6. A Practitioner’s Guide for When (Not) to Use BOSs

Introduction

New evidence generated for this report and findings from previous studies provide guidance to practitioners on whether and how (not) to rely on businesses of the state (BOSs) as tools for development policy. The objective here is to support policy makers in getting the most from BOSs and at the same time highlight potential risks and propose reform options to improve expected outcomes. This chapter offers principles and practical checks on how to proceed.1

State ownership of enterprises is part of the toolkit that governments use to correct market imperfections and institutional failures. But, as this report argues, the best policy response rarely requires mobilizing state ownership. Fiscal and regulatory policies can provide incentives to private firms so that they provide universal access to services or protect the environment. And, when confronted with macroeconomic fluctuations or crises, governments often find that fiscal policy and monetary policy are better suited for stabilizing an economy.

In reality, reliance on BOSs can create good, bad, or ugly outcomes, as illustrated with the following examples:

- **Good outcomes.** Some BOSs perform well. They effectively meet valid policy objectives, create markets, and innovate. BOSs with majority private ownership can provide market discipline that contributes to higher productivity.

- **Bad outcomes.** A bad outcome could be that some BOSs’ good performance is driven by preferential treatment. This can enable them to meet their objectives but can be inefficient and costly and prevent crowding in private investment.

- **Ugly outcomes.** An ugly outcome—a worst-case scenario—can occur when some BOSs underperform and do not have a social mandate justifying state ownership. These entities may fail to fulfill their intended social objective, become a fiscal drain, engage in anticompetitive practices, or are heavily protected from competition. Such BOSs can inhibit innovation by private investors or suffer from political patronage and corruption.

Evidence in this report confirms that outcomes across markets can indeed be good, bad, and ugly, providing motivation to revisit policy approaches. The features that distinguish BOSs from private firms—the soft-budget constraint, the nonprofit
objectives, and the favorable regulatory environment—affect those outcomes. And the
way BOSs affect outcomes depends on how they interact with market imperfections
and institutional failures in the rest of the economy. Because BOSs are unlikely to go
away, it helps to clarify when relying on them can be viable.

**Five Guiding Principles for Engagement with BOSs**

The impact state participation in markets has on an economy is shaped by three factors:
the type of public-private ownership characterizing BOSs, the structure of the markets
they operate in, and the broader policies and institutions that regulate state ownership.
Hence, when policy makers decide whether to rely on BOSs to attain specific develop-
ment objectives, they should be guided by principles that bring to the surface the least
visible parts and risks of the state's involvement in business at the country, sector, and
enterprise levels.

This report proposes five principles for government engagement with BOSs:

1. Develop a nationwide mapping of BOSs under various line ministries and
   agencies and in different sectors, and monitor their performance and fiscal cost.
2. Apply the subsidiarity principle economywide, which calls for a limited role of
   the state if private firms are interested and capable of supplying goods and
   services that fulfill demand adequately.
3. Put in place strong institutions to regulate sectors and address the risk of
   capture by insiders.
4. Ensure competitive neutrality of regulations and policies and their
   enforcement, including labor regulations, the separation between commercial
   and noncommercial roles of BOSs, and implicit and explicit support to BOSs
   and privately owned firms.
5. Prepare phase-out strategies for BOSs that are no longer needed.

**Principle 1: Ensure Transparency and Monitoring of the Entire State
Footprint in the Economy**

The first step is to gauge the true extent of the state's footprint. For example, uncovering
indirect ownership stakes in other firms, across markets, and in value chains can unveil
upstream and downstream relationships and vertical integration issues that can inhibit
competition and create fiscal risks.

The transparency of BOSs fosters accountability and fiscal sustainability at the
aggregate level, creates a level playing field at the sector level, and provides confidence
to private investors. It is especially important in countries with a large state presence,
with conglomerate groups whose operations are not easy to grasp, and with sovereign
wealth funds.
The transparency of BOSs’ operations requires timely and full disclosure of their financial reports. It is good practice to define and subsequently monitor the fulfillment of a BOS firm’s immediate-term objectives and targets in relation to its main economic and, where relevant, public policy objectives. These mandates should be translated into financial, operational, and nonfinancial indicators that are specific, measurable, and timebound (table 6.1) and are subsequently reported in an annual aggregate report (OECD 2022).

Having a clear picture of the advantages the state grants to each BOS firm in direct transfers, consumption or production subsidies, tax exemptions, and other preferential treatments is crucial. Transparency also involves the explicit costing of the public service obligations for each company with state ownership, as well as an assessment of its contingent liabilities.

**Principle 2: Apply the Subsidiarity Principle Economywide**

The economic rationale for BOSs needs to be carefully assessed and can be guided by the subsidiarity principle (box 6.1 and box 6.3). The subsidiarity principle calls for the state to play a subsidiary role in economic activities. It must assign scarce public resources to the most critical needs that cannot be supplied by markets. If private firms are interested and capable of supplying goods and services that fulfill demand adequately, the state should be limited to a supervisory role. The state should provide goods and services only when the private sector cannot do an adequate job (OECD 2009; Ruiz, Martinez, and Quintana 2006).

