporation officers who served at the pleasure of the general meeting. The new Board took on responsibility for managing production and agro-industry business activities as well as the sale of the geographic/economic units.

2. Phase II Collective and State Farm Privatization Activities[3]

Phase II (which started March 16, 1992) constitutes the actual restructuring of geographic/economic units formerly part of the collective and state farm system to new ownership forms. The formation of smaller private farms (from less than 5 hectares to up to 50 hectares) had been ongoing for several years. In mid 1992 an estimated 45,000 private farms existed in Latvia. The dynamics inherent in the privatization process is expected to increase the speed of private farm creation. It is estimated that over 60,000 will exist by the end of 1992. The goal is to achieve over 120,000 private farms by the end of 1993.

a. Technical Operation of the Privatization Process

By and large the process of trading shares among shareholders using certificates with values fixed in July 1991 Rubles worked reasonably well during the first few months into Phase II. There were several notable exceptions where certificate holders sold shares at face value, (sometimes to outsiders) thus losing appreciation from inflation induced price increases.

Loss in Value of Asset Certificates

At the time this report is written, hyperinflation has seriously eroded original certificate values when stated in current rubles. However, government ruled against increasing asset or certificate values by indexing them to inflation. The justification was that since enabling legislation required non-land assets to be purchased with share certificates, unless otherwise determined by the general meeting, it was unnecessary to increase the certificate face value as

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[3] As this is written the restructuring process has been evolving for just over five months. The discussion and conclusions in this section are based on informal interviews with workers and managers of the new joint stock companies, Latvians engaged in formal research and analysis of the privatization process, Latvian government officials and Latvian and non-Latvian individuals having direct experience with the on-going process

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the value assigned to the physical assets remained constant. Moreover, individuals were free to trade certificates for whatever price buyers and sellers agreed upon, thus introducing an informal market for shares. The JSC management administered and recorded the selling or trading of shares.

Non-use of Agricultural Land

Most heirs to farm lands do not live in the rural areas where their new land holdings are located. The law allows them to gradually increase agricultural production on this land. Since most have little or no experience with agricultural production short run productivity and total production will decline on this land. Anecdotal evidence suggests that many of these new owners are not interested in leasing all or even part of their land to other farmers or to JSCs. It appears that the psychology of land ownership (after 50 years of state ownership) is sufficiently strong or their mistrust of the "system" is sufficiently great (or a combination of the two) that earning low or erratic returns from agriculture is preferable to receiving an annual rent which may be based on actual productivity.

Deterioration of Economic and Technical Production and Marketing Conditions

Prior to the dissolution of the Soviet Union, Latvian agricultural products, especially dairy and meat products, were major exports to the Soviet republics. Official statistics suggest that about 27.5 percent (487,000 mt) of Latvian dairy products was shipped to the Soviet Union in 1990, down from 36.3 percent (680,000 mt) in 1988. For meat products, 1990 deliveries constituted 18.5 percent (42,200 mt) of total Latvian production, down from 35 percent (89,000 mt) in 1988. These markets were severely disrupted after the breakup of the Soviet Union and the disintegration of centralized management structures. In addition to a declining percentage of deliveries to the USSR these figures also indicate a decline in total production of Latvian meat and dairy products over the period.

In the past, Latvian farmers and processors were concerned primarily with production activities. Product sales and input purchases, capital funds and payment for products sold were all organized and directed from Moscow. Payments for products sold and funds for purchasing new machinery and other capital investments were transferred directly by the state to appropriate farm business accounts maintained in state banks.

Now, the former state banking system is in shambles. The private sector banking system is not yet able to easily transfer funds between banking institutions to pay farmers for products sold, much less provide a ready source of credit. The problem is compounded with respect to foreign trade with other CIS countries as bank clearing systems are perhaps in greater disarray there than in Latvia. Under the previous system price relationships between inputs and between inputs and outputs were stable and predictable (even if highly distorted in a macro-economic sense).

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Market liberalization and hyperinflation combine to make present price relationships highly erratic and unpredictable. As a result, business planning can not be easily done. Moreover, banks have been unable, or unwilling, to convert the individual rubles established in each of the former soviet republics which has severely hampered payment mechanisms. This has often led to firms having large accounts receivables that are likely to remain unpaid and has forced them to conduct business either on barter or cash-payment terms.

The loss of central planning product distribution activities requires plant managers and their staff to become directly involved with marketing and distribution activities. New private sector trade channels will have to be developed to recapture lost markets and develop new ones.

The net effect of the above disruptions has been a continuation of the decline in aggregate milk products produced and marketed (the major agricultural export commodity) that started in 1989. Milk processing plants report milk deliveries from JSC operations in mid 1992 running about 15 to 25 percent below comparable levels in 1991. In 1991 milk deliveries were already 10 to 15 percent below the previous year. Some increase in deliveries from small private sector farms has been noted in some regions in 1992, but the amount is insufficient to compensate for production losses from the JSCs.

The widespread occurrence of a form of bovine leukemia (reported to have infected from 30% to 50% of milk producing cattle on JSCs) suggests that by mid 1993 milk production from these farms could be an additional 30 to 40 percent below the already low levels prevailing in mid 1992.

Since the disease is incurable, but does not seem to affect meat quality, the volume of meat available in the coming year should be above levels of recent years, if reports of increased slaughter plans are followed. This should lead to relatively lower farm and consumer prices for beef and beef products.

A poor 1992 growing season reduced production of spring grains used mostly for livestock feed by 25 percent below normal. However, when balanced against the need to slaughter diseased cattle this winter actual shortfalls may not be as great as could have been expected.

Land privatization has reduced the amount of land under the control of JSCs by 10 to 40 percent depending on area as most new owners have exercised their rights to take actual possession of redistributed land.

b. Management of Joint Stock Companies

Although the JSC is already a private sector entity, many rural Latvians seem to believe that it serves primarily as a temporary holding company whose purpose is to manage the process of asset distribution into smaller units. However, interviews with managers of JSCs, indicated that many are: a) trying to hold the existing enterprises together, or b) promoting devolution of

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production activities into smaller units while retaining agro-processing activities -- meat and milk processing, machinery hire, grain milling etc. as part of the core long term JSC activities. The goal is to build vertically integrated production, processing and marketing units.

