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ON THE ECONOMIC PREMISES OF THE "RESTRUCTURING" BY LIQUIDATION[1]

Some consideration over the economic fundamentals of the liquidation of state-own companies into the restructuring process of Romanian economy from 1990s

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Abstract: At the ends of 1990's under the pressure of the international financial institutions, Romania agreed to close some state-owned firms with significant and durable loses and limited perspectives. In this context, the present paper intends to offer an economic analysis of the main issues regarding the liquidation of state-owned companies. We discus on: the impact on macroeconomic results, on aggregate production, as well as on other industries production and supply; consequences on market competition; the influence of financial result of the firm on others, on its economic environment; economic perspectives of the unit and its market; effects and efforts for state budget and the alternative of privatization at any price.

[1] A first version of this material was published under the title *Restructuring by Liquidation: a solution? (Restructurarea prin lichidare: o solutie?)* in Tribuna Economica no.24/1999, pp.16-17. A slightly different version (a revisited one and with some added content) was presented at the International Symposium: *Development and Integration in the conditions of transition* (Cluj-Napoca, Babes-Bolyai University, 2003). The present English version of the paper integrates both materials and we also made several (but not essential) completions and minor modifications. Changes operated to the initial text are marked here in blue.

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Introduction

The liquidation of certain entities is undoubtedly a necessity and a characteristic of any economic system, not only of one in "transition". It represents an essential component of the functioning mechanism of the market economy, mechanism based on the principles of economic rationality. The problem that arises is **who** sets and on what **criteria**, which entities are need to be liquidated? Under normal circumstances, those of a market economy that effectively (and efficiently) function this problem is solved "naturally" by the very way its inner mechanisms operate in a well-established legislative framework. However, the Romanian transition was (and still is) far from such a solution, and that leaves, on the one hand, the decision into the account of the state-owner and, on the other hand, imposes its presence in this process.

The right of each and every owner to dispose of how he wants to its property is incontestable. Under the conditions of Romania, the state - as owner - is the one that ultimately has the decisive word on state property. From this view, the SPF[2], as the general administrator of this property, has the legal abilities necessary to initiate and enforce such measures.

Economic premises applied to Romanian conditions

The way in which this process has been carried out so far has been lacking a real and substantive analysis of decisions and has been chaotic and inconsistent. We believe that it is necessary, at least from now on, for a discussion to take place serious about the objective criteria on the basis of which one firm or another is "condemned" to extinction, as well as to the aims pursued. Considering past experiences related to reorganization and/or liquidation, it is necessary to pay attention at least to the following aspects:

1. The assertion - commonly seen lately in the expositions of opinions on this subject - according to which the closure of certain enterprises would lead to the increase of the Gross Domestic Product [GDP] as a result of elimination of the so-called "negative value added" cause by them requires a more detailed analysis. If such a relation is essentially undeniable, what is required is that **attention should not be directed to gross added value but on net added value**. And, consequently, not on what happens to GDP but with NDP [Net Domestic Product]. The differences regard the consumption of fixed capital, and its recovery in fully can be sacrificed, at least over a certain time horizon, to the extent that a particular firm achieves positive net positive value. Even in the context of a certain decrease

[2] State Property Fund

in GDP (estimated for the firms with the highest losses up to 0.5% from GDP[3] in the most critical year, still a tolerable figure) and accumulation of losses.

This solution is based on the mechanism - well-known to any economist - of determined the "breakdown point" of firms in short run, as it appears in the economic literature. In a simplified and partially adapted form, it implies that **a firm can continue its activity even it registering losses**, *if by selling its production fully recovers material and personnel costs, less the amortization (depreciation) of fixed capital and, at the same time, can do pay all its due obligations* (loans, suppliers, employees, taxes). The activity may continue under the described conditions at least as long as replacing fixed capital items (e.g. machineries, equipment) due to physical and/or moral depreciation is not a stringent necessity.

2. **The effects of shutdown a business cannot be "retained" within an industry/market**; so the analysis of the opportunity of such a decision must be a global one. The closure of a firm can generate chain reactions of equilibrium changes on its market as well as in other markets.

Obviously, the price for goods may rise on that market (with a high probability considering the markets structure in the majority of the industries subject of the present restructuring) as a direct result of the overall supply restrains. In the situations in which this decrease in production are "compensated" (in fully or partially) by additional imports and / or by other domestic producers, we will see, in the first case, an accentuating in the deficit of the Balance of Trade and of the Balance of Payments, and, in the second case, an increasing in the concentration (monopolization) level on the market, with expected effects over competition and again on prices. At the same time, each firm is, on the one hand, a supplier and, on the other hand, a customer of other firms and, as a result, its disappearance can cause problems to all the firms with which it is in business relations. And, whatever it is said, **the shutdown of a company will result in a reduction in revenues in the economy, in aggregate demand and production**. Here we mainly (but not exclusively) look at what is happening in the area of households' demand.

Therefore, the consequences may be more complex than those estimated at first glance, and the negative impact may be greater than the eliminated losses.

