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FDI AND DEVELOPMENT: THE CASE OF PRIVATIZATION-RELATED SERVICES FDI: TRENDS, IMPACT AND POLICY ISSUES

Note by the UNCTAD secretariat

Executive summary

This note first discusses the importance of competitiveness of the services sector for development. Services form the largest GDP sector in transition and developing economies and their competitiveness matters for the entire economy. FDI in services has expanded rapidly and services are now also the largest sector in FDI flowing into those economies. Hence FDI affects increasingly the competitiveness of their service industries. Much of FDI in industries such as telecommunications, power and water generation and distribution, transportation and banking, which affect overall competitiveness, took place through privatization of State-owned firms. The note documents trends in privatization-related services FDI and discusses its economic impact. Finally, it examines the role of policies in influencing this impact.

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CONTENTS

Chapter *Page*

Introduction: Services and competitiveness 3

I. Privatization-related FDI: Trends, impact and policy issues 5

A. Trends 5

B. Impact 8

C. Policy implications 12

References 15

INTRODUCTION: SERVICES AND COMPETITIVENESS

1. The Commission on Investment, Technology and Related Financial Issues, at its seventh session (22–24 January 2003), decided to hold an Expert Meeting on FDI and Development. Specifically the Commission indicated that, "host countries seek to attract FDI for many reasons in order to foster long-term development. Underlying these efforts is a desire to increase their competitiveness. The issues that require attention in this context are varied and include, in particular, the type of FDI that host countries attract (more than half is in the services sector) as well as the various rules and regulations that affect competitiveness, bearing in mind the need to enhance the development dimension of FDI" (UNCTAD, 2003a, annex II, p. 29).

2. The Expert Meeting and this issues note will therefore consider the case of FDI in services, which in most countries are the largest sector not only in terms of FDI stock but also in terms of output. In addition, by entering the value chain of goods and other services from start to finish and being increasingly exported, services have a significant indirect and direct bearing on the competitiveness of countries. A good part of services FDI that is relevant for competitiveness has occurred through the participation of foreign investors in privatization programmes, especially in infrastructure. The benefits for development have largely depended on rules and regulations and, in effect, policies, which host countries adopted when attracting FDI to these programmes. Therefore, after considering general issues related to the competitiveness of services and examining trends in services FDI, this note will focus on the impact of privatization-related FDI on host countries and in particular on their competitiveness and policy implications.

3. Access to efficient and high-quality services is the basis for the productivity and competitiveness of firms and industries as well as for the standards of living of people in an economy. The development and competitiveness of service industries is thus a matter of growing importance to all countries. For developed countries, it is an important factor for increasing incomes and ensuring a high level of employment of their factors of production on a sustainable basis in an internationally competitive environment. For developing countries, the building up of competitive service industries is essential for initiating and accelerating the development process by raising productivity and living standards, increasing exports, realizing economies of scale and scope, and moving up the skills and technology ladder (UNCTAD, 2002a, pp. 117–118).

4. There are several aspects of services competitiveness. First, it can be defined narrowly as export competitiveness and be measured by countries' export shares of services in global exports. However, the interest of developing and transition countries in improving export competitiveness (including the role of TNCs in it) has focused mainly on goods, and especially on manufactured goods. Partly, this is because the direct relevance of services for export competitiveness – a key concern of many developing countries – has been considered limited, as many services are not tradable and, consequently, only a small part of the production of services (less than one tenth in 2001)[1] enters international trade, compared with

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[1] Calculated as a ratio of services exports to services output from World Bank (2003a).

over half of the production of goods. But this situation is rapidly changing as the tradability of information-related services, cutting across all activities, is increasing as a result of advances in information and communication technologies (Sauvant, 1990). This permits also a greater role for FDI in services exports from host countries. Both services- and goods-producing TNCs can now pursue integrated international strategies in the production of services by splitting up the production process of services or their components and relocating them to countries where they can be produced more cheaply. Also, the role of FDI in traditional (location-bound or non-transportable) services such as tourism, which can be an important source of revenues from international sales, has become more significant.[2]

5. Secondly, and more importantly, there is an indirect impact of services supply capacity on competitiveness and growth in general, as services are inputs to the production of goods and other services supplied to both domestic and international markets. In addition, many services are final consumer products, and it is no less important to pay attention to these services with a view to increasing growth rates and living standards for the population at large. Consequently, access to efficient and high-quality services matters for the productivity and competitiveness of the entire economy. Measures of this aspect of competitiveness include prices of services, their quality and availability and, most importantly, sustained productivity growth.

