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World Trade Organization
Trade Policy Review Division

TRANSITION ECONOMIES, BUSINESS AND THE WTO

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TRANSITION ECONOMIES, BUSINESS AND THE WTO

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ABSTRACT

Transition economies are going through a process of changing the role of the state, allowing a greater role for the private sector. This is consistent with the market-oriented approach of the WTO. Remaining state agencies and enterprises will need to adapt their ways of doing business, including in their approach to procurement of goods and services, for economic and legal reasons. There is some hesitation about privatization, as for foreign direct investment, and, where accepted, about the precise timing. Where privatization of basic service monopolies occurs, the role of the state shifts towards a regulatory function. In some private sector activities, a non-interventionist approach to competition may be justified by market considerations, while in others a pro-active policy may be necessary to ensure the benefits of economic liberalization.

Key words: WTO, transition economies, procurement, state-trading, privatization, foreign direct investment, regulatory policy

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TRANSITION ECONOMIES, BUSINESS AND THE WTO

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I. INTRODUCTION

1. This paper is mainly concerned with the process of transformation from a centrally planned to a market economy and accession to the WTO. The issues covered are procurement, state trading, privatization foreign direct investment and the regulatory framework.

2. The WTO does not explicitly exclude a state-trading or “socialist” country or centrally-planned economy from membership, but a number of the obligations can only be fulfilled by market economies. A number of Eastern European were contracting parties to the GATT, but a number of special conditions were written into their respective protocols of accession and they did not receive the same benefits as full participants.

3. The core philosophy of the WTO system is equal treatment of members under the MFN rules and the national treatment provisions of Articles I and III of the GATT. The modalities of the system are the prohibition under Article XI of quantitative restrictions, which are inherently discriminatory, and the use of bound tariffs under the procedures of Article II. These rules are intended to allow trade to develop progressively under comparative advantage enhancing the welfare of all members, without arbitrary and discriminatory disruption. However, state-trading countries and state-trading enterprises are perceived as making purchasing and sales decisions which need not be determined on the basis of the best price for equal quality of products or services, duplicating the effects of quantitative restrictions.

4. Today, for a variety of reasons, many economies are reducing the role of the state and state-trading enterprises, radically changing the way they do business and creating an enhanced role for their business sectors. There are still some reservations about privatization, as for foreign direct investment, but, where privatization goes ahead, the state also has a role in regulatory and competition policy – even non-intervention is a stance. In the case of countries aspiring to WTO membership the process of yielding up productive activities to the private sector will greatly facilitate their accession while allowing them to capture the welfare gains from their own restructuring.

II. GOVERNMENT PROCUREMENT

5. It has been estimated that, depending on the economic system, central government purchases of goods and services as inputs into education, defence, utilities, infrastructure, public health, and so on, typically account for 10 per cent of GDP (Hoekman and Mavroidis, 1997a). This figure is higher when account is taken of the purchases of state-owned enterprises, regulated monopolies, regional governments and municipalities. In transition economies the figure would be much higher. While privatization has a tendency to reduce the importance of government procurement, it has been argued that in a number of countries this trend may well be overshadowed by large-scale procurement under “build-operate-transfer” projects and other forms of privately financed infrastructure construction or rehabilitation and operation (Wallace and Sahaydachny, 1998). Moreover, despite privatization, there are substantial core activities of governments in the provision of basic services, defence, health and education which will continue to have important purchasing requirements.

6. In many countries curtailing public expenditure is a pressing need, driven by the desire to get inflation under control and free resources for social programmes, and the more important the role of the state, the more important is it to avoid waste in government procurement. To this end, using some kind of bidding or tendering process is normally used to improve the efficiency of procurement procedures and get value for money. In some cases, efforts are also being made to train public entities in procurement skills and to reduce poor implementation of procurement procedures, while helping

small and medium-size enterprises to participate more effectively in bidding (Wallace and Sahaydachny, 1998).

7. However, governments also use procurement procedures for other goals, such as the development of certain technologies, support small and medium-size enterprises or for national security reasons, e.g., in defence contracting. The policies are sometimes described as "Buy National". In such cases, the procedures are usually a supplement to other measures which discriminate in favour of domestic industries, such as tariffs, quotas or subsidies. These all have a welfare cost for the home country, but there may be a political judgement that the net social benefits outweigh such costs. It is also possible that the letting of public contracts is influenced by the corruption of public officials.

