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PRIVATIZATION AND THE INTERNATIONAL EXPERIENCE: THE FOREIGN INVESTMENT DIMENSION

by

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PRIVATIZATION AND THE INTERNATIONAL EXPERIENCE: THE FOREIGN INVESTMENT DIMENSION

by

Maurice Odle1/

Preface

In discussing with the Regional Co-ordinator one month ago about what should be the thrust of my paper on privatization, I immediately thought of debt-equity swaps or, alternatively, the role of privatization in the development of a capital market, given the monetary and central bank aegis of this regional programme of studies. A second impulse, based perhaps on a supposed comparative advantage of living in the 'capital of the world', was to take the grand and eclectic approach of reviewing the global experience and at the same time comment on the theory and perspectives that underpin a lot of the thinking on privatization. A third and overriding impulse, informed by my present place of employment, was to focus on the foreign investment dimension, while making reference to the rapidly expanding literature and the evolving and rather fascinating practice.

This paper has five parts. Chapter I constitutes a general overview of the international experience with respect to privatization. Chapter II indicates that privatization, while rapidly expanding, is in its early stages in some countries and its mature stage in others and that privatizing to foreigners is likely to present some of the same problems as obtained prior to nationalization. Chapter III illustrates that privatizing a

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1/ This paper is in no way intended to reflect the views of the organization, United Nations Centre on Transnational Corporations, to which I am attached at present. The paper is also intended to be part of a wider research effort.

whole country, rather than particular enterprises in the USSR and East Europe, represents a very special experience. Chapter IV attempts to distill the relevant lessons from our recent experience and Chapter V is made up of concluding remarks.

CHAPTER I. INTERNATIONAL EXPERIENCE WITH RESPECT TO PRIVATIZATION: AN OVERVIEW

A. Origin and Rationale of Privatization Process

In recent years, there has been a veritable revolution in the way many developing and developed countries perceive the state's productive role in the transformation process. Whereas most of these countries previously felt that state-owned and private enterprises constituted twin pillars in their mixed economy structure, there has been a decided shift towards viewing state-owned enterprises (SOEs) as playing a merely subservient and supporting role. However, in the developing countries the rhetoric extolling the need to privatize has sometimes exceeded the actual practice. This is due to a number of factors including the unavailability of a well developed private entrepreneurial class, the weakness of the local capital market, and conflicting thoughts about handing over certain public assets to foreign ownership.

The rise of the privatization phenomenon is very much linked to the persistent crisis in the international economy. The oil price rises of 1973 and 1979 created serious problems for oil importing economies and the fall in oil prices in the 1980s and the burden of servicing the huge foreign debt run up by both oil producing and oil importing countries has created confidence related recessionary conditions and serious balance of payments problems. In some cases, the foreign exchange problem has forced governments to adopt deflationary policies that aggravated the recession. In any event, the loss prone and subsidy dependent state-owned enterprises became a prime target for belt tightening since their deficit impost on the budget was sometimes equivalent to more than 5 per cent of GDP; in addition, their external

borrowing had reached astronomical proportions accounting, for example, in the case of the three largest Latin American countries (Argentina, Brazil and Mexico) for over half of the country's external debt (Belassa, 1989). At the same time, there was a movement towards liberalization of policies relating to foreign investment so as to increase the inflows of foreign capital, alleviate the foreign exchange problem and accelerate the rate of economic activity. The conjuncture of the debt burden and the relaxat n of policies towards foreign investment also led to the introduction of new instruments, such as debt-equity swaps, as a means of reducing the debt servicing burden created by state-owned enterprises, inter alia.

The idea of privatizing state-owned enterprises in developing countries was not an entrely home grown product of local politicians. It can be said to have had strong origins in the philosophy being espoused by international financial institutions and certain developed country governments. Privatization has become a key aspect of the restructuring and adjustment programmes advocated by the World Bank and the IMF (and, to a lesser extent regional development banks) as a consideration for lending to developing countries. Structural adjustment loans where privatization was one of the important elements amounted to about $4 billion from 1982 to 1990. The developed countries that dominate these international financial institutions have also been carrying out a programme of privatization in their own countries and found it natural to recommend such a course of action to developing countries during multilateral and bilateral aid negotiations. Needless to say, the local private sector is also very much in support. The constellation of international and national economic forces and multilateral and bilateral lending practices has been a major driving force behind the privatization effort.

More dramatic and capturing of the international limelight has been the effect of 'Gorbachevism' in the USSR and its effect on Eastern Europe and certain socialist-oriented countries in the Third World.1/ Gorbachev's vision of a few years ago was of "perestroika" or economic restructuring being introduced to deal with the economic malaise that was afflicting the Soviet Union in its agricultural sector where material incentives were lacking, in the storage and distribution sector, where technology was inadequate, and the consumer goods sector, where not even the most powerful computers in the hands of central planners could match the stodgy supply system with the myriad wants and preferences of the population for good quality and varied Western type goods. Moreover, less and less resources were becoming available for old style rehabilitation efforts because the Reagan "Star Wars" tactics required an increasing share of GNP to be devoted to a new arms race.

At the political level, Gorbachev also trumpetted the concept of "glasnost" or social and political opening-up so as to make decision making more transparent and accountable. Glasnost was conceived as a sort of support or prop to perestroika. However, the citizens took their glasnost more seriously than expected and the mushrooming of free thinking, new political groups with their propaganda newsheets and other material caused activism to spill over into unchartered waters and the unexpected territory of ethnicity and nationalism. Starting with Armenia and Azerbajan, the movement spread to former Eastern Europe which

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1/ For the rest of this paper, I shall use the term developing countries instead of Third World. The term 'Third World' arose after the Second World War when those poor countries that did not want to align themselves with the developed and ideologically rivalling Western and Soviet blocs chose a path of neutrality and security seeking solidarity. However, with the dismantling of the "Second World" a rethinking of terms may be in order.

withdrew from the Warsaw Pact and declared itself totally independent of the USSR. Glasnost was now equalling the force of perestroika and its ethno-nationalism effects spread to Yugoslavia and then back to the USSR where the attempted coup hastened the emergence of the Baltic States of Estonia, Latvia and Lithuania and the fast unravelling of the remaining Soviet republics. Gorbachev was riding a tiger and had lost control. Glasnost had now given a depth of meaning to perestroika that no one had expected. The mutually self-reinforcing effects of glasnost and perestroika had set in train a process of rapid dismantling of the old socialist system.

These developments have had an important impact on Eastern Europe where privatization has now become a major objective and means for moving towards a market economy. The dismantling of the USSR and the tremendous disruption it has wrought on its former trading and supply partners in Eastern Europe has made the central planning model of these regional economies totally unworkable and the countries are rushing franctically to insert capitalism into the yawning vacuum. Privatization is an integral part of this process.

Those developing countries which were once socialist-oriented have not escaped the convulsions that are occurring in the USSR and Eastern Europe. The upheaval in the latter and the resulting destruction of the trading and supply relationships has reduced their ability to give aid to friendly developing countries. Even before the cataclysmic developments in the USSR and Eastern Europe, such socialist oriented developing countries were having second thoughts about the appropriateness of their particular path of development as a result of the same forces mentioned above. The discrediting of socialism has hastened the movement to a market economy in these 'newly open-door economies' in the developing world. There has been an ideological

demonstration effect. For them, too, privatization is fast becoming a watchword, thus making it a truly international phenomenon.

I have attempted to give in Table I.1 what can be considered a not exhaustive list of 25 causes of present day privatization. It is interesting to compare this list with a past World Bank list (Table I.2) of 25 causes of nationalization, from the point of view of the inter-temporal movement of social, economic, political and philosophical forces.

B. Incidence, Strategies, Modes and Techniques

Concrete statistical information on privatization is not easy to come by. However, there has been a considerable amount of comment in the literature on modes and techniques of privatization.

Privatization is not an entirely modern phenomenon. For example, since 1868 the Meiji restored Japanese Government practiced a policy of initiating an activity that they had perceived to be in the economic interest and once it had been seen to be viable selling it to the private sector. In the post World War II period, selected elements of such a policy was also implemented by Singapore and South Korea.

Over 1500 privatizations have occurred in the developed and developing countries. (This does not include Eastern Europe where many thousands of very small "mom and pop" enterprises in each country have already been privatized). About half of the privatizations have taken place in Latin America, the region with the biggest foreign debt burden, including about 430 in Mexico and 265 in Chile, alone. Significant privatizations have also

Table I.1: A Partial List of the Objectives of Privatization 1/

1. Reduce fiscal burden
2. Make profit maximization paramount (over other objectives)
3. Reduce foreign debt (through debt-equity swaps, etc.)
4. Promote foreign investment
5. Minimize technological weaknesses
6. Utilize allocative efficiency of market mechanism
7. Strengthen capital market (as populist ownership vehicle, performance monitor and capital mobilizer)
8. Increase entrepreneurship
9. Democratize domestic investment process
10. Reduce public sector corruption and patronage
11. Increase administrative accountability
12. Reduce secrecy and increase transparency
13. Further meritocracy over seniority based system
14. Make management positions and professional salaries performance related
15. Increase worker motivation
16. Minimize political interference
17. Downplay protectionism
18. Devote more time and management resources to remaining non-privatized SOEs
19. Pressure from multilateral financial institutions and bilateral sources
20. Capitalist ideology driven
21. Collapse of an alternative paradigm (i.e., world socialism)
22. Increasing competitiveness of the world economy
23. International bandwagoning
24. Developmental exigencies and imperatives - in search of a panacea

1/ My order of listing is not intended to reflect any weighted importance.

Table I.2: A Partial List of the Objectives of Public Enterprise 1/

1.	Provide entrepreneurial support/substitition
2.	Control monopolies
3.	Control commanding heights
4.	Provide public services
5.	Earn profits for investment
6.	Utilize resources efficiently
7.	Prevent business failure
8.	Offset externalities
9.	Train skilled managers and technicians
10.	Increase employment
11.	Raise output
12.	Reduce income inequality
13.	Promote regional development
14.	Stabilize prices
15.	Subsidize necessary commodities
16.	Set "modernization" example
17.	Earn/save foreign exchange
18.	Promote primary exports
19.	Achieve socialism
20.	Counterbalance power of domestic capitalists
21.	Increase national self-sufficiency
22.	Enhance national prestige
23.	Implement government policy
24.	Promote national security
25.	Offset multinationals

Source: Based on World Bank, State Intervention in the Industrialization of Developing Countries: Selected Issues, Staff Working Paper, No. 341, July 1979.

1/ The rank ordering is not intended to be suggestive of priorities.

taken place in Bangladesh and the Philippines in Asia and in Senegal and Togo in Africa.

In Western Europe, the most dramatic expressions of a privatization policy are the experiences of Britain and France. During the 1980s the Thatcher Government privatized 41 companies of considerable size and value. For the 19 that were sold as securities on the London Stock Exchange, a total of £18 billion was raised; the rest were private disposals and management buyouts. The French Government's action reflected a dramatic turnaraound. When Mitterand came into office in 1981 his government nationalized wholly 5 industrial groups, the 36 largest banks and 2 major financial holding companies. But within a few years the same Government began to engage in a massive programme of privatization (T. Jenkinson and C. Mayer, 1988). The privatization of public sectors (many of which were quite profitable) in these two countries was inspired partly by the need to boost revenues for election winning spending sprees and reduce the budget deficit and, in the case of Britain, partly by the momentum of an ideological crusade to elevate the role of market forces and to minimize the importance of SOEs. However, in the case of Italy, it is felt that the purpose of privatization was to strengthen the public sector rather than to weaken it. Thus privatization in Italy mainly involved giving up only part ownership (as in the case of IRI) in order to acquire funds for much needed expansion and modernization (R. Vernon, 1987).

In the USSR and Eastern Europe a "privatization binge" is said to be underway (D. Fairlamb, 1990). Here the problem relates to the exigencies of trying to privatize a country, rather than privatizing an enterprise or group of enterprises. However, these countries were not monolithic in terms of their public sector dominance. For example, the percentage share of

state sector dominance in Czechoslovakia (1986), East Germany (1982) and USSR (1985) was 97.0, 96.5 and 96.0, respectively,1/ whereas the share for Poland (1985) and Hungary (1984) was 81.7 and 65.2, respectively (S. Fischer, 1991). As will be seen later on in this paper, these countries have been experiencing tremendous problems in the planning and organization of the privatization exercise, in the choice of the mode of privatization, and in the techniques of privatization.

In the developing world, a number of countries have in recent years announced plans for privatization, frequently as part of a formal World Bank/IMF structural adjustment programme or a unilaterally determined policy of economic reform. For example, Table I.3 on Africa indicates that a large number of countries have indicated their intentions of implementing a privatization programme and in many of these individual privatization projects have already taken place.

Three groups of industries involving state participation can be identified. The first group has been traditionally associated with the state, partly because the intrinsic nature and form of the goods and services produced resulted in their being monopoly prone enterprises (MOPE). Examples are public utilities, such as electricity, gas, rail transportation, air transportation and telecommunications. (When to public utilities are added defense industries along with the major export earners or "commanding heights", the whole group has tended to be referred to

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1/ The share of the state sector in value added was probably similarly high for Albania, Bulgaria, former East Germany and Romania.

Table 1.3: Privatization Programmes in Africa

Country	Year Programme Began	IBRD Assessment1/	Public Awareness/ Support2/	Major Sectors to be Privatized	Progress made in Privatization	Expected Foreign Involvement	FDI Regime
Angola	1987 (SAP)	Became World Bank/ IMF member (1989)		Agric, trade, transpt, indus, hotels	Progress in hotels, coffee plantations, trade houses	Hotels, coffee plantations, trade house; gen FDI promo	Liberalization but political uncertainty
Botswana	No major programme; always emphasized private sector/FDI; 9 major parastatals to be "restructured" (World Bank, '89)						
Cape Verde	1986 (2nd Nat. Dev. Plan) 1987 (Pub. ent. reform; 2nd phase SAP)		No specific info	Promoting FDI; not necessarily tied to privatization			Attractive but political uncert.
Cote d'Ivoire	1990 (announcement re priv. of 5 "mixed economy" co's) 1991 (progr. will affect some agric and energy holdings)			Selective; episodic (see footnote 2/)		Always been liberal regarding FDI	
Egypt	1989 (Cabinet Cttee to review SOEs)	See footnote 1/	See footnote 2/	No hard data	No hard data	Liberal; promoting FDI in general	
Ethiopia	1990	Positive		Plans to liberalize economy (1990); no sectoral details		Liberalization; but political uncertainty	
Ghana	1983 (ERP) 1987 (SAP; priv); etc.	Positive	Lively, Govt suspects general opposition, but ramming things thru	Industry; some mines; hotels, etc.	After slow start, some hotels & mines privatized	Liberalization; but political uncertainty	
Guinea-Bissau	1983 (private sector/FDI promo) 1987 (public ent. reform)	Engaged in SAP	No specific data	No specific data	No specific data	Liberalization	
Kenya	1990 (President: loss-making SOEs will be privatized	- No specific information -				Always been liberal but recent political uncertainty	
Lesotho	1988 (SAP)	Engaged in SAP	- Private Investment/FDI focus of SAP; not specific re privatization -				
Madagascar	1987 (SAP 1990 (Sporadic privatizations)			Agriculture, airports	Agriculture, airports	Promoting FDI generally	Liberal; EPZ "booming" (1990)
Morocco	1983 (SAP) 1989 (Minister of Privatization appointed)		Opposition charges "making rich richer, poor poorer"	Tourism, manufac; agric; agro-industry; clothing; banking	112 enterprises earmarked (1989)	Promoting FDI generally	Liberal

Mozambique	1987 (ERP)	Positive	No specific info	Industries; services (i.e., hotels); agric	47 "large) over 40 "small) 1985-88	Liberalization, but political uncertainty	
Namibia	1990	Emphasis on FDI promotion; no privatization programme as such					Liberal
Nigeria	1986 (SAP) TCPC (Tech. Ctte on Privatization & Commercialization) Established (yr?)	Positive (see footnote 1/	No specific information	Banks, industries	39 "earmarked" (1989) 22 already priv (1989) data sketchy	Promoting FDI in general	Liberalization
Sao Tome & Principe	1987 (SAP) 1989 (P.M. announces "a number" of privatizations)			Telecom; ceramic factory; tourism; cocoa producing cos		Promoting FDI	Liberalization
Tanzania	1986 (ERP) 1990 (Survey of parastatals; 400 in existence; plans on "restructuring"; considering privatization)		FDI promo	Agric; mining, manufacturing; transport;tourism	No hard data	FDI promotion	Liberalization of FDI law ('90)
Uganda	1987 (ERP) 1990 (Privatization Plan)	Engaged in ERP, etc.	- No specific information -			Liberalization of [Draft] FDI law (1990)	
Zambia	1985 (ERP) 1987 (NERP) etc.	Roller-coaster relations, watching new govt.	General elections & change of govt (1991)	New govt intends to promote private sector & FDI in general; outgoing govt started privatization discussions		Liberalization; watching new govt	
Zimbabwe	1990 (Budget statement: "Those parastatals which cannot operate efficiently will on a selective basis, either be allowed to go out of existence o be converted into joint ventures in order to introduce new management skills". (No other (specific) info re privatization)						

1/ Footnotes

Country	Summary of World Bank prognosis
Angola	Angola applied for IBRD/IMF membership after preparing its own reform programme (including privatization) in 1987; admitted 1989.
Botswana	World Bank Report (1989) suggests that existing parastatals should prepare to face commercial market conditions; Botswana: Financial Policies for Diversified Growth [Doesn't specifically call for privatization]
Ethiopia	May '90; after (Mengistu) Govt announces plans to liberalize the economy (incl. privatization) IMF/World Bank are reported to be willing to increase assistance.

Guinea-Bissau	No further details
Kenya	No further details
Mozambique	"State control over the manufacturing sector, partly forced on the govt by circumstances, is relatively extensive, and possible options for divestment are under continuous consideration": World Bank, 1990.
Egypt	IBRD Country Briefs, 1989: Govt "initiated a reform of public industries designed to decentralize decision-making."
Nigeria	World Bank, 1989: The experience over the last three years bears out previous expectations that the dynamic and entrepreneurial spirit of the Nigerian people would respond well to the shift to a more market-oriented incentive framework.

2/ Footnotes

Country	Comment in the Press or Journal
Angola Botswana Etc.	Press statements mostly descriptive; reflected in table.
Egypt	There is considerably less consensus over the question of privatization, especially within the bureaucracy ... The ruling National Democratic Party maintains that a wholesale transfer of SOEs to the private sector is politically unrealistic in view of the risks of big job losses.
Cote d'Ivoire	Petroci (state-owned oil monopoly) selling off some of its downstream holdings (distribution) to concentrate on exploration and production: Africa Energy & Mining, March '90.

Sources: Based on data SIDA.

generically as strategic industries).1/ These industries mainly public utilities lend themselves to a natural monopoly situation partly because ease of entry or competition is restricted once the provider of the service gets a headstart. This, in turn, is due to high capital intensity and falling average and marginal cost curves.

