Foreign direct investment as part of the privatization process

Maurice Odle*

Privatization accounts for a significant share of the foreign direct investment that is occurring during the current phase of rapid globalization of the world economy. For a number of cost-cutting, market opportunity and networking reasons, transnational corporations have actively sought to participate in the privatization process. Host countries, for their part, have sought to involve foreign investors in order to tap their vast capital resources and to gain access to their considerable technological, management and marketing skills. This is particularly so in the case of large and complex enterprises in the public sector. This intensive foreign investor role is likely to be sustained over the next few years as a result of the increasing functional convergence of the strategies of transnational corporations and the policies of host Governments.

The upsurge of privatization throughout the world has been matched by an explosion of writings on the subject. The reasons for privatization, the scope of the privatization process in various countries and related social and political constraints, the modes and mechanisms for disposal of state-owned assets, immediate fiscal effects and the hopes for long-term benefits of private managerial efficiency for enterprise performance and industrial development have received considerable attention. While these issues are relevant to all privatizing countries, emphasis in the writings has varied between regions. In the developing countries, a major concern has been the role of privatization in the reduction of both the domestic and external debt and in the development of the stock and capital markets (Ramanadham, 1989). In the developed countries, analysts have tried to assess the economic gains of a conversion from a public to a private monopoly (Vickers and Yarrow, 1991). In the case of the transitional economies of Central and Eastern Europe, commentators have been particularly interested in the fast-track plans and procedures for privatizing virtually a whole economy and the various infrastructural and institutional constraints on the acceleration of this process (Sachs, 1991).

*Head, Advisory and Training Services Branch, UNCTAD Programme on Transnational Corporations. The views expressed here are those of the author and do not necessarily represent those of the United Nations.

In dealing with privatization, the literature has tended to treat the process as a domestic phenomenon played out between local sellers and buyers. This is probably because of the ideological motivation and social dimensions of the conversion of state-owned enterprises to private entities, whose operations would be determined by the market mechanism rather than Government decision-making. There is more concern with who is selling and what is being sold (industries or firms) and less with distinguishing between the buyers, except for the issue of whether employees have become part-owners ("labour capitalism"), shares have been offered to the general public ("popular capitalism"), or a single buyer or group of buyers has acquired a controlling interest ("institutional capitalism") (Lüders, 1990).

This article attempts to fill a gap in the literature by focusing on the role of foreign direct investment (FDI) in the privatization process. It makes reference to equity and non-equity aspects of foreign involvement and to the experiences of developing and developed countries, and of economies in transition. The introduction describes the general environment. The first section outlines the legal and institutional framework as regards foreign participation in privatization. The second section analyses the incidence of foreign participation in this process. The strategic reasons why transnational corporations (TNCs) participate in the privatization process are discussed in the third part. The final section and the conclusions provide an assessment of why and to what extent countries may want to involve TNCs in the privatization process.

The enabling environment

The significant degree of foreign involvement in the privatization process has been the result of the considerable liberalization of FDI policies (UNTCMD, 1992, UNCTAD, 1993) and other macroeconomic reforms that were undertaken within the last ten years. These measures have produced an enabling environment, not only for new investment flows, but also for a participation by TNCs in the privatization of existing assets. Three types of policy measures are particularly noteworthy.

- First, the FDI legislative framework: host countries have relaxed restrictions on investment inflows and introduced measures to attract and facilitate them. These include greater ease of entry and improved rights of establishment, an increase in the foreign ownership share allowed in various sectors and industries, and more generous tax incentives, particularly for export-oriented activities. The streamlining of the implementation of these legislative measures has been achieved via the introduction of "one-stop shops" and other improvements in the institutional machinery. In addition, many countries have given guarantees, sometimes within the context of bilateral investment treaties, regarding the repatriation of profits and dividends; the expropriation of assets (except in very special circumstances and with adequate compensation); fair and equitable treatment of foreign investors, at least comparable to that accorded to nationals; resort, where necessary, to international arbitration; and protection of intellectual property rights.

- Second, the conducive, but nevertheless passive, legislative framework has been buttressed and supported by a complementary set of pro-active measures. Among other things, host countries have devised information systems and means of accessing international databases for seeking out prospective foreign investors, have undertaken promotion visits abroad to encourage joint-venture partnerships and have organized numerous investment fora and round-tables, sometimes with the aid of embassies, whose functions have become more commercially oriented.

- However, passive and pro-active FDI measures *per se* would not be sufficient. Countries have also liberalized their macroeconomic policies, as part of a general reform and structural adjustment process. Macroeconomic policies include, *inter alia*, a revamping of a country's fiscal policy by reducing corporate and personal income tax rates, a lowering of tariff and non-tariff barriers with respect to the import of intermediate and capital goods, and financial deregulation, allowing foreign investors access to short-term credit in local commercial banks.

These reforms have helped to ensure the success of national privatization programmes and to attract FDI. Successful privatizations have also sent a strong signal that the reforms undertaken are profound and durable. Whereas corporate tax rates, for example, can be altered quite easily, certain types of privatization are very difficult to reverse. Successful privatizations can also boost the confidence of foreigners and serve as a magnet for greater flows of investments in other sectors of the economy.

Incidence of foreign participation

Data are not available concerning the incidence of foreign participation in the privatization process of host countries. It is estimated that more than 2,000 privatizations have taken place in developing countries (Shirley, 1992) in which a significant proportion involved foreign participation. For example, in Jamaica (which has one of the largest privatization programmes among developing countries), nine out of 38 privatized entities involved the participation of foreigners (Jamaica, National Investment Bank, 1991). In Central and Eastern Europe, the majority of the privatizations that have taken place since the late 1980s consist of sales of enterprises to local investors. In the case of the developed countries, few privatizations involved an outright sale to foreigners, even though, in certain cases, a percentage (usually in the percentage range of 15-20) of the shares was sold in foreign stock markets.