6. Among key services affecting competitiveness are infrastructural services as well as financial and business services. If they are competitive they can be an important factor in attracting additional FDI, including export-oriented FDI. But FDI can also contribute to increasing their competitiveness by bringing capital and technology, enhancing skills, restructuring inefficient enterprises, and so forth, and making services cheaper and better. FDI can also introduce services which are not available from domestic firms, but are needed for exporters and foreign investors as well as domestic firms. In fact, there has been considerable FDI in these services in many countries and industries through the participation of foreign investors in privatization programmes in Latin America and the Caribbean and in Central and Eastern Europe (CEE). In a number of countries these programmes are still continuing and several countries are launching new privatization initiatives.

7. In the light of the importance of the competitiveness of services, experts may wish to consider the following questions:

- Why and how can TNCs contribute to services competitiveness of host countries, indirectly and directly?
- What are the main areas and channels of impact? How do they differ from those in the case of goods? What is the role of non-equity forms such as franchising, management contracts and partnerships? How is the impact changing due to progress in information and telecommunication technologies?
- What is the role of international production networks in services?
- There are many indications that firms in home countries are increasingly relocating or outsourcing service functions to low-cost locations. Which services are affected? Will this process gain momentum? Does it represent

[2] As these services are technically not tradable across borders in the way that information-related services are, this takes place through the establishment of producers in host countries and the movement of consumers.

similar opportunities for developing countries, as was the case with low-cost manufacturing several decades ago? Does relocation take place through arm's length transactions, non-equity forms or FDI?

- What is the role of FDI related to privatization in enhancing the competitiveness of host countries indirectly? Is it still the most important aspect of FDI competitiveness impact? Will it be overtaken by direct impact on services exports?

I. PRIVATIZATION-RELATED FDI: TRENDS, IMPACT AND POLICY ISSUES

A. Trends

8. Services are the largest sector of the world economy. Developed countries became service economies long time ago,[3] while in developing and transition economies services surpassed 50 per cent share of the GDP during the 1990s, accounting in 2000, respectively, for 52 per cent and 58 per cent of their production (UNCTAD, 2002b). During the 1990s they also became the largest sector in FDI worldwide (accounting for 56 per cent of inward stock in 2001; see table 1), and in all groups of countries. The ascendance of services in FDI in host countries initially took place in host developed countries (which have also always been dominant home countries for services FDI), with developing host countries joining the process in the second half of the 1980s (when they began to open service industries to FDI, including especially through privatization)[4] and transition economies since the early 1990s.

9. Within the services sector, finance- and trade-related activities dominated for many years the FDI stock of most home and host countries. This was partly due to early international expansion of banks and trading companies (for example, Japanese *sogo shosha*), but more importantly, to large FDI in wholesale and marketing affiliates by petroleum and manufacturing TNCs and finance-related foreign affiliates (often taking the form of holding companies) by TNCs from all sectors (Mallampally and Zimny, 2000).

10. With the liberalization of FDI in services a new industry pattern for services FDI began to emerge during the 1990s.[5] Although trading and financial services remain large industries for service FDI (still accounting for half of the stock), they are not the most dynamic ones (table 1). Opening of utilities to FDI through privatization programmes triggered unprecedented increases in FDI in telecommunications and power generation and distribution: between 1990 and 2001, inward FDI stock in these industries increased worldwide, respectively, 16 times (9 times in developing countries) and 13 times (16 times in developing countries). Another large and dynamic category was business services (a more

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[3] Already in 1965, services accounted for 57 per cent of GDP of developed countries, increasing to almost 70 per cent by 2000 (UNCTAD, 2002b, p. 330).
[4] From 1970 to 1985 the share of services in the total inward stock of FDI of developing countries remained at around 20 per cent (Mallampally and Zimny, 2000, p. 26).
[5] Note that the international expansion of firms in fast-food, car rentals, retail trading, hotel industry and business services takes place through non-equity arrangements such as franchising, management contracts or partnerships. Thus FDI data do not capture this expansion in host countries.

than fivefold increase worldwide and a twelvefold times increase in developing countries). Health services have also emerged as a dynamic FDI industry (a ninefold increase), but FDI stock in this industry is still relatively small. Between 1990 and 2001 the combined share of dynamic services in world inward stock doubled, from 18 per cent to 36 per cent. At the other end of the spectrum are the construction industry and hotels and restaurants, where FDI stock more than doubled during the same period. FDI in trading and financial services increased around threefold.

