



Strengthening public finance through reform of state-owned enterprises

In almost every developing country the public sector undertakes a significant share of its production and investment through state-owned enterprises (SOEs). SOEs are financially autonomous and legally distinct entities wholly or partly owned by central or subnational governments. Unlike government departments that generally depend on taxes, SOEs can earn most of their revenue by selling goods and services. The output of SOEs can be a substantial share of GDP, although it varies widely from country to country (see Figure 8.1). SOEs have an even greater share of total investment; they accounted for more than 20 percent in thirteen of the nineteen developing countries shown in Figure 8.1. In Zambia, Burma, and Venezuela their share of total investment was more than half in 1984.

SOEs produce a wide variety of goods and services, many of which are also produced by the private sector. They range from power generation, water supply, telecommunications, and transport to manufacturing, mining, agricultural marketing, and finance. Varying degrees of state control and different legal forms further underscore the diversity of SOEs. However, the pricing and borrowing practices of SOEs have much in common; so do their financial implications for government budgets. As a result SOEs have been a major element in public finance in developing countries. In the past their fiscal effect was often hidden by a lack of consolidated financial data on their operations, opaque budgetary procedures, extrabudgetary financing, implicit subsidies, and protection from

competition. More recently tight budget constraints, limits on domestic and external financing, and the effects of devaluation and trade liberalization have exposed the weakness of SOE finances and their worrying effect on the fiscal stability of many developing countries.

SOE contributions to rising public sector deficits and growing foreign indebtedness are increasingly recognized as key issues in public finance. Moreover, during the past twenty years many governments have added dramatically more SOEs to the utilities, marketing boards, and other enterprises they inherited at independence. More than half of Africa's SOEs were established between 1967 and 1980; during the same period the number of SOEs grew rapidly in many other countries, including Mexico, Peru, the Philippines, and Portugal. By establishing a wide array of largely manufacturing and service-oriented SOEs, governments have sought to localize ownership of assets, to control strategic resources, and to foster infant industries. More recently, this trend has led to mounting concern over possible displacement of private initiative in areas where the public sector does not have a clear advantage. This chapter focuses on the issues of public finance common to many SOEs and explores the scope for reform.

How SOEs interact with public finances

As an integral part of the public finance system, SOEs both affect and are affected by public finance policies and institutions. Direct transfers to SOEs

from government budgets are the most obvious sign of this. Others are harder to see: interagency arrears and government guarantees of SOE debts do not appear by name in the budget. Through these interactions SOEs have added to public sector deficits and to a lack of transparency in public finance.

SOEs have imposed direct budgetary burdens

The budgetary effect of SOEs is the balance between central government financing of SOE operations through subsidies, net lending, and equity injections, on the one hand, and SOE contributions to the budget in the form of dividends and interest payments, on the other. In eight developing countries with suitable data the net budgetary transfers to SOEs ranged from more than 1 percent of GDP in the Dominican Republic to more than 5 percent in Sri Lanka during 1983–85 (see Figure 8.2). In a few cases—most notably Turkey—these transfers have fallen in recent years, through reforms in pricing and management and cuts in investment. In 1984 the net budgetary transfers to the SOEs among six of the countries shown in Figure 8.2 ranged from one-tenth of the overall central government deficit in Turkey to twice the deficit in the Philippines.

Some SOEs do make sizable positive contributions to the budget. In Egypt, for example, SOEs in the construction and services sector—as well as the Suez Canal and petroleum authorities—made positive net contributions. Persistently weak performance elsewhere, however, meant that Egyptian SOEs as a whole were a drain on government finances.

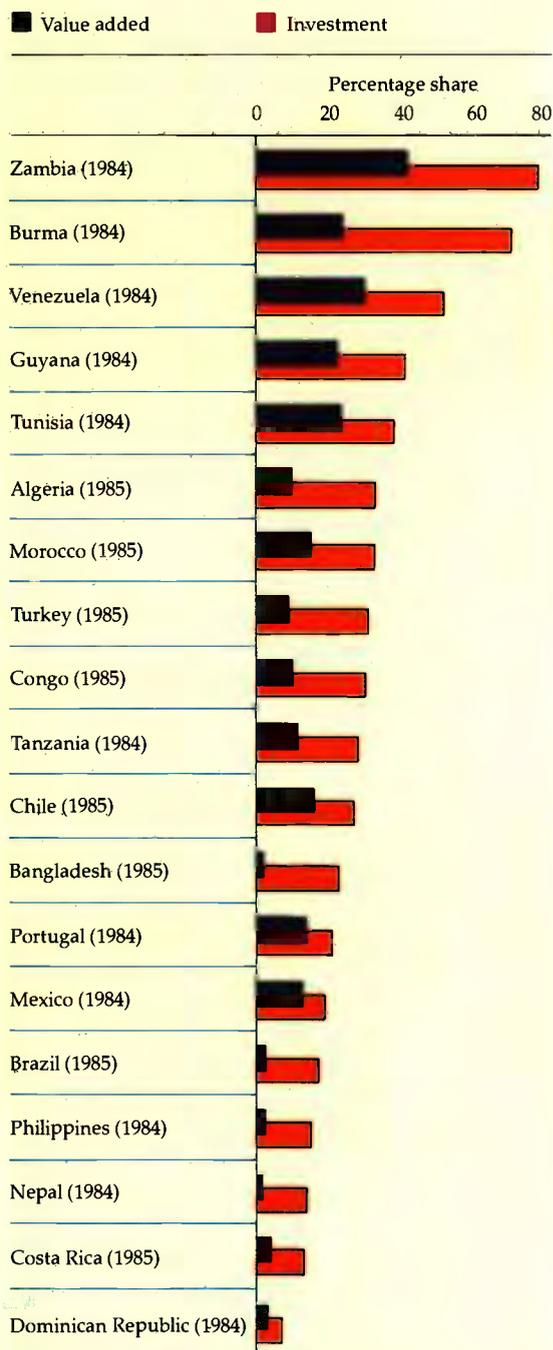
Transfers to SOEs can sometimes be justified by economies of scale, externalities, or attempts to relieve poverty. As discussed below, such goals might be achieved if SOE transfers were evaluated in advance, appropriately targeted, and closely monitored. Too often, however, such controls have been lacking. Budgetary transfers have thereby been the unintended outcome of poor decisions in investment, pricing, and management.