When a company acquires a headstart, it is able to charge a lower price than a new entrant and therefore able to drive the newcomer out of existence, unless the latter is able to bear a considerable amount of losses in the short run, making for an obvious case of market failure. This situation is reinforced if the service is fairly standardized in nature and there is little opportunity for a newcomer to introduce differentiation in the type of service and so bid customers away from the existing enterprise that happened to be the first to set up operations. MOPE tend to be large and technologically complex and their privatization frequently involves foreign investors.

A second group are those 'enterprises with a clear and long involvement with private sector encouragement' (ECLIPSE). For such enterprises the private sector usually had a comparative advantage and the state only became involved because private sector entrepreneurship was not forthcoming (owing to a shortage of capital or a lack of knowledge) or an existing private sector enterprise was about to go out of existence and the rescue act would save a number of jobs. Such activities were usually in the manufacturing sector, e.g., cement, steel and fertilizers. Over time government tended to not only use these enterprises as a source of patronage and a medium for free wheeling cronyism but,

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1/ Banking is an example of an industry which is not monopoly prone but is nevertheless considered strategic. The previous domination by transnational banks in this sector attracted countervailing government ownership intervention.

also, to acquire even small manufacturing and services sector enterprises and this aggravated a management stretching problem. The trend towards privatization of the ECLIPSE is not unexpected, given the new emphasis on the role of the private sector in the developmental process.1/

A third group relates to those Government Ministries, Departments and Agencies which are being emptied of functions that can possibly be performed by the private sector and which are being subjected to as much lean-stripping as possible, thus creating a set of what we might call 'newly embodied private sector activities' (NEPSA). This has taken the form of a greater incidence of inviting tendering for the provision of services such as garbage collection, water treatment, road maintenance, airport operations, zookeeping, wharfing, hospital cleaning and laundering, security guarding, school lunches and other catering, and certain other welfare activities. In the USA, there has even been a recent case of a franchise being given for the operation of a security prison. It would also appear that four private tollroads worth $2.5 billion will soon be coming into operation in California to operate not very much different from the 5000 miles of franchise toll highways currently in operation in France, Italy and Spain (R. Poole, 1991) involving build, operate, transfer (BOT) and build, own, operate, transfer (BOOT) arrangements whereby the private entrepreneur undertakes and finances infrastructural projects, and then runs same for a number of years until he recoups his capital with profit before handing over to the government.2/ This can be said to

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1/ It should be noted that an ECLIPSE can be transformed into a MODE as a result of tariff and other protective barriers.

2/ Also, Hungary has invited bids to construct a $150m privately financed toll motorway with a concession for somewhere between 20 and 50 years. See Tracking Eastern Europe, Vol. 2, No. 58, September 1991.

represent a form of privatization with certain inter-temporal dimensions.

The privatization strategy of a government, and its related intensity, modes and techniques, will very much depend on the trade offs between multidimensional objectives of a government in a continuing process of satisfying and dissatisfying (R. Rose, 1989). In terms of the scope of the programme a lot will depend on the government's need to reduce the fiscal burden or to reduce its external debt, as in the case of debt-equity swaps.1/ If revenue earning is a primary concern, the government may want to start its privatization programme with the largest and most profitable of the public enterprises (as occurred in South Korea and Taiwan). But privatizing of profitable enterprises can be questioned especially when it involves sale to foreigners. An alternative approach, according to the experts, is to start with a medium size enterprise whose shares are easy to unload to the public (the "winner approach") and to use this as both a learning vehicle and a means of enlisting the support of the public for the programme. However, if a stock market mechanism is either not possible or appropriate and a direct sale method is employed the bidding process has to be seen to be transparent. There is inevitably an interplay of government objectives and people's perceptions. The dynamics of this process are very much reflected in the modes and techniques employed in the privatization process.

1/ The scope of the actual programme may also be determined by the number of public companies the government decides to liquidate, given their poor condition, rather than attempt to sell. Significant liquidation occurred in Mexico and Togo.

Modes of privatization1/ vary with respect to both ownership and instrument. With respect to ownership, privatization can involve the transfer of asset ownership2/ or such non divestiture forms as leasing and management contracting. Transfer of ownership has tended to take three basic forms - "institutional capitalism", "labour capitalism" and "popular capitalism" (R. Luders, 1990). An alternative, but nonetheless corresponding typology is "sell-off and cross-ownership model", "employee stock-ownership plan model" and "social dividend model" (Business Week, Feb. 5, 1990).

Institutional capitalism relates to the state selling off an enterprise to a single buyer or coherent group of buyers such as a mutual fund, pension fund, etc. With respect to medium and large scale enterprises, foreign investors are frequently involved.

Labour capitalism or employee stock ownership plan (ESOP) involves selling shares to the managers and employees. It is the form that seems to create a lot of excitement and attract a great deal of media attention. Proponents of this approach state that it fulfills certain democratic ideals and that the resulting higher motivation that shareholding brings will be reflected in higher productivity. However, arriving at a share price that actually clears the market takes some doing. Moreover, as we shall see later on, there is a tendency towards increasing share concentration, as a result of workers selling off their rather cheaply acquired shares.

1/ Here it is assumed that privatization relates to the sale of an existing asset and does not include the creation by private persons of an essentially new entity.

2/ However, privatization can also include the positive and activist attempts on the part of the State to stimulate existing and new private sector activity.

Popular capitalism is achieved by selling off the shares of an enterprise to the general tax paying public so that the entire (working) society can participate in the profits and dividends being earned from productive activity. In Eastern Europe a voucher system has been used to allow citizens to bid for ownership. As with labour capitalism, this system has the advantage of creating instantly a capital market or accelerating the development of an existing one.

The non-divestiture model (a sort of 'capitalism with reduced risks') involves the contracting out of the management function or the establishing of leasing and franchising arrangements. The management and leasing arrangements are particularly prevalent in the hotel industry, for example, where the expertise and network system of the international hotel chains is very much in demand.

In any one privatization transaction, it is not impossible to find a combination of these forms at work. For example, in preparing for a privatization a government may hire off a small segment of the company that is either not very profitable or very integral to its operations and then may sell 49 per cent of the remaining entity to a foreign investor who would then invariably assume the management function despite his minority ownership status. The government may at the same time offer part of its shares either to the employees or to the general public.

The services related to the techniques of privatization that are offered by international accountants, lawyers, investment banks, etc., constitute a fast growing industry. Such assistance is particularly useful with respect to the commercial valuation of assets, preparation of a prospectus and public share

offering, the number offerings (tranches)1/ and whether offers should be made at a preannounced fixed price or by public tender and private placings by institutional investors in quantities they desire but at or above a minimum price. If the market bearing price (based on applications received) is below the minimum tender price then a system of rationing of shares may be required. In a placing, shares are sold not to the public but to a specific group of investors.

C. Administrative, Distributional and Allocative Efficiency

There are certain costs associated with the privatization process. One is the direct cost of employing the services of investment bankers, and accountants, etc. and the payment of taxes and listing fees. These direct costs consist of fixed and variable elements and decline as the size of the issue increases. In the UK the direct costs of offers averaged around 4.5 per cent of the size of the issues but small placings tend to be cheaper (T. Jenkinson and C. Mayer, op. cit.). As with everything else, the transfer of the privatization technology seems to be quite slow and the fees do not seem to be getting any smaller. For example, in an announcement last September (1991) about Costa Rica's plans to privatize the Electricity Institute, ICE, (which produces 90 per cent of the country's energy and administers telephone and communications services) for between $500 and $700 m., Paine Webber, the financial consultants, were slated to receive a commission fee of $5m.

Another cost relates to underpricing of the asset. Underpricing may occur when a direct sell-off occurs without a

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1/ This may reflect a strategy of testing of the waters in order to arrive at the correct price, in addition to considerations of stock market capacity.

bidding or tendering process. In this non-transparent process, kickbacks might be involved. But underpricing can also occur in the course of a public offering. For example, in the French and UK fixed price offers, percentage discounts on issue price were in double figures for 18 out of 23 cases and 13 of these were in excess of 20 per cent. According to one estimate, the underpricing resulted in loss of government revenue in the UK of up to 51 per cent or 4.8 billion pounds sterling and in France up to 16 per cent or 7.4 billion francs (R. Seth, 1989). This was said to be equivalent to 51 per cent underpricing in the case of the UK and 16 per cent underpricing in the case of France (G. Yarrow, 1986).

This tendency to underpricing seems to have been replicated in the developing world. For example, the Chilean privatization seems to have involved a not insignificant amount of underpricing. In the case of the UK's sale of British Telecommunications, two million applied for the billion shares available to the public and on the day trading opened shareholders were in a position to sell at 90 per cent profit. The undervaluation was estimated to be £1337.2m. Also, the British enterprise, Amersham International, which was floated at a fixed 'give away' price, was oversubscribed 22 times and the undervaluation of Cable and Wireless was estimated at £46.6m. In Italy, the selling of 40 per cent of the Sirti, a subsidiary of the Stet Telecommunications Company for only 200 billion lira was considered a case of gross underpricing. In Jamaica, when the Government in 1986 divested 51 per cent of the National Commercial Bank, the heavily oversubscribed shares were sold at a substantial premium after the offering. Of course, overpricing can also take place during a share issue. In the case of Thailand's second largest bank, Krung Thai, which had a reputation for underperforming, the shares were only sold after strong government pressure on underwriters and investors who were

apparently told that unless they pushed the issue they would not be able to participate in future divestment stock (M. Montagu-Pollock, 1990).

The redistribution concept of 'sharing the wealth' relates to public and employee share offerings. The proposed give away of shares in certain East European countries is an extreme example. However, the effects can be partly reversed very quickly. In Korea, when one-third of the shares of the huge and highly profitable Pohang Iron and Steel Co. (POSCO) went on the market in 1988 with 3.2 million investors making purchases, low income investors were offered a full 75 per cent of the offered shares at well below market prices (and) another 20 per cent went to POSCO's own employees. However, many POSCO workers realized that by selling out they could make a quick windfall profit and, within a year, only 1.1 million shareholders were left. In the case of the giant Korea Electric Power Corporation (PEPCO) (which was even bigger than POSCO and accounted for 13 per cent of total stock exchange capitalization) the selling of 21 per cent of the shares to 6 million people in 1989 ended up with only 4.5 million shareholders only a year later.1/ In Britain, although employees typically bought less than 5 per cent of the shares issues there was considerable unloading after privatization. "Within a month of flotation, the number of shareholders in Amersham had fallen from 62,000 to 10,000; within one year of flotation, the number had fallen from 150,0000 to 26,000 in Cable and Wireless (first tranche) and from 158,0000 to 27,000 in British Aerospace" (G. Yarrow, op. cit.). This tendency towards

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1/ Reference has been made to the 'quick kill' approach even in countries with a fairly developed stock market. In less developed stock market situations, share disposal may arise because of lack of information (victims of a type of insider trading) and lack of frequent trading facilities in the secondary market for those in search of liquidity, in addition to lack of asset holding tradition and experience.

concentration is likely to reproduce and replicate old patterns of class privileges and wealth disparities. In the Philippines, it is said that the privatization process has served to reverse the trend towards undermining of the elite family domination and political cronyism of the Marcos era (T. Killick and S. Commander, 1988).

In espousing the redistributive benefits that are said to arise from privatization, certain negative and offsetting factors should not be neglected. First, while theoretically discounts on the market clearing price (over the original offer price) represent a transfer of wealth to the new owners from the taxpayers and wider public it has been shown that the share ownership structure is not static and that some employees and low income earners are likely to hold their shares for only a limited period of time.

Second, privatization frequently involves a reduction in employment. Either the government trims the labour force to make it attractive to new buyers or, upon acquisition, the new owners take action to cut the labour force so as to minimize costs and so maximize profits. There are many instances of this. For example, New Zealand's State Coal Mines, which had lost money for 20 out of 22 years broke into profit in 1989 by sacking half its staff after privatization. New Zealand's Telecom also cut its staff from 25,000 to 16,500 (including a cut in head office administrative staff from 2,000 to 350) prior to it being sold to Ameritech and Bell Atlantic Corp. In the Philippines, after the cement producer, Solid Cement Corp. was privatized, the labour force was cut in half.

This situation of apparent excess labour in many countries arose partly as a result of past governments having as an objective the maximization of employment and using SOEs as a

medium for the achievement of this goal. However, dispensing patronage and rewarding grass roots political supports was another reason for the labour surplus. But while workers should not be locked into a failing enterprise the adjustment process should be made as less painful as possible. In the case of the Solid Cement privatization in the Philippines the new management had also 'eased out' the labour union and cut workers wages by 15 per cent.1/ This emasculation of the role of trade unions within the last decade, at a time of chronically high levels of unemployment is a universal phenomenon and, like the privatization process, itself, is an integral part of a new alignment of social forces and weighting in the importance of the factors of production, labour, capital and entrepreneurship. Those least powerful are inevitably asked to make the required adjustment. Government are themselves captives of this process.

However in some countries there is a considerable degree of sensitivity to the plight of the workers2/ in this period of fundamental change. For example, in Malaysia the Government does not allow privatized enterprises to lay off workers for three years. Indonesia also has restrictions on the level and speed of dismissals. Remedies to this situation of dismissals and 'givebacks' in particular privatized enterprises has to be seen

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1/ Labour hostility is not unanimous. Before its implementation, privatization may have strong grass roots support. In Zambia, Frederick Chilumbia, a labour unionist, used the dismantling of state corporations as an important plank of his campaign and won the recent election against Kaunda by a landslide. (New York Times, Nov. 7, 1991)

2/ The fear of workers of becoming unemployed is one of the most important inhibitive factors to the privatization process. In some countries, e.g., Brazil, Argentina, Thailand, Nicaragua unions and workers have voiced strong opposition to certain privatizations. In Britain, deliberate dimunition of union power is said to have been an important motive for the Thatcher Government privatizations.

within the broad macroeconomic policy framework. While enterprises have the right to make themselves as efficient and profitable as possible, the government needs to encourage the multiplication of the amount of enterprises producing commercially viable goods and services so as to maximize employment.

Third, the government's windfall from the sale of the SOEs can be used in either an optimum or sub-optimum manner depending on social preferences. This shows the need to consider privatization within a broad socio-economic context, especially since the windfall is not once-and-for all but involves an initial capital gain plus the annual subsidies that are no longer necessary. By the end of 1990, proceeds from the 25 privatizations in Jamaica were equivalent to about 7 per cent of GDP. In Chile, proceeds represented 15 per cent of GDP and, in Mexico, where the average privatized entity was relatively smaller, proceeds were 2 per cent of GDP.

Fourth, redistributive effects also occur when a privatized enterprise raises the price of the good or service it sells to the public (and the size of the rise will depend on whether the commodity was previously supplied at a subsidized price or not). This is particularly important in the case of 'natural monopolies' that provide basic commodities for which the demand is fairly price inelastic. These commodities would tend to account for a higher proportion of the disposable income of the poorer sections of the population and so any increase in price could have a significant impact. Governments try to limit the power of these natural monopolies by controlling either the price/rate/tariff or rate of profits, in addition to guidelines with respect to quality and reliability of the product. The need for regulation is very much linked up with the efficiency issue

and concern that after privatization efficiency may not be guaranteed.1/

There are many types of efficiency, including productive (and financial) efficiency, allocative efficiency, economic efficiency and social efficiency. When an enterprise that is already subject to national and international competition is privatized, the forces of competition should ensure that the enterprise seizes initiatives and makes decisions that lead to both productive and allocative efficiency, provided that private shareholders (the larger the blocs the better) monitor the performance keep it on its toes (especially with takeover threats always present) and there is not much scope for government interference even if the privatization is a partial one. However, if the enterprise is a natural monopoly it may make decisions that lead to productive efficiency, only, in which its ability to raise prices allows it to maximize its financial rate of return.2/ This, allocative efficiency may not be enhanced if there is no contestability and competitors are kept out either because the capital cost of entry into the industry is prohibitive, the enterprise is able to erect price3/ and non-price strategic barriers or the government continues to provide direct support, or indirect support, in the form of government

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1/ A fourth redistribute effect is the transfer of income to those providing financial, accounting advertising and legal services to the Government during the course of the privatization process.

2/ Of course, if the old managers that held sway during state ownership are retained when the enterprise is privatized real profit maximization may not always take place unless they have undergone a mental and attitudinal metamorphosis.

3/ Because of typically declining cost curves a national monopoly may be able for a while to adopt a low price system in order to deter a would-be competitor from entering the industry.

guarantees or preferential access to the private capital market.1/ Of course, economic efficiency would be partly determined by the nature of the linkages the natural monopoly has with the rest of the economy and social efficiency by the extent to which certain non-commercial objectives are met.2/ The latter objectives can only be attained by the instituting of a regulatory regime.

When a natural monopoly is privatized there is need for an anti-trust type regulatory commission to protect the public consumer interest. This was not clearly realized at the initial stage of the privatization process,3/ as was the case in Britain:

> "The difficulty which the privatization policy has run up against has been that when dealing with natural monopolies some sort of regulatory agency inevitably has to be set up, and this raises the question of what sort of rules it will follow. This is particularly relevant in the case of British Telecom, and the future privatization of British Airways, British Gas and perhaps the electricity supply industry will pose similar problems. What has been disappointing about privatization in the UK to date is that

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1/ In Britain, it was said that when British Telecom was privatized competition was resisted by the incumbent management and Government went along with this policy in order to boost market valuation and protect the integrity of the privatization programme.

2/ Note that the USA, a country with very few SOEs, still manages to have both the world's largest (as per cent of GNP) budget deficit and BOP deficit. The social matrix, trade-offs and social efficiency are subjective.

3/ One exception is the USA where a number of so-called natural monopolies began to operate as private companies and the Government instituted in 1890 the Sherman Anti Trust Act.

so little attention has been given to the rules of the game under which OFTEL, the regulatory agency that deals with British Telecom, is meant to operate." (G. Yarrow, op. cit.)

However, regulators may not have enough information to determine whether a particular activity is anticompetitive or may be unduly influenced by the activities of various pressure groups, by the Government or by the enterprise itself. Moreover, once an anticompetitive act has been identified the compliance mechanism may get so mired in either long hearings or long litigation and dispute settlement procedures that the anticompetitive act would already have worked itself through and had its intended effect (R. Hemming and A. Mansoor, 1988).

Finally, what perhaps has not yet been perceived is that rapid technological change will probably modify the incidence and scope of MOPE. For example, the television industry in developing countries is no longer exclusively government owned partly because changes in the technology made it difficult for the government to operate in a protected market within existing national boundaries. A very large dish in the hands of an enterprising private entrepreneur could receive satellite television signals which can then be relayed to individual households thus moving part of the industry into the category of ECLIPSE. Also, small backyard dishes can be used by individuals to achieve nearly similar effects,1/ with television for them fast becoming a self-generated service based on a new technology that is assuming the characteristics of an international quasi-free good.

