—Executive Summary—

LATIN AMERICA'S TURNAROUND

Privatization, Foreign Investment, and Growth

EDITED BY PAUL H. BOEKER

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Contents

Contents of the book *Latin America's Turnaround*

Preface

When the decade of the 1980s opened, the state was the engine of economic growth in Latin America. From the 1930s through the 1970s, Latin American economies were characterized by ever-greater state control. Governments from Mexico to Argentina nationalized what they considered "strategic" industries. New state-owned enterprises burgeoned. Direct foreign investment was excluded, to be replaced by state borrowing from abroad.

After the recession and debt crisis of the early 1980s forced a rethinking of economic strategy in Latin America, however, a new generation of leaders came to power, determined to set their economic houses in order. Carlos Salinas de Gortari in Mexico, Carlos Menem in Argentina, and others, following the early example of Chile, aimed to turn the productive sector of the economy back over to the private sector. Because local investors in many Latin American countries were short on capital, both for purchasing these enterprises and for making necessary new investments in some industries, governments in the late 1980s began looking to foreign investors.

Latin America's Turnaround: Privatization, Foreign Investment, and Growth, outlined in this executive summary, documents and analyzes this remarkable shift in economic thinking. It presents the findings of the "Second International Conference on Privatization in Latin America," sponsored by the Institute of the Americas and held in April 1991. The Institute gathered policy makers, academics, journalists, and business-people to look at this two-pronged strategy of privatizing state enterprises and attracting foreign investment. The participants assess the progress of privatization and foreign investment in individual countries and economic sectors, pointing out the opportunities available and the challenges to be met. In the telecommunications industry, for instance, the task for Latin American countries is to develop regulatory arrangements that will both encourage the extension of basic telephone service and stimulate the competition needed to produce more sophisticated telecommunications services. For the electric power sector, privatization may be the only way of raising efficiency and attracting enough capital to meet the huge need for new investment in the sector.

The associated trends toward a smaller state role in the economy and a dynamic private sector that includes foreign investors hold great promise for Latin America. These developments could lead not only to greater prosperity, but also to improved services from government, which will be better able to carry out its basic commitments—related to education, public health, and roads, for example—without the financial burden of debt-laden state enterprises. *Latin America's Turnaround*, copublished by the International Center for Economic Growth and the Institute of the Americas, offers valuable insights into this exciting period and will be useful to policy makers not only in the Western Hemisphere but also in other developing regions of the world.

Nicolás Ardito-Barletta
General Director
International Center for Economic Growth

Panama City, Panama
March 1993

Summary of Conclusions

In *Latin America's Turnaround* experts from a variety of countries and economic sectors examine the progress of privatization in Latin America and the role that foreign investment has played in the transfer of state-owned enterprises to the private sector. Their principal conclusions are as follows:

1. Throughout the 1980s virtually all of Latin America rejected the entire economic approach that included a leading role for state enterprises. Under the new approach, economies were deregulated and opened to international competition, and the government's intervention in the productive sector was scaled back to nurture more competitive, and less inflationary, economies. Although the countries of Latin America are at different stages in their drive for privatization, most see that drive as an essential step in restoring economic growth.

2. As governments expanded their focus on privatization as a key part of the transformation to more efficient economies, the requirements for successful privatization expanded beyond stopping the deficits and getting a good price for the treasury to such factors as introducing real competition in the privatized industry and attracting investors with adequate capital to modernize and improve products and services and with access to the best technology. In the late 1980s, therefore, Latin America's governments

launched a quest to attract foreign direct investors to privatizing companies and industries. By 1990 premier international companies were making investments of hundreds of millions of dollars, and in some cases over US$1 billion, in Latin privatizations.

3. Since foreign investment is an important capital reservoir for privatization programs in developing countries, it is important for those countries to understand the requirements of foreign investors. Foreign investors look carefully for certain macroeconomic conditions, such as

   - strong and stable economic indicators
   - relatively developed capital markets
   - fiscal and tax policies that favor price stability
   - open market regimes

   They also look for political conditions, including

   - a stable government
   - a clear and open policy-making process
   - government support for private business
   - guaranteed property rights

4. To attract foreign investors, Chile found that it had to offer financial incentives. These were

   - tax incentives
   - the allowance of earnings repatriation

   The government also offered incentives for domestic investors, specifically employees of public enterprises to be privatized, purchasers on the stock exchange, and pension fund administrators. These incentives included

- below-market prices for stock subscriptions
- subsidized credit
- special tax credits

The sales of public enterprises therefore were subject to various implicit subsidies.

5. In the telecommunications sector, countries might best begin the privatization process by reforming their regulatory structures. Such a reform process would involve

   - establishment of clear quantitative and qualitative goals for the telecommunications network
   - creation of a strong regulatory agency
   - design of a flexible regulatory framework
   - careful implementation of regulatory policies in transitional phases

6. For many developed and developing countries, private participation in the electric power sector can assist in resolving the recurring problems of insufficient financing and inefficient operations. Private participation can come in several forms:

   - independent generation plants
   - industrial cogeneration and self-generation with sales to the public grid
   - privatization of utility ownership through partial or complete sale of assets
   - privatization of distinct utility services such as generation, distribution, or transmission functions through management contracting and leasing

   No single approach is best suited for all countries.

