The worst business proposition in human history: The appropriate role of state-owned enterprises in developing countries

La peor propuesta de negocios en la historia humana: el apropiado rol de las empresas estatales en los países en desarrollo

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1. Introduction: The worst business proposition in the world

In 1965, the South Korean government decided to build a modern steel mill and applied for a loan from a consortium of potential donors (the US, UK, West Germany, France, and Italy). The idea was so outrageous that it can be called the worst business proposal in human history.

At the time, Korea was one of the poorest countries in the world, relying on natural resource-based exports (e.g., fish, tungsten ore) or labour-intensive manufactured exports (e.g., wigs made with human hair, cheap garments). According to the received theory of international trade, known as the theory of comparative advantage, a country like Korea, with a lot of labour and very little capital, should *not* have been making capital-intensive products, like steel.

Worse, Korea did not even produce the necessary raw materials. Sweden developed an iron & steel industry quite naturally because it has a lot of iron ore deposits. Korea produced virtually no iron ore or coking coal, the two key ingredients of modern steel-making. Today, these could have been imported from China, but this was the time of the Cold War when there was no trade between China and South Korea. So the raw materials had to be imported from countries like Australia, Canada, and the US – all of them five or six thousand miles away – thereby significantly adding to the cost of production.

To make it viable, the Korean government proposed to subsidise the steel mill left, right, and centre – free infrastructure (ports, roads, railroads), tax breaks, accelerated depreciation of its capital equipment (so that tax liabilities are minimised in the early years), reduced utility rates, and what not, thereby exactly proving the critics right that producing steel was not something that the country should be doing.

The Korean government proposed two more things that made the project look even less appealing. When the company to run the steel mill – the Pohang Iron and Steel Company (POSCO) – was set up in 1968, it was as a state-owned enterprise (SOE), as there was no private sector company that was willing to take the risk. And to cap it all, the company was to be led by Mr. Park Tae-Joon, a former army general with minimal business experience as the head of a

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state-owned tungsten-mining company for a few years. Even for a military dictatorship, this was going too far. The country was about to start the biggest business venture in its history, and the man put in charge was not even a professional businessman!

Given all this, it was not a big surprise that all the potential donors pulled out of the negotiations in 1969. The Korean government, however, managed to build the steel mill by persuading the Japanese government to channel a large chunk of the reparation payments that it was paying for its colonial rule (1910-45) into the steel-mill project and to provide the machines and the technical advice necessary for the mill. The company started production in 1973 and established its presence remarkably quickly. By the mid-1980s, it was considered one of the most cost-efficient producers of low-grade steel in the world. By the 1990s, it was one of the world's leading steel companies. It was privatised in 2001, not for poor performance, but for political reasons (ascendancy of neo-liberalism), and today is the fourth largest steel producer in the world (by the quantity of output).

2. Many more successful SOEs than you think

The story of POSCO is one of the most fascinating success stories of a state-owned enterprise, but there are many other success stories. There are many world class firms that were set up and succeeded as a SOE, although privatised now – EMRAER, the Brazilian aircraft manufacturer that is the third largest in the world. Many world class firms are majority-owned SOEs – Singapore Airline (56%), Finnair (57%), Swisscom (57%), Statoil of Norway (67%), EDF of France (85%), and so on. There are many former SOEs in which the government still has a controlling stake (voting rights) by the government – Stora Enso of Finland (37%), Renault of France (30%), Commerzbank of Germany (25%), Volkswagen of Germany (19% owned by the state government of Niedersachsen, or Lower Saxony, but with a 'veto' right through the so-called Volkswagen Law).

Many countries have achieved impressive economic development with very heavy SOE presence. France and Austria produced 13-15% GDP in SOEs until the 1980s (the world average in this regard was around 11% for 1978-91 period, according to the World Bank estimate in *Bureaucrats in Business*). Taiwan produces 16% of GDP through SOEs and Singapore 22% even today. In contrast, many poorly-performing countries have small SOE sectors. Argentina produced only about 5% of GDP through SOEs even before the 1990s mass privatisation. The Philippines produces 2% of GDP through SOEs. Econometric studies have found no clear stastical correlation between a country's share of SOEs in GDP and its economic performance.

