GLOBAL EXPERIENCE WITH STATE-OWNED ENTERPRISES REFORMS

1. Governments see state-owned enterprises (SOEs) as tools to help them meet their social and other political objectives (such as job creation), and, in some cases, also for accelerated development and global expansion. Globally, SOEs account for 20% of investment and 5% of employment. SOEs also account for up to 40% of output in some countries. They continue to deliver critical services in important economic sectors such as utilities, finance, and natural resources. Additionally, large-scale manufacturing and services in competitive sectors remain in state hands in many countries.¹

2. From the end of the Second World War until the 1980s, SOEs were developed and expanded in most developing countries throughout the world and in virtually every sector. In the socialist or command economies of central and eastern Europe, the former Soviet Union and the PRC, SOEs were prevalent in all sectors, including small-scale retail and service establishments. SOEs were originally created because it was thought that they would be better at providing basic goods and services than a non-existent, embryonic or socially unresponsive private sector. Until the 1970s, these SOEs were financed by government allocations, supplier credits, directed credits through state-owned development banks, and development partners.²

3. Many SOEs were developed under import substitution industrialization policies with high tariffs, other forms of trade protection, exchange controls and tax incentives to protect them. In many infrastructure and other sectors—such as utilities, transport, oil and gas, mining, petrochemicals, steel and fertilizers—these firms operated as state-owned monopolies.³

A. The Rationale for SOE Reform and Performance Improvement

4. SOEs in many developing and emerging market countries contributed to their government’s fiscal and national debt crises, which led to calls for SOE reform and debt rescheduling. SOEs engaged in providing infrastructure (water, electricity, rail) and other services (airlines) as well as manufacturing (heavy industry) have traditionally relied on government budgetary support to meet their operation and maintenance costs. They have also generated nonperforming loans for state-owned commercial banks and financial institutions. SOE-related fiscal costs to governments include not only direct operating losses and direct subsidies, but also the cost of servicing their debts, forgone taxes, and dividends, and shortfalls in payments to major suppliers (including electricity and water utilities) and social charges for their employees. The urgency for SOE reform arose in the 1980s, when sovereign debt crises led many countries in Latin America, Eastern Europe and others (including Morocco, Philippines and Turkey) to restructure and reschedule their debts. This happened repeatedly under the Baker Plan (1985–1989) which emphasized SOE reforms⁴ and the Brady Plan (1990–1994) which sought debt relief

² Supplier credits were often guaranteed by credit insurance agencies in the developed industrial economies. They were often short-term and did not match well with the maturity profiles of large and capital intensive SOEs, and defaults on trade credit were frequent.
for national governments in exchange for economic reform.\(^5\) The structural reforms that took place in these countries became known as the Washington Consensus.\(^6\)

5. **Devoid of Soviet-era subsidies,\(^7\) the Soviet Union countries of central and west Asia could no longer sustain their SOEs and had to reform them.** With the break-up of the Soviet Union in 1991, these countries had no choice but to begin transitioning to market economies. Given the large numbers of SOEs in these command economies (small retail and service establishments were also state-owned), the transitioning was in many ways similar to reforms under the Washington Consensus. It included liberalization, stabilization and privatization, but on a much larger scale than reforms in other developing and emerging market economies.

6. **Although the Asian Financial Crisis of 1997 resulted from bold corporate spending and large public infrastructure projects in many rapidly growing Asian economies coupled with increased interest rates in the United States,\(^8\) a sustained solution to the crisis required these countries to carry out numerous reforms that also led to the reforming of SOEs.** The International Monetary Fund (IMF), which provided loans to stabilize Indonesia, the Republic of Korea, and Thailand required them to undertake reforms; the reform programs were formulated in collaboration with the respective governments, the World Bank, and ADB. Given the origins of the crisis, financial sector reform was necessary and entailed the closure of insolvent financial institutions, recapitalization of potentially viable financial institutions and strengthened financial supervision and regulation.\(^9\) The IMF also proposed structural reforms that included measures to increase transparency in the corporate sector, improve efficiency of markets and increase competition—all of which resulted in SOE reforms to varying degrees in these countries. A sustained solution to the Asian financial crisis called for a state takeover of the management of significant banking assets, until the banks could be restructured and sold to private buyers. The workout of the bad debts and disposal of distressed assets thus became one of the major tasks for policy makers for several years thereafter, with success at reforming SOEs varying significantly among these countries.\(^10\) The Republic of Korea appears to have been the most successful in reforming its SOEs, as the government began to reduce its role in economic management to enable SOEs to respond better to the changing economic environment domestically and globally, as well as to reduce SOE monopolies and their unsound investment decisions.\(^11\)

