State-Owned Enterprises (SOE): Current Issues, Challenges, and Reforms

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Contents

1. Issues:

Definition, Trend and Importance
Efficiency
Effectiveness

What are SOEs?

Referred to,

government corporations, government-linked companies, public enterprises or public sector enterprises

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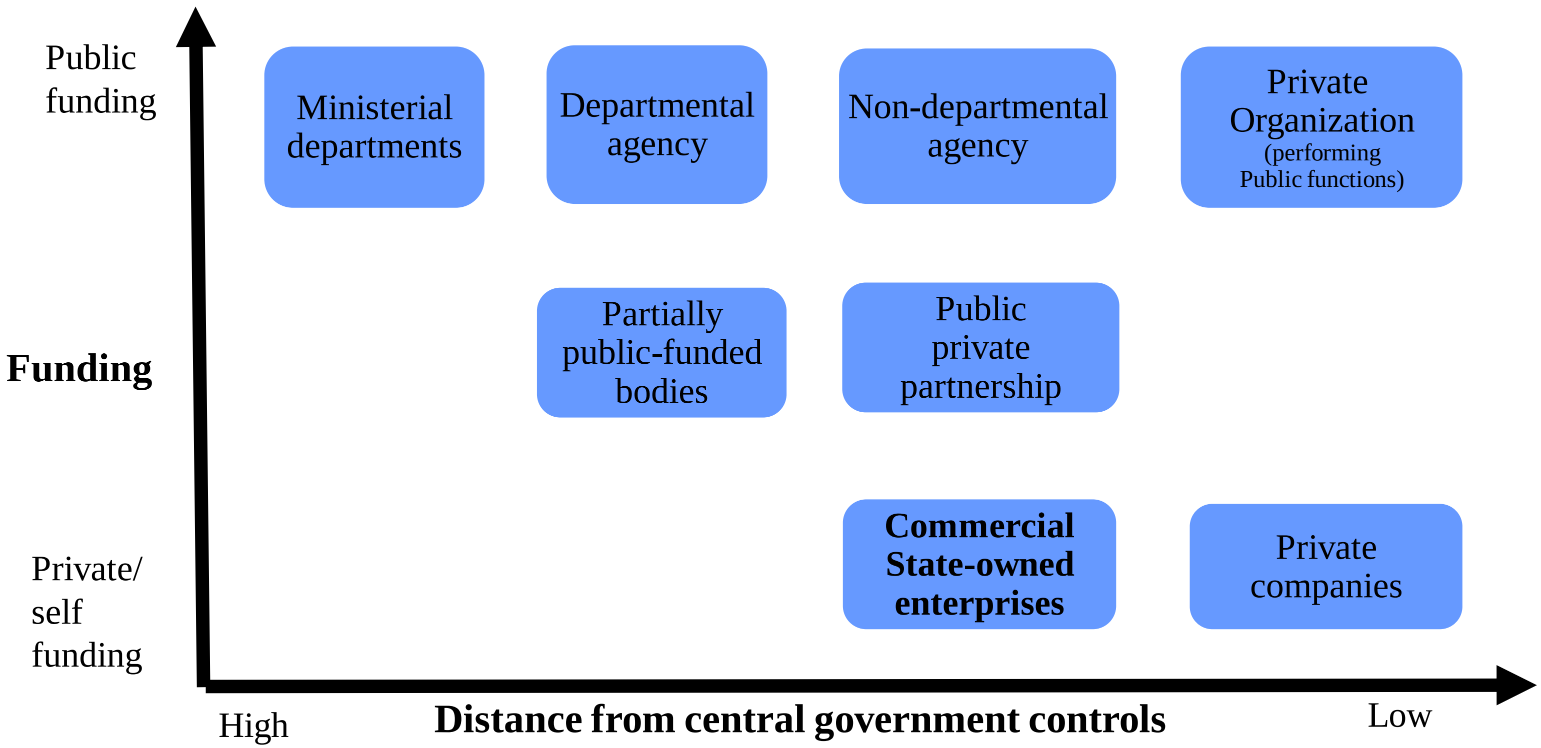
Types of organizations



Based on MacCarthaigh (2010)"Managing State-Owned Enterprises in an Age of Crisis"

Criteria: 1.Ownership 2.Legal form 3.Funding 4.Function
5.Powers and organizational form 6. Governance level

Definition of SOEs : Widely varied

- Organization for Economic Co-operation and Development (OECD)

“All autonomous government entities that generate at least half of their income through the sale of goods and services and have autonomous budgets and balance sheets.”

- World Bank Group (WBG)

“Commercial SOEs at the national level in which the government has significant control through full, majority, or substantial minority ownership. SOEs across a range of sectors—such as manufacturing and services, utilities, banks and other financial institutions, and natural resources—are included.”

- International Finance Corporation (IFC)

“A legal entity that is majority owned or controlled by a national or local government whether directly or indirectly.”

- Asian Development Bank (ADB)

“A state-owned enterprise (SOE) includes, but is not limited to, any entity recognized by the borrower’s national law as an enterprise in which the state or government exercises direct or indirect (whole or partial) ownership or control.”