Managers are frustrated with the continuing increase in input costs, especially for fuel and machinery, and more recently for feed grain. They report that returns to dairy production has traditionally been low, but the loss was recovered from favorable profits from pig operations. At the same time, workers are interested in using certificates to buy out perceived high profit operations. Managers fear that workers will want to reorganize the units that were historically profitable while letting the JSC retain those that are not.

Anecdotal evidence suggests that industrial sabotage is occurring on many farms. In part, this is due to loss of managerial discipline caused by rapid management changes brought about by the privatization process. Small tools and equipment are being stolen while parts are being removed from larger farm equipment making them unusable in the short run. The motive seems to be to lower the selling price and then using accumulated spares to "repair" the non-working machines after they have been "privatized". Moreover, the lack of ownership incentives results in poorly adjusted harvesting machines leading to high harvest losses.

Managers with effective people management skills operating in better agricultural areas report greater success in holding the JSCs together than managers with weaker people management skills or those operating in areas with more limited farming opportunities.

c. Development of Small Scale Farms

Discussions with small scale private farmers provides a different perspective. Collective and state farms exercised dominant economic and in some cases political control over small scale farmers. Most of the latter were and continue to be subsistence farmers. Although the old system is in the process of breaking up, many small scale farmers continue to feel threatened by the existence of large production and service units. They complain that charges for services provided -- land preparation, grain threshing etc. -- are too high, the quality of service is too low, and work is not done on time.

Tensions between small scale producers and workers and management on JSCs varies across regions, but is a factor contributing to distrust between the groups and results in limited coordination between the two groups. Aggravating this small farmer/large farmer tension is the general deterioration of the economic climate in which both groups work. Small scale farmers generally have fewer out of pocket expenses for inputs, but need to hire equipment from JSCs to work their fields. Inflation affects small scale subsistence farmers to a lesser degree than it does the former collective farms. Lower resource use means that small scale farmers are not as seriously affected by the inflationary input price rises -- but average crop and livestock product yields are also below those of many JSCs. Because of their small size and non-commercial production technologies, this group cannot, in the short run, be expected to make up production losses taking place on former collective and state farms.

A new Agricultural Advisory Service (AAS) has been established to provide technical and business management assistance to small scale private farmers. Following models developed in other European countries it is designed to be funded, in the future, by farmers through their cooperative institutions. Currently staff salaries are paid by the state. Limited donor contributions are provided.

3. Conclusions and Recommendations

Latvia chose to privatize it's collective and state farms using a spontaneous privatization approach. The long run goal was to breakup collective and state farms into smaller and more efficient units with minimal interference from the state. State and collective farms were transformed into joint stock companies. Many rural Latvians consider this to be a temporary ownership form. The operational idea guiding the privatization process seems to be that in all cases the existing and newly formed small scale farms will be more efficient than the new joint stock companies restructured to take advantage of the emerging market economy. This concept should be reevaluated using objective farm economics criteria.

1. The broad policy goal of farm privatization should be to achieve efficient economic production units through restructuring of former collective and state farms and commercial growth of small scale farms. To achieve this goal:

    - Farm management research is needed to identify optimum farm sizes under alternative technology and pricing options. This information can form the basis for educational programs for government officials, Agricultural Advisory Services (AAS) staff and farmers so that the on-going farm privatization process will result in economically sized commercial farming units.

    - The AAS should be expanded and additional donor support secured to promote rapid growth over the next few years. It should investigate possibilities for providing appropriate business management skills for both small scale and large scale farming enterprises. JSC managers also require improved personnel management skills. The broad goal of the AAS should be to serve as a bridge between small and large scale farmers rather than to further divide them.

2. Land laws should be amended, if required, and procedures and educational services developed to encourage new land owners to lease land to JSCs and other commercial farmers rather than keep land in sub optimal agricultural uses. Progressive land taxes should be considered as a policy instrument to achieve improved agricultural land use.

3. To promote interfirm competition and a market economy, widely disseminated producer, wholesale and retail market prices are needed. Public sector data collection and dissemination programs should be developed for this purpose. Donor support, including provision of computers, should be secured to implement such a program.

B. Models for Dairy Producers' Associations in Latvia

Forming dairy producers' associations may be the most challenging activity of the dairy processing privatization process. Latvia has had no experience with western style cooperative associations for almost fifty years and the former Soviet style cooperatives do not provide an appropriate model.

1. The Purpose of Farmer Cooperatives

Cooperatives are not organized primarily to provide profit to their owners, as is the case with most other business organizations. The purpose of cooperatives is to provide services to its members which cannot be obtained at less cost from other business enterprises. If other private sector enterprises can provide identical services at less cost, or better service at the same cost, there is really little need for a cooperative. In Latvia, farmers cooperatives are important because there are no other private sector supply and marketing enterprises available.

Although primarily a business organization, local level cooperatives can also serve social and educational needs of their members. Business objectives are better served through unions of local cooperatives into regional and national structures. Because it is a commercial enterprise, the cooperative must, at all times be concerned about securing a sufficient volume of business to cover its operating costs, and to continue to supply services to members at costs lower than competing private or public enterprises.

2. General Purpose and Industry Specific Cooperatives

Farmer cooperatives can be divided into two groups: 1) those organized primarily on a geographic basis to meet general member needs, and 2) those organized primarily around an economic activity (such as dairy production or input supplies).

General purpose cooperatives organized along geographic lines (pagast or region) serve the general needs of farmers within the area. These cooperatives often represent members views on farm policy or undertake bargaining activities on behalf of members. Some provide input supply services as well. They function best where the common interest of members is easily understood and articulated. A general purpose cooperative will have difficulty representing farmers when interests are in conflict. For example dairy farmers would prefer lower rather than higher grain prices, while grain farmers prefer higher prices. A general purpose cooperative representing both groups may face serious tensions. As a result, general purpose cooperatives usually have greater difficulty in raising funds.