Interagency arrears have grown

SOEs also affect government finances through the buildup of interagency arrears and cross-debts. Sizable arrears can impede effective financial management because they obscure the true pattern of financing within the public sector. This situation has been especially common in Egypt, Morocco,

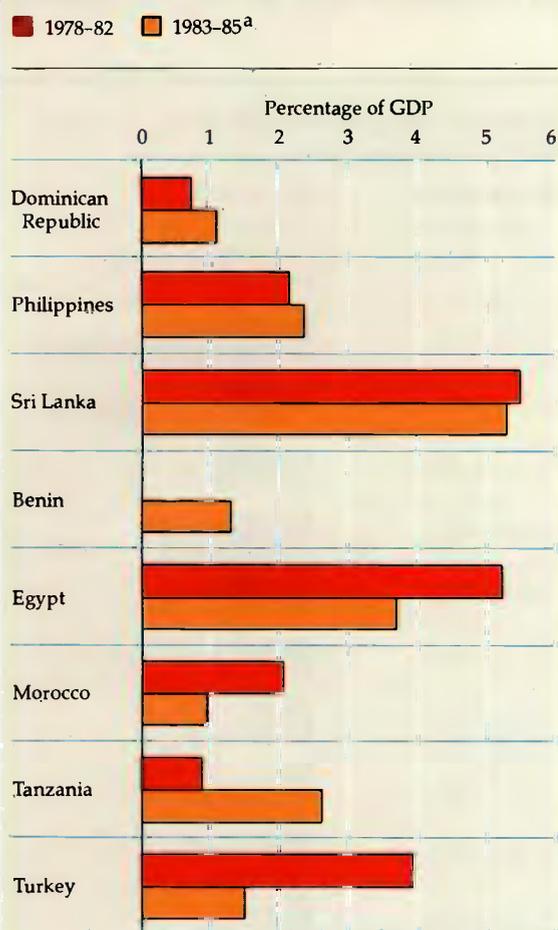
Portugal, and many Sub-Saharan African countries. In several instances unpaid government bills from state-owned utilities producing power, water, and telecommunications services have amounted

Figure 8.1 Nonfinancial SOE shares of value added and investment



Sources: World Bank and IMF data.

Figure 8.2 Average annual net transfers from government to nonfinancial SOEs



Note: Net transfers from government are defined as government equity, loans, and subsidies to SOEs minus SOE dividend and interest payments to government.
 a. 1983 for Benin and Tanzania; 1983-84 for Egypt.
 Sources: World Bank and IMF data.

to the equivalent of one year or more of the government's consumption of the relevant SOE output. Governments sometimes fail to hand over promised capital grants or subsidies; these become obligations for future fiscal years. If capital grant arrears had been counted in Morocco's central government budget in 1984, they would have added two and a half percentage points of GDP to the net budgetary transfers shown in Figure 8.2.

Sometimes, however, SOEs do not pay their obligations to governments: taxes, dividends, debt service, and so on. Often this happens after governments have failed to meet their financial obliga-

tions toward the SOEs; mutual arrears are a short-term answer for all concerned. The Gambian state power company owed the treasury an equivalent of 16 percent of current government revenue in 1984; its own unpaid claims on the government amounted to one-quarter of these arrears. At the same time interlocking arrears accumulated among other Gambian SOEs and municipalities. In extreme cases chain reactions may occur that seriously undermine the financial discipline of the entire public sector. For example, Egypt's publicly run railway company refused to pay state-owned engineering industries because of mounting government arrears. In turn the engineering industries did not pay the state-owned steel industries; the steel industries then refused to pay the state power company.

Government guarantees of SOE debt can be risky

SOEs have borrowed significantly in domestic and foreign credit markets. Governments have commonly guaranteed substantial parts of their debt and have often assumed the debts of SOEs in financial difficulties even where there were no formal guarantees. Explicit or implicit guarantees of this kind create contingent liabilities, but lack of accounting discipline means that often they do not appear in government budgets or accounts. Recent experience in many countries has made it painfully clear that the government's contingent liabilities can have serious repercussions if the financial situation of one or more major SOEs deteriorates. For example, when the former state agricultural marketing board in Senegal was liquidated in 1980, the government assumed bank debts equivalent to 15 percent of GDP.

Partly because of government guarantees SOE borrowing has added significantly to foreign debt. The direct foreign borrowings of SOEs accounted for more than one-fifth of total foreign debt in ninety-nine countries as a group and grew faster than the foreign debt of private borrowers during 1970-86 (see Figure 8.3). The total contribution of SOEs to external indebtedness is greater than this suggests, because governments passed much of their own foreign borrowing on to SOEs. SOEs have accounted for more than half of the outstanding external debt of Brazil, Mexico, the Philippines, Portugal, Zambia, and other countries. In most cases overambitious investment programs explain the rapid rise in foreign borrowing. Foreign interest rates often were, or at least appeared to be, lower than domestic rates; foreign lenders pre-

ferred lending to SOEs rather than to private enterprises because of explicit or implicit guarantees.

Government backing of SOE borrowing is all the more risky when public ownership is extensive in the financial sector. Credit granted to SOEs by government-owned banks poses the well-known risks of any financial institution lending to borrowers connected with its owners. Standard lending criteria may not be applied, so that loans are made for unsound investments, and foreclosures, where called for, are too long delayed. When SOEs perform badly, this can then mean a sharp rise in the banking sector's nonperforming assets, as in Cameroon, Madagascar, and Mali, for instance. In such cases public capital is required to recapitalize the banking system, which implies heavy future claims on the budget. In Benin, for example, SOEs created central government contingent liabilities to the domestic banking sector ten times larger than the direct budgetary transfers shown in Figure 8.2. Moreover most of their borrowing—which accounted for more than one-third of outstanding domestic bank credit and 13 percent of GDP in 1986—became nonperforming. This virtually paralyzed the country's banking system and put heavy demands on future budgets. The total effect of SOEs on public finance is understated when they contribute to financial crises. This is because public

expenditure associated with resolving financial crises is usually not included in the public sector deficit (see Box 3.3).