3. Arguments for and against SOEs

Now, in discussing the role of SOEs, we should not forget that there are many respectable theoretical cases for SOEs. First of all, there may be certain commodities which the society simply does not want to be produced and traded according to profit motives – for example, water, healthcare, blood, basic education, arms. Second, there are equity considerations: such as the provision of universal access to 'essential services' (e.g., water, postal service), job creation in backward areas, and more active affirmative actions for women and minorities in the state sector. Third, SOEs may be better able to take various forms of market failures (e.g., externalities, public goods) into consideration in making decisions. Last but not least, SOEs may be a convenient way to reduce political and administrative costs. For example, state operation of basic inputs industries (e.g., fertiliser) allows subsidisation of private producers who generate externalities without having to raise taxes in the first place.

Of course, there are arguments that say that state-owned enterprises will be inefficient and they need to be taken seriously.

The most prominent of these arguments is based on the so-called principal-agent argument. It says that, since a SOE is by definition run by somebody who does not own it, its manager would have no incentive to run it efficiently. The owners (in this case, the general public) cannot monitor and sanction their agents (i.e., the SOE managers) because they cannot fully know how much efforts the agents have made – this is the case of asymmetric information.

However, any enterprise which is not run by the owner-manager, and not just public enterprises, has the same principal-agent problem. Especially when the ownership is dispersed, there is a problem of collective action among the shareholders in monitoring. The improved enterprise performance is a 'public good' in the sense that even those who did not devote their efforts to monitoring the performance of the managers can benefit from it. This means that no one will have the incentive to devote time and energy to monitor the managers, because the gains are 'public' while the costs are 'private'. Moreover, under certain circumstances, it may be easier to monitor SOEs than to monitor private sector firms with dispersed ownership. In the SOE sector, there is often one, or, at most a few, clearly identifiable agencies responsible for monitoring SOE performance (e.g., relevant ministries, public holding companies, government audit board, dedicated SOE supervisory agency), whereas dispersed shareholders of private enterprises typically do not have such agency.

The second problem with the principal-agent framework is that the assumption of total self-seeking behind it is wrong. Human motivations are diverse. Indeed, if everyone is totally self-interested as depicted in the standard principal-agent models, it will not be possible to run any large, complex organisation, public or private, due to excessive monitoring costs. Large organisations can function properly only if its members are not totally self-seeking and have high degree of organisational loyalty, commitment to their colleagues, pride in their work, and other 'intrinsic' motivations.

In addition to the principal-agent theory, there are arguments saying that SOEs are inefficient because they are not subject to market discipline: SOEs are often statutory monopolies and thus not subject to product market competition; they are not subject to the discipline of the capital market in the sense that they do not go bankrupt or are subject to the threat of takeover.

However, these arguments have to be taken with a grain of salt. Many private firms are also monopolies and thus are not subject to product market discipline. SOEs are also open to the threat of bankruptcy and takeover, although not usually through the capital market – there are regular changes of public enterprise management due to bad performance, which are equivalent to takeover and there are many examples of liquidation of inefficient public enterprises, which are equivalent to bankruptcy (the UK, Italy, Israel, Korea, Ivory Coast, Brazil, and Singapore). SOEs may have more of 'soft budget constraint', but this often has more to do with their size than their ownership – this is proven by the fact that bail-out of large private sector firms are often organised by rightwing, rather than leftwing, governments (see all the examples in the powerpoint).