Industry specific cooperatives, as their name implies, serve the needs of a special economic group such as dairy producers or users of input supplies such as feed or machinery. Although membership tends to be limited to a defined geographic area the primary organizational purpose is to serve the needs of a special economic group.

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Industry specific cooperatives through which members market their products usually have a better basis for survival than general purpose organizations. Patronage deductions to cover administrative expenses can be regularly withheld from products sold by members.

3. Large and Small Cooperatives

Small cooperatives can effectively serve social and educational needs of members, and may function well for purchase of consumer goods. But small cooperatives (of less than 500 members) will generally have difficulty meeting the business needs of dairy producers. Volume of business must be sufficiently large to cover administrative expenses, in order to reduce the need for large patronage deductions.[4] Moreover, since the purpose of a cooperative is to provide services for the group which can not be provided as well by individuals acting on their own or by other private businesses discussion of organizing dairy producers' associations by five or seven members is a contradiction of terms.

In Latvia some farmers have been cooperating informally by purchasing equipment jointly and then sharing its use. Often such group are made up of four to five individuals who agree to share costs equally or according to use. Such informal cooperation should be encouraged and may well serve the needs of many farmers. But, this type of informal cooperation should not be confused with a formal cooperative association.

4. Unions of Cooperatives

An important part of cooperative management principles is that the organizational impetus springs from felt needs at local levels rather than from directives at the top. Once local needs have been met cooperatives may want to form or merge into larger unions. Organization into unions may bring greater control over services or increased market share. But along with these advantages organization into regional and national union also brings with it a need for more complex management and coordination structures and additional costs. Some local producers cooperatives may well decide to remain outside a larger union, especially if they have developed successful small scale marketing mechanisms. However, experience in western countries with mature dairy processing industries suggests that, in the long run, consolidation of small local level cooperatives into larger unions will take place as the industry becomes more efficient. But, this should be an evolutionary process determined by economic signals of the market rather than by an administrative process designed simply to gain perceived market share at the expense of market efficiency.

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[4] From the more important perspective of dairy processing plants, the minimum plant size for efficient operation, using western criteria, is about 100,000 tons per year. Most central plants in Latvia attain this capacity but are currently processing only 60,000 to 80,000 mt annually. By comparison, many Latvian regional plants have a total annual capacity of 20,000 to 50,000 mt per year, while local plant capacities are usually less than 10,000 mt per year.

5. A Model for Dairy Producers' Cooperative Associations

This section provides a brief discussion of the structures of the Latvian dairy processing industry, the privatization process in Latvia, and the role of cooperatives in the privatization process.

a. Structure of the Latvian Dairy Processing Industry

The Latvian dairy processing industry is organized on three basic levels: a) the central fluid milk and milk product processing firm, usually located in a major population center, b) regional milk processing plants with activities similar to the central plants but on a smaller scale, and c) local level milk collecting stations. The latter may have basic cream separating facilities and may produce small quantities of cheese.

These three levels are usually organized as a business entity called a "Kombinat". The Kombinat is similar to a western corporation with geographically separated subsidiaries. But the similarity ends there. Individual subunits are treated as cost centers, not profit centers. Profits are calculated only for the Kombinat as a whole. The more efficient units subsidize the less efficient ones. Unemployment is disguised throughout the organization, but exists most often in the less efficient regional or local level units. (However, the team's review of central plants uncovered some highly inefficient central plants as well.) Wage and salary levels are standardized rather than differentiated by personnel effectiveness or firm efficiency. Production supplies are provided, at cost, by a division of the central plant.

In addition to the typical structure, there are several specialized cheese and skim powder processing plants that operate as stand alone central units. Some have smaller processing plants or collecting points associated with them, while others receive product (skim or cream) from other plants.

b. The Latvian Privatization Process

Latvia has adopted a decentralized privatization approach. Privatization Commissions are appointed for each enterprise or group of enterprises to be privatized. The process is designed, in part, to break up the existing Kombinat structure, and to begin the process of restructuring along more economic lines. Consequently, the bottom up restructuring focus found in the farm privatization process is present in the processing privatization process as well. Since there were minimal plant closings and restructuring in the past, the market realities now faced by Latvia suggest that many plants now in business will not be operating five years from now.

Some of the future plant closings will be at local and regional levels, while some will be at the central level. The decentralized approach provides flexibility to tap local production, management and marketing skills where they exist and allows the restructuring processing to take place along economically rational lines.

c. The Role of Cooperatives in Privatizing the Dairy Processing Sub-sector

Government policy is to allocate dairy plant assets to producers through producer cooperative societies. Assets may also be distributed to employees and other groups and individuals. Assets can be either sold or distributed free of charge. Specific decisions for each plant to be privatized will presumably be made by the Privatization Commissions.

Producers associations can claim dairy plant assets illegally nationalized after 1940. In some cases, individuals can file claims for assets citing restitution of former property. Individual claims are probably less than ten percent of all assets affected and most of these are at local collecting and small processing plants.

The cooperative form of business ownership is the most appropriate organizational form for ownership of collecting stations and other small scale local processing plants. This is also the level at which most asset claims by former owners (individuals or cooperatives) are likely to be made. Government policy is to distribute all assets at this level, free of charge, to legally formed, renewed or new producers' associations.

While all producers should remain free to join or not to join a cooperative, the advantages of the cooperative form are greater when a larger rather than a smaller number of producers are members (as noted above.) But, since there are costs involved in joining and maintaining a cooperative it is appropriate that producers be given incentives to join.

It is suggested that cooperatives should first be formed at local levels with membership limited to producers delivering milk to collecting stations or local processing plants. Before setting up such cooperatives prospective members should verify that processing plants are economically viable at that level. Producers should also have guarantees from their cooperatives that all milk produced will be purchased.

d. Costs of Membership in Producers Cooperatives

When joining a cooperative, an individual must invest in shares and usually pay a membership fee. Dairy plant assets transferred free of charge during the privatization process can cover these initial costs. At the same time, each member becomes a part owner of the plant for as long as milk deliveries continue. When no longer delivering milk the member can redeem accumulated shares for cash.