Table 1. Inward FDI stock in the services sector, 1990 and 2001
(Millions of dollars)

Sector/industry	1990[a]			2001[a]				Index of increase 2001/1990	
	Developed countries[b]	Developing economies[c]	World[d]	Developed countries[b]	Developing economies[c]	Central and Eastern Europe[e]	World[d]	Developing economies[c]	World[d]
Services	**597 695**	**61 456**	**659 151**	**2 071 473**	**375 346**	**40 889**	**2 487 708**	**611**	**377**
Electricity, gas and water	5 347	2 324	7 671	54 943	38 133	2 789	95 865	1 641	1 250
Construction	13 292	2 929	16 221	22 212	11 931	927	35 070	407	216
Trade	159 309	9 124	168 433	426 134	58 215	9 830	494 179	638	293
Hotels and restaurants	16 899	2 905	19 804	33 557	7 428	601	41 586	256	210
Transport, storage and communication	12 702	5 512	18 214	228 483	47 644	11 642	287 768	864	1 580
Finance	220 498	23 199	243 697	656 736	116 703	9460	782 899	503	321
Business activities	89 460	4 253	93 713	451 856	53 027	4 927	509 810	1 247	544
Education	75	..	75	323	1	12	337	-	448
Health and social services	795	-	795	6 210	537	18	6 765	-	851
Community, social and personal services	10 683	5	10 688	20 934	2 475	190	23 599	47 214	221
Other services	57 641	10 403	68 044	37 435	25 632	492	63 559	246	93
Unspecified tertiary	10 994	803	11 797	132 651	13 619	-	146 270	1 697	1 240
Memo item:									
FDI in all sectors	1 221 921	201 670	1 423 591	3 441 843	938 205	71 953	4 452 001	465	313

Source: UNCTAD, FDI database.

[a] Or latest year available.

[b] Data cover 16 countries accounting for 87 per cent and 86 per cent of inward stock of developed countries in 1990 and 2001, respectively.

[c] In 1990, data cover 32 countries accounting for 38 per cent of inward stock of developing countries. In 2001, data cover 31 countries accounting for 40 per cent of inward stock of developing countries. In the absence of actual data, approval data were used in some countries.

[d] Data cover 48 countries in 1990 and 57 countries in 2001. They account for 73 per cent and 70 per cent of world inward stock in 1990 and 2001 respectively. In the absence of actual data, approval data were used in some countries. In 1990, totals exclude countries in Central and Eastern Europe for which data are not available.

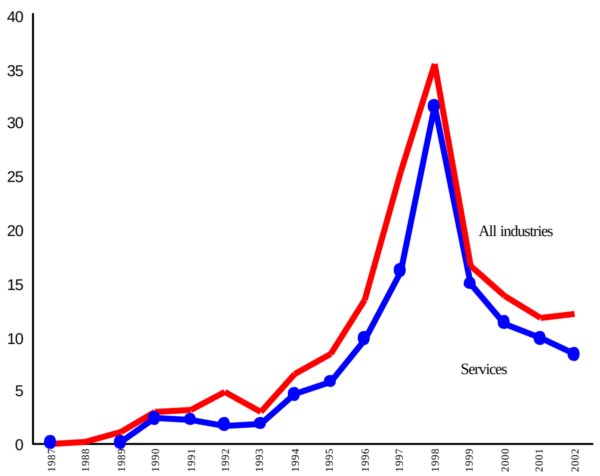
[e] Data cover 10 countries, accounting for 62 per cent of inward stock of the CEE countries.

11. Privatization has been an important means of attracting FDI into the services sector in transition countries of CEE and developing economies, particularly in Latin America. Judging from the data on cross-border mergers and acquisitions (M&As), privatization-related FDI in these economies took place predominantly in the services sector (figure 1). Purchases of State-owned service firms were increasing continuously since the late 1980s, reaching a peak around 1997–1998 and then falling. The downturn continued during the economic slowdown of the early 2000s.