Moreover, the capital market discipline argument assumes that capital markets function well, but there is plenty of evidence against the assumption. It is well established that size, rather than efficiency, of a firm is the most important determinant for its exposure to the threat of takeover. Enterprise performance does not necessarily improve after takeover. Even when it works well in its own terms, capital market discipline may produce socially undesirable outcomes; it leads to 'short-termism', as clearly shown by the 2008 global financial crisis. Forms of enterprise restructuring other than through the takeover mechanism (e.g., bank-led enterprise restructuring as practiced in Japan or Germany, state-mediate restructuring in Korea in the 1970s and the 1980s) may be more efficient.

4. What is the evidence?

If there are theoretical arguments on both sides, then, what is the evidence?

Studies often do not fully take into account non-ownership factors which affect enterprise performance, especially enterprise size (that is, often incompatible firms are compared). But from those few studies which do control for non-ownership determinants of enterprise performance, no clear general evidence emerges for against SOEs. There is also a 'sampling bias' in the sense that very few studies for countries where SOEs are efficient (e.g., Singapore), whereas there are a lot of studies on countries where SOEs are not doing well (e.g., India).

Saying that there is no general case against SOEs does not mean that their performances do not need any improvement. What it means, however, is that privatization is not necessarily going to be the solution. And indeed there are many other ways to improve SOE performance.

In discussing privatization, we need to first bear in mind that the choice is not 'all or nothing'. There are many intermediate solutions. The government can sell some of the shares of a SOE while retaining majority control or a controlling stake (most SOEs are of this form these days). Such 'partial' privatization may be done in order to raise revenues, but it is also done in order to gain access to key technologies or key markets through partnership with a major foreign company. Some governments have utilized the so-called 'golden share' to retain control over key matters (e.g., control over key technology, M&A) while selling almost all its stake (e.g., EMBRAER). Or the government can retain its whole or majority ownership and contract out management in certain sectors (tourist hotels are the best examples in this regard).

Evidence shows that privatization of profitable SOEs makes little difference to their performances, so the government should focus on privatizing unprofitable SOEs. Unfortunately, the private sector is not very interested in buying unprofitable SOE. Therefore, in order to generate private sector interest in a poorly-performing SOE, the government often has to invest heavily in it and/or restructure it. This raises a dilemma – if SOE performance can be thus improved while in state ownership, why privatize in the first place?

Indeed, there is evidence that gains in productivity in privatized enterprises usually occur *before* privatization through anticipatory restructuring. This suggests that restructuring is more important than privatization. Therefore, unless it is *politically* impossible to restructure an enterprise without a strong government commitment to privatization, a lot of problems in the SOEs may be solved through restructuring without privatization.

Moreover, the very process of privatization involves financial expenditure (valuation, flotation, etc.). This is especially a problem for developing countries, as the process has to be managed by expensive international accounting firms and investment banks (developing countries that do not have such firms domestically). Privatization can also put an excessive burden on the regulatory capabilities of the government, especially if done on a large scale or if regulation is given to local governments (as they have lower capabilities). When the SOEs concerned are natural monopolies, privatization may replace inefficient but restrained public monopoly with inefficient and unrestrained private monopoly, in the absence of adequate regulation.

Corruption inside SOEs is often used as an argument for privatization. However, the processes of privatization have been often corrupt – sometimes illegal (e.g., bribery, insider trading) but often legal (e.g., government 'insiders' acting as hidden consultants). As a result, the corrupt have often pushed through privatization at all costs, because it means they do not have to share the bribery with their successors and can 'cash in' all future bribery streams. A government that is unable to control corruption in SOEs is not suddenly going to have the capacity to prevent it when it is privatizing them. Finally, it should also be added that privatization

will not necessarily reduce corruption, as private sector firms can be corrupt too.

It should also be pointed out that the timing and the scale of privatization matter. For example, trying to sell many enterprises within a relatively short period – the so-called "fire sale" approach – weakens the government's bargaining power, thus lowering the proceeds it gets. Trying to privatize when the stock market is down may force the government to lower prices, so setting a rigid deadline for privatization is a bad idea. There is also a need to get the privatisation contract right. The contract needs to have arrangement for reclaiming assets when the purchaser extracts profit and walks away. There is also the need to set the right performance requirements.