Cooperatives have authority to raise working or investment capital by imposing a charge (patronage deduction) on producer-members in proportion to milk delivered. This can be an important feature in Latvia where a commercial credit and lending system is not yet in place. By raising working capital through patronage deductions (which are usually repaid sometime in the future) the organization has a source of capital at much lower cost than if it was borrowed on the open market. Cooperatives also raise investment and working capital by retaining patronage dividends accruing to each member. Entered as a liability on the cooperative balance sheet, retained patronage dividends constitute member asset shares in the organization.

e. Organizing Cooperatives

The new Agricultural Advisory Services has taken the lead in organizing small scale farmers into functioning cooperatives. However, this work is not taking place within in a comprehensive policy framework. Local AAS staff are not well trained in group organizational skills, cooperative principles or cooperative financial and management skills. Nonetheless, they are the only source of professional expertise available for the job and should be mobilized for the job. It is essential that, as the work of the service expands, government policy remains firmly grounded in recognizing that AAS staff are seen as representatives of farmers interests. Obtaining a broader funding base is one way to achieve this objective. Cooperatives, other private sector institutions and initial donor funding provide potential sources.

6. Conclusions and Recommendations

Government policy is to allocate assets of local and regional plants free of charge to farmers through producer cooperative societies. In central plants assets will also be distributed to employees and other groups and individuals. At this level assets will be sold at discount to producers and employees. This option may be available to larger regional plants at the option of the enterprise Privatization Commission.

1. Cooperatives are the most suitable business organizational form for privatizing assets of collecting stations and small scale processing plants -- if economic analysis indicates that they can be viable business entities. Assets distributed free of charge can be used to cover initial membership fees and required minimum stock purchases. Membership should include only producers delivering milk to the plant or plants being privatized.

2. Joint stock companies are the most suitable organizational form for privatizing assets of regional and central plants.

3. Organizing producers into functioning cooperatives may be the single most difficult activity of the dairy processing plant privatization process. Latvian farmers do not have experience in making decisions affecting the economic welfare of the group rather than just the individual.

4. Staff of the AAS should be trained in cooperative principles and farm and agribusiness management techniques, including double entry bookkeeping. They require training in the practical aspects of group dynamics and organization. Outside donor support should be mobilized for this effort.

C. Economic Relationship Between Producers' Cooperatives and Regional and Central Dairy Processing Plants

The case was made above that producer cooperatives could become sole owners of first level collecting stations and dairy processing plants when doing so will still promote industry competition leading to improved efficiency. In this section the role of producers' cooperatives with respect to regional and central processing plants is discussed within the context of privatization of the dairy processing industry.

At local levels, the justification for cooperative ownership of collecting stations and small processing plants is very strong. Most legitimate restitution claims exist at these levels. If producers desire to strike out on their own, initial capital costs may be lower. Second,it may be easier to successful resolve marketing and management issues at the level of the small plant than at larger plants. (This assumes that the product line faces favorable market conditions.) Third, the workforce at local plants is smaller suggesting that fewer workers will be retrenched during the restructuring process. Moreover, management requirements are not as great in small plants than in large ones.

At regional and central levels the case for cooperative ownership is not so strong. There are two reasons for this. First, principles of fairness suggest that both management and non-management employees should gain access to state assets during privatization along with producers.

Second, principles of competition suggest that complete ownership of processing plants by producers' associations can lead to inefficient monopolistic ownership and management structures in the industry. Transferring all state enterprises to cooperatives with no regard to efficiency may be simply setting up another monopoly enterprise while shifting the cost of restructuring to producers.

1. Fairness of Asset Distribution

Most processing plants, apart from the collecting stations or older small scale plants, were built during or after the 1950s. Even where initial construction dates back before 1940, most serviceable plant equipment has been installed in the 1970s and 1980s. Hence, within the context of the free distribution of state assets to the private sector, former and current management and non-management employees have a stronger claim to ownership of assets in these plants than do producers.

Fairness principles suggest that blocks of assets be distributed free of charge to producer and employee groups. But, to achieve a balance with maintaining competitive principles free asset distribution should not grant either group with a majority asset ownership.

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2. Maintaining Competitive Structures

Generally, the role of cooperatives is: 1) to provide service to members at cost, 2) finding and keeping markets, and 3) improving farmers' bargaining positions. As with other economic structures, if a cooperative becomes the only supplier of services or the only marketer of a product it is, by definition, a monopoly. As a monopoly it's incentives to provide efficient services are reduced. As a result, services to members are likely to decline in quality and in the case of food products costs to consumers are likely to increase. Consequently, competition may be better served if cooperatives compete with other business forms, or individuals and groups other than just cooperatives have partial asset ownership. This will provide a greater incentive to carry out the industry restructuring needed to improve operational efficiency.

Within the joint stock company structure cooperatives would not need to own all shares to control the company. However, management staff would have an incentive to buy up sufficient shares to keep producers' associations from gaining majority control on their own. These activities should be promoted in the name of competition. Employees, unless organized into an employees' organization would have little incentive as individuals to buy up additional shares. But some would no doubt be interested in selling shares to either management or producers.

Auction sales of shares remaining after free distribution can provide a basis for market valuation of assets. Privatization Commissions may want to consider opening such sales to managers, producers and employees before opening them to other Latvian investors.

3. The Role of Foreign Investors

It is unlikely that foreign investors will be interested in plants at regional or lower levels. Most offer limited potential for returns sufficiently high to justify risks taken. However, they may be interested in some central plants with current or potential export sales. Major reasons for bringing in foreign investors is to gain access to new technology and secure foreign markets for Latvian products. The latter is probably the most important for the Latvian dairy industry. In general, unless the firm has been targeted for purchase by foreign investors it is suggested that they be encouraged to introduce new capital rather than buying existing assets. Alternatively, they should be brought into the process after distribution of free shares or after exhausting sales options to local buyers. There are several reasons:

- bringing foreign investors into the process before asset distribution to producers and employees and other local investors is complete may raise political issues at a time when they are most difficult to resolve.

