State-Owned Enterprise Restructuring
Better performance through the corporate structure and competition

The modern corporation—as an ownership and management structure

The legal structure of the modern corporate form has four fundamental elements—separate identity, limited liability for shareholders, centralized management, and transferability of shares. These, together with the dynamics of the governance relationship between the owners (shareholders), the supervisory board (board of directors), and the executives of the firm, provide what can be called internal incentives for efficiency.

The legal form, while necessary, is not sufficient to ensure efficiency, however. In addition to the internal incentives, certain external incentives must be in place for sustainable efficiency gains. Corporate performance is influenced by external pressures from competition in product, factor, debt, and equity markets and by regulation (company and securities law, bankruptcy law). The interplay of the internal and external incentives causes the managers to act in accordance with the goals of efficiency and profitability set by the owners—and causes the modern corporation to act with a clarity and singleness of purpose. The absence of any of the internal or external incentives can seriously undermine performance.

The SOE—as a modern corporation

Countries as diverse as Chile, New Zealand, the Republic of Korea, Sweden, and the United Kingdom have tried, with some success, to reform their state-owned enterprises (SOEs) by imposing on them the same framework of internal and external incentives that applies to the successful modern corporation. This Note reviews the measures that appear to be the most crucial in improving performance.

Internal incentives

Clarify the principal and agent incentives

Principal and agent incentives are best clarified through three mechanisms. First, property rights should be defined, used, and accounted for under the same rules as pertain to modern private sector corporations. In practice, many SOEs have been operated as if part of a government agency. Often their accounts resemble those of a government office and as a result cannot be relied on by creditors nor used to evaluate performance against similar private firms.

Second, the corporation and its owners should have separate legal identities to insulate management from political leadership. One of the
most common features of inefficiently run SOEs has been continual intervention by the state's designated representative in day-to-day management (to achieve noncommercial goals), to the detriment of the enterprise's profitability.

Third, among successfully reformed SOEs, share transferability has turned out to be a fundamental attribute. In private sector firms, the residual risk bearers must have effective control over management decisionmaking or have the ability to sell their ownership rights to new owners (for example, through the sale of shares to a strategic investor). But in SOEs, the residual risk is borne by the entire population—taxpayers and consumers—which has no easy way to control the enterprise or to sell its ownership rights. So the incentives for state agencies to ensure that SOEs perform efficiently are weakened. While a corporatized SOE like Coalcorp in New Zealand or Statoil in Norway may look like a privately owned enterprise, it lacks the discipline imposed by residual risk. This deficiency could undermine all the other reforms. Many countries, including New Zealand and the United Kingdom, have confronted this problem by going beyond restructuring and diversifying SOE ownership. In some cases, these countries have fully divested SOEs to secure the full benefits of diversified ownership.

**Separate commercial from social objectives**

Many SOEs are told to pursue a complex agenda of social and political targets that often conflict with sales or profit-maximizing objectives. For example, SOEs often face pressures to generate or preserve high levels of employment. While SOEs can act as model employers, honor labor market legislation, and provide comprehensive benefits to employees, the reality of their employment strategies is not encouraging. Many SOEs are overstaffed, with unacceptably low levels of productivity, absenteeism well above the private sector average, and unbridled growth in nonmonetary benefits. These conditions place too heavy a financial burden on the enterprise and make targets set by the government unattainable. The temptation to mix social and commercial objectives should be resisted. Governments should set has been continual intervention by the state's commercial objectives for SOEs and give them incentives similar to those that apply to private firms. Where social objectives are imposed, the cost should be identified and the enterprise fully compensated.

**Provide incentives to corporate participants**

Effective internal governance for corporatized SOEs has been achieved when the state has provided adequate incentives to boards, managers, and employees to meet commercial objectives. Efforts to seek efficiency gains through increased managerial autonomy in the day-to-day operations of the SOE will inevitably fail if the financial rewards for management are insufficient. The more efficient reformed SOEs—such as Statoil, Semen Gresik (Indonesian cement), Usinor Sacilor (French steel), and Coalcorp—have all recognized that to attract and retain top-level managers willing to assume their full responsibilities, the link with typically rigid and inflexible civil service pay and conditions must be severed. These SOEs have offered terms and conditions more akin to the risks and rewards in private firms and have sought to compete with private firms in hiring experienced and competent management. Incentives for employees—such as profit sharing and equity distribution—have also worked well.

**Put the private sector on boards**

It is important to establish a strong board structure to develop the overall strategy for the SOE and to monitor the performance of management.
But choosing board members on the basis of strong political ties or alliances should be avoided. This usually encourages political interference in the day-to-day operation of the business and will achieve little by way of improved corporate governance. A more effective way of ensuring that boards perform their strategic and monitoring role is to introduce private sector representatives. In Norway, Statoil has had non-government representatives on its board for some time, as have the French steel firm Usinor Sacilor, all the large Korean SOEs (known as government invested enterprises), and, more recently, Semen Gresik in Indonesia. But experience shows that maintaining the distance between politics and business is difficult. In New Zealand, the SOEs that have not yet been privatized have begun to suffer from the re-emergence of interference from politicians.