8. In general, when a government has other objectives than making purchase at the best possible price, such objectives are met by introducing a price preference for domestic goods and services in determining the outcome of public tenders. For example, it is common to apply a fixed notional percentage increase to the price of importable goods before deciding on whether the imported goods are cheaper than the domestic goods.¹ If domestic production is relatively high cost, this means the government will pay a higher price for domestically produced goods and purchase more of them than in the absence of this practice. However, the private sector will continue to buy at the world price. Thus, there are segregated markets with price discrimination between them.² This is also true if there is a tariff as well as a domestic preference, although this can be offset if government agencies and state-owned enterprises are exempt from payment of duty. In the aggregate, there is an average implicit tariff which is lower than the notional rate of preference to the extent that the private sector is also a purchaser in the market for the importable good. This implicit tariff is what would be taken into account in estimating the effects of removal of government procurement preferences. In the aggregate, it increases production and decreases consumption. Consumers (government agencies, etc.) pay more, but the transfer is directly from the government to the producer because of the higher price. This has to be financed from taxation.

9. The domestic market structure can influence the size of the effects just described. For example, if in the absence of a preference system, domestic production exceeds government purchases, competition among domestic producers of close substitutes can ensure that the government and private purchasers pay the same price and the preferential treatment has no price effects (Baldwin, 1970).³ However, if domestic production falls short of demand, then preferences will cause a rise in the price that government pays; moreover, if the import supply inelastic, then the prices of imports to consumers could actually fall. The possibility of collusion between suppliers, domestic and/or foreign, may also demand a strategic response from governments.

10. The local preference may also be applied to goods or services which are not wholly produced in the local market but which meet a certain level of local content. This kind of preference is often applied where the local firm is unable by itself to fulfil a contract, and can be used to encourage foreign firms to share their technical expertise or technology. Like all local content plans and mixing schemes these raise the costs of the final good or service, providing high effective protection for the winner of the contract (Laird, 1997).

11. Another, less transparent, way in which a preference can be applied is through the design of the project or the drafting of the product or delivery specifications in such a way that only a local

¹ The preference may be "absolute" so that domestic suppliers will charge as much as domestic competition or the market will bear.

² Domestic producers supplying the government and the private market will allocate their output to each market in such a way that their marginal revenue is equalized in each market.

³ Baldwin (1970) also shows that, when there is less than full employment, preference policies can increase employment and help improve the balance of payments situation.

supplier can meet the terms. This usually raises the cost of the contract and works in exactly the same way as a price preference.

12. Domestic preference in government procurement also provides a domestic distortion in favour of the supplying industries in the same way as a non-uniform tariff. In general, the only rationale for such non-uniform treatment is that the sectors which benefit also produce externalities, social benefits which exceed the social cost of the measures, in this case the transfer from the government to the supplier. For example, Baldwin (1970) suggests that in matters of national security or public health there may be welfare gains from the use of domestic products and firms even where their prices are higher than foreign firms. Again, preferences may be used to foster infant industries or help depressed regions, although other instruments may produce the same effects with less distortions. However, unlike arguments in favour of import-substitution industrialization (ISI), the benefits of a general preference in government procurement could fall anywhere in an economy without any evaluation of the costs and benefits, whereas tariff rates are usually based on some explicit trade or industrial policy. Moreover, in the case of goods, the preference is usually applied in addition to the tariff increasing dispersion in import protection and the misallocation of resources in the economy. However, Deltas and Evenett (1997) argue that in practice the welfare gains from preferences are likely to be small.

13. GATT Article III:8 explicitly excludes government procurement from its national treatment provisions, although it may require MFN treatment when a contract is open to other WTO members, as discussed later. To attempt to remedy this loophole in the system, the Tokyo Round Agreement on Government Procurement (GPA) allowed for international competition in public purchasing, extending the principles of non-discrimination and transparency into this field. However, it was limited to the procurement of goods, had fairly high monetary thresholds and covered only entities specifically listed in its annexes ("positive" lists). This agreement only applied between signatories, as is the case with the WTO Agreement, which is one of the very few exceptions to the Single Undertaking of the Uruguay Round, by which all members agreed to be bound by all the WTO Agreements.

14. For signatories, the basic principles of the GPA are MFN treatment, prohibiting discrimination among foreign suppliers, and national treatment, prohibiting discrimination between domestic and foreign suppliers. However, the non-discrimination does not apply to tariff rates, other charges or other regulations and formalities applied to imports (Article III:3 of the GPA). Discrimination may not be applied between locally established suppliers on the basis of the degree of foreign affiliation or ownership nor yet on the basis of the country of production or service being supplied (Article III:2); thus, the GPA applies to trade and sales through establishments, whereas the Tokyo Round Agreement applied only to goods.