- once the internal asset distribution process is completed the private sector management (operating within the general Latvian laws on foreign investment) can work more easily with foreign owners within the general context of Latvian laws regulating foreign investment.

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- existing exchange rates between rubles and hard currency held by potential foreign investors makes it highly probable that foreign investors may acquire a controlling interest in the enterprise. This is not an undesirable position for Latvian owners. The foreign partner will most likely bring new technology and/or markets which will increase firm profits. Latvian owners will share in the dividend distributions. If the enterprise shares are eventually traded on the public securities markets Latvian owners will again share in the potentially increased equity value.

4. A Suggested Business Structure for Dairy Processing Plants at Regional and National Levels

Within the decentralized privatization process being implemented in Latvia free and equal distribution of state assets to producer associations and employees is suggested for larger regional and central plants. Business organization would be within the framework of a joint stock company. Unions of local producer associations would hold stock in the name of member associations, along with other individuals and groups of stock holders.

To balance fairness with competitive principles it is suggested that free distribution should not give either group majority asset ownership. A distribution of 30 to 35 percent to each group is suggested. This leaves from 30 to 40 percent remaining for sale or to be retained by the state. After the basic free distribution of stock to producers unions and employees has been completed the remaining shares could be sold either on an auction or a priority group basis. The most likely potential buyers would be management staff, (probably as a group), producer associations and then employees or other local investors.

Plant managers are the single most important group in guiding day to day plant operations. Hence, giving this group an option to buy sufficient shares, perhaps on a priority basis, to form a majority when combined with either producers or employees may provide an initial ownership structure to promote competitive management able to balance both employee and producer interests. An auction has the advantage of determining a market based value for shares.

Restructuring the industry to achieve greater efficiency will result in plant closings and retrenching workers, managers and technicians. This is one of the expected objectives of the process. When privatizing the dairy sector (or any other state owned agribusiness) it should be expected that some plants may have to be liquidated and not restructured.

5. Cooperative Development in the United States Dairy Industry

A brief summary of cooperative development in the United States dairy industry may provide a useful guide to the potential future development of the Latvian dairy industry. Cooperative ownership of smaller cheese and butter making plants was very common in the period from 1920 to 1940. But, they made up only about one third of all processing plants. By 1957, there were still almost 1,600 dairy cooperatives in the U.S. But, the number had declined

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to 435 by 1980. Many cooperatives owning processing plants merged with larger ones as fluid milk became the major processed dairy product. While farmers belonging to cooperatives produced 74 percent of the milk marketed in 1980, cooperatively owned dairy processing plants produced only 16 percent of fluid milk, but 87 percent of dry milk products and 64 percent of butter. This experience suggests that: 1) central plants may achieve greater efficiency if government policy encourages cooperatives to compete along side other private sector businesses, or share ownership with employees and managers, and 2) cooperatives have a stronger role in operating cheese and butter processing plants than fluid milk plants.

6. Conclusions and Recommendations

In Latvia, farmers cooperatives are important business entities because there are no other private sector supply and marketing enterprises available. However, if farmers cooperatives simply inherit the existing inefficient state dairy processing system, the cost of restructuring the industry will become the responsibility of producers -- unless of course the state continues to subsidize excess production at prices above those that would prevail in a market system.

Unlike most western countries which used subsidies to promote self sufficiency, Latvia dairy producers have already achieved this status. Latvia's needs are to rapidly create an efficient production and processing industry that can respond to existing domestic and export demand. The major policy consideration is how to recapture a major share of eastern markets lost over the past few years, supplemented by new niche markets in selected western countries.

1. The ultimate goal of privatization is to improve enterprise and industry efficiency. Fairness considerations suggest that asset ownership be divided free of charge, among producers and employees. Competitive considerations suggest that neither cooperatives or employees should gain absolute control over the industry through free asset distribution. After free share distribution is completed remaining assets may be sold, preferably at auction, to establish a market value for shares distributed free of charge.

2. Full cooperative ownership of all dairy processing plants is likely to restrict necessary industry restructuring required to create an efficient dairy processing industry.

3. At regional and central levels government should promote joint stock company structures including producers, employees and management.

4. Government should minimize it's share of assets retained in privatized enterprises. The goal should be to transfer full asset ownership to the private sector at the time enterprises are restructured. Transferring all state enterprises to cooperatives with no regard for efficiency may be simply setting up another monopoly enterprise while shifting the cost of restructuring to producers.

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5. To minimize negative political reactions, foreign investors should be brought into ownership only after assets have been distributed or sold to new Latvian owners. Their investments will expand enterprise equity capital.

6. Government should minimize the share of assets retained in privatized enterprises. The goal should be to transfer full asset ownership to the private sector at the time enterprises are restructured.

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III. MONTHLY AID REPORTS

June 29 AID Washington Briefing

July Progress Report

August Progress Report

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LATVIA COUNTRY BRIEFING
June 29, 1992[1]

This summary is based on field experience in Latvia from May 14 through June 19, 1992.

1. Latvian approach to privatization: A decentralized approach is followed. The Ministry of Economic Reform provides oversight, individual line ministries are responsible for implementation. Privatization Commissions are appointed with responsibility over a designated enterprise or industry sub-sector

2. Farm land privatization: Private use rights to land have been assigned to individuals, at no cost, as of June 1991. Distribution is based on two principles: a) restitution to former owners (prior to 1940) or their heirs, and b) accumulated "sweat equity" (based on labor earnings on the collective or state farms since their formation). Legislation is being developed to transfer free and clear ownership titles in the near future. Under this process, land ownership patterns will be similar to those prevailing in 1940. Most new farms have between 15 and 50 ha. of crop land. 50 ha. of cultivatable land is the maximum distributed under the privatization process.

3. Non-land farm asset privatization: All non-land farm assets for each collective and state farm have been valued. Share certificates have been issued to current and former employees (sweat equity principles) and to former asset owners (restitution of former property rights). Machinery have been grouped into semi-economic units (tractor, plow, harvesting equipment etc.) and sold to individual or group holders of share certificates. Share holders are encouraged to sell or swap shares, thus developing an informal market.

