

ESSAYS IN INTERNATIONAL FINANCE

No. 76, November 1969

HOW TO DIVEST IN LATIN AMERICA,
AND WHY

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INTERNATIONAL FINANCE SECTION

DEPARTMENT OF ECONOMICS

PRINCETON UNIVERSITY

Princeton, New Jersey

This is the seventy-sixth in the series ESSAYS IN INTERNATIONAL FINANCE *published from time to time by the International Finance Section of the Department of Economics of Princeton University.*

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International Finance Section

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Department of Economics
Princeton University
L.C. Card No. 70-107369

Printed in the United States of America by Princeton University Press
at Princeton, New Jersey

HOW TO DIVEST IN LATIN AMERICA, AND WHY

The dispute between Peru and the United States over the expropriation of the International Petroleum Company is only one of a monotonously long list of incidents and conflicts which call into serious question the wisdom of present institutional arrangements concerning private international investment. This paper will discuss the principal weaknesses of these arrangements, with particular emphasis on political economy rather than on economics proper, and will then survey a number of ways in which current institutions and practices could be restructured. It is written against the backdrop of rising nationalism and militancy in the developing countries, particularly in Latin America, and of an astounding complacency, inertia, and lack of institutional imagination on the part of the rich countries.

The basic position adopted here with respect to foreign private investment is that it shares to a very high degree the ambiguity of most human inventions and institutions: it has considerable potential for both good and evil. On the one hand, there are the celebrated and undoubted contributions of private international investment to development: the bringing in of capital, entrepreneurship, technology, management and other skills, and of international market connections, all of which are either wholly lacking in the poor countries, or are in inadequate supply given the opportunities and programs for economic development. On the other hand, foreign investment brings not only the dangers of economic plunder and political domination which are the stock-in-trade of the various theories of imperialism, but a number of other, more subtle, yet serious effects and side-effects which can handicap the development efforts of countries placing prolonged and substantial reliance on private investment from abroad. The picture that has sometimes been painted of the career of foreign investment is that at one time, long ago, the negative aspects predominated: there was sheer exploitation of human and natural resources as well as crude power play in the early free-wheeling days, when capital followed the flag or was, on the contrary, the "cat's paw of empire"; but this unfortunate phase has been outgrown, so it is widely thought, with decolonization, with the world-wide assertion of national sovereign states and their taxing powers, and with the desire, on the part of modern foreign investors, to perform as "good corporate citizens" of the host country and as

“partners in progress.” Unfortunately, this edifying story of human progress is incomplete and one-sided. It can, in fact, be argued that certain negative aspects of foreign investment do not only continue to coexist with the positive ones, but typically tend to predominate over them as development proceeds, at least up to some point. These are the just-mentioned “more subtle” effects and side-effects that will now be briefly explained.

PRIVATE FOREIGN INVESTMENT—AN INCREASINGLY
MIXED BLESSING

The positive contribution of foreign investment to an economy can be of various kinds. In the first place, it can supply one of several *missing* factors of production (capital, entrepreneurship, management, and so forth), factors, that is, which are simply and indisputably not to be found in the country receiving the investment. This is the situation often prevailing in the earliest stages of development of a poor country. More generally, foreign investment can make it possible for output to increase sharply, because it provides the recipient economy with a larger *quantity* of comparatively scarce (if not entirely missing) inputs.

Another contribution of foreign investment, conspicuous in relations among advanced industrial countries and inviting often a two-way flow, is of a rather different nature: it can have a teaching function and serve to improve the *quality* of the local factors of production. By on-the-spot example and through competitive pressures, foreign investment can act as a spur to the general efficiency of local enterprise. This effect is likely to be particularly important in economic sectors which are sheltered from the competition of merchandise imports from abroad. Such sectors (services, industries with strong locational advantages) appear to expand rapidly at advanced stages of economic development. If foreign investment is successful in enhancing the quality of local enterprise, then its inflow will be providentially self-limiting: once the local business community achieves greater efficiency, there will be fewer openings for the demonstration of superior foreign techniques, management, and know-how. But what if local businessmen, faced with overwhelming advantages of their foreign competitors, do not respond with adequate vigor and, instead, deteriorate further or sell out? This is, of course, the nub of recent European fears of the “American challenge.” I cannot deal here with this problem, but the fact that it exists has interesting implications for the topic at hand.

If foreign investment can fail to improve and may even harm the *quality* of local factors of production, then the question arises whether

it may also, under certain circumstances, lead to a decrease in the *quantity* of local inputs available to an economy. In other words, could the inflow of foreign investment stunt what might otherwise be vigorous local development of the so-called missing or scarce factors of production?

This question has been little discussed. (Important exceptions are the article by J. Knapp "Capital Exports and Growth," *Economic Journal*, September 1957, and the paper by Felipe Pazos cited below.) The reason for the neglect lies in the intellectual tradition which treats international investment under the rubric "export of capital." As long as one thinks in terms of this single factor of production being exported to a capital-poor country, it is natural to view it as highly complementary to various local factors—such as natural resources and labor—that are available in abundance and are only waiting to be combined with the "missing factor" to yield large additional outputs. But, for a long time now, foreign investors have prided themselves on contributing "not just capital," but a whole bundle of other valuable inputs. In counterpart to these claims, however, the doubt might have arisen that some components of the bundle will no longer be purely complementary to local factors, but will be competitive with them and could cause them to wither or retard and even prevent their growth.