15. The GPA is essentially concerned with procedures for the conduct of government procurement, now extended from goods to services (including rental and leasing contracts), and to sub-central government authorities (Hoekman and Mavroidis, 1997b). Goods, other than those for defence contracting, are covered by negative lists specific to each country, while defence items and entities procuring services are specifically identified on a positive list; the implication of these derogations is that the schedules are essentially the outcome of bilateral reciprocal negotiations. The GPA applies lower monetary thresholds than under the Tokyo Round Agreement, exempting purchases by scheduled entities with a value of SDR 130,000 in 1988 (cf. SDR150,000 under the previous agreement), but these thresholds can be as high as SDR 15 million for construction services procured by non-central government entities. The agreement contains several annexes which list the entities for which all procurement of goods is covered, but in the case of services only specified services for each country are covered. The agreement does nothing to reduce market access restrictions on trade in goods and services, but national treatment applies in the areas which are

covered. While the enforcement mechanism was substantially strengthened, a number of weaknesses have been identified.⁴

16. Under the GPA, three methods of tendering are allowed: open, selective and limited (Articles VII and XIV), and all three may be complemented by competitive negotiation (Hoekman and Mavroidis, 1997b). Open and selective methods are preferred, the first allowing any interested supplier to tender, while the second, intended to speed up the process, involves a pre-selection of potential suppliers who can meet the technical specifications. Pre-qualified suppliers, all of whom are entitled to bid, are included in an open list which is updated each year. Limited tenders or single tenders are only permitted where there is no response from a call for tenders; they are also allowed in cases of urgency where additional supplies are required from the successful tenderer or in the case of additional construction services not intended to be included in the original contract. They are not to be used to avoid competition or for discriminatory purposes (Article XV). Negotiation may be used to complement the tendering process if indicated in the initial call for tenders or when no tender is evaluated as being the most advantageous.

17. A number of provisions are intended to foster transparency (Article IX) and to ensure that technical specifications do not create unnecessary obstacles to trade (Article VI). There is no obligation to provide a reasoned explanation (“motivation”) for the decision on the award of the contract, except on the specific request of unsuccessful tenderers or on the intervention of their government(s) (Articles XVIII:2 and XXII, respectively). The scope for circumvention of the provisions of the GPA is reduced by imposing deadlines, prohibiting the splitting of contracts and establishing detailed rules on the content of tender documentation and the award of contracts. A challenge procedure is established under Article XX, allowing private parties to invoke the GPA in domestic courts in the awarding country, and, although less satisfactory, on a *post hoc* basis through their own governments to a WTO panel.

18. Mattoo (1997) identifies an important weakness of the challenge procedures in that there is no provision for challenging *post hoc* bail-outs. For example, under fixed price (cf. incentive or cost-plus contracts) the government agrees to pay a fixed fee, but in the event of a cost over-run the government may choose to pay the additional costs (bail-out) rather than switch to other sources (which may be more costly). This entails a moral hazard in that if bail-outs are common then all firms would choose to underbid to win contracts. If the government chooses to bail-out local firms and sue foreign firms for non-compliance, then there is a *de fact* discrimination against which there is no recourse under the GPA.

19. Most developing countries and some developed countries have decided not to accede to the WTO GPA. Hoekman and Mavroidis (1997a) suggest several reasons. For example, the decision of some countries not to adhere to the agreement is related to the desire to avoid the costs of information and contract compliance associated with international tendering procedures under the GPA. Again, it may be that low-cost foreign firms can exercise market power and drive out local firms before hiking their prices, similar to predatory dumping. Small non-member countries may perceive that they have little chance of winning export contracts for which they would be able to tender if they were members of the agreement. Domestic firms, which benefit from preferences, may be exercising pressure on their governments not to adhere (and corrupt officials may fear losses under more transparent international tendering).⁵ There may also be little pressure on some countries to adhere to the GPA because their markets are of minor importance and contracts are often tied to foreign aid. Hoekman and Mavroidis suggest that, rather than approach procurement in the traditional “GATT manner” of

⁴ Mattoo (1997) identifies the low level of compensation for a successful challenger to a contract, the absence of restrictions on settlements in a dispute and the lack of provisions for a challenge and review of *ex post* bail-outs of firms that win contracts on unsustainable terms.

⁵ The GPA prohibits preferences in favour of domestic suppliers. However, a preferential margin of 15 per cent for domestic suppliers is allowed under UNDP and World Bank lending operations which entail purchasing contracts.

reciprocal concessions, it would be preferable to adopt a general non-discrimination principle, enforced by bid-protest mechanisms, greater domestic and multilateral transparency and surveillance as well as anti-trust liability. They also comment that the GPA sends conflicting signs by allowing offsets but not preferences, which they believe might be allowed for developing countries. Of course, such preferences are already available through tariffs on goods, but not on services, so a general margin could be developed, discounting the applied tariff rate, where necessary. Indeed, this would be consistent with an even-handed approach between the goods and services sectors.