SOEs Trend and Importance

Post-war rise of SOEs (50-70s) → Privatization waves (80-early 00s) → Rise of "New State Capitalism" (with china, high oil price and global financial crisis)

- Size: significant
  - SOEs account for 15% of GDP in OECD countries and 20-30% of GDP in transition economies
  - SOEs account globally for 20% of investment and 5% of employment
  - In 2017, 102 of the world's largest 500 enterprises are wholly, or majority owned by sovereign governments
- Role: important
  - Infrastructure (telecom, utilities, transportation)
  - Public services (welfare, postal)
  - Strategic sectors (defense, steel, oil)

Importance of SOEs

20% of GDP in Russia

28% of GDP in Poland

14% of GDP in Turkey

13% of GDP in India

2% of GDP in Indonesia

30% of GDP in China

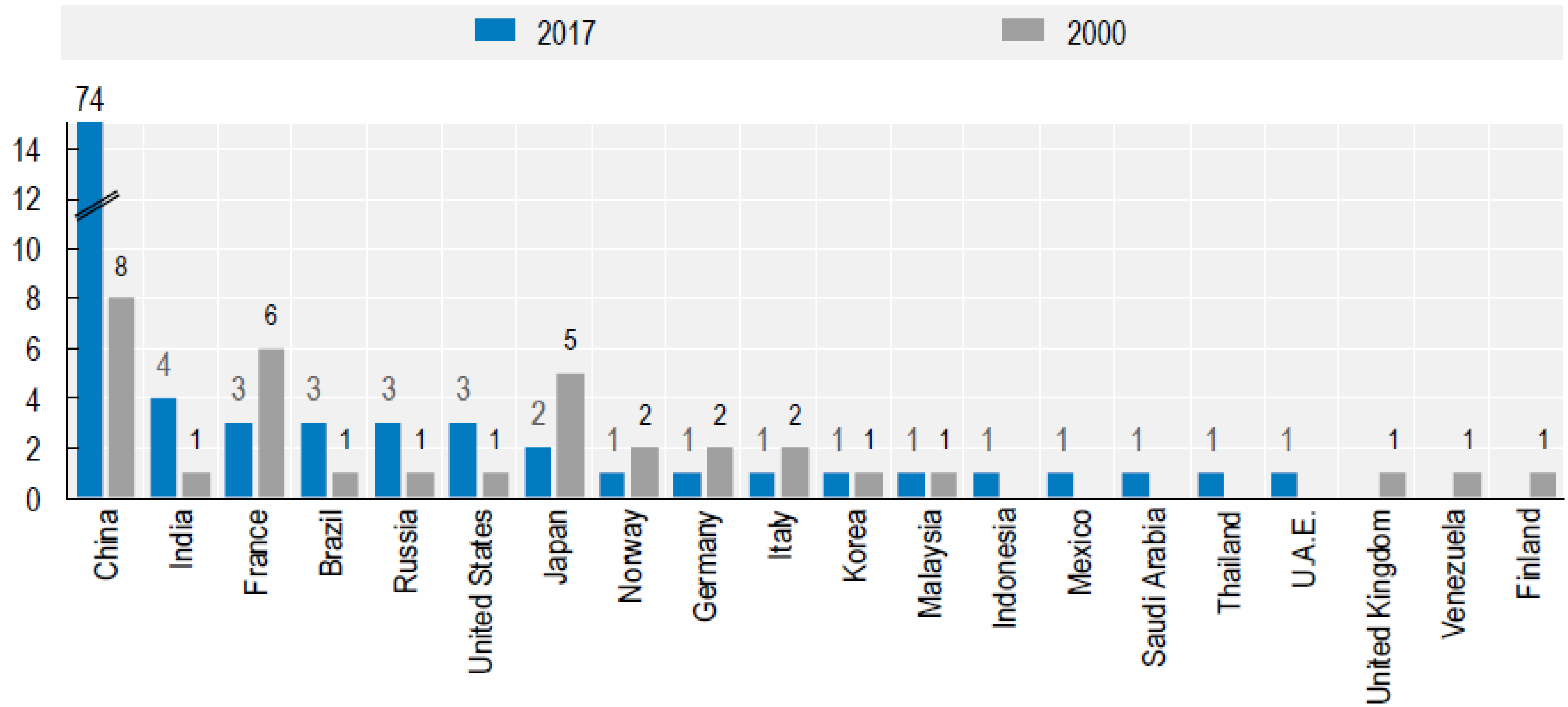
34% of GDP in Vietnam

26% of GDP in Thailand

Source: Singh and Chen, 2017

Growing Number of SOEs

(In World's largest 500 companies)



Source: OECD, Business and Finance Outlook, 2019

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Why SOEs: Market Failures

- Types of market failures
  - Public goods – non-rival and non-excludable consumption
  - Externalities – negative or positive
  - Information asymmetries – moral hazard and adverse selection
  - Incomplete markets – can't obtain optimum products
  - Natural monopolies – one provider, undersupply or overpricing
- Solution: tax, regulation, direct provision (= SOEs)
- Depends on market structure and ability of state
- Negatives: State capture, lack of capacity, crowding out

Source: Cuervo-Cazurra et. al, Governments as owners: State-owned national companies, 2014

Why SOEs: Ideologies, Political Strategies

- **Communist or socialist** – Citizens and the state are rightful owners of productive assets (ex. land, companies)
- **Development ideology** (nationalism, import substitution or 'commanding heights') – Create SOEs to speed up development and address inability of private sectors
- **Social ideology** – Create SOEs to facilitate socially desirable objectives (ex. Education, health)
- **Economic strategic ideology** – Justifies SOEs as being strategic for the country (ex. defense, energy, airspace)

Source: Cuervo-Cazurra et. al, Governments as owners: State-owned national companies, 2014

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SOEs - Efficient? (1)

❖ One stream of thought: SOEs are inherently inefficient

Agency Theory

- Owners in public firms have less ability to monitor the behavior of managers than in privately-owned firms.