12. Within the service sector, foreign acquisitions of State-owned companies were not equally important in all country groups. They were concentrated in CEE, where privatization through FDI has been an integral part of the transition to a market economy, and in Latin America, where large countries, notably Brazil, Mexico and Argentina, privatized to foreign investors State-owned companies in the telecommunication and power industries. In developing economies of Asia, non-privatization acquisitions of domestic services firms (e.g. in financial services) were dominant, especially after the financial crisis of the second half of the 1990s. As a result, at the aggregate level of CEE and developing economies, since 1997 privatization was accounted for a diminishing part of total cross-border M&As in the service sector (figure 2).

Figure 1. Foreign acquisition of domestic firms through privatization,[a] total and in the services sector in developing countries and CEE, 1987–2002

(Billions of dollars)

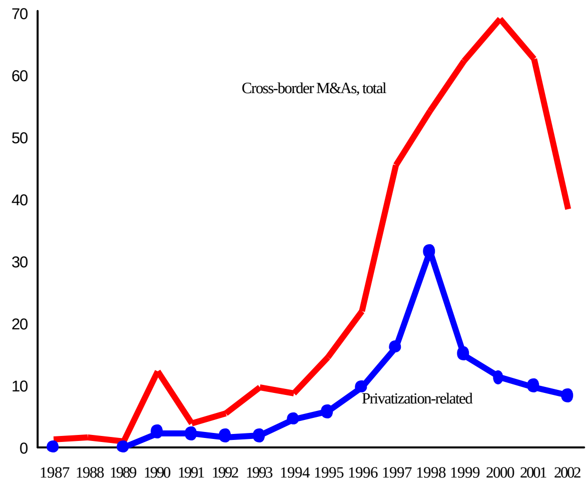


Source: UNCTAD, cross-border M&A database.

[a] Cross-border M&As recorded as privatization deals in the UNCTAD cross-border M&A database.

Figure 2. Cross-border M&As in the services sector in developing countries and CEE, total and privatization-related,[a] 1987–2002

(Billions of dollars)



Source: UNCTAD, cross-border M&A database.

[a] Cross-border M&As recorded as privatization deals in the UNCTAD cross-border M&A database.

13. Asia, and especially East Asia and Pacific, has adopted from the beginning a different general model of infrastructure privatization from that pursued in Latin America and the Caribbean and CEE. While in the latter regions divestitures (and concessions) of existing assets predominated (leading to privatization-related FDI), the former region focused on creating new assets through greenfield projects that complemented investments by public sector providers. North Africa followed an approach similar to that in East Asia.[6] These two approaches explain interregional differences in the importance of privatization-related FDI.[7]

B. Impact

14. In theory, the economic rationale behind privatization is that it can increase *allocative* efficiency (through increased or improved output and/or lower prices) and *productive* efficiency (by way of a more efficient use of resources within the firm), thus resulting in increased competitiveness of firms and contributing to development and welfare. But in practice, although these are often declared objectives, they are not always vigorously pursued. In addition, countries often have other objectives with privatizations (generation of budget revenues or foreign exchange, preservation of employment, supply of services to poor segments of the population or protection of local interests), which may conflict with the objectives of competitiveness and efficiency (Stiglitz, 1998). If conflicting objectives are pursued, tension arises and the result is often inconsistent policies. At the same time, there are concerns associated with privatization of services, related for example, to the risk of the abuse of monopoly power and the resulting distribution of benefits or impact on employment. Governments need to define the boundary line of what to privatize and what to keep in the public domain, as a better way to pursue broader societal objectives, and then decide whether or not to involve foreign investors in industries that are privatized.

15. There are various reasons to invite foreign companies to participate in the privatization of services. In many developing countries and transition economies that have launched large privatization programmes, recourse to FDI has often been motivated by lack of capital, technology and managerial expertise to restructure ailing enterprises and revitalize key industries of their economies. But given the power and superior capabilities of many TNCs as compared with local firms in these countries, there have also been fears that foreign investors will crowd out local players and interests, abuse monopoly power with adverse effects on competition and consumer welfare and pursue their own interests not sufficiently taking into account those of host economies.

16. Most empirical assessments of the impact of privatization focus on the question of private verses public ownership without making a distinction between foreign verses domestic ownership. Given, however, that more than two thirds of all privatization deals in developing countries involved foreign investors (Nellis, 2000), they still provide illustrations of the pros and cons of involving foreign investors in the privatization process in these countries. The situation is somewhat different with regard to CEE, for which a number of

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[6] See World Bank (2003b).

