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Efficient Management of State-Owned Enterprises: Challenges and Opportunities

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Key Points

- State-owned enterprises (SOEs) often make up the country's mega-infrastructure projects and remain a critical source of employment and economic growth in developing Asian countries.
- SOEs' performance has declined vis-à-vis private companies, largely because of corruption, mismanagement, and technical incompetence of their staff.
- To improve SOEs' performance efficiency, developing countries must appoint competent and autonomous management bodies to oversee SOEs' day-to-day operations.
- SOE management bodies should set clearly delineated, realistic, and time-bound goals.
- Unlike private enterprises, SOEs' performance evaluations must entail their profitability as well as social benefits.
- SOE management must encourage a competitive work culture by hiring and retaining talented individuals through competitive compensation packages and performance-based bonuses.

State-owned enterprises (SOEs) are classified as those enterprises in which the state exerts significant control through full, majority, or significant minority ownership. This definition includes SOEs that are owned by the central or federal government as well as the ones owned by regional and local governments (Sturesson, McIntyre, and Jones 2015). Despite a wave of privatization in the last 3 decades, SOEs still contribute significantly to economic growth of both developed and developing countries (Robinett 2006). For example, SOEs account for about 30% of gross domestic product (GDP) in the People's Republic of China (PRC), 38% in Viet Nam, 25% in India and Thailand, and about 15% in Malaysia and Singapore (OECD 2010). In 2005, they accounted for more than 50% of GDP in Tajikistan, Turkmenistan, and Uzbekistan and about 20%–40% in other Central Asian countries respectively (World Bank Group 2014a). If we include those firms in which the state owns more than 50% of their total shares, directly and indirectly, at the national or subnational level, then 10% of the world's largest[1] firms (204 enterprises) could be classified as SOEs with a net worth amounting to \$3.6 trillion. Figure 1 details the equally weighted shares of SOEs in assets, sales, and market value of the top 10 firms in the selected countries to show which countries have the highest presence of SOEs among their firms. SOEs' presence in rapidly developing countries such as the PRC (96%), the United Arab Emirates (88%), the Russian Federation (81%), Indonesia (69%), and Malaysia (68%) is higher compared with more developed countries such as Germany (11%) and Finland (13%) (Büge et al. 2013).

In many countries, SOEs often make up the mega-infrastructure projects, such as for railways, telecommunications, power, and gas. For example, the 13 largest oil companies which control 75% of global oil production are SOEs. A significant number of firms in the commercial and financial services industries are SOEs, although their share has declined from 67% in 1970 to 22% in 2009 (World Bank Group 2014a). SOEs are different from private enterprises in that they are often granted favorable treatment such as subsidies, debt waivers, favorable loans,

[1] Derived from the Forbes Global 2000 rankings which are based on equally-weighted measures of revenue, profits, assets, and market value of SOEs (Jurney 2017).

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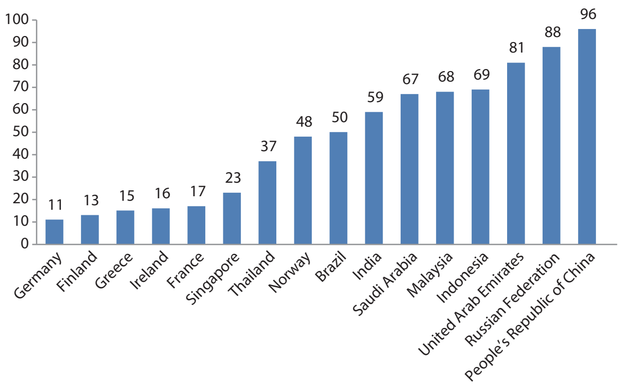
Figure 1 Shares of State-Owned Enterprises among Countries' Top 10 Firms (%)



Source: Büge et al. (2013).

and protection against bankruptcy. As such, they are also expected to provide pivotal public goods and services to their citizens, which is often not financially profitable. In Cambodia, for instance, the Phnom Penh Water Supply Authority, established in 1895, aims to provide clean drinking water to all its citizens. To achieve its purpose, it charges lower rates (below production costs) for domestic consumers and compensates this by charging higher tariffs to industries. The Phnom Penh Water Supply Authority has provided clean water to 30,000 households since 1993 and helped improve their health and sanitary conditions (Sturesson, McIntyre, and Jones 2015).