Property Theory

- Managers in public firms do not suffer from the economic consequences of their managerial decisions (soft budget constraints), leading to inefficient decisions.

Public Choice Theory

- Public firms must consider the social objectives and/or interests of politicians and bureaucrats that are not clear and compatible with profitability and efficiency.

SOEs - Efficient? (2)

❖ Other stream of thought: effects of SOEs depend on country-specific institutions/other factors

Macro

- Market conditions
- Financial markets
- Status of property rights

Micro

- Type of products
- External risk
- Internal governance

❖ Empirical test: largely supports that SOEs are inefficient, but inconclusive

SOEs – Effective?

- SOEs need to be evaluated by **their effectiveness** (e.g. achievement of objectives), not just by efficiency (e.g. profitability)

✓ Major tool for national development – the earlier the stage of the economy's development, the larger the role of SOEs

✓ Social goals and quality dimensions – how to measure and capture?

✓ Time horizon - short-term vs. long-term delivery (e.g. education)

- Important, but often argued as **convenient excuses to inefficient management**

2. Challenges

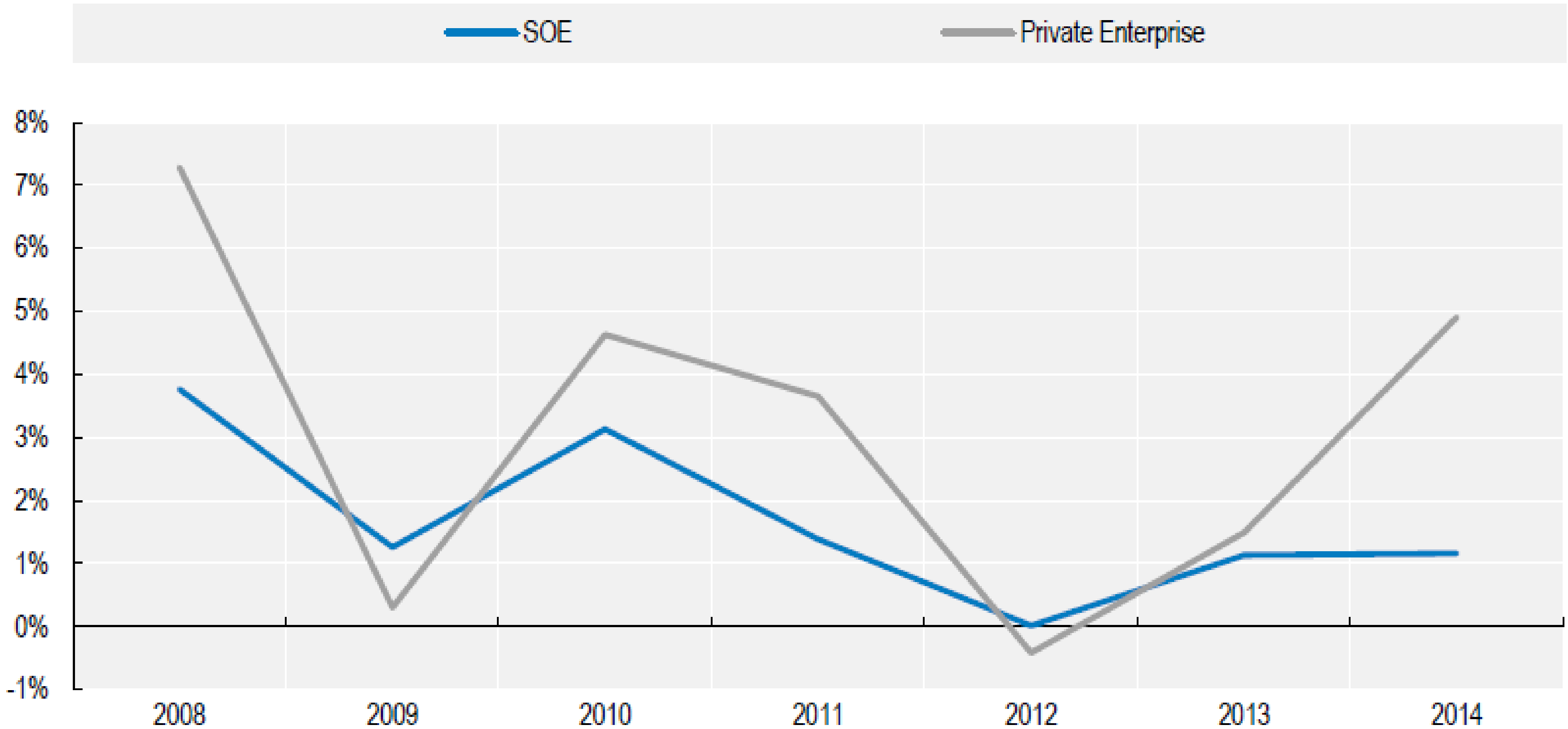
Low Performance
Economic and Financial Risk
Competition and Crowding Out
Prone to Political and Bureaucratic
Interference in Management

Challenges – Low Performance (1)

- “**Private ownership is more efficient**, often massively so”
  - According to much research, and a recent survey by Megginson (2018) looking at research since 2004
- Of course, there are **many cases where SOEs perform well**
  - The 25 largest SOEs in the Fortune 500 (2012) were more profitable than private peers (Musacchio, 2015)
  - Kind of “national champions” with majority/minority shareholdings, listed at stock exchanges, improved governance structures, and performance-oriented operation (e.g. 13 biggest oil firms, Gazprom, China Mobile, Saudi Basic Industries, Russia Sberbank, Dubai Ports, Emirates)
- Generally, SOEs have low performance compared to their peers