3. **Level of the traditional indicators of microeconomic results (profit and losses) should not be in such cases the main decision criterion**. In many circumstances they fail to disclose the economic reality of a firm. The existence of losses is not - as I have shown - necessarily a problem, at least if they do not exceed a certain level (that of the consumption of fixed capital)

[3] The estimates made at that time related to the cumulative impact of the financial results of the first 50 firms with largest losses.

and especially if they have a trend to elimination (reduction). The company's perspectives appear to be the most important element to be analyzed in the context. The present situation and estimated evolution of outputs and resources markets as well as the general economic conditions are essential items to be appreciated. And this because some losses may be result of an economic conjuncture, others may not be imputable to the firm, and sometimes they are the result of state interference in the economy (see, for example, the procedure and the consequences of the subsidy' mechanism in the case of pork and chicken production). In the same time, there may be and there are firms that do not currently record losses or have very low losses, but the analysis for the next period indicates that those will significantly increase.

4. The problem of indebtedness, the level and, in particular, the possibilities and the modalities of repayment should rather be taken into consideration, as well as the **way of payment of firm's obligations in general**. The non-payment of taxes and of utilities and other supplies (e.g. electricity and heating, natural gas) delivered by state-owned companies has become a common practice in the "management" of companies. And this practice is now the main cause for the financial jam, of the payment crises. As result, the **situation of outstanding payments and the contribution of each unit to the financial lock-up** must be the fundamental "indicators" of deciding the "destiny" of each economic unit. Selecting the companies that will be closed based on this criterion will lead, if not necessarily and automatically to reducing the payments problems in the economy and to a financial "unblock" (partial), certainly will stops accentuating it. *The initiative of starting a reorganization or liquidation (bankruptcy) proceeding it must not necessarily belong in such cases to the state or SPF, but directly of interested parts (the largest creditors).*

5. From a **budgetary outlook**, what should prevail is the **effort-effect ratio of each and every closed firm on the state budget (a cost-benefit approach)**. And this should represent, plus the (mentioned above) contribution to financial transfer lock (in chain), the decisional criterion. Closing a business generally means a **minus in revenues for the state budget**. We do not refer here to the profits that we assume to be inexistent (this is the motivation of the decision), but to the value added tax for the products produced, the taxes on wages and the social security contributions and other funds. On the other hand, it will be an **increasing in the state expenditures**, materialized at least in the unemployment benefits to be paid and in this economic aberration represented by "compensatory" payments. Making here a necessary specification, we must explain that our previous affirmation does not consider compensatory salaries to be aberration in itself, but their level. A level so high in many cases, that such payments became an goal for employees as well as for management, and so their

interest was perverted from the improving the economic activity of the firm to an opposite direction of increasing losses. It is more appropriate - as proved by practice too - that at least some of these amounts to be oriented towards investment (or to stimulate the investments) generating new jobs. Otherwise, we will only replace a problem (loss-making firms) with another (unemployment) and, moreover, we can create at least a "new"[4] problem: inflation.

Returning to the budget and budgetary approach, we appreciate that only if the state revenues (respectively the future estimated revenues) from these units, plus those supplementary expenses as well as the costs of actual liquidation (e.g. preservation of the physical objectives) do not exceed the value of the losses (plus, if appropriate, any state subsidies and estimated net amounts to be recovered following liquidation), only then the decision of closing a firm really gets an economic foundation.

6. Finally, if the declared purpose of restructuring is to increase the efficiency and to eliminate the losses, then the selling price of the firms (in privatization process as a pre-liquidation step) should not be the element of interest for the state but the business plan, investments level and commercial contribution. And only if there are no buyers, liquidation becomes a solution.

Taking over debts to the budget, refunding a portion of the price for paying these debts or investments is a false issue. They have no essential consequences on privatization. The buyer will be willing most likely to offer a higher price if he knows that part of it will be returned to him or if he has will received a debt reduction in any form (or any other benefits). Or a correspondingly lower price if he takes over the company with all its "unresolved issues". So, it is reasonable to presume that there are not significant differences in the net value of budgetary income from privatization between any of these ways. Moreover, differences can therefore only arise in relation to the price level offered, and if the price is not important, then such measures are of no relevance. This is because the purchasing decision is normally based mainly on the company's perspective and only indirectly on its financial situation at some point.

Final Considerations

The purpose of the above is neither to argue for the artificial maintenance in operation of certain state companies for unlimited period nor to challenge the validity and the necessity of liquidation as a form of restructuring the economy. We just wanted to present some "milestones" according to which the entire process should be thought, design and developed. The final goal should be - in our opinion - both economic (eliminating the so called "economic black holes" with the lowest possible costs and without affect the prospect of economic development; increase

[4] Inflation was already a major problem in Romania in the 1990s.

efficiency and, why not, ensure higher incomes for the state) and social (the need to maintain a certain level of employment, tolerable social costs, the least possible negative impact on the population). What is required is a complex analysis of all the estimated consequences and, in particular, a **case-by-case analysis**. The necessary tools exists, we just need to use it.

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