7. The countries of Latin America have widely differing approaches to drawing on foreign investment in the oil and gas sector. Nonetheless the ownership and development of Latin America's oil and gas will probably remain largely in the hands of state companies. The exception is Argentina, which is breaking up the monopoly of Yacimientos Petrolíferos Fiscales (YPF). The government has sold some YPF fields to foreign and local private companies and obtained some private involvement in production and exploration. The objective is not to make YPF smaller, but to create a balanced, integrated company, running on its own cash flow, paying taxes, and no longer receiving the government subsidies it needed to cover more than US$2.6 billion in losses in the past.

   In other countries such as Bolivia, Colombia, Ecuador, Peru, Trinidad, Venezuela, and even Cuba, gradually increasing foreign and domestic private participation appears to be the trend. These changes will help bring the necessary investment, technology, and skilled personnel to improve efficiency and performance of the region's state-owned oil sector.

8. Recent movements in Latin America and the Caribbean toward the privatization of air transportation and tourism (principally hotels) may help create a tourism industry that is more productive, committed to greater quality, and likely to be more profitable. A conducive economic environment, including instruments such as legislative changes, a viable capital market, and coherent macroeconomic policies, is needed to support the liberalization and rationalization of the economy in countries seeking to privatize the tourism sector. While in many respects Mexico and Jamaica have led the way in privatization of tourism and air transportation, other countries have made progress or are seeking to move in the direction of privatization. The sale of state airlines has taken place in Argentina, Chile, Guatemala,

and other countries, with programs under way to sell state carriers in Panama, Uruguay, and elsewhere in the Americas.

9. In the marketplace, Latin America's economic reform and privatization programs now appear irreversible. Increasing foreign participation in the region's extensive privatizations has become a touchstone of success for both these drives. It has also become the ultimate measure of Latin America's opening to the world market. In this new environment Latin America's ambitious quest to attract extensive foreign capital and technology is the widest opportunity ever presented to foreign investors in Latin America.

An Overview of *Latin America's Turnaround*

Over the past thirty years Latin America's approach to foreign investment has come full circle, along with its approach to economic growth. The foreign investor, once nationalized and almost declared obsolete, has become a critical player in Latin America's drive for modernization and renewed growth. And the debt-laden state enterprise, once portrayed as the Latin substitute for foreign equity investment, is being privatized virtually everywhere in Latin America. The most graphic reflection of Latin America's new approach to growth is the point at which foreign investment and privatization come together: Latin America's quest to get foreign buyers for the large number of former state enterprises it plans to sell—hundreds of companies, including many of the region's largest, with a total value that could reach US$100 billion in assets before the 1990s are over.

The change is so dramatic and complete that one must ask: will it last? The answer to that question is by and large a positive one. Privatization and openness to foreign investment are fundamental parts of Latin America's new approach to economic growth, an approach that is bringing the region out of the stagnation in which the turgid inflexibilities of state capitalism left it mired. The new approach has also thrived on Latin America's disillusionment with big government and on the modern political philosophy of the region's leadership and people.

The Pace of Privatization in Latin America

The privatization trend has taken hold with remarkable speed in Latin America. In his chapter William A. Orme, Jr., points out that the new generation of leaders is pragmatic and practical rather than ideological, and the new politicians are determined to make economic change so sweeping and profound as to be irreversible.

The biggest problem related to privatization is that the global privatization craze has created a buyer's market in airlines, steel mills, and other budget-bleeding properties. To sell at an attractive price is getting harder all the time. Competition from sellers within and beyond the region is forcing Latin America to confront the basic paradox of privatization: inefficient businesses that drain the treasury attract few bidders, while well-managed enterprises that pump in capital are the easiest to divest.

Privatization nonetheless seems likely to prevail in most Latin American economies because there are few alternatives—and because it is politically prudent. Although critics note that in no Latin American country has a wholesale privatization effort yet been endorsed by voters, it is also true that no one is moving in the opposite direction. Once installed in office, politicians throughout the region have been able to sell state companies with little resistance. There is no evidence that any Latin American opposition bloc believes it can make electoral gains by proposing the return of divested companies to the public sector fold.

Instead, the mechanics of privatization have come under intense criticism. Complaints, many justifiable, have centered on the specific terms of sales, including bidding procedures, treatment of workers' contracts and pensions, the viability of consortiums of private buyers, and special concessions to foreign creditors. In too many cases privatization has led to a dangerous reconcentration of economic power (in one example, a single Mexican industrialist now owns 95 percent of his country's newly privatized copper reserves). And even enthusiasts couch their support for privatization with concerns about reconcentrated wealth and the sale of undervalued assets during a global recession.

Ultimately, though, the options are limited. For Latin America's pragmatic new economic managers, privatization's continuing appeal calls to mind the Churchillean dictum about democracy: it is the worst strategy for economic survival, except for all the rest.

Argentina. In the space of a few months Argentina's economy underwent a transformation far more rapid and extensive than the massive privatization program carried out by Margaret Thatcher in the United Kingdom in the early 1980s, notes Pablo L. Gerchunoff. In late 1990 and early 1991, the government of Carlos Menem privatized Argentina's state telephone company, its national airline, its national highway maintenance services, much of its petroleum reserves, and several other interests. Many other privatizations are under way.

Broad support exists in Argentina for this large-scale sell-off of state enterprises, for two reasons. First, Argentina's state enterprises have been notoriously inefficient and poorly managed. Second, the government will no longer be obligated to finance the investments of state enterprises. Since the beginning of the foreign debt crisis the public sector has been forced to slash capital expenditures and spending on public services.