1/ Video cassettes, with pre-programmed movies and other entertainment, are an important supplement to this displacement process.

D. Transformation and Development

Despite the booming literature on privatization not much has been written on the issue of transformation and development. This is not totally unexpected when writers from developed countries come to reflect on the privatization process occurring in their part of the world. In most cases the SOEs in developed countries were profitable and doing quite well prior to privatization. In these developed countries privatization took place partly because of ideological factors (including attempts to undermine part of the union support base of rival political parties) and partly because the boost to the national treasury from such an exercise could be used not only to reduce the budget deficit but, also, to buy public support through various social expenditure programmes, in addition to capturing the favour of new stockholders. Moreover, the lack of a technological capability to operate large and complex industries was not a public sector problem in these countries. The only issue was probably one of the appropriateness of the objectives given by the political directorate to the managers of these SOEs. Because many of the privatized entities were monopoly prone and because with a mere change of ownership market failure would still obtain, it is no wonder that most authors came to the conclusion that the economic gains from privatization were likely to be marginal.

In the developing countries where, despite the hesitation in some states the privatization process is likely to be more widespread and far reaching than in the typical developed country, there has also been little discussion about the economic growth that will result from the privatizations. One reason is that privatization, per se, does not immediately result in an increase in net capital formation, unless expansion and modernization are stipulations in the sale arrangement. In all

divestiture cases there is a mere transfer of assets, from the state to private locals in certain cases and from the State to foreigners in other cases.1/ In both cases it is the State that ends up with increased liquidity. What the State does with the increase in resources is therefore critical.

This raises the issue of what should be role of the State in the post-privatization period. With the resulting bonanza, the State could withdraw into its shell as a producer or take a more pro-active approach and look for creative opportunities to initiate industrial activity which it can then hand over to the private sector. This was the historical path of Japan which Singapore is following. Singapore has had an ambitious privatization programme (which, incidentally, it implemented successfully) not because its managers were incompetent at running industries but, quite the contrary, they were so good that the Prime Minister publicly expressed the view that he did not want their talents to be spread too thinly. Singapore's public sector officials are therefore able to continuously pick 'winners' and then to move on to tomorrow's new field of enterprise (S. Montagu-Pollack, op. cit.). Perhaps it is appropriate to look at privatization in a dynamic, rather than static, context.

Fortunately or unfortunately, privatization is occurring at a time when most developing countries are undergoing a process of restructuring. The fortunate part is that for privatization to be effective it has to be combined with a whole package of macro-economic reforms and liberalization policies, which facilitate entrepreneurship and development. Privatization is no panacea

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1/ Perhaps what developing countries need even more than privatization is the creation of a multitude of new and high value economic activities. This should be an important role of foreign capital.

and cannot be seen in isolation from other restructuring measures. A high privatization count or tally is not sufficient. The unfortunate part is that the restructuring tends to induce painful deflationary conditions, at least in the short run, which is not conducive to new local owners that cater to the home market making significant capital investment. Moreover, a macro-policy stipulation within the restructuring programme, for balance of payments equilibrium purposes, may relate to restrictions on bank credit. However, new foreign owners of privatized enterprises may have alternative sources of capital and may be able to engage in expansionary investment, particularly for the overseas market.

One developmental phenomenon that has achieved attention has been the nurturing of a stock market through the privatization process. In the developing countries, which lack a *shareholding* tradition (except in states such as Korea, Hongkong and Taiwan Provinces and Singapore) this has required a great deal of educating, advertising and marketing. The problem is compounded by the fact that SOEs that are being offered on the market for the first time do not have a secondary market price which could be a market determined guide to share valuations and, in the case of monopoly firms, there are no price/earnings ratios (in addition to estimated risk) of comparable firms that can be used as a yardstick.

Nevertheless, some countries have managed to increase considerably the number of stockholders. For example in Chile, stockholders of privatized companies increased from 26, 604 in 1985 to 169, 733 in 1988, representing an increase from 6 per cent to 30 per cent of total Chilean shareholders (M. Stanley, 1991). In corporate trading frequency terms the figures are even

more impressive.1/ Mainly as a result of this privatization stimulus stock market value as a per cent of GNP grew from 14.4 per cent in 1985 to 42.5 per cent in 1989. Despite the considerable spread of share ownership, the level of concentration of financial control by pension funds and other institutional investors was significant. Twelve or fewer shareholders controlled more than 50 per cent of the outstanding shares of 22 of the 24 most actively traded companies in 1988 and 21 of the 24 most actively traded in 1989.2/ This may reflect the perverse situation of "local elites who buy back, in many instances at magnificent discounts, their old business that were nationalized because of their failure to repay government guaranteed loans" (P. Yotopoulos). Merely restricting individual ownership in each initial share offering to a certain percentage is therefore insufficient . Although figures are not available, the impressive rise in the spread of shareholding was stimulated by some amount of underpricing of the shares. In the case of developed capital market countries, Britain and France, it was estimated that each percentage point in underpricing of issues "bought" on average 19,000 initial purchasers of privatized assets (R. Seth, op. cit.).

1/ The trading figures would have been greater were it not for 10 year restrictions on the reselling of shares held as a result of debt-equity swaps. This is analagous to the adverse effect on liquidity in the secondary market that loyalty bonuses had in Britain and France in encouraging investors to hold shares for up to 3 years.

2/ "In 1989, eight of the ten stocks with the highest transactions value were among those privatized in whole or in part during the period 1983-1989. Six of the ten stocks with the largest market value (shares times year end closing price) were among those privatized in that period. Of the seven stocks that traded on 100 per cent of the trading days in 1989, five were stocks of companies privatized in whole or part in the 1983-1989 period; of the thirteen stocks that trade on more than 90 per cent of the available trading days, nine were those of privatized firms." (M. Stanley, op. cit.)

The reduction of state ownership brought on by privatization does not necessarily diminish the role of the State. The burden of the State has become greater as a regulator cum monitor and, in the case of the developing countries, as a promoter of investment and development. Regulation, particularly of monopolies, can be seen as government involvement by other means. Monitoring is a critical pre-requisite for effective regulation, particularly of foreign owned enterprises. At the same time promotion of foreign investments is much more necessary in the new competitive international economic environment.

Finally, even public ownership of very selective producing enterprises should not be ruled out on grounds of dogma. Privatization needs to be considered in relation to specific sectors, and not as a blanket panacea (D. Heald, 1990). A high level expert group of ex Prime Ministers and internationally renowned economists, has struck an interesting balance:

> "Neither the capitalist market system nor the socialist command economy have proved to be perfect in satisfying individual or collective needs or bringing about a fair income distribution. The failure of the socialist model should not be taken as a pretext to advance a 'theological solution' of pure capitalism as the only possible alternative. Even among countries with successful market economies, an amazing diversity prevails. The experience of Western countries and Japan shows that planning - though not centrally planned and authoritarian - is not stultifying per se. In these countries, Government influenced the economy in the form of indicative planning by means of incentives and other forms of encouragement, forecasts and consultation. Regulation of markets proved desirable to guarantee product quality, consumer safety, institutional stability, market access and competitiveness." (Pierre Trudeau, 1991)

CHAPTER II. FOREIGN INVOLVEMENT IN DEVELOPING COUNTRIES

A. Selling Off Major Enterprises: The Second Wave and Mature Stage of Privatization

Hardly a week seems to pass without some announcement of a privatization deal being struck that involves a large SOE. Previously, most developing countries had started the privatization programme by selling (and liquidating) relatively small enterprises in the manufacturing and services sectors. Only a minor proportion of these deals seemed to involve foreign direct investment, although management, leasing and other non equity arrangements were quite significant in particular industries, such as hotel and tourism. Having gained sufficient experience and confidence, the governments have now turned to what has frequently been described as their strategic sectors, which include the major utilities, banking services, defense industries and the 'commanding heights' industries, such as petroleum and mining, that account for a large proportion of export earnings. In some countries a significant proportion of the large SOEs still remain in the hands of the government. Table II.1 gives some indication of the strategy mix in an important developing country and Table II.2 gives a probably fair representation of the incidence of privatization techniques.

Privatization of the telecommunications and airline industries have particularly captured the public's attention. The telecommunications industry is an industry that has been subject to very rapid technological change since the Second World War: step-by-step, cross-bar, analog and digital. In recent years, the microelectronic driven digital technology has itself

Table II.1: Strategies of Privatization in Mexico, June 30, 1991

PROCEDURE	PROCEDURE FINALIZED	PROCEDURE IN PROCESS	PROCEDURE AUTHORIZED
Liquidation	254	60	314
Extinction	149	6	155
Merger	82	4	86
Transfer	29	3	32
Sales	258	50	308
SOE Federal Law	70		70
TOTAL	842	123	965

Source: Office of Privatization of State-owned Enterprises.

Table II.2: Incidence of Equity and Non-Equity Arrangements and Techniques in 41 Large Privatizations in Selected Countries, Early 1990

	Public Offering (I)	Transfers of Equity or Assets (II)	Staff Buy-Out (III)	Unsubscribed Increases of Capital (IV)	Leases (V)	Management Contracts (VI)	Reorganizations Combined with (I,II,III,IV)	Debt-equity, Debt-Assets Swaps (I, II)
GHANA		(5)				(6)		
MOROCCO		(5)			(2)	(7)		
TUNISIA		(20)	(1) 100%	(3)			(2)	
BOLIVIA		(1)					(1)	
CHILE since 1985	(14)	(34)	(12) incl. (2) 100%	(1)				(6)
JAMAICA	(3)	(29)	(2)		(9)	(14)		
MEXICO	(13)	(18)	(4) of w/c (1) 100%					(1)
BANGLADESH since 1987	(9)		(9)					
MALAYSIA	(3)	(4)			(6)	(5)	(1)	
PHILIPPINES	(1)	(15)						(3)
TOTAL (255)	(43)	(131)	(28) of w/c (4) 100%	(4)	(17)	(32)	(4)	(10)
FRANCE	(14)	(11)	(1)	(1)		(1)	(1)	
UNITED KINGDOM	(14)	(19)	(12)	(1)		(1)	(3)	

Source: A. Bouin and Ch.-A. Michalet, Rebalancing the Public and Private Sectors: Developing Country Experience, OECD, 1991, p.130.

been undergoing rapid change1/ and countries have been finding it difficult to keep up. Moreover domestic demand, fueled by the rapid internationalization of the world economy in terms of trade, investment and financial relations has been tending to increase at a faster rate than capacity expansion and systems have frequently become 'flooded' and prone to failure; in this situation maintenance has become more problematic. Partly as a result of the technological factor, countries have sought to involve transnational corporations (TNCs). Portugal, probably the last country besides India with an analog system privatized some years ago and Singapore and Puerto Rico have done the same. Chile privatized its local telephone call company, CTC, in 1987 with Bond Corporation which then sold out to the Telephone Company of Spain. International and Chase Manhattan Bank had controlling interests via a debt-equity swaps transaction. Adjustments in rate structures and other efficiencies were introduced prior to the privatization in return for which the new owners pledged to double capacity by 1992. The Chilean Government then privatized the international communications company, ENTEL, in 1989 with a block of shares being purchased by international investors via debt-equity swaps: 9.3 per cent was bought by Chase Manhattan Bank and 3.5 per cent by American Insurance Group. Telefonica de España and Banco de Santander established controlling interest through a block share purchase of 20 per cent. With permission to rent ENTEL's lines, CTC (flushed with high profits) and ENTEL proceeded to engage in lively non-monopolistic rivalry.

1/ For example, AT&T recently announced that it was switching from reliance on a large telecommunications satellite, which has a capacity of 135,000 calls or so, to fibre-optic technology utilizing undersea based cables that would add capacity for 160,0000 more calls, as well as data and video, resulting in a total capacity of nearly 300,000 calls. (New York Times, Nov. 5, 1991)

In Mexico, also, the Government seems to have successfully privatized the telecommunications (TELMEX) operations with involvement of foreigners, while keeping control in the hands of Mexican investors. Prior to privatization, the Government took steps to restructure the enterprise by reducing the company's debt, eliminating cross-subsidies between local and long distance, streamlining telephone taxes and consolidating labour contracts. In turn, the Government obtained a binding obligation from the company to make approximately $1 billion a year modernization investments until the late 1990s (I. Lieberman, 1991). In Argentina, the major interest of the monopoly telephone company, ENTEL, was sold in 1990 to two groups led by Bell Atlantic and the Spanish firm Telefonica. In return for 60 per cent of the Company, the Government got $214 m. in cash and debt relief on about $5 billion.

In Jamaica, Cable and Wireless' involvement in the JAMTELCO 1990 privatization seems to have involved a commitment to a $400 m. modernization plan, a non-risky undertaking given the vast backlog of unsatisfied consumer demand. Cable and Wireless seems to have solved the problem of illegal calls and both Government and the TNC partner seem to be reaping rich financial benefits. However, the rate structure seems to be too kind to Cable and Wireless, the reason being that, prior to privatization the World Bank had set a high rate in order to ensure repayment of its own rehabilitation loan to the Government and this rate remained after privatization.

In the case of Guyana, also, the rate structure has been a big bone of contention between a Virgin Islands based company, ATN, and the Government. Following the privatization in early 1991, the company introduced a significant rate increase which the Government's regulatory commission injunctioned before it

could be put into effect. In November 1991 an agreement was apparently reached for a 150 per cent increase in the tariff.

It is important for effective regulatory and tariff structures to be set up in connection with monopoly prone public utilities, like telephone industry. Equally important are the commitments that the foreigner should be required to make with respect to expansion and modernization, including such things as number of new lines per year, new areas to be serviced, and quality control factors like percentage of non-working lines, time to repair these lines, waiting time to install new lines and waiting time to receive tone.

The airline industry experienced similar interest from foreigners. For example, in 1989 the Chilean airline, LAN Chile was privatized with SAS Airlines of Sweden ending up with 35 per cent of the airline. Foreign ownership could not exceed 50 per cent since international rules would have considered it a non Chilean airline, but rather a part of a foreign carrier's operation, and forced the airline to give up valuable landing rights. What is particularly significant is that the LAN Chile pilots' union had objected to a bid from another group, on the grounds that the bid could not inject new capital into the company, which was considered vital for the airline's operation (Business International, Dec. 1990).

The privatization of Mexican airlines in 1989 also involved a commitment to modernization and expansion. The structure of the sale involved the Government holding 49.9 per cent and a new private entity, Falcon, holding 50.1 per cent of which Chase Manhattan Bank led the foreign group with 46 per cent of Falcon, Drexel Burnham 7 per cent and Sir James Goldsmith 6 per cent, with the rest of Falcon owned locally by Grupo Xabre. Falcon pledged to invest $3 billion in Mexicana and other industrial

properties over the next 10 years, so as to improve ground facilities, computerize the reservation system, replace aged planes, double the size of the fleet, and increase employment from 13,000 to 21,500 jobs (Business International, op. cit.).

In Argentina, the state flag carrier was put up for sale in 1990 because its international routes were too small compared with other foreign carriers and it was outside the global trend toward networking of major routes for greater efficiency and integration of services. A consortium headed by Iberia Airlines (Spain) and which included a number of important local partners won the bid in strong and intriguing competition over many other interested parties. Iberia acquired a 20 per cent share in Aerolineas with an option to purchase another 10 per cent. (However, as in the Mexico case, it cannot acquire a major interest, otherwise Aerolineas would have been considered a Spanish airline and not been granted permission to operate the Buenos Aires-Miami route). The minimum purchase price set by the Government ($236 million in two payments) was increased to $260 but to be paid over a longer period - $130 million at the time of transfer and $130 million over five years to be paid in 10 equal installments. The minimum capitalization of $1.5 billion in debt-equity swap certificates was increased to $2 billion, which cost the Group $271 million at the secondary market value of Argentina debt of about 13 cents in the dollar. The consortium will therefore pay $531 million for 85 per cent of the shares of a company that nets $700 million annually.

This seems like a handsome financial deal for Iberia and the Groupcal shareholders, especially since, up to the time of privatization, Aerolineas (unlike ENTEL, the telephone company) was functioning quite well. Also, while the privatization may present wider opportunities for Aerolineas, critics feared that its North American and European routes, immensely popular among

the wealthy, would be merely folded into Iberia's operations. On the other hand, Aerolineas anticipated more flights to the US and Europe (with destinations of Madrid, Paris and Rome) and felt that, through Iberia, it would be able to sell tickets to most of Europe, via Madrid, for every day of the week. For its part, Iberia saw the Aerolineas acquisition as a strong link in its global network. It anticipated triangular flights between Europe, Argentina and the US, with Buenos Aires, Rio de Janeiro, Sao Paulo, Santiago, Miami, Los Angeles and Madrid, linked in the new Iberia-Aerolineas network of planes and schedules. Whereas Iberia could previously fly, for example, a Madrid-Buenos Aires or Madrid-New York route, it could not complete the third leg of the voyage (Business International, op. cit.). It should be noted that Iberia made losses of $243 million in 1990 and is expected to make losses of approximately $421 million in 1991.

Also in Venezuela, the Government in September 1991 sold 60 per cent of VIASA, the largest of the country's three airlines to the Spanish state-owned airline Iberia for $145.5m. VIASA owns eight jets and has routes to 16 countries. Since Iberia is also considering the purchaser the issue of regional monopoly versus regional rationalization comes to the fore. When a foreign government entity is involved in the privatization of an enterprise owned by another government, it gives rise to interesting scenarios including the ability of the privatized entity to sustain losses in the short run. Table II.3 shows the foreign investor share of the airline deal in relation to other privatizations.

Other governments have been preparing for whole or partial privatization of their airlines. For example, the Philippine Government has been trying to find a foreign investor, preferably an airline, to take 35 per cent with another 55 per cent being auctioned off. In Trinidad, the Government hopes to privatize

Table II.3: Share of Foreign Capital in Recent Privatizations, Argentina

	Foreign Investment in the capital (after privatization)
Telefonos (zona norte)	75% 1/
Telefonos (zona sur)	53% 1/
Aerolineas Argentinas	4[illegible]%
Concesiones Camineras	Not significant
Ferrocarril Rosario - Bahia Blanca	2%
Areas Petroleras Secundarias	25% 2/
Asociacion en areas Petrol. Princip.	55% 3/
T.V. Canal 11	0%
T.V. Canal 13	0%
Polisur S.A.	0%
Monomeros Vinilicos	10%
Petropol S.A.	0%
Induclor S.A.	0%

Source: D. Hatchetti and R. Luders, 1992 (forthcoming).

1/ The participation of holding foreign companies that have 60% of shares in each case.

2/ Of 37 concessionary secondary areas, 12 have foreign investment.

3/ Foreign investment: Huemul 100%, Vizcacheras 50%, Tordillo 50%, Puerto Hernandez 38%.

the British West Indies Airways (BWIA) by the end of the year with a foreign airline taking a 20 per cent stake and the remaining stock being placed on the region's stock exchanges. Three of the attractions are the Government's willingness to write off $17.6m in debt, the useful bilateral routes out of the rapidly growing Caribbean market and the relatively young fleet of aircraft.