The possibility, and indeed likelihood, that international *trade* will lead to the shrinkage and possibly to the disappearance of certain lines of local production as a result of cheaper imports has been at the root of international-trade theory since Adam Smith and Ricardo. This effect of trade has been celebrated by free traders through such terms as "international specialization" and "efficient reallocation of resources." The opponents of free trade have often pointed out that for a variety of reasons it is imprudent and harmful for a country to become specialized along certain product lines in accordance with the dictates of comparative advantage. Whatever the merit of these critical arguments, they would certainly acquire overwhelming weight if the question arose whether a country should allow itself to become specialized not just along certain commodity lines, but along factor-of-production lines. Very few countries would ever consciously wish to specialize in unskilled labor, while foreigners with a comparative advantage in entrepreneurship, management, skilled labor, and capital took over these functions, replacing inferior "local talent." But this is precisely the direction in which events can move when international investment, proudly bringing in its bundle of factors, has unimpeded access to developing countries. (In the fine paradoxical formulation of Felipe Pazos: "The main weakness of

direct investment as a development agent is a consequence of the complete character of its contribution." See his paper "The Role of International Movements of Private Capital in Promoting Development," in John H. Adler, ed., *Capital Movements and Economic Development*, 1967, p. 196.)

The displacement of local factors and stunting of local abilities which can occur in the wake of international investment is sometimes absolute, as when local banks or businesses are bought out by foreign capital; this has in fact been happening recently with increasing frequency in Latin America. But the more common and perhaps more dangerous, because less noticeable, stunting effect is relative to what might have happened in the absence of the investment.

As already mentioned, foreign investment can be at its creative best by bringing in "missing" factors of production, complementary to those available locally, in the early stages of development of a poor country. The possibility that it will play a stunting role arises later on, when the poor country has begun to generate, to a large extent no doubt because of the prior injection of foreign investment, its own entrepreneurs, technicians, and savers and could now do even more along these lines if it were not for the institutional inertia that makes for a continued importing of so-called scarce factors of production which have become potentially dispensable. It is, of course, exceedingly difficult to judge at what point in time foreign investment changes in this fashion from a stimulant of development into a retarding influence, particularly since during the latter stage its contribution is still ostensibly positive—for example, the foreign capital that comes in is visible and measurable, in contrast to the domestic capital that might have been generated in its stead. One can never be certain, moreover, that restrictions against foreign investment will in fact call forth the local entrepreneurial, managerial, technological, and saving performances which are believed to be held back and waiting in the wings to take over from the foreign investors. Nevertheless, a considerable body of evidence, brought forth less by design than by accidents such as wars, depressions, nationalist expropriations, and international sanctions, suggests strongly that, after an initial period of development, the domestic supply of routinely imported factors of production is far more elastic than is ever suspected under business-as-usual conditions. If this is so, then the "climate for foreign investment" ought to turn from attractive at an early stage of development to much less inviting in some middle stretch—in which most of Latin America finds itself at the present time.

The preceding argument is the principal economic reason for anticipating increasing conflict between the goals of national development and

the foreign-investment community, even after the latter has thoroughly purged itself of the excesses that marred its early career. The argument is strengthened by related considerations pertaining to economic policy-making, a "factor of production" not often taken into account by economists, but which nevertheless has an essential role to play. In the course of industrialization, resources for complementary investment in education and overhead capital must be generated through taxation, the opening up of new domestic and foreign markets must be made attractive, institutions hampering growth must be reformed, and powerful social groups that are antagonistic to development must be neutralized. The achievement of these tasks is considerably facilitated if the new industrialists are able to speak with a strong, influential, and even militant voice. But the emergence of such a voice is most unlikely if a large portion of the more dynamic new industries is in foreign hands. This is a somewhat novel reproach to foreign capital, which has normally been taken to task for being unduly interfering, wire-pulling, and domineering. Whatever the truth about these accusations in the past, the principal failing of the managers of today's foreign-held branch plants and subsidiaries may well be the opposite. Given their position as "guests" in a "host country," their behavior is far too restrained and inhibited. The trouble with the foreign investor may well be not that he is so meddlesome, but that he is so mousy! It is the foreign investor's mousiness which deprives the policy-makers of the guidance, pressures, and support they badly need to push through critically required development decisions and policies amid a welter of conflicting and antagonistic interests.

The situation is in fact even worse. Not only does policy-making fail to be invigorated by the influence normally emanating from a strong, confident, and assertive group of industrialists; more directly, the presence of a strong foreign element in the dynamically expanding sectors of the economy is likely to have a debilitating and corroding effect on the rationality of official economic policy-making for development. For, when newly arising investment opportunities are largely or predominantly seized upon by foreign firms, the national policy-makers face in effect a dilemma: more development means at the same time less autonomy. In a situation in which many key points of the economy are occupied by foreigners while economic policy is made by nationals it is only too likely that these nationals will not excel in "rational" policy-making for economic development; for, a good portion of the fruits of such rationality would accrue to non-nationals and would strengthen their position. (For some interesting remarks along these lines, see Hans O. Schmitt, "Foreign Capital and Social Conflict

in Indonesia," *Economic Development and Social Change*, April 1962.) On the other hand, the role and importance of national economic policy-making for development increases steadily as the array of available policy instruments widens, and as more group demands are articulated. Hence the *scope* for "irrationality" actually expands as development gains momentum. That its *incidence* increases also could probably be demonstrated by a historical survey of tax, exchange-rate, utility-rate and similar policies that were aimed directly or indirectly at "squeezing" or administering pin pricks to the foreigner, but managed, at the same time, to slow down economic growth.