4. Breakup of collective and state farms: All collective and state farms are given transitional joint stock company status. They can rent or lease land previously distributed to individuals but are prohibited by law from owning land. This provides an incentive for individual private farm land and farm ownership to develop. It is estimated that some 40,000 private farms existed by mid 1992. It is expected that about 60,000 will exist by the end of 1992 and up to 100,000 after 1993.

5. Legislation to privatize processing and agro-service industries: Sub-sector legislation to privatize agro-processing and agro-service industries is moving through Parliament. The agro-processing law is in its third reading with mid July as the target date for passage. The agro-service legislation has been through it's first reading. The C&L/Chemonics team is working with Latvian professionals in the Agrarian Economics Institute and the Academy of Sciences responsible for drafting these laws and have provided input. The

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[1] Prepared by C. Fritsch and N. Melngailis

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basic decentralized approach followed for privatizing collective and state farms is being followed. Once enacted, the legislation provides the basis within which enterprise privatization takes place.

6. Status of dairy processing industry: The dairy processing industry will be the first agro-industry to be privatized. The C&L /Chemonics team has begun initial analysis of the ten sub-sector groupings slated to be privatized. It is expected that the initial sector analysis will be completed by the end of September 1992. In general, the industry structure has changed little since the mid 1960's. Since nationalization in the 1940s, there have been few, if any, plant consolidations, and little, if any, work force consolidation. Consequently, equipment is mostly old, the industry is inefficient and has considerable excess employment. Some central plants can be transformed into reasonably efficient private sector operations but many will have to be closed, and staff laid off if a competitive industry is to be established. Short term returns to investment are quite low in this industry suggesting minimal interest from foreign investors. There are political factions which strongly oppose major foreign investment, citing the fact that the industry has for many years been the major national earner of foreign currency.

7. Price distortions from market liberalization: Price distortions from market liberalization are quite severe, affecting both farmers and wage earners. Between the first quarter of 1991 and the first quarter of 1992, average wage monthly earnings rose about 3.3 times while producer prices for dairy products rose about 11 times. Basic grains rose about 4 times. Oil and gas products, and farm machinery are close to world level prices. They increased more than 22 times over the period.

8. Deteriorating terms of trade for agricultural exports: The major market for dairy products has been the former Soviet Union and now the Russian state. Under prevailing barter arrangements the value of Latvian dairy products traded with Russia has been reduced by half since the first quarter of 1991 as Russia charges world prices for petroleum products exported. Surpluses, subsidy policies and product dumping practices followed by Western countries makes Latvian dairy products non-competitive in western markets.

9. Collapse of state banking and trading systems: Centralized state trading and banking mechanisms have collapsed and private sector trading and banking institutions have not yet been established. Consequently, funds from state trading stores selling dairy products are not being returned to the state banking system and processing firms lack alternative mechanisms to collect moneys owned them. As a result, farmers have not being paid since May for their products sold through the state trading network.

10. Short term problems faced by Latvian agriculture: Latvia has moved more quickly than any eastern European country in effectively privatizing farm land and collective farms. Markets have been liberalized and privatization of specific agro-industry sub-sectors is imminent. Price disequilibria prevails as former stable (but economically irrational) price

levels are set free and a new set of price equilibria, based on free market principles, is not yet established. Western banking and corporate legal institutions are not yet in place as substitutes for the previous set of socialist institutions. The following problems need to be addressed:

- lack of short and long term credit availability to accommodate the fast pace of farm privatizations;
- deteriorating terms of trade with Russia and inability to compete in western markets with traditional agricultural exports;
- rapid increase in costs of imported farm inputs;
- strong farmer demand for government subsidies to make up losses from breakdown in state trading system and rapid price increases in purchased inputs
- grain shortages -- due to breakup of former trading patterns -- may reduce availability for dairy and meat industries as human population needs are met first.

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STATUS REPORT
LATVIA AGRIBUSINESS PRIVATIZATION PROJECT
JULY 1992

Both advisors were on-site most of the period. N. Melngailis returned July 1 and C. Fritsch returned July 9. Work continued on deliverables contained in the present workplan. New work was initiated to identify dairy processing plants for privatization. Criteria for ranking plants by privatization potential were developed.

The following subsectors were identified as MOA priority areas for project assistance: (1) dairy processing, (2) meat processing, (3) grain milling, and (4) farm machinery and equipment services.

1. The original law on privatizing agricultural processing enterprises was not enacted before Parliament recessed in July. A new law has been prepared for introduction at the next session beginning in mid August. This has been reviewed by the team and comments have been prepared.

2. The MOA agribusiness privatization strategy is to obtain a decree from the Council of Ministers authorizing privatization of several model dairy processing plants. This activity is expected to be on-going while the revised law is being discussed by Parliament. Experience gained during the model privatization phase is to be included in the new law.

3. The ministry has identified some 65 regional and local plants to be privatized in the first phase. An additional 10 large city plants are to be privatized in the second phase.

4. Field trips were made to fourteen city, regional and local milk and cream processing plants. Plants were visited to identify potential sites to be included in the model privatizations.

5. Initial discussions were held with farmers, farmer organizations and MOA staff to address workplan objectives to: (a) determine terms and conditions to form dairy producer societies, and (b) determine economic relationships between dairy producers societies and state owned central processing companies. This activity is progressing according to workplan schedule. It provides guidance for developing local level agricultural producer associations which are targeted by government to become part owners of assets in privatized dairy processing plants.

6. A report developing guidelines for management and control of state enterprises was completed in accordance with the workplan.

7. Because of the heavy emphasis on privatizing dairy processing plants, government has not yet submitted legislation to guide privatization of agricultural service enterprises. As a result, project activities relating to privatizing agricultural services have been delayed.

STATUS REPORT
LATVIA AGRIBUSINESS PRIVATIZATION PROJECT
AUGUST 1992

C. Fritsch was on site the complete month. N. Melngailis was away from site August 12 to 25. V. Morabito, Chemonics Director for Central and Eastern Europe was on-site from August 10 through August 15. He conducted a supervisory visit and assisted in developing the draft workplan for the new Delivery Order No. 9. Preparation of the new workplan is a deliverable on the existing Delivery Order No 4.