Other strategic sectors have recently received the attention of foreign investors. For example, Brazil started its privatization programme by selling in October 1991 the massive steel company, USIMINAS, for $1.17 billion of which foreign investors acquired 6 per cent of the shares. The firm was not exactly inefficiently run and had profits of $33m in 1989 while employing 13,500 workers. In Argentina, the privatization of the San Martin railway in October 1991 resulted in Carac International Inc., a subsidiary of Canadian National Railways, becoming the new managing operator even through its share equity is miniscule. In the banking sector, Mexico's privatization limits a single foreigner to 10 per cent of a bank's assets and foreign investors, as a group, to 30 per cent share control. However, foreigners seem to be awaiting the outcome of the Mexico-US free trade agreement to see whether it would allow them to open a small branch, over which they have control, rather than the less preferential option of a small stake in an existing bank.1/ In Colombia, also, moves are afoot to privatize Banco Cafetero with 51 per cent of the stock going to foreign investors, 35 per cent to the public and 16 per cent to the National Coffee Fund.

1/ In September 1991, Banamex, Mexico's largest bank, was sold to a consortium led by a leading Mexican brokerage house, Acciones Y Valores, for $3.2 billion or 2.62 times the book value.

Even the most sacred of sacred cows are not being spared. In mid 1991, the oil industry, which under the Constitution has to be state-owned, was somewhat opened up by an announcement by the President that foreign companies would be invited in to engage in research and development of new oil fields, a case of gradual "re-privatization". (In the past foreign investment had been limited to tertiary and speciality petrochemical products rather than basic petrochemicals). This coincided with similar announcements in Venezuela and Nigeria. The Venezuelan situation is particularly interesting in that Carlos Andres Perez, who made the announcement, was the same President who nationalized the industry in the 1970s. In Argentina, it was announced in September 1991 that the State oil company will transfer 23 out of 28 secondary oil fields to private local and international operators. The privatization process seems to be very infectious. The ideological pendulum has come full circle.

Participating in this wave of privatization of strategic sectors are TNCs whose assets were nationalized in a previous era of strident economic nationalism. For example, in Guyana, Bookers (sugar) and Alcan (bauxite/alumina) have returned, this time in a risk averting managerial role. There are two conflicting views with respect to the appropriateness of the role of such 'returnee TNCs'. One is that such TNCs would be returning with a lot of historical baggage and attitudinal hang-overs based on their previous experiences in the country. According to a different view, such TNCs are now wiser and more knowledgeable than others of the conditions prevailing in the country, the social, labour and cultural norms, the physical environment and, most importantly, the productive and technological capabilities of the particular plant and equipment.

B. Debt-Equity Conversions

From the above it can be seen that debt-equity conversions are being frequently used in the privatization deals involving large and strategic industries. The debt-equity conversions can take many forms (Table/Chart II.4) and have accounted for significant part of the investment flows in certain countries (Table/Chart II.5). For example, debt-equity conversions were mechanisms utilized for helping to finance the Argentine telephone and airline privatizations, the Chilean telephone privatization and the Brazilian steel privatization. Since the debt of SOEs account for approximately 60 per cent of the Latin America's debt, debt-equity conversion can be a useful medium for reducing same. In fact, when President Carlos Menem privatized the Argentine telephone and airline companies, one of his political advisers1/ stated that Menem could wipe out two-thirds of the total foreign debt if he quickly exchanged another five unnamed public companies for debt relief. Similar high hopes exist in Brazil for reducing the more than $100 billion external debt.2/ Significant privatization linked debt-conversion programmes also exist in such countries as Honduras, Jamaica and the Philippines, inter alia.3/ In the latter

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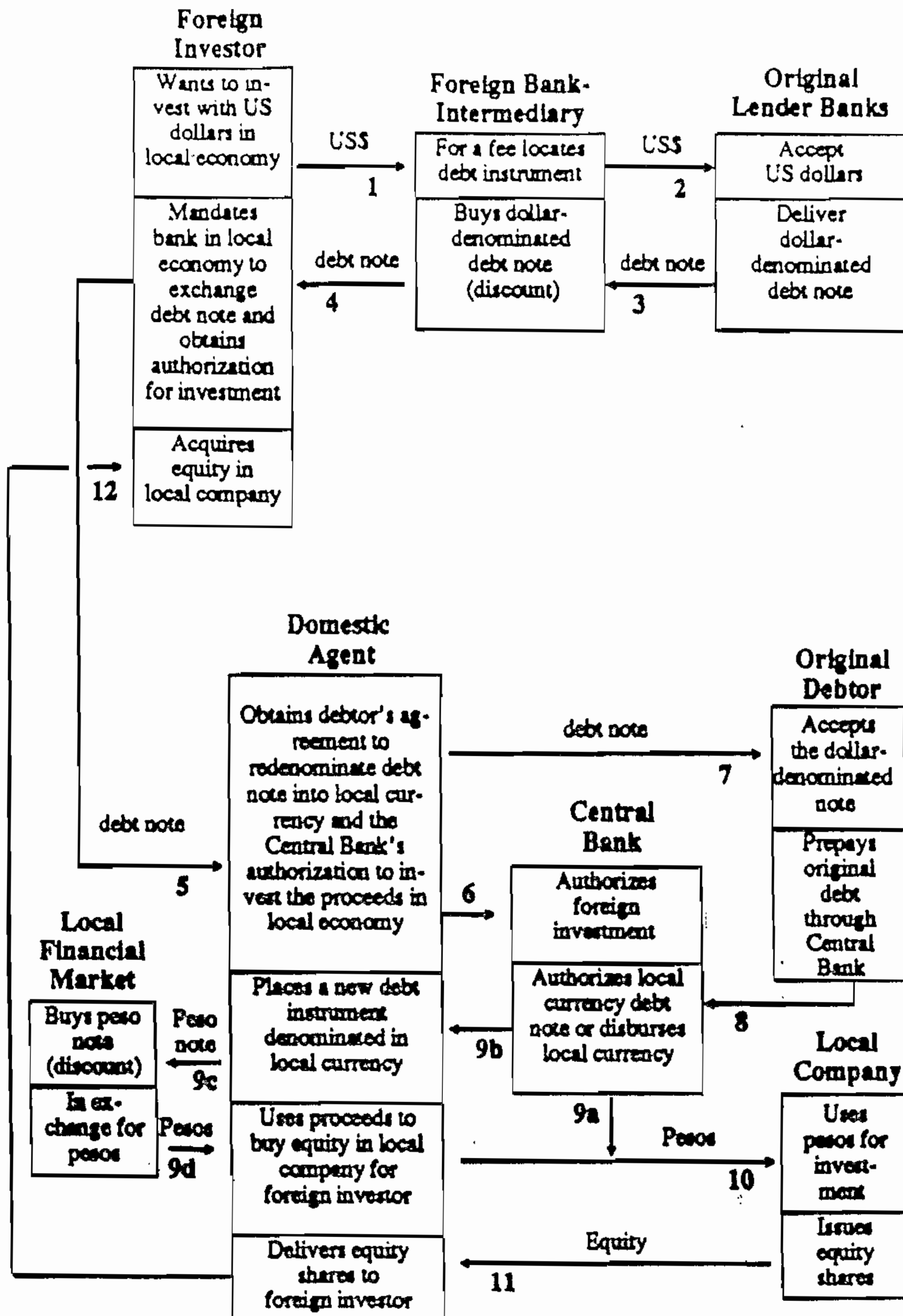
1/ Alvaro Alsogaray, a leader of the Union of the Democratic Center, a conservative party. (Washington Post, July 24, 1990)

2/ The instruments available for debt-equity swaps and the dollar amount in US$billions are as follows: MYDFA Principal 30, Interest Accrued (external) 10, Blocked Cruzados Novos 35, SOE Debenture 5, SOE Supplier Payables 10 and Privatization Certificates 5.

3/ In Mexico, the privatization is not explicitly linked to the privatization programme. Nevertheless, there have been significant debt-equity investments in the past by firms including Volkswagen ($141m.), Chrysler ($110m.), American Express ($100m.) and Nissan ($60m.). See UNCTC, Debt-Equity Conversions: A Guide for Decision-makers, UN, New York,1990,p.72.

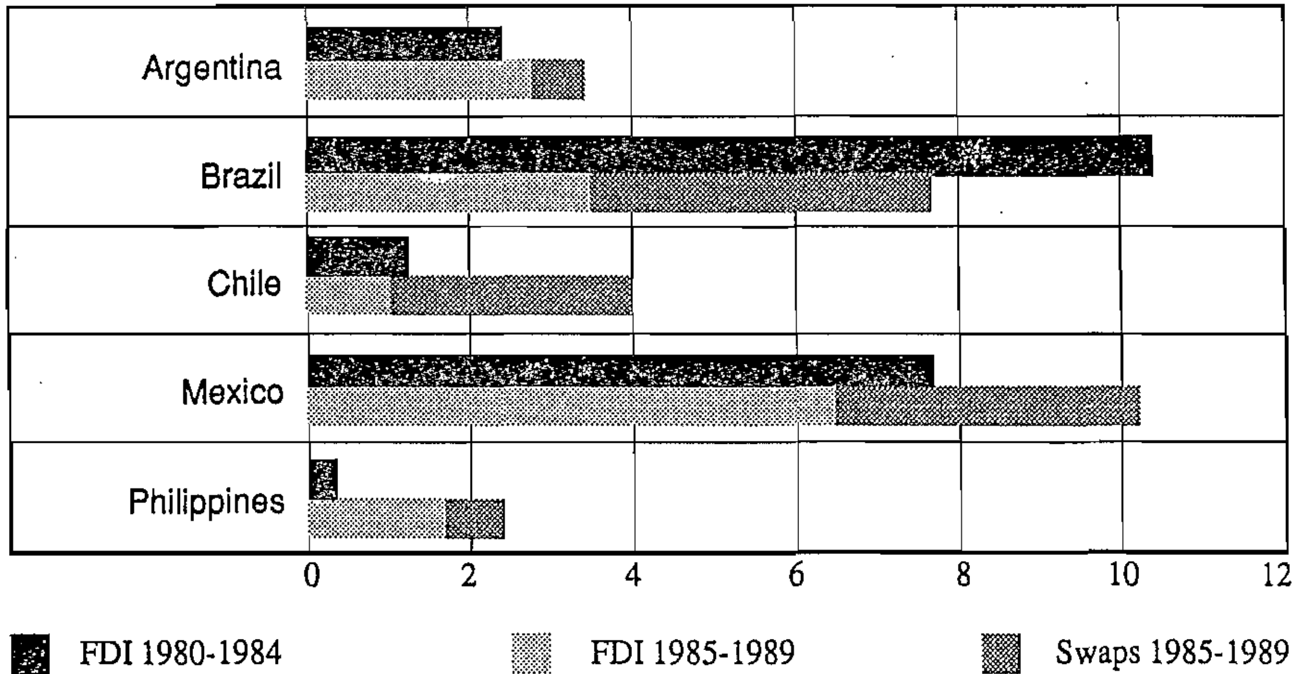
Table II.4: **Principal elements involved in debt equity conversion procedures**



Source: UNCTC/ECLAC Joint Unit, based on World Bank, *World Development Report 1987*, Washington, D.C., 1988.

Table II.5: Foreign Investment Through Swaps

(Billions of dollars)



Source: UNCTC, Transnational Banks and Debt-Equity Conversions, 1991.

country, the debt-equity conversion programme aided by special incentives, has contributed to the fourfold rise in "foreign investments in existing firms" from 1582 million pesos ($500m.) in 1987 to 6174 million pesos ($2,000m.) in 1990.1/ Over 27 per cent of the debt conversions went towards privatization.

The national benefit from the debt-conversions or "securitization" of foreign loans, in which obligations of the debtor country in the secondary market are bought at a substantial discount over the face value, is in the investment that is so by created. However, if the investment would have taken place anyway, the net benefit is not significant and so it is important that such investments be chanelled into priority areas2/ that have been designated as debt capitalization opportunities under the capitalization programme. Also, in cases where capital flight had been significant, and to encourage return of such capital non resident nationals and/or nationals are allowed to participate, careful monitoring is necessary of the parallel exchange rate and the monthly volume of allowable debt-equity conversions of nationals so as to prevent "round-tripping". Partly as a deterrent to such practices and partly to capture a share of the discount at which the debt is traded on the secondary market, certain governments, e.g., Chile and the Philippines, charged a fee on each conversion.

There is also no obvious national disbenefit or loss associated with a foreigner making equity investment with instruments bought at a discount. "Although the investor gets a subsidy in the sense that he buys the foreign instrument at a

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1/ Philippines Securities and Exchange Commission: Selected Philippine Economic Indicators, 1990.

2/ In non-priority areas, there sometimes are restrictions on the speed with which dividends and profits can be repatriated.

discount and converts it to local currency at approximately face value, it may be argued that the subsidy comes from the creditors that dispose of the debt instrument at a lost" (A. Basile, 1990). However, some argue that a real cost relates to the probability that the debt would never have been repaid anyway. The resolution of this dilemma involves fine judgement and trade offs since non-payment of the debt has a harmful effect on foreign investor confidence, in addition to denying the defaultor further access to the international capital market. A real socio-political cost, however, would obtain if the country is forced ('forced investment') to dispose of strategic assets that it would prefer to have national ownership over, purely in order to reduce the foreign debt overhang. Another requirement is for the government to prevent any inflationary inducing 'crowding-out' tendencies by employing judicious monetary control.

In general, debt-equity conversion can be an effective instrument for furthering the privatization process for those countries which have significant private sector loan indebtedness.1/ However, for foreigners to want to invest in the country the investment climate must be right.2/ In particular, the foreigner should feel that the investment regime is such that he can repatriate profits and dividends without undue difficulty and that he would not suffer the same fate as those banks which originally made the private loans.

1/ For many countries, outside of Latin America and Asia, however, the debt burden is more multilateral and bilateral.

2/ A 1987 amendment to Regulation K in the USA also stimulated the process by allowing an American bank to acquire 100 per cent of a non-financial company (rather than the previous 20 per cent limitation) if the latter was in the process of being transferred from public to private ownership. As a result, banks like Chase Manhattan and J.P. Morgan became quite active in the privatization process.

C. Foreign Investment and Related Legislation

In order for foreigners to become interested in SOEs that are being privatized, the investment conditions have to be sufficiently attractive. It is for this reason that economic policy reform should precede (or at least accompany) the privatization programme. The foreigner is likely to be particularly interested in such aspects of the foreign investment regime as entry and ownership regulations, repatriation of profits, incentives, performance requirements and access to credit. Yet the most liberal investment code, by itself, would be ineffective in improving the climate for investment if it is inconsistent with the macro-economic policies. In other words, the investment code cannot be insulated as a self-sufficient instrument for addressing the major concerns of the investor; in this regard, the host country's broad fiscal, monetary/financial exchange rate, and trade policies are more critical than the measures stipulated in the code itself. In addition, clarity, transparency and predictability of the policy regime, along with a reputation for judicial evenhandedness, and streamlined and fast acting institutional machinery for handling investment applications are useful for attracting foreign investment flows.

Over the last decade the host countries, particularly those in the developing world, have done a great deal to measure up to these requirements amidst the recognition that foreign investment is not a zero sum game. The marked change in attitude to foreign investment and the role of TNCs began in the late 1970s, following a period of confrontation, particularly in the natural resource sector, in which foreign investment was seen as a threat to hard won political sovereignty. In particular, developing countries have learnt since then that ownership did not necessarily mean control and that TNCs had developed means of maximizing their take even without equity holdings; the

developing countries for their part, gradually found new usefulness in various instruments for deriving benefits from the TNCs presence without resorting to ownership. For economic distress reasons that have already been discussed, the more pragmatic approach of developing countries to foreign investment was accelerated in recent years. This is reflected in a number of legislative changes in various countries. For example, the following measures were taken in selected African countries towards the end of the 1980s:

(i) The relaxation of restrictions on access to sectors and industries (e.g., Nigeria, Guinea, the Central African Republic)

(ii) The relaxation of equity limitations (e.g., Nigeria and Ethiopia)

(iii) The relaxation of regimes for repatriation of profits and capital (e.g., Ethiopia, Cote d'Ivoire, Nigeria, Guinea, the Central African Republic, Mauritius)

(iv) More liberal incentive regimes (e.g., Guinea, Zaire, Nigeria, Cote d'Ivoire, Zimbabwe, Mauritius)

(v) Guarantees against expropriation and assurances of international arbitration and fair and equitable treatment (e.g, Zaire, Guinea, the Central African Republic and Angola)

(vi) Devaluation and price liberalization or free convertibility (e.g, Tanzania and Ghana)

(vii) Tariff reform (e.g, Tanzania and Nigeria)

(viii) Reform of institutional machinery and "one-stop" procedures for processing investment applications (e.g, Nigeria, Zimbabwe and Angola)1/

In Latin America, a similar process of policy reform has been underway. For example, Mexico in 1989 revised its 1973 Law so as to allow 100 per cent foreign ownership in a broad range of industrial categories, including important sectors such as glass, cement, iron and cellulose. The law also relaxed restrictions on the purchase by foreigners of existing enterprises, thus facilitating the privatization process. Just as importantly, the new regulation made approval of applications for investment below $100m automatic and stipulated that applications above $100m could be considered approved if not rejected by the Secretary of Commerce within 45 days. In Venezuela, as a result of a 1990 revision in the law, foreign investment was permitted in all economic sectors, except petroleum and iron extraction, banks, insurance and Spanish-language media. Other features included the removal of all limitations on reinvestment of earnings and on repatriation of capital, TNC access to local medium- and long-term credit, elimination of the 2 per cent R&D withholding tax, automatic approval of trademark and patent licences and automatic approval of royalties below 5 per cent. The law was further modified in 1990 to allow for the participation of foreigners in the privatization of SOEs, inter alia.

While privatization may be a useful means of attracting foreign investment and of triggering a process of renewed foreign investor confidence in a country leading to new investment from scratch is outside of the privatization programme, it has its

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1/ UNCTC, 1990

limitations. There is a finite stock of SOEs to be privatized. Moreover, foreigners are likely to be interested only in those SOEs that are profitable or which have significant profit potential. This type of investment in existing enterprises is less risky than investment involving the creation of an enterprise from scratch. In fact, a number of countries have introduced all of the foreign investment and macro-economic policy reforms mentioned above (including offering generous fiscal incentives and EPZ frameworks for export-oriented activity) and failed to generate any significant flow of investment in non-privatization areas. This is because appropriate policy reform is not the sole determinant of foreign investment. Other determinants include the existence of a skilled and disciplined labour force,1/ a sizeable domestic market, significant natural resource endowment and political stability. One possible reason for the sluggish growth of foreign investment in developing countries is that developed countries have found that it is just as profitable, and perhaps more safe in the long run, to invest among themselves. The newly open-door economies of USSR and Eastern Europe are also likely to become an important alternative location for foreign investment.