The privatization policies have aimed to improve the quality of services, increase private financing of investments, limit the power of the unions and big business, reduce the foreign debt, and obtain additional liquidity for the public sector. Initially, priority was given to those objectives linked to macroeconomic stabilization. The country had passed through two periods of hyperinflation, the Treasury's situation was critical, and there was increasing pressure from foreign creditors trying to collect debt payments that were in arrears.

Privatization in Argentina has entailed some costs. In the rush to complete the sale of companies and shares, most public services were transferred without an adequate regulatory environment to protect consumers. In addition, the privatizations were carried out in an economy without a capital market, so there was no process of broad diffusion of ownership. Instead, early privatizations created closely held companies, with ownership concentrated in a few hands and with the majority of shares held by foreign firms. The mechanism of capitalizing the government's debt means that debt service payments are saved now but at the likely price of losing the remittance of earnings in the future of newly privatized firms.

The privatizations planned for the 1990s are likely to take place in a calmer macroeconomic environment, with greater investor confidence, a lower rate of inflation, and more order in the fiscal accounts. Such an opening is likely to lead to more benefits for both the state and society.

Brazil. Announced together with President Fernando Collor de Mello's first stabilization attempt in March 1990, Brazil's privatization program, described by Carlos A. Primo Braga, had a slow start. Its initial objective of privatizing forty-two state-owned enterprises in two years, generating US$17 billion for the quasi-bankrupt Brazilian public sector, proved too ambitious.

One of the most attractive companies listed among the state-owned enterprises for sale was USIMINAS (Usinas Siderúrgicas de Minas Gerais, S.A.), a producer of flat products that is well known for high standards and international competitiveness. Officially, its privatization program started in June 1991 with a special offer of shares—around 10 percent of the company's total capital—to USIMINAS employees. There was political opposition to the privatization of USIMINAS, however, by those who said that building a plant like USIMINAS today would cost some US$7 billion, a cost not nearly covered by the minimum estimate set by the national development bank in charge of the privatization program. Nonetheless, in late 1991 USIMINAS was privatized. The firm was acquired by a consortium of Brazilian banks and firms in an alliance with Nippon Usiminas and an association of USIMINAS employees.

As a test of the privatization program, the USIMINAS case gets mixed reviews. The participation of foreign capital was low—only 5 percent of the company's capital was acquired by foreign investors, suggesting that foreign investors remain uncertain about the economic and legal prospects of Brazil's privatization program. On the positive side, it can be argued that the Collor administration pushed forward a major privatization project despite strong political opposition, opening the way for the reorganization of the Brazilian steel industry. In the first nine months of 1992 the privatization program gained speed, with eleven additional companies being privatized.

The replacement of Collor de Mello by Itamar Franco as a result of impeachment proceedings, however, has led to changes in the privatization procedures, which have been interpreted by some analysts as a sign that the new administration is not particularly enthusiastic about the program. It is quite clear that the timetable and final results of Brazil's privatization program remain hostages of the country's political and macroeconomic crises.

Chile. Since 1974, when Chile's massive privatization program began, some six hundred of the country's largest state-owned enterprises have been sold off, generating approximately US$2.5 billion in revenues.

Dominique Hachette and Rolf Lüders describe how Chile's state-owned enterprises were sold off in two rounds: from 1974 to 1978 and from 1985 to 1990. During the first round the government offered incentives to buyers to gain additional liquidity for the public sector in an effort to reduce the large fiscal deficit consequences of the sociopolitical crisis of 1970–1973.

This system eventually ran into problems and contributed to the deep financial crisis of 1982–1983. As a result, management of the largest privatized enterprises fell back into government hands. Those enterprises were eventually privatized again. During the next round, however, all sales were carried out on a cash basis. The lack of transparency (insufficient financial data for privatization projects) that may have deterred investors during the first round was significantly reduced by the second round and did not affect the fiscal impact of the privatization process.

On the whole, Chile's privatization program was successful in the distribution of property ownership. It stimulated the private sector to improve efficiency, it opened new investment opportunities and created new responsibilities in the private sector, and it helped reduce the country's dependency on the powerful and pervasive public sector. The process was also successful in persuading critical and strongly antagonistic groups that privatization was beneficial. By so doing, it reduced the dangers of reversibility after the transfer of power from the military government of General Augusto Pinochet to the civilian government of Patricio Aylwin.

Jamaica. Jamaica has made privatization one of the critical elements in its strategy to remove distortions in the economy, to increase levels of efficiency, and to foster sustained economic growth and development, writes

Peter Phillips. The commitment to privatization is not new in Jamaica, nor is it new to the administration of Prime Minister Michael Manley. Since 1989 the government has completed an ambitious privatization program in the tourism sector. Fourteen hotels were put up for sale—with net proceeds in excess of J$882 million (US$110 million). The administration has also concluded major privatizations in the telecommunications sector, not only earning foreign exchange but also vastly expanding the technical and financial capabilities of this sector.

Despite these developments, privatization in Jamaica has been spasmodic, excessively restricted in scope, and all too often driven more by the need to balance the books than by the need for a comprehensive effort to reform the country's economic structure so that it can compete in world markets.

The scope of the current program is extensive and has two goals: to reorient the public sector's role to that of an "enabler" that provides the appropriate policy framework and infrastructure to support the productive sectors, and to recognize and support the role of the private sector as the main vehicle for economic growth and development.