20. For countries which are yet to put in place a coherent government procurement mechanism are considering the revision of their existing system, some guidance can be obtained from the Model Law on Procurement of Goods, Construction and Services developed by the United Nations Commission on international Trade Law (UNCITRAL). This is a modern, market-oriented procurement law which is being used by many transition economies as they develop their procurement legislation and practices (Wallace and Sahaydachny, 1998). It codifies what are widely recognized as a set of minimum essential procedures for economy and efficiency, economic development, competition and fairness, transparency and accountability. It appears largely compatible with the GPA (Beviglia-Zampetti, 1997), but allows for a preference margin for domestic suppliers, subject to transparency and procedural safeguards.

21. A number of factors have been identified by Wallace and Sahaydachny (1998) as essential element of an open government procurement system. In the first instance, timely and effective planning determines the efficacy and ultimate success of proceedings and the level of openness and competition. Transparency and competition in procedures depend on information about procurement opportunities and are ensured through the issue of indicative notices of planned procurement, widely published invitations to bid, allowing adequate time for the preparation and submission of bids. Qualification procedures for bidders should be limited to technical, financial, managerial and professional capability, and lists of suppliers and contractors should be published and open for entry at any time. The technical description of the project should be focused on performance characteristics and desired results, referring to international or recognised national standards where possible, and channels should be provided for clarification by potential bidders. While price should be the main focus, some deviation might be permitted for quality and performance, within pre-defined and transparent boundaries. The rules applicable to the competition between bidders should be clear and transparent. Following the award of a contract, notice of the award should be published and information on the reasons for their failure should be made known to unsuccessful bidders (although it is sometimes argued that this can lead to collusion in future contracts). Making known the reason for the award of contract is important in the event of a challenge and possible compensation in the event of non-compliance or less than full compliance. (It may be observed that such a challenge procedure is an important check on the operation of the system, not merely to redress rights in specific cases).

22. The method itself is also crucial to obtaining the best value in procurement. Unless there are good reasons for proceeding otherwise, the preferred procedure is open tendering, with selection based on the lowest price or lowest evaluated price. Such open tendering maximises competition and provides access to the procurement market for domestic and foreign bidders. It is included in the UNCITRAL model law as well as many national laws and the guidelines of the international financial institutions, but is not required by the GPA, which also allows restricted tendering with direct solicitation of a limited number of bidders. However, if the value of the procurement is very low, then the benefits of an open tender may be outweighed by its costs, while for a procurement of intermediate value a restrictive tender or solicited bids may result in net savings. Such alternative methods may also be applied where it is known that there is a sole provider or a limited number of providers of the good or service to be procured; in such cases the procurement agency may need to work closely with the supplier to avoid over-charging, while allowing a reasonable profit, not unlike a regulatory situation (as discussed later). Such alternative methods may also be justified under certain other limited circumstances (see Wallace and Sahaydachny, 1998).

23. Overall, it may be quite difficult to devise a generalised set of rules that will maximize national welfare or minimize procurement costs in all circumstances (Mattoo, 1997). However, a significant benefit of adherence to the GPA may be to help national agencies resist pressures from domestic enterprises to grant contracts to high-cost local producers and to combat corruption among local officials. In any case, irrespective of adherence to the GPA, cash-strapped governments will want to seek the benefits of more open and competitive procurement procedures, and may well wish to look at the UNCITRAL Model Law as a basis for revising their procurement practices. There is no more basis in economics for procurement preferences than there is for tariff protection. If tariff rates provide protection for goods (presumably for some social benefit), then, in the interest of inter-sectoral neutrality in the distribution of resources, consideration may be given to introducing the same general level of preference in procurement of services, including construction. On the other hand, as discussed earlier, there may also be non-economic reasons for some modest preference.

III. STATE TRADING

24. Article XVII of the GATT on State Trading Enterprises has begun to receive increasing attention (Davey, 1998). One reason relates to the important role that such enterprises play in agriculture: now that the sector has been brought more fully under the WTO rules with the completion of the Uruguay Round Agreement on Agriculture any measure or procedure that could circumvent the commitments on export subsidies, market access and domestic support is being closely scrutinized. The second reason is the role that such enterprises play in the transition economies which are in the process of accession to the WTO. Under the GATT, state trading enterprises were not always fully notified, but there have been many more notifications under the WTO's more stringent requirements.

25. It should be noted that under the WTO Understanding on the Interpretation of Article XVII the working definition of a state trading enterprise includes "Governmental and non-governmental enterprises, including marketing boards, which have been granted exclusive or special rights or privileges, including statutory or constitutional powers, in the exercise of which they influence through their purchases or sales the level or direction of imports or exports." While this leaves some questions unanswered, the important point to note is that the scope of the Article goes beyond governmental enterprises.