Avoid large holding company structures

International experience suggests that the significant disadvantages of large holding companies far outweigh any limited advantages they were perceived to have—such as centralized support services and economies of scale in procurement. Holding structures create additional layers of bureaucracy, they fail to shield the operating companies in the group from undue political intervention, they allow cross-subsidization between the companies, and they distort signals and incentives for management. Finally, it is notoriously difficult to control their growth and longevity once they are established. Experience in France (Usinor Sacilor), India (Hindustan Machine Tools), Italy (IRI), and Turkey (Sumer Holdings), as well as in Algeria, Egypt, and Kazakhstan, amply demonstrates many of the drawbacks of these structures.

External incentives

Encourage competition

Perhaps the most important external factor in performance is the degree of competition that the enterprise faces. Statoil, the fully integrated Norwegian oil company, has had to compete vigorously in international markets against large multinational companies. As a consequence, both its owner—the Norwegian government—and its managers have been united in their resolve to match the efficiency levels of their larger private competitors in order to survive commercially, particularly in the absence of large state subsidies. Similarly, Coalcorp in New Zealand has maintained acceptable financial performance despite hard budget constraints and competition from other energy sources. This success has been due in large measure to the pressure Coalcorp faces in the domestic market, from forty to fifty privately owned coal mining companies, and in the international market, where the company is a small player in a highly competitive environment. The increases in Coalcorp’s export sales in 1993 and 1994 are testimony to its emphasis on commercial practices and productive efficiency.

BOX 1 SEMEN GRESIK: THE IMPACT OF THE INITIAL PUBLIC SHARE OFFERING

In July 1991, Semen Gresik became the first Indonesian SOE to issue shares on the Jakarta Stock Exchange in order to finance a major capital investment project. This initial public offering comprised 27 percent of total share capital and generated about 280 billion rupiah (US$140 million). Of the new shares sold, about 85 percent are held by foreigners, mostly institutional investors.

The successful listing of the company has led to significant changes in the management and oversight of the enterprise. First, under regulation 55/1990, the company became exempt from cumbersome government supervision and monitoring and onerous government procurement rules, and it enjoys greater flexibility in the sourcing of funds. Second, company performance has come under close scrutiny by the (minority) private shareholders. Public reporting now takes place every three months, and company finances are audited in line with international accounting standards by a reputed international auditing firm. Company performance is also scrutinized by external financial analysts, who publish periodic evaluations of the attractiveness of Semen Gresik’s shares for current and potential investors. Management and government officials agree that the much closer scrutiny and the external pressures that have accompanied the listing of shares have led to greater transparency in the company’s performance and created a greater sense of accountability by company management for efficiency improvements. While Semen Gresik’s performance remained satisfactory in 1994, further improvements in efficiency and financial performance are expected as a result of new capital investments coming on stream.
But governments sometimes prohibit competition between SOEs, even when there are many operating in the same sector, and restrict entry or competition from private sector firms. The Indonesian cement industry comprises nine companies, of which five—including Semen Gresik—are state owned. The government intervenes in the domestic market by setting regional benchmark prices and by allocating regional markets on the basis of proximity, installed capacity, and projected cement demand. Exports of cement must be authorized and are allowed only when domestic cement demand has been met. This market control system provides Semen Gresik and the other producers with captive regional markets. The minimal competition has led to supply bottlenecks and shortages. The government is therefore considering deregulating cement pricing and marketing to improve efficiency and provide incentives for investment in the sector.

**Improve financial discipline: The role of debt**

Creditors can exert a discipline akin to that imposed by shareholders. But where the state as owner protects its corporations from that discipline—usually by guaranteeing their debts—it removes a strong incentive for management to be efficient and it introduces the possibility of moral hazard. All too often—as in Italy, Japan, Pakistan, and Turkey, for example—governments have been unwilling or unable to impose debt market discipline on SOEs through the banking system. Turkey’s Sumer Holdings is a case in point. With most loans to Turkey’s SOEs backed by government guarantee, management has faced little commercial discipline in investment decisions. Bad SOE loans have become a major drain on the Turkish government’s finances.

**Improve performance through equity markets**

Where there is an active equity market, diversified sales of SOE shares or the dilution of government ownership through rights issues can do much to improve a company’s performance. Some of the external pressures that can motivate improved governance can be created by selling even a minority portion of the government’s shares to the private sector. More and more governments have done so in recent years (box 1). The market exerts an important discipline on management, demanding information flows and, through pricing of equity, evaluating management performance. Indeed, experience suggests that there are in fact systemic limits to SOE reforms that do not increase private participation in financing, management, and, especially, ownership.

**Avoid complex monitoring**

Some countries—France, Indonesia, Korea, Mexico, New Zealand, and Pakistan, for example—have put a great deal of effort into designing elaborate monitoring systems. These systems usually include management controls and complex formulas for various markets. Some are poorly designed: they distort incentives and are difficult to enforce. There is little hard evidence that these systems have been able to develop and—equally important—maintain objective performance benchmarks that reflect decisions that management can control. An efficient internal governance system coupled with the discipline of external incentives works better than these complex, centralized monitoring schemes.

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