[7] Sub-Saharan Africa, where privatization focused on the telecommunication sector, took a middle road between these two approaches by divesting incumbent State-owned companies and issuing greenfield mobile licences (ibid., p. 3). It is not known to what extent private greenfield projects in Asian countries generated new FDI.

studies have highlighted the foreign ownership dimension. In addition, as the bulk of cross-border acquisitions of State-owned firms in these two groups of countries occurred in the services sector (figure 1), the studies, without necessarily making a distinction between sectors, also well reflect the impact of FDI on service industries of host countries. What follows is a brief summary of key empirical findings.[8]

17. In terms of the performance of privatized entities (without making a distinction based on their ownership), the literature suggests that privatized firms seem to become more efficient and more profitable, increase their capital investment spending and become financially healthier (Megginson and Netter, 2001). Obviously, increased firm profitability is not synonymous with increased efficiency of the economy as a whole, especially if firms are operating in an uncompetitive environment. Nor does it mean that all societal objectives are met. With regard to the labour impact, for example, most (but not all) studies conclude that employment in privatized firms usually falls.[9] But the reduction of a usually inflated workforce is typically a key condition for the improved performance of firms. The critical question is whether the divested firms' output and sales will increase enough after privatization to offset the higher levels of worker productivity. Studies show that although the employment effect is often negative in the short run, it tends to be positive in the medium to long term (Sheshinski and López-Calva, 2003).

18. Evidence from economies in transition makes a distinction between foreign- and domestically-related privatizations. It generally shows that foreign ownership, where allowed, was associated with greater post-privatization improvement than was purely domestic ownership.[10] In addition, majority ownership by outside investors was associated with stronger post-privatization performance improvements than was any form of local control (Megginson and Netter, 2001).

19. Many studies furthermore conclude that privatization often had a positive impact on the development of the financial sector and the system for corporate governance. In most countries outside the United States, privatized firms often appear among the two or three most valuable companies and the 10 largest share issues in financial history were all privatizations. Countries that launch large-scale privatization programmes often also have a strong incentive to modernize their corporate governance systems, including in terms of securities market regulation, information disclosure rules and other components of financial systems (Megginson and Netter, 2001).

20. In a number of cases, privatizations have been found to produce negative welfare effects. Some industries, such as the distribution of electricity and water, are particularly

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[8] This summary draws mainly on Sheshinski and López-Calva (2003) and Megginson and Netter (2001).

[9] For example, in CEE, where State-owned enterprises accounted for half or more of total employment prior to the beginning of transition, privatization to cross-border investors (as well as to domestic ones) and the restructuring that followed led to large employment cuts in the enterprises acquired. A 1999 UNCTAD survey of the pre- and post-privatization performance of 23 major companies acquired by foreign investors in seven countries of CEE found that employment in the enterprises decreased before as well as after privatization (Kalotay and Hunya, 2000).

[10] According to Mihályi (2001), in the case of Hungary, privatization simply does not produce the expected results without the involvement of TNCs.

sensitive. Given that access to water is considered a fundamental human right,[11] the social consequences of privatization are particularly critical, and it is often therefore argued that such services should remain in the public domain. Privatization of water in developing countries in Asia, Africa and Latin America has been criticized for failures in providing water of acceptable quality to the poor and for too high price increases (box 1). There can be various reasons for unwanted consequences. One is that not enough attention is given to ensuring that an adequate regulatory framework is in place to ensure beneficial impacts from privatization. Weak regulatory bodies may allow foreign investors to extract more privileges from Governments through strategic post-privatization behaviour. Governments may also find themselves in a difficult bargaining position since countries seeking foreign investment in the water industry often do not have many candidates to select from. The global water industry is dominated by three large company groups that are among the 25 largest TNCs in the world (UNCTAD 2003b, p. 187): Vivendi Water and Suez, both of France, and Thames Water (owned by the German conglomerate RWE). In a developing country context, such large players can more easily than elsewhere create or consolidate a dominant position. Another reason may be that water privatizations are often undertaken by way of offering concessions, which may give the private service provider an incentive to under-invest (or little incentive to undertake adequate investment). In some countries, such as Ecuador and Chile, moreover, some water concessions have been awarded for 70-year periods or even indefinitely.