26. State trading enterprises can be sub-divided into several major categories: marketing boards, fiscal monopolies, canalizing agencies, foreign trade enterprises and nationalized industries (WTO, 1998). Although at a global level they operate mainly in the agricultural sector, in transition economies and in a number of developing countries they also operate in industry. In agriculture, they are often the instruments of a number of policy objectives, including price stabilization and food security (Laird, 1998). In industry, state trading enterprises often have monopolies in the sale of alcoholic beverages, tobacco, and energy. These operations may be related to domestic regulatory functions or for revenue purposes. In mining and petroleum, state monopolies often derive from a view that such products and their exploitation belong to the nation. Banking, transport and telecommunications are service areas which in the past have been dominated by state-owned enterprises but where the private sector now has a key or dominant role.

27. Concerns about the operation of state trading enterprises exist on the import and export side, where the lack of transparency gives rise to suspicions as to whether their selling and buying operations are conducted on the basis of market conditions or government directives. On imports, they decide on the amounts and from whom they purchase, and may well only make purchase on the world market only after local supplies have been exhausted at prices which they determine. In other words, there is no guarantee, in deciding between purchases from local or foreign suppliers, that the decision would be based on a comparison between the local price and the import price plus the import duty. Even when they decide to import, they may then exercise discrimination in their sourcing. They also decide on how much to release on their own markets and at what price.

28. In the long term, both in their import and export operations, the sales and purchase prices of state trading enterprises would have to match, as for any private enterprise, unless they were able to recuperate from government injections of funds to make up for any losses resulting from low-priced sales or the costs of stockholding when their prices were too high. Low-priced export sales could breach WTO rules on export subsidies, unless as part of a self-financed stabilization scheme.

29. It is important to emphasise that the WTO rules on state trading do not prohibit state-owned enterprises nor yet state trading enterprises, rather they are required to operate in a manner consistent with the general principles of non-discrimination prescribed in the GATT. This has been interpreted to mean the MFN principle, but the principle of national treatment would also normally apply under Article III to governmental measures. WTO rules also require that state trading enterprises make their sales and purchases in accordance with commercial considerations (Article XVII:1(b)), but this appears to refer to the non-discrimination principle rather than market access *per se*; on the other hand a number of other GATT articles prohibiting import and export restrictions have also been applied to such actions by state trading enterprises. Moreover, under Article II:4 import monopolies may not operate in a way as to afford protection on the average in excess of the protection allowed under the binding commitments of the member country, nor may an import monopoly charge prices in excess of costs plus a reasonable margin of profit. The rules apparently do not preclude setting different prices in different export markets or taking advantage of tied loans.

30. For transition economies, an important provision is that government procurement appears to fall under the cope of Article XVIII. Thus, Davey (1998) shows that Article XVII:2 which, in excepting members from the obligations of paragraph 1 in respect of non-discriminatory treatment and making purchase according to commercial considerations, requires “fair and equitable treatment” for other members when importing products for government use. Davey interprets this as requiring MFN treatment in government procurement, although there has been no panel ruling at this time.

31. If state trading enterprises operated on the same principles as private sector firms or in competition with in their purchasing and selling operations, some of the concerns would not exist. However, even in such cases, the extent of their market power may lead to pricing inconsistent with normal competition. Under such conditions, a government may wish to consider an appropriate form of regulation for the sector.

IV. PRIVATIZATION

32. Irrespective of political or philosophical reasons, the main economic reasons for privatization include the search for greater efficiency, the need to reduce domestic fiscal deficits and the reduction of foreign debt. Greater efficiency arises when enterprises make business decisions according to the best prices and management practices; other business and consumers then benefit from lower prices which feed throughout the economy. The reduction of fiscal deficits is possible when loss-making enterprises are divested and there is a lesser need to re-inject new capital from time to time; the importance of the gain is that lower deficits are consistent with the control of inflation and the money saved can be used for other social goals, such as education, health and infrastructure. The reduction of foreign debt is possible through cash sales or debt-for-equity swaps, both of which reduce the burden of debt servicing.

33. There is a strong case for privatization, even where state-owned enterprises are operating without having to call on the state for operating or capital replacement funds. A recent study of 61 privatized companies in 18 countries (six developing and 12 developed) showed that, in at least two-thirds of the divestitures, privatization increased profitability, sales, operating efficiency and capital investment – all without any reduction in employment (World Bank, 1996). Recent studies of the emerging results in Central and Eastern European countries and the former Soviet Union are also encouraging, although there is some variation in the results which seems to be linked to the method of privatization and the identity of the new owner (e.g., new investors or insiders from the previous state-owned enterprise). In a different approach, East Asian planned economies adopted swift and far-

reaching state enterprise reforms, eliminating budget support, cutting the number of firms, allowing some private sector competition and dismissing workers; this has produced important benefits in the short-term, but a number of distortions continue which could hinder long-term competitiveness. China continues to be concerned with the performance of its state companies, and has been expanding the scope for private sector initiatives.