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\(^5\) Under the Brady Plan, countries were required to implement market liberalization in exchange for a reduction in the commercial bank debt—and in many cases, new money from commercial banks and multilateral development partners. Brady bonds with long term maturities, which comprise the most liquid market for below-investment-grade debt, provided debt relief. [https://www.federalreserve.gov/boarddocs/supmanual/trading/4000p2.pdf](https://www.federalreserve.gov/boarddocs/supmanual/trading/4000p2.pdf) and [https://www.emta.org/template.aspx?id=35](https://www.emta.org/template.aspx?id=35).

\(^6\) The Washington Consensus focuses on liberalization, stabilization and structural reform, and refers to a set of broadly market economic ideas, such as free trade, floating exchange rates, free markets and macroeconomic stability. It is supported by the United States Government and international organizations such as the International Monetary Fund, the World Bank and the European Union.

\(^7\) The volume of these subsidies is not known, but they were substantial. For example, the Soviet Union provided implicit subsidies to FSU countries during the 1970s and 1980s by declining to raise prices of exported raw material (including oil) when world market prices rose. Such economic policies helped Soviet Union to receive non-economic benefits such as greater ideological cohesion and Soviet leaders to increase their political support. See D. Andrew Austin, 1996, *The Price of Nationalism: Evidence from the Soviet Union, Public Choice* (Vol. 87, No. 1/2, April 1996), published by Springer.

\(^8\) Growth in the region’s export commodities had led to high levels of foreign direct investment, which in turn soared real estate values, and led to bold corporate spending and large public infrastructure projects—all funded by heavy bank borrowings. And when the United States Federal Reserve began to raise interest rates, exports became less attractive for countries whose currencies had been pegged to the dollar. The Thai baht was the first one to be floated and devalued, followed by the Indonesian rupiah, the Malaysian ringgit and the Korean won (among others).


7. **The rise of state capitalism has provided further impetus to SOE reforms.** Since the Asian financial crisis, the rise of state capitalism (principally in the PRC, the Russian Federation, and Viet Nam) has resulted in a further push for SOE reforms. In state capitalism, the means of production are organized and managed as state-owned or state-influenced enterprises, the state undertakes profit-oriented economic activity, and the state becomes increasingly adept at using market forces for furthering its development objectives. Key enterprises in certain sectors also begin to be increasingly viewed as accelerators of economic growth and (potentially) world leaders. In the case of the PRC, the SOEs that were closed between 1998 and 2007 were smaller than those that survived and had lower labor and capital productivity; as a result, the productivity gap between SOEs and private firms reduced.\(^\text{12}\) Although this example might imply that state capitalism has directly challenged the hegemonic sway of the free market model of capitalism, in other cases, the relatively poor performance of state-controlled firms when compared with private companies shows the model's inherent shortcomings.\(^\text{13}\)

8. **Other factors—such as peoples' demand for reliable and affordable services—have also contributed to increasing pressure to reform SOEs and improve their performance.** The pressures on SOE performance come from the need to provide essential infrastructure, and pervasive and continuing shortcomings in the provision of financial and other services to businesses and other consumers. Improved services not only help improve the quality of life but help enhance the country's overall economic competitiveness. Where governments cannot continue to support the upgrading or rehabilitation of SOE plants and facilities, SOEs have tended to become unproductive and inefficient and in some cases to be the cause of serious environmental problems (footnote 11).

9. **Overall, empirical evidence from developing, emerging market and transition economies shows the fallacy behind the “infant industry” argument to continue protecting SOEs.** In theory, protection was to give SOEs (the infant industry) the opportunity to ready themselves for freer trade and competition by becoming more productive as they gained experience by serving the domestic market. The reality however, is that, despite such protection over prolonged periods, most SOEs did not achieve best-practice productivity that the protection was intended to facilitate, and even if they did become sufficiently productive and competitive, perverse political and economic incentives continued to offer opportunities for political lobbying for continued protection. Besides, even where SOEs in a protected sector expanded, aggregate national welfare might still have suffered—especially if the resources could have been used more efficiently in another (less protected or unprotected) sector.\(^\text{14}\)

### B. The Challenge of Reforming SOEs and Lessons

10. Key problem areas for SOE reforms are presented first, followed by what has been attempted to date and some important lessons.