Overseas involvement is being welcomed in the privatization program, especially in cases involving foreign exchange inputs and access to advanced technology.

Mexico. In a reversal of its long tradition of heavy state intervention in economic activity, Mexico today is privatizing many of the more than one thousand state entities that existed in 1982, notes Rogelio Ramírez de la O. The turnaround, motivated initially by budgetary constraints, now is being pushed by an ever-stronger private sector demanding that the government pull out of nonstrategic industries.

As a result of large budget deficits, caused in part by inefficient state organizations, the government in the mid-1980s signaled that it wanted to divest gradually from manufacturing and nonstrategic areas. During the early stage of this policy, the government lacked a philosophy recognizing that the private sector is the best mechanism for efficient allocation of resources. It took a long time, therefore, for the public to understand that privatizations marked a new economic policy.

The first sectors targeted were mining and manufacturing, where small firms were sold in 1988–1989. They were followed by the major sale of the Cananea copper company for over US$900 million. The Mexican government also put up for sale its ownership in the two airlines, shipyards, trucks and engines, chemicals, sugar, and food distribution. In 1990 it became clear that the public thought well of privatizations and would support the government against strong labor unions. Part of the reason was that customers wanted better public services and considered the government a poor administrator. By 1991 only 280 enterprises remained public, down from 1,155 in 1982.

Mexico needed foreign capital, and privatization could attract it. In 1991, however, foreign participation was accepted only in nonvoting shares or in a minority capacity. The internationalization of the economy suggests that such restrictions will become less acceptable in the future and that in coming years the preservation of niches for large Mexican conglomerates will be more difficult.

As Mexico's economy becomes more international in character, privatization objectives and policies are likely to evolve in two important ways. One is that the concept of what the state should own will be slated for revision. Another is that the role of foreign investment in privatized entities will become more significant. Nevertheless, the Mexican government has great discretionary power to outline the scope of the program in the future.

At the same time, the internationalization creates fresh economic forces that will be less disposed to tolerate ad hoc limitations and rules. The North American Free Trade Agreement, as part of this process, will tend to eliminate discrimination among investors. The result is likely to be a greater presence of foreign investors in activities that only a few years ago were reserved for Mexicans.

Venezuela. Venezuela's ambitious privatization program, announced with great fanfare in early 1989, is finally making progress after a slow and painful start. Joseph A. Mann, Jr., points out that in August 1991 the government of President Carlos Andrés Pérez carried out its most important privatization to date, when a consortium comprising Spain's Iberia and Venezuela's Banco Provincial group won the right to purchase a majority of shares in Venezuela's international airline, VIASA.

Until the VIASA sale the Venezuelan government had sold only three commercial banks from a list of scores of state-owned or statecontrolled companies slated for privatization. These include airlines, hotels and tourist facilities, sugar mills, a shipyard, banks, water and electric power concerns, the state telecommunications company, and other public services.

Virtually all of the companies on the privatization hit list are money losers. VIASA, for example, reported a net loss of US$47 million for 1990. The government is interested in finding international and domestic investors for everything it has put on the block, except for the commercial banks. Venezuelan law currently limits foreign holdings in banks to a maximum of 20 percent.

At the end of 1991 the privatization of CANTV, the state telephone and telecommunications company was successfully carried out. A consortium headed by GTE (of the United States) placed the winning bid of US$1.89 billion for 40 percent of the company's shares plus operating control. This was the largest privatization to date and one of the biggest anywhere. In effect, the government had set the minimum price for the company at US$2 billion, making the minimum price for 40 percent US$800 million. The GTE bid therefore exceeded the minimum by more than US$1 billion.

Why has it taken so long to advance Venezuela's privatization program? The Venezuelan Investment Fund, the government agency charged with carrying out the privatization plan, faced a formidable task. It had to draw up an accurate list of government properties, study the myriad legal problems associated with selling government assets, and decide on priorities and bidding procedures. Inventory was a problem, because past governments in Venezuela had no clear idea of what the state actually owned.

As the Fund developed a tentative list of privatization candidates in early 1990 (major producers of red ink and public services in desperate need of reform), stiff opposition began to appear from almost every quarter. The opponents were individuals and groups who benefited in some way from the status quo at state-owned enterprises, such as company administrators, union leaders and workers, and others. Despite the difficulties of the task and domestic opposition, however, the Venezuelan privatization program continues to move forward.

Privatization as a Remedy for State-owned Enterprises

In the 1980s the role of state-owned enterprises (SOEs) underwent close scrutiny in Latin America and in other parts of the developing world. Many governments seemed to be concluding that SOEs were not the ideal hybrids they had been made out to be: only rarely did they combine the strengths of the public and private sectors as originally expected, and occasionally they combined the worst of both. In response, a program of SOE reform emerged in developing countries that had no parallel in scale and in scope in the postwar period. One class of reform—privatization—was particularly important. In his chapter Ravi Ramamurti explains why.

Privatization gained considerable momentum in the developing world in the 1980s. By December 1987, 571 SOEs had been privatized in 57 developing countries, according to a World Bank report.

Goals and conflicts. Privatization was motivated by many different goals. Studies show that these goals include improving the government's cash flow, enhancing the efficiency of the state-owned enterprise sector, promoting "popular capitalism," curbing the power of labor unions in the public sector, redistributing incomes and rents within society, and satisfying foreign donors who want to see the government's role in the economy reduced. Occasionally privatization is consistent with several or all of these goals. More commonly it is not.