However, the number of privatizations with foreign involvement is not a good indication of the share of foreign direct participation in the privatization process. Foreign direct investment is predominant in large deals in all groups of countries. In Argentina, for example, foreign equity ownership at the end of 1992 amounted to 28 per cent of the $16.5 billion of privatized assets (table 1). In the case of Mexico, the 12 largest foreign participations amounted to approximately 25 per cent of the total value (29.6 trillion Mexican pesos, or about $30 billion) of the 867 enterprises privatized up to November 1991 (table 2). In Poland, of the 52 large enterprises that were privatized by the end of 1992, 25 had very significant foreign share ownership; more specifically, 12 of these had a foreign ownership share of 80 per cent and 10 others had a foreign share of over 50 per cent (table 3). In Hungary, foreigners accounted for about 70 per cent of the approximately $900 million proceeds from the sale of the first 250 privatized enterprises. In the former Czechoslovakia, the share purchased by Volkswagen in the Skoda motor vehicle company amounted to $6.1 billion; the next six largest foreign holdings in Central and Eastern European privatizations were within the $175 million to $106 million range and the next seven were between $83 and $80 million (table 4).

Table 1. Foreign and other share ownership of privatized assets, Argentina, December 1992

	[illegible]	
[illegible]	Millions of dollars	Percentage
Foreign companies	4 607.0	27.9
Local companies	6 821.2	41.2
National Government	5 104.5	30.9
TOTAL	16 532.7	100.0

Source: Argentina, Ministry of Economic Affairs.

Table 2. Selected large Mexican enterprises sold to foreign corporations, 1991

Mexican enterprises[a]	Transnational corporation	Country	Amount (Millions of Mexican pesos)
Interruptores de México	Siemens	Germany	147.4
Renault de México Equipos Automotrices y Automotores Mexicanos	Renault	France	4 699.5
Grupo Garci-Crespo	Pepsi Cola	United States	1 960.0
Envases Generales Continental	Continental Can Co.	United States	1 450.0
Porcelana Euromex	JMP Newcor	United States	6 411.4
Dina Cummins, SA	Cummins Engine Co.	United States	7 920.0
Mecánica Falk, SA	Sundstran Pacific Ltd.	Singapore	2 910.8
Cabezas de Acero Kikapoo, SA	Trinity Industries	United States	1 596.6
P. Nacional de Redes	Momoi Fishing Net	Japan	3 407.5
Teléfonos de México	Grupo Carso Southwestern Bell and International France Cable	United States France	6 596 575.8
R. Minerales Mexicanos	E.I. Dupont De Nemours	United States	839.2
Productos Pesqueros	Servac International Ltd.	United States	13 000.0
		TOTAL[b]	6 673 887.8

Source: Mexico, Centre for Latin American Monetary Studies (CEMLA), 1991.

[a]The value of this group of enterprises is approximately 25 per cent of the total value (29.63 trillion Mexican pesos) of the 867 enterprises privatized up to November 1991. In January 1992, the exchange rate was $1 = approximately 3 000 Mexican pesos.

[b]Regarding the other enterprises sold to foreigners, in eight cases the Government sold its share to the co-owners, usually the technological partner. In three of these cases the Government had a minor participation in the capital of the enterprise divested. The firms in this situation were: Cia. Mexicana de Radiología; Sistemas de Energía Autónoma (SEASA); Envases Generales Continental; Cabezas de Acero Kikapoo, SA; Mecánica Falk, SA; Renault de México, SA de CV (closed in 1986); Equipos Automotrices; Dina Cummins, SA.

Table 3. Share of foreign investors in Polish privatizations, December 1992

Company's name	Name of foreign investor	Country of foreign investor	Amount paid by foreign investor (Millions of dollars)	Foreign investors' share (Percentage)
Exbud S.A.	International Trading and Investment	Luxembourg	2.3	17.5
Koszalinskie Zaklady Piwowarskie S.A.	AMS Anlagenplanung GMBH	Germany	0.6	30.0
Beloit Fampa S.A.	Beloit Corporation	United States	7.0	80.0
Philips Lighting Poland S.A.	Philips	Netherlands	21.2	66.7
E. Wedel S.A.	Pepsi Co. Inc.	United States	24.1	40.0
Polfarb S.A.	Basic American Foods	United States	2.3	80.0
Pollena Bydgoszcz-Level Poland S.A.	Unilever	Netherlands	19.8	80.0
Pollena Racibórz-Henkel Poland S.A.	Henkel	Germany	3.9	72.4
Pollena Nowy Dwór-Benckiser S.A.	Joh Benkiser GmbH	Germany	2.5	80.0
Alima S.A.	Gerber	United States	6.9	60.0
Pomorska Fabryka Mebli sp. z o.o.	Karl Heinz Klose	Germany	1.9	80.0
Elta sp. z o.o.	Asea Brown Boveri Participations Ltd.	Switzerland	9.0	51.0

(Table 3, cont'd)

Company's name	Name of foreign investor	Country of foreign investor	Amount paid by foreign investor (Millions of dollars)	Foreign investors' share (Percentage)
Mostostal - Export S.A.	Gerd Bonn Kurt Schroder	Germany Germany	1.3 3.0	28.9 11.1
CPC Amino S.A.	CPC Europe (Group) Ltd.	United States	7.6	80.0
Zaklady Celulozowo-Papiernicze S.A.	International Paper Inc.	United States	120.0	80.0
Fabryka Papieru Malta S.A.	Kronospan GmbH	Germany	1.2	80.0
Przedsiebiorstwo Przemyslu Miesnego w Opolu	Penetex Exp.-Imp. GmbH & Co. KG	Austria	3.2	55.0
Romeo sp. z o.o.	Adolf Ahlers A.G.	Germany	3.6	80.0
Chifa sp. z o.o.	Aesculap AG	Germany	2.8	80.0
Wydawnictwo Naukowe sp. z o.o.	Cambridge Holding S.A.	Luxembourg	1.0	51.0
Bydgoskie Fabryki Mebli S.A.	Schieder Trading GmbH & Co KG	Germany	2.4	30.0
Tefla S.A.	AT&T Network System International BV	United States	28.0	80.0
MEFTA sp. z o.o.	AEG AG/T.H. Elektrim S.A.	Germany	1.8	60.0
Wizamet S.A.	Gillete Co.	United States	1.5	80.0
Olimex sp. z o.o.	Marga BV (Unilever)	Netherlands	0.3	70.0

Source: Poland, Information Center of the Ministry of Privatization.

