CANA PUBLIC ENTERPRISES CONTRIBUTE TO DEVELOPMENT?
A CRITICAL ASSESSMENT AND ALTERNATIVES FOR MANAGEMENT
IMPROVEMENT

by

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INTRODUCTION

Public enterprises were created in most countries to accelerate economic and social development. Yet increasing evidence indicates that most public enterprises either do not contribute strongly to development or perform their public service functions ineffectively or inefficiently. Policy makers engage in continuing debates over whether or not state-owned corporations contribute to economic and social development, why so many have failed to deliver effectively the services for which they were created, and how their management can be improved. These issues will become more crucial as governments in developing and emerging market countries consider how best to achieve economic and social development in an age of globalization, how to spread more widely the benefits and mitigate the potential negative impacts of international economic interaction, and how to alleviate poverty so that larger numbers of people can participate effectively in productive activities and gain access to social services essential for human development.

Over the past 50 years governments around the world established large numbers of public enterprises to accomplish development objectives, among the most important of which were to provide services and infrastructure that could not easily be extended by conventional departments and agencies of the State or by a weak or fledgling private sector. In many countries, however, state-owned enterprises took on a life of their own. Many pursued their objectives independently of government development policy or failed to perform efficiently and effectively functions for which they were created. In other countries political intervention and strenuous government control inhibited public enterprises from fulfilling their intended missions. Although public enterprises in some
countries are managed effectively and do provide services that are needed for development, too many merely became another bureaucracy plagued by inefficiency, ineffectiveness, corruption, and incompetence, draining resources from the public treasury.

Recognizing their ineffectiveness, governments have been restructuring or liquidating public enterprises since the early 1980s. Many state-owned enterprises have been commercialized, corporatized, or privatized. Some governments require them to compete with private providers, forge partnerships with private businesses and non-government organizations, or outsource functions to the private sector.

Although many enterprises remain in public ownership, their rationale, purposes, and effectiveness continue to be questioned. Governments seeking to meet the Millennium Development Goals (MDGs) should be asking if there is still a justification for public enterprises in countries where the private sector has grown stronger, where market economies are established or emerging, and where development depends at least in part on providing services and infrastructure to larger numbers of people.

I will argue that in many developing countries, state-owned enterprises have lost their efficacy as instruments for economic and social development for a variety of reasons: because governments never infused them with strong developmental missions or because they used them for purposes that were not directly related to economic and social development, or because the inherent limitations of state ownership render public enterprises ineffective. I will also argue that the primary justification for continued public ownership and operation of service-providing enterprises is that they efficiently achieve development objectives (using the Millennium Development Goals or other
measures of economic and social progress) that are not and cannot be achieved more effectively by the private sector or by non-government organizations.

Moreover I contend -- as much of the literature on public enterprises now shows -- that the organization and structure of state-owned enterprises inherently create difficulties in providing developmentally-oriented services and facilities in many countries whether or not they have strong private business or civil society sectors. Public enterprises face continuing risks of political interference, of cronyism and corruption in their governance and operation, and of an inability to generate adequate financial returns to either cover their costs or return a surplus to the government, all of which can divert them from fulfilling development objectives.

In an era of increasing globalization, emerging markets, and expanding private sectors, governments must have a clear strategy for deciding which enterprises remain in public ownership and how they will contribute to achieving social and economic development. The record of experience with public enterprise failures is now so strong that the “burden of proof” should be on governments to justify continued state ownership, and on SOEs to demonstrate definitively their contribution to development. Although none of the alternatives to state ownership is necessarily a panacea for the problems of weak public enterprise management, under appropriate conditions they can often resolve continuing difficulties that seem to plague many SOEs. When governments decide to keep them in state ownership, serious consideration must be given to the need for reforming their internal structures, governance, and operations in ways that assure that they pursue clear development objectives.
HOW PUBLIC ENTERPRISES LOST THEIR WAY AS INSTRUMENTS OF DEVELOPMENT

In both economically advanced and developing countries, governments created public enterprises as revenue-generating ventures, to support an import-substitution development strategy, or to provide services or infrastructure that were considered to be essential to national, regional, or local development. In reality, however, many governments created public enterprises for reasons that were only tangential to development or that ineffectively contributed to it.