One common conflict is between the desire to privatize quickly and extensively and the wish to maximize proceeds from privatization. Country studies suggest that if a sufficient volume of state assets is sold, a government can rake in a tidy sum of money in the short run, such as in the United Kingdom and Chile. Observers believe, however, that in both countries the governments realized less than they could have if privatization had been implemented more slowly and carefully. Governments that were seen as strongly committed to privatization sometimes weakened their hands at the bargaining table, especially in developing countries, where the number of bidders for SOEs was usually small. In public offerings, SOE shares were often underpriced, especially if wide share ownership or a quick and "successful" sale was desired. Several other factors could also lower a government's cash realization from privatization. Sometimes workers must be assured that no one will be fired after privatization, as was the case in Bangladesh. To be sure, some of these losses may be avoided as countries gain experience with privatization, but others may be inescapable if a government wishes to move swiftly, seizing a political window of opportunity for privatization. Conversely, a government that takes time and care to maximize proceeds from privatization may give too much time for opponents of the policy to organize their resistance.

To offset revenue losses from the above factors, government may compromise on another common goal of privatization—increasing the economic efficiency of SOEs. Empirical evidence suggests that reforms designed to promote competition—or even the threat of competition—may well improve efficiency. Yet, a firm facing little or no competition will usually sell for more—and possibly sell faster—than one facing intense competition. Competition may be compromised during privatization for another reason as well: governments may prefer buyers from the same industry as the SOE because they are regarded as more likely to be able to make the firm succeed.

What if competition is infeasible and undesirable, as in the case of natural monopolies? In these circumstances efficiency depends at least as much on the quality of government regulation as on the ownership of the equity. Privatization may therefore have to be accompanied by liberalization in some instances and better regulation in others to improve efficiency.

Implementation. Several studies have shown that privatization tends to get bogged down during its implementation. Workers, managers, civil servants, and politicians are known to resist privatization because its costs are often concentrated in these groups while the benefits are thinly dispersed across customers, investment bankers, and prospective buyers. These obstacles, however, are not insurmountable. In most countries worker support can be garnered, civil service resistance can be overcome or bypassed, managers can be induced to support the policy, buyers can be found, and capital can be raised to privatize at least a few of the state-owned enterprises, including some large ones. Commitment at the highest political level appears to be a necessary, though in itself insufficient, condition for seeing privatization through.

Effects of privatization. The indirect impact of privatization may be at least as important as the direct consequences. The privatization movement is forcing countries to reexamine the rationale for state ownership of firms; it is leading them to think more carefully before creating new state-owned enterprises; and it is inducing them to search for better management techniques. Some evidence indicates that when a program of privatization is launched, even the performance of state-owned firms that have not been privatized improves, at least in the short run. Besides, although privatization and competition are independent factors, privatization may make it easier for a government to promote competition.

In the long run privatization is likely to strengthen the institutions necessary to make markets work, whether through the establishment of stock exchanges, the tightening of managers' accountability to shareholders, the establishment of bankruptcy laws, or the strengthening of regulatory institutions.

Privatization Requirements of Foreign Investors

In many Latin American and Eastern European countries that are attempting to privatize state-owned enterprises, the population does not hold savings anywhere near what is required to buy the assets being offered for sale. To overcome this obstacle some countries have tried debt-led privatization programs, in which small investors buy the bulk of assets with credit. These debt-led privatizations, however, run high risks of stretching local capital markets to their limits and even of renationalization. Foreign investment, therefore, can be an important contributor to a successful privatization effort.

Although foreign investment does not necessarily constitute the majority of investment in the privatization programs of developing nations, it is an important capital reservoir. It is accompanied by a steady inflow of technology and business acumen that is often severely lacking, especially in privatizing the largest state-owned enterprises.

Although much has been written about what elements privatization programs must have to be palatable to local populations, the question of the needs of foreign investors has been ignored in much of the literature and in the development of specific programs. Edgar C. Harrell contends that like other investors, foreign investors in privatization programs seek to maximize return while minimizing risk to their investment. They will take into account both macroeconomic and political considerations.

Their macroeconomic considerations include the following:

1. strong and stable economic indicators
2. relatively developed capital markets or a competitive, two-tiered banking system
3. other capital available in the domestic economy for future improvements or expansion
4. fiscal and monetary policies that favor price stability
5. international creditworthiness
6. demographic characteristics that complement business needs
7. relatively open market regimes for the pricing of goods and factors of production
8. an explicit automatic pricing system for natural monopolies, such as electric utilities

Foreign investors will also look at political considerations:

1. the stability of the government
2. freedom from excessive political risk
3. flexible regulations but clear guidelines
4. a clear and open policy-making process
5. government support for private business
6. a tax system that does not penalize foreign investment
7. a foreign policy that does not create conflicts with private businesses

8. a favorable legal environment for business
9. regulations and mechanisms that allow for the repatriation of capital dividends and other funds
10. few restrictions on the percentage of shares of a company that can be purchased
11. use of generally accepted accounting standards
12. access to reliable, consistent, and comparable financial information
13. guarantees that the buyer has clear title to purchased property
14. immigration regulations that do not curtail foreign management participation

Governments that ignore these requirements of foreign investors risk losing investor confidence and thereby a major source of revenue.