11. **Many state-owned entities lacked a defined legal structure and were (and are to this day) simply owned by the state.** Hence, the starting point for reform has invariably been corporatization i.e., giving the SOE a legal form, most often as a joint stock company with the state as 100% shareholder (for a start). Corporatization provided the SOE with an initial number of issued and authorized shares as well as an initial share value. In principle, corporatization placed the SOE under the country's commercial or

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company law, and if the SOE was listed then under the securities law. If done well, corporatization paved the way further reform. For example, corporatization allowed the government to allocate ownership rights in whole or in part to a state management agency, a holding company, a fund, or to workers. In time, it also allowed governments to privatize all or a minority of shares to a strategic investor or to float those shares via an initial public offering. The corporatized SOE could also set up subsidiary holdings such as downstream production units which could be divested or in time floated independently of the parent entity, with the parent generally maintaining a stake in the subsidiary.\textsuperscript{15}

12. **Government expectations for SOE performance are often undermined by interference in operational and commercial decision-making.** Although lack of market discipline or competition is considered to be the primary cause for SOE underperformance, many problems stem from the exercise of political influence that interferes with operational and commercial decision making.\textsuperscript{16} Such political interference manifests itself in many ways, including through: (i) pricing controls on infrastructure services; (ii) using SOEs as employment vehicles; (iii) politically motivated board level appointments, resulting in insufficient professional governance or independent governance; (iv) politically motivated management appointments lacking in requisite experience, skills and talent; (v) inadequate remuneration for both managers and workers, particularly compared to private sector; and (vi) lack of transparency and accountability, and weak reporting and monitoring systems. All these factors contribute to slow decision making and difficulties in adapting to changing management practices and new technologies.\textsuperscript{17}

13. **Governments have normally found it difficult to impose hard budget constraints on SOEs and provide them greater autonomy in commercial decision-making.** The very factors that contribute to SOEs’ underperformance have made it difficult to reduce their drain on public finances. In addition, imposing financial discipline through hard budget constraints has proved difficult as governments seldom allow SOEs to fail.

14. **Unlike private firms in market economies, which generally restructure dynamically in reaction to market signals,\textsuperscript{18} it is unusual for SOEs in developing, emerging market and transition countries to restructure on their own.** A clear argument for restructuring is that it prevents or alleviates the social and political impact of failure. Other reasons for SOE restructuring are: (i) the dominance of SOEs in sectors whose below-par performance impinges on the cost efficiency and performance of many other industrial and commercial sectors—and adversely impacts the overall competitiveness of the economy; and (ii) preventing or delaying a sovereign debt and/or financial crisis when SOEs are operating with large deficits and relying on subsidies or unilateral transfers.

2. **Approaches to Reforming SOEs**

15. **SOE reforms require a comprehensive approach.** The SOE reform effort is based on the premise that any commercial enterprise, whether public or private, functions most efficiently when it seeks to maximize profits, operates in a competitive market,\textsuperscript{19} is accountable to shareholders and for the use of resources, and reports in accordance with established and accepted financial standards. Its managers should have the requisite autonomy and capacity and motivation to respond to market signals. An added


\textsuperscript{16} In other words, the SOE owners often have multiple and often conflicting objectives and profit and loss are not the only considerations. SOE managers are expected to cover costs but also to employ more labor, make a profit but reduce prices, reduce costs and purchase inputs from national suppliers to the maximum possible extent, have a good management team and an effective board yet appoint people who are politically connected.


\textsuperscript{18} Restructuring refers to actions by enterprises to improve their financial and operational performance, compete domestically, and eventually become internationally competitive.

\textsuperscript{19} This requirement of operating in a competitive market (and closure if not competitive) does not apply to SOEs operating in natural monopoly sectors.
requirement is that enterprises that are not able to compete should go bankrupt and be closed.\textsuperscript{20} Although lack of market discipline or competition is considered a primary cause for SOE underperformance, many problems stem from the exercise of political influence that interferes with operational and commercial decision-making in many ways.\textsuperscript{21} Improvements in transparency and disclosure of financial and non-financial information, performance management systems, and in the SOE boards and management are among the necessary conditions for improving corporate governance but may not be sufficient.