The preceding pages have said next to nothing about the direct cost to the capital-importing country of private international investment nor about the related question of the balance-of-payments drain such investment may occasion. While these matters have long been vigorously debated, with the critics charging exploitation and the defenders denying it, the outcome of the discussion seems to me highly inconclusive. Moreover, undue fascination with the dollar-and-cents aspects of international investment has led to the neglect of the topics here considered, which, I submit, raise issues of at least equal importance and suggest a simple conclusion: strictly from the point of view of development, private foreign investment is a mixed blessing, and the mixture is likely to become more noxious at the intermediate stage of development which characterizes much of present-day Latin America.

Hence, if the broadly conceived national interest of the United States is served by the development of Latin America, then this interest enters into conflict with a continuing expansion and even with the maintenance of the present position of private investors from the United States. Purely political arguments lend strong support to this proposition. Internal disputes over the appropriate treatment of the foreign investor have gravely weakened, or helped to topple, some of the more progressive and democratic governments which have held power in recent years in such countries as Brazil, Chile, and Peru. Frictions between private investors from the United States and host governments have an inevitable repercussion on United States-Latin American relations. In a number of cases such disputes have been responsible for a wholly disproportionate deterioration of bilateral relations. The continued presence and expansion of our private-investment position and our insistence on a "favorable investment climate" decisively undermined, from the outset, the credibility of our Alliance for Progress proposals. Land reform and income redistribution through taxation are so obviously incompatible, in the short run, with the maintenance of a favorable investment climate for private capital that insistence on both could only be interpreted to sig-

nify that we did not really mean those fine phrases about achieving social justice through land and tax reform.

If these political arguments are added to those pertaining to economics and political economy, one thing becomes clear: a policy of selective liquidation and withdrawal of foreign private investment is in the best mutual interests of Latin America and the United States. Such a policy can be selective with respect to countries and to economic sectors and it ought to be combined with a policy of encouraging new capital outflows, also on a selective basis and with some safeguards.

THE "LOST ART" OF LIQUIDATING AND NATIONALIZING FOREIGN INVESTMENTS

Before the possible elements of such a policy are examined, it is worth noting that liquidation of foreign investment has frequently happened in the history of capital movements. But, as a result of convergent developments, such liquidation has strangely become a lost art. Worse, this art has not been properly recorded by economic historians. In part, this is so because economic historians, like both the advocates of foreign investment and its critics, have been far more interested in the tides of capital flow than in its occasional ebbs. Moreover, the tides have been more regular and easier to detect and measure.

Some of the "mechanisms" which in the past permitted partial liquidation of foreign investment have been the unintended side-effects of such large-scale, sporadic, and wholly unedifying happenings as wars and depressions. The two World Wars led to a substantial decline in both the absolute and the relative importance of foreign investment in the national economies of Latin America. In the first place, with most Latin American countries joining the Allies, German investments, a not unimportant portion of the total (think of all those prosperous breweries!), were expropriated. Secondly, the British were forced in both World Wars to liquidate a good portion of their security holdings, in order to pay for vitally needed food, materials, and munitions. Some of these securities were acquired by the citizens of the countries for which they had originally been issued. Thirdly, Latin American countries acquired large holdings of gold and foreign currencies during the wars, as they continued to export their primary products, but were unable to obtain industrial goods from the belligerents. These accumulated holdings made it possible for them to buy out some foreign investments in the immediate postwar period. The most conspicuous, but by no means the only, instance of this sort of operation was the purchase from their British shareholders of the Argentine railways by the Perón government in 1946. Finally, the wars led to a complete interruption

of capital inflow. Since, at the same time, Latin America's industrial growth was strongly stimulated, the relative importance of activities controlled by foreign capital declined substantially.

The depressions which periodically afflicted the centers of capitalist development until the Second World War had similar results. Again, capital inflow would stop for a while during periods in which the Latin American economies frequently received growth impulses because, with foreign-exchange receipts low, imports had to be throttled, giving domestic industrial production a fillip. Moreover, when overextended corporations based in the United States and Europe fell on hard times, a sound management reaction was frequently to retrench and consolidate. In the process, foreign branch plants and subsidiaries were sold off to local buyers, a process which has been well documented in the case of American investments in Canada during the depression of the thirties. (See H. Marshall, F. A. Southard Jr. and V. W. Taylor, *Canadian-American Industry*, 1936, pp. 252-262.) Sometimes, especially in the case of European firms, these transfers took the form of ownership and control passing into the hands of the parent company's local managers who, while of foreign origin, would eventually become integrated into the local economy. Finally, of course, there were cases of outright bankruptcy and forced liquidation.

The quantitative importance of these various factors remains to be established. But, in the aggregate, they must have had a substantial limiting effect on the foreign-investment position in Latin America during the first half of the 20th century.

Actually, a less cruel mechanism permitting the nationalization of foreign investment was also at work before the "good old days" of portfolio investment had been eclipsed by direct investment. While those days were of course by no means wholly good, portfolio investment, which took primarily the form of fixed-interest bond issues, did have several advantages for the capital-importing country. Among these, the lower cost and the existence of a termination date have been mentioned most frequently. There is, however, one further property of portfolio investment which is of particular interest in the context of the present essay. This is the fact that nationalization of portfolio investment could take place at the option of the borrowing country and its citizens, who were free to purchase in the international capital markets securities that were originally issued and underwritten in London or Paris. I have collected (and hope eventually to publish) considerable evidence that these so-called "repurchases" of securities by nationals of the borrowing countries took place on a large scale in such countries as the United States, Italy, Spain, Sweden, and Japan in the

late 19th and early 20th centuries. They also occurred in much poorer countries, such as Brazil, and were in general so widespread that the phenomenon is referred to in one source as "the well-known *Heimweh* [homesickness] of oversea issued securities." (J. F. Normano, *Brazil: A Study of Economic Types*, 1935, p. 157.) As a result of this *Heimweh*, then, an increasing portion of maturing bond issues often came to be owned by the nationals of the borrowing country, so that payment at maturity did not occasion any balance-of-payments problem.