Table 4. List of the 16 largest foreign direct investments in privatized entities in Central and Eastern Europe, 1991

Volkswagen	Germany	Skoda	Czechoslovakia	Automobiles	6 330
CBC	France	Tourinvest	Czechoslovakia	Hotels	175
General Electric	United States	Tungsram	Hungary	Light bulbs	150
General Motors	United States	Raba-Gyor	Hungary	Cars, engines	150
Pilkington	United Kingdom	HSO	Poland	Glass	140
Guardian	United States	Magyar Uveg	Hungary	Glass	120
Suzuki, C. Itoh	Japan	Ikarus	Hungary	Automobiles	110
Linde	Germany	Technoplyn	Czechoslovakia	Technical gas	106
Electrolux	Sweden	Lehel	Hungary	Refrigerators	83
Hamburger	Austria	Dunapack	Hungary	Packings	82
Ford	United States	Videoton	Hungary	Auto-components	80
Sanofi	France	Chinoin	Hungary	Pharmaceuticals	80
Oberoi	India	Hungar Hotels	Hungary	Hotels	80
U.S. West, Bell	United States	State Authority	Czechoslovakia	Telecommunications	80
Sara Lee	United States	Compack	Hungary	Food	80
ABB	Switzerland	Zamech	Poland	Turbines	50

Source: Wirtschaft (Economy), Wenig Kapital aus dem Westen, 1991.

In some countries, FDI inflows resulting from privatization were a significant proportion of total FDI inflows. For example, in Jamaica during 1987-1990, on average, 40 per cent of the $450 million of private foreign capital inflows resulted from privatization (Allen, 1991); in one of these years, 1987, the figure was as high as 94 per cent (table 5). In the Philippines, it is estimated that, for the same period, foreign inflows from privatization amounted to nearly one third of total private foreign capital inflows (Philippines, Central Bank, 1991).

Table 5. Private foreign capital inflows to Jamaica resulting from privatizations, 1987-1990 (Millions of dollars)

Item	1987	1988	1989	1990	1987-1990 (Total)
Gross private long-term capital	65.70	51.40	133.20	199.40	449.7
of which: Privatization[a]	61.95	0.58	52.58	62.89	178.0
(Percentage share)	94.3	1.1	39.5	31.5	39.5

Source: Jamaica, Bank of Jamaica, and Allen, 1991.

[a]During the 1987-1990 period, debt-equity swaps amounting to $2.2 million are included.

Besides being involved in the privatization of existing assets, FDI can be used to avoid new capital expenditures by the State. Foreigners may undertake from scratch an investment activity that would normally have been initiated by the State. This type of contracting-out to the private sector may occur in the case of infrastructure and utility projects, and it is fundamentally different from turnkey projects, which involve a Government providing the risk capital but retaining ownership. This approach originated on the occasion of the construction of the Channel tunnel. Subsequently, contracting out has taken place in highway projects in Hungary and the Philippines and power-generating projects in Nigeria, Pakistan and Turkey. These projects tend to be large in size and require a considerable amount of capital. Contractors are allowed to build and then operate the plant or project for a specified number of years, until they have fully recouped their capital investment; thereafter, they are contractually required to transfer the asset to the Government. Given the increasing tendency towards downsizing the role of Governments, such "build, own and operate" (BOT) schemes may remain permanently in private hands, as Governments may decide to sell their repossession rights to the highest bidder.

In addition, there is foreign participation in a number of non-divestiture forms. For example, leasing or management contracts are prevalent in the hotel industry and land-related development schemes.

Privatization involving TNCs tends to be concentrated in large-scale industries. The enterprises concerned are those in which foreign investors are able to exercise their ownership advantages as sources of capital, technology, management and organizational and marketing skills. Thus, besides consumer products ranging from chocolates to automobiles, TNCs are involved in privatizations of intermediate-goods industries, such as cement, glass, steel, fertilizers and wood and pulp, as well as capital goods industries, such as turbines, transformers, tools and components. Transnational corporations are also increasingly involved in the privatization of enterprises in strategic industries, some of which had been the subject of nationalization only a generation or two ago. The privatization of strategic industries, such as public utilities (including telecommunications, airlines and rail transportation), banking and other sensitive financial institutions, petroleum, mining and other natural resources, and security and defence-related industries, often take place at a later stage of the privatization process, only after the Government has acquired enough experience in the use of various divestiture modes, mechanisms and procedures (Odle, 1993). Past successes would also have conditioned public acceptance of the privatization of such key industries. Because of the large size of these industries and their technological complexity, there tends to be, paradoxically, an even greater foreign involvement in their privatization than in non-strategic industries.

Among key industries, the incidence of privatization has probably been greatest in telecommunications. The privatization of British Telecommunications PLC included the offer of a minority of shares in the Canadian, Japanese and United States stock markets; foreigners were similarly involved in that industry's privatization in Canada, France and New Zealand. Major privatizations in telecommunications in developing countries involving TNCs are listed in table 6. Given the rapid pace of technological change as a result of digital applications, developing countries feel that one way of guaranteeing access to the continually improving technology is to involve TNCs in joint ventures. Also important in developing countries is the need for additional capital to expand and increase the availability of telephone services or simply to reduce the budget deficit.