Foreign direct investment has been playing a major role in the process of globalization of the international economy, increasing by 30 per cent a year between 1983 and 1989, compared with only 9 per cent a year growth of world exports and 8 per cent a year growth of world output in current values. Since a considerable proportion of world trade is between parents and subsidiaries of TNCs, it can be said that investment (as a

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1/ In this connection, note that the micro-electronic driven improvements in automation techniques are causing TNCs to revert the siting of labour intensive segments of the production process to home locations and away from the developing countries. (See K. Hoffman and R. Kaplinsky, 1990)

financial expression) is the hub around which revolves technology, trade and other flows. However, as an 'engine of growth' foreign investment has been by-passing many developing countries, in particular Africa. Developing country share of world investment flows have steadily declined from 30 per cent in the late 1970s to 25 per cent in the mid 1980s to 19 per cent at the end of the 1980s. Inflows to least developed countries declined in absolute terms, thus accelerating the marginalization process. Their share remained less than one half per cent of the world total. Three quarters of the foreign direct flows to developing countries (in which Asia has replaced Latin America as the largest recipient) during the last decade of the 1980s went to only 10 countries, among which only one was an African country.

Data on sources of foreign investment to host developing countries show a tendency toward a clustering of these host countries around a single TRIAD home region. Japan is increasingly the dominant investor in East Asia, the US in Latin America and the EC in Eastern Europe and much of Africa. Such clustering reflects economic, financial, historical and cultural ties. More recently, the clustering has been tending to reflect the strategies of TNCs which have begun to emphasize the establishment of production and distribution facilities on a regional basis ("regional core networks"). These strategies have partly been in response to anticipated or actual reductions in trade barriers (e.g., Mexico and NAFTA, and ASEAN countries and Japan) between the host developing state(s) and regional Triad member (UNCTC, 1991). The increasing regionalization process is affecting the direction and trajectory of the increasing globalization process - they are both part of the same phenomenon.

It is in the above context that we ought to view the potential, challenges and limitations of the privatization process. An optimistic scenario is that favourable experiences from privatization would restore the confidence of TNCs in the developing countries and will serve as a catalyst for renewed general investor interest and a reversal of the declining trend in their share of world investment flows.

D. Some Problems Revisited

During the 1960s and early 1970s, when there was a spate of nationalizations, the developing countries gave, among the reasons for their action, a dissatisfaction with the benefits accruing to the host economy from the operations of TNCs. While recognizing that the TNCs had, in addition to massive capital resources, the technology, management and marketing skills that were required in the running of large and complex strategic industries, the developing countries at the time felt that the costs of TNC ownership outweighed the benefits. (Note that even during the nationalization period TNCs were still involved, this time mainly at a non-equity level of providing technical assistance and, in some cases, specific work contracts). The above attributes of TNCs are the same ones which are now partly responsible for propelling the developing countries towards a new relationship with TNCs. The question to be asked then is whether the issues which generated so much conflict are no longer relevant and whether the relationship this time will be a more amicable one.

With respect to the much vaunted capital endowment of TNCs, only time will tell whether the multiyear modernization and expansion plans that are required for the strategic sectors, and which were sometimes a provision in the privatization sale arrangement will be honoured or whether, when the public

spotlight has been removed from the new enterprise, the capital expenditure being undertaken in the early post privatization period will quickly taper off under the weight of the worldwide capital crunch and chronic recession. TNCs are profit maximizers and their objectives and time horizons may not always be consistent with those of the host government. Moreover, in minimizing risk TNCs adopt a production strategy which takes into account other operating locations, a case of corporate integration versus national integration. This geographical *spreading of risk* and interlocking netwc :: arrangement reflects a global perspective and international production system which cannot please every host country at the same time. For example, a certain friction with respect to the issue of promoting backward and forward linkages is likely to result.

One aspect of the backward linkage issue relates to local content. This is becoming increasingly important as a performance requirement now that most parts of the world are trying to forge free trade areas and/or regional economic integration. This local content issue is not exclusively a developing country problem. For example, a big battle is currently brewing between the US administration and Japan with respect to the Honda motor car. Honda claims that the US made 'transplant' has a local content of 75 per cent whereas the Customs officials say it is much less because the US suppliers of parts and components are mainly owned by Japanese and are engaged in adding very little value to their basic imports from Japan-based suppliers. A recent University of Michigan study, using different definitions, concluded that only 16 per cent of the 1989 Civic is truly from American owned suppliers. That figure would be higher, or 36 per cent if overhead costs and depreciation of Japanese capital equipment were included. The US Customs officials also calculate that the Honda car that is manufactured in Canada has only 40 per cent local content, i.e.,

less than the statutory 50 per cent for duty free shipping between the two countries, and that therefore the company owes $20m in back tariffs for each year.1/

Abusive transfer pricing is also likely to remain an issue. The opportunities for intra-firm, rather than arms length, pricing have become greater because of the rapidly increasing globalization of the world economy (in terms of the share of trade, investment and other financial flows, each as a percentage of world GNP) and the greater incidence of strategic alliances and other interlocking arrangements between firms. In addition, there are now many more offshore banking arrangements and related tax havens. At the same time, it can be argued that repatriation of profits has been liberalized, to varying degrees, in most parts of the developing world and, as a result, there is less need for TNCs to resort to transfer pricing as a means of getting their money out of the host country. On the other hand, if divestitures are partial and the government retains a significant equity share, the TNC will have an incentive to engage in transfer pricing (by shifting net income elsewhere) in order not to have to share the profits with its government partner. Whether opportunity will prove a more dominant force than need has to be viewed in the context of the TNC being an organization that tries to minimize its tax liabilities in order to maximize its global profits.

In the Honda dispute, mentioned above, transfer pricing is also an issue. The Customs Service accuses the parent company in Tokyo of telling its US (and Canadian) based suppliers (many partially owned by Honda and part of the vast Japanese "keiretsu" or industrial grouping) to sell parts at a loss in order to minimize its US tax exposure. The US Internal Revenue Service

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1/ Business Week, Nov. 18, 1991.

had earlier alerted the public to this problem, in which the Japanese were singled out for special mention, when it reported in February 1990 that of the 36,800 foreign owned companies filing returns in 1986 more than half reported no taxable income and that "suspected underpayments amounted of $12 billion".1/ If an agency as experienced as the US Internal Revenue Service can feel cheated, the incidence of transfer pricing must be much higher in the developing countries.

Transfer of technology is another issue that would most probably engage the attention of the government in its new role of primarily a regulator, rather than producer. In the past governments had as an objective for their SOEs (and other indigenous enterprises) the development of a genuine technological capability. However, now that the enterprise is (or is likely to be) privatized and owned by a foreigner the emphasis of the government should be on training of local workers. This training requirement should be clearly speltout in any privatization sale agreement. It is not enough for the agreement to state that the new owner will exert his "best efforts" to train local workers. What is needed is a clear spelling out of the number of workers to be trained, the types and levels of skill attainment, the location of such training (i.e, head office, host country or third country) the duration of the training and the expected results from such training, inter alia. Foreign ownership also does not necessarily mean that all the managers and key technicians should be foreigners or that the core technology and know-how should reside among the foreign worker corps and peripheral skill activity relegated to the local staff. There is also a by-product social benefit to be derived

1/ For example, Yamaha Motorcyle company was accused of underpaying income taxes by a total of $133 million from 1977 through 1984. (New York Times, Feb. 18, 1990)

when trained local technicians and managers branch out to form their own companies.

Some of the newly privatized strategic enterprises, e.g, telecommunications, are engaged in high tech activities and so governments have to ensure that those foreign entities who qualify for consideration under the bidding process are indeed at the cutting edge of technological change. In this situation of rapid technological change, therefore, privatizing governments have to be just as concerned about the technological competence of prospective new owners as about their financial strength and viability. Similarly, in deciding on the choice of foreign owner, there could be trade offs between commitments to modernization and the level of the purchase price. For example, in the case of the Brazilian privatization of USIMINAS one author had the following observations:

> "Yet, as I look at this program from a distance and discuss it with colleagues analyzing the steel privatization program in Brazil, it appears that very little strategic thinking has taken place from the government side on the role of Brazilian steel or petrochmicals in an international context, as to who should be their 'ideal' investors. The government appears to lack a proactive approach to the privatization process and ultimately will be a passive taker based on the bidding process... A strategic study of the steel industry in Brazil, prior to its sale, might have concluded that based on its cost structure the steel sector is one where Brazil could be a world class player. Recognizing the strategic potential of the industry might lead the privatization administrator to seek an important 'stakeholder' in each of the steel enterprises who has technical expertise, world market position and long term interest in steel." (I. Lieberman, 1991, op. cit.)

The ability to negotiate a good privatization deal depends not only on bargaining skills but also in the non-corruptability of the process. Too often, instead of a transparent bidding process, outright sales are made to a foreign entity without even a public statement as to why that company was chosen above all others.1/ Even when there is a bidding process, the pre-qualification exercise should be based not only on identifying those technically competent to bid but also on determining which of the foreign operators have an international strategy and subsidiary growth and network system that seem consistent with the optimum role and developmental path of the enterprise within the national economy. Similar considerations have to be taken in deciding on a management contract, e.g., for managing a hotel. Under such a contract, management fees should be partly performance related, not only on the basis of profits (which could be achieved by pruning labour) but also on occupancy rates which could depend on whether the manager can tap into his international hotel chain and network system (UNCTC, 1990).

According to the conventional wisdom, reputable foreign companies are interested in dealing with knowledgable partners so as to arrive at a deal which is equitable and mutually beneficient and therefore, durable and long-lasting. However, the reality is that developing countries need to acquire as much information as possible on the industry and the major actors and a well developed strategy (in addition to the technical aspects of the valuation exercise) prior to the negotiations in order to secure what can be considered as a reasonable privatization deal.

1/ For example, the forestry enterprise in Guyana, Demerara Woods, seems to have been sold for only $9.7m to Lord Beaverbrook who then turned around and re-sold it for $60m. The GUARDIAN (UK), Nov. 1, 1991.

Finally, the government needs to institute an effective monitoring system in order to determine whether the commitments and performance requirements entered into at the time of privatization were being honoured. These would typically relate to modernization and expansion plans, employment, output and capacity utilization, local content, export intensity, training and transfer of technology, etc. Such a monitoring system is important not only for determining the impact of divestiture related privatization but, also for making appropriate decisions about renewal of leases and management contracts. But it is also a critical and vital tool for evaluating general foreign investment policies. Without such feedback data and information, it is not possible to make effective economic analysis directed towards making general economic policy decisions and fine tuning future foreign investment regulations. Too often developing countries' interest in the foreign investment operations do not extend past the project approval stage.

III. USSR AND EASTERN EUROPE EXPERIENCE

A. Privatizing a Whole Country

The economic transformation taking place in the USSR and Eastern Europe1/ represents one of the most dramatic historical phenomena. What is being attempted is the reversal of over 70 years of history in the case of the USSR and over 40 years of history in the case of its former military and economic partners. This transition to a market economy has started without certain supporting legal, economic and financial infrastructures and without other institutional machinery being entirely in place. The Investment law, company law, contract law, property law and others, along with complementary legislation in such areas as income tax and foreign exchange, are only now being enacted and/or appropriately revised to meet the evolving economic circumstances. At the economic level, practitioners were not acquainted with Western accounting principles and such concepts as profits (and its relationship to the balance sheet) and 'assets equal liabilities'. The notion of price as an indicator of value and as an allocative mechanism for rationing and channelling resources was also foreign to economists in these countries. With respect to the financial system, a meaningful stock exchange did not exist, except perhaps in the case of the Czech and Slovak Federal Republic2/ and Hungary3/, to a lesser extent. In the banking sector, officials were not

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1/ During this chapter, the term Eastern Europe may occasionally be used to include the USSR. Also, any statistics on the USSR would tend to include figures for the newly independent Baltic States of Estonia, Latvia and Lithuania.

2/ Formerly called Czechoslovakia.

3/ Certain authors had described this country as being on a path to "market socialism".

practiced in the art of distributing loans according to traditional creditworthiness criteria but were more used to the command system of a centrally planned economy.

The "marketization" process in Eastern Europe is therefore very unique. Privatization is an integral part of this marketization process. For some Eastern European countries, this privatization process began many years ago rather than within the last few years of democratic political change. For example, Poland's agriculture was always significantly privatized and Hungary and the Czech and Slovak Federal Republic had embarked on a significant joint venture promotion policy in addition to stimulating small and medium scale private sector activity nearly a decade ago. However, even in these countries, such capitalist activity constituted mere enclaves within a general socialist socio-economic system. To this extent, therefore, the privatization process in Eastern Europe is unique and different from that being experienced in the capitalist developed and developing countries.1/ The process involves the privatization of a whole country rather than a particular enterprise or a set of enterprises.

The need for this large scale programme of privatization is of course well known. Socialist enterprises were simply not performing. Whereas, the socialist system might have been barely adequate with respect to heavy capital and intermediate goods production in the 1950s and 1960s, it was found hopelessly wanting in coaxing out an adequate supply of agricultural goods. In the 1970s and 1980s, its pricing signals, incentives and

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1/ The exception, of course, would be those newly open-door economies in Africa, Asia and Latin America. These would include Afghanistan, Cambodia, China, Laos, Mongolia, Myanmar, North Korea and Viet Nam in Asia; Angola, Benin, Ethiopia and Mozambique in Africa; and Cuba in the Caribbean.

cumbersome plant structures were incapable of responding to the highly consumer oriented society where manufacturing product differentiation, style and quality were requirements for success. For the same reasons, the socialist system could not meet the highly customized needs of a would be services sector dominant economy.

The privatization process in Eastern Europe has been receiving a great deal of international support. For example, the European Bank for Reconstruction and Development was set up to aid the marketization process and, at Washington's insistence, 60 per cent of its resources must be devoted to the private sector, or sectors "in the process" of being privatized.1/ Also, bilateral assistance has not been lacking. For example, in the case of Hungary, in 1990 Germany offered $500m in credit to help fund joint ventures between Hungarian and German firms, Finland offered $100m and Sweden $150m to import goods from those countries, and the USA offered $60m in the form of a Hungarian-American Enterprises Fund. This level of assistance has helped to place the privatization process on probably an irreversible path, although the decline in standards of living during this turbulent and dislocative transnational period can give rise to pauses for reflection, as has occurred in Hungary, where the privatization process is on hold, and in Poland, where the recent election results were a sort of vote of no-confidence in the entire marketization process.2/ What also has been causing a

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1/ Although the United States is the largest single contributor shareholder with a 10 per cent stake, the countries of the European Community, together with the European Commission and the European Investment Bank, control 51 per cent of the shares. Eastern Europe and the USSR hold 13.5 per cent of the shares.

2/ In the October 27, 1971 election, no party came close to winning a majority and Lech Walesa's fortunes slumped. "Most of the parties that ran well in the Parliamentary race campaigned on

great deal of debate is the appropriate mode(s) or method(s) for implementing the privatization programme.

B. Methods and Modalities

There is a certain amount of similarity in the modes and techniques used by the governments in Eastern Europe to privatize their SOEs. On the other hand, as can be seen in Table III.1, there are some important differences. Restitution is a phenomenon that does not concern either the developed Western countries or the developing countries since past nationalization in these countries had tended to be accompanied by fair and reasonable compensation, although not the "prompt, adequate and effective compensation" that TNCs had usually demanded. In Eastern Europe, however, there was a large number of claims on the announcement of the privatization programmes and the system got mired and bogged down in a considerable amount of litigation and recrimination and vexing issues with respect to value at time of expropriation and present market value. For example, the German decision to return East German land, property or business expropriated by either the Nazis (1933-1945) or the Communists (1949-1989) attracted more than 1 million claims.1/ This created a great deal of uncertainty for new businesses. As a result, some of the governments are downplaying the restitution objective. For example, the German Government recently decided that "in most cases, new investment has priority over

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platforms of looser money and more Government help for failing state enterprises." (New York Times, Oct. 29, 1991)

1/ Treuhandanstalt, The Chance of the 90s: Investing in Eastern Germany, Berlin: Treuhandanstalt, August 1991, pp. 3-4.

Table III.1: Selected Methods of Privatization in Eastern Europe

(1)	Restitution to former owners a/
(2)	Transfer of assets free of charge to the public b/
(3)	Public auction of small enterprise
(4)	Public bidding (among selected pre-qualifiers) for large enterprises
(5)	Direct sale to domestic or foreign buyer
(6)	Conversion into a joint stock company
(7)	Commercialization of a departmental function
(8)	Partial sale of state-owned shares in enterprises belonging to legal persons

Source: Passim.

Notes:

a/ Practiced in various degrees within Eastern Europe. Former East Germany seemed to have made the most progress.

b/ Practiced particularly in the Czech and Slovak Federal Republic, Poland and Romania.

restitution. No new investor need fear that a former owner can lay claim to a factory or plot of land after it has been sold" (Truehandanstalt, 1991).

Another difference between the East European experience and that of others relates to the concept of transfer of shares free of charge to the public. This approach has been proposed by the Czech and Slovak Federal Republic, Poland and Romania and is partly as a result of their frustratingly slow pace of privatization and the lack of adequate investment capital in their countries for the purchasing of the SOEs.1/ Whereas it was relatively easy to dispose of the many thousands of small craft shops and small retail enterprises by public auction in each of these countries,2/ disposal of the larger enterprises presented a much more serious problem. (Fewer than 100 of the medium- and large-sized companies up for sale in Hungary, Poland and Czech and Slovak Federal Republic had been sold by late 1991 whereas 3,300 had been snapped up in Eastern Germany). The method proposed is the issuing of coupons or vouchers3/ to all citizens above 18 years of age. These holders would then exchange their coupons for shares in the SOEs.

1/ For example, in Hungary where the book value (and not even the much higher market value) of all SOEs is approximately 2,000 billion Hungarian forints (or about US$30 billion), it was estimated that it would take about 100 years for Hungarians to purchase the SOEs at the current rate of savings.

2/ So far, five thousand of such small businesses have been sold in the Czech and Slovak Federal Republic alone. 100,000 state-owned shops, restaurants and land parcels were proposed for auction. In former East Germany, 20,000 small shops have been sold.

3/ The term coupon is used in Poland and vouchers in Romania.