5. What is to be done?

If privatisation has all these potential problems, what else can be done?

First of all, we can reform the way in which objectives of SOEs are chosen and prioritised. SOEs often serve multiple objectives. There is nothing wrong with this, but, often the objectives are not clearly specified, there are too many objectives, and the hierarchy among these often conflicting objectives are left unclear. Thus, we need to clarify the objectives, reduce their numbers, and establish a clear hierarchy among them.

Second, there is a need to improve the quality of information available to the agencies monitoring the SOEs (e.g., dedicated monitoring agency, holding company, government ministries). In doing this, clear lines and schedules of reporting need to be established in order to monitor and improve performance without the government engaging in micro-management. Also, the monitoring authorities' ability to process information should be improved, as information without the ability to use it is meaningless.

Third, public sector compensations are often not related to performance. There is a clear need to link the manager and worker remuneration to performance. However, remuneration needs to be more broadly defined than monetary compensation.

Fourth, institutions that manage the SOEs need to be improved. Sometimes creating a special agency devoted to the monitoring of SOEs can improve monitorinig efficiency. Such agency can save duplication of efforts and resources. Being the sole agency it cannot 'pass the buck' in relation to minotoring responsibility. And there being just one monitoring agency, SOE managers are freed from excessive inspection, which can happen when there are multiple agencies. Having said that, checks and balances needed against such agency, as it can become too powerful. Reducing the number of SOEs to supervise by liquidating and merging enterprises can also increase monitoring efficiency.

Fifth, competition can be increased. More competition is *not* necessarily better under all circumstances, but there is evidence that competition is more important in determining enterprise performance than ownership. For example, we can increase competition among SOEs, as Korea did by setting up a new state-owned telecommunication company that competed with the existing SOE in providing international call services in the 1980s. The increased competition could be provided by liberalising a sector dominated by private enterprises and let it compete with a SOE supplying a partial substitute – this is what happened in the UK in the 1980s following the liberalisation of bus services, which then competed with the state-owned rail company. Or the government can push SOEs to export, which will force them to compete with private (and state-owned) firms from foreign countries in foreign markets; this is what the Korean government did with POSCO in the 1970s.

Finally, we need to think about political reform. Often, public enterprises are used as a means to redistribute income to politically favoured groups; political appointment of party loyalists, creation of employment in certain

regions (Italy) or for certain ethnic groups (white workers in South Africa under apartheid). Under certain circumstances, this practice may be justified, but it is often done to such a scale that it seriously damages the economy. Getting rid of such political patronage may be the most important, albeit most difficult, remedy for SOE inefficiency in some countries.

6. Concluding Remarks

The debates on the role of SOEs in the economy and on the role of privatisation as a remedy to the problems of SOEs have been heavily tinged by ideological biases – mostly biases against SOEs in the recent period. This short essay shows how the reality is a lot more complex.

There are many different theories for and against SOEs, all with some elements of truths and all theories requiring very nuanced and context-dependent interpretation. The empirical evidence is also complex. There are many examples of excellent SOEs, as well as those of very poor ones, and there is no clear systematic statistical correlation between the size of a country's SOE sector and its economic performance.

Privatisation is but one solution to the problems of SOEs and not even necessarily the most effective one. Privatisation is in itself an expensive process that is also open to corruption. Its timing, scale, and design can seriously affect its outcome. Moreover, partial privatisation, contracting-out of management, reform of the internal structure of SOEs (objectives, remuneration, information flows, etc.), restructuring of the monitoring mechanism, increased competition, political reform are all measures that may sometimes be more effective than privatisation.

The former Chinese leader, Deng Xiaoping, once famously said that he does not care whether the cat is black or white as far as it catches mice. The problems of SOEs need to be approached in that pragmatic spirit; we should try to assess the merits and demerits of a SOE without any prejudice for or against public ownership and implement solutions that are the best for that enterprise.