SOEs contribute to public sector deficits

The aggregate effect of SOEs on public finance shows up in the overall deficit of the public sector. For some of the years shown in Figure 8.4, SOEs realized deficits larger than the overall public sector deficit in Brazil, the Dominican Republic, Ecuador, Egypt, Turkey, and Venezuela. In other words, the rest of the public sector would have generated a fiscal surplus without the net transfers to the SOEs. In the Philippines and Costa Rica, SOE deficits on average accounted for one-half of the overall public sector deficit during 1981–84. In many other countries such calculations are impossible for lack of data. Most countries fail to monitor the financial position of their public sector as a whole, even though macroeconomic management and stabilization policies call for control of public sector deficits, broadly defined. What accounts for this weakness in fiscal management?

SOEs have diminished the transparency and accountability of public finances

Traditionally, public finance analysts and policymakers have focused their attention on the central government budget as the main determinant of fiscal policy. Analysis of SOE finances had largely been left to sectoral experts. Thus few systematic attempts have been made to monitor SOE financial performance in the aggregate or to compile fiscal data for all levels of the public sector. In Brazil, for example, where SOEs were the fastest growing part of the public sector during the 1970s, the government had no consolidated statistics on their earnings, spending, or debt until 1979. Where efforts have been made to gather information, the rapid growth of SOEs has often outpaced the analysts' ability to collect and evaluate it. In Tanzania in 1986, where the number of SOEs had increased tenfold since the mid-1960s, almost a third were more than two years behind in submitting accounts for audit. SOEs often do not follow uniform accounting standards, so their financial statistics are difficult to consolidate with other public sector statistics. Unforeseen budgetary claims can also arise from failing private enterprises in which public holding companies and state-owned banks had acquired portfolio interests. These indirect and minority state shareholdings have rarely been subject

Figure 8.3 SOE contributions to the growth of external debt in developing countries, 1970 to 1986

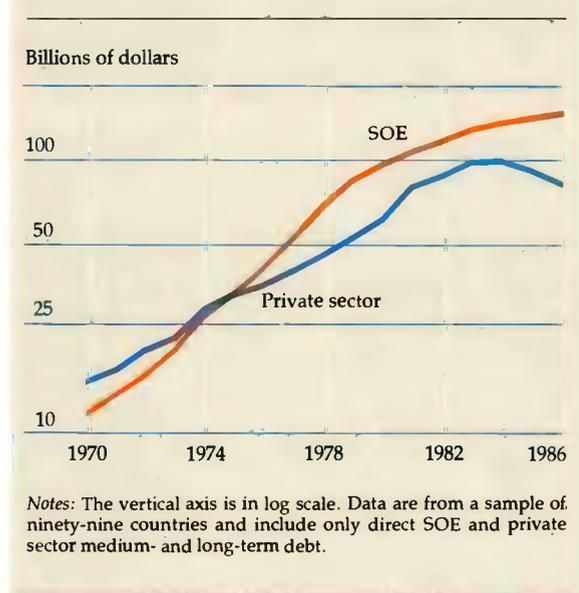
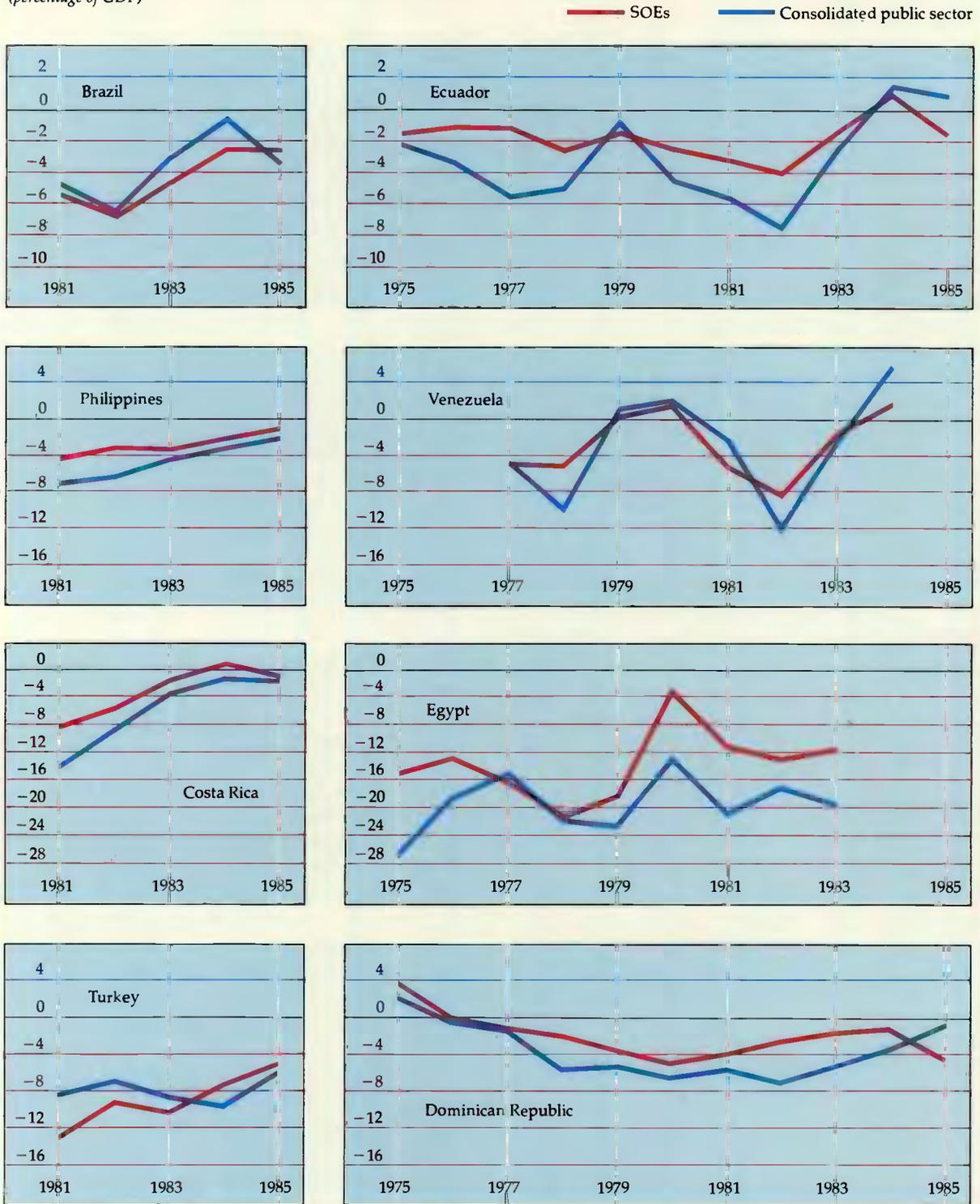


Figure 8.4 Trends in SOE and public sector balances
(percentage of GDP)



Notes: SOE balances are calculated after taxes and before net transfers from government. Public sector balances are defined as total public revenue minus total public expenditure and are based on consolidated government and nonfinancial SOE accounts. The years covered vary because of differing data availability for individual countries.
Sources: World Bank and IMF data.

either to strict investment criteria or to central monitoring.