Challenges – Low Performance (2)

Profit margins by ownership type



Source: OECD, 2019

Challenges – Low Performance (3)

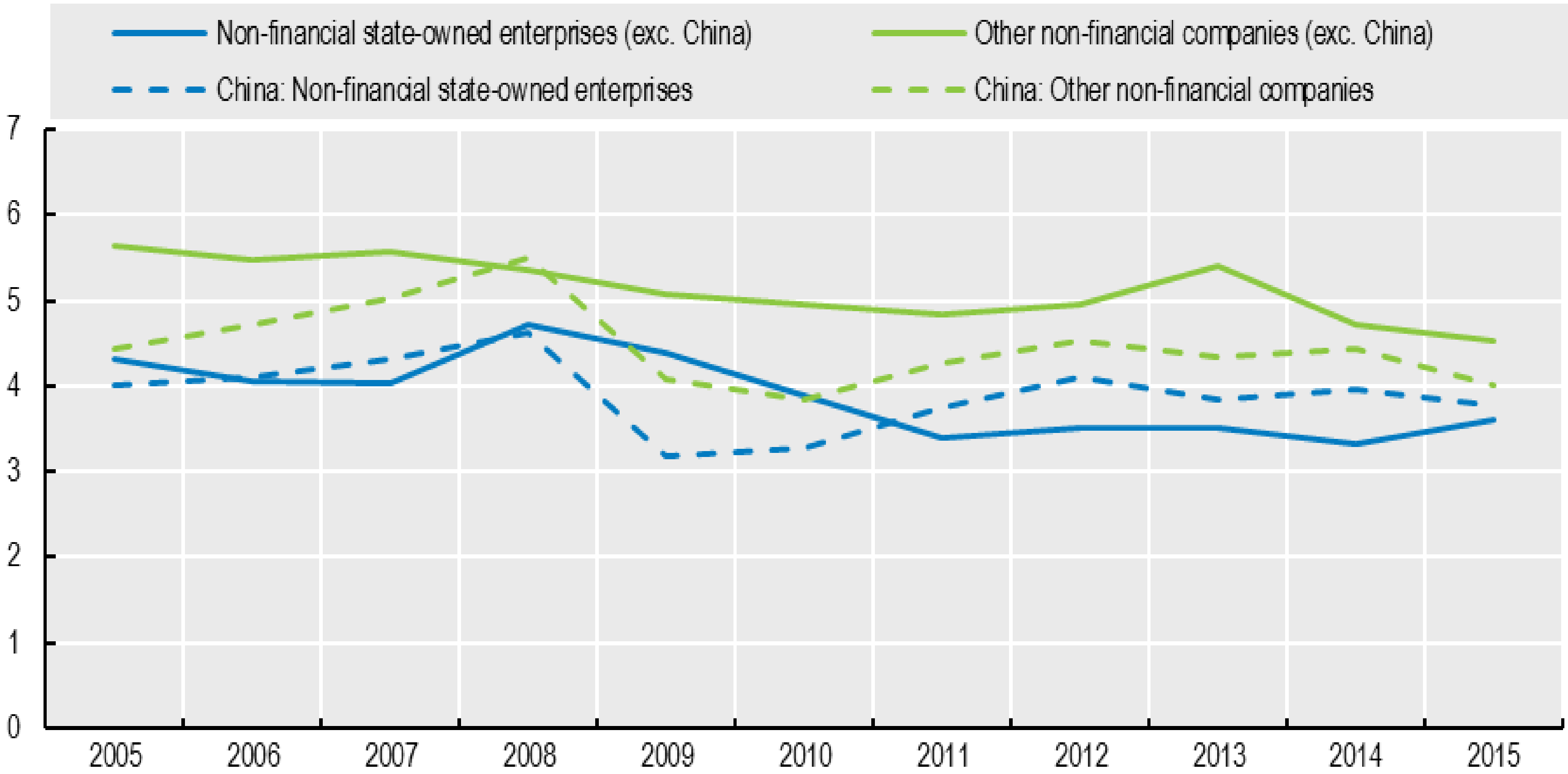
Performance and leverage for SOEs and non-SOEs at end of 2017

	Number of companies		Average leverage			Average performance		
	SOEs	Non-SOEs	SOEs	Non-SOEs	Difference	SOEs	Non-SOEs	Difference
China	470	823	41.5%	15.5%	26%	6.7%	10.8%	-4%
Hong Kong, China	98	132	69.7%	45.9%	24%	8.8%	14.8%	-6%
Hungary	3	7	21.3%	33.4%	-12%	7.4%	9.2%	-2%
Indonesia	15	47	58.3%	54.6%	4%	10.3%	21.3%	-11%
Lithuania	3	11	29.2%	22.1%	7%	3.7%	12.0%	-8%
Malaysia	44	61	63.7%	30.8%	33%	20.4%	19.0%	1%
Russia	31	45	50.6%	88.7%	-38%	5.0%	55.0%	-50%
Saudi Arabia	21	45	67.8%	36.4%	31%	14.7%	15.8%	-1%
Slovenia	6	3	49.3%	62.7%	-13%	6.9%	-1.5%	8%
Viet Nam	19	37	33.4%	39.3%	-6%	22.9%	18.0%	5%

Source: OECD, 2019

Challenges – Low Performance (4)

Cost of debt for non-financial state-owned enterprises and other non-financial companies (in percent)