August activities were concentrated heavily on completing remaining workplan deliverables due on August 31. They included developing analysis and recommendations on: a) general terms and conditions of farm privatization and development of a model to form dairy producers associations, b) the economic relationship between dairy producers societies and state owned central dairy processing companies, c) GOL plans and legislation for cooperatively owned agricultural service enterprises, and d) phase II of collective and state farm privatization activities.

The MOA requested that item c be postponed until later in the Fall as the heavy emphasis on privatizing the dairy processing industry resulted in slippage of the planned time table for developing legislation and plans for privatizing enterprises in the agricultural services subsector. Analysis and recommendations on the remaining deliverables were completed. The executive summary is attached to this report.

Privatizing dairy processing enterprises is unique from other agribusiness enterprises in that there is strong pressure from Parliament to restructure them into the private sector giving producers associations majority asset ownership. This accounts for the heavy emphasis in the current workplan for analysis of farm privatization, models for producers associations and the economic relationships between associations and central processing plants. Government policy is to privatize dairy processing plants in two phases: the first phase (targeting regional and local plants) is likely to start in October. The second phase (targeting large city plants) is likely to start in early December or January. Under Latvian law Privatization Commissions, composed primarily of stakeholders, are responsible for all substantive decisions regarding privatization of firms within their jurisdiction. The team expects to complete, by early September, a short list of processing firms for ranking by a dairy industry specialist.

Because of the unique complexities involved in preparing the dairy industry and individual enterprises for privatization, a model privatization plan was also developed for use by Latvians responsible for drafting enabling legislation. Parliament returned from summer recess in mid-August. By the end of the reporting period pressures for action to pass enabling legislation mounted, with Latvian technicians using recommendations provided by the team.

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IV. WORKPLANS / STAFFING

Latvian Staffing Chart

DO #4 Workplan for May 11 through August 31, 1992

Letter from Atkacuns

DO #9 Workplan for September 1, 1993
through June 30, 1993

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Latvian Staffing Chart

Name	Company Affiliation	Time in Latvia
Conrad Fritsch Team Leader	Chemonics International	May 17 - Jun 13 Jul 9 - Aug 31
Nils Melngailis Economist	Coopers & Lybrand	May 25 - Jun 20 Jul 2 - Aug 11 Aug 26 - Aug 31
Vincent Morabito Privatization Specialist	Chemonics International	May 11 - May 23 Jun 8 - Jun 19 Aug 10 - Aug 15
Robert Anderson Privatization Specialist	Coopers & Lybrand	May 11 - May 26
Rasma Miltina Translator/interpreter	local hire	May 18 - Aug 31
Maris Graudins Translator/Interpreter	local hire	May 25 - Aug 31

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CONTRACT NO. EUR–0014–C–00–1058–00
DELIVERY ORDER NO. 4
LATVIA PRIVATIZATION ASSISTANCE TO MINISTRY OF AGRICULTURE
COUNTRY OF PERFORMANCE: REPUBLIC OF LATVIA
WORKPLAN: MAY 11, 1992 – AUGUST 31, 1992
COOPERS & LYBRAND/CHEMONICS INTERNATIONAL

TASKS	WEEK BEGINNING																
PHASE I: IMPLEMENTATION	5/11	5/18	5/25	6/1	6/8	6/15	6/22	6/29	7/6	7/13	7/20	7/27	8/3	8/10	8/17	8/24	8/31
I Review GOL privatization legislation and strategy for the Agr sector	<–	–>															
II Conference with key GOL Agr. privatization officials on:	<>																
A. comparison of privatization methods in CEE	<>																
B. review of consultant's workplan	<>																
III Review and recommendations concerning:																	
A. draft privatization law for processing industries		<–	––	––	–>												
B. draft privatization law for service industries						<–	––	––	––	––	––	––	––	––	––	–>	
IV A. review of implementation of collective and state farm privatization and determine terms and conditions for an acceptable model for dairy producers associations									<–	––	––	––	––	––	––	–>	
B. determine the economic relationship between dairy producers associations and state owned central pro–cessing companies									<–	––	––	––	––	––	––	–>	
C. analyze and provide opinion on GOL plans and legislation for cooperatively owned Agr. service enterprises									<–	––	––	––	––	––	––	–>	
D. analyze and recommend on the status of Phase II imple–mentation of collective and state farms.									<–	––	––	––	––	––	––	–>	

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August 10, 1992

Dr. Conrad Fritsch
Latvia Agro-industry Privatization Project
Riga, Latvia

Dear Dr. Fritsch:

I enjoyed meeting with you and Mr. Morabito on August 6 to discuss the Coopers & Lybrand work plans for your current assignment. The Ministry considers that the papers prepared as part of the workplan have been useful for planning the work of the ministry.

There are a few changes in emphasis that we would like you to take into account regarding your work during the next month. Section III.B. of the workplan required a review and recommendation of the draft privatization law for the agricultural service industry. We would like you to defer this work until later. As you know, the preparation of this law has been delayed and does not have the same priority as the processing law. Therefore, we do not expect you to complete review of this legislation in the timeframe stated in Section IV of the workplan.

We appreciate the comments received from you on the processing law. Although we had expected Parliament to pass this legislation before it adjourned for the summer, this did not happen. Therefore we would like you and Mr. Melngailis to spend some additional time reviewing and making comments on the new proposals.

We hope that the above changes will not cause you any inconvenience. Although we understand that your new contract does not directly include policy advice, we hope that you will continue to provide comments on policy issues related to your work and on legislative issues that are still outstanding.

Again, let me thank you on behalf of the Ministry for your work and for that of the team.