21. The scarcity of studies calls for further research on the role of privatization with FDI participation in the area of services in helping developing countries improve their competitiveness and better meet the challenges of globalization.

22. Against this background, experts may consider the following questions:

- What are the main advantages and disadvantages of involving FDI in the privatization of services?
- What has been the impact of FDI on the performance of privatized firms in different countries?
- How has inward FDI in the context of privatization of services affected the quality, price and range of services offered to consumers and other companies?
- How has privatization of services with FDI involvement affected the supply of services to the poor and to households in sparsely populated areas?
- How has the employment level of privatized firms been affected after these firms were taken over by foreign investors?
- To what extent do impacts differ between industries, such as financial services, telecommunications, power generation and distribution, water distribution and transportation?

[11] On 27 November 2002, the United Nations Committee on Economic, Cultural and Social Rights agreed on a "General Comment" on water as a human right. A "General Comment" is an interpretation of the provisions of the International Covenant on Economic, Social and Cultural Rights. It implies that the 145 countries that have ratified the Covenant will be compelled to progressively ensure that everyone has access to safe and secure drinking water and sanitation facilities – equitably and without discrimination (see www.who.int/mediacentre/releases/pr91/en).

- What privatizations can be considered to be successful cases and unsuccessful cases, respectively, in your country.

Box 1. Water privatization in Argentina

In 1991, the Government of Argentina initiated the privatization of the State-owned water industry. Between 1991 and 1999, about 30 per cent of water companies covering approximately 60 per cent of the population of Argentina were privatized. The largest deal involved the transfer to Aguas Argentinas, a consortium led by Lyonnaise des Eaux (part of the French TNC Suez), of Obras Sanitarias de la Nación (OSN), a federally owned water utility in Buenos Aires. The objective was to improve productivity and the supply of services at lower cost and with higher quality.

Some ten years later, views still diverge on the merits of this privatization, and many observers are critical. They note that many areas of greater Buenos Aires have not yet been connected to the water and sewer mains, services have not improved, rates have doubled and wastewater treatment is inadequate.

Before privatization, OSN had been unable to cope with demand. It suffered from under-investment and only half of the residents of outlying districts had access to piped water, and two thirds were not connected to the city's sewerage system. In 1993, Aguas Argentinas agreed to invest $4 billion to improve the infrastructure and expand the water pipe and sewerage systems to an additional 4.2 million and 4.8 million people, respectively. The Government for its part accepted that the company's personnel would be cut from 7,600 to 4,000. A regulatory body was created to monitor post-privatization performance.

Initially, Aguas Argentinas lowered the rates by 26.9 per cent. The company's investment rose from the $25 million per year that OSN had undertaken in the decade prior to privatization, to an annual rate of $200 million in 1993–2000. Connections to the water and sewage networks rose and the number of customers paying their bills increased to 90 per cent.

By 2001, the rates had increased by more than 100 per cent. And while the company claims to have invested $1.7 billion and to have connected nearly 2 million people to the water system and 1.15 million to the sewer network between 1993 and 2001, the provincial government argues that 3.5 million people among Aguas Argentinas' potential clients still lack water and sewage services. Meanwhile, it has been suggested that Aguas Argentinas achieved an average 23 per cent profit rate during the 1990s as compared with 7–8 per cent in the water industry in the United States and the United Kingdom. There are also complaints that the company has not adequately addressed the question of wastewater treatment.

In the light of the financial crisis in Argentina, in 2002 the Government abolished the "convertibility" systems that had pegged the peso. This led Aguas Argentinas to file a complaint with the International Centre for Settlement of Investment Disputes (ICSID). By 2002 Suez had to write off $500 million in losses because of the Buenos Aires concession.

Other observers are less critical about the privatization programme in Argentina and argue that water privatization in fact turned out to be good for the poor. One study concluded that public water systems in Argentina had deteriorated so far that privatization not only generated private profits, and attracted investments, but also expanded service, and reduced child mortality. The authors argue that even if the private sector provides suboptimal services in some ways, it does much better than either the public sector or the non-profit cooperative sector (Galiani et al., 2002).

Sources: "Water and sewage privatisation gone sour", *Inter Press Service News Agency,* 15 August 2003; "Raise a glass: How to improve child health", *The Economist*, 22 March 2003, p. 70; Galiani et al., 2002; Grusky, 2003.