16. With the objective of improving SOE performance, governments have tried various ways to improve the SOEs’ corporate governance. Five dimensions of corporate governance reform are found to be correlated with operational performance improvement: legal and ownership framework, board composition, the performance management system, degree of transparency and disclosure of financial and nonfinancial information, and staff characteristics (education, skill base, and compensation levels).\textsuperscript{22} Many countries, including some in Asia (including the PRC, India and Viet Nam) have listed some SOEs that are required to meet the listing requirements for increased reporting and transparency.\textsuperscript{23} It is evident that partial privatization yields better results when fewer political connections are retained.\textsuperscript{24} Some countries have been centralizing SOE oversight by ensuring that: (i) SOEs report to the Ministry of Finance (or its equivalent) in addition to their respective line ministries;\textsuperscript{25} (ii) an institution is set up within the government to advise SOEs on board structure, governance and financial reporting in order to improve their financial and operational performance (as in India and Thailand);\textsuperscript{26} or (iii) an institution is set up outside the government, with the objective of professionalizing the approach to SOE governance (this is feasible when there are relatively few or large or strategically important SOEs to manage).\textsuperscript{27}

17. Although various stakeholders share the responsibility for corporate governance, the board of directors plays a central role. Important measures carried out at the board level for good corporate governance include: (i) depoliticizing boards by recruiting external board members who are independent and bring a diversity of skills;\textsuperscript{28} (ii) establishing board committees that do a major part of the board’s work outside the formal board meetings and report to the full board;\textsuperscript{29} and (iii) overseeing the

\textsuperscript{20} These requirements mean there should be no external political influences on SOE management, governments should compensate SOEs for the public service obligations they perform, and governments should impose hard budget constraints. These requirements are seldom fully met in any country, and a comprehensive approach is needed to address impediments to SOE reforms.

\textsuperscript{21} In other words, the SOE owners often have multiple and often conflicting objectives wherein profit and loss are not the only consideration. So the SOE managers are expected to cover costs but employ more labor, make a profit but reduce prices, reduce costs and purchase inputs from national suppliers to the maximum possible extent, have a good management team and an effective board yet appoint people who are politically connected.


\textsuperscript{25} Although the Ministry of Finance (or its equivalent) and well as the Office of the President or the Prime Minister play a role in directing SOE operations (particularly when the SOE relies on large subsidies), the line ministry often populates the board of directors and the SOE is its source of power and influence. Argentina, Mexico and Turkey follow this model.

\textsuperscript{26} In India, the Department of Public Enterprises located within the Ministry of Heavy Industries performs this function. In Thailand, the State Enterprise Policy Office and Fiscal Policy Office, both located within the Ministry of Finance, perform this function for non-financial SOEs and financial sector SOEs, respectively.

\textsuperscript{27} For example, Temasek Holdings Private Limited in Singapore, which began as a state-owned holding company with the Ministry of Finance as its sole shareholder. It has now transformed into a globally diversified investment company.

\textsuperscript{28} Although it is naïve to expect most governments, line ministries or finance ministries to give up all their power and influence over a SOE, governments could ensure that majority of board members are recruited externally.

\textsuperscript{29} The following board committees can be set up: (i) and audit committee, to work with the SOE’s external auditors and to whom the internal auditors report; (ii) a compensation committee, to approve increases in salaries and benefits to all employees and specially the top and senior managements, set the standard for management performance targets, and tie incentives to performance benchmarks; (iii) a finance committee, to provide oversight on the SOE’s financial and operational performance, and to examine proposed borrowings and capital raises; (iv) a governance committee to select new board members as appropriate. In addition, state-owned banks may also need specialized risk and credit committees, and all boards may also
development of a mission for the SOE, including a medium-term strategy, a short-term business plan, and an annual budget. At the heart of board oversight is the quality of the information and reporting system, which requires a good management information system, and qualified accounting, financial and other teams. The Board should also be able to ensure orderly succession in appointing a new chief executive officer and ensuring that a chief executive officer recruits or appoints senior staff with the skills and experience necessary to fulfill their responsibilities.\textsuperscript{30}