Table 6. Foreign equity ownership in privatized telecommunications firms in selected developing countries, 1993

Region/country	Domestic firm	Transnational corporations (Percentage ownership)
Asia-Pacific		
Fiji	Fiji International Telecommunications Ltd.	Cable & Wireless (49)
Malaysia	Syarikat Telekom Malaysia Berhad	Portfolio (4)
Solomon Islands	Solomon Islands International Telecommunications Ltd.	Cable & Wireless (51)
Vanuatu	Vanuatu Telecommunications	France Cable et Radio (49)
Latin America and the Caribbean		
Argentina	ENTEL	Bell Atlantic International in ENTEL North (part of winning Consortia) (32) Telefónica Española in ENTEL South (30)
Barbados	Barbados External Telecommunications Ltd.	Cable & Wireless (65)
	Barbados Telephone Company Ltd.	Cable & Wireless (65)
Belize	Belize Telecommunications Ltd.	British Telecommunications (25)
Chile	CTC	Chase Manhattan Bank (12); Telefónica Internacional (23); and Banco Santander(20)
Dominican Republic	CODETEL	GTE (100)
Guyana	Telephone and Telegraph Ltd.	Atlantic Tele-Network Inc. (80)

(Table 6, cont'd)

Jamaica	Telecommunications of Jamaica	Cable & Wireless (59)
	Jamaica International Telecommunications Ltd	Cable & Wireless (49)
Mexico	Teléfonos de México	Southwestern Bell and France Telecom (58)
St. Kitts and Nevis	St. Kitts and Nevis Telecommunications Ltd.	Cable & Wireless (80)
Trinidad & Tobago	T & T Telephone Co.	Cable & Wireless (49)
Venezuela	CANTV	International Consortium (40) consisting of CTE, Telefónica Española, Electricidad de Caracas, Consorcio Inversionista Mercantil and AT&T
Africa		
Cameroon	FCR	France Cable et Radio (100)
Central African Republic	SOCATI	France Cable et Radio (40)
Chad	Société des Télécommunications Internationales	France Cable et Radio (43)
Djibouti	STID	France Cable et Radio (25)
Equatorial Guinea	GETSA	France Cable et Radio (40)
Madagascar	Société des Télécommunications Internationales de la République Démocratique de Madagascar (STIMAD)	France Cable et Radio (37)
Mali	Télécommunications Internationales du Mali	France Cable et Radio (35)

(Table 6, cont'd)

[illegible]	[illegible]	[illegible]
Nigeria	STIN	France Cable et Radio (23)
Sierra Leone	Sierra Leone External Communications Ltd.	Cable & Wireless (40)
Togo	Satelit	France Cable et Radio (45)
Middle East		
Bahrain	Bahrain Telecommunications Company	Cable & Wireless (40)

Source: Based on data in International Finance Corporation (IFC), 1990; The World Bank, 1990; International Telecommunication Union, 1991; and various recent reports.

In the developed countries, the privatization of airlines has sometimes involved foreign investors. British Airways was privatized in 1987, with 15 per cent of the shares being purchased by foreigners. On 14 September 1992, in announcing the $290 million merger of the international carrier Qantas Airways with the domestic carrier, Australian Airlines, the Government indicated that up to 35 per cent of the shares could be offered to either Singapore Airlines, British Airways or Air New Zealand (*The New York Times*, 1992); British Airways eventually won the bid. There has been similar involvement of TNCs in the privatization of the international airlines of a number of developing countries (table 7). As these examples indicate, foreign ownership is usually limited to a minority share so that the airline may still be considered a national carrier and thus be able to continue to receive landing rights in other countries. In the airline industry, the management skills of TNCs and the need to be integrated into their networks are important considerations for a Government in deciding to internationalize (partially) the ownership structure of the airline.

Even highly sensitive industries are beginning to be touched by the privatization process. For example, under the constitution of Mexico, the petroleum industry has to be state-owned; but, in a recent decision, TNCs have been allowed to engage in the exploration and development of new oil fields. In the past, FDI had been limited to speciality petrochemicals, rather than to basic petroleum

Table 7. Foreign equity ownership in privatized airlines in selected countries, 1993 (Percentage)

Country	Share of foreign ownership
Argentina	30
Australia	35
Chile	35
Costa Rica	10
Czech Republic and Slovak Republic	19
Guatemala	30
Honduras	40
Malaysia	18
Mexico	48
Nicaragua	49
Philippines	30
Peru	49
Russia	31
United Kingdom	15
Venezuela	45[a]

Source: Various reports.

[a]This relates to VIASA, the largest of the three airlines in Venezuela. Since the purchaser, Iberia Airlines of Spain, is state-owned, this may not, strictly speaking, constitute a privatization.

products. In Venezuela, the Government announced in September 1991 that the state oil company will transfer 23 out of 28 secondary oil fields to private local and international operators. Likewise, Argentina and Chile have admitted foreign participation in new concessionary areas.[1] Similar developments have taken place in the Nigerian petroleum industry. Ecuador, having recently withdrawn from OPEC, is exploring ways of involving TNCs as a means of significantly increasing its oil output. In the somewhat less attractive mining, forestry and agricultural industries, foreigners have also begun to return, sometimes in a management capacity.

[1]Subsequently, the Government of Argentina decided to privatize the existing state petroleum enterprise, YPF. A total of $3.04 billion worth of shares, equivalent to over 45 per cent of YPF, were sold on 27 June 1993, with the bulk being taken up by foreign investors.

There are considerable intercountry differences in the incidence of TNC involvement in the privatization process. As will be seen in the next section of this article, these differences are partly a result of host-country policies. Some developing countries, such as Brazil, Malaysia and Mexico, have statutory limitations on the share of foreign ownership of privatized assets. Also, certain countries, like France, Italy, New Zealand and the United Kingdom, have imposed ceilings on foreign share holdings in strategic enterprises.