**TABLE 6.1 Financial and Nonfinancial Targets and Outcomes for a Reporting Year**

<table>
<thead>
<tr>
<th>Enterprise name</th>
<th>Profitability</th>
<th>Capital Structure</th>
<th>Dividends</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(Return on equity, or other relevant metrics)</td>
<td>(Equity/assets ratio, or other relevant metrics)</td>
<td>(Based on earnings, or other relevant metrics)</td>
</tr>
<tr>
<td>Targets vs outcomes</td>
<td>Target vs outcomes</td>
<td>Share of SOEs that achieved capital structure targets (achieved, partly achieved, not achieved, no targets)</td>
<td>Share of SOEs that achieved dividend targets (achieved, partly achieved, not achieved, no targets)</td>
</tr>
<tr>
<td>Aggregated by portfolio</td>
<td>Share of SOEs that achieved profit targets (achieved, partly achieved, not achieved, no targets)</td>
<td>Share of SOEs that achieved capital structure targets (achieved, partly achieved, not achieved, no targets)</td>
<td>Share of SOEs that achieved dividend targets (achieved, partly achieved, not achieved, no targets)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Enterprise name</th>
<th>Public policy target adopted</th>
<th>Target level</th>
<th>Outcome</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Enterprise-specific public policy targets</td>
<td>Expressed as percent, share, other relevant metrics</td>
<td>Expressed as percent of target achieved per reporting year</td>
</tr>
<tr>
<td>Aggregated by portfolio</td>
<td>Share of SOEs that achieved public policy objectives (achieved, partly achieved, not achieved, no targets)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: OECD 2022.
Note: SOE = state-owned enterprise.
This means that the best policies rarely require state ownership. However, state interventions in markets could be necessary in rare cases. One is supplying essential goods and services not being provided by private firms, such as public goods that embody the social role of the state and are driven by distributive and welfare objectives. Another is economic activities that for other strategic reasons cannot be performed by the private sector, such as national security or strategic natural resource activities.

Although state ownership of commercial businesses is rarely the best policy response, governments still choose to rely on BOSs to achieve certain objectives, even if those objectives could be attained through better policies. For example, BOSs are often used to deliver on socially valuable tasks not privately profitable, such as providing service coverage for lower-income households and those in remote areas or advancing the decarbonization of the economy. Alternatively, however, the financial resources to accomplish these goals could be channeled through the demand side rather than the supply side.² BOSs are also used as an industrial policy tool, with the goal of solving market failures in emerging sectors and jump-starting economic activity in lagging areas. But other policy instruments are likely to achieve the same goals with lower risks of resource waste or political capture.

A key question is whether the public resources devoted to these social or development goals would be used more effectively if channeled through private firms rather than BOSs. For service delivery, there are risks that public utilities will be overstaffed relative to their private counterparts, and that they will have lower responsiveness to customers. Universal service coverage may be mandatory for privately run utilities;

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**BOX 6.1**

**Subsidiarity Principle**

According to the subsidiarity principle, the state plays a subsidiary role in the provision of economic activities. This principle is grounded in both economic and social considerations. The state’s resources are limited and must be assigned to the most valuable objectives. The principle of subsidiarity represents a limit to state action in the market, as it establishes that the state can only intervene in the market with a state-owned enterprise if the private supply is insufficient or nonexistent. If private agents are interested and capable of supplying goods and services to attend demand, then the best means for the state to intervene in those markets is by supervising and controlling the behavior of those private agents. Meanwhile, the direct intervention of the state focuses on (1) supplying essential goods and services that will not be provided by private agents, that is, the social role of the state driven by distributive and welfare objectives; or (2) on those activities that, according to the country’s highest ranking laws, cannot be performed by the private sector. In parallel, complementary regulatory reforms are implemented for goods and services to be provided in a competitive manner. Deregulation should be implemented to incentivize entry and foster a competitive private sector.
however, when that coverage is unprofitable, governments could use budget transfers to fill the gap rather than operating BOSs. For climate-related goals, taxes, subsidies, and standards can incentivize the adoption of green technologies by the private sector. Similarly, instead of relying on using BOSs as instruments for industrial policy, governments can use subsidies to make private firms internalize the positive network spillovers they generate in emerging sectors, or their positive externalities in lagging areas. Direct support to universities can compensate for the difficulties of appropriating the benefits from basic research. Private innovation efforts toward social goals can become profitable with advance purchase commitments.

Any protocol related to using BOSs should identify the least distortive policy alternative to attain specific social goals. Doing so requires understanding the trade-off between state ownership and potential unintended consequences and recognizing that state participation in the production of goods and services is not always necessary to solve market imperfections or address institutional failures.

**Principle 3: Put in Place Strong Institutions to Regulate Sectors**

The overall quality of governance in a country is likely to determine whether BOSs deliver good, bad, or ugly outcomes. Preventing an excessively loose budget constraint requires good fiscal institutions and being able to transfer resources to BOSs only when justified. But support should be based on performance, which should be assessed to ensure that targets are indeed being met. Avoiding bailouts of BOSs requires solid debt management capabilities, so that BOSs’ liabilities and risks can be evaluated in real time. And providing incentives for BOSs’ management to perform as expected requires strong accountability mechanisms, including the ability to reward or dismiss those in charge of delivering, from chief executive officers down to technical cadres and workers.

At the heart of the institutional quality in which BOSs operate is the strength of the competition regulatory framework. That framework needs to include BOSs under the provisions and oversight of the competition agency authority and sector regulators. Beyond the regulatory framework, effective enforcement—free of political influence—is key to exercising market discipline and deterring anticompetitive practices.

Around the world, BOSs operate in a range of sectors that differ both in their market structure and in the way competition among market players is regulated. The World Bank’s *Businesses of the State and Private Sector Development: Policy Toolkit for Practitioners* identifies sector-specific policy considerations depending on whether BOSs operate in competitive, partially contestable, or natural monopoly markets (World Bank, forthcoming; also see annex 6A). For example, unless market regulation ensures a level playing field, a strong presence of BOSs in competitive or partially contestable markets runs the risks of undermining private sector entry, fostering market consolidation, and slowing innovation.
Principle 4: Ensure the Competitive Neutrality of Regulations and Policies, and Their Enforcement

In parallel to the subsidiarity principle, complementary regulatory reforms should be implemented for competitive provision of goods and services. Competitive neutrality principles should be incorporated across BOS-related laws, regulations, and policies to avoid explicit or implicit preferential treatment for BOSs.