C. Policy implications

23. While the literature shows that privatization on balance has tended to produce efficiency gains for the participating economies, it is also clear that the ultimate outcome has been greatly affected by the way in which privatizations were undertaken, the nature of competition in privatized industries and the national regulatory framework and institutions governing activities of privatized firms. Thus, it is important to consider what policy lessons can be learned in this context. What can be done to maximize the benefits from FDI in this context?

24. To the extent that Governments do decide to privatize services to foreign investors, a number of factors need to be considered when designing and implementing associated policies. First, Governments need to establish objectives for involving FDI in privatization and ask whether the same objectives can be achieved by domestic investors; prioritize these and other objectives, not well served by FDI; and match them to the privatization methods. While certain objectives can be well served through a sale to a specific, “strategic” foreign buyer, others may be better served by a sale through initial public offerings in the domestic and foreign stock markets, a sale to employees of the firm to be privatized or a liquidation and subsequent sale of assets. For example, in addition to firm-specific objectives of FDI privatization (such as making the firm competitive), Governments might seek to achieve economy-wide objectives, such as macroeconomic stabilization (and focus on the revenue aspect) and capital market development, which may be less well served by FDI-related privatization.

25. The situation of the State as a seller of assets confers a special responsibility on policy makers in negotiating individual privatization transactions. It is particularly important to strike a balance between budgetary and other considerations. Policy makers often face a trade-off between the need for the efficient and competitive provision of services and the need to supply them at affordable prices to the poor and/or in sparsely populated areas. Budgetary considerations may prompt Governments to negotiate the highest price possible, and use the revenues for social purposes, neglecting the competitiveness aspect. Other considerations, such as employment preservation or regional policy concerns, may call for the negotiation of specific commitments by investors. Similarly, if Governments focus too much

on the sale price of a State-owned company to maximize revenues, neglecting the regulatory framework and institutions needed to maintain or improve the efficiency of natural-monopoly-type industries, the benefits to society may not be maximized. Controversies surrounding the privatization of electricity and water delivery services are a case in point.

26. Given the highly political and delicate nature of large privatizations involving FDI, it is also important to build an appropriate institutional environment that guarantees policy consistency, coherence and efficiency. A privatization programme geared towards FDI sales presents specific problems. Counterparts are powerful private institutions with ample legal and financial power. Transactions are often highly specific and might involve the imposition and monitoring of numerous post-privatization obligations. Meanwhile, developing countries and economies in transition often suffer from the structural weaknesses of their institutions. Most countries that have focused on FDI sales have opted for specialized privatization agencies. This can help provide a one-stop shop function for investors, facilitate the recruitment of adequate expertise, limit the possibility of buyers' capturing sellers and regulators and maintain independence from Governments and vested interests in State-owned enterprises. The agency needs at the same time to be accountable to parliament and adequately audited.

27. From the point of view of pricing of assets, a major risk for the host country is that if an enterprise is sold at a price below its "correct" (social) price, there is a loss to the budget and the economy. And under certain conditions, for example when equity markets are underdeveloped or economic systems are in transition, it may be difficult to price assets correctly. The possibility of undervaluation increases if the negotiating position of the host country vis-à-vis foreign investors is weak, or if the host country does not make potential investors compete through bidding. The economic and political setting can also influence pricing. Broadly speaking, a clear political commitment to strong rules of the game may result in higher prices.

28. The privatization process itself also affects the sales price. One approach is to get a large number of competitive bids from a variety of (domestic and foreign) firms and, if foreign firms are the only contenders, from established TNCs with a good reputation. Where the objective is to get a strategic partner with specific technological or other assets, there may be a need for a trade-off between the upfront price and other conditions.[12] An important institutional requirement in this context is the establishment of a competitive selection process. It is only by ensuring the participation of a maximum number of foreign investors in the bidding that a Government will get a competitive price for its assets and secure the highest level of post-privatization commitment by the buyer. It is also important to make the rules and selection criteria clearly known to potential bidders in advance.