However, the triple role of the government as the regulator, enforcer of those regulations, and owner of SOE assets in their respective country can sometimes undermine the SOEs' competitiveness and efficiency because of corruption, mismanagement, and technical incompetence of their staff (Büge et al. 2013). Indeed, despite their socioeconomic importance, the SOEs' performance has been "disappointing" over the years compared to their private counterparts (Sturesson, McIntyre, and Jones 2015). The underperforming SOEs not only drain scarce resources to provide essential services to people in developing countries, but can also crowd out private investment and distort domestic financial markets (World Bank Group 2014a). Many developing countries, therefore, have sought to reform their SOE management and governance structures to improve their performance.

Reforms at a Glance

SOE reforms have long been the focus of developed and developing countries alike. Beginning in the 1970s, member countries of the Organisation for Economic Co-operation and Development (OECD) such as France, Spain, and the United Kingdom began to seriously examine the causes of poorly performing SOEs amid the mounting fiscal constraints they faced to control their public spending and debt. Over the subsequent 2 decades, partial or complete privatization of SOEs became a key source of economic reforms initiated, at first, by OECD countries and later by most developing countries in the last 25 years. Evidence from OECD countries also strongly suggests that privatization leads to "significant" increase in profitability, real output, and efficiency of privatized firms, especially when the privatized firm operates in a competitive market where deregulation levels converge with those of the private sector (OECD 2003).

However, efficiency gains from privatization are largely dependent on continued political commitment by the government to overcome bureaucratic inertia, ensuring a transparent privatization procedure, clearly delineating privatization motives and goals to the concerned stakeholders, and allocating the necessary human and capital resources to achieve those goals (OECD 2003). Many developing countries struggle to ascertain these conditions.

First, most SOEs, especially in developing countries, are not just expected to be financially profitable, but are also tasked to provide crucial public goods. The provision of clean water, electricity, and sanitation services in remote towns and villages, for example, might not be as financially profitable as they would be in big towns, but they are equally essential for both sets of populations. Privatizing SOEs, which provide these essential services often at subsidized rates, thus could deprive people of critical public goods, as SOEs may stop their operations in less profitable regions. Such policies may also be fatally unpopular for governments in developing countries. Second, some countries may be unwilling for security reasons to privatize, even partly, their "strategic" industries—those that a government considers to be very important for the country's economy or safety (Cambridge Dictionary 2017). These issues, among others, suggest that privatization of SOE shares might not always be a workable option to improve SOE profitability and performance in developing countries.

Apart from privatization, therefore, many developing Asian countries have introduced other reforms to improve the SOEs' performance by establishing better institutional frameworks responsible for managing them. These reforms include allowing SOE management more autonomy in their business operations, and strengthening ex post monitoring and incentive mechanisms. The results from these reforms, however, have been largely mixed. In 2003, for example, the PRC formed the State-owned Assets Supervision and Administration Commission (SASAC) to reform SOEs by optimizing their sectoral allocation and increasing the value of state assets. Some of the key SOE reforms included separation of administrative and business operations where the latter were entrusted to a board of directors who were responsible for reporting SOE performance to the shareholders. A large number of SOEs have since been publicly listed and their governing structures now include both private and foreign firms as minority or majority shareholders such that the government is no longer involved in most SOEs' day-to-day operations (Zhang and Freestone 2012).

By 2010, about half of the large SOEs in the PRC had some form of a diversified ownership structure involving public–private partnerships, whereas publicly listed SOEs accounted for 60% of the SOEs' total revenues and 80% of their total profits. These reforms have seemingly improved SOEs' return on equity from below 2% in 1998 to around 15% in 2010 (Zhang and Freestone 2012). However, these improvements have been significantly aided through "explicit" and "implicit" government subsidies including low effective taxes, low dividend payouts, little or no royalties on resource extraction, and protection of "strategically important" SOEs from competition.