This is not the place to speculate on the reasons for which the bonds issued abroad became so often a preferred medium of investment for national capitalists; suffice it to say that patriotism or nationalism on the part of local investors probably had little if anything to do with it. Whatever the reason, it appears that international investment, as formerly practiced, permitted the gradual transfer, via anonymous market transactions, of foreign-held assets to nationals, entirely in accordance with the capabilities and wishes of the borrowing country's own savers.

Today's arrangements are totally different, of course. Transfer to local ownership and control of foreign-held subsidiaries requires either an initiative on the part of the parent company or a decision to expropriate on the part of the host government. A valuable mechanism of smooth, gradual, and peaceful transfer has become lost in the shuffle from portfolio to direct investment.

Up to this point, it has been established (1) that progressive liquidation and nationalization of foreign private investments is likely to become desirable in the course of economic development, and (2) that mechanisms to this end functioned, if unwittingly and irregularly, in the 19th and through the first half of the 20th century, but have no longer been available over the past 25 years or so.

The purpose of recalling these mechanisms was to sharpen our institutional imagination and perception for substitute mechanisms which it may be desirable to put into place at the present time. An open and far-ranging discussion of various possible alternatives is obviously desirable. The following pages are meant as a contribution to such a discussion, rather than as a fixed set of proposals.

A SURVEY OF POSSIBLE DIVESTMENT MECHANISMS

An attempt will now be made to sketch possible answers to the following questions:

1) What arrangements should be made to permit the transfer to local ownership and control of existing foreign-held investments?

2) What arrangements should exist for this transfer in the case of new foreign investments?

3) To what extent should devices that are designed for the purposes just indicated be modified in the light of other important objectives of the developing countries, such as the export of manufactures and the promotion of local centers of technological research and innovation?

These questions will be taken up in order, although there is considerable overlap between the answers to the first two questions.

An Inter-American Divestment Corporation

In the light of the above considerations, partial liquidation of *existing* foreign investments in Latin America is outstandingly important. The book value of direct investments by the United States in Latin America amounted to 11.9 billion dollars at the end of 1967, while the annual outflow of fresh capital from the United States (outside of reinvested profits) never reached 500 million dollars during the past five years, even on a gross basis. The steady increase in book values is, moreover, due more to the reinvestment of profits than to fresh funds newly invested. In other words, if the quantitative and qualitative role of foreign-controlled enterprise in Latin America is judged to be excessive, something must be done about the existing foreign firms operating in the area, rather than only about those that may conceivably establish operations there in the future.

Vital as it is, this subject has received much less attention than the desirable regime for new foreign investments. It is of course the politically most delicate part of the operation here contemplated. Also, from the economic point of view, the use of any capital and, worse, foreign-exchange resources for the purchase of property rights over assets already located and functioning within the territories of the developing countries seems perverse to those who remain basically convinced that the pace of economic development is conditioned on little else than the availability of capital and foreign exchange. Those who are not so convinced and who take seriously the economic and political arguments developed earlier would see nothing fatally wrong in allocating a portion of the country's savings and foreign-exchange resources to the purchase of foreign investments already in their midst. From the purely financial point of view, moreover, expenditure of foreign exchange for the purchase of existing foreign assets could in a number of cases be preferable to the indefinite servicing of these assets (depending on one's estimate of the applicable discount rate and of future earnings and remittance patterns). The trouble is that the recipient countries do not generally have the financial resources to seize these opportunities nor have they in fact been able to borrow or to use aid funds for this purpose. Moreover, even when local resources

are available there may be difficulties in bringing seller and buyer together, because the foreign owners may be ready to sell at a time when the local investors are not quite ready to purchase or because the two parties have difficulty in agreeing on the value of the assets to be transferred, without a mutually-trusted third party.

A need exists, then, for a financial intermediary, an agency, that is, which has resources of its own enabling it to acquire foreign-owned assets and to hold them until such time as it can place them with local investors. Dr. Raúl Prebisch earlier this year proposed that such an agency should be established within the Inter-American Development Bank. This course may well be preferable, because of the special urgency of the Latin American situation, to a suggestion I made as early as 1961, but with total lack of success, to the International Finance Corporation (IFC) that it devote a portion of its resources to this task.

The proposed agency—I shall call it the Inter-American Divestment Corporation—would engage in several distinct types of operations. In some cases it could limit its role to that of arbitrator and guarantor. As just noted, it could help set the fair price of the assets to be transferred from the foreign to the domestic owners and, if payment is to be made over a period of years, it could guarantee the debtor's obligation and, to some extent perhaps, the convertibility of his currency into that of the creditor. One can imagine situations in which the purchaser would have to be granted longer terms than can or should be imposed on the seller, as is common in some agrarian-reform operations. In this case, the Corporation would need to supply funds of its own to bridge the gap between the two sets of credit terms. The most usual type of operation would presumably consist in the outright acquisition by the Corporation of a controlling block of shares of the firm to be divested, without any fixed schedule of repurchase by local investors.