In Central and Eastern Europe, TNC participation in the privatization process varies from one country to another, depending on degree of market orientation, FDI policies and strategies adopted. The privatization of medium and large enterprises has been gathering momentum in the Czech Republic, Hungary and Poland, partly because these countries are quite market-oriented and possess an institutional framework that is conducive to FDI inflows. In the case of the five new federal States of Germany, massive privatizations have taken place. On the other hand, the members of the New Independent States and the Baltic States, along with Albania, Bulgaria and Romania, after a hurried enactment of FDI laws, have only recently put into place the basic legislative framework for conducting private business (for example, property laws, company laws, contract laws, bankruptcy laws and income tax laws). As a result, privatization to date involves almost exclusively domestic citizens purchasing assets of small enterprises. For example, in Romania, up to the end of 1992, there were only three privatizations involving foreign investors: a 71 per cent Italian share in a cloth-manufacturing concern, a 49 per cent German acquisition of a brewery and an 81 per cent Swiss holding in a firm manufacturing agricultural products (Romania, National Agency for Privatization, 1993).

The fact that TNCs from most of the major home countries are taking part in the privatization process can have a favourable effect on the selling price of assets, *ceteris paribus*. It was shown above that, of the 12 largest privatization deals in Mexico involving TNCs, seven of the TNCs were from the United States (including one international consortium arrangement), two from France, and one each from Germany, Japan and Singapore. Of the 16 largest privatizations in Central and Eastern Europe, six involved TNCs from the United States, two each from France and Germany, and one each from Austria, India, Japan, Sweden, Switzerland and the United Kingdom. In the five new federal States of Germany, firms from Switzerland, Austria and the United Kingdom head the list of the top ten home countries whose TNCs are participating in the privatization process (table 8).

Table 8. Frequency of foreign direct participation, by top 10 home countries, in the privatization process in the former German Democratic Republic, end-1992

Home country[a]	Number	Frequency (Percentage)
Switzerland	90	15.6
Austria	85	14.7
United Kingdom	78	13.5
France	60	10.4
Netherlands	54	9.4
United States	54	9.4
Italy	27	4.7
Denmark	25	4.3
Sweden	25	4.3
Canada	7	1.2
Other[b]	72	12.5
Total	577	100.0

Source: Germany, Treuhandanstalt, March 1993.

[a]Excludes the former Federal Republic of Germany.

[b]Includes developing-country investors from Brazil, Guatemala, India, Indonesia, Iran, Islamic Rep. of, Israel, the Republic of Korea, Malaysia and Turkey.

As with FDI, TNCs from developing countries also play a role, albeit minor, in the privatization process. For example, of the 18 factories privatized in Cambodia by the end of 1991, 11 were acquired by TNCs from Thailand and by a TNC from Singapore (Cambodia, MOI, 1991). Most of the Cambodian cases involved leases of up to 20 years, rather than outright sales. In Latin America, previously privatized Chilean electricity and gas corporations have been investing heavily in privatizations in Argentina and Peru.

Strategic corporate reasons for transnational corporations to participate in privatizations

A number of the issues related to normal FDI are equally relevant to foreign acquisitions of existing enterprises through privatization. But some concerns are directly relevant to privatization.

Cutting start-up costs

In some instances, TNCs have a choice between greenfield investments and acquiring existing assets. For example, K-Mart (United States) chose to purchase the second largest supermarket (Prior and Maj) in the former Czechoslovakia for $118 million instead of setting up an entirely new enterprise. Such a strategy eliminates a potential rival, exploits appropriate site and locational advantages, avoids any zoning problems, and capitalizes on established local-supplier networks and previous goodwill and name recognition. This captive market strategy also avoids the various approval and licensing difficulties involved in starting up an enterprise in a bureaucratic system that has not yet shed all of the vestiges of central planning. In addition, the acquisition price may be relatively low as the divesting authority may try to compensate TNCs for operating in a still relatively unattractive economic environment (Brezinski, 1992). Similar considerations probably influenced, for example, the decision of Marriott Corporation (United States) to purchase for $20 million the Duna Intercontinental hotel in Budapest, where a shortage of hotel space and prime sites for development exists.

Transnational corporations are frequently not impressed with the enterprise restructuring efforts of Governments prior to privatization. Governments are therefore advised not to engage in costly and time-consuming rehabilitations of plants in the hope of acquiring more favourable selling prices. This relates particularly to export-oriented activities. The reason is that the TNC that wins the bid has not only its own conception of what needs to be done to make the enterprise viable, but also its own understanding of how the newly privatized enterprise fits into its transnational network, what specific product areas and market segments need to be targeted and what others need to be downplayed. The end result is that the TNC may acquire the pre-rehabilitated asset at a relatively low price.

Building regional and global networks

Transnational corporations may view a company to be acquired through privatization not merely as a standalone entity, but as an integral part of a regional or globalized network in which maximizing the profits of a particular affiliate is less important than maximizing the profits of the entire regional or global enterprise (UNTCMD, 1992; UNCTAD, 1993). For example, when Iberia Airlines of Spain bought into Aerolineas of Argentina, it anticipated triangular flights between Europe, Argentina and the United States, with Buenos Aires, Rio de Janeiro, Sao Paulo, Santiago, Miami, Los Angeles and Madrid linked in the new combined network of planes and schedules. Whereas Iberia could previously fly, for example, a Madrid-Buenos Aires or Madrid-New York route, it could not complete the third leg of the voyage because of lack of landing rights. Iberia hoped to reduce the losses it suffered in 1990 and 1991 by acquiring Aerolineas which had made a profit in those years. Iberia's subsequent purchase of Viasa of Venezuela only served to reinforce this network.

Gaining market share

Maximizing their share of the international market for a particular product (for example, automobiles), or services (such as telecommunications) allows TNCs to maximize long-term profits. Such a strategy sometimes requires a sacrifice of short-term profits. Transnational corporations may acquire assets that are in poor condition and require upgrading and modernization, i.e., assets that may not be immediately profitable. However, if the national market that the privatizing entity serves is large or the international market niche is significant, the enterprise may be integrated effectively into the international production and marketing system of the acquiring TNC. Such an approach is possible even when TNCs acquire less than majority ownership, provided that they succeed in securing management control. For the same reason, TNCs may prefer to maximize their share ownership if profitability prospects are high. Thus, in the case of the Trinidad telecommunications privatization, six of the ten prospective foreign buyers contacted by the consulting firm hired by the Government (Morgan Grenfell) had as a pre-condition majority ownership (Saunders, 1991).