Similarly, some central Asian countries such as Tajikistan have also introduced SOE reforms as they continue to switch from a planned to a market economy. SOEs in Tajikistan provide almost a third of all the jobs in the economy and form 42% of the total value added and 50% of the total investment in fixed capital. As such, SOEs are major stakeholders in Tajikistan's economy. Yet, the financial and management data about most of these SOEs remain incomplete or inaccurate, which makes monitoring their performance more difficult. Nonetheless, the Government of Tajikistan instituted the SOE Monitoring Department (SOEMD) within the Ministry of Finance in 2008 to monitor SOE performance. SOEMD found that 5 of the largest SOEs (large SOEs in Tajikistan each have more than 1,000 workers and an annual gross revenue of more than 30 million somoni) contributed to 80% of the country's gross income, whereas 24 of the biggest SOEs had a $1.9 billion debt, equivalent to 97.7% of Tajikistan's public revenues of all kinds in 2013. The 3 biggest SOEs among the 24 owed 84% of that debt. By 2014, these 24 SOEs were also responsible for half of all the tax arrears. The Civil Code of the Republic of Tajikistan provides a legal framework for SOE management and monitoring, but multiple or uncoordinated functions of SOEs as well as lack of proper oversight and management by the relevant government agencies has hindered SOE performance efficiency in Tajikistan (World Bank Group 2014b).

Malaysia, on the other hand, provides a successful example in SOE reforms for other Asian countries to follow. In 2004, the Government of Malaysia embarked on the Transformation Programme for Government-Linked Companies (GLCs). The program has realistic and performance-based objectives in line with international benchmarks. It was overseen by the Putrajaya Committee on GLC High Performance chaired by the Deputy Finance Minister and comprising representatives of all key SOE shareholders and external experts. The program introduced key performance indicators (KPIs), as well as performance-based contracts and compensation, along with a change in the composition of GLC boards and senior management. It addressed the root causes of underperformance in SOEs, upgraded the legal and operational framework of the SOEs to corporatize them, and infused newer management from the private and public sector into SOEs. Management were given a clear mandate and sophisticated indicators to improve SOE performance within a set time frame. These reforms helped instill a performance-based culture, and improved SOE management through better utilization of capital and other resources, all of which translated into higher profitability. Between 2004 and 2014, Malaysian GLCs tripled their market capitalization generating a return on equity equivalent to those recorded by the listed companies. The GLCs also grew 11% annually during this time (Luna-Martinez 2016). Inspired by the success of the GLC transformation program, the government initiated the New Economic Model, which required GLCs to expand their operations globally. By 2014, GLCs had operations in 42 countries and the 20 largest SOEs operating overseas had tripled their revenue to $22 billion from $7 billion in 2004 (Luna-Martinez 2016).

However, apart from Malaysia, most Asian countries have had limited success in implementing SOE reforms over the past 15 years. For example, the SOEs' performance in the PRC has continued to decline vis-à-vis the private sector in many crucial metrics over the past 15 years. For instance, the SOEs' gross output (that measures their combined impact on the PRC's economic output) halved between 1998 and 2010, compared to the gross output of the non-state sector, with SOEs only contributing slightly more than a quarter of the PRC's total industrial output. Similarly, the SOEs' share of fixed asset investment also declined from 58% in 2004 to 45% in 2009 to 35% in 2012 as that of the non-state sector has outpaced it in recent years. Moreover, between 1998 and 2010, the SOEs' share of total industrial employment in the PRC declined from 60% to 20% as the non-state sector has emerged as the leading industrial employer (Zhang and Freestone 2012).

Similarly, the lack of political commitment to SOE reforms along with the prevalent overarching role of the government in SOE management and unspecified performance mandates still pose significant challenges for improving SOE performance in most other Asian countries.