18. **Governments have found it difficult to impose hard-budget constraints on SOEs.** Even where governments are required to provide budgetary support to an SOE if it meets the government-directed public service obligations, few governments are able to calculate the true cost of meeting these.\textsuperscript{31} Besides, even where governments have negotiated performance contracts with SOEs, the outcome has been mixed.\textsuperscript{32}

19. **Governments have initiated SOE restructuring efforts.** In doing so, where governments have been selective in deciding which SOEs to restructure, they have effectively picked winners. It would be best if these could have been selected on the basis of the SOEs' performance when they are exposed to market competition, i.e. when prices have been set by the market and subsidies eliminated (except perhaps targeted subsidies to the poor and vulnerable), and when hard budget constraints have been imposed. In transition countries, where many SOEs had set up and managed schools and hospitals and offered those services below cost-recovery, these assets have been hived-off into separate businesses, along with debt restructuring or write-offs.\textsuperscript{33} In the PRC, since the late-1990s the government has consolidated SOEs to boost competitiveness. Nonetheless, in recent years, when economic growth began to slow down, the government has pointed SOEs (at least in tradeable sectors) toward greater autonomy and mixed ownership.\textsuperscript{34}

20. **Governments have sought to create a competitive environment for SOEs to encourage reform and performance improvement.** While governments tend to prioritize price and social stability (which often translates to below-cost pricing and minimizing employment redundancies),\textsuperscript{35} in their desire to improve SOE performance, they have increasingly liberalized trade through reduced tariffs and non-tariff trade barriers over the past 2 or 3 decades (for example, the PRC, India and all major economies of Latin America). This has provided impetus to their SOEs across all sectors to improve performance. In sectors where the private sector has also become internationally competitive, SOEs are under greater pressure to improve their performance.\textsuperscript{36}

21. **During the 1990s, governments privatized many SOEs.** Since the turn of the century, however, governments have been generally cautious toward privatization in response to public criticisms


\textsuperscript{31} Footnote 1.


\textsuperscript{35} In contrast, the private sector normally prioritizes profit and market share.

\textsuperscript{36} Among the many examples are light manufacturing industry in the PRC, including textiles, furniture, and food processing. See R. Sharma. 2016. *The Rise and Fall of Nations: Forces of Change in the Post-Crisis World*. New York and London: W.W. Norton & Company, Inc.
advocated by opposition politicians that assets were sold off too cheaply. Public disenchantment has also been caused by substantial layoffs of SOE personnel and price increases following privatization.37

22. **Governments have sought to engage the private sector in offering public services in several other ways.** The private sector has participated in offering public services through management contracting, leasing, and investment through various public–private partnership (PPP) models (build-operate-transfer and its variants). In transition economies particularly, management and employee buyouts (utilized extensively for small and medium enterprises), spin-off and sale of non-core assets have been other ways for involving private sector.

3. **Lessons from Reforming SOEs**

23. **Multiple measures are required to improve SOE corporate governance, and the initial steps need to be as uncontroversial as possible and to avoid confrontation with vested interests.** Improvements in transparency and disclosure of financial and non-financial information, or in performance management systems, or in the SOE boards and management are needed to improve corporate governance but they may not be sufficient. Depending on the political, economic, institutional, legal and regulatory landscape of a country, an appropriate way for the government to exercise oversight of SOEs is also required.

24. **Defensive restructuring measures can be useful in developing, emerging market, and transition economies.** Such measures include the shedding of excess labor, closure or spin-off of non-viable or non-core assets and financial restructuring (including debt rescheduling and/or write-off) and are normally adopted with a view to privatization (full or partial). However, governments that have mismanaged their SOEs in the first place generally lack the skills or capacity to restructure large and complex SOEs, or more than a few SOEs in the short to medium term.