In the automobile industry, when Volkswagen purchased 31 per cent of Skoda (with an agreement for an increase in its shareholding to 70 per cent by 1995), it managed to outbid Renault and Volvo. While the plant is currently geared to supply the Czech Republic and the Slovak Republic, it will probably become increasingly integrated into Volkswagen's network for the whole European market. The alternative, regarded as a second-best solution, would have been to supply Central and Eastern Europe from abroad by expanding the capacity of the plant in Spain, where the inexpensive SEAT model is produced. The market-share and regional-network strategies are twin aspects of long-term strategies pursued by TNCs.

Seeking low-cost investment opportunities

The possibility of acquiring a capital asset at a relatively low price ("bargain basement effect") is an important motivation for TNCs to be involved in privatizations. The recessionary period of the late 1980s and early 1990s has forced TNCs to become more cost-sensitive, especially given the increasingly competitive nature of the world economy. Adjustments on the cost side tend to have both a capital and operational aspect.

In countries with privatization schemes, assets may sometimes be priced below market value partly because fiscal and/or foreign-exchange exigencies demand a quick "fire sale" and inhibit the full exercise of governmental bargaining power. In valuing state-owned enterprises, the true size and earnings potential of local and overseas markets are often not known or not fully taken into account. Of course, the same lack of information could conceivably cause a Government to set too high a price. For example, in the sale of a Hungarian cosmetics company, a prospective buyer, Colgate-Palmolive, originally offered more than any other bidder, but significantly less than the privatization agency's $50 million minimum price. The agency rejected the bid but invited Colgate-Palmolive to continue negotiating; however, the firm decided to withdraw (*The Washington Post*, 1991). In other cases, Governments are eager for share issues to be fully taken up in order to build public confidence in future privatizations; accordingly, share prices can be undervalued. Moreover, international accounting firms and investment banks which sometimes advise Governments and organize the sale of these shares earn generous bonus fees for successful issues.

A dramatic increase in the value of shares and related capital gains frequently occurs soon after privatization. For example, "at the time of sale of the first tranche of Telmex shares, the market valued the company at $8 billion; at the second sale six months later, it was $14 billion; and a year later when the third tranche was sold, the value was $30 billion" (The World Bank, 1992, p. 11). There are also cases in which a private placement (that does not involve a competitive bidding process) results in an immediate capital gain. For example, Demerara Woods, a forestry enterprise in Guyana, was sold for 9.7 million pounds in 1991 (including a fifty-year lease on 440,000 hectares) to Lord Beaverbrook, who then resold it within a few months for 60 million pounds (*The Guardian*, 1991).

Certain TNCs and creditor banks showed an interest in debt-equity swap arrangements in Latin America partly because of the resulting indirect price discount on the assets earmarked for privatization. In Central and Eastern Europe, TNCs demanded a negative premium or a below-market price for what they perceived as political and social risks, bureaucratic obstacles, repatriation-of-profits difficulties and other economic problems associated with operating in the environment of a transitional economy. In certain developing countries, despite FDI and macro-economic policy reforms, TNCs factor in the adverse effect of current political instability and tend to seek a compensating price reduction to offset the higher rate at which future profits need to be discounted.

Low unit-operating costs of privatized assets are another attractive feature to TNCs. Some state-owned enterprises in developing countries tended to pay lower wages than those in the private sector; this sometimes compensated for the quantity of labour being higher per unit of output. For example, the average wage in the Tungsram Lighting Company in Hungary was one tenth that of General Electric in the United States. Although the size of the labour force in Tungsram at the time of the purchase was deemed to be too large, labour costs in that company accounted for only one quarter of the cost of making a light bulb compared with one half in General Electric in the United States. It is also possible to shed surplus labour in order to enhance profits, unless employment-performance requirements in the purchase contract explicitly prevent it.

In certain circumstances, TNCs may initially prefer to hold a management contract rather than purchase assets of an enterprise. This allows a TNC to assess the enterprise from an insider position, gaining a bargaining advantage over other potential bidders in the event that the Government eventually decides to divest the assets. For example, certain TNCs adopted this strategy in the mining industry because of either the poor state of the privatized firms or the weakness of the international market for commodities (Greenidge, 1991).

In this regard, the three- to five-year moratorium on the repatriation of profits and the 10- to 12-year moratorium on the repatriation of capital that are typical of debt-equity swaps, have reduced the attractiveness of low prices of the latter as a mechanism for encouraging TNCs to participate in the privatization process.

Considerations for Governments when involving transnational corporations in privatization programmes

Governments involve TNCs in the privatization process to widen their options, increase the potential price at which the assets can be sold (the higher the number of bidders, the greater the probability of receiving a higher price) and guarantee access to current and future international capital, managerial, technological and marketing resources. At the same time, security concerns are such that Governments sometimes retain some degree of national involvement (in the form of either a local private, employee or residual public-sector holding), especially in key enterprises.

Special needs of large-scale privatizations

In those countries in which the savings rates are low, local financial institutions tend to be underdeveloped and other aspects of the capital markets are lacking in absorptive capacity. The ability of the local private sector to purchase state-owned enterprises is therefore limited. At the same time, some Governments may feel that FDI should be a supplement, rather than a substitute, for local capital.

Consequently, small and medium-size state-owned enterprises have typically been offered to local investors, and TNC involvement has been restricted mainly to the larger enterprises. For example, in Central and Eastern Europe, only citizens were allowed to participate in the auction of the thousands of "mom and pop" retail and restaurant businesses. Only in the second round of the auction process were bids from foreigners entertained, although for at least one country it was said that "many foreigners, mostly Germans, are using Czech fronts to buy property" (*The Chicago Tribune*, 1991). Similarly, there was a tendency for TNCs in developing countries to be denied, de facto, the right of entry by the Governments' administrative apparatus with respect to the purchase and sale of small enterprises, partly in an attempt to develop the local private sectors.