The regulatory advantages of BOSs are often associated with unfair competition with private firms. Such advantages typically reflect a conflict of interest. As a policy maker the government has a broader responsibility toward the public. Its regulation of the market and its enforcement of competition law should increase economic efficiency and ensure a fair distribution of its benefits. But as an owner of BOSs the government has an interest in maximizing their revenues and distributing them in politically advantageous ways. These conflicting roles raise the possibility that the state will make decisions that advantage BOSs over their competitors.

The blurred lines between public interest and financial gain call for a careful examination of the regulatory environment in which BOSs operate. This is especially needed in competitive markets, where there is no strong economic rationale for state participation. Because the state may not adequately protect against anticompetitive behavior or prevent undue exercise of market power by the businesses it owns, the assessment needs to go beyond the letter of the law.

Measures to limit conflicts of interest and guarantee independence of the regulators are essential. Responsibilities for market regulation and oversight of BOSs should not lie with the BOSs or any other entities or actors involved in the day-to-day management of these firms’ commercial activities. Anticompetitive regulations are less likely when a specialized agency that operates at arm’s length from BOSs designs and enforces the regulations. This kind of separation is less frequent in middle-income countries than in high-income countries.

Given the limited fiscal space and the goals of minimizing market distortions and maximizing the effectiveness of public interventions, competitive neutrality should be embedded in BOS firm governance and operations and be an overall requirement for targeting state support. Because evidence presented in this report shows BOSs with higher state ownership and direct state ownership perform worse than minority state-owned firms, a greater detachment of the owning state authority from day-to-day BOS firm management could increase BOSs’ efficiency.

It matters which state agency or government body is in charge of BOSs. The exposure of BOSs to state influence is greatest when ownership rights are exercised by a line ministry and lowest when they are exercised by a specialized agency that operates at arm’s length from the government. Less-developed countries have a higher proportion of BOSs with a greater state influence through ownership
exercised by the line ministries in charge. High-income countries are more likely to have safeguards to ensure that BOSs’ chief executive officers are appointed by board members rather than public authorities, which reduces the propensity for government to influence day-to-day decision-making.

For BOSs’ operations, there should be a separation of commercial functions from public service obligations (unbundling) to ensure that the allocation of public funds does not cross-subsidize commercial activities and potentially distort pricing mechanisms in markets. Cost-allocation mechanisms should guide unbundling.

**Principle 5: Prepare Phase-Out Strategies for BOSs**

Governments can make a solid case for using BOSs as policy instruments when outcomes are good—BOSs perform well following the first four principles—and when the best options are out of reach or take time to implement. But what about when outcomes are bad, as when BOSs fulfill their objective but operate inefficiently and generate fiscal costs, or if BOSs perform well because of preferential treatment? Then the government could pursue reforms to improve on the first four principles, ranging from strengthening BOSs’ corporate governance to enforcing competitive neutrality in the markets where they operate.

What about when outcomes are ugly? That can happen when BOSs underperform, have no social objective, or do not fulfill it and are a fiscal drain. It can also happen when BOSs behave anticompetitively and crowd out private investment, and when they suffer from political patronage and corruption. In such cases, the prospect for successful reforms in the short to medium term may be slim. Charting a sunset path for these weak BOSs should then be a central tenet of development policy. Options range from greater private sector involvement to divestiture and to outright closure (box 6.2).

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**BOX 6.2**

**Framework for BOS Reforms for Practitioners**

The World Bank’s *Businesses of the State and Private Sector Development: Policy Toolkit for Practitioners* proposes a new framework for reforms related to businesses of the state, or BOSs (World Bank, forthcoming)—see figure B6.2.1. The private sector has opportunities to engage in and benefit from such reforms. The framework goes beyond privatization and broadens the type of instruments for reform that governments can use to foster private sector–led growth. Reforms to restore market-based incentives and foster contestable and efficient markets focus on promoting the private sector

- **As a market player (competing alongside BOSs),** by abolishing and reforming policies and regulations that otherwise inhibit private entry and investment in relevant market

*(Box continues on the following page.)*
## BOX 6.2

### Framework for BOS Reforms for Practitioners (continued)

#### FIGURE B6.2.1 BOS Reform Options

<table>
<thead>
<tr>
<th>Nature of ownership change</th>
<th>Role of private sector</th>
<th>Policy instrument</th>
<th>Reform objectives</th>
<th>Potential issues or problems</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>None</td>
<td>Corporate governance, ownership policy, restructuring, and performance management</td>
<td>To ensure transparent government structures and accountability</td>
<td>Lack of oversight and poor corporate governance</td>
</tr>
<tr>
<td></td>
<td>None</td>
<td>Pro-competition regulatory frameworks and strengthened market institutions</td>
<td>To level the playing field between BOSs/SOE and private investors</td>
<td>Anticompetitive laws and regulations</td>
</tr>
<tr>
<td>Partial</td>
<td>Partial/Full</td>
<td>Management contract and public-private partnerships</td>
<td>To promote competition and market reforms to enable private entry and investment</td>
<td>BOSs/SOE benefitting from undue advantages</td>
</tr>
<tr>
<td></td>
<td>As manager and/or temporary owner of BOSs/SOE</td>
<td>Ownership transfer by divestiture and privatization</td>
<td>To enable reform through rational and sectoral laws and regulations</td>
<td>BOSs are also the sectoral regulator</td>
</tr>
<tr>
<td></td>
<td>As market player (competing alongside BOSs/SOE)</td>
<td></td>
<td></td>
<td>High prevalence of BOSs in competitive sectors</td>
</tr>
</tbody>
</table>

**Source:** World Bank, forthcoming.  
**Note:** BOSs = businesses of the state; SOEs = state-owned enterprises.
Private actors can be mobilized through various mechanisms. Management contracts retain state ownership but delegate operational decisions to private investors for a specific period. They are particularly useful when service delivery involves public goods for which delivery is relatively straightforward to monitor, as for waste management. Public-private partnership (PPP)3 arrangements and concessions transfer assets or stakes to the private sector. They are especially well suited for BOSs in sectors such as transportation, power generation, or telecommunications.