29. A difficult issue is related to the extent to which countries should require specific commitments from investors when privatizing services. As one of the most important considerations in an FDI privatization is investors' continuing engagement in a country, by

[12] For example, the privatization of telecommunications companies to foreign strategic investors has generally been by means of "controlled auctions" designed to achieve the highest possible price for the shares sold, from among a limited number of pre-selected candidates that meet pre-established criteria.

providing more investment, employment and contributing to its growth over the long term, some Governments feel that they need to specify future investment levels and even mandate contractually certain investments at specific times. Such commitments are widespread, although in many places (such as the former East Germany, Hungary and Poland) the enforcement of contractual commitments and penalties proved to be often ineffective. There is typically a trade-off between the amount of commitments attached and the sales price of the company to be privatized. Active post-privatization commitments are also expensive to manage from the point of view of the State, as it has to monitor a large number of contracts and lawsuits with investors.

30. The regulation of monopolies is another challenging task, especially in the context of services. While foreign investors are often attracted to privatized assets in firms that enjoy monopolistic or oligopolistic rents, the interest of the host societies and their Governments is in minimizing those rents, for example by regulating the relevant industries. Indeed, a key challenge is to ensure that a public monopoly is not simply turned into a private one. Difficult questions arising in this context relate to the degree to which a temporary monopoly can be tolerated in exchange for the modernization of technology and equipment; what techniques to use to circumscribe monopolies; how to decide on an adequate time frame; and the sequencing of regulation and privatization.

31. A strong regulatory authority needs to be endowed with adequate tools to protect consumers. A well-designed regulatory regime, aimed at ensuring quality, scope and availability of service, contributes to improvements expected from FDI, just as it contributes to improvements under local (public or private) owners. The independence of the regulatory body is important for minimizing regulatory risk by making the regulator more predictable and in order to make it possible to attract highly qualified professionals by offering better salaries and more flexible employment terms than may otherwise be acceptable in the civil service. Some developing countries, such as Bolivia and Peru, have established multi-utility regulators in order to address scarcities in qualified personnel and be able to prevent regulated companies from capturing regulators.

32. In the case of network/infrastructure industries, commitments on quality and reliability of services and incentives for future investment built into a regulatory framework may be preferable to negotiating specific performance requirements and including them in privatization covenants. Chile and Peru, for example, built detailed requirements into their electricity regulatory framework. Hungary, on the other hand, sold its electricity companies with little concern about post-privatization service-related performance. This resulted in considerable post-privatization problems with investors and consumers (Nestor and Mahboobi, 2000).

33. Having a proper regulatory framework should also be complemented by an appropriate policy to encourage competition. The only credible threat of potential competition to large TNC incumbents will come from another TNC. In a developing country context, foreign investors often create (or consolidate) a dominant position more quickly and more forcefully than in developed countries. In some cases, such as water, there are very few TNCs with the expertise to compete globally. In other cases, such as the telecommunications

market in Latin America, the development of regional hegemony in some markets may further reduce the contestability of national markets.

34. One way to further consumer welfare and the public interest in this context is a competitive restructuring of the relevant industry before privatization. The purpose of pre-privatization competitive restructuring is to introduce competition in the upstream/ downstream segments through the break-up of vertically integrated firms. In the Chilean electricity sector, for example, the two main companies – Endesa and Chiletra – were broken up into seven generators and eight distribution companies, which were privatized separately. The transmission grid was also sold as a separate firm (Nestor and Mahboobi, 2000). In Bolivia, the Government broke up its main generation company into four parts and sold them to different foreign investors; it transferred the transmission grid to one of the existing electricity distributors (Nestor and Mahboobi, 2000). Alternatively, competitive restructuring can be initiated through horizontal break-up along geographical and functional lines. This was done in the Telebras case in Brazil, where the Government split the incumbent holding into three geographical markets/companies, one long-distance operator and eight cellular operators (Nestor and Mahboobi, 2000).

35. In the light of the above, exports may consider the following questions:

- Under what circumstances is it desirable to involve foreign investors in the privatization of services?
- What has been the experience with the use of specific commitments in negotiations with foreign investors in this context? How has the price of the privatized entity been affected? How have the commitments been monitored? To what extent do the privatized companies live up to the commitments?
- Should regulation occur before or after privatization?
- To what extent should golden shares be used to retain control?
- How can competition best be encouraged in previously monopolistic industries?
- What role could technical assistance play in the area of privatization of services involving TNCs?
- What are the main dos and don'ts that Governments should keep in mind when involving FDI in privatization programmes?

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