For the larger state-owned enterprises, however, there is often a need to tap the reservoir of capital resources that TNCs represent. This would be even more necessary if the State had disposed of a considerable number of enterprises within a relatively short period, and the local capital market had become somewhat saturated. In the developed economies, where state-owned enterprises tend to be large in size, the local capital market has considerable absorptive capacity; however, Governments have often tried to attract TNCs in order to earn higher prices from the increased aggregate demand (Jones, 1991).

Of course, capital is not the only reason for engaging TNCs in the privatization process. Many of the larger enterprises involve complex technologies and are constantly undergoing rapid product or process change. Furthermore, advanced management skills are often in short supply and, in some cases, the effective marketing of a product requires access to the global or regional networks of TNCs.

Reducing the foreign debt has been an additional motivating factor for the increasing involvement of TNCs in the privatization process. Thus a number of important privatizations involved the capitalization of debt, including the Argentine telephone and airline deals, the Chilean telephone transactions, the Philippines airline arrangements and the minority foreign acquisition of the Usiminas steel plant in Brazil. However, some countries, instead of utilizing debt-equity swaps, have preferred to use the proceeds from traditional direct sales to retire existing foreign debt. In addition, a number of countries, Jamaica being a notable example, deliberately chose to sell certain enterprises to foreigners (via a private placement process) in order to acquire quickly foreign exchange, in keeping with the imperatives of the International Monetary Fund and The World Bank restructuring process.

Control measures relating to strategic enterprises

Many Governments decide to retain a certain degree of national involvement in strategic enterprises they choose to privatize. At the same time, they do not want to exercise control, even though they desire to enjoy the financial benefits of substantial ownership. Thus, in the privatizations of Telmex and Mexicana Air, the Government ceded control by retaining non-voting stock in the case of the former, and putting voting shares into a trust in the case of the latter. Thus, the Government was merely interested in exercising influence rather than effective management control. Eastern Europe tends to employ a fairly standard majority/minority/residual formula for foreign, employee and government share-ownership with respect to the privatization of large enterprises. So far, those enterprises have not included what was traditionally classified as strategic enterprises, partly because those countries have not yet reached an advanced stage in the privatization process.

In the developed countries, Governments have sought to retain special voting rights if the foreign investor's share exceeds a certain amount. This approach arose out of the United Kingdom's experience with the privatization of British Aerospace, in which foreigners managed to acquire more shares (in the secondary market) than was originally allotted to them. Under the "golden share" rule of the United Kingdom, a special rights preference share of one pound allows the Government to intervene if the national interest is deemed to be threatened, as in the case of a TNC securing more than 15 per cent of the shares of an enterprise. The figure is 20 per cent in the case of the "specific share" provision of the privatization law of France.[2] In New Zealand, the same concept is referred to as the "Kiwi share". In the case of the Australian airline privatization, the Government has stated that it plans to introduce a "golden share" measure in order to be able to commandeer aircraft in the event of a national emergency. In Italy, the golden share rule applies to public utilities.

In addition, Governments have tended to set up public-utility Commissions to protect the public interest with respect to telecommunications, electricity, gas and other such activities. Typically this involves a stipulation of either a maximum rate of return or, even more preferably, a maximum price under which an enterprise being privatized can seek to minimize costs and thus enhance profits. In addition, the Commissions monitor the availability and quality of services. In the case of tradable products, Governments have sought to expose the privatized enterprises to international competition.

[2]Ministerial approval is required in relation to foreign acquisitions beyond 10 per cent and, in the case of defence-related enterprises, 5 per cent.

Performance requirements

In privatizing strategic industries and other large state-owned enterprises, host countries have sought to gain firm commitments, equivalent to performance requirements, to advance economic development. Such commitments relate primarily to expansion and modernization and are a *quid pro quo* for operating in a large and, frequently, near monopolistic market and for selling a product or service that has an important economic and social impact. To complete a deal, a trade-off is sometimes made by Governments between accepting a lower price in exchange for performance requirements to capture certain external economies. In other situations, incentives are used to offset performance requirements. For example:

- In the case of the 1990 privatization of Mexico's telecommunications enterprise, the Government obtained a binding obligation from the foreign companies to make modernization investments valued at $1 billion a year until the late 1990s (Lieberman, 1991). The new entity is also required to install 4.5 million new lines, amplify rural service by 100 per cent, introduce optical-fibre communication, increase digitalization by at least 65 per cent, upgrade 480,000 obsolete lines and maintain the same price in real terms until 1996, with a 3 per cent annual decrease thereafter.

- Similarly, in the case of the privatization of telecommunications in Chile and Jamaica, commitments were made with respect to modernization plans valued at $250 million and $400 million, respectively.

- The Mexican authorities also obtained certain commitments when privatizing the airline industry. The leading firm in the consortium of foreign investors pledged $3 billion in investment over the next ten years to improve ground facilities, computerize the reservation system, replace aged planes, double the size of the fleet and increase employment from 13,000 to 21,500 (*Business International*, 1990).

- In Chile, SAS of Sweden promised to inject new capital into the privatized airline and thereby won the bid over other foreign airlines.

- In the former Czechoslovakia, Volkswagen managed to win the bidding for the Skoda Motor Company partly because of its commitment to invest $5.3 billion by the turn of the century; double Skoda's annual production to 400,000 cars a year by 1997; help Skoda to develop a new range of models; make available to Skoda its purchasing and parts network while allowing Skoda to retain its own identity; and clean up the pollution of the factory sites (*The Economist*, 1990).

- In the five new federal States of Germany, performance requirements are an integral part of the privatization process across sectors: "Price is not the only criterion; indeed an investor who pledges to inject new capital and management and to keep or create jobs will be preferred to one who is merely offering more cash" (Treuhandanstalt, 1991, p. 5).