34. In areas other than the “natural monopolies” (basic services or utilities), some transition economies, instead of divestiture of state-owned enterprises, have preferred to follow an approach which imposes stricter financial disciplines and restructuring of the enterprises while allowing a degree of competition from the private sector. In other cases, privatized companies are given subsidized supports, technical assistance, management training, cheap loans debt forgiveness, export assistance and protection from import competition. This is a regime similar to a number of East Asian NICs (newly industrialising countries), which, until the current Asian crisis, seemed to be a formula for success. The argument is similar to the infant industry argument for trade protection, allowing the enterprises time, protection and resources to become more competitive. But the history of trade protection shows that such “infants” do not always grow up, remaining a drain on national resources. A study of four Central and Eastern European countries also shows that governments are have no special advantage in “picking winners” in determining survivor enterprises, so that direct intervention is best avoided except perhaps in transparent subsidies to facilitate adjustment (World Bank, 1996).

35. The radical approach to privatization is to abolish or privatize state-owned enterprises, allowing the private sector to fill the gap. This also reduces the risk of reverting to a full state-owned operation in any sector. In the early stages of transition, where private sector may be weak, it may be preferable initially to allow private sector to compete alongside such enterprises. But this is a second-best, interim solution, because the private sector will be reluctant to enter the market under the threat of unfair competition from a public enterprise with unlimited resources. Thus, despite the risks, a brisk move towards full privatization is more likely to bring the benefits more rapidly.

36. In mixed economies, such as most developing countries, a privatization can proceed quickly, but in the transition economies it may be necessary, before wholesale privatization, to take the time to put in place a business framework in which private firms can easily be established and compete freely. Such a business environment needs a transparent and secure institutional, legal and regulatory framework to protect property rights, etc. Efficient financial markets may also be a prerequisite for private sector development. In some countries, it may be necessary to build public support for privatization with a clear statement of the goals, including the planned social programmes to be financed with the fiscal gains, and the establishment of open and competitive mechanisms for divestiture and means by which the public can also participate (e.g., voucher programmes).

37. Another case for a slower privatization may be the desire to slim down the operations and make the state-owned enterprise more attractive to potential private sector buyers. It may also be argued that putting a large number of enterprises up for sale at the same time will flood the market and reduce the amount that may be obtained from the sale. On the other hand, this has to be weighed against the cost of ongoing losses, the risk that the managers and workers of enterprises to be privatized will strip the more valuable assets, and the possibility that the continued operation of such enterprises will delay cost savings in other sectors (World Bank, 1997). Moreover, even when higher sales prices are anticipated in the future, these have to be discounted back to their present values.

38. In making such calculations, the fiscal situation in the country will need to be taken into consideration. A country with a sizeable external debt and deteriorating fiscal and BOP situation will want to move more quickly, both to stem the cash flows as well as to obtain the efficiency gains as soon as possible, as was the case in Argentina’s Convertibility Plan of 1991. It is also likely that a full-scale, rapid privatization adds to the credibility of the overall reform package, encompassing the whole gamut of macro-economic and trade policy adjustment.

39. The case of "natural monopolies" is somewhat different from industrial sectors. These are large, capital intensive industries providing inputs into other sectors as well as public services. Privatization usually entails separating the pure monopoly part, such as the distribution networks for gas, water or basic telecommunications, from the parts where competition is feasible. The new enterprises have to be created and then sold. The major difference for the natural monopoly is that a regulatory institution and framework covering price and quality have to be established for the monopoly part (see section on regulation). Such policies are crucial for a successful privatization which will also ensure future investment in the sector (as in the case of Hungary).

40. Of course, in very few countries is there comprehensive privatization and it takes time to push through any privatization programme. Moreover, privatization may replace a state-owned monopoly with a private or partly private monopoly, as is common in many basic services or utilities. In other cases, the state-owned enterprise is maintained under full or partial state ownership but private firms are allowed to compete fully. Thus, most economies have a mixture of private, state-owned and mixed enterprises.

V. FOREIGN DIRECT INVESTMENT

41. In many countries, attitudes to privatization resemble attitudes to foreign direct investment (FDI), and in some cases they amount to the same thing. Casual observation suggests that foreign investment policies, like trade and other industrial policies, are often based on perceptions of the gains to influential groups within the community rather than the national interest as a whole. This is because, as with trade and industrial policies, the natural instinct is not necessarily what is good for national welfare as a whole and the apparent conflict between national and foreign interests often disappears on close analysis. As Kindleberger (1973) said: "Social man tends to some considerable degree to be a peasant with a territorial instinct which leads him to object to foreign ownership of national natural resources: a Populist, which makes him suspicious of banks; a mercantilist, which makes him favour exports over imports; a xenophobe, which leads him to fear those from outside the tribe; a monopolist, who reacts strongly against competition; and an infant, to the extent that he wants to eat his cake and have it too. It is overstating the case to suggest that these instincts are at the basis of three quarter of the objections to foreign investment, but the proportion cannot be much below two thirds..."