As in any foreign-aid project, some contribution should be forthcoming from the local government as an earnest that it judges the particular divestment to be important enough for it to commit some resources of its own. As the Divestment Corporation acquires experience, it should be able to attract additional resources from the private-investment-banking community, much as is done by the IFC in connection with new ventures.

Which foreign-owned firms should be eligible for divestment assistance on the part of the Corporation? In deciding this crucial matter, the Corporation should probably take its principal cues from the governments of the host countries. Just as the doctor asks the patient where it hurts, so the Corporation could periodically inquire among governments which are the firms where foreign ownership is felt to be irksome.

In many cases there will be a history of conflict which will clearly point to the main trouble spots. One can also easily imagine situations in which governments are reluctant to point a finger at specific firms. For this and other reasons, it should be possible for private parties in the host country, for the foreign investors, and for the Corporation itself to take the initiative in the divestment process which, in the end, will require the agreement of the host government as long as it is expected to contribute some of its own resources to each divestment operation.

An interesting question arises with respect to the eventual disposition of the equity which will be acquired by the Corporation. One objection will surely be levied against the operation: Is it really desirable to transfer presently foreign-owned firms to local ownership when the new owners cannot but be drawn from the very small clique of already too powerfully entrenched local capitalists? History issues a warning here, for this very sort of thing happened in the second half of the 19th century when liberal parties came to power in a number of Latin American countries. The newly installed, anti-clerical governments expropriated the sizable lands owned by the Catholic Church—and then proceeded to sell them at bargain prices to the landed elite. As a result, the concentration of landholdings became far more pronounced.

At the present time, the weight of concern over a similar development in case of nationalization of foreign investment varies no doubt from country to country, as well as from industry to industry within each country. Moreover, the Corporation could make a deliberate attempt to broaden the basis of industrial ownership when it sells its portfolio. This should, in fact, be one of its principal functions. If foreign-owned assets were to be sold directly to local investors, it would be impossible not to sell to the few and the powerful. But, if an intermediary stands ready to hold the divested assets for some time, the outcome may be quite different. One attractive possibility is that the agency would sell, on the installment plan, a substantial portion, and perhaps a majority, of the equity of the erstwhile foreign firms to white- and blue-collar workers, with first choice being given to those who are employed in such firms. This would be a method of tapping entirely new sources of capital formation. Moreover, in this manner, the liquidation of foreign ownership would become the occasion for effectuating, by the same stroke, a more equitable distribution of income and wealth within the host country. As in the case of the Mexican *ejido*, special safeguards may then have to be established to protect the new asset-holders against the temptation to sell out right away.

Those who have stressed the advantage of a late start have usually had in mind the technological windfalls accruing to the newcomers and

their freedom from a declining industrial plant based on some previous but now passé phase of industrial expansion. For various reasons, these advantages have been more in evidence for Germany and Japan than for countries whose industrialization was much more tardy; but the latter could perhaps attempt some social leapfrogging, as, for example, in the manner just indicated.

It is quite conceivable, moreover, that the foreign investors themselves would take a more benign view of divestment if they knew that their assets were to be transferred to their workers and employees rather than to their local competitors or to some public agency.

The projected divestment operations via a financial intermediary could be made to serve another objective that is particularly important within the present Latin American setting. It could help create financial and, hence, managerial ties among firms located in several Latin American countries. In this form a foundation would be laid for truly Latin American multi-national corporations. The absence of such corporations, combined with the ever alert presence throughout Latin America, of United States-controlled multi-national corporations, accounts for much of the timidity with which Latin Americans have moved so far in the direction of a Common Market. Thus, the proposed divestment, combined with a measure of "Latinamericanization," rather than mere nationalization, of the divested enterprises could impart a much needed momentum to the integration movement.

By now, I hope to have convinced the reader that it is worthwhile to raise funds for the Corporation. In part, such funds should simply be taken from the general pool of foreign-aid monies. For the reasons indicated, the use of aid funds for this purpose could be eminently "productive," using this term in a wide and realistic meaning. The question what fraction of the total should be allocated to this purpose is no doubt difficult to resolve; but it is not more so than many other allocation decisions that are constantly made in practice without the guidance or availability of precise "cost-effectiveness" criteria.

Nevertheless, the nature of the proposed operation may point to special sources of finance that are not available for other purposes, so that the Corporation would not have to compete for general-purpose aid funds. A first thought that comes to mind in this connection is that the opposition in the United States Congress to appropriations for foreign aid is now motivated, to an increasing extent, by apprehension over the way in which aid and its administration makes for uncontrollable and possibly escalating involvements by the United States in foreign countries. A program of financial assistance which would have disengagement as its principal objective might therefore gather more public support at

this point than the conventional aid program. In fact, if such a program were presented separately from conventional aid, a new political coalition might get behind it so that in the political sense the funds accruing for our purpose could become truly additional. Appropriation for the Corporation might also have other appeals. Aid for divestment is unexceptionable from the points of view of both balance-of-payments and inflationary impacts. The dollars disbursed by the agency would immediately return in full to the divesting country, such as the United States, but they would not enter directly into that country's spending stream.

The program may be opposed on the ground that the taxpayer of the United States should not be asked to "bail out" its corporations that have engaged in foreign operations at their own risk. In reply it may be argued that a large part of the risk of recent foreign investments has already been taken over by the taxpayer, through the investment-guaranty program. Moreover, the Divestment Corporation should be in a good position to minimize the "bail-out" aspect of its operations: one of its principal tasks would be to negotiate a fair price for the assets and to convince the foreign investors that are being bought out to accept deferred payment for a substantial portion of their claim.