After the Second World War, governments in Europe and North America used public enterprises to develop economically lagging regions, to provide specialized services that were beyond the expertise or resources of traditional government agencies, or to protect industries that were considered essential to future economic growth. But a significant expansion of public enterprises also took place both in Western Europe and in the former Soviet Union and its satellite countries for political or ideological reasons. Many countries with socialist governments nationalized industrial and service enterprises and collectivized agriculture in order to centrally plan their economies and minimize or eliminate market influences.

In the post-colonial period of the 1950s and 1960s, governments in Africa, Asia, and Latin America sought rapid economic growth through industrialization strategies that required heavy investment in physical infrastructure and production facilities. In many of the post-colonial developing countries the government expropriated foreign-owned companies and centralized control over natural resources, mining, mineral, and some manufacturing industries. And in their push to accelerate economic growth and
consolidate political control, governments in many developing countries created new
corporations rather than looking to the private sector for investment. The number of
public enterprises also grew rapidly because the private sector was often viewed with
suspicion by both political leaders and the public, especially in countries where colonial
regimes previously ruled, or where major industries were owned by foreign companies,
or where commercial activities were dominated by foreign or ethnic minorities.

By the late 1970s, however, the contribution of public enterprises to economic
and social development came into question when military or authoritarian civilian
governments in some Latin American countries nationalized nearly all major industries in
order to consolidate their political power and control over the economy and sometimes to
extract public resources for private gain. Moreover, the developmental orientation of
public enterprises became more ambiguous as many African governments, pursuing the
concept of "African Socialism," took control of agricultural and agribusiness sectors as
well as mining and natural resources industries that they lacked the expertise or financial
capacity to manage effectively. Nationalization of production and service enterprises
increased the already growing number of public employees in many developing countries
and the public wage bill grew rapidly.

Although not all of the growth in government employment took place in public
enterprises, SOEs were often convenient organizations for locating surplus labor and
providing a wide array of social benefits for workers. Directorships and senior
managerial positions in public enterprises were often viewed as political patronage
positions for retired military and high level civil servants or for relatives and friends of
powerful political leaders. In Eastern Europe, the former Soviet Union, and in many


Asian countries public enterprises hired large numbers of redundant employees to reduce social disaffection and to build political support. In Eastern Europe and in China, governments imposed strong social burdens on state industrial enterprises to hire redundant labor and provide social services while at the same time allowing them to operate with soft budget constraints, leading to inefficiency, low levels of productivity, and financial losses.³

The developmental orientation of public enterprises was more seriously questioned with the growing economic and financial problems that accompanied worldwide recession in the late 1970s, the debt crises faced by many African and Latin American countries in its aftermath, the succession of politically conservative governments in North America and Europe during the 1980s, and the shift to market economies in Asia, Latin America, and Eastern Europe during the early 1990s, all of which focused attention on the failures of public enterprises to deliver services effectively, contribute financially to the national economy, or to promote social progress. These trends were reinforced in the 1980s and early 1990s by growing dissatisfaction with the way governments provided goods and services, especially to the poor; by political interference in the operation of public enterprises; by continuing charges of cronyism and corruption in some state-owned corporations; by the imposition of surplus employment requirements; and by their inefficient operation.⁴

By the end of the 1980s widespread criticism of the performance of both national government ministries and public enterprises in providing goods and services and of the rising costs and ineffectiveness of government control of economic activities in general led political leaders in both Western and developing countries to reconsider their
efficacy. Their inefficiencies were seen clearly in their limited abilities to satisfy the rapidly growing needs for commercial and social services that were becoming crucial for economic growth and for widespread participation in a globalizing economy. The investment decisions of government agencies were constrained by special laws and by central government planning criteria and procedures; they rarely considered the needs of communities or the preferences of consumers.5