However, the failure to view public finances comprehensively is not entirely caused by a lack of data. SOEs were often set up or enlarged precisely because they were largely exempt from fiscal control. Where strict legal or administrative rules limited the creation of new SOEs, ways were often found to circumvent them. For example, in the Philippines during the 1970s and early 1980s some sectoral ministries were able to avoid legal restrictions on the establishment of new SOEs by forming subsidiaries of existing ones. This practice has been widespread elsewhere, as in Brazil, where the creation of SOE subsidiaries was largely uncontrolled until 1979.

SOEs have therefore been both a cause and a symptom of weak fiscal discipline and lack of transparency. Transparency—the ability to assess the financial implications of public sector activities in advance, to evaluate them after the fact, and to identify who bears the costs and who receives the benefits—is necessary if decisionmakers are to be accountable for their actions. Of course, developing countries are not alone in these difficulties. A recent study has documented the growth of off-budget SOEs and agencies at all levels of government in Japan, the United Kingdom, and the United States—“underground public sectors” not subject to the usual fiscal and political controls. Even in the United States, where SOEs have traditionally had only a limited role, off-budget enterprises borrowed an estimated \$50 billion in private capital markets in 1982; this sum was implicitly or explicitly guaranteed by the federal government. However, lack of transparency has been particularly disruptive in developing countries. The SOE sector has often been the source of unexpected fiscal crises when the economic or political fortunes of a country worsened, which exposed the weaknesses of substantial segments of the economy that had directly or indirectly come under public control.

Recent fiscal crises have forced the governments of developing countries to reconsider the role and management of SOEs. Official reports in India, Kenya, and Tanzania, for example, have drawn attention to poor management of the SOE sector and to its budgetary implications. More than thirty governments have undertaken studies to identify weaknesses in the sector and in its relations with government. More than ten developing countries have begun comprehensive reforms as part of broader efforts to improve resource mobilization,

allocation of public expenditures, and overall fiscal management. One approach is to reform the traditional instruments of fiscal policy: pricing, taxation, subsidies, and expenditure allocation. Another is to enhance fiscal discipline within the public sector. A third is to increase the role of the private sector.

Strengthening SOEs through fiscal instruments

SOEs finance their spending in three main ways: through revenues from the sale of goods and services, through transfers from the government (including receipts from earmarked taxes, subsidies, and equity contributions), and through borrowing. For commercial SOEs the first of these three sources of finance is generally by far the most important.

Rationalizing SOE pricing policies

Better pricing can have many benefits. It can make SOE operations and investments self-financing, thus reducing the SOE contribution to the overall public sector deficit. This facilitates the pursuit of sound public finance policies. For example, it alleviates the pressures on central government to raise taxes, which are often costly in terms of administration and economic distortions (see Chapter 4). It also alleviates pressure to raise financing through inflation, crowding out, and foreign debt (see Chapter 3). In addition, it helps to limit the overall imbalance between savings and investment in the economy, thus reducing pressures on the balance of payments. The scope is substantial. In Argentina in 1985 the sale of SOE outputs accounted for roughly one-third of public sector revenue. Pricing adjustments in Costa Rica helped move the SOE overall deficit from more than 5 percent of GDP in 1982 to a small surplus in 1984 (see Figure 8.4).

As discussed earlier, raising revenue from the sale of publicly provided goods and services can also improve the efficiency of resource allocation, provided prices or user charges are set to reflect economic cost (see Boxes 4.1 and 6.1). Where SOEs produce internationally traded goods, prices in international trade—also called “border prices”—are generally the appropriate reference point. The coal industry provides an example. In many countries its domestic price was often set below border prices. The implicit subsidy to users was met by grants, equity contributions, or loans from governments to coal-producing SOEs. This encouraged

inefficient use and excessive expansion of capacity. Tighter budgets then forced deep cuts in investment, in some cases compromising longer term energy plans. This happened in Indonesia and the Philippines during the 1970s; since 1980 both have taken steps to align domestic coal prices with border prices.

For SOE outputs not traded internationally—for example, power, water, and telecommunications—the long-run marginal cost of production is the basis for efficient pricing. The principles were discussed and illustrated for the water and power sectors in Chapter 6. Underpricing leads to overexpanded capacity, unnecessary burdens on government budgets, and excessive foreign borrowing by the SOEs concerned. Often it happens because cumbersome centralized mechanisms for revising utility tariffs delay price increases after costs have gone up. Political difficulties can then cause further delay. Small but frequent price increases, in line with broad factors affecting costs (such as inflation or devaluations), have successfully avoided these problems in some countries.

Limiting SOE subsidies

Setting SOE prices with reference to economic cost will go a long way toward limiting both the call on central government transfers and SOE borrowing. Experience has shown that for most SOEs efficient prices will be compatible with financial viability. However, subsidies will still be appropriate in some cases, most notably for the relief of poverty or on the grounds of declining costs, since efficient prices will then not cover financial costs.

In principle, to ensure financial viability and transparency, SOEs should be explicitly reimbursed from the budget for the cost of financially unviable, but socially desirable, projects. Otherwise they may have an incentive to underprovide such services or may encounter financial difficulties. The costs and benefits of such subsidies should be evaluated according to standard investment criteria, and a budgetary provision should be made in advance. In some instances, though, it may be more effective to subsidize low-income consumers by charging them less than cost and charging better-off consumers more. Some countries have applied this approach to water, power, and rural telephone services. Cross-subsidies are particularly suitable where the obstacles to raising general taxes are insurmountable.

Rather than receive subsidies, commercial SOEs should pay taxes just as private enterprises do.