Ownership changes are, however, neither a necessary nor a sufficient condition for reforming sectors with a BOS firm presence. Just as state participation in markets does not necessarily solve market failures, private sector ownership is not a panacea either. Reforms that privatize BOSs or open state-dominated markets to private participation can create new opportunities for collusion if effective anticartel enforcement does not accompany liberalization. Reforms should start by setting the preconditions for proper market functioning. Doing so includes removing rules that limit or deter entry of the private sector, such as legal monopolies or bans on foreign direct investment, even before discussing divestiture options.

The institutional capacity and the implementation of competitive neutrality across markets also matter when transitioning BOSs to private sector players (box 6.3). Governments have several measures at hand to implement this transition effectively for the benefit of consumers and businesses. Effective pro-competition regulation of incumbents that were former BOS monopolies is essential to ensure sector transformation and further benefits from transition to the private sector.

BOX 6.2
Framework for BOS Reforms for Practitioners (continued)

segments, or regulatory provisions that grant specific protections and privileges that upset the playing field, which is particularly relevant in competitive and partially contestable sectors;

- As a manager of a BOS firm, as a temporary owner-manager of state-owned assets through concessions or public-private partnerships, which can fill important investment gaps and bring in private sector investment in sectors with high perception of risks or uncertainty including the development of new technologies (for example, green energy production); and
- As a long-term owner-manager through divestiture measures.
BOX 6.3

The Subsidiarity Principle for BOS and Market Reforms: The Case of the Peruvian Telecommunications Market

In Peru, during 2001–02, Indecopi’s Free Competition Commission analyzed state-owned enterprises in a variety of sectors, including the postal service, commercial aviation, ship building, and the commercialization of coca leaves. This helped reform these sectors and bring in private investment. For example, the commission applied the subsidiarity principle when it opened up the telecommunications sector. In line with this principle, the commission established a strong regulatory and institutional framework to guarantee a proper transition from the state-owned dominant player. The state granted a concession contract for provision of telecommunications services to a private player, initially for a five-year period, including a national monopoly in fixed telephony and domestic and international long distance.

During this period, the concessionaire was to expand and improve fixed telephony service, public service telephony, and universal service obligations in rural areas. Competition was permitted in other services, including mobile telephony, pay phones, beepers, and cable television. Additionally, the contract set specific investment goals to build the infrastructure (new lines) and thus decrease the price and increase the quality of the service for consumers. The concession contract included an explicit competition clause stipulating that the concessionaire was obliged not to abuse its dominance position, not to engage in tying practices, not to discriminate in allowing other service providers access to the network, and to eliminate cross-subsidies between long distance and local telephony services. The telecommunications regulator played a fundamental role in the transaction. It participated in all the final stages of the privatization and renewal of contracts to make sure that the contract adhered to competition principles.

This strategy resulted in successful bidding for the concession, over US$2 billion (almost four times more than the minimum asked price), an additional 1.19 million lines in the first five years, reduction of cross-price distortions between services (that is, rebalancing of rates) with a recompositing of the structure of operating earnings, completion of calls from 35 percent to over 95 percent, digitization of the network from 30 percent to over 90 percent, significant reduction in the cost and time of installing a line (from more than US$1,500 and several years to get a fixed line installed), more efficiency in the number of employees, and reduction in the allocation of its costs to wages and salaries, which was estimated at about 40 percent. The impact on consumer welfare was also significant. An important regulatory improvement after privatization was the guidelines established by the ministry and regulator for the full opening of the market, setting up rules for new market concessions to competing firms, tariff policies such as the application of the total factor productivity factor to reduce rates, cost-based models to set interconnection rates, interconnection policy, access to infrastructure and essential facilities, new obligations for expanding the network’s connectivity and penetration, spectrum access, network digitization and quality of service, and revision of compliance with competitive regulations.

Scorecard to Identify Strengths and Weaknesses of BOSs

Although state ownership of commercial businesses is rarely the first-best policy response to any development challenge, there may be circumstances in which governments still choose to rely on their BOSs to attain certain goals. Whether they can expect good outcomes from this choice, and contain the ensuing risks, depends on the characteristics of the BOSs and how they interact with the rest of the economy. Therefore, it is worth assessing the strengths and weaknesses of individual BOSs before deciding to rely on them for economic policy.

A key prerequisite for relying on BOSs is to have transparent and reliable information on their finances and performance, which is not always available. But characteristics of the broader economic environment, the sectors they operate in, and the BOSs themselves can also make a significant difference for the expected outcomes.

The findings in this report suggest that outcomes of individual BOSs are determined by four major dimensions: (1) the transparency of the information available about them, (2) the broader institutional environment ensuring their accountability, (3) the structure of the markets they operate in, and (4) their own characteristics as firms.

So, when deciding whether to rely on BOSs to attain specific development objectives, policy makers could use country, sector, and enterprise indicators for BOSs to prepare a scorecard, in addition to assessing the footprint of BOSs in their economies (table 6.2).

