Policy Brief

Reforming State-Owned Enterprises in Central Asia: Challenges and Solutions

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Executive summary

In key sectors of the Central Asian economies, state-owned enterprises (SOEs) still retain a dominant role. Low productivity SOEs slow the economic growth in countries where SOEs have a significant share. In addition, the low productivity SOEs make the business environment more severe for the private sector (Taghizadeh-Hesary et al., 2019). Privatization can introduce competition in the market which can reduce costs and increase social welfare.

The motivated private sector is considered more efficient. Several countries managed to adjust their inefficient economic structures through privatization; however, privatization is not panacea either. Rather, it would be appropriate for each country to identify specific reasons for their economic challenges and opt for customized solutions.

Examples of deficient privatization cases demonstrate that most transition economies face the same set of challenges, namely: (i) lack of price-setting mechanism for state assets; (ii) unrealistic goal setting in the privatization process; (iii) lack of strategy, comprehensive plan and clear timetable; (iv) lack of public awareness about options; (v) insufficient expertise and knowledge about privatization; and (vi) underdeveloped capital market.

The policy brief assesses and reviews this set of challenges and provides policy recommendations for the Central Asian economies with the large public sector including:

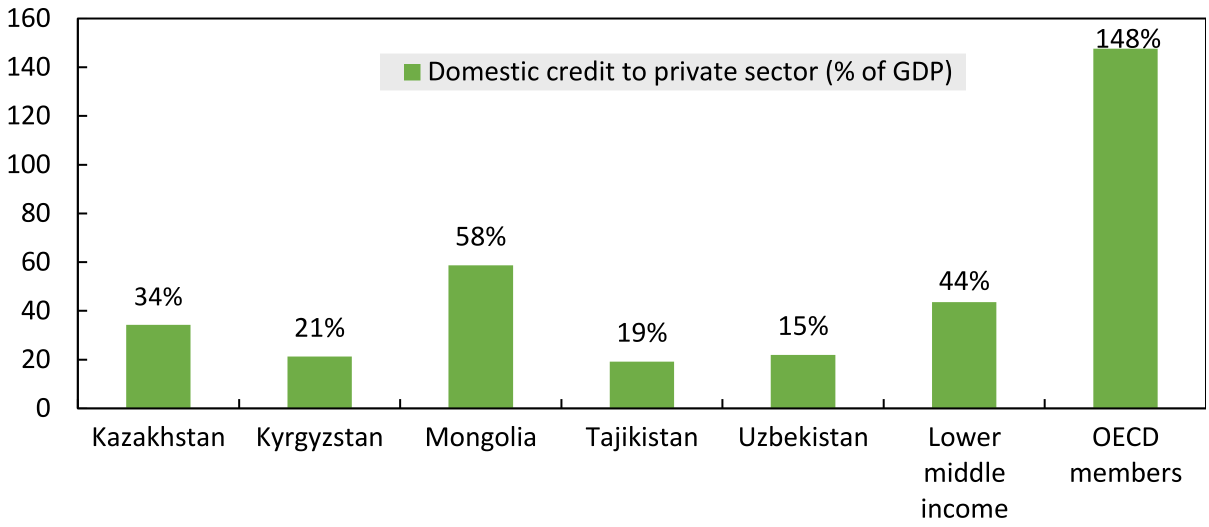
- Small-scale privatization program should come first
- Managerial reforms are required during the privatization process
- Policies must be transparent to public
- Policies must consider the local culture and shall not follow blindly external prescriptions
- Lessons shall be drawn from previous attempts of privatization
- Non-productive enterprises shall be liquidated, and their property shall find more productive use
- Establishment of a fully independent advisory committee for privatization of SOEs would be needed
- establish a synergy between privatization and capital market development as the sale of state assets provides a tremendous impetus to stock market activity.

1. Introduction and background

The SOEs dominate key sectors in most Central Asian economies as significant borrowers and trade controllers of major exports and imports. They also command a sizable share of public resources (Taghizadeh-Hesary, 2019). These types of enterprises also actively provide social services (Forfas, 2010) and preserve social stability (Huang, Li, and Lotspeich, 2010). They often dominate sectors, such as finance and telecommunications. In 2015, the 51% of global SOE activity (except for the ones in the PRC) was concentrated in electricity, gas, transportation, telecom, and other utilities, representing around 70% of total employment in SOEs. In the PRC, particularly, financial firms (such as banks) hold over half of the SOE value. Manufacturing, electricity, gas, transportation, and the primary sector each accounted for at least 5% of the SOE value.