25. **There is by now mounting evidence that privatization does improve financial and operational performance,** as acquiring private investors can deal with positive restructuring measures such as changes in management, product mix, technologies and marketing strategy. Many empirical studies produced or published since 2004, which examine privatization programs in various countries and various sectors, have documented significant performance improvements after SOEs are fully or partially privatized.38 The short-term problems (layoffs and price increases) are often followed by delayed benefits to the public at large when the privatized firms can begin adding to employment, and the benefits of improved service quality begin to become evident. Additionally, the state can also benefit in the medium term as fiscal losses reduce, external debt is retired, and tax revenues increase with improved performance.39

26. **Nonetheless, given public disenchantment with the privatization experience, politicians and business people in developing, emerging market and transition countries now take a more balanced view of the effectiveness of privatizations.** Partial privatizations are now more prevalent. Privatization may take place by issuing new shares (a form of partial privatization which allows the government to raise capital for SOEs but not to dilute control), or by transferring control from the state to private owners through asset sale or private trade shares, or by reducing government ownership through equitization (as in Viet Nam) or by primary share offerings in which the government does not participate (as in the PRC). However, privatization in some Asian nations has picked up in recent years, apparently because

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38 This is seen from 13 studies that examined privatization experiences across sectors in a single country; and four other studies that examined the privatization experience in specific sectors. (see annotated bibliography).

private enterprises are in a better position to keep pace with new technological developments and managerial practices.40

27. **A well-developed policy, regulatory and institutional regime is required for PPP models to work well.** Among the necessary preconditions for successful PPP programs are: (i) a clear and stable market structure and rules for the sectors in which PPP is sought; (ii) a sound and predictable legal and regulatory environment; and (iii) well-structured PPP projects, including appropriate risk allocations. Hence, government authorities must be in a position to frame sector reform policies, assess fiscal risks associated with PPPs, make comprehensive value-for-money assessments (and accordingly decide on public procurement versus PPP options), and access transaction advisory services that make PPP deals bankable and sustainable. Additionally, there should be several potential investors with adequate regional experience in bidding for PPP projects, and long-term capital should be available to the private sector.

28. **PPP and other ways of engaging the private sector in offering public services do not provide long-term solutions to managing SOEs.** For most part, these measures are complementary to privatization, and can lead to efficiency gain, reduced pressure on the government’s fiscal situation, increased transparency, and less crowding out of the private sector. However, the need for continued efforts to improve SOE performance will remain.41

C. **Lessons by Sector**

29. SOE reform experience in four broad sectors is summarized below and elaborated in Supplementary Appendix 1. The sectors are infrastructure (including utilities), financial services, industry and services, and natural resource extraction.

1. **Infrastructure**

30. **The traditional view that each infrastructure utility is a natural monopoly no longer holds.** Governments have started to adopt a new paradigm that is based on regulatory reform, restructuring, unbundling and privatization. There are trade-offs between vertically integrated and unbundled forms of organization. Unbundled SOEs can lead to a loss of coordination and economies of scale coupled with potential increases in transaction costs, yet they can also lead to potential efficiency gains from competition and increased transparency. It is important to draw a distinction between unbundled components that are amenable to competitive restructuring (such as power generation) and those that are natural monopolies (such as power transmission). Even in the latter group, some element of competition can be introduced, with multiple players made to compete for exclusive rights for the provision of those services.42 Because private sector entities are seen as having a comparative advantage in the rapidly changing markets and technologies for infrastructure, a rebalancing of the roles of private and public sectors is an integral part of every infrastructure utility reform program.

31. **Infrastructure reform, restructuring, unbundling and privatization is complex, and the road map varies by country.** In the case of infrastructure, there may be a regulator for each specific sector (e.g., power) or a centralized regulator. Creating such institutions with appropriate regulatory standards and knowledge takes time, and a good deal depends on the capacity and human resource capital in the country.43 Efforts to unbundle, re-organize and privatize infrastructure entities in developing, emerging

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40 This is led by the large transactions of the PRC’s SOEs that focused on partial share floated primarily in Shanghai and Hong Kong, China but also in New York through American Depository Receipts (ADRs). India, Malaysia, Thailand and Republic of Korea have also executed privatization transactions.


43 It often requires development partner support through technical assistance, training, study tours, and twinning arrangements with regulators in other countries.
market and transition countries without adequate regulatory frameworks have often led to reform failures.\textsuperscript{44} So institutional factors strongly influence the path to reform, restructuring, and privatization.\textsuperscript{45} It is important to keep options open and delay irreversible changes until it is clear that benefits from these changes outweigh potential costs. In monopolistic or oligopolistic infrastructure markets, ideally, restructuring to introduce competition should occur before privatization, and regulations should be in place to provide assurance to potential buyers of both competitive and monopoly components.\textsuperscript{46} A key argument for privatization—even though it is difficult to change the degree of vertical integration post privatization—is that, relative to state utilities, private owners and operators who face competition have stronger incentives and are better able to control costs, respond to consumer needs, and adopt new technologies and management practices. This has, in the main, proven to be the case; but it is not always so (there have been some failures, such as in the Bolivian water sector). Privatization has generally proved to be beneficial, but it is not a panacea (and needs to be implemented carefully).