Source: OECD Business and Finance Outlook 2017

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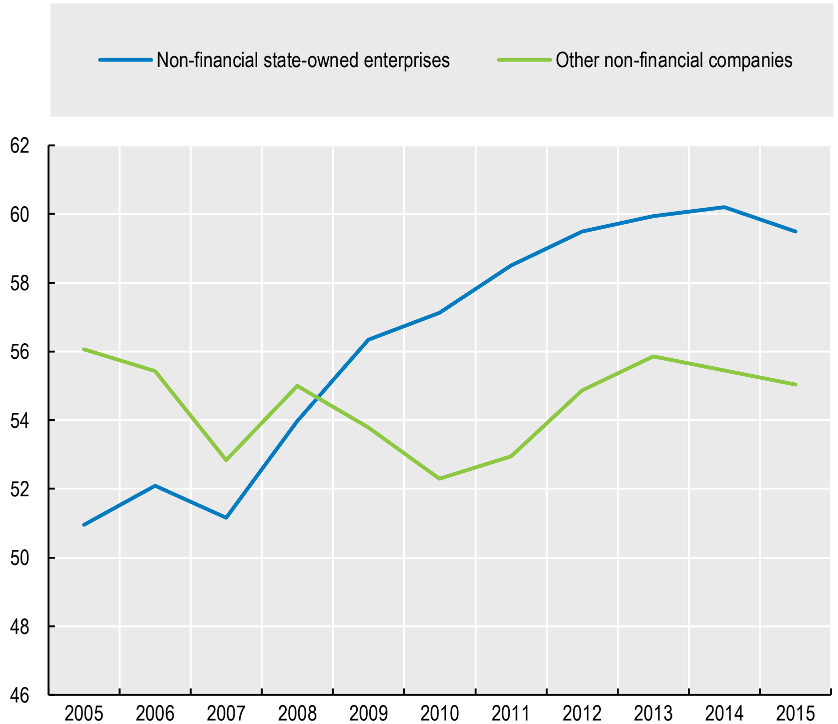
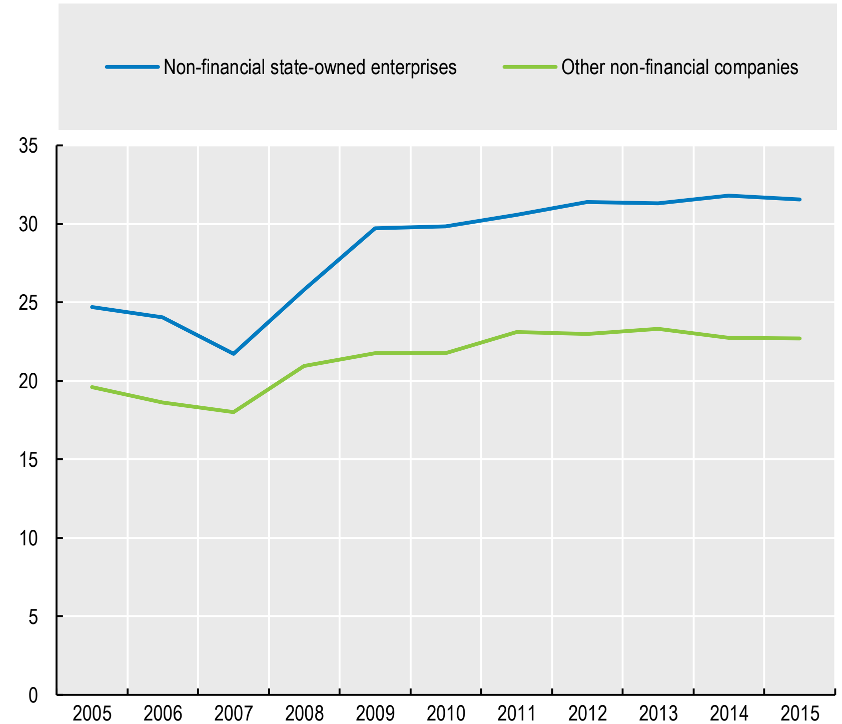
Challenges – Low Performance (5)

Leverage in the Chinese non-financial corporate sector (in percent)

Panel A: Total Liabilities as share of total assets



Panel B: Long-term debt as share of firm book value



Note: Enterprise value is defined as long-term debt plus common equity.
Source: Thomson Reuters, Factsheet and OECD calculations.

Source: OECD Business and Finance Outlook 2017

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Challenges – Economic Risk (IMF, 2017)

Fiscal risk:
Contingent liabilities with excessive SOE indebtedness

- SOEs debts outside general government accounts represent off-balance sheet debt and contingent liabilities aggravating the risk profile of the public debt position in countries (e.g. China, Korea)

Financial sector stability risk:
Regulatory failures with SOEs banks

- Cross-enterprise ownership, connected lending, and a lack of proper supervision combine to create economy-wide stability risks (e.g. Slovenia banking crisis in 2012-2013)

Risks to productivity and growth:
Spillovers to other firms and the economy

- Poorly functioning SOE-dominated sectors generate negative spillovers on the productivity of downstream firms and the economy (e.g. network service, energy)

Challenges – Fair Competition

- **Whether SOEs are anti-competitive? (Competitive neutrality)**

– The largest SOEs (so-called national champions) may benefit from an unfair edge in domestic as well as cross-border activities through financial support, tax concessions, preferential treatment in public procurement, and regulatory privileges.

- **Whether SOEs crowd out private investment?**

– Keeping inefficient SOEs obviously contributes to the crowding out of more efficient competitors. Empirical tests on Viet Nam (2009) and Malaysia (2013) found that SOEs density in provinces is negatively related to the growth of the private sector.