Regards,

D. Gegers
Minister

Latvia Agroindustry Privatization
Workplan Phases I & II
August 26, 1992

	Sept (1)	Oct	Nov	Dec	Jan

I Sectoral Analysis

Identify four priority sectors — completed in prior delivery order

Enterprise survey and selection

1. macroeconomic analysis

2. microeconomic analysis
   - enterprise 1:
   - enterprise 2:
   - enterprise 3:
   - enterprise 4:

II Pilot Privatizations

A. Enterprsie analysis and privatization preparation

enterprise 1
- Enterprise business reveiw
- Enterprise restructuring
- Implementation plan

enterprise 2
- Enterprise business reveiw
- Enterprise restructuring
- Implementation plan

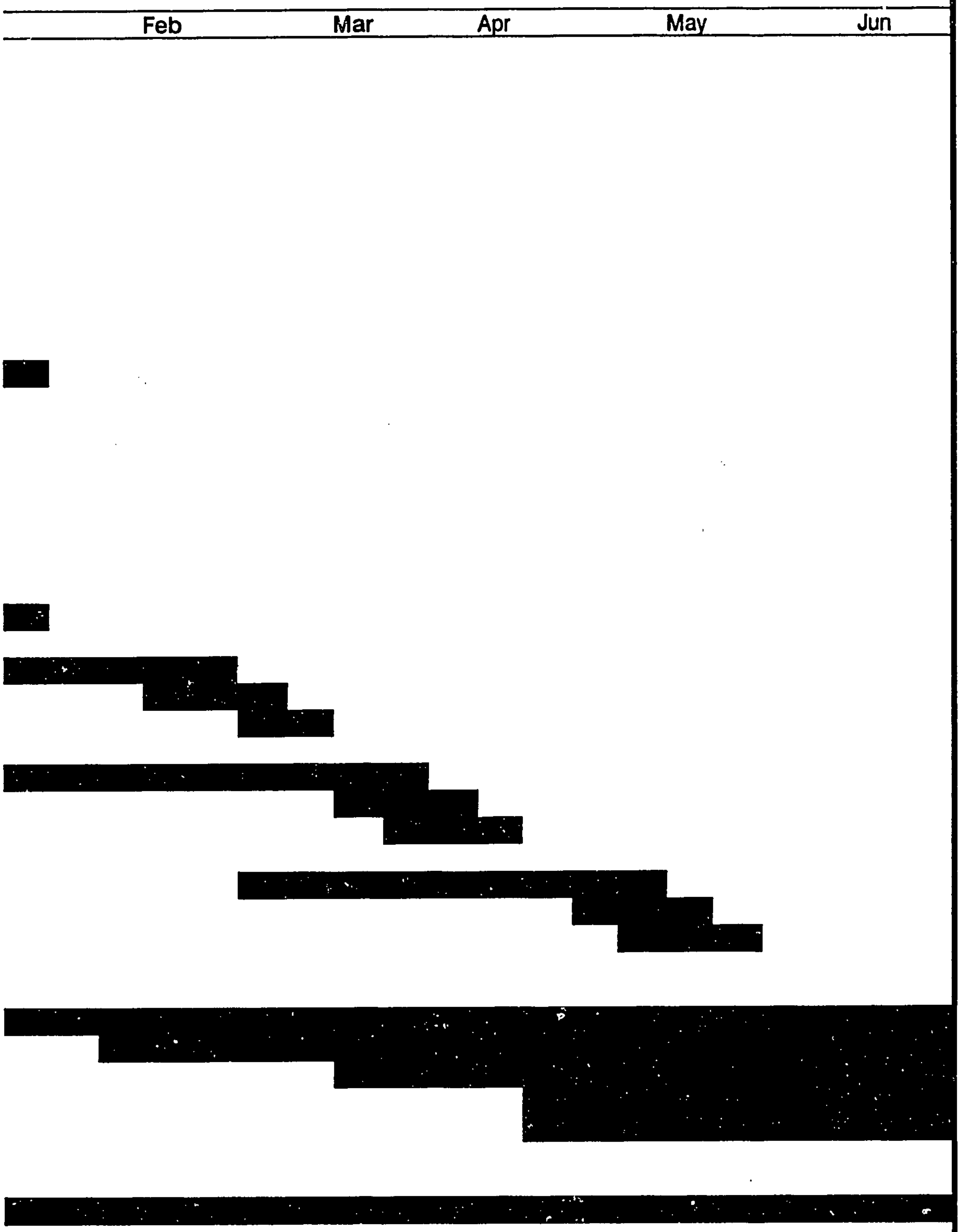
enterprise 3
- Enterprise business reveiw
- Enterprise restructuring
- Implementation plan

enterprise 4
- Enterprise business reveiw
- Enterprise restructuring
- Implementation plan

B. Privatization implementation
- enterprise 1
- enterprise 2
- enterprise 3
- enterprise 4

C. Training and development of generic models to be under taken during provision of enter– specific technical assisitance (2)

Notes
1. Assume September 1, 1992 start date
2. Training will be delivered to MOA technician counterparts working with expatriate advisors. MOA technical counterp technical advaisors in complettion of these tasks for all four enterprises.



arts will work with expatriate

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V. ANNEX

Latvian Laws Translated into English

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Latvian Laws Translated into English

Law:

1. "On Privatization of Agricultural Enterprises and Collective Fisheries" (21/6/91)
2. "On Land Reform" ()
3. "On Cooperative Companies" (6/8/91)
4. "On State Tax Inspectorate" (7/1/92)
5. "On Budget Rights" (27/6/90)
6. "On the Transformation of State and State owned Enterprises into Charter Companies" (7/7/92)
7. "On the Order of Privatization of State and Municipal Enterprises" ((17/6/92)
8. "On Bankruptcy of Enterprises and Companies" (3/12/91)
9. "On Land Privatization in Rural Areas" (9/7/92)
10. "On State Enterprises" (9/7/92)
11. "On Foreign Investment in the Republic of Latvia" (5/11/91)
12. "Export Tariffs" (5/28/92)
13. "Statutes of Dairy Producer's Association" (12/21/37)
14. "Valuation of State and Municipal Property" (10/6/92)
15. "On Cooperative (Joint Activity) Companies" (8/6/91)
16. "On Land Privatization in the Rural Areas" (9/7/92)
17. "On Non Profit Organizations" (12/17/91)

Others:

18. "Model Charter of Agricultural Machinery Services" (16/6/92)
19. "Model Charter of a Dairy Producers Cooperative Association" (4/6/92)