This will put them on an equal footing with private competitors and thus encourage efficiency. Where SOE prices act as taxes, as in commodity boards, surpluses should be transferred to the treasury. In areas such as telecommunications and natural resource extraction, efficient SOE prices may lead to financial surpluses. In these cases it is better to tax away some of the surplus to finance other high-priority public investments than to plough it all back into the same sector, pass it on to SOE clients through insufficient charges, or pay SOE employees higher wages. In several oil-producing countries, for example, much of the income generated by state-owned oil companies was wasted in excessive domestic consumption of oil, gas, and electricity.

Controlling SOE borrowing

Borrowing is justified as a way of allocating part of the financial burden of large-scale, lumpy investments to future users. However, it should not become a substitute either for justified increases in user charges or for injections of equity by the government.

It is also important that SOEs bear the full marginal cost of borrowing—especially foreign borrowing. The marginal cost will exceed the nominal cost if the loan has been provided on concessional terms or if access to foreign lenders is rationed. To ensure adequate discipline, some central control of borrowing will be needed in most countries. SOEs in Brazil and Côte d'Ivoire, for example, became subject to such controls in the late 1970s. Thailand has a strict ceiling on total public sector borrowing from abroad that also applies to government-guaranteed SOE loans. In addition, there are regulations that require SOEs to satisfy certain self-financing ratios and to remit a prescribed amount of profit to the government in order to be eligible for government loan guarantees.

Government guarantees on SOE borrowing should be given sparingly and mainly for public works and infrastructure that could spur private investment. They should not be used for commercial projects or joint ventures where unguaranteed credit on market terms is available. Informal or implicit guarantees are to be avoided; this can be done only with strict, pre-established limits on government exposure to SOEs, clear bankruptcy laws for SOEs, and the willingness of governments to liquidate insolvent enterprises. In the interest of fiscal discipline two socialist countries—China and Yugoslavia—have recently begun to

apply their bankruptcy laws to SOEs. Another remedy is to pass laws that clearly excuse governments from liability for SOE debts that are not formally guaranteed.

Improving the allocation of SOE spending

SOEs often operate in areas of special concern to the government; their investments are seen as crucial for development. In allocating their resources, they may not be subject to a direct market test. Moreover, in financing their expenditures, they often draw on subsidies, loans, or guarantees from government. Accordingly their spending—and especially their investment—should face an evaluation as rigorous as that applied to direct government transactions (see Chapter 5). Much of this can be properly carried out within the enterprise by applying standard criteria for project appraisal and operational cost-effectiveness. Central government agencies, in particular the planning and finance ministries, should restrict themselves to ensuring that the broad directions of SOE investment fall within national planning parameters, that the SOE carries out the appropriate analysis, and that SOE managers are accountable for the resources they use. However, the precise dividing line between central and delegated responsibility will vary from enterprise to enterprise.

In practice governments and SOEs everywhere—not just in developing countries—have deviated from these principles. The demands on public managers could be reduced by excluding from public sector planning those activities in which SOEs could compete among themselves or with private enterprises for banking credit—in manufacturing, for example, and many services. Financing in these cases would then be independent of government subsidies, loans, or guarantees. The point is also relevant for socialist countries that have begun to move away from central planning. Since 1984 the profits of SOEs in China, instead of being remitted to the government budget, have been taxed and the balance retained by the enterprises. SOEs in China have thus increasingly financed their investments from internal resources and bank loans rather than from government budgetary grants.

Enhancing fiscal discipline

Fiscal discipline is more than a matter of controlling borrowing and allocating spending more efficiently. This section highlights three further as-

pects: eliminating interagency arrears, improving the transparency of the financial reporting and monitoring of SOEs, and increasing the accountability of SOE managers. Experience in several developing countries has shown that after progress has been made in these areas, sound public finance becomes much more feasible.

Eliminating interagency arrears

Clearing government arrears to SOEs can be a laborious and expensive exercise, but it can greatly strengthen SOE finances. In 1982, using the proceeds of a special bond issue equivalent to 6 percent of GDP, the Ethiopian government settled its unpaid bills to SOEs and strengthened their capital base. Eliminating government arrears in Portugal has improved the financial ratios of several SOEs. Once arrears have been settled, government consumption of SOE outputs must be rigorously budgeted to prevent the problem from recurring. By reducing waste and by making civil servants pay the cost of utilities in government housing, the Moroccan government reduced its consumption of water, power, and telecommunications services—all provided by SOEs—by 4 percent, although its arrears remain substantial. An integrated government cash control system in Jamaica allows adequate budgetary provision and timely payment for SOE outputs.

The arrears of SOEs to governments also deserve attention. They are often settled by being converted to equity. But as long as SOEs do not pay dividends, such conversions are akin to government grants: they provide no incentive for fiscal discipline. Conversions should therefore be complemented by reforms in SOE taxation and pricing. Government auditing should monitor financial balances between individual SOEs and guard against the accumulation of arrears, which hamper efficient financial management in individual enterprises.

Improving financial reporting and monitoring

Improving the transparency of SOE finances calls for up-to-date data. These should include data on actual and planned spending and revenues and on changes in assets and liabilities, organized in a systematic accounting framework, and assembled regularly by a central agency. Most utilities in developing countries that receive foreign assistance or loans already apply standards of this kind; in principle they can be adapted for other commercial

SOEs without much difficulty. The use of a common fiscal year for all public bodies facilitates the consolidation of public sector accounts. Once established, such a reporting system is an invaluable tool of fiscal analysis and policy. In Thailand the central bank compiles SOE financial data in a comprehensive and timely manner. In 1979 Brazil created a federal body (SEST) charged with centrally monitoring SOE finances; it permitted the government to exercise better control over the creation, expansion, and liquidation of SOEs, as well as over their foreign and domestic credit operations. Kenya recently established a debt-reporting system, and it is already beginning to improve the management of SOE debt (see Box 8.1).

It is often useful to separate commercial and noncommercial public entities. Noncommercial activities are usually best integrated into the budget, as in Brazil, where 200 noncommercial agencies were removed from the oversight of SEST and put into the government budget. Separating these two kinds of public bodies (which is also being planned in the Central African Republic and Malawi) allows enterprises that are able to finance themselves to be overseen in a different way from those that must continue to depend on budgetary transfers.

Competent auditing is one of the keys to accurate financial reporting. It is also essential for creating or maintaining good internal financial management and for ensuring public confidence that funds collected by SOEs are not misused. Where public audit institutions and the domestic audit profession are too weak to carry out a radical reform of SOE audit procedures, it may be necessary

to bring in foreign firms on a temporary basis, both for initial rounds of audits and to train local staff.