<table>
<thead>
<tr>
<th>Dimension</th>
<th>Indicator</th>
<th>Rating</th>
</tr>
</thead>
<tbody>
<tr>
<td>Data transparency and performance monitoring</td>
<td>1. Financial reports are timely, reliable, and publicly available. Direct and indirect government support is quantified and systematically monitored. Debt and its service are adequately documented. BOSs' efficiency and performance with specific key performance indicators (KPIs), execution of performance contracts, and achievement of other goals (for example, sustainability and resilience) are monitored. KPIs include the return on equity and equity/assets ratio, dividend policy, share of employment, portfolio value, labor productivity, and utilization of production capacity.a</td>
<td>0–10</td>
</tr>
<tr>
<td>Company characteristics</td>
<td>2. State ownership rights are exercised by a specialized agency rather than by a line ministry. The BOS firm has a competitively selected private partner with a stake in its performance. Board members representing the state are appointed based on professional rather than political criteria.</td>
<td>0–10</td>
</tr>
<tr>
<td></td>
<td>3. The management of the BOS firm is appointed based on professional rather than political criteria. Sound corporate governance principles are followed. The personnel of the BOS firm are subject to the same labor regulations that apply to private firms. Dismissal for underperformance is feasible.</td>
<td>0–10</td>
</tr>
<tr>
<td></td>
<td>4. The commercial and noncommercial activities of BOSs are clearly separated, and the costs of each activity can be properly identified and allocated. The commercial activity of BOSs yields rates of return like comparable private businesses over a reasonable period to prevent private sector competitors from being undercut.</td>
<td>0–10</td>
</tr>
</tbody>
</table>

(Table continues on the following page)
The table illustrates how a simple scorecard can be adapted to each country context and BOS firm. It can be complemented with specific key performance indicators (KPIs). KPIs go beyond financial performance indicators and should include efficiency measures. Efficiency KPIs measure the degree of efficiency in using resources (labor, management, and capital) to generate output and revenue (for example, labor productivity and utilization of production capacity). In the table, the larger the aggregate score, the higher the probability that good outcomes will be attained, and the lower the risk of bad—or even ugly—consequences for the rest of the economy. This aggregate score is not a statistically rigorous predictor but more of a heuristic tool.

This approach can make the BOSs in a country more visible and help build a consensus on their various strengths and weaknesses. The rating exercise would also provide guidance on whether a specific BOS firm could or should be used for policy purposes. And it would help identify the areas where further policy reforms are needed to maximize the chances of obtaining good outcomes.

**TABLE 6.2 A Suggested Scorecard with Indicators to Assess BOSs (continued)**

<table>
<thead>
<tr>
<th>Dimension</th>
<th>Indicator</th>
<th>Rating</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sector characteristics</td>
<td>5. The sector is a natural monopoly or is characterized by positive or negative externalities. Some potential for contestability by private entrants exists.</td>
<td>0–10</td>
</tr>
<tr>
<td></td>
<td>6. The agency in charge of regulating the sector operates at arm’s length from the company. Efficiency, equity, and security are its most important goals.</td>
<td>0–10</td>
</tr>
<tr>
<td></td>
<td>7. Effective competition policies apply to the sector. Mergers leading to anticompetitive effects are prevented, and abuse of significant market power is penalized. Regulatory neutrality applies (for example, equal treatment for corporate and commercial law).</td>
<td>0–10</td>
</tr>
<tr>
<td>Institutional context</td>
<td>8. Transfers of resources from the government are linked to well-specified mandates. The BOS firm is not automatically supported if it underperforms. The compensation paid by the public authorities to the BOS firm for the delivery of public service obligations is transparent and limited to the minimum necessary to avoid cross-subsidization. Mechanisms of adjustments and compensation should balance out the BOSs’ preferential access to finance through state-owned banks or government guarantees. The transfers to BOSs are assessed, monitored, and captured in published subsidies data.</td>
<td>0–10</td>
</tr>
<tr>
<td></td>
<td>9. The buildup of contingent liabilities by the BOS firm and its potential to create systemic risk are adequately assessed, regularly monitored, and captured in overall contingent liabilities disclosures.</td>
<td>0–10</td>
</tr>
<tr>
<td></td>
<td>10. There is reasonable control of corruption in the country, including disclosure of beneficial ownership for procurement contracts. The chances that the BOS firm will be used for private gain are limited. The access of the BOS firm to public contracts and their overall treatment during public procurement is open, transparent, and nondiscriminatory.</td>
<td>0–10</td>
</tr>
<tr>
<td>Overall</td>
<td>Aggregate score</td>
<td>0–100</td>
</tr>
</tbody>
</table>

*Source:* Original table for this report.

*Note:* BOSs = businesses of the state.

a. A good practice is to evaluate the fulfillment of individual BOSs against financial and nonfinancial targets set by the state-owner and disclosure of noncommercial assistance (OECD 2022).
Key Lessons from Previous BOS Reforms

This report builds on lessons learned from BOS reform strategies during the 1970s through the 2000s, when such reforms focused primarily on privatization and governance improvements. Seven country case studies prepared for this report illustrate past reform priorities and reflect the BOS reform histories across countries, income groups, and regions.

For every BOS reform, the case studies illustrate how country context matters. They describe reform episodes and the main lessons learned from Costa Rica, Ethiopia, Kazakhstan, the Republic of Korea, Pakistan, Serbia, and Uzbekistan. Some describe key reform episodes when countries underwent major medium-term structural changes and switched from a state-led economy to a market-based economy. Others describe BOS reforms that were part of larger fiscal or economic reform packages in answer to acute crises. They also reflect the importance of the political economy of the BOS reform episodes described.