There are also significant variations in the coupon plan and related divestiture approach being taken in the East European countries. For example, in Poland, it was planned that 60 per cent of the equity in each of the companies to be privatized (400 in number) would be handed over to 20 investment funds which are comparable to mutual funds. According to the Ministry of Ownership Changes, each adult Pole would receive coupons worth one share of each fund and would in fact be the owners of the investment funds. In order for each investment fund to have an incentive to supervise the management and financial performance of enterprises in which the fund had a stake, 33 per cent of each company (out of the 60 per cent) would be concentrated in just one investment fund. As a result, ownership would be diffuse but control would be concentrated. In the Czech and Slovak Federal Republic case, for the proportion of equity being made publicly available, adults have to pay a fee of $66 before being eligible for the "give away" 80,000 korunas ($2,600) worth of shares. A proportion of the shares in the SOEs will also be up for bidding at arranged auctions. In Romania, only 30 per cent was planned as give away. While allowing for public and employee participation, each enterprise about to be privatized usually has to submit a Privatization Plan to the authorities (see Table III.2) including the role of foreign investors.

In Poland, the balance of the firm beyond the 60 per cent give away would be owned by the state (30 per cent) and the workers (10 per cent).1/ The workers could buy the shares at a 50 per cent discount. The proposal, therefore, includes a mass share ownership plan (MSOP) and an employee share ownership plan (ESOP) component. In the case of Romania, the employees were to

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1/ In time, the workers share could rise to 20 per cent at the expense of the State's share.

Table III.2: Information to be Provided by Large Enterprises Up for Privatization with Foreign Participation in Czech and Slovak Federal Republic

1. The Enterprise's name and specification of the property for privatization.
2. Information on how the state acquired the property to be privatized.
3. Identification of the property unusable for business purposes (i.e., uncollectible claims, unusable fixed assets and stocks).
4. Valuation of the property to be privatized.
5. Manner of transferring the property to be privatized, including the settlement of claims of entitled persons.
6. The definition of the legal form of the commercialized company.
7. When establishing a joint stock company, the distribution of stock shares and their value or type, as well as the information whether and how investment vouchers will be used.
8. The location and method of sale, pricing and terms of payment.
9. The proportion (if any) of the privatization proceeds to be handed over to the authorities.
10. The manner of transfer of intellectual property rights of the enterprises to be privatized.
11. The potential buyers and investors.
12. The market position of the enterprise.
13. The number and qualification structure of the enterprise's workforce.
14. The strategy and goal of the enterprise.
15. The privatization project time schedule.

Source: Basic Conditions for Foreign Investment in Czechoslovak Economy: Investment Guide for Foreign Enterprises in the Czech and Slovak Federal Republic, Federal Agency for Foreign Investment, Prague, July 1991.

receive 10 per cent of the shares, whereas in Yugoslavia the main emphasis in the privatization programme was on ownership by employees with schemes for them to buy out enterprises under preferential terms.

As exciting and innovative as is the coupon privatization method, it has run into problems. The week before the October election, Parliament ordered the Polish Government to suspend free distribution of shares. The reasons are not clear, but it can be imagined that, besides the administrative problem in implementing the scheme, there were concerns about holders selling their shares soon after acquisition, thus leading to unwanted concentration in individual ownership that could later challenge the control of the investment funds and, secondly, the foregoing of a considerable amount of government revenue (since the individual fixed shareholder fee was a paltry $66) that could have been earned if the SOEs were sold outright to either domestic or foreign buyers. Likewise, Romania and Czech and Slovak Federal Republic have suspended their coupon schemes.

Hungary, on the other hand, did not follow the approach of the three above-mentioned countries, partly in order to retain a strong and concentrated shareholder pressure on management of privatized enterprises to perform efficiently, and partly in order to reduce the domestic debt of US$15 billion. An additional motivation to purchase shares are the tax provisions that were enacted at the beginning of 1991 permitting taxpayers to offset their investments in shares and joint ventures against their taxable income. In addition, employees in privatized companies will be able to buy about 10 per cent of available shares at discounted prices and can acquire subsidized credit up to 80 per cent of the buying price if they choose to purchase additional shares. The adverse Chilean experience in their first stage privatization programme shows that this policy of

subsidization of employee purchase of shares has to be handled very carefully.

Prior to 1991, Hungary had gone through a rather turbulent privatization period. Because of the tremendous financial difficulties which large SOEs experienced in the late 1980s and because there were no available Government bailouts (or time for financial restructuring), there ensued a spate of "spontaneous privatization" whereby such enterprises began to hive off profitable segments of their operations in order to acquire funds to pay debt or make necessary investments and purchases of materials.1/ Medicor, Hungary's largest producer of medical instruments, pioneered this approach in 1987 when it restructured 10 of its plants into joint stock companies and sold their shares to various investors. Although in theory the proceeds belonged to the Hungarian Government and the nation as a whole, they remained in the company and solved the immediate and medium term problems of Medicor's management. This approach quickly caught on and by 1990 about 150 other companies had adopted it, helped by an ex post legislation of a de facto situation and on-going process by Parliament in 1988 via the enacting of a Transformation Act and the creation of a related State Property Agency (SPA) from which permission for spontaneous privatization had to be obtained (UNCTC, 1991). In September 1990 the SPA added three other methods - public offer, competitive bidding and employee buyout for the purpose of dealing particularly with the privatization of 300 to 400 large SOEs.2/ For speed of

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1/ The spontaneous privatization system received a lot of criticism because it unfairly benefits the "nomenklatura" or old party managerial elite who became the owners (along with the workers) of the new spin off enterprises at a price they themselves determined.

2/ With respect to the intended privatization of the 25,000 or so small shops and catering establishments in two years, progress has been very slow. The plan to privatize 1,565 of

implementation, a method of "self privatization" was designed whereby the targeted enterprise, rather than the SPA (which still retains the final approval authority, particularly with respect to sale prices) would do all the preparatory work, including the identification of foreign firms that should be invited to tender.1/

National debate has arisen with respect to the proportion of shares that should be in coupon form and the respective percentages that should be assigned to the public and the employees and, as a result, the privatization programme seems to be in a state of limbo, with the Ministries of Finance, Industry and Finance, each having their own views on the matter. What seems to have been decided is a plan to be implemented in 1992 called "mass privatization". To implement the 'fast track' concept of mass privatization, investment funds specialists are being invited to Poland next spring to be given authority to run and restructure more than 200 SOEs. Instead of controlling just one company, Western investment funds will supervise and restructure the selling of the 20 to 30 SOEs that fall into a particular industrial category, such as paper making or machine tool manufacturing.

Finally, the privatization process has not really gotten underway in either Bulgaria or Albania. In Bulgaria, both the foreign investment law and the privatization law were enacted

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these (all retail stores) in the first 6 months of 1991 was a dismal failure with only 100 being sold, supposedly for want of local capital and high transactions costs.

1/ On September 14, 1990 the SPA announced the so-called First Privatization Programme consisting of 20 SOEs to be privatized. On December 3, the SPA launched the Second Privatization Programme with 20 more SOEs to be sold and planned to offer a new batch of 20 every three to four months until 70 per cent of the economy was in private hands by 1996.

only in mid 1991 while in Albania the basic foreign investment law is only now being drafted. However, the debate in these countries is as lively as anywhere else.

C. The Foreign Investment Role

Conditions pertaining to the participation of foreign investors are sometimes spelt out in the privatization law and in other cases are covered by the provisions in the basic foreign investment law. In any event, the foreign investment regulations have been undergoing a process of change as the East European countries realize that the old strategy of enclave foreign investment, in the form of joint ventures in certain select sectors, was not bringing the type of benefits or level of economic transformation that they expected in their economies.1/ This eventually gave way to sweeping changes in the legislation.

For example, the USSR revised its foreign investment law in October 1990 not only to permit 100 per cent foreign investment but, also, to allow foreigners to acquire property, shares, land use rights and other securities, thus probably implicitly allowing privatization. Meanwhile, in the other East European countries specific privatization legislation had begun to be introduced, starting with Hungary in 1989, Eastern Germany, Poland and Romania in 1990, and Czechoslovakia and Bulgaria in 1991. As the dynamic process of privatization has unfolded, the interpretation of the law has also become more flexible and certain selected strategic industries have formed joint venture arrangements with TNCs.

1/ It should be noted that even before the advent of equity centred joint venture relationships certain technology agreements existed between enterprises in Eastern Europe and TNCs from the rest of the world.

However, one clear area in which privatization deals are not permitted relates to the small scale sector of restaurants, shops and other retail businesses. This is the case in Albania (draft law), Bulgaria, and Hungary. In the Czech and Slovak Federal Republic foreigners are not allowed to buy small shops except in the second round of the auction process and in Poland the blanket 10 per cent limit on acquisition of privatization shares by foreigners was lifted only in mid June 1991. However, the market for very small enterprises is said to have a second "invisible hand". For example, many citizens in Prague feel that foreigners, mostly Germans, are using Czech 'fronts' to buy property.1/

Foreign investment is, therefore, to be found in the non-micro sector, i.e., among the not so small, medium and large scale enterprises. The bare numbers2/ are impressive. In Poland, by mid-1991 there were approximately 2,500 joint ventures (one-third set up by the end of 1986 and two-thirds thereafter) with capital valued at nearly $200-million. In Hungary, there were 7,000 registered joint ventures with foreign capital of $1.8 billion, by June 1991, 2,000 alone being registered in the first quarter of 1991. In Romania, which had only five joint ventures before December 1989, the number registered had risen to 4,196 by mid-1991, with a foreign capital of $192 million. In the USSR, where there were 23 registered joint ventures at the end of 1987, the number had risen to 1,754 by June 1990 and 3,000 by July 1991 (Table III.3). Despite these relatively high numbers, there are two things worthy of note. First, a significant number of the joint ventures are mere "shells", registered but not active partly because many registrants were probably dubious companies

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1/ Chicago Tribune, Oct. 22, 1991.

2/ Passim.

Table III.3 Total Number of Registered Joint Ventures and Average Invested Foreign Capital Per Enterprise in Selected Countries in Eastern Europe, Mid-1991

Country	Total Number Registered	Average Invested Capital Per Enterprise ($)
Poland	2,500	80,000
USSR	3,000	150,000
Romania	4,196	45,758
Hungary	7,000	25,758*
Yugoslavia	3,500	n.a.
Bulgaria**	500	n.a.

Source:

Re Romania, UNCTC, Transnationals, Vol. 3, No. 3, Oct. 1991;

Re USSR, Financial Times, 12 Oct. 1991; Financial Times, 1 Feb. 1990;

Re Hungary, UNCTC Transnationals, Vol. 3, No. 3, Oct. 1991;

Re Poland, UNCTC Transnationals, Vol. 3, No. 3, Oct. 1991.

Re Yugoslavia and Bulgaria, CTC data base.

* For the larger ventures, the foreign share averaged about $100,000.

** Estimate

on the lookout for a killing and partly because the problems of operating in the particular environment appeared too daunting. For example, of the 1,274 joint ventures registered in the USSR by 1 January 1990 only 184 were operating anyway.1/ Second, the average foreign capital invested per venture was very small, again probably reflecting the cautious attitude of the foreign investor. In one sampling of 127 joint ventures that had been registered in the USSR by 1988, the average percentage (numerical rather than weighted) foreign partner shareholding was 40, significantly less than the statutorily permitted limit of 49.9 per cent.2/

The small amount of average invested capital is probably also related to the types of sector in which foreign investors have shown the most interest. For example, Tables III.4 and III.5 for USSR and Eastern Europe, respectively, show that traditional manufacturing activity is not very dominant and that investors are much more predisposed to supplying consulting, merchandising and tourism related services. This situation, however, is rapidly changing since the introduction in 1990 of explicit privatization programmes in most of Eastern Europe (except the USSR) has made available large and potentially very profitable SOEs for purchase or participation by foreign investors.

Also, TNCs from some home countries seem much more likely to invest in both the USSR and Eastern Europe than TNCs from other countries. Table III.6 on the USSR, dealing with TNC home country percentage share of joint venture capital, and

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1/ Financial Times, 1 February 1990.

2/ UNCTC database.

Table III.4: Sector/Activity Composition of Joint Ventures in the USSR, July 1991

Sector/Activity	% Share
Computers	14%
Consulting	10%
Consumer Goods	8%
Chemicals	6%
Tourism	6%
Food	6%
Machinery	6%
Retail	5%
R&D	5%
Others	34%

Source: Financial Times, 12 October 1991.

Table III.5: Sectoral Classification of Recent Joint Ventures Announced for Eastern Europe, by Industry

Industry	Number	Industry	Number
Technology	64	Fin. Services	11
Specialty Prod.	58	Tele. Equip.	10
Lodg./Rest.	44	Agriculture	10
Gen. Merchand.	39	Air Transport	9
Biotech/Hos. Sup.	38	Oils	9
Consulting	34	Mains & Micros	9
Building	31	Photography	8
Machinery	29	Cons. Elec.	8
Comp. Software	28	Household Prod.	6
Tex./Ap./Fib.	27	Oil Services	5
Entertainment	23	Truck/Air Freight	4
Div. Companies	22	Railroads	3
Food & Drug	20	Cosmetics	3
Automotive	18	Aerospace	1
Food: Packaged	18	Broadcasting	1
Publ./Print	18	Cellular Comm.	1
Forest P&P	17	Dept. St.	1
Tele. Services	16	Disk Dr. Sup.	1
Advertising	16	Insurance	1
Chemicals	15	Offshore Drill	1
Metals	15	Retail	1
Elect. Equip.	12	Utilities	1

Source: Goldman Sachs, 3/19/90.

Table III.6: TNC Home Country Share of Joint Venture Capital in the USSR, July 1991

TNC Home Country	% Share
German	12
Italy	11
France	11
Finland	8
USA	8
Austria	6
UK	4
Others	40

Source: Financial Times, 12 October 1991.

Table III.7: TNC Home Country Share of Total Number of Joint Ventures Registered in Romania, End 1990

Country	Number	Percentage
Germany	654	21
Italy	461	15
Syria	388	12
Turkey	343	11
USA	273	9
Lebanon	250	8
France	208	7
Israel	182	6
Austria	128	4
Greece	118	4
Hungary	109	3
	3,114	100

Source: Based on UNCTC, Transnationals, Vol. 3, No. 3, October 1991.

Table III.7 on TNC home country share of total number of joint ventures registered in Romania, indicate that Germany and Italy are first and second, respectively, on both lists while the USA, for example, appears somewhere in the middle of both lists.

Some of the above-mentioned joint ventures were created from scratch while others were a merger of Western capital and technology with an existing SOE. Some also were a product of the period of what we may call 'informal privatizations' that occurred prior to 1990 while most of the others (except for the USSR) are the result of the explicit strategy of privatization that occurred after 1990. However, the available data are not disaggregated along these lines. Nevertheless, it can be assumed that most of the large joint ventures with foreigners are indeed privatizations and were almost invariably set up since 1990. So far, the practice tends to be for host SOE enterprise to hold an equity share in the privatization venture ('partial privatization') rather than to relinquish 100 per cent ownership. Table III.8 presents a list of the 16 largest joint ventures operating in Eastern Europe.

The speed with which such large privatizations have been consummated and the smoothness of their subsequent operations have been plagued by a number of factors. First, there has been the quantification problem relating to valuation, particularly with respect to capitalizing the technology contribution of the foreign partner and the intangible factor of "goodwill" or international market reputation that he brings to the enterprise. A second and related problem concerns depreciation of high technology and the claims of the foreign partner that it should be four to five years, rather than eight to 12 years, because of its rapidly changing nature. Third, there is the issue of the convertibility of the local currency. Fourth, and related to

Table III.8: List of the 16 Largest Foreign Investments in Privatized Entities in Eastern Europe

Investor	Country	Partner	Country	Field	Invest. in Mil $
Volkswagen	Germany	Skoda	Czechoslovakia	Motor cars	6,330
CBC	France	Tourinvest	Czechoslovakia	Hotels	175
General Electric	USA	Tungsram	Hungary	Illumination	150
General Motors	USA	Raba-Gyor	Hungary	Cars, engines	150
Pilkington	Great Britain	HSO	Poland	Glass	140
Guardian	USA	Magyar Uveg	Hungary	Glass	120
Suzuki, C. Itoh	Japan	Ikarus	Hungary	Motor cars	110
Linde	Germany	Technoplyn	Czechoslovakia	Technical gas	106
Elektrolux	Sweden	Lehel	Hungary	Refrigerators	83
Hamburger	Austria	Dunapack	Hungary	Packings	82
Ford	USA	Videoton	Hungary	Car-pieces	80
Sanofi	France	Chinoin	Hungary	Remedy	80
Oberoi	India	Hungar Hotels	Hungary	Hotels	80
U.S. West, Bell	USA	Adm. Authority	Czechoslovakia	Tel. Connexions	80
Sara Lee	USA	Compack	Hungary	Food	80
ABB	Switzerland	Zamech	Poland	Turbines	50

Source: WIRTSCHAFT (ECONOMY), 1991.

convertibility, is the problem of repatriation of profits.1/ Probably because of the repatriation problem, TNCs are said to be resorting to transfer pricing.2/ Fifth, and still related is the issue of performance requirements and such stipulations as local content ratio, export ratio and balanced foreign exchange budget. Sixth, there is the problem of the inherited social and welfare obligations of the enterprise, over and above those normally provided in the West. Seventh, the issue of technology transfer and the rights to inventions emanating from the workings of the joint venture. Eighth, the role of the so far non-privatized banking system in providing working capital, as a complement to the slowly developing stock exchange system still has to be resolved with respect to foreign access and the issue of the "crowding out" effect (UNDP, 1991). Ninth, and related to the local content issue, is the problem of raw material supplies in an economy emerging from a command supply system. Tenth, there is the issue of the appropriateness of incentives and the role of free economic zones (or EPZs).

D. Selected Case Studies

A few of these issues are reflected in the following six case studies of privatization: Two of the case studies relate to Poland's experience with respect to confectionary manufacture and conversion from a military to a civilian airline; two deals based on the experience of Treuhandanstalt3/ in the privatization of a drive shafts company and an elevator and escalator production company in Eastern Germany; one is on the privatization of the

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1/ In Poland, for example, it is as low as 15 per cent.

2/ See Financial Times, Feb. 1, 1990.

3/ The privatization holding agency for the assets of the SOEs prior to sale.

CASE STUDY NO. 1: PRIVATIZATION OF A CONFECTIONARY COMPANY, POLAND

PepsiCo, the American softdrinks giant, in late October, 1991 purchased 40 per cent of Wedel SA, the leading Polish confectionary company with a famous brandname, for $25 million. The share proportion under Polish law gave it management control. The remaining shares were offered to the public and to employees.

PepsiCo will invest $56 million over the next five years developing Wedel, and another $60 million over five years on PepsiCo's existing Polish bottling industry.

PepsiCo's investment in Wedel will be used to expand and upgrade existing facilities, develop a nation-wide distribution system for Wedel products, and build a new plant for the production of salty snacks.

Wedel generated sales of $58 million in 1990. Ten percent of its sale are earned through exports to 29 countries, including the United States. The introduction of salty snacks will complement Wedel's existing product lines and utilize Poland's domestic commodities and markets.

Poland is the world's third largest grower of potatoes, but has so far had no salty snacks on its markets. The introduction of new markets with the new distribution system could, over a two- to five-year span, add 500 to 600 new jobs to the existing 3,100 within the company. PepsiCo has given a commitment not to lay off any employees in the first year following its investment.