Increasing the accountability of managers

Reliable and timely information on the operations of SOEs improves the accountability of SOE managers. At the same time data collection and monitoring systems are of little help unless they are part of a broader effort to give managers incentives for efficiency. Recently some developing countries have introduced incentive systems based in part on indicators of financial performance. In Pakistan an evaluation system provides managers and employees with bonuses based on performance; these have led to better cost control (see Box 8.2). In Senegal the government and six major SOEs signed contracts that established objectives and performance indicators and set out the reciprocal obligations of the government and the enterprises. Compared with others in the first three years of the experiment, these enterprises had greater sales growth and lower personnel costs. However, continued restrictions on SOE managers and the government's inability to honor financial commitments have reduced the effectiveness of these experiments. Similar experiments have recently started in other developing countries, including Bangladesh, Guyana, Mexico, and Morocco; others are being considered in Argentina, Egypt, and India. Agreements on pricing, subsidies, loan and equity financing, and investment programs should feature in performance contracts or evaluation systems.

Box 8.1 Improving the monitoring of SOE debt in Kenya

During the 1970s and early 1980s Kenya's SOE sector was plagued by poor debt reporting. No clear indication existed whether funds provided by the government to its SOEs were loans, equity, or grants, and the interest and amortization schedule for loans were often unspecified.

In 1984 the government began to assemble data on all outstanding loans to SOEs. The Kenya Internal Debt Reporting System (KIDRES) became operational in 1986. The system computes amounts due from SOEs according to banking principles, with penalty interest accruing on overdue balances. Retroactive agreements are sought where no loan records exist. If an SOE does not pay, the Treasury will not approve its budget.

During implementation several weaknesses in the

system became apparent. KIDRES cannot legally enforce debt servicing. It does not cover commercial bank lending to SOEs and thus presents an incomplete picture of debt-servicing obligations. Inadequate administrative resources have handicapped the smooth running of the system.

Nonetheless KIDRES has achieved progress in several areas in a short time. First, better information is now available for judging existing as well as new debts of SOEs. Second, a standard agreement is now completed before any new government funds are released to an SOE. KIDRES has also enabled the government to recover loan repayments from SOEs with above-average financial performance. In the past these SOEs had been unwilling to repay their loans.

Box 8.2 Evaluating SOE performance in Pakistan

In 1980 an Experts Advisory Cell (EAC) was established in the Ministry of Production in Pakistan to administer an oversight system for industrial SOEs. The system consists of enterprise information, performance evaluation, and incentive components. By evaluating SOEs on the basis of financial after-tax profits as well as indicators measuring physical production and energy consumption, the EAC focuses on increasing SOE production and sales while minimizing costs. Each SOE is required to provide cost-accounting data in a standard format. Targets based on budgetary proposals presented by SOEs are officially agreed on in a contract between the EAC and SOE managers, subject to approval from the ministry. A comprehensive weighted indicator based on agreed criteria and weights is used to grade the performance of each SOE into one of five categories. Managers receive bonuses ranging from three months of base salary down to nothing on the basis of this performance evaluation.

The new system appears to have induced managers to increase after-tax financial profits, which rose for most of the SOEs evaluated. By linking performance evaluation to bonuses, the new system also provided incentives for improved SOE accounting. Audited reports, which previously were delivered one to three years after the fiscal year, are now received within five to seven months. SOE managers more readily understand and accept performance targets, because these are negotiated with them rather than set from above. Required periodic meetings organized by the EAC between SOE managers and the heads of their holding companies have increased motivation and communica-

tion of problems.

Several constraints have, however, limited the ability of SOE managers to increase operating efficiency. Among them are the inability to reduce labor to cut costs, lack of control over compensation decisions, inability to close certain product lines, inflexibility in procurement decisions, and constraints on the choice of product mix, markets, and suppliers. In addition credit and foreign exchange ceilings are allocated as part of the budgetary process through negotiations between SOE holding companies and the Ministries of Production and Finance. There is no reason why these ceilings would tend to favor the more efficient firms, especially since price distortions make it hard to judge efficiency. Finally, the system's profit measure appears to provide incentives to SOE managers to minimize taxes, undertake interest arbitrage, underprovide for depreciation, and focus on nonoperating income that does not reflect operating efficiency.

These problems could be mitigated by reducing restrictions on managers in employment and production policies as well as by lowering barriers to domestic and foreign competition with SOEs. Further improvements might result from using the indicator originally proposed when the system was first considered. Performance was to be evaluated using "public profits" in constant prices based on private profits plus taxes, interest costs, and depreciation minus nonoperating income. These adjustments were designed to discourage SOE managers from activities that do not directly enhance the efficiency of their operations.

Although performance monitoring can bring improvements, the scarcity of managerial skills in most developing countries severely limits the number of SOEs that governments can oversee effectively. Improved SOE performance demands a balance between autonomy and accountability that is especially difficult to achieve when the number of SOEs and parent ministries is large. Evaluating SOEs that encompass utilities, manufacturing enterprises, transport companies, marketing boards, and financial institutions requires skill and resources. Where such expertise exists, it is usually captured by the enterprises, so governments often depend on the SOEs themselves for technical evaluation. As long as the number of SOEs remains large, measures to avoid arrears and to monitor financial flows will severely strain public resources. Where possible, therefore, SOEs should

accept competition and involvement by the private sector.

Reappraising the environment and the scope of SOEs

In recent years several industrial and more than fifty developing countries have begun to reduce the administrative and financial burden of the public sector by liberalizing and narrowing the SOE sector. These efforts have meant more competition and a smaller role for the government in the management and ownership of the enterprises. Because the span of effective government oversight is limited, such avenues should continue to be explored through periodic reviews of government shareholdings. These should assess the benefits of privatization, broadly defined as increased private

Box 8.3 Performance of public bus companies in two Indian cities

Comparing the performance of public bus companies in two Indian cities illustrates how prudent management, financial independence, and competition can combine to produce efficient and commercially viable public systems.