In a search for special sources of finance, it is natural to eye those parties which stand to gain from the proposed operations. The beneficiaries, in a sense, are the foreign investors themselves. In the first place, they will receive a valuable new option—to sell out at a fair price—as a result of the contemplated arrangements. The proposed agency would in effect administer a program whose purpose is to *prevent* the confiscation of foreign-held assets by timely transfers of these assets. Obviously not all foreign-owned firms will be able to exercise the option. But the orderly liquidation of foreign ownership in the cases where it is particularly objectionable to the host country cannot help but be a boon to the remaining foreign-controlled firms. The presence in a country of foreign interests that are felt as irritants poses a danger for the prosperity and, indeed, the life of *all* foreign firms, no matter how constructive and popular they may be. Hence a contribution from all corporations with foreign assets can be justified. As long as firms are willing to pay a premium which insures them against the risks of actual confiscation, there is no reason why they should not contribute something toward a program which materially decreases these risks.

Another possible source of special finance for the divestment agency should be briefly mentioned. The agency may well be the ideal beneficiary of the much discussed "link" between the new monetary reserves created as a result of the Rio Agreement (the Special Drawing Rights) and the developing countries. The principal objection against any such

link has been that the reserve creation should not become a mechanism for effecting permanent transfers of real resources from one set of countries to another. This objection would be largely met if the industrial countries used part of their allocation of Special Drawing Rights for the subscription of capital or bond issues of the Divestment Corporation. The partial use of the new reserves for the repatriation of foreign-held assets could not have an adverse effect on the intended increase in world liquidity, for the simple reason that this use, unlike others that have been proposed, would not entail any real transfer of goods and services.

Built-in Divestment—a Garland of Schemes

Considering the mass of foreign investment, the Divestment Corporation will be able to operate only on a highly selective, *ad hoc* basis. The question arises, therefore, whether the institutional framework within which foreign investment is conducted should be modified with a view toward building into it a mechanism making for eventual divestment. This question is best discussed in considering desirable regimes for *new* investments. Whether any such regime could or should be extended to existing foreign-owned firms can be considered subsequently.

The topic has given rise to a considerable literature and to several proposals. For example, the desirability for foreign capital to become associated with local capital in joint ventures has been exhaustively canvassed. Whatever the merits of this device, its usefulness is now recognized to be limited. In many situations, particularly those involving the transfer of new and complex technology, complete foreign control and ownership is said to be required or desirable at the outset. For this reason, increased attention has been given—by such authors as Paul Rosenstein-Rodan, Paul Streeten, and Raymond Vernon—to the possibility of a gradual transfer of all or the majority of the new firm's capital to local ownership, in accordance with a fixed schedule.

This is a fruitful idea which should be spelled out in full institutional detail. Consideration should, for example, be given to the granting of fiscal incentives to firms electing this option. In the capital-exporting countries, the parent company committing itself to gradual divestment of its foreign assets over a stated number of years could be given a credit against its income-tax liability for some portion of its foreign-capital outlays; alternatively or additionally, the firm could be exempted from all capital-gains taxation on profits made in selling its foreign assets to local investors. The capital-importing country could facilitate divestment by allowing the foreign-owned company to pay income taxes in stock in lieu of cash. Such an arrangement would probably have to be restricted to economic sectors in which foreign enterprise is not com-

peting with domestic enterprises. Where there is actual or potential competition, the arrangement would give an unfair cash-flow advantage to the foreign firm.

Gradual divestment over a given number of years normally means expenditure of scarce foreign exchange. It also requires the finding of local partners. The difficulties here are, first, that such partners are not always easy to come by. It would be necessary to designate some public agency of the host country, perhaps acting in cooperation with the Inter-American Divestment Corporation, as a residual buyer of the stock to be transferred from the original owners in accordance with a fixed schedule and a prearranged price formula. Another drawback of a direct sale of assets from the foreign owners to nationals has already been mentioned. The local buyers that would be found most readily may not be the most desirable, if advantage is to be taken of the unique opportunity afforded by divestment for diffusing ownership more widely than before. Finally, in most situations, there will be a need to agree on a "fair price" of the assets: the potential for conflict over this issue is almost as great as that over the actual presence of foreign investment.

These problems of a scheduled gradual sale of equity from foreigners to nationals point toward a simpler and more radical arrangement: namely, that a firm established with foreign capital be given a term of x years, at the end of which all or the major portion of foreign ownership would simply be vacated, without any compensation. Some of the ideas already discussed in connection with the Divestment Corporation can be utilized in deciding on the parties on which ownership should be bestowed at the end of the term. Up to a certain percentage, the foreign owners could distribute the stock directly to their employees and workers, or to their favorite local charity or foundation, and another portion would be handed over to the Inter-American Divestment Corporation for the purpose of fostering industrial integration. The new owners would be free to negotiate a management contract with the former owner-operators.

Arrangements which set a time limit on ownership have long existed in concession contracts. The major drawback of such arrangements has also long been known: they encourage early depletion and discourage keeping up with technical progress during the years immediately prior to expiration. In manufacturing, the former danger would be rather smaller than in mining, and the latter would be reduced if the divesting firm is scheduled to maintain a minority equity position and is interested in a continuing relationship with its erstwhile foreign branch through management contracts and other technical-assistance services. Also, if the foreign owners know that they will be handing a substantial portion

of the equity over to their workers and employees or to their favorite charity or foundation in the host country, they will presumably be more reluctant to squeeze their property dry in the last years than they might be if it were to be handed to the government. Nevertheless, the objection to a fixed termination date is serious enough to prompt consideration of yet another institutional design.