32. While experience has varied across countries, infrastructure reforms have often improved aspects of performance, both in enterprises that involve the private sector and in those without private participation. In most cases, productivity and cost-effectiveness have risen, prices have become more closely aligned with underlying costs, services quality has improved, and services have become more responsive to consumer and business needs and to opportunities for innovation.\textsuperscript{47} Reforms have also significantly increased private investment in infrastructure: between 1990 and 2017, almost $2.6 trillion was invested in 7,200 private infrastructure projects in developing and transition economies.\textsuperscript{48} Yet, in cases where the distributional effects of infrastructure reforms have been studied, it is found that population in the bottom half of the income distribution suffered most owing to job losses from privatized utilities although improved service quality and increased access to the poor offset these negative effects.\textsuperscript{49} However, there is no clear pattern to price changes, with prices falling in about half the cases.\textsuperscript{50} In one case, the poorest groups seemed to benefit the most from increased productivity and access that followed reform, restructuring and privatization.\textsuperscript{51}

2. Finance

33. Regulatory oversight is required to provide discipline to the financial sector. In this sector, the banking regulator or supervisor may often be reporting to the central bank or may be the central bank itself. Efforts to liberalize and reform the financial sector with inadequate regulation and supervision contributed substantially to financial crises in emerging markets in Mexico (1994), East Asia (1997), Turkey (2001), and Argentina (2004).\textsuperscript{52} These examples, where inadequate time and effort was devoted to building capacity for the effective regulation and supervision of financial sector institutions, have also

\textsuperscript{44} For example, efforts to incorporate regulations in concession contracts to operate state utilities have frequently been renegotiated by governments and concession holders within the first year of operation due largely to their complexity. See World Bank. 1995. Bureaucrats in Business. Washington, DC.

\textsuperscript{45} The performance of state-owned network industries reflects a variety of country characteristics, including institutional capacity, business culture, nature of organized interest groups and patterns of social conflict.


\textsuperscript{47} W. Megginson and N. Sutter. 2006. Privatisation in Developing Countries. Corporate Governance.14. (4).


contributed to policy makers’ views on privatization. Where a monopoly SOE was replaced by a private monopoly, the need for effective regulation and supervision was greater.

34. **An efficient and effective banking sector requires adequate regulatory and supervisory capacity, and an insolvency or bankruptcy regime capable of dealing with firm failure and non-performing loans.** Regulatory frameworks, prudential operating guidelines, licensing requirements, an independent regulator, an independent central bank with a clear mandate, and detailed disclosure and reporting requirements are all key requirements for commercial banks and other financial sector entities (capital markets, insurance companies, pension funds, state financial institutions). Extensive restructuring of commercial banks has often proved unproductive if the banks remain under state ownership and continue to offer directed and subsidized credits to other SOEs.\(^53\) Prior to sale, most bank privatization efforts clean-up the bank’s balance sheet by, for example, transferring nonperforming loans and other non-saleable assets to an asset management entity. But publicly-owned asset management entities have a poor track record, and more needs to be done to commercialize the process of asset management. Ideally, liberalization should also open the sector to foreign banks, which bring not only competition but also expertise and access to larger pools of international funds.\(^54\)

35. **The performance of state financial institutions (SFIs) that assist economic development at the national and local levels has also come in for considerable criticism.** Many governments have set up SFIs to operate in parallel with multilateral financial institutions, but they may not operate on the same principles. They may be vehicles for lending to projects that meet the social and political objectives of the government of the day, or for lending at subsidized rates. SFIs have a history of generating nonperforming loans in many developing, emerging market, and transition economies.\(^55\) Their governance and performance will improve if they are strictly regulated as part of the entire banking system and be subjected to an independent board and management that are not tied to the government in power. It may also be useful to separate record keeping and accounting for directed lending transactions from normal commercial transactions.