PepsiCo was selected as a buyer in a competitive bidding process conducted by the Ministry of Ownership Changes. PepsiCo was the most attractive investor because of price, the investment plan, and the employment plan. PepsiCo was also helped by its 19-year business in Poland.

PepsiCo's bottling industry in Poland consists of nine plants employing a total of 2,000 people. Indirect employees in advertising, marketing, distribution, etc. bring this total to 4,000 employees of the Polish bottling industry. The five-year investment plan will increase this employment by 3,000. Modernization of the industry will consist of development of existing bottling lines, introduction of convenience packaging, training, and distribution. Projected sales are $75 million, relying on increased consumption.

Source: Based on (1) Eastern Europe Report, August 12, 1991 and (2) The Washington Post, October 27, 1991.

CASE STUDY NO. 2: PRIVATIZATION OF A 'CIVILIANIZED' MILITARY AIRLINE, POLAND

Aglow with the free market spirit, the Polish army is going into business with American investors in a venture that propels the concept of airline deregulation to new heights.

The unlikely deal-makers plan to convert a small piece of the Polish military into a privately operated regional "feeder" airline offering cargo and passenger flights to smaller Polish cities.

Air Batory, named after an early Polish king, plans to use idle Soviet-built cargo planes, military landing fields and more than 100 Polish military pilots, navigators, mechanics and other support personnel.

The American partners are now trying to raise $6 million to get the venture off the ground. Delayed repeatedly by bureaucratic hurdles, organizers hope to begin operations this fall under the management of retired U.S. airline executives, headed by Cary E. Smith, former chief pilot and vice president-operations of Delta Air Lines.

Half the profits are to be used for the "cultural" needs of Polish military personnel, government officials say. The other half will go to Consolidated Ventures International of Ann Arbor, Michigan, and Krakow, Poland.

The airline scheme is one of the more colourful examples of Eastern Europe's "privatization" and the unexpected directions it can take.

"It's the Wild West", says H. Joseph Pratt, president of the U.S. arm of the joint venture.

Air Batory apparently owes its wings to Polish army Lt. Col. Zbigniew Kusnierek, 37, who persuaded the Ministry of Defense to allow the use of surplus elements of the military for moneymaking purposes to offset the impact of massive budget cuts.

A big share of the military existed to support Soviet troops. People and equipment were idled as the Soviets began to withdraw.

"If the army had abandoned these facilities - airstrips, hangars and so on - they would have sat unused and the army would have had to maintain them at budget expense", Kusnierek said.

Kusnierek approached Leslaw Kuzaj, a Pole who head the Krakow-based operations of CVI Poland. CVI puts Kusnierek in touch with Harry R. Snoke, a retired Marathon Oil Co. pilot from Findlay, Ohio, who put together a business plan. The new firm is 50 per cent owned by Artwoj, the military foundations created for the purpose, and 50 per cent by CVI.

Artwoj is supplying the venture with a dozen Antonov cargo planes, two years' worth of spare parts, a network of landing strips and maintenance facilities and more than 100 military personnel who otherwise would be laid off.

The personnel include pilots and navigators who have already received U.S. training in the 24-passenger Grumman G-1 turboprops that will be leased to provide the Warsaw-based passenger service. Cargo operations will fly out of Krakow.

Among the most valuable assets the military brings to the venture are landing rights at airports throughout the region. Nine Polish cities plus Berlin, Prague, Czechoslovakia, Vienna, Budapest, Hungary and the Soviet cities of Kiev and Minsk are to be served. On the domestic routes, at least, Air Batory will have no competition; Lot Polish Airlines, the state-owned carrier, has dropped its regional service.

Officials admit that customer demand is almost totally unknown because several of the cities have not been connected by air service before. But there is no competition, either, notes CVI's Pratt.

"Hypothetically, there should be great demand", he says. "But we project a profit within 18 months based on an occupancy rate of just 30 per cent".

Source: Los Angeles Times, July 9, 1991.

CASE STUDY NO. 3: PRIVATIZATION OF DRIVE SHAFTS PRODUCTION, FORMER EAST GERMANY

GKN buys Gelenkwellenwerk Mosel:

GKN is one of the UK's largest engineering companies with worldwide sales of close to DM8bn. It specializes in motor components and through its west German subsidiary in Siegburg has been a long-standing supplier to Volkswagen.

Gelenkwellenwerk Mosel is a producer of drive-shafts employing about 1,300 people. GKN made clear from the start that it did not want to buy the land or building and wanted to pay as little as possible for the working assets. The buyer was, however, prepared to take on all 1,330 workers and share some liability for environmental contamination.

Establishing a reasonable rent for the buildings and sale price was also difficult because of the lack of a market in the east. After careful examination of the assets of the plant, especially its machinery and equipment, the Treuhandanstalt and the GKN negotiators reached a compromise.

Agreement

In March 1991, a final agreement was signed. GKN paid just under DM4m for the assets. Rent for the 190,000 sq. metres of land (60,000 of which is built upon) and the buildings was entered into for a 20 year period (with a 10 year optional extension). Part of the rent goes to Suden Leasing, the leasing company which bought the site for DM40m. The Treuhandanstalt shouldered the trading liabilities and Sachsenring financial debts. GKN did agree to cover 20 per cent of ecological clean-up costs up to a maximum of DM300,000. The company also took on the workers. The buyer promised that total investment over the next few years will be several times the purchase price.

Post-acquisition

Mr. Bonner said he was relieved to discover no significant surprises after taking over the plant. It had produced about 1.6m driveshafts a year, a number which GKN was expecting to cut by about 25 per cent in 1991. Sales of about DM90m and a small loss were expected in 1991 and a small profit was hoped for in 1992.

GKN's main task was to restructure the high-volume standard model production, into smaller, more flexible and differentiated, production runs. The Mosel plant lost its east German market with the closure of Trabant production but continued to produce for Skoda, PSA of France and for the Soviet Union.

The real test, however, according to Mr. Bonner, will be when it starts producing for Volkswagen in 1993. A small number of new managers were placed in the company after the takeover. Mr. Peter Goss, former managing director of GKN's Trier forge, took over as chairman, and the former east German plant manager became technical director. A controller and a personnel director were also brought in from the west.

Source: Treuhandanstalt, The Chance of the 90s: Investing in Eastern Germany, Berlin, August 1991.

CASE STUDY NO. 4: PRIVATIZATION OF ELEVATORS AND ESCALATORS PRODUCTION, FORMER EAST GERMANY

Otis buys Aufzugwartung Berlin:

Otis is a US-owned multinational producer of elevators. Its West German subsidiary, Otis GmbH,based in west Berlin, had sales of DM611m in 1990 and employed 3,716 people. Aufzugwartung Berlin (AWB) was a small elevator service company in east Berlin. In 1990, it employed 110 people and had sales of about DM4.5m. Because AWB employed less than 1,500 people, it fell under the responsibility of the Treuhand regional office in Berlin.

Approach

Otis GmbH was one of the first to invest in eastern Germany and in December 1989 was already examining the possibilities of acquisitions and joint ventures. To date, it has acquired 11 companies in eastern Germany. Its largest acquisition was the lift business of Takraf AG, eastern Germany's monopoly producer, which was bought for about DM10m. This case study, however, concentrates on the smaller deal for AWB.

Information

AWB was first visited by Otis in February 1990, but negotiations did not begin until September. In the meantime, the auditors Peat Marwick had prepared a DM Opening Balance Sheet which gave a small positive value of DM70,000.

Negotiations

Mr. Jürgen Reuning, head of Otis GmbH, said that he was impressed with the Treuhandanstalt's professionalism in negotiation but that, at least in 1990, patience was required in dealing with the organization. One reason for that was the rapid increase in Treuhandanstalt staff. Negotiations for AWB finally began in September 1990 with one representative of the Treuhandanstalt head office and two officials from the Berlin regional office. Otis was aware of the Treuhandanstalt's concern to retain as many jobs as possible and therefore offered to take on almost all the staff at AWB. The initial bid for the company, however, was rejected by the Treuhandanstalt despite the absence of competitor bids. Soon thereafter a new offer of about DM100,00 which is, slightly above the asset valuation, was made and was taken much more seriously.

Agreement

The journey from agreement in principle to an actual contract involved numerous negotiations. Otis was not buying the land on which the AWB business stood but it did agree to take on some of the old debts, which increased the real purchase price about DM400,000. In February 1991, everything was finally settled at one long negotiating session and AWB had a new owner.

Post-acquisition

In the second half of 1990, AWB lost about 30 per cent of its roughly 1,000 lift maintenance contracts. Most of these contracts were recovered in 1991. Otis is expecting sales of about DM5m and a small profit. Mr. Reuning said that AWB required no full-time new management but a considerable amount of re-training for almost all staff. Staff was reduced soon thereafter the takeover from 107 to 90.

Source: Treuhandanstalt, The Chance of the 90s: Investing in Eastern Germany, Berlin, August 1991.

CASE STUDY NO. 5: PRIVATIZATION OF SKODA MOTORCAR COMPANY, CZECHOSLOVAKIA

In April, 1991 Volkswagen purchased 31 per cent of SKODA (an SOE with a 30,000 strong workforce) with an agreement for an increase in the shareholding to 70 per cent by 1995. Volkswagen managed to beat out bids from France's Renault and Sweden's Volvo partly because of its significant commitments. Volkswagen committed itself to (a) invest $5.3 billion in Skoda by the turn of the century; (b) double Skoda's annual production to 400,000 cars a year by 1997; (c) help Skoda develop a new range of models; (d) make available to Skoda its purchasing and parts network; (e) allow Skoda to retain its own identity and its own dealers throughout Europe in exchange for Skoda selling the exclusive use of its trademark to Volkswagen for $8.3m; (f) pay for the clean-up of pollution at the factory sites.

In exchange, the Government promised, inter alia, that, if it ever sold its 30 per cent share in Skoda to the public, it would accommodate Volkswagen to maintain tight control over the new subsidiary and prescribe any hostile moves by the new shareholders. This is achieved by permitting the Government to retain voting rights even though the shares will be sold to private investors. Consequently, the private shareholders will enjoy benefits like dividends, but no voting rights.

Volkswagen's strategy is to expand its manufacturing capacity to satisfy an expected boom in car sales in the opening-up markets of Eastern Europe, once the difficult transnational period in the countries comes to an end. There is believed to be a huge pent-up demand for cars since, for example, of the 1m western-built cars sold in the former East Germany in 1990, some 800,000 were second hand models.

Volkswagen felt that the cheapest way of satisfying the latent East European demand for cars at the low end of the price spectrum was to build in a relatively low cost site such as Czechoslovakia. Moreover, Volkswagen reasoned that its other low cost site, Spain, where the relatively cheap SEAT car is produced, did not have the capacity to meet the expected explosion of demand in Eastern Europe.

Source: Based on (1) Economist, December 15, 1990 and (2) New York Times, April 20, 1991.

CASE STUDY NO. 6: PRIVATIZATION OF TUNGSRAM LIGHTING COMPANY, HUNGARY

In November 1990, General Electric (GE) bought 50 per cent plus one share or a majority (first time for a foreign company in Hungary) of the shares of Tungsram, the relatively successful Hungarian lighting company that was founded in 1896, for $150m.

GE's basic strategy and reason for buying out Tungsram was to use it as a spring-board into integrated Europe 1992. Although GE is second to Philips world-wide, GE was only sixth in Europe with just 3 per cent of that market for light bulbs. On the other hand, Philips had within recent years captured a substantial share of the US market and GE intended to repay the compliments. Building a new plant was too costly ($300m) and so a partner with an existing plant had to be found.

Tungsram was the perfect medium for this Europe bound penetration strategy, for a number of reasons: (a) it was prepared to concede majority control whereas alternative partners like Siemens and Thorn EMI of the Britain were not; (b) Tungsram was a robust exporter and earned 70 per cent of its $300m in revenues from the West, chiefly Europe; (c) Tungsram's average wage is one-tenth that in the United States and Western Europe, even though the total labour force is too large; overall labour accounted for one quarter of the cost of making a light bulb compared with one half in the USA; (d) Tungsram's incandescent bulbs are of high quality; and (e) with a little bit of know-how in the area of breakage reduction and inventory control, Tungsram would be able to save millions.

GE also felt that competitiveness and profits could be vastly increased by investing $15m a year (three times Tungsram's yearly investment in the 1980s owing to government siphoning off the profits) in the fast growth, high tech energy efficient areas (of which incandescent bulbs was not one) such as compact fluorescent bulbs for homes and offices, high-pressure sodium lamps used in street lighting and miniature spotlights that lend sparkle to shop windows displaying jewelry or antiques. GE also believed that Tungsram's thriving business in automobile headlights could achieve an even higher quality (given the increasing standards imposed on automakers) with a $10m investment.

For its part, the Government was willing to make a number of concessions, including freedom of GE to choose product areas for investment, repatriate profits, and lay off workers. GE intends to save $10m. a year by gradually reducing the work force.

Source: Based on (1) Hungarian Observer, January, 1991 and (2) Fortune, October 22, 1990.

Skoda motor car company in the Czech and Slovak Federal Republic; and the final case study is on the privatization of the Tungsram lighting company. Although, the choice of case study was primarily based on the availability of information, the group is fairly representative of the more important privatizations taking place in Eastern Europe.

Although, the case studies all relate to very different sectors and/or activities, a few issues and meaningful lessons can be identified with most of them. First, in making a decision to participate in the company the foreign investor takes into consideration not simply the profitability of the single entity being privatized but the extent to which the new firm matches its entire world production system and the resultant maximization of profits, systems wide. Second, there is need for a commitment on the part of the foreign investor to have a long term strategy for the privatized enterprise and to use its considerable capital and technology resources to expand and modernize the plant, machinery and equipment to meet the challenges of an increasingly competitive world economy, in which domestic production can no longer hide behind protective tariff barriers and production for export requires the industry to be at the cutting edge of technological change. In Eastern Germany, the privatization agency's position is reflected in the following policy statement:

> "Price is not the only criterion, indeed an investor who pledges to inject new capital and management and to keep or create jobs will be preferred to one who is merely offering more cash" (Treuhandanstalt, op. cit., p.5).

In Eastern Germany, the privatization agency also requires the bidder to include in his offer "the implications for the suppliers and subcontractors in the new federal states" (Treuhandanstalt, p.10). This concern for local networking (and,

by implication, local content) would tend to conflict with the global integrated approach of the TNC.

Third, it is clear that it is better for the TNC to do the required restructuring after the privatization rather than for the Government to attempt to rehabilitate and streamline the SOE prior to privatization in the hope of then acquiring a more favourable price, etc. The reason is that the particular TNC that wins the bid has not only its own conception of what needs to be done to make the enterprise, per se, viable but, also, its understanding of how the newly privatized enterprise fits into its global scheme of things and what specific product areas and market segments need to be highlighted and what others need to be downplayed; this will very much inform the type of modernization and expansion plan that is effected. Of course, there are plants that might be in such bad shape that no meaningful offer can be expected from a foreign buyer. In such a case, it may be better to liquidate the enterprise or make it available for a token sum, but in a manner that retains the public confidence.

Fourth, the plan for dealing with the factor of production, labour, should be just as carefully thought out and elaborated as that for dealing with capital and land. Here it is debatable whether the shedding of labour should occur before the privatization or after. In any event, the Government, which was responsible for the feather bedding in the first place, has to take an active role. If there is planned reduction of labour before the privatization, the Government should steer the surplus labour to alternative employment in the more expanding or dynamic sectors of the economy or provide re-training programmes with an interim welfare cushion of unemployment benefits. Although privatization is tantamount to the reduction in the role of the Government as a producer, a social and regulatory role still remains! If labour shedding is to take place after

privatization, it should be spelt out in the sale transaction and should indicate numbers to be laid off, types of skills, sequency and duration, severance pay and the re-training and skill enhancement of the remaining workers.1/

Fifth, the proposed privatization of a 'civilianized' airline in Poland shows the creativity that can be unleashed under privatization and the so-called "peace dividends" that can be earned with the relaxation of the Cold War. It also demonstrates that a new privatized firm cannot infrequently emerge as a result of a spin-off from a public entity.

Sixth, although the case studies relate to instances of total, majority and minority acquisition by the TNC, almost invariably management control was conceded to the foreign entity. While in most cases this may be critically necessary for capturing the interest of would-be bidders who want the leverage so as to effectively integrate the new entity into their global structure, the Government should ensure that it maintains an overseeing and monitoring role so as to preserve the national interests and attain the host country's objectives.

Seventh, the case studies indicate the need for effective preparation and negotiation, even this delays the privatization process somewhat. The TNCs invited to bid should be those whose global structures and objectives are not inconsistent with those of either the host country or host enterprise. The SOE also

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1/ In Eastern Germany, to prevent further deterioration in the unemployment situation, the Government hurriedly introduced a system of short time working under which the State pays 70 per cent of the wages of workers who work only part-time, or in some cases not at all, while remaining on a company's payroll and receiving a top-up payment (to 90 per cent of the full wage) from the company itself. This system was extended until the end of 1991 (Treuhandanstalt, p.7).

needs to gather all the information necessary for negotiations, be cognizant of all its options and alternatives, and conduct the bargaining process in such a way that a fair and reasonable deal emerges. To level the playing field, it may require to seek outside technical assistance.

Finally, the actual practice is probably more important than the letter of a privatization or sale agreement. The privatizations sited above have not been in operation long enough to determine whether national development objectives are being achieved, in addition to the profit maximization goals of the TNCs. Careful monitoring in the future will yield the answers.

CHAPTER IV: EXPERIENCES GAINED AND LESSONS LEARNT

The foregoing analysis points to a number of ways in which host countries can better plan, prepare and negotiate privatization deals; improve the terms of such deals; regulate and monitor post privatization operations to ensure that the national interests are being safeguarded; stimulate the performance of the remaining SOEs; and prepare themselves for a world in which SOEs are no longer a significant economic category.

A. Planning, Preparing and Negotiating

The experience of the privatization process so far indicates that countries preparing a privatization programme should first have a strategy in mind as to what role the public sector (and simultaneously its obverse, the private sector) as a producer should play in the national economy, the available options (and divestiture methods and techniques) for arriving at this reduced role of SOEs and the planning and organizing that have to be done to bring each such identified SOE up to the stage where a reasonable sale arrangement can be effected. The process should be a rational and controlled one, rather than a blind stampede towards some ideal which can turn out to be a mirage.

But for privatization policy to be effective, the general macro-economic policy framework has to be an appropriate one. Preceding privatization, or at least accompanying it, there should be a set of economic reforms in order to encourage potential domestic and foreign investors to purchase the assets with the expectation that a fair yield will result. Such reforms should relate to trade policy, pricing and subsidy policy (in terms of "getting prices right", not only with respect to

domestic terms of trade but, also, external prices and the related exchange rate), fiscal incentives and general taxation policy (while remembering that incentives can sometimes be just as distorting as subsidies) and a policy to promote competitiveness, inter alia.