Limiting ownership of a firm to a certain time period, at the end of which that ownership lapses or "expires" automatically, is tantamount to setting a ceiling on the profits the firm can remit to its parent. Why not make explicit this implicit ceiling on profit remittances? Instead of specifying the number of years a firm may remain in foreign hands, it would, in other words, be conceivable to limit the total amount of profits a subsidiary could remit to its parent. This amount would be related to the capital originally committed to the project, as well as to any fresh funds brought in subsequently over and above reinvested profits. Such a regime for divestment would have incentive effects directly opposite to those of the traditional concession. Since the firm can make the pleasure of control and ownership last by remitting as little as possible, that is, by reinvesting all of its profits, the incentive to deplete and milk the subsidiary would be replaced by the incentive to reinvest (on the assumption that management, control, and growth are important motivating forces for the modern corporation).

It may be useful to pick a number for illustrative purposes. Suppose that the ceiling on remittances is 200 per cent of the originally invested capital. This could mean, for example, that a parent company would lose ownership of its subsidiary after it had received a 10 per cent dividend on invested capital for 20 years. The internal rate of return of such a financial result would be just short of 8 per cent. In other words, if a rate higher than 8 per cent were appropriate as a discount rate in the particular environment where the subsidiary operates, a financial situation in which 10 per cent would be earned for 20 years would be superior to one in which 8 per cent would be earned in perpetuity. Hence, the perishable nature of the investment need not impair decisively its rentability, particularly in the frequently encountered situations where the applicable discount rate is fairly high.

Consideration could be given to the question whether, in computing the aggregate "allowable" profit, some discount rate should apply to the dividend remittances themselves. If this were done, payments made at a later date would contribute less heavily to the eventual extinction of ownership than payments made in the first years of the new enterprise and the incentive to postpone and hold down profit remittances might be further strengthened. The arguments against any such complication

are: first, that it is a complication; and, second, that the real burden of profit remittances for the host country does not depend so much on the country's national product, which can be expected to be larger in later years, as on its balance of payments, which could well be in a more critical position ten years *after* the initial investment than at the time at which the investment is made.

The last point highlights an important advantage of the scheme under discussion. One of the major complaints with respect to foreign investment has been that because of reinvestment of profits—which in turn are made possible in part through local borrowing—the book value of the foreign-owned firms is likely to grow apace during an initial period, so that eventual dividend remittances may be a multiple of the capital originally brought into the country. While the scheme here discussed encourages reinvestment of profits, it averts the threatening prospect of huge remittances which might be made once the firm's growth slowed down, when they could represent an unacceptable burden for the country's balance of payments.

In all fairness, so it may well be asked, if cumulative profits are subject to a ceiling should they not be granted a floor in compensation? No doubt, such a floor could make the scheme much more attractive to the capital-exporting firms. The floor should obviously be at most 100 per cent of the initially invested capital and probably rather less, so as to preserve an adequate degree of risk. Suppose a payback of 50 per cent of the invested capital is to be guaranteed as a consideration for the 200 per cent ceiling that is imposed on profit remittances. The capital-exporting country could provide such a guarantee simply by permitting the parent company a tax credit against its income-tax liability up to 50 per cent of the capital invested. As was pointed out before, such a tax credit may be desirable in any event in order to encourage firms that invest abroad to take advantage of the divestment options.

Once some of the divestment arrangements sketched out here become available for *new* investments, it will be desirable for *existing* investments to be able to participate in them. Existing foreign firms should, of course, be eligible to operate under one of the several divestment options that will be offered to new firms. Once again, fiscal incentives granted by the capital-exporting or capital-importing country, or by both, could be used to make participation attractive. There is no particular difficulty in adapting to existing firms the options calling for gradual sale of equity or for outright divestment after a certain number of years. Problems are more likely to arise with respect to the option terminating foreign ownership after remittance of profits in some multiple of the originally invested capital. Applying this rule to the original

capital of the existing firms may be too restrictive, yet taking the present book value as a yardstick may be too generous. Some middle ground between these two solutions may have to be found.

To what extent would the existence of the Inter-American Divestment Corporation keep existing firms from electing to convert to some of the automatic divestment procedures here advocated? If a firm could be sure that it would become an object of the tender mercies of the Divestment Corporation, it might well prefer that course to any automatic divestment arrangement (other than gradual sale of equity), since it would be paid for its assets instead of losing them outright after a certain lapse of time. Actually, this sort of "competition" from the Divestment Corporation is not a serious danger. In the first place, the Corporation will not have sufficiently large funds to make acquisition a likely prospect for the average foreign-owned firm. Secondly, given its limited resources, the Corporation will generally acquire the assets of existing firms under medium and long-term credit arrangements instead of paying cash. In these circumstances, foreign firms may often decide that they can do better under divestment schemes which allow them to manage their affairs and earn profits for a number of years ahead.

Combining Divestment with Other Objectives

The purpose of the preceding pages was to present, in bare outline, a variety of possible institutional arrangements for divestment. It is now necessary to consider how these arrangements could be modified if divestment conflicts with other important objectives of the developing countries.