Certain countries have instituted general regulations with respect to the level of employment and wages after privatization. Both foreign-oriented and domestic-oriented privatization are affected. For example, in Malaysia, a retrenchment of employees is not permitted during the first five years of privatization (Montagu-Pollock, 1990). In Cambodia, labour is not permitted to be hired for less than $25 per month in privatized enterprises.

Finally, there is the issue of the appropriateness of performance requirements in a rapidly liberalizing world of trade and investment relations. Reference was already made to the possibility of a lower price for the privatized asset, specific incentives and monopoly-type conditions being used as counterbalancing factors. Moreover, privatization *per se* constitutes a mere transfer of assets and is not equivalent to net capital formation. In addition, TNCs have a choice whether or not to participate in a privatization; this contrasts with a situation in which a Government imposes performance requirements on foreign enterprises that are already operating in the country, without compensatory subsidies.

Preferred forms of foreign participation

The form and degree of foreign participation vary considerably between countries, partly because of differences in levels of economic development, technological capabilities, availability of local capital and stock-market maturity, the size of foreign debt and fiscal burdens, and the political environment of the privatization process. For example, certain countries seem to be pursuing a "majority-share-permissive model" whereby a foreigner is allowed to acquire the bulk of the equity in a privatizing enterprise. This seems to be the path that Poland has taken with respect to large enterprises. Foreign investors are frequently allowed to hold as much as 80 per cent of the equity, with 20 per cent being reserved for employees. Similarly, in Hungary and in the former Czechoslovakia, foreigners tend to be offered a majority share, with the remainder divided between employees and the Government.

In developing countries, however, there is no consistent pattern of foreign majority ownership, even in those countries whose privatization policies are foreign-exchange driven. Rather, a "minority-share-limitation model" seems to be applied, although control frequently resides with the foreign investor (rather than the Government or a local private partner). Moreover, some countries exercise flexibility in implementing their foreign minority ownership policy by not ruling out the possibility of TNCs acquiring majority equity shares during the life of the projects as a result of investment and expansion plans that, in effect, reduce the shares of the local partners. The most extreme manifestations of the minority-equity approach can be found in countries such as Brazil and Malaysia. However, even Malaysia has recently relaxed its ownership restrictions by differentiating between sectors; majority ownership is permitted in export-oriented enterprises and in high-technology industries.

In most developed countries, a "sector-determined participation model" is rigorously applied by way of the golden share mechanism to limit foreign share ownership severely in public utilities and other strategic enterprises. Most developing countries do not adopt such a rigid approach to their strategic industries. However, all countries deny so far majority ownership to foreign investors in the airline industry.

Finally, in a number of transactions, developing countries have also employed the non-equity form of contracting out the management function. In some cases, these enterprises may be sold outright after the foreign managers make them more profitable and manifestly viable. This "transitory-management model" is reflected in the privatization practices of such West African countries as Guinea, Côte d'Ivoire, Nigeria and Togo. Leasing and BOT arrangements contain elements of both the transitory-management model and the majority-share permissive model. A sort of macro version of the transitory management model is the recent "mass privatization" decision by the Goverment of Poland to turn over a majority of the shares in 600 large state-owned enterprises to 20 national investment/mutual funds to be run (with full powers of restructuring) by Western investment companies for ten years for a fee based upon the performance of the companies under their jurisdiction (*The New York Times*, 1993).

Conclusions

The involvement of TNCs in privatizations has constituted an important element in the liberalization process. Many strategic industries previously under public ownership, which had excluded (wholly or partly) the local and foreign private sectors, have become more open to both. In addition, there are many other large, though not necessarily strategic industries, in which, for similar reasons, countries have seen fit to involve TNCs in the privatization process.

This process of intensive foreign involvement is likely to continue, partly because of the continuous movement of macroeconomic philosophy in the direction of greater competitiveness (both within and across borders) and the related change in attitudes towards FDI. The privatization process is not only dynamic but also infectious, and the role of FDI is much greater than has been indicated by the previous literature on the subject. However, the incidence and timing of large-scale privatizations will probably continue to vary across regions and subregions. In certain developed countries, such as the United Kingdom, the process is tapering off, whereas in France, Italy and Sweden, for example, a major phase has just begun. There are similar variations in the developing countries. In a number of Latin American countries, with Brazil as a notable exception, the mature stage of privatizating large enterprises has already been reached. In most countries of Africa and many parts of Asia and Central and Eastern Europe, however, this has yet to occur.

Foreign direct investment plays an important part in the privatization process because it is a critical source of capital. Capital markets in many developing countries are inherently thin; competing against foreign buyers maximizes the selling price of the assets being privatized and improves the performance requirements and other conditions pertaining to their use. Even when local capital is adequate and available, the participation of TNCs can help to bolster foreign exchange (or reduce the level of foreign indebtedness).

In addition, an involvement by TNCs is often seen as a source of technology, management, marketing and organization skills. This helps to explain why, in certain cases, even profitable state-owned enterprises have offered a proportion of their shares to foreign investors. The capital and technological requirements of modern industry are such that a local enterprise frequently cannot survive as a standalone entity in an increasingly competitive environment and in a world of very rapid technological change. The goal of national self-reliance has not been found sustainable and has been replaced by the paradigm of global interdependence.

The benefits that accrue from foreign involvement relate not only to the short-term gains from greater efficiency but depend also on the TNCs' willingness to use their considerable capital, technological and managerial resources to expand and modernize plants, machinery and equipment to meet the challenges of a more competitive international economy. In this regard, the behaviour of a TNC depends partly on how the privatized entity fits into its larger corporate network. Backward and forward linkages may not necessarily be maximized within a single local market. As a result, although TNCs are much more cognizant than they used to be of host-country goals, the imperatives of producing for an international market result sometimes in a conflict of objectives. The privatization process is of a much too recent vintage to have yielded sufficient empirical evidence on the net social gains to a country, even though the long experience with respect to normal FDI and a recent study on the consequences of selling public enterprises (World Bank, 1992) could provide some guidance. ■

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