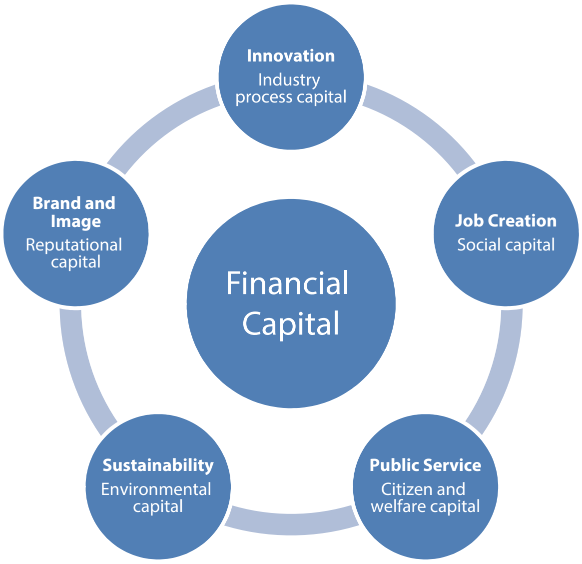
Improving Performance: Key Challenges and Solutions

The foremost challenge facing SOEs in developing countries is the separation between its ownership and management entities. Unlike most private enterprises, SOEs in most developing countries are likely to have board members from the ruling political party or the government who are difficult to remove or replace. This, along with a lower probability of bankruptcy of many SOEs, reduces incentives for board members to contain costs and improve performance through competition. At worst, most board members could exploit SOEs for personal and partisan benefits while compromising short-term efficiency and long-term efficacy of the SOEs (Robinett 2006).

To address this problem, countries must institute a balance between a state's ownership mandate (appointing boards and providing oversight) and improving SOE competitiveness simultaneously. They should begin by introducing a clear legal and regulatory framework supported by a strong coordinating mechanism for oversight (World Bank Group 2014a). Some Latin American countries, for instance, have centralized SOE ownership within a single entity which oversees SOEs and maintains their separation from government activities that could obstruct competition. Moreover, the SOE board members must be carefully selected through competitive and professional recruitment based on their technical, financial, and corporate governance skills. They must be safeguarded against political interference and be autonomous in their commercial decision-making (World Bank Group 2014a). In Peru and Chile, for example, board members are appointed on these merits and not on political affiliation. This empowers them to make autonomous decisions (Weiner, Ivins, and Riveira Cazorla 2015). Nelson and Nikolakis (2012) in their study also cite empirical evidence from 6 Australian state forest agencies to corroborate the claim that corporatization of these 6 SOEs helped improve their performance through operational efficiency. In particular, they argue that an independently appointed board of directors with greater managerial autonomy was responsible for redirecting their respective SOEs' focus onto commercial interests, which led to short- and long-term performance improvement. Their findings were also consistent with similar research conducted on public enterprises in the United Kingdom. These studies, therefore, offer compelling empirical evidence for appointing independent management bodies for running SOEs (Nelson and Nikolakis 2012).

Second, the governments should explicitly delineate realistic, time-bound, and quantifiable outcomes to better guide and evaluate SOE performance. This includes drafting a clear scorecard that evaluates progress on not only the financial viability and strengths of SOEs but also social objectives such as job creation, public service, welfare provision, and other social benefits (Figure 2). In Sweden, for example, the national rail operator is asked to maintain and report on industry standards for returns on equity (13%), interest coverage (2:1), and minimum debt-to-equity ratios (1:1) regularly. Similarly, the New Zealand Railways Corporation operates urban commuter trains in two major regional centers on behalf of their regional councils (which are responsible for providing affordable public transport there). The operational costs of these trains are sustained by a mix of passenger fares, council payment for contracted services, and government grants. Without these subsidies, the railways corporation would likely be commercially unviable. The government regularly monitors the corporation's performance by setting up a transparent and detailed mechanism for cost declaration to prevent mismanagement of funds and by instituting penalties to discourage underperformance (Christiansen 2013).