Challenges - Prone to Political and Bureaucratic Interference in Management

- **May force SOEs to conduct politically motivated non-core business without due processes**
  - e.g. expand investment in a financial crisis, maintain unnecessary employment, etc.

- **May appoint politically key individuals to positions** (CEOs, board members) **regardless of qualifications/talent**

- **May intervene directly and/or indirectly in day-to-day operations** (especially through line ministries)

3. Agenda for Reforms: Maximize "Value for Society"

SOE Reforms
Regular Assessment
State Ownership Reforms
Privatization (Full or Partial)

SOE Reforms: Goal and Strategy

- **Goal:**

  Establish mechanisms to ensure efficiency/effectiveness, transparency and accountability of SOEs

- **Strategy**
  - Regular assessment on why SOEs
  - SOEs reforms – ownership function, market and governance reforms, operational reforms
  - Privatization (full or partial) – with effective regulation and competitive measures

Regular Assessment of SOEs

Rationales for state ownership (OECD, 2015)

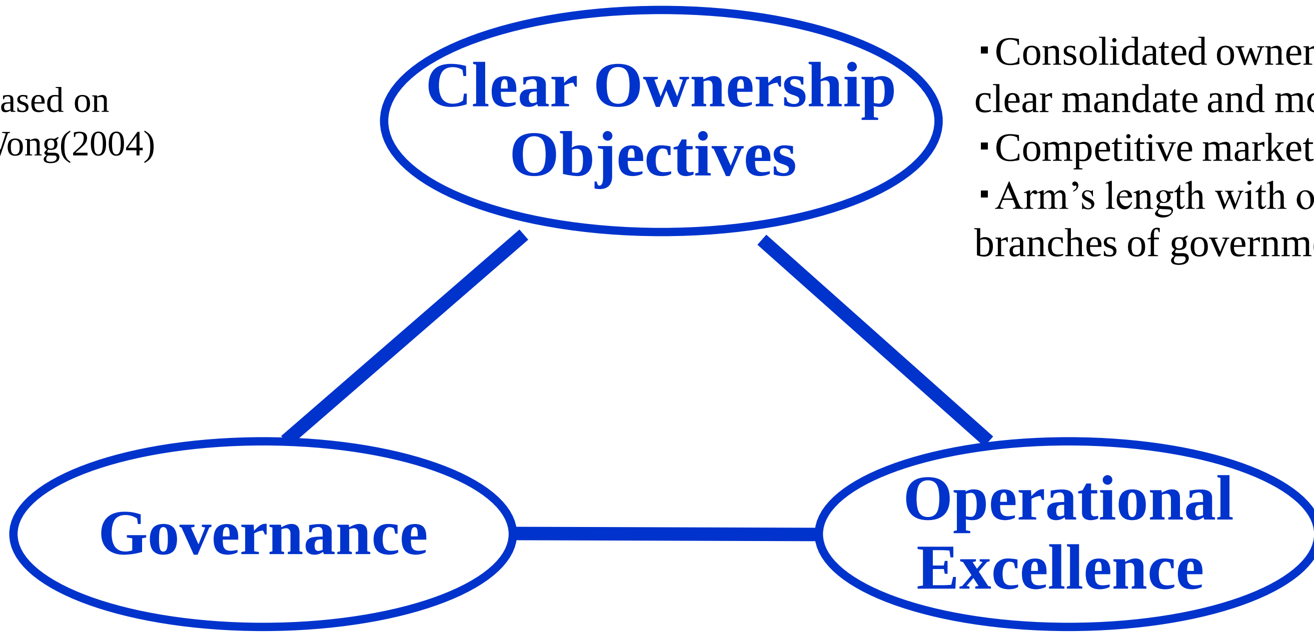
- The delivery of public goods or services where state ownership is deemed more efficient or reliable
- The operation of natural monopolies where market regulation is deemed infeasible or inefficient (market failures)
- Support for broader economic and strategic goals in national interests

Transparent, consistent and recurrent review

- Reviewing whether existing state ownership fulfills these criteria and whether SOEs could be ensured to be fully corporatized and competitive
- Leading to the decision to keep state-ownership or privatize
- Through a battery of standardized evaluation tools, including cost-benefit analysis and regulatory impact assessments, aggregate SOE sector audits and report with regularity (e.g. Germany: every 2 years to review)

Key Pillars of SOEs reform

Based on
Wong(2004)



- Consolidated ownership, clear mandate and monitoring
- Competitive market
- Arm's length with other branches of government

- Corporate structure with professional board
- High level of disclosure by SOE and government
- Constructive dialogue among government, SOE and public

- Vigorous performance elevation mechanism
- Clear performance metrics and cost of non-commercial activities priced in
- Political insulation in SOEs operation

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Ownership and Market Reforms