36. **Capital markets in many developing, emerging market and transition economies remain small, but may grow to play an important role in SOE privatization and strengthening private sector.** Capital markets play an important role in private sector economies by allocating capital to firms that require it and can put it to good use. They are also important politically for supporting economic reforms, including SOE privatization, by providing citizens a stake in the economy and the opportunity to participate in the benefits of economic development and growth. While capital markets have grown in many developing, emerging market and transition economies since the early 1990s, they do not yet have sufficient depth to provide a ready exit strategy for many SOEs or provide a way to raise funds for private companies with high growth potential. This has prompted many large emerging market companies (including SOEs) to raise capital from the markets for American and global depository receipts—which in turn has exposed them to the relatively high standards of reporting and disclosure (compared with those of domestic capital markets) to meet the needs of large and sophisticated institutional investors.\(^56\)

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\(^{55}\) For example, Colombia’s Instituto de Fomento Industrial, a development bank, had a large portfolio of credits to Colombian industry. Although the NPLs from these credits were manageable, the bank was forced to acquire or assume management of several loss-making SOEs in the 1980s and 1990s. To fund these SOEs, the bank borrowed from the social security fund through bonds indexed against inflation—which weakened the social security system. The World Bank supported the government decision to divest the bank’s industrial holdings and transform it to a more efficient financial institution. See World Bank. 1992. *Instituto de Fomento Industrial Restructuring and Divestiture Project (Staff Appraisal Report)*. Washington, DC.

\(^{56}\) Besides, they set relatively high standards of reporting and disclosure (compared with those of domestic capital markets), and met the needs the large of sophisticated institutional investor.
3. Other Sectors

37. SOEs in the manufacturing and tradeable services sectors have often been among the first to be corporatized and privatized by governments that have opened their economies to trade and competition. These were often large SOEs that operated as state monopolies, crowded out potential or actual private sector competitors, and benefited from an unfair competitive advantage (receiving subsidies and/or easy credit and/or being exempt from taxes and duties, or favorable environmental and other regulations). SOEs in the cement, beer and tobacco businesses have been highly attractive to foreign investors and the presence of SOEs in these “tradeable” sectors has declined significantly in the Former Soviet Union, central and eastern Europe and Latin America. In the transition economies, such privatizations were complemented and reinforced with the liberalization of small businesses that allowed greenfield entry of new businesses that created millions of jobs and allowed large SOEs to shed redundant workers somewhat more easily. The World Bank’s experience in reforming, restructuring and privatizing SOEs in manufacturing shows that: (i) comprehensive restructuring efforts are better than one-dimensional industrial rehabilitation projects; (ii) industrial restructuring programs often need to consider the complex dynamics of rehabilitation, managerial change and financial engineering; (iii) restructuring efforts may require a two-stage approach—initial changes to stem losses by closing uncompetitive units and longer-term more strategic changes, including policy changes; and (iv) restructuring is a process of change that calls for a series of interventions to address challenges facing diverse industrial sectors.

38. Governance of SOEs engaged in the extraction of petroleum and other natural resources continues to be a significant challenge in many countries, regardless of the government stance on exports and extraction. National wealth is not a precondition for good governance in the natural resource extraction industries. It is noteworthy that, in 2010, national (mostly state-owned) oil companies accounted for 75% of global oil production and controlled 90% of the proven oil reserves. In 2016, their investments were at a 40-year high as private oil companies decreased their investments due to low profit margins. This may indicate that upstream petroleum exploration and production has become less driven by market forces. Climate change concerns have made renewable energy sources and electric cars more attractive and may lead to a significant reduction in investments in fossil fuels and other high-carbon emission sectors. It is likely that national oil companies and coal extracting SOEs will need to restructure to remain competitive in world markets.

57 In diverse industries such as breweries, cement, fertilizers, petrochemicals, steel, and tobacco.  
60 Brazil, Chile, Colombia and India are ranked in the top 10 Natural Resource Governance Index 2017, along with Australia, Canada, UK and USA. Yet it is noteworthy that some of the worst-governed countries globally are highly dependent on oil exports. These include Angola, Chad, Equatorial Guinea, Libya, Nigeria, South Sudan, and Venezuela. See T. Rosenberg. 2013. Avoiding the Curse of the Oil-Rich Nations. The New York Times. 13 February. https://opinionator.blogs.nytimes.com/2013/02/13/avoiding-the-curse-of-the-oil-rich-nations/.  