The Calcutta State Transport Corporation (CSTC) has a fleet of some 1,100 buses, of which usually less than 700 are in operation, mainly for want of repair and maintenance and sometimes because of lack of drivers. It has a high staffing ratio of 20.7 per operational bus. The CSTC has also been plagued by fare evasion estimated at more than 15 percent of revenue. The resulting combination of low productivity with fare inadequacies and evasion necessitates a subsidy of about \$1 million a month. By contrast, the city's 2,200 private buses—operated mainly by small companies or individual owners grouped into several route associations—have been able to survive financially without subsidy and to maintain low staffing ratios and high fleet availability. The drivers and conductors of private buses receive a percentage of revenue, which gives them a strong incentive to combat fare evasion. As a result the fare losses of private bus operations are extremely low, and their operating costs are about half those of the CSTC and are more than covered by revenues.

The Cheran Transit Corporation (CTC) in Coimbatore, a city of about 1 million inhabitants, is one of fourteen publicly owned bus corporations in the state of Tamil Nadu—all of which are financially viable and efficient. The CTC does not have an exclusive franchise but operates in direct competition with private buses. The corporation operates with a very high level of efficiency: more than 95 percent of the fleet is regularly in service, and the staffing ratio of 7.3 per operating bus is comparatively low for public bus corporations. Despite very low fares (\$0.04 for a five-kilometer trip), the CTC is able to make a profit (\$750,000 in fiscal 1984–85), which enables it to expand its fleet in line with demand. Much of the success of the CTC must be attributed to its dynamic and accountable management and to relatively consistent state government support for adequate and timely fare revisions. Also the CTC pursues prudent commercial policies, comprehensively monitors and costs its services, and has incorporated staff incentives that are common among its private competitors, including bonuses based on revenue gains and savings that result from a higher rate of bus use and better fare collection as well as an annual bonus for accident-free driving.

sector participation in the management and ownership of activities and assets controlled and owned by the government. Leases, management contracts, and divestiture are the principal modes of privatization. Among 600 documented privatizations completed worldwide since 1980, nearly 400 have occurred in developing countries and more than 160 in Sub-Saharan Africa alone. This excludes the divestiture of government shareholdings in many nationalized enterprises that were once in private hands, as in Bangladesh, Chile, and Uganda.

Reducing SOE protection

In many areas, exposing SOEs to domestic and foreign competition would promote economic efficiency. This means, as a rule, removing several forms of protection, including budgetary subsidies. In India public bus companies have performed better in cities where they are fully exposed to competition without subsidy than in cities where subsidies and inappropriate incentives have fostered inefficiency (see Box 8.3).

SOEs are also be protected by regulated domes-

tic markets that keep out private competitors. This has occurred in agricultural marketing, where SOEs have been especially inefficient because of the geographical dispersion of their operations under diverse market conditions and rapidly changing circumstances. Eliminating state marketing monopolies in China led to big gains in agricultural efficiency and drew greater output from private farmers and collectives. Replacing SOE monopolies with private trading networks to import, export, and distribute crops and fertilizers can also improve the distribution of income. By using decentralized modes of transport instead of the capital-intensive systems generally employed by SOEs, private sector marketing can generate higher productivity while favoring unskilled workers and small entrepreneurs.

Tariffs or import quotas protect SOEs from foreign competition and make their inefficiencies less transparent. Tanzania's industrial SOEs were profitable in terms of domestic prices, but, when their inputs were valued at world prices, more than one-third of the enterprises (compared with one-tenth of private industrial firms) were producing negative value added. In other words the output of

the enterprise was worth less than its inputs. Removing protection brings inefficiencies into the open: in Turkey, for example, eliminating the trade monopoly of a giant meat-processing SOE in 1980 led to fewer subsidies and to the closing of inefficient slaughterhouses. Private agents generally adapt more quickly to the removal of trade distortions than SOEs, unless the government removes its budgetary and banking support for SOEs at the same time.

Using private management

In sectors where the domestic and foreign private sector have strong technical and management skills, governments can use management contracts and leases to increase the operating efficiency of its SOEs while retaining ownership. Management contracts for state-owned hotels in several countries including Egypt, Jamaica, Sudan, and Zaire have proved to be politically acceptable and commercially successful. In Sri Lanka management contracts transformed the financial performance of state-owned textile mills. Water and sewerage services of a high standard are provided in Côte d'Ivoire by a joint venture company comprising local and foreign interests. Where private operators might be unable to manage an entire SOE, it is often feasible to hive off certain parts. For a port,

for instance, these might include stevedoring, transit, container, and other activities. The Kelang Port Authority in Malaysia initially arranged for private management of its container terminal through a lease.

Nonetheless leases and management contracts can be difficult to draw up and can pose the same dilemmas as enterprises run by public managers. Contracted managers can be efficient only if they are given autonomy in day-to-day operations. At the same time management fees may be payable regardless of performance. Incentives rewarding managers for increased profitability are therefore useful. Governments need to avoid depending on a single contractor if the service is not provided competitively. With a lease the business risk is borne by the lessee. Although governments might shed their immediate financial burdens, they need safeguards to ensure that a viable asset is returned at the end of the lease. Leases are often used as an intermediate step toward eventual transfer of ownership from the public to the private sector.

Divesting SOEs

To alleviate the burdens of a large public portfolio of commercial enterprises, several governments in industrial countries and an even larger number in developing countries have begun to divest part or

Box 8.4 An SOE public offering in an undeveloped capital market

In December 1986 the Jamaican government sold 51 percent of its equity in the National Commercial Bank (NCB), the country's largest bank. Although this was not the first privatization undertaken by the government, it was by far the largest and the first to involve a public share offering on the Jamaican Stock Exchange. The NCB, which had been a private bank before it was nationalized in 1977, had a record of moderate profitability and had not created any financial burden on the government. The government decided that the most important objective of the public offering was to promote broad share ownership and to demonstrate the merits of privatization rather than to maximize government revenues.

Supported by a major media campaign explaining share ownership, the offering attracted tens of thousands of new Jamaican shareholders, none of whom was allowed to acquire more than 7.5 percent of the voting shares. Oversubscription at the end of the offering led the government to use a sliding scale to allocate proportionately more shares to small buyers. The larg-

est single group of new shareholders were the NCB's own employees, who were offered a special share purchase scheme; they controlled almost 13 percent of the voting shares after the offering.