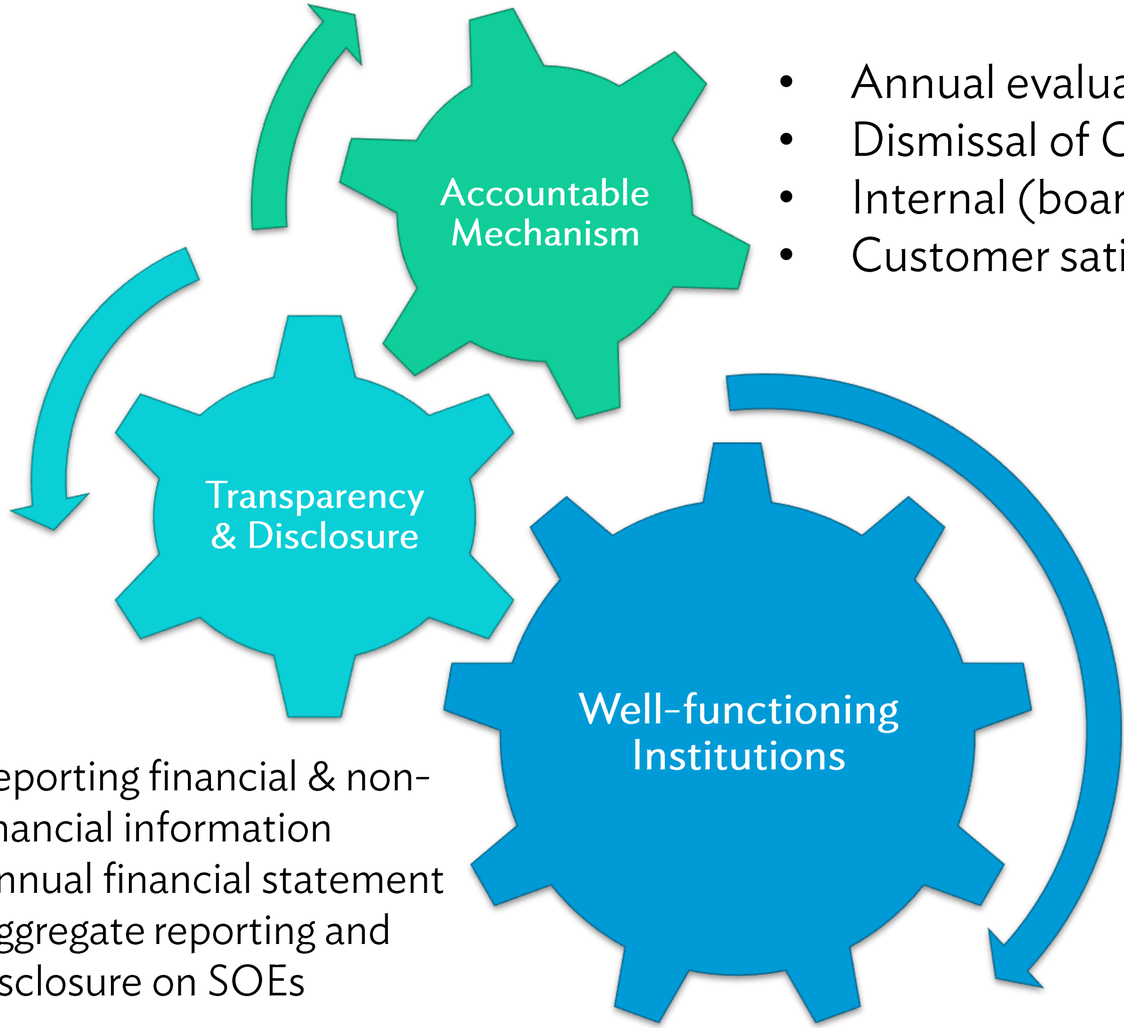
State as an owner
– Clear and consistent ownership policy
– Neither passive nor excessive

- Mandate, function, roles and responsibilities of **ownership entity** (single or coordinating body)
- **Clear mandate and objectives** of SOEs
- **Regular and transparent disclosure and reporting** to public and national assembly

Regulatory and market reforms
– Level playing field

- **Regulatory framework**: separation between ownership and regulation functions
- **Legal framework**: corporatization, standardizing of legal forms of SOEs
- **Fair competition**: market opening, transparent in nature, and cutback of preferential treatments

Governance Reforms



- Annual evaluation of board performance
- Dismissal of CEOs
- Internal (board) and external audit process
- Customer satisfaction survey

- Professional and independent board of directors providing strategic directions
- CEO in charge of operational management
- Equitable treatment of minority shareholders

- Reporting financial & non-financial information
- Annual financial statement
- Aggregate reporting and disclosure on SOEs

Managerial/Operational Reforms

Performance Monitoring and Management

Setting clear criteria
(financial and non-financial targets and indicators)

Regular monitoring and evaluation
(preferably by external experts)

Linking performance to incentives/disincentives
(payment, promotion, prizes)