The goals of past BOS reform approaches (of privatization and strengthening corporate governance) were to boost economywide productivity and growth either by handing back to the private sector some of the economic functions of BOSs or by improving BOSs’ performance. Although privatization efforts focused on reducing the state footprint in the economy by providing more space to the private sector, which operates under market incentives, the assumed impact of BOS governance reforms was as follows.

To improve public service delivery and resource allocation, BOSs should be managed more like private firms in the same economy. By following similar professional corporate governance practices as in the commercial sector, BOSs would become more efficient, with positive spillover effects to the rest of the economy.

As BOSs perform better, fiscal risks in relation to BOSs could be better managed and the fiscal burden to support BOSs reduced. Evidence across countries suggests that better governance and more competitive and transparent management can make investments in those entities more attractive. This reform strategy could also help steer BOSs away from competitive markets where the private sector is better positioned to provide goods and services. This shift could lead to economywide benefits of higher productivity growth and economic expansion.

Important benefits of privatization were in the medium term reduced fiscal risks. Consumers also benefited from better service delivery. Privatization reduced losses of BOSs and improved financial performance, yet success varied across different sectors and gains were unevenly distributed (ADB 2022). The benefits accrued to new owners, whereas losses were suffered by workers, consumers, and sometimes other stakeholders. Legitimate concerns also arose about opacity and corruption in privatization processes (ADB 2020).
Efforts to improve BOSs’ corporate governance continued, but improvements to BOS firm oversight and governance did not consistently improve BOSs’ performance (World Bank 2014). BOSs face distinct governance challenges. At one end of the spectrum, directly owned and majority-owned BOSs can experience overly hands-on and politically motivated ownership interference, leading to unclear lines of responsibility, a lack of accountability, and efficiency losses in operations. At the other end of the spectrum, the lack of oversight by the state can weaken the incentives of BOSs and their staff to perform in the best interests of the enterprise and the general public and raise the likelihood of self-serving behavior by corporate insiders (OECD 2015). So far, corporate governance requirements for when the state is an owner have been applied primarily to majority-owned and directly owned BOSs. In line with the new strategies of partial divestiture of state ownership, they should also be applied to minority-owned and indirectly owned BOSs. Annex 6B illustrates these continuous governance challenges by examining six state-owned airlines that received technical advice from the World Bank.

For crowding in a productive private sector, reforms from corporate governance to privatization programs need to be accompanied by broader reforms to institutions and competition. Over time, recognition has grown that traditional BOS reforms cannot replace facilitating market discipline and creating other sustainable business models. An Independent Evaluation Group evaluation highlights both institutions and competition as essential conditions for successful engagement to support BOS reforms (IEG 2020).

That evaluation notes that, first, better institutions and control of corruption are key for improving the effectiveness of BOS reforms. Second, BOS reforms have more impact, and BOSs perform better, when competitive market conditions prevail that reinforce market discipline and competitive neutrality at the market and enterprise levels. However, only seven countries and one subregion had comprehensive competition analysis for more than 1,000 projects analyzed across 142 countries when supporting BOS reforms (IEG 2020). Given the changes in the BOS landscape over the past two decades, key BOS reform strategies are being redrafted.

Emphasis on stronger regulation to ensure competitive neutrality and competition is expanding the traditional firm-level BOS reform agenda and links it firmly to broader private sector development strategies. This shift is consistent with moving from a more firm-driven policy agenda of BOS privatization and governance reforms toward market-level approaches, like creating an enabling environment for private sector development that focuses on a level playing field between all actors in the economy, whether state owned or privately owned. A particularly important aspect regarding a strengthened regulatory framework for competition and enforcement is capacity building for competition agencies or commissions. However, the focus on stronger regulation does not mean more regulation, and the importance of
strong regulation differs for markets with a BOS presence (and that importance is greater for competitive sectors).

In sum, what it is critical for maximizing the potential gains of BOS reforms for growth and private sector development is having in place policies and regulations that ensure a level playing field among market players, including incumbents and new entrants. Even with full privatization, if market discipline and market incentives to perform are not in place, BOS reforms might have limited results. The incentives for BOSs or private firms to reach their full potential are shaped by the rules in the market including corporate governance, performance contracts, pro-competition regulation, and proper enforcement and monitoring (World Bank, forthcoming).

Annex 6A Reform Priorities for Competitive, Partially Contestable, and Natural Monopoly Markets

Competitive Markets

Ensuring that effective legal and policy reforms create a level playing field is a priority for competitive markets.

A large presence of BOSs in competitive sectors points to the potential risk for crowding out private investments when the regulation, governance, and market conditions to ensure a level playing field are not in place. As a starting point, governments could, therefore, reform rules in competitive sectors (those typically with low barriers to entry and a weak economic rationale for state ownership) that shield BOSs from private entry (for example, import monopolies, legal monopolies, price regulations, and specific subsidies) or that increase the costs for private firms to operate. Competition authorities can use competition advocacy tools such as market assessments to identify the most restrictive regulations and promote more pro-competition reforms.

If BOSs operate in competitive sectors with poor performance, the most pragmatic reform option is likely to analyze whether some business lines of the loss-making BOSs can be made profitable. The options are to unbundle these business lines and turn their performance around through governance and management reforms. For those business lines deemed unprofitable in the long run and impossible to turn around, divestiture is likely the most sensible option.