As with similar offerings in industrial countries with substantially more sophisticated capital markets, getting the "right" price was difficult; in accordance with common practice the issue was priced at a discount from the share price of the NCB's closest competitor, a publicly quoted private bank. Because of heavy oversubscription NCB shares traded at a substantial premium after the offering. Since the government retained a 49-percent stake in the NCB, it will be able to sell shares in the future at market prices. The NCB's privatization demonstrates that a developing country with a relatively low per capita income can mobilize domestic savings from a broad spectrum of the population; can channel these funds through a small, undeveloped stock market; and can shift control of a major SOE to the shareholding public.

all of their ownership in several SOEs. In the few industrial countries such as France and the United Kingdom where divestiture has been extensive, it has sometimes proved difficult. Appropriate valuation of SOEs, resistance from public employees and interest groups, and the dangers of substituting private monopolies for public ones have been significant problems even where capital markets are well developed, where public debate has been open and extensive, and where regulatory mechanisms are strong. The constraints are far more severe in developing countries, where capital markets are thin, where deep fears prevail of economic domination by foreigners or by ethnic minorities, and where the regulatory capacity of governments is limited.

Nonetheless divestiture is being actively pursued in several developing countries. Where SOEs are financially sound and can attract a large number of local investors, some governments have made public offerings partly to develop domestic capital markets (see Box 8.4). Private offerings are, however, likely to remain the primary form of divestiture in most developing countries. They include the outright sale of assets of SOEs (see Box 8.5).

Along with divestiture the government needs to

decide on whether to continue providing protection and subsidies to the newly private enterprise. Generally this will not be desirable, especially where SOE reform is part of a broader adjustment in trade and fiscal regimes. Some SOEs are unsuitable for divestiture because they are not financially viable once protection and subsidies are removed. In these cases liquidation may be the only feasible course of action. Many small unviable SOEs have been closed or liquidated in several countries, including Guinea, Mali, Mexico, and Venezuela.

Agenda for SOE reform

Some SOEs in developing countries have been able to operate as successful commercial ventures without burdening public finances (see Box 8.6). In most countries, however, many have drained budgetary resources, contributed to overall public sector deficits, weakened fiscal management, and made negative contributions to value added. Such problems, although they may vary across countries and SOEs, suggest common areas for reform.

A few key SOEs in developing countries, especially those concerned with infrastructure, are likely to remain under public ownership, as in several industrial countries. Strengthened account-

Box 8.5 Divestiture of state-owned textile mills in Togo

Like many other African countries, Togo undertook an ambitious state-led industrial development program in the 1970s using the windfall from short-lived commodity booms and substantial foreign borrowing. By the early 1980s the country was left with several ailing SOEs, including its two largest textile mills. One of these textile mills, designed to produce knitted and woven garments for exports, was completed by the government in 1980 at a cost of \$50 million. It was closed shortly after start-up, however, because of inadequate management, faulty equipment, lack of technical expertise and working capital, and insufficient knowledge of the market. The second mill, built by a private concern that went bankrupt in 1981, had been taken over by the government. Although it was in fair condition, it required extensive rehabilitation.

On the basis of proposals from several interested groups, the government decided to sell to private investors the assets of the mills but to retain their liabilities. Three independent audits confirmed a sale price of about \$10 million. A Korean group with U.S. financing was selected.

The resulting privatized concern was established in mid-1987 and engaged 120 Korean technicians and managers to supervise the rehabilitation of the existing plant. Overall, a \$20 million investment in rehabilitation and additional equipment is envisioned. At full capacity the two plants are expected to employ about 5,000 Togolese workers and to produce more than 24 million garments for export and 12 million yards of printed fabric.

In early 1988 a U.K.-based investment group acquired a majority interest in the operating company to cover a shortfall in the U.S. financing. The original Korean and U.S. investors remained as minority shareholders. The shareholders plan to be operating both plants on a significant scale by late 1988. By creating a private concern that will substantially increase employment, maximize the use of existing equipment, and assume significant financial risk with no direct subsidy, this transaction has provided a favorable impetus for further privatizations that are planned by the Togolese government.

Box 8.6 Malaysia's power utility: a financially viable SOE

Malaysia's National Electricity Board (NEB) is an example of an SOE that is well run and financially sound. Through appropriate pricing policy, investment planning, financial discipline, and adequate autonomy, it has avoided the debt-servicing difficulties and dependence on government budgets of commercial SOEs in many other countries. After adjusting its tariffs to fully reflect the effect of fuel price increases in the late 1970s, the NEB maintained those high rates until 1985. In its 1986 financial year the NEB tariffs were adjusted twice. The NEB has no significant problems with accounts receivable (arrears).

Through maximizing its use of internally generated cash to finance investment, the NEB has been able to maintain a strong capital base and to finance 50 percent of its investment from its own resources. Although 40 percent of NEB total capital was provided in foreign

exchange, prudent management had led to a relatively small financial risk based on its existing loan portfolio. By introducing a foreign exchange stabilization reserve in its accounts in 1986, the NEB will be able to adjust its investment program or its financing patterns quickly in response to any changes in exchange rates.

The government of Malaysia reviews tariff changes and the financial performance of the utility, but it does not interfere in operational matters or investment decisions. As natural gas (managed by another SOE) and large-scale hydropower (purchased from another domestic utility) have recently become attractive options for power generation, the government has become more involved with the NEB. However, it has been providing mostly advice and arbitration rather than imposing decisions.

ing, incentive-based performance evaluation, and rigorous investment appraisal are essential if these SOEs are to contribute to development rather than burden public finances. It is also vital for governments to define, and then follow, pricing, taxation, and oversight policies to permit cost recovery, proper accounting, and a balance between autonomy and accountability.

The degree of state ownership does not itself determine the performance of an enterprise. However, a large portfolio of SOEs can severely burden public administrative and financial resources. Many governments in industrial, as well as developing, countries have halted and even reversed their earlier policies of extending public ownership. Governments should continually review the costs and benefits of maintaining public management and ownership in individual SOEs and consider, where feasible, divestiture to private hands. For many activities, notably manufacturing and

services, it is often possible to use management contracts and leases as intermediate steps in that direction.

Such reforms demand substantial adjustments by the public and private sectors alike. Often they also encounter serious financial, managerial, and political constraints. To help overcome political resistance, greater transparency is needed to demonstrate the costs of unviable or poorly managed SOE operations. The transfer of management or ownership to private agents should occur according to explicit criteria and without additional protection. Since better performance is the strongest argument for privatization, governments should ensure that private agents operate within a macroeconomically sound framework and without the distortionary pricing and subsidies that produced inefficiency in SOEs. The challenge calls for government commitment and adequate resources to support adjustment.