Countries are well advised to make use of assistance available internationally from investment banks, accounting and legal firms, United Nations and other agencies with respect to the planning, valuation and negotiation process.1/ Of course, to be able to make use of international advisers who have not only technical skills but, also, the knowledge of similar deals that might have taken place in other parts of the world, it is important that there be sufficient lead time and that the government does not feel that adverse economic conditions are forcing it into a 'fire sale'. At the same time, care should be taken that there is no conflict of interest arising with respect to the international bank or accounting firm that gives the advice on valuation price and performance requirements also having an ongoing client relationship with the buyer or winner of the management contract;2/ this would constitute a sort of 'insider trading'.

1/ For an excellent listing by an accounting firm of some of the required tasks and skills, see Coopers and Lybrand, Restructuring and Privatization: Capabilities Statement Part I: Services and Approach, July 1991, pp. 4-12.

2/ Local counterpart teams should be closely associated with the international advisers because of the learning experience.

B. Performance Requirements

As an integral part of the sale document, government (should extract from the foreign purchaser1/ a commitment to expansion, modernization, local sourcing, transfer of technology, re-training of local workers, minimizing usage of imported technicians, etc. There should be less pre-occupation with ownership and more concern shown for performance. However, these performance requirements have to be conceived within the framework of a clear industrial strategy for the enterprise within the national developmental context. Although TNCs are endowed with capital, technology, management skills and marketing outlets and a network system, benefits to the host country are not automatically maximized.

A related performance question is the continuation (or replacement) of the old management team when there is a privatization. Some pertinent questions to ask are the following:

1. "Can the existing management effectively operate the enterprise where survival is dependent on offering goods and services that generate sufficient revenue to cover all costs?

2. "Will the existing management team be able to adapt to working effectively in the free market rather than the protected world of government support, subsidies and guarantees of credit?

3. "Can the exsiting management team make the hard decisions to eliminate products or services that are politically popular, but economically insupportable?

1/ Some requirements are also applicable to local buyers.

4. "Is the holdover management team adept at using capital markets and investment bankers to generate needed capital, or to negotiate capital budgets in the intricate internal workings of a multinational firm? Can the managers generate funds in an international arena when the viability of the privatized firm may be in question?

5. "Can the management team make the hard decisions about laying off workers that are unproductive or unwilling to adopt to more efficient technologies?

6. "Can the existing management team focus on the long term - five or ten years into the future - when decisions may begin to pay off from large investments in production technology or product research and development?" (R. Molz, 1989)

In practice the above can frequently be moot points since we have seen that the TNC almost invariably demands control irrespective of whether he acquires a majority or minority (except for a mere portfolio investment) shareholding. For this reason, it is probably not very important for government to have a strategy of partial divestitute except in very special circumstances, such as in the case of strategic industries.

However, with respect to a management (and employee) buy-out in which there is very little or no foreign equity stake, the issue is important. For example, a particular privatization mode (usually a dispersed public offering with no large dominant shareholder) was in certain UK cases devised by the old managerial order partly in order to perpetuate their own management lives (Yarrow, op. cit.). This situation has sometimes arisen in Eastern Europe.

C. Monitoring and Regulation

The government's role does not end after an enterprise has been privatized. Especially if the enterprise is large and important to the economy, there is need to monitor its performance very carefully. As such appropriate monitoring machinery needs to be set up and some method of encouraging (and ultimately enforcing) compliance with the performance requirements needs to be devised. This is especially vital in cases where the conditions in the sale document are such that payment for the privatized enterprise is really dependent on future performance and related earnings.

At the same time, the government should avoid behaving like a 'shadow management' and should 'let business get on with the job of business' but within certain clear guidelines and rules of the game. In any event, privatized industries should be required to operate without subsidies or other special concessions. Tariff protection, if any, should also be very selective, for a limited period of time and phased out steadily. Such protection should normally not be accorded to a foreigner, since to him the privatized enterprise could not be considered an infant industry.

In the case of natural monopolies, privatization simply means the transfer of a non competitive situation from the public sector to the private sector. If a pre-privatization decision had not already been taken to break-up the enterprise into separate competitive firms, then it may be necessary to introduce legislation and regulations for regulating the privatized enterprise. The regulations would take the form of control of prices or profits, the quality of service and the terms and conditions of supply so as to simulate what would normally occur in a competitive situation.

Divestiture of banks and related services, a possible third wave of the privatization process, has not occurred as yet. In the few cases where it has taken place, shares have mainly been sold to local shareholders. However, if transnational banks were ever to become significantly involved, this could require an international regulatory dimension, as the BCCI case illustrates. The microelectronic revolution has facilitated not only the easy international transmission of funds, but, also, the easy transmission of bank failure simultaneously and contagiously across nations. The State cannot relinquish its regulatory responsibility even though today it is fashionable to talk about "getting government off the back of the people".

D. Role of the Remaining SOEs

Many developing countries have programmes for privatizing a large proportion of their SOEs. Many of these countries have already privatized some of the small enterprises for which the private sector has an obvious comparative advantage. Some countries have already begun to tackle a few of the large and strategic enterprises. An obvious question is what should become of the remaining SOEs, i.e., those that have not been included in the privatization programme as designed at present. There are a number of reasons for thinking that these remaining SOEs, typically large and complex, may become more efficient and able to survive without government largesse and in an immensely more competitive world.

First, by getting rid of a number of small and medium size enterprises the government may be able to divert the released management resources to more critical and important areas. The government would therefore no longer suffer from a management stretching problem.

Second, if the policy is to privatize the more sluggish enterprises, then the more profitable state-owned companies that remain would be the ones earning enough surplus for an effective programme of research and development and for reinvestment in new plant and equipment embodying the latest technology, thus raising productivity levels. Proceeds from the sale of certain enterprises can also help to serve this modernization process, provided the governments make this an explicit aim rather than view it as solely a budget-deficit reduction exercise. The problem is that enterprises that are likely to be the most attractive when put up for sale are the profitable ones.

Third, the close scrutiny and evaluation that the privatization process creates may force governments to develop a clearer strategy with respect to the role of the public sector, a sharper focus with respect to technology planning for state-owned enterprises, and more explicit and coherent objectives with respect to their economic and technological efficiency. In the case of public utilities and manufacturing enterprises catering to the domestic market, such a strategy may require, inter alia, having a pricing policy which makes for a reasonable surplus and to relegate redistributional objectives to fiscal measures involving progressive taxation and welfare expenditure. For export-oriented industries, where output prices are determined on the international market, an effective surplus creating strategy would have to rely more on controlling the costs of production. If inputs have a high import content, the search for cheaper alternative sources would need to be combined with measures designed to prevent labour costs from escalating. An important factor making for success is whether the enterprise, having been given clear objectives, is able to operate without too many bureaucratic constraints and is allowed to respond freely to the dictates of the market place. The enterprise shold also be allowed and encouraged to access, adapt, adopt and absorb

technology from the most efficient sources. It is this bureaucratic versus market approach which makes it possible for two companies in different developing countries producing the same product to have entirely different performance profiles. "It is not ownership so much as market environment, firm organization and managerial incentives which determine the performance of companies." (Jaylen, 1987). As the World Bank has indicated:

> "SOEs can be run as efficient commercial concerns responsive to consumers. In many developing countries, improving the performance of SOEs is as urgent as privatization in its own right." (World Bank, 1991)

Fourth, the privatization shake-out is likely to eliminate the less efficient managers of strategic state-owned enterprises. In any event, those managers that remain are likely to feel threatened by the prospect of further privatization, and the likely loss of their jobs, if they do not perform at a sufficiently high level. Their remuneration should be partly based on performance rather than solely a fixed fee. This abandonment of managerial complacency, could be further inspired by the demonstration effect of the increased presence of TNCs. At the same time, it should be observed that currently state-owned enterprises are operating in a domestic and international environment which is much less sympathetic to their existence and this may adversely affect their performance; this may, in turn, create a "demoralization effect", and force the government to put the enterprise up for privatization. Such a scenario is especially likely if other governments are also privatizing their strategic sectors ("contagion effect"). Whether the demonstration effect eventually wins out or whether the demoralization effect and the contagion effect prove to be dominant, only time will tell. For now, the latter forces appear

to be assuming dominance in a very dynamic and fast evolving situation.

In the case of those troubled state-owned enterprises that do not experience a transfer of ownership, the governments may resort to management or leasing contracts. The problem that many developing countries have experienced in the past is that management contracts tend not to have a strong built-in transfer of technology feature, in terms of training of nationals for eventual running of the enterprises. In addition, the management fee tends to be fixed rather than based on the foreigner's economic and technological performance. The problem of technology transfer with leasing arrangements could be just as acute. If a government leases a hotel or manufacturing plant to a foreigner it would need to ensure, inter alia, that adequate training is taking place. There is also need to guard against the danger that during the renewal period the lessee may from his inside track position have an unfair advantage vis-a-vis the other bidders because he has more information than they or may even be withholding information from the government that may have a bearing on the terms of the lease.

In an objective sense, what is important is the impact on the economy as a whole. No industry is the exclusive preserve of either the public or private sector. The quality of the performance at the economic and technological level is the critical factor. By this criterion, industries can move in and out of the public and private domain. At times, techno-economic circumstances (as in today's world of rapid technological change) may dictate that 100 per cent state ownership in a particular industry be replaced by total foreign ownership; in other cases by a joint-venture approach where the state holds either a majority or minority share. In cases where a foreign partner is not prepared to accept much equity risk and his contribution is

mainly of a technological nature, the government majority share can be quite involuntary. Other situations may require similar flexibility and sharing between the public and private sectors.

E. From Socialist Ideal to Market Mythology

The grand experiments in the last couple of years in Eastern Europe, particularly in the Czech and Slovak Federal Republic, Poland and Romania indicate that a market economy is not something that can be introduced overnight. The socialist system itself took a long time to be set up and the market system will hopefully take much less time (K. Poznanski, 1991). The process is less a leap and more a series of steady and determined steps. This is the clear experience with respect to attempts at accelerating the privatization process.

Mass privatization, or the plan to auction off thousands of medium and large size SOES almost instantaneously, was at its most egregious in the Czech and Slovak Federal Republic where individual shareholdings rather than investment funds would have been the pivotal point of the voucher system relating to over 1700 businesses. So many business could not have been appraised by the Government in the very short period that it set itself and so without adequate information most of the best shares would have eventually found themselves in the hands of the smart insiders and the foreign businessmen. But even in the case of the slightly less populist and more pragmatic Polish model, where investment funds would have played a more prominent role, there are problems. This is because it might have been dangerous to repose too much power in the hands of an investment fund that has no management track record and does not have the fund managers own money at stake. Moreover, if the investment fund were allowed to gain controlling interests of enterprises, this might lead to the creation of very powerful holding companies, immune

to any threat of a hostile takeover, and which behaved in such an anti-competitive way that the development of the capital markets would be stultified (J. Sachs, 1991).

The other privatization methods are not without their drawbacks. For example, while employee share ownership as a concept has much to recommend it, it is not the most efficient system since, for example, workers should seek to diversify their capital rather than concentrate it in the firm in which they work. Moreover employees may have the incentive to press for excessive salary and wage increases and the appropriation of handsome non-wage benefits at the expense of other share owners. It should also be noted that employees should not be the sole recipient of state assets since they are a minority in the population. In addition, there is the problem that not all enterprises are profitable. If some are not and/or are liquidated then those workers do not benefit nor do the unemployed and the army of farmers, civil servants and self employed artisans and professionals. Partly for these reasons, the complementary free coupon system was proposed for all adults over 18 years old but this also has its limitations, as was shown above.

Investment banks have favoured the public offering approach to privatization partly because this method is very financially rewarding to them. The going baseline fee for their services seems to be as high as 12 percent which, in the case of large enterprises, can earn the advisers a fee of many millions. When success bonuses are included, the effective fee could almost double (J. Sachs, op. cit.). Moreover, this method is very time consuming, particularly in situations of a virtually non existent capital market and no effective supporting domestic financial institutions; it is therefore very inappropriate as a means of expediting the privatization process.

Foreigners are playing an important part in the privatization of large and medium scale SOEs and will play an even more important role in the future. In the absence of a meaningful local capital market, selling off 100 per cent of most of such enterprises to foreigners would have been the quickest way of proceeding. However, this is politically unacceptable, because the State would like the local private sector to be involved and wishes to use privatization as a medium for stimulating and developing local entrepreneurship. Moreover, foreigners have contributed to the delay in the negotiation process by demanding a sizeable discount on most market prices, partly as a compensation for the difficulty of operating in the Eastern European environment. In return, those host countries should seek to maximize the social benefits via selective performance requirements.

Any process of fundamental socio-economic change requires good and effective management. Such a requirement is not restricted to the producing enterprise. It is required of the entire supporting cast of governmental and private machinery (e.g., stock exchange and banking and financial system). The privatization problem is part of an entire social and systemic problem. No revolution is either spontaneous or automatically self-sustaining. It has to be carefully nurtured. Finally, the so-called 'magic of the market place' is not likely to yield benefits until the market is actually in place.

CHAPTER V: CONCLUSION

Privatization has become a very important global phenomenon, in terms of its geographical spread across regions and ideologies, the considerable number of countries participating, the large number of transactions and the size of some of the recent deals, and the industrial significance of the related industries. As to the extent that the privatization process varies between countries and over time, we can attempt a sector/size typology based on a stages approach - "traditional", "transitional" and "mature".

Countries in the traditional or early privatization stage are those which are still engaged in privatizing very small service oriented enterprises (including a bit of cottage scale manufacturing) which should probably never have been in the public sector. This is primarily an East European phenomenon but there are many developing countries which, for one reason or another, had found themselves running a number of such micro enterprises and have been selling off same to the local private sector.

What we may call the transitional privatization stage probably relates to the bulk of the countries in the developing world and Eastern Europe. They have either already privatized, or are in the process of privatizing, or have drawn up plans to this effect, a very considerable number of medium-sized enterprises, mostly of the manufacturing variety, and for which the private sector has a clear comparative advantage.

The mature stage of privatization involves the sale of the strategic enterprises, which would include the public utilities group, large manufacturing concerns, banking, defense and the

very large foreign exchange earners in the natural resources sector. This is the stage that Western Europe reached a few years ago. In the developing world, some Latin America and Caribbean countries seem to have now reached this stage. This is a critical threshold for many countries in the developing world, partly because it frequently involves the participation of foreign investors. Many of these developing countries have moved within the short space of two decades from a philosophy of nationalization to one of privatization.

Lest the above typology be said to be too schematic and stylistic, let me make some qualifications. First, the actual privatization programme in a country may reflect a combination of all these stages and at the same time include certain small, medium and large enterprises. This may be a product of unclear strategy and a lack of priority setting with respect to which industries/enterprises should be privatized.

Second, and related to the first factor, the stages approach does not suggest that there is some rigid and fixed sequencing occurring in each country. There are probably instances of a government starting its privatization programme with the divestiture of a large and strategic enterprise while still having within the public sector fold a number of small and medium SOEs. This would be equivalent to a temporary skipping of stages. Budgetary or foreign exchange factors may be a decisive factor with respect to timing. Nevertheless, neither actual profitability nor potential profitability is a good guide in predicting the sequencing of privatization, given the myriad economic, social and political causes of privatization and certain related constraints.

Third, there is no automatic transmission or graduation (or even time frame within which to do so) from one stage to another.

A country could get mired or bogged down in the transitional phase and never reach the mature stage; or not to proceed further may be a conscious political/ideological decision.

Fourth, TNC involvement is not restricted to the mature stage since a great deal of foreign involvement can be found in the transitional stage. A few foreigners are also to be found operating in the traditional stage, despite regulations which frequently minimize or prohibit foreign participation.

The role of TNC's is very important in the transitional and mature stages, partly because of the underdeveloped state of the capital market in developing countries and Eastern Europe. The role is particularly critical in the mature stage because the industries concerned require not only large infusions of capital but, also, access to modern technology, management and marketing skills. This may be the only option available to these countries for reversing the increasing tendency towards technological divergence between the developed countries and the rest of the world.

Thus even when a government could possibly successfully offer all shares of a strategic enterprise to the local public, it tends to prefer to offer a sizeable block of the shares to a TNC. The TNC, for its part, frequently prefers to have a local partner (preferably a "silent partner" that does not have management control) so as to share the capital risk and also to facilitate its passage and "integration into the local economy". The TNC may also want to spread the political and other risks geographically, i.e., have a limited amount of capital invested in a considerable number of countries, rather than a huge bloc of capital in a single country. Sharing the capital risk may not necessarily be with the government, since there are many instances of local private sector partners being involved in

consortia for privatization, particularly in Latin America, in the airline, mining and banking sectors, inter alia.

There is another type of integration besides integration into the local economy. I refer to the "networks" of closely integrated activities performed by independent firms but managed and controlled by a single TNC (but not necessarily owned). There are four basic types of networks: supplier networks, first popularized by the Japanese through their "kieretsu"; regional networks which are sets of subsidiaries in different foreign locations producing segments of a product, which could possibly have been produced in one single location; regional core networks, which are linked directly to the home country of the TNC; and industry networks which are strategic alliances of independent TNCs for the purpose of sharing technology and risk while at the same time rivalling each other for markets in a increasingly competitive world economy.

This network system of the TNCS has important implications. For example, in the case studies of privatization in former East Germany, it was shown that an important strategy of the TNC was to integrate the privatized entity into its international network system in order to serve the purpose of global maximization of profits, rather than the mere maximization of profits in a particular location. What this means is that, even if TNCs are more cognizant of host country objectives than they were in the pre-nationalization era, there are certain irrepressible (and pro-competitive) forces in the world economy propelling TNCs in a direction which is not consistent with the maximization of host country benefits. Will this cause governments to once more intervene as a producer or will the government be content with being simply a more vigilant regulator. Is the divestiture process reversible? Based on the present day trajectory of the world economy, it does not seem so. However, the experience of

the last few years show that history is unpredictable and that it is dangerous to attempt a prognosis of the course and path of great social forces.

What then is the future of the State and the balance between the public and private sectors? Privatizations are likely to remain at the top of the developmental agenda and accelerate in many countries, with considerable TNC capital involvement. Note that TNCs also participated in the wave of privatizations in Western Europe; in some cases, the SOE being privatized was itself a transnational (i.e. a "state transnational"). The outcry against the "re-foreignization" of economies has not been as great as might been expected. In some plural societies, the privatization programme may even show a preference for foreign investment because of ethnic rivalry. TNCs are also expected to continue their recent increase in the rate of "greenfield investments".

This globalizing role of TNCs, as reflected in their increasing share of GDP and trade flows, has prompted certain authors to wonder whether national society is not being transformed into a "corporate state", a type of withering away of the political state that Lenin would not have dreamt of. At the international level, because of the increasingly free movement of TNCs across borders, the question being asked is whether we are entering a "stateless world".

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