Divestiture in competitive sectors should follow the subsidiarity principle. Divestiture (either full or partial) may be desirable to transfer loss-making BOSs in competitive sectors to private owners, where neither externalities nor the public good nature of services calls for involvement of BOSs. Under “free market conditions” private ownership ultimately could lead to performance improvements and income to the government in the form of tax revenues.
The subsidiarity principle may be a useful tool in assessing both ex ante and ex post the adequacy of state presence in a given sector. At the same time, it is important to keep in mind that regulatory reforms should be carried out to prevent the private sector from enjoying protections or preferential treatment and to embed competitive neutrality principles (that is, in primary laws and relevant sector-specific provisions). Doing so requires strong coordination not only with the competition authority but also with relevant regulators mandated to determine rules in the market.

**Partially Contestable Markets**

For contestable sectors the reform priority is to explore potential management contracts or PPP arrangements for BOSs.

BOSs operating in contestable sectors such as transportation, power generation, or information and communication technology infrastructure could also benefit from management arrangements or PPPs, including concessions to attract private investment and associated skills and expertise. Management contracts allow the government to retain control over assets but transfer the day-to-day management and business operations to the private sector, allowing for increased efficiency in service delivery. As noted earlier, management contracts are particularly useful when service delivery involves public goods for which the delivery is relatively straightforward to define and measure, for example, waste management.

PPP arrangements typically transfer more risk and responsibilities to the private investor, including rehabilitation and maintenance as well as design, build, and (time-bound) ownership of the asset, for example, under build-own-operate-transfer contracts. PPPs find their application in transportation infrastructure (for example, toll roads) and services (for example, rail cargo), or power generation (for example, through independent power producer arrangements). A review and reform of the PPP framework may be necessary to attract private investment, along with reforms to rules that restrict or inhibit entry of the private sector (for example, sectors reserved for BOSs). Further meaningful oversight and open tenders are required to ensure a competitive and transparent process, including appropriate frameworks for unsolicited proposals (World Bank 2017).

PPP, like BOSs, are not immune to political patronage and corruption. As with BOSs, PPPs can increase fiscal risks (see chapter 4), especially since PPPs are off budget. For that reason, PPPs need to operate in an environment of adequate regulation of such contracts to minimize fiscal risks.

**Natural Monopoly Markets**

In natural monopoly markets, BOSs’ operations should complement and crowd in private sector activity.
BOSs that operate in natural monopolies (for example, water distribution and transmission lines) can be supported through enhancements in the regulatory and policy environment; in BOSs’ internal governance, operational, and financial performance (such as raising commercial capital); and in investments to improve service delivery. Alternatively, the service that these BOSs deliver can be transferred to private operators through PPPs (or other hybrid models) to improve performance, which requires careful regulation and proper enforcement mechanisms.5

Support to BOS reform should leverage the full range of instruments in carefully sequenced interventions, ranging from (1) regulatory and policy change (including the review of tariff models, least-cost development plans, regulatory and supervisory bodies, and so on), to (2) improving BOSs’ internal governance and performance (strengthening governance, professionalizing boards of directors, automating business processes, achieving higher revenue collection, and enhancing better credit ratings), to (3) investments and credit lines to support investment programs or enable performance improvements in service delivery.

Private investments in the sector allow private firms to operate these natural monopolies and allocate those rights based on open and competitive tenders (for example, PPPs, including concessions, or a simple management arrangement assigned through bids). Competition for the market can attract multiple interested stakeholders and grant the rights to the provider with the best offer (for example, in terms of capacity, investment plans, or service delivery).

Regulations to avoid abuse of the dominant position of private monopolies (for example, price controls or quality controls) and stronger enforcement mechanisms (for example, strengthening the sectoral regulator and competition authority capacity) should be considered an essential part of such reforms. Rules and design of concessions should minimize negative effects in other markets (for example, access regulation or account separation in the case of vertical integration and even more when receiving compensation for public service obligations). Regulatory requirements that integrate the public service obligations of state-owned enterprises (SOEs) will also be needed to safeguard the public interest as ownership and service delivery are transferred to private owners or operators.

Annex 6B Corporate Governance in the Airline Industry: A Case Study

The airline industry is a capital-intensive industry with high barriers to entry. In many countries, it started as a state-owned sector characterized by a national carrier that operated using bilateral agreements with limited or no competition among market

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This case study is based on findings from six World Bank engagements that assisted state-owned airlines, with most engagements consisting of assessing the financial viability of the enterprise with the objectives of de-risking and limiting their fiscal burden.
players. The deregulation of the US market in 1978, the privatization wave of the 1990s, the financial crisis of 2008, and the recent COVID-19 (coronavirus) crisis have shaped the industry and transformed it into a highly competitive sector with a focus on cost control and profit maximization.

The corporate governance practices of successful airlines have evolved alongside their business models. Today, the ownership structure is dominated by publicly listed companies and privately held groups, but in many developing countries state ownership remains the prevalent form of ownership.

State ownership of airline companies has benefits and drawbacks, with differences observed across regions. However, adequate corporate governance practices have been shown to reduce the over politicization, bureaucracy, and overstaffing in state-owned airlines.

Airlines with the best governance practices have a more balanced approach toward hedging, de-risk decisions, behave in a more agile manner, and are more likely to reduce fleet size and staffing to control costs. Research by Chen, Chen, and Wei (2017) finds that non-state-owned airlines dominated and outperformed the state-owned companies, whereas Duppati, Scrimgeour, and Stevenson (2016) observe that a government holding in the Asia-Pacific region had a positive effect on airlines. Regardless of airline ownership structure, these studies conclude that good corporate governance makes it more likely that airlines will adopt performance management methods that improve financial performance.