Figure 2 Model Scorecard for Performance Management of State-Owned Enterprises

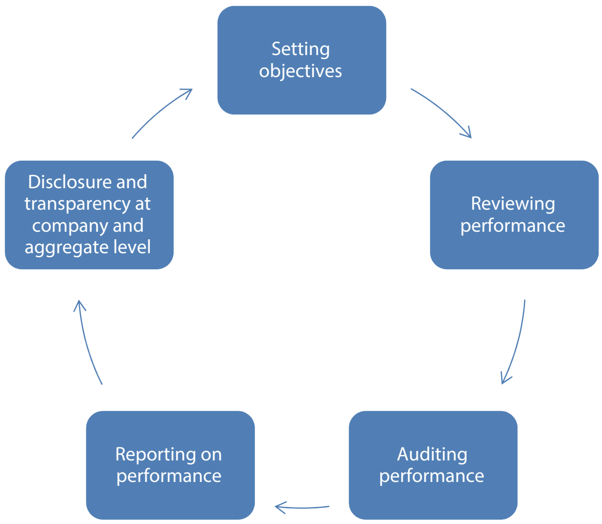


Source: Sturesson, McIntyre, and Jones (2015).

Third, regular monitoring and evaluation of SOEs should also be a key responsibility of SOE ownership entities. These entities must track SOE performance through annual performance reviews, reporting, regular board meetings, and internal and external audits to detect underperformance early on and rectify it to promote a "continuous cycle of improvement" (Figure 3). In Italy, for instance, the Ministry of Finance and Economy as the country's SOE ownership entity requires each SOE to provide an annual budget for the coming year, biannual financial and performance review reports, and year-end projections. Shareholders can also request this information from each SOE through their appointed representatives on the board of directors and board of auditors. The Putrajaya Committee on GLC High Performance in Malaysia launched the "Blue Book: Guidelines on Announcement of Headlines KPIs and Economic Profit" in 2006. The guidelines task every GLC to file 5–8 KPIs concerning its financial, customer-oriented, organizational, and operational goals. Each of these KPIs is benchmarked with comparable international counterparts. The chief executive officer (CEO) is responsible for implementing those KPIs and reporting them to the market. The guidelines also advise CEOs on economic profit reporting and how to manage poor or missed results. The KPIs have already been put in place for most GLCs' CEOs and senior management to monitor their performance and are annually reported (OECD and KIPF 2016). Other developing Asian countries could therefore also benefit from instituting similar monitoring and evaluation mechanisms.

Fourth, SOEs must attract and encourage meritorious people to join them. The perception that SOEs are hierarchical and bureaucratic, where job promotions are based more on personal connections and seniority rather than performance may discourage talented people to join their ranks. Therefore, performance-based competitive salary and benefits packages must be designed to attract talented people. Some SOEs such as China Mobile, the PRC's largest mobile service operator, offer salary packages comparable to those offered by multinational corporations. When applicable, SOEs should also provide higher compensation packages in tenured jobs to offset the benefits of long-term employment. One Eastern European telecommunications company, for instance, offers higher salaries for short-term contracts for some positions. In addition to increased benefits, SOEs must invest in and encourage consistent job training of its employees to upgrade their skills and expertise (Budiman, Lin, and Singham 2009). Employee performance should then be evaluated fairly and regularly with incentives for higher performance. Finally, while laying off consistently underperforming employees may be unpopular and difficult at times, SOE management must make those difficult decisions to develop a competitive and effective work culture (Budiman, Lin, and Singham 2009).

Figure 3 Continuous Improvement Cycle in Management of State-Owned Enterprises



Source: OECD and KIPF (2016).

Conclusion

SOEs remain a critical source of employment, public service provision, and socioeconomic development in most developing Asian countries. However, the overlapping ownership and management functions of most developing countries' governments coupled with the unclear and indefinite mandates for most SOEs have severely undermined the efficiency of SOEs in their countries for several decades. The lack of a centralized and credible database on SOEs in some countries has made monitoring and evaluating their performance even harder. Therefore, to improve SOE performance in their countries, developing countries in Asia must ensure separation between the ownership and management functions of SOEs. Second, they must chart clear and quantifiable short- and long-term goals, and appoint autonomous and competent management to strategize how to achieve these goals. Third, SOE management must institute transparent and independent monitoring and evaluation mechanisms to share regular performance reports of SOEs with all of their key shareholders and suggest improvements whenever needed. Finally, SOEs must attract qualified and talented people to join their ranks with competitive salary packages. These employees should be rewarded for better performance and penalized for chronic underperformance to establish a professionally competitive work culture and improve SOEs' efficiency and profitability.

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