Foreign Direct Investment in Latin America's Privatization

Ben Petrazzini considers the amount of private investment that the sale of state-owned enterprises has attracted and the accompanying role of foreign direct investment in privatizations in Latin America.

Mexico. When Carlos Salinas de Gortari came to power in 1988, his economic team realized that the country would need to attract massive amounts of foreign direct investment—US$30 billion in the following six years—to achieve the country's macroeconomic objectives. Accordingly, the Salinas administration liberalized the investment laws. Foreign investment flows were meager until the second half of 1990, when they shot up dramatically, probably because of both the new openness of the economy and expectations regarding the North American Free Trade Agreement (NAFTA).

Since 1982 Mexico has privatized numerous state-owned enterprises. The largest privatization transaction concerned Teléfonos de México (TELMEX), Mexico's telephone company. The level of interest by foreign investors in this privatization was extremely high, and the amount of foreign direct investment received by the Mexican government exceeded expectations. Competition among foreign investors was also strong for cellular telephone concessions. In late 1991 the government was preparing a second round of privatization in which foreigners were to play a still more important role.

According to a state report, privatization has allowed the Mexican state to reallocate resources more productively and to concentrate on the provision of public services in areas of basic needs. The state is becoming a smaller and more efficient institution in the management of Mexico's modernization strategy and the insertion of the country in the global economy. What is not yet clear, however, is what will be the effect of privatization on the economy as a whole and how the recently sold state-owned enterprises will perform.

Argentina. Although the administration of Raúl Alfonsín attempted to implement a privatization program, privatization did not really take off until the election of Carlos Menem. Menem's privatization program was so radical that Argentina became, in a short time, the leading force in state reform in Latin America. The program included, in the short run, major state companies such as the Empresa Nacional de Telecomunicaciones (ENTEL, telecommunications), Aerolíneas Argentinas (airlines), Ferrocarriles Argentinos (railways), and Yacimientos Petrolíferos Fiscales (YPF, oil). Foreign direct investment was a key element in the new privatization program.

Privatization of state-owned enterprises in Argentina has attracted, through various financial mechanisms, a considerable amount of foreign direct investment. The prospect of further foreign capital inflows improves as the privatization program is consolidated and the country's economy becomes more stable and prosperous. Besides some economic problems tied to foreign direct investment, Argentina is expecting approximately US$700 million of additional investments in the privatized sectors.

Chile. Probably the most significant privatization in Chile is that of Chile's local telephone company, Compañía de Teléfonos de Chile (CTC). With its sale to the Bond Corporation Chile in the late 1980s, CTC was transformed from a slow-moving parastatal enterprise into a fast-growing business with a fresh image and an impressive presence in the market. In April 1991 the company was sold to Telefónica de España, creating problems of potentially reduced competition because Telefónica also has a considerable share in Chile's long-distance telephone company.

Another important sale involved LAN-Chile, the state-run airline company. The company was purchased by the Scandinavian airline SAS, in a joint venture with local investors. When the company plunged into the red, however, the government, which still owned 22 percent of LAN's shares, took over the presidency of the company. The Chilean government plans to sell its shares as soon as the airline regains financial and operational stability.

Despite suffering large-scale failure in its first privatization attempts of the 1970s, Chile has been able to carry forward its second privatization program successfully. The country, which is seen today as a model of stable economic policy, has been able to attract large numbers of foreign investors. In fact, the effort to bring in investment from abroad has been so successful that the government is now trying to restrain the entrance of more foreign capital because of the fear that excessive capital inflows will intensify existing inflationary pressures.

Financial Incentives for Investment in Chile's Privatization

When the Chilean government first opened its banks and public enterprises to privatization, it was greeted with a relative lack of interest on the part of potential buyers and virtually no interest from foreign investors. As a result, incentives had to be offered to entice foreign as well as domestic investment.

To attract foreign investors, Chile offered tax regime assurances and made allowances for the repatriation of capital, subject to certain conditions. Incentives for local buyers were aimed at three groups: employees of the public enterprises to be privatized, purchasers on the stock exchange, and pension fund administrators. These groups received incentives that included credit at below-market rates, special tax credits, reduced prices on stock subscriptions, and advance payment of employee compensation for their years of service.

In addition, the government provided three main types of implicit subsidies. The first is an economic subsidy, the present value of the difference between the enterprise's economic value and the actual price of the sale. Second, a financial subsidy is the present value of the flow of net income arising from credit granted with special provisions, such as at below-market interest rates. Third, a fiscal subsidy is the present value of income tax credits originating in the acquisition of shares of Chile's reprivatized banks (Banco de Chile and Banco de Santiago). In his chapter, Juan Foxley Rioseco estimates the values of implicit subsidies for several firms.

The financing of the privatizations during the authoritarian regime that governed Chile until 1990 was sometimes criticized as contradicting the interests of the state by transferring hidden subsidies to the private sector. The Chilean case shows a high degree—80 percent—of subsidized financing in the case of the banks. Nonfinancial enterprises, which were in a better situation than the financial enterprises when they were put on sale, required subsidies of only 10 percent. The latter amount does not seem unduly large if it is assumed that eventual efficiency gains will generate larger future tax revenues for the state. Whether this occurs or not is the responsibility not only of the new enterprises but also of the government, which is charged with the general administration of the economy.