42. A number of non-economic factors are often brought into decisions to approve investment or allow it to proceed. These include defence arguments and arguments relating to the non-functioning of markets, e.g., the infant industry argument in developing countries. The most often expressed fear about FDI is that the country will lose control of its domestic resources. Most commonly controls on foreign investment are applied in the area of natural resources such as petroleum or mineral exploration and exploitation. However, it is also often extended to "key" industries such as defence industries (armaments, aircraft manufacture, etc.), as well as service industries, such as shipping, air transport, ports, etc. or industries related to cultural independence, such as the mass media - TV stations or programming, press, films.

43. In some cases foreign investment is not prohibited but limited to less than a controlling interest, e.g., less than 50 per cent of total or equity shares. In other cases, where foreign investment is allowed, there are special terms imposed by the host Government. This occurs, for example, in cases of joint ventures or industrial collaboration arrangements. Controls may be imposed on the royalty payments or the repatriation of profits. There may be limits on sales of assets, perhaps to discourage footloose industries. With respect to production there may be local content requirements, export-performance requirements, a need to use local labour or upgrade local management, technology requirements, etc. The host Government may set limits to patents on products and/or processes.

44. By contrast, some governments promote FDI by offering a variety of incentives, including tax holidays, tax exemptions, tax rebates, etc. as well as protection or industry assistance. However, such

incentives can dissipate the benefits of FDI, and it has been found greater importance is attached by foreign firms to open and transparent investment regimes, with protection for property rights, judicial security and good governance. Moreover the costs and benefits of different policies, be they performance requirements, cash grants or other forms of incentive - and of the benefits the investments ultimately confer on the host country - are not transparent. This opacity makes it difficult for taxpayers and other countries to know how much protection is being afforded and what are its effects. As Guisinger (1987) notes: "It is doubtful that governments ever know the exact tax or subsidy on firms achieved by investment policies. But the great variety of policy instruments and the proliferation of investment-screening agencies with discretionary powers suggest a strong desire to intervene in a discriminating fashion rather than to remain passive providers of protection."

45. The bulk of experience of recent years is that FDI brings important advantages through new technologies and enhanced access to overseas markets, stimulating production and trade. Foreign investment, like domestic investment, increases income and employment in the process of capital formation and in due course increases capacity to reach even higher income levels after capital has been formed. The gains from trade liberalization can be enhanced by allowing investment to pursue the more efficient production capabilities from comparative advantage (and hence achieve also the increased consumption possibilities associated with trade). If markets are functioning efficiently, foreign investment, like foreign trade, increases global economic welfare and can also eventually help to equalize the returns to the different factors. With appropriate pricing and regulatory policies, many of the fears of FDI are proving unjustified.

VI. COMPETITION AND REGULATION

46. Competition policy and the regulatory framework within individual countries are important to ensure the working of internal markets and to ensure the benefits of trade liberalization are passed on to consumers. Countries using trade polices as part of their efforts to tackle domestic inflation are also similar concerned to ensure the transmission of international prices onto domestic markets. However, such policies have also attracted increasing attention at the international level because of concerns that restrictive practices are negating the effects of market access negotiations. Again, the development of international rules on the treatment of foreign companies in the areas of investment (cross-border supply of services under the GATS and potentially under the OECD Multilateral Agreement on Investment) and intellectual property has led to parallel international co-operation to deal with possible anti-competitive practices by such companies (WTO, 1997).

47. There is a substantial body of literature (reviewed in WTO, 1997) that suggests that open and functioning competitive markets are the most conducive to economic development. In practice, it would seem that different market structures may require different competition or regulatory approaches. A government monopoly may not need regulation on the assumption that it always acts in the public interest. On the other hand, mergers in the private sector may lead to an abuse of dominant market position and where a private monopoly is approved it may normally be expected to operate under a regulatory framework covering pricing policies. Of course, a government may also take the view that the market does not require regulation, for example, because, when there is free trade in goods and services, new entrants will be attracted by high profits if existing firms try to extract high profits (economic rent). This argument is valid unless there are high set-up costs and long establishment periods in the particular sector, e.g., related to economies of scale, legal procedures or construction.

48. Research and experience show that there are areas where certain business practices that are themselves anti-competitive may under certain circumstances lead to improvements in economic welfare. For example, mergers may bring productivity gains that offset higher prices to consumers. Protection of intellectual property is seen as necessary to promote investment in research and development that have long-term benefits, e.g., in pharmaceuticals. Under certain circumstances, vertical market constraints, between operators at different stages in the production and marketing chains, may enhance product choice and after sales service for consumers. These possible trade-offs

mean that it is not possible to have hard and fast rules for all cases and that is often necessary to apply a rule of reason under which the authorities evaluate practices on a case by case basis. While mergers may reduce costs, they may also raise prices and shut out competitors; for this reason mergers have to be examined in terms of the market concentration, barriers to entry and the existence of substitutes as well as the relevant product and geographic markets to ensure that there is no abuse of dominant position. On the other hand, there is wide-spread agreement that certain practices such as bid-rigging or horizontal price fixing are unambiguously harmful and should be prohibited *per se*.