In Central Asia, government's large role in the economy, reflected in the dominance of SOEs in local markets, impedes efficiency and entrepreneurship. For example, in Kazakhstan, SOEs account for about half of total value added, one-third of employment, and hold assets equal to nearly one-half of GDP. In Uzbekistan, SOEs account for about half of total value added, and 20% of the employment GDP (World Bank 2018; OECD 2018a).

Figure 1. Domestic credit to the private sector in Central Asia



Source: OECD (2018b)

The inefficient SOEs make the business environment tough for the private sector. While SOEs find it easier to access the state-bank loans, access to finance is challenging for the private enterprises. Figure 1 compares the domestic credit to private sector (%GDP) in selected Central Asian economies with lower middle-income countries and OECD members. Credit to the private sector in Central Asia remains comparatively modest, while majority of credit is allocated to the SOEs. The domestic credit to the private sector (%GDP) in 2017 was 34% in Kazakhstan, 21% in Kyrgyzstan, 58% in Mongolia, 19% in Tajikistan, 15% in Uzbekistan, compared with 148% in OECD countries (OECD, 2018).

In Central Asia, objectivity and transparency of indicators to measure results of financial and economic performance of SOEs remains an issue. In the management of SOEs, the political component prevails over the economic. The civil society and other stakeholders do not necessarily have a platform to raise concerns about effective management of SOEs. Thus, it proves necessary to reform the public sector in the region to improve productivity, provide a level playing field to the private sector, enhance competition, and boost innovation.

In essence, corporatization is the process of transforming state assets and government agencies into corporations. Privatization is a process whereby the public sector facilities and functions are transferred to the private sector. According to D'Souza, Megginson & Nash (2007), "privatization exposes the firm to the discipline of the product market. Having to compete with other firms for customers and market share may provide the required pressure to stimulate greater efficiency and profitability and identify competition as a major determinant of the post-privatization performance improvements." Since privatization is a strategy, it should be applied to reach a balance between political and economic goals. Privatization alone does not provide solution to all issues.

The basic goal for corporatization and privatization is ending the dominant and inefficient role of the government in the economy to achieve economic growth. Hence, turning SOEs into profit-making entities led by free enterprise rules of market economy shall make them become efficient to survive in market conditions and make profits. After privatization, they are expected to rationalize their economies to ensure sustainable growth and health over time despite predictable fluctuations in their performance caused by market forces. However, this does not mean that privatization proves a good solution for all SOEs as some of them serve the social welfare and equity goals.

Briefly, privatization of the public sector is meant to achieve certain objectives, including decreasing government involvement in economy and reducing its operating costs, stimulating competition in the market, and increasing efficiency of state agencies to secure economic growth, wealth and prosperity. The resulting benefits for the governments include decreasing budget deficits caused by injecting government funds into inefficient SOEs, ending costly subsidies, making their products and services competitive, reducing the number of government employees to rationalize its workforce, releasing government funds locked in non-profitable SOEs to help increase investments in profitable sectors, and increasing government revenues by cutting large financial contributions to SOEs.

2. Challenges of Corporatization and Privatization

2.1. Lack of price-setting mechanism for state assets

One important issue that needs to be considered during corporatization and privatization is the pricing of the economic units to be privatized. The underpricing of the government assets would generate a windfall for the private buyers, while over-pricing would scare off the prospective buyers. Consequently, the government needs a mechanism to avoid corruption and price the asset rationally. It is important to consider income-generating potential of the asset, their historical performance in the preceding years, and the necessary amount of investment to address shortcomings to make the asset operational and profitable. Evidence suggests that this approach was underestimated in many developing countries during privatization leaving the door open for many flaws in the process.

2.2. Unrealistic goals setting

Another challenge in corporatization and privatization is setting realistic goals when the government plans to privatize thousands of large and small SOEs over a short period of time in the absence of a private sector capacity to absorb such privatization.