In many countries, the national-level legal and regulatory framework lacks a unified corporate governance policy and accountability mechanisms for state-owned airlines. Often the government has weak capacity to act as a competent owner and to support the management board in identifying and implementing necessary measures for restructuring. It also lacks mechanisms to hold management accountable for reforms with the goal of reducing airlines’ losses. Governments face difficulties in implementing severe cost-cutting measures, so the measures are often watered down.

State-owned airlines often lack professional nonexecutive boards of directors. Board members are frequently nominated from the overseeing ministries rather than selected independently on the basis of relevant professional expertise. Independent experts, when invited to the board of directors, often cannot adequately support the company because they lack the professional, technical, or industry profile required by good practice standards to be effective in such a position. This practice is partly due to weak bylaws and governance policies that could empower management to execute decisions without political interference. Most publicly held airlines with external support have improved their performance.
Many state-owned airlines have limited or no fiscal and financial transparency, have weak audits that are mostly performed by state audit organizations or finance ministries with weak capacity, and do not have transparent public procurement procedures. Although in many countries SOE regulatory frameworks stipulate that the ministry of finance is responsible for exercising the government shareholder responsibilities and fiscal oversight of SOEs, the discharge of such responsibilities is often uneven and undermined by lack of data that track SOEs' financial performance. Oversight responsibility is often fragmented or delegated to the relevant ministries the SOEs belong to, creating conflicts of interest because the oversight body is often represented in the management team of the SOE. Most countries have no centralized or publicly available SOE database with recent financial results and debt profiles, including contingent liabilities and expenditure arrears. External audits mostly focus on compliance with local regulations and laws, and do not provide adequate information about the reliability of financial results and compliance with internationally recognized financial reporting standards. Moreover, audit reports are not publicly disclosed.

Most airlines lack a complete enterprise resource planning solution and have weak financial and accounting tools. Financial management information systems are often inadequate to support management reporting and strategic planning with identifiable objectives and measurable metrics. The periodic reports issued by the airlines for the management and board are not prepared using a comprehensive enterprise management solution or uniform project management software to track basic project actions: duration, costs, human resources, and expected completion. This has contributed to a lack of synchronized action plans and comprehensive reporting.

In addition to being often overstaffed when compared with well-performing industry peers, state-owned airlines in many countries lack performance management plans for employees and lack incentivized remuneration. Regardless of the digitization of airlines in the past 10 years, the airline industry remains people-centric, and performance management is an important catalyst of success if accompanied by good communication and continuous training of staff. Performance management helps transform the corporate strategy and business priorities into executable and measurable activities by ensuring that employees understand what is expected of them and when, that they have access to adequate tools, and that their level of completion of deliverables is measured periodically. For example, Southwest Airlines, the airline with the best human resource performance in the industry, has evolved performance monitoring from once a year to a continuous process, and has transformed managers into leaders and coaches for staff (HCI 2020).

These governance and management weaknesses perpetuate the cycle of poor performance of several state-owned airlines that results in debt accumulation and contributes to significant fiscal risks and costs for the government. Along with a dearth of periodic management reporting on key performance indicators, the absence of...
periodic controls monitoring means management does not receive adequate and timely
feedback on the drivers of poor financial performance and compliance gaps, and thus
cannot sufficiently address the causes of poor performance that resulted in the build-up
of losses. In addition, airlines—as capital-intensive entities purchasing high-value
equipment and services—require transparent and competitive public procurement
procedures and digital platforms.

Key reform recommendations for improving governance build on best practice
from successful international public and private airlines’ strategies and align with the
Guidelines on Corporate Governance of State-Owned Enterprises (OECD 2015):

- Incorporate at least one expert with international airline experience in the board
  of directors, familiar with airline turnarounds and restructuring of financial
dept.
- Establish a chief financial officer and financial controller role as part of the exec-
  utive board and upgrade the organizational structure for full compliance with
  international best practice, to reflect the direct connection between the account-
  able manager and all nominated persons, as well as the level of accountability
  among the different management roles.
- Upgrade the management and develop and implement company processes
  establishing detailed corporate governance guidelines focusing on transparency,
  leadership culture, management information, and performance management.
- Upgrade management information systems, focusing on integrated enterprise
  management solutions and accounting and manpower management solutions.
  Implement project management software, training staff to use Microsoft Project,
  Smartsheet, or other simple tools, to improve task monitoring and offer a com-
  plete perspective on project duration, costs, human resources, and expected
  completion.
- Capacitate the workforce to perform effectively and minimize staff turnover of
  the airline, streamlining personnel needs to avoid excessive personnel costs.
- Acquire external support for the implementation of a performance management
  strategy, with tailored solutions for the aviation industry.
- Develop a publicly available procurement manual in line with airline purchasing
  requirements and facilitate a digital platform, owned or through the govern-
  ment’s electronic platform, to create a transparent process and attract a higher
  number of international bidders.
- Use International Financial Reporting Standards to ensure financial reporting
  accuracy and ease in international transactions, or potential attraction of foreign
  investors and international financing.
- Conduct annual financial statement audits and publicly disclose the audit report.
- Adhere to transparent and competitive procurement practices to maximize value
  for money and minimize rent-seeking behavior. Publicize invitations to tenders
  and awards.
Notes

1. The chapter draws on Business of the State and Private Sector Development: A Policy Toolkit for Practitioners (World Bank, forthcoming).
2. This is not possible in cases when the provision of the good or service is not available in the first place.
3. A PPP is “a long-term contract between a private party and a government entity, for providing a public asset or service, in which the private party bears significant risk and management responsibility, and remuneration is linked to performance” (World Bank 2017, 5). PPPs differ from management contracts, which typically involve no or very limited risk transfer.
4. Concession is mostly used to describe a user-pays PPP.
5. Independence of the sectoral regulator and strong competition agencies are among the success factors for this alternative.

References


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