It has, for example, been pointed out by Raymond Vernon that foreign-owned firms have a special aptitude for contributing to the exports of manufactures from the developing countries. In many cases, of course, foreign branch plants have been criticized for exactly the opposite tendency, namely for the determination to confine themselves to the local market and to reserve all exporting to the parent company. Nevertheless, this is no necessary and permanent failing; the multinational corporation in particular is obviously able to establish an integrated network of manufacturing facilities and commercial operations which could insert its individual producing units in different countries into a world-wide pattern of specialized production and internal exchange.

It looks, therefore, as though in some sectors some developing countries are likely to face a dilemma: continued foreign ownership or no exports. But in reality there is no need to make so difficult a choice. The dilemma can be transformed into a trade-off situation where both

objectives are pursued simultaneously and one of them is only marginally given up for the sake of achieving a limited gain for the other. The schemes already put forward can easily be adapted to this end. Take the scheme under which a majority ownership ceases automatically at the end of x years. It would be relatively easy to introduce a variant such that a firm achieving exports of z per cent of its total output by the time the x years are up, would retain majority ownership for another y years. In this or some similar fashion, the built-in divestment provisions can actually serve to provide incentives for the achievement of other desirable objectives.

The same argument applies to other objectives, namely, promotion of regional integration and of establishment by foreign firms of centers of applied technological research. In these cases it is, of course, difficult to quantify performance. Nevertheless, an independent expert commission could be created with the task of appraising whether in any individual case the contribution of a foreign firm to, say, the implanting of technological research and innovation warrants a slowing down of the divestment schedule.

In the end, therefore, a developing country may spell out for foreign investors several distinct mixes of objectives, among which divestment would be only one; and each foreign investor could elect the particular mix that corresponds most closely to his taste and capabilities.

CONCLUSION

Rapid and incomplete as it is, the preceding survey of conceivable divestment arrangements will have given the reader a sense of the sizable alteration in the institutional environment for foreign private investment that is advocated here. Several questions are raised in consequence: (1) what would happen to the outflow of private investment funds if some of the arrangements spelled out were actually adopted as national policy by the developing countries of Latin America as well as by the capital exporters such as the United States? Would that outflow slow down to a trickle or come to a full stop? And (2) if the latter occurred would considerable damage be done to economic development in Latin America?

To answer the last question first, it is my belief that the larger countries of Latin America are today in a quite favorable bargaining position to insist on substantial institutional changes of the kind here indicated. The damage that would be inflicted on them if international capital took offense and stopped flowing to them is no longer what it might have been 100, 50, or even 25 years ago. Most literature and official reports about Latin America stress the continent's continuing poverty and prob-

lems. These laments have hidden from view the very real economic progress that has been accomplished over the last 25 years. With a per capita income of around 500 dollars and a population of 250 million people, the Latin American continent is now well supplied with both "light" and "basic" industries. Countries such as Brazil, Mexico, and Argentina produce a large and constantly increasing portion of the capital goods needed by their industrial establishment. A boycott of Latin America by international investment capital might reveal the strength and resilience and ability to *fare da sé* in a great number of areas which the Latin American industrial establishment has acquired, in much the same way in which the two World Wars permitted its then fledgling industries to take vigorous steps forward. Perhaps Latin America really needs at this point a sort of "economic equivalent of war," a measure of insulation, that is, from the advanced economies that would permit it fully to deploy the potential for entrepreneurship, skills, and capital formation which it has accumulated over the past 25 years of continuing intimate contact. In other words, it is quite conceivable that a temporary suspension of the flow of private capital toward Latin America would be beneficial rather than calamitous for the area's growth. That Latin Americans can afford to make "demands" from a position of strength was perhaps sensed when their official representatives started to speak in quite a new voice to the United States at the Viña del Mar conference of May 1969.

The question remains whether a boycott by private capital would necessarily result from a Latin American attempt to change the rules by which the game of international investment is being played. This is not at all certain. There are at least some signs that a number of private investors may be willing to operate in a substantially altered institutional environment. In the first place, they know how to bend with the wind—an example is the "Chilenization" of Kennecott and now also of Anaconda. Some farther-sighted corporations in mining and telecommunications are no longer waiting for pressures from the host countries to provide for "ization" of substantial equity in their concession contracts. A few scattered experiments in divestment are also going forward under the auspices of IFC, ADELA, and of the AID guaranty program. Furthermore, where official ideology proscribes "private ownership of the means of production" altogether, private companies located in Western Europe and the United States have been able to do business via so-called "co-production agreements" through which capital goods, technology, and skills are transferred, with repayment scheduled often in kind, on a medium or long-term basis. As a result, Western business firms find themselves in the ironical position of grant-

ing a better deal to their ideological foes than to their friends. Finally, a few small experiments in bringing manufacturing operations into an area and then turning them over to community ownership and control are now being tried out in the United States in some of the black ghettos; corporations such as Xerox and Aerojet have been pioneering in this field.

It may well turn out, then, that the corporation will once again justify its reputation for flexibility. The radical nature of the changes required should nevertheless be clearly visualized. If the corporation is celebrated as an institution, this is so to a large extent because it has permitted business to be carried on *sub specie aeternitatis*, by an organization, that is, whose life span has become as unlimited as that of older permanent institutions such as the nation-state and the church. It is here suggested that, in some of its foreign operations, the corporation ought to institutionalize its own demise. Having achieved deathlessness, it must rediscover how to die.

Putting it less brusquely, the corporation must learn how to plan for selective impermanence. Perhaps it would do so more cheerfully once it realizes that the same need exists increasingly for other institutions proud of their permanence, such as the nation-state. So, why not be a trail blazer?

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