2.3. Lack of strategy, comprehensive plan and clear timetable

Another challenge of SOE privatization in most Central Asian countries is the lack of strategy, and absence of a comprehensive corporatization and privatization plan with the corresponding timetable. Turkey provides a successful example of a large and orderly privatization in 1986. The Turkish plan clearly set the main goals of the privatization and the necessary legal changes for its successful implementation. It specified the 32 SOEs to be privatized and determined their privatization steps (Fazelian, Peimani, Taghizadeh-Hesary, 2020).

2.4. Lack of public awareness about options

Lack of awareness about engagement options for the market players in the privatization process can create an obstacle to its successful implementation. If privatization takes place through the stock market, potential investors need to be informed. However, evidence shows, that majority of privatization in the region happens without creating awareness about the sale, thus depriving potential investors of the opportunity to invest.

2.5. Lack of expertise in privatization

Many governments lack required expertise to devise the plan appropriate to the country's needs and realities and implement it accordingly. By not acquiring such expertise, the governments miss the opportunity to reduce the size of the public sector, decrease their financial liabilities, increase financial means, and foster development of the private sector. The lack of expertise sometimes demonstrates in selling SOE stocks below their market value due to wrong valuation which can results in corruption, loss of public assets to speculators, bankruptcy of the privatized SOEs, and worsening of the government's financial status.

2.6. Underdeveloped capital market

The Central Asian economies are often characterized by bank dominant economies (Yoshino and Taghizadeh-Hesary, 2015). The financial markets in developing Asia, including the Central Asia, are dominated by bank loans. The share of capital market and non-banking financial institutions is insignificant.

Given that selling shares of SOEs is the main form of privatization in many Asian economies, the underdevelopment of the capital market in developing Asia can be considered a serious challenge. On the other hand, if governments have a clear plan for developing the capital market, there could be a synergy between privatization and capital market development, as the sale of state assets provides a tremendous impetus to stock market activity. Hence, there is a linkage between privatization and capital market development (McLindon and Reich, 1996).

3. Policy recommendations for reforming SOEs in CAREC countries

Drawing on experiences of the Central Asian economies in corporatization of public assets and privatization of their SOEs, the following policy recommendations are proposed both for the Central Asia and countries which are undergoing similar processes.

The small-scale privatization program should come first

Some of the examples of unsuccessful privatization cases demonstrate that they started with the privatization of large companies at a high price tags which the private sector could not afford. The process should have started with the privatization of small and less expensive companies to help the private sector generate the required capital gradually to afford privatization of large companies.

The merit of this approach is evident in the case of Central and Eastern European countries. They have adopted separate programs for privatization of small-scale enterprises, usually in the early phase of transition. Examples include the Czech Republic, Estonia, Hungary, Latvia, and Poland, each of which has used a different method, for example, auctions in the case of the Czech Republic and concessions to insiders in the case of Poland.

Considering these experiences, Uvlaic (2003) concludes that by distinguishing between small-scale and large-scale privatization, the issues that delayed privatization of larger firms have been avoided, including high capital requirements, major restructuring needs, and regulatory weaknesses. Small firms proved much easier to privatize than large ones. Most small firms in transition economies were concentrated in trade and services, and were characterized by use of simple technologies, easy entry, and rapid returns. This helped reduce both uncertainty and risk for generally risk-averse post-transition investors.

Need for managerial reforms during the privatization process

Often, existing SOE personnel and management provide substantial resistance to SOE privatization out of fear to lose privileges and benefits associated with their position in the SOE. Transferring or selling SOE shares without changes in the managerial structure or competences might result in no change in elevating the SOE productivity and competitiveness. While privatizing a SOE, electing or appointing management with the right mindset, and changing managerial approaches, would be critical to spur quality and competitiveness of the privatized products and services.

Other practical recommendations for effective privatization

Privatization in CAREC and similar transitional economies can be made more effective through the following:

i. Provide transparency about the privatization policies to the public
ii. Consider the local culture and context, do not follow blindly external advice
iii. Draw lessons from previous attempts of privatization and other country experiences
iv. Liquidate non-productive enterprises, and find more productive use of their property instead of privatizing them
v. Establish an independent advisory body for privatization of SOEs
vi. establish a synergy between privatization and capital market development as the sale of state assets provides a tremendous impetus to stock market activity.

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