The Chilean privatization experience should be judged as successful, at least as regards the nonfinancial enterprises. This gives rise to a second step of private participation: the financing of new projects. In this undertaking, privatization combined with investment will be the biggest priority.

The Telecommunications Sector

Mark S. Fowler and Aileen Amarandos Pisciotta argue that one of the most important, but often overlooked, roles in the privatization process is that of the regulatory structure. A sound regulatory structure is critical to the promotion of long-term growth in the telecommunications sector, economic expansion, and the realization of certain societal and political objectives in the construction and operation of the telecommunications network.

Privatization is not synonymous with regulatory reform. In many cases it is far preferable to initiate regulatory reform long before the privatization process. This would permit the identification of goals and the establishment of an industry structure that reflects long-term telecommunications sector objectives.

Key elements of an effective regulatory structure for the telecommunications sector include, therefore, the establishment of clear goals. These goals should include both quantitative considerations, such as the number of lines served and waiting time for installation, and qualitative considerations, such as the structure of the industry and the status and inventory of network and transmission equipment.

Another objective is the creation of a strong regulatory agency that can make effective, quick decisions, yet whose intervention in market relationships is minimized to the greatest extent possible. Goals guiding the entity should include availability of affordable basic service to all citizens and fair and equitable technical and market circumstances to encourage competitive entry. The entity should function as independently as the country's legal framework will allow. It should establish internal decision-making procedures that produce, to the extent possible, fair and consistent decisions. Finally, the entity should be organized internally in such a way that it has maximum flexibility to adjust to market developments.

Before specific regulatory policies can be adopted with respect to particular services, an overall regulatory framework should be devised. Generally, regulatory frameworks that are based on classifications of operational characteristics and service definitions tend to require periodic change to accommodate different market circumstances. Regulatory models also often classify carriers according to market power, such as dominant and nondominant. In many administrations the basic distinction is still between the monopoly service provider and services open to competition. Finally, an alternative framework may be structured around levels of regulatory oversight, ranging from heaviest regulation to virtually no regulation.

The privatization process causes great dislocation and requires tremendous adjustment. For most countries, therefore, it is advisable to develop a transitional plan, spanning five to ten years, that would incorporate steps for steady progress toward a more competitive market. In the initial stages, the regulatory entity must focus on strengthening the backbone network and infrastructure. In an intermediate phase, once pricing structures have been rationalized and an investment program is well established, additional facilities-based competition may be authorized. In a final and more mature period of transition, competition may be introduced into international services. As progress toward competition is implemented through these various phases, regulation may be liberalized and even eliminated.

The Electric Power Sector

For many developed and developing countries, private participation in the electric power sector can help resolve recurring problems of insufficient financing and inefficient operations. Faced with increases in demand, many developing countries now experience power shortages of over 10 percent of their generation capability, disrupting productive economic activities and threatening future industrial, agricultural, and commercial investments. James B. Sullivan examines this sector in his chapter.

Huge investments are required to meet future demand for electricity, and assembling the financial resources for the necessary level of expansion and investment is clearly beyond the capabilities of developing countries alone. More and more developing countries are looking to the private sector to help develop needed improvements and expansion in the power sector. The reasons most often given by developing countries for increasing private sector involvement are financing, efficiency, and innovation. Private investment, if it can mobilize additional sources of funds, can help alleviate the serious drain on the public treasury now imposed by the power sector. This would free up resources for expenditure in other areas such as education, health, or agriculture. It would also provide a new capital market for local private investment.

Arguments for private participation related to efficiency are rooted in the fact that many developing country utilities are state-owned monopolies where investment decisions are dictated by the monopoly supplier, with rate payers having little influence. Private participation would end this monopoly. Under the assumption that competition would dictate that profit margins of the plant depend on the efficiency of the operations, private participation would thus create savings that could be shared between the plant owner and the utility's customers.

Finally, the private sector rather than the public sector has been the source of most technological and system management innovation in the power industry.

Three general approaches to private participation have been used in the power sector: independent power production, privatization through divestiture of utility assets, and utility service contract management. Independent power facilities are stand-alone, privately owned and operated electric power plants that sell bulk power to the national grid. The second approach, the privatization of utility assets, is being implemented in a number of countries in the Caribbean and Latin America. For example, the government of Argentina has authorized a restructuring of the generation, transportation, and distribution of electricity. The Dominican Republic is assessing the market for potential privatization of specific municipal and electric utility services. In Chile the electric utility system has also been privatized.

Privatization of electricity provision by contracting out specific utility services, the third approach, constitutes a contractual obligation: delivery of electric service for a fee to be paid by the utility. Electricity services can be privatized through the purchase and rehabilitation of existing generation or distribution functions by private investors, a contract in which a contract company manages a state-owned utility, a joint venture between the private sector and the public sector, or the leasing of a privately owned power plant to the public sector through a long-term power purchase agreement.

Private participation requires a favorable public policy environment, a clear regulatory and institutional framework, firm contract arrangements, and sufficient and secure revenues.

The Oil and Natural Gas Sector

Latin America's state-owned oil and natural gas sector is facing major challenges in the 1990s, but a large-scale privatization of the industry's assets appears less likely than a gradually increasing role for foreign and national private companies, asserts Kim Fuad. The challenges reflect the need for capital, technology, and skilled personnel required to upgrade and expand activities at virtually all levels, from the wellhead to the gasoline pump. Annual investments of around US$30 billion are needed to achieve an expansion in Latin American energy production—including oil, natural gas, and electricity—and half of that must come from outside sources.