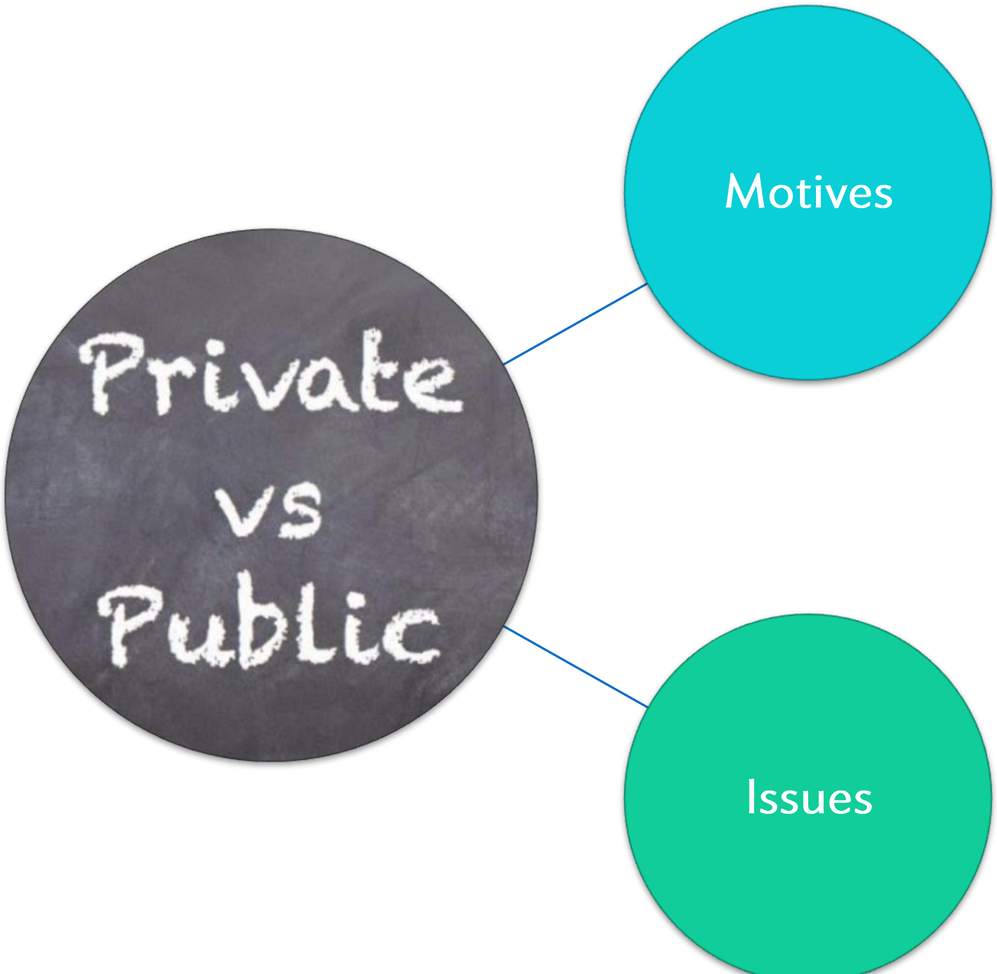
Human Personnel Management: Attracting Talents

Transparent merit-based recruitment

Management compensation: benchmarking and link to performance

Competitive remuneration system that is separate from civil service pay scale

Privatization (1): Ownership Transfer



- No need for state ownership, economic and market reforms
- Fiscal revenues, selling back temporary ownership (e.g. financial crisis)
- Political factors, ideological direction

- Process: **what, how and whom to privatize, what methods at what price**
- Necessary pre-conditions (e.g. legal and regulatory frameworks, governance structure, accounting practices)

Privatization (2)

What to privatize

- Healthier (profitable) or poorer firms, larger or smaller ones ("keeping the large and letting the small go" (China)), firms in strategic sectors, specific locations
- Restructuring firms before privatization – increase of firm values, cushioning negative effects, etc.

How to privatize

- Management and employee buyouts, trade sales and IPOs/secondary offerings, voucher
- Factors: size and profits of SOEs, degree of capital markets and property rights, impact on income inequality, government deficit
- Competitive bidding is important, to increase revenue and to offset unfairness

Whom to sell

- Domestic investors, SOE insiders, foreign and institutional investors, or mass investors
- Factors to consider: buyers' financial constraints, redistributive pressure from populace, etc.

Privatization (3)

Full or partial privatization

- Governments resort to mostly partial sales – only 11.5% involved the sale of entire SOEs (Jones, 1999)
- Tend to retain veto power through a variety of techniques (e.g. golden share)
- Why – potential gains, social concerns (e.g. employment), environmental factors (e.g. political constraints, employment protection laws, societal attitude)
- Partial sales as a signal of government's commitment to a future policy

Sequencing and valuation

- Sequencing for boosting long-term revenues and evolving regulatory regimes
- Price should be set to reflect the future expected earnings
- However, sales tend to be significantly underpriced
- Underpricing could be a signal of commitment to future policies

Privatization (4): Effects overall positive, But have context and be sector specific!

- Privatization generally **improves financial and operating performance** of former SOEs (Megginson, 2001 and 2017)
- Mostly dealt with financial improvements; **effects on social goals and distributional impacts** (e.g. ownership, employment, income, prices and access, fiscal) **were not clear**
- Many **bad cases** as well – private monopoly without regulation, service decreases/price increases, continued political meddling
- **Context and sector specific** – privatization in competitive or to be competitive markets had more positive impacts, and not so compelling in markets of natural monopolies or public goods

[Case] Privatization of British Rail

Restructured and privatized into 100 companies (93)

- Railtrack
- Many maintenance companies by region and function
- 3 companies holding locomotives and carriages
- 25 train operating companies

→ What happened?

A complex mixture of successes and failures

- Passenger and freight grew, and upgrade of infrastructure implemented
- But, Incentive incompatibility between companies and little incentive for security and maintenance
- 1996-2000 3 big fatal accidents, "Broken Rails"

Privatization (5): Best Practices

- Positive impacts **in competitive/contestable markets**
- **Appropriate regulatory framework in place** – anti-trust regulation to ensure competition and/or specialized regulation
- **Appropriate corporate governance mechanism** in place
- **Equitable transaction is important!**– competitive bidding including foreign investors, policy consideration given to specific groups, and/or break-up of the company to curb centralization of privatization benefits
- **Transparent processes and well-implemented communication** with the public

Conclusion – Key Messages

- SOEs/State ownership is country and context-specific! - The important is **how to maximize value for society**.
- Generally, **SOEs lag their private peers**, have economic risks and competitive concerns, and are prone to political meddling, requiring comprehensive reforms.
- **Careful assessment of SOEs** could lead to state ownership reforms and/or privatization.
- State ownership reform includes **a clear ownership policy, market and regulatory framework, transparent and accountable governance, and incentive-oriented operational reforms**.
- **Successful privatization (pull or partial) requires a proper regulatory framework** that is well placed and careful considerations on process management.

Thank You!