49. The adoption of competition laws can strengthen the role of market forces in an economy and can be a factor in enhancing the attractiveness of host countries for foreign investment and technology transfer. Although there is an argument that the needs of developing and transition economies can best be served by the promotion of large domestic firms with mandates for the production and marketing of certain products, a large body of evidence suggests that the international competitiveness of firms is more likely to be enhanced than undermined by the existence of vigorous competition in home markets, obliging them to constantly upgrade their product and marketing techniques and to respond quickly to changing market conditions (WTO, 1997).

50. A number of areas have been identified where regulatory policies and practices, implying an ongoing relationship between the firms and the regulator, can enhance welfare, correcting market imperfections. They can prevent the abuse of monopoly power by private or privatized enterprises which are otherwise exempt from the normal competition laws. They can also protect consumers from information asymmetries. For example, banks know more about the quality of their portfolios than their customers who need to be protected by adequate prudential supervision and reporting requirements. Good regulatory policies also provide assurance of fair prices with reasonable profits, e.g., by price capping, under a stable long-term operating framework, which encourages investment in infrastructure projects, power generations, telecommunications, and so on. Regulation can also oblige operators to take account of social costs by requiring operators to use technologies to avoid environmental damage or to provide for subsequent corrections by landscaping or re-forestation, as appropriate. Moreover, good regulatory policies can help win public acceptance of privatization programmes (World Bank, 1997).

51. A “good regulatory policy” not only refers to the design of the policy but also to the transparency and stability of the mechanism. There is also a need for restraint on regulatory discretion, including well-developed rules of administrative process and constitutional protection, otherwise the process can be captured by special interests and subject to political whims (World Bank, 1997). Any such instability is not conducive to long-term investment or innovation, which can weaken the infrastructure, with negative knock-on effects on other sectors of the economy. Membership of the World Bank’s Multilateral Investment Guarantee Agency (MIGA) can provide a strengthening of guarantees for foreign investors and offset pressures on governments to reverse policies.

52. However, the precise regulatory framework may need to be tailored to the country’s institutional capability. For example, if the market appears to be working then a hands-off approach is indicated: competition, transparency and public pressures avoid the need for rules-based solutions. If formal rules are thought necessary to correct market failure, then there needs to be the political will and judicial institutions to enforce the rules in a transparent and stable manner.

VII. CONCLUSIONS

53. Transition economies in the process of accession to the WTO should find that their drive towards improved economic policies will take them further than strict WTO rules in the areas of procurement, state trading and competition policy, but, as in other areas, accession negotiations are unique in each case and larger markets are likely to come under pressure to sign the GPA and assure other WTO members that their remaining state-trading enterprises do not constitute obstacle to trade. While privatization will help markets work more efficiently, the remaining core of state activity in

natural monopolies will be sizeable so that opening up procurement markets and reducing the role of or eliminating state-trading enterprises will continue to be desirable to help reduce fiscal deficits and improve the allocation of resources. The fact that so many countries have hesitated to adhere to the GPA suggests serious weaknesses with the agreement, and new WTO members, while opening their procurement markets for their own good reasons, may yet hesitate to take on the precise undertakings of the GPA; in the meantime, they may wish to consider adoption of the procurement practices under the UNCITRAL Model Law.

54. The absence of multilaterally agreed rules on government procurement is an important weakness in the WTO system. This will be partially remedied by the current negotiations for an agreement under the General Agreement on Services (GATS). Moreover, there is expected to be pressure to extend the GPA into an obligatory undertaking in any new round of negotiations, at least by providing for transparency in procurement.

55. Some resistance may occur both with respect to privatization of state-owned enterprises and the establishment of competing private investment, especially where foreign direct investment is involved. Both privatization and FDI tend to provoke nationalist and populist sentiments, but have proven to be important catalysts in revitalizing economies of all kinds. The key to successful privatization and capturing the gains from FDI is a stable, secure and transparent investment regime in a framework of good governance and political stability.

56. Where privatization takes place and, in any case, where there are market imperfections, an appropriate regulatory or competition policy framework is also essential, but the extent to which the state will intervene in this way depends on individual markets. In a number of basic services, there may be a need for a core monopoly element which requires ongoing regulation under a stable, long-term framework that provides incentives for innovation and investment. Peripheral services and other economic endeavours may well fall under the normal competition policy framework, prohibiting certain activities *per se* while applying the rules of reason to other activities. Such rules are essential to achieving the benefits of economic liberalization.

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