While the region's oil-producing countries all have these needs, their approaches to drawing on outside help vary widely. Some, such as Mexico and Brazil, remain resolutely opposed to foreign ownership of oil and gas. Other, such as Venezuela, are resuming associations with foreign oil companies whose assets they had nationalized. And some, like Argentina, are dismantling their monopolies.

Despite these and other changes, ownership and development of Latin America's oil and gas is likely to remain largely in the hands of state companies. More than 77 percent of the region's 1990 daily oil output of nearly 7 million barrels was produced by Mexico's PEMEX, Venezuela's PDVSA, and Brazil's PETROBRAS—all state-owned companies.

The proven ability of these three state companies—and, to a lesser degree, of a few others—to develop successfully their countries' oil and natural gas is a better guarantee of their continuing dominant role than the nationalistic drive that created them. National pride, along with the support of vested interests such as labor unions, nonetheless still provides a prop for some of the region's less efficient state companies. Pressure to improve the performance of many of these state oil companies is increasing, however, and reforms are under way.

In 1985 Argentina began a radical reform of the state-owned Yacimientos Petrolíferos Fiscales (YPF), which included attracting greater foreign investment, deregulating the Argentine oil industry, and breaking up YPF's forty-year monopoly. Argentina's reform is likely to prove the exception, however, since no other country with substantial production now appears ready to open itself to free competition as a way to force state companies to become more efficient. In Brazil, for instance, no clear challenge to PETROBRAS's oil monopoly seems likely in the planned 1993 review of the constitution, which ratified the monopoly in the 1980s. Privatization of the Latin American oil and natural gas sector on the whole, therefore, will not involve the sell-off of state-owned assets. Instead, the private sector's role will increase largely through association with the state oil companies as partners in developing oil and natural gas resources.

Since Latin America's private sector largely lacks the expertise and the capital needed to take up the opportunities offered by association with state oil companies, private investment will continue to be mostly foreign. With the exception of Mexico and Brazil, most of the rest of Latin American state oil companies have already associated with foreign oil companies or are moving to do so under a variety of different terms. Even die-hard Marxist Cuba has recently signed exploration and production agreements with France's Total, Brazil's PETROBRAS, and others.

The Tourism and Air Transportation Sector

Tourism and air transportation are two of the most vital parts of the global economy. Recent movements in Latin America and the Caribbean toward the privatization of air transportation and tourism (principally hotels) may help create a tourism industry that is more productive, committed to greater quality, and likely to be more profitable, write David L. Edgell, Sr., and Wanda Barquin.

The growth of quality tourism (and the emphasis on privatization in this sector) is indicative of the changes taking place in the productive economic system worldwide. The goods-producing sector no longer predominates; services do.

As countries privatize tourism and air transportation, they should take into consideration the specific features of their economies, such as the scale of the privatization, the level of distortion in the capital markets, the extent of the local entrepreneurial culture, and the degree of investor confidence. The transfer of the means of production from the public sector to the private domain, especially in the tourism sector, should include steps to deregulate, to decentralize, and to foster competition and market-oriented mechanisms in order to achieve an optimal state divestiture.

Privatization in the field of tourism is not a panacea for the tourism problems of any specific country but rather is just one step in a larger strategy to increase the economic development of the region. While privatization might be expected to bring fiscal efficiency, allocative effectiveness, increased productivity, greater competition, improved policy making, improved quality management, and increased creativity and innovation, it may also stimulate the reduction of certain social goals important to the nation as a whole, less stimulus for competition in parts of the tourism industry, potential for the development of private monopolies or duopolies, disregard for the environment in some cases, and elimination or lack of services (particularly air service) critical to small communities because of inadequate economies of scale.

Several countries have made significant progress in privatizing this sector. Jamaica, one of the leaders in the privatization of the tourism industry, has sold fourteen state-owned hotels to local and foreign investors. Furthermore, Jamaica is seeking to sell the government-owned airline, Air Jamaica, as another step in its privatization efforts.

In Mexico, during the first phase of the tourism sector's privatization, the government disengaged itself from nineteen hotel enterprises and from two of its airlines (Aeroméxico and Compañía Mexicana de Aviación). Even though the Mexican government no longer owns a majority interest in these airlines, it retained some ownership of Aeroméxico and 40 percent of the stock of Mexicana.

The government of Mexico continues to welcome private participation in the financing of infrastructure projects and services in the tourism sector. The Mexican experience in the sale of state-owned enterprises has been largely satisfactory and will encourage wider participation of national and foreign private investors in the tourism industry.

Other countries have focused on privatizing state airlines. In August 1991, the Venezuelan government agreed to sell 60 percent of the shares in the state-owned airline, Venezolana Internacional de Aviación, S.A. (VIASA). In 1989, the government of Chile sold LAN-Chile for US$42 million to a domestic investor and to the Scandinavian company SAS. Aviateca, Guatemala's national airline, was privatized in 1989. Aerolíneas Argentinas was sold in November 1990 to a consortium of companies and individual investors. The transaction ultimately led to a US$34 million reduction in Argentina's annual deficit. And in March 1991 the government of Ecuador announced the sale of 49 percent of the shares of the state-owned airline Ecuatoriana de Aviación to both domestic and foreign investors.

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