Almost everywhere, government-owned telephone and telecommunications companies, for example, were notoriously ineffective in meeting demand for services that had become crucial to the participation of both small and large enterprises’ in global trade and investment and for creating jobs that would help alleviate poverty and raise people’s standards of living. During the 1980s and early 1990s, the average waiting period for telephone installation in Indonesia was nearly 8 years, in the Philippines 7 years, and in the former Soviet Union and in Pakistan 10 years. Call completion rates were extremely low in many developing countries because of the inability of public enterprises to invest in even basic telecommunications equipment and switching capacity. Completion rates for trunk calls were as low as 12 per cent in Pakistan and for local calls as low as 31 per cent in Indonesia. Many of the state-owned telecommunications companies in developing countries lacked investment capital and financial resources for maintenance and line expansion, and were seriously over-staffed. The World Bank reports that state-owned telephone companies in developing countries had 50 to 100 employees per 1,000 telephone lines in service compared to 0.2 employees or fewer in the United States and Europe.6

The inability of public enterprises to deliver basic services extended to other
sectors as well. In Nigeria, for example, state ownership and the monopoly position of the National Electric Power Authority, an organization plagued by corruption, inefficiency, and mismanagement (conditions that characterized many of Nigeria’s public enterprises) compounded rather than solved that country’s continuing energy service delivery problems.7

Doubts about their ability to contribute to development increased with growing evidence that many public enterprises were loss-makers rather than revenue generators. Studies by the World Bank indicate that by the beginning of the 1980s, public enterprises in developing countries accounted for one-quarter to one-half of all outstanding domestic debt and for a substantial portion of foreign borrowing.8 In Thailand, 61 public enterprises accounted for more than 60 per cent of the government's foreign debt in 1988.9 About 40 per cent of Malaysia's external debt service payments in the late 1980s were made by non-financial public enterprises.1011 The heavy demands of many public enterprises for capital squeezed private investors out of capital markets in some countries, and in others limited the private sector's access to borrowing for investments that could generate jobs, income, and public revenues.

These limitations on the capacity of public enterprises to contribute to development continued into the 21st century. In Romania, for instance, the survival of loss-making public enterprises through direct and indirect state subsidies led in the late 1990s to pervasive networks of arrears throughout the economy and to negative impacts on the national budget and for overall economic efficiency.12 In Turkey, the government’s manipulation of the prices of goods and services produced by public enterprises during periods prior to elections to reduce inflation and potential political
backlash, placed both public and private service suppliers in unstable financial positions.\textsuperscript{13}

The inability of public enterprises to contribute to development arose not only from their inefficiencies due to their monopoly or protected status but also because of lax governance and oversight. The checks-and-balances that come with private ownership -- that is, the pressures that shareholders and external directors can exert on managers to improve efficiency, that capital markets can exert on companies to allocate scarce resources economically and to operate within "hard budget" constraints, and that managers who are responsible to shareholders and outside directors can exert on workers to improve productivity -- are all usually missing from public enterprises. Where SOEs were too strongly controlled by the state they often became inflexible bureaucracies.\textsuperscript{14} In the former Soviet Union, former socialist regimes in Poland, Hungary, and Czechoslovakia, authoritarian regimes in many Latin American countries, and in China and Vietnam most of large state enterprises were over-staffed and had obsolete technology and deteriorating facilities that made it difficult for them to compete effectively with Western multinational firms in global markets or to provide goods and services in adequate amounts and at reasonable prices in domestic markets.

In many countries ineffective public enterprises not only failed to contribute to development but siphoned-off resources that could have gone to development activities, thus creating significant opportunity costs in resource-scarce economies. The costs of continuing to subsidize unprofitable state enterprises took a heavy toll on the treasuries of even the largest countries. The government of China, for example, had to commit $11 billion (17 per cent of the national budget) in direct subsidies and $20 billion in loans to
inefficient state enterprises in 1990. Despite these high subsidies the state-enterprise sector's industrial production grew by less than 3 per cent.\textsuperscript{15} The highest rates of growth in the value of industrial output were in private enterprises (about 21 per cent) and joint ventures and foreign firms (56 per cent).\textsuperscript{16} Recent studies of public enterprises in China found that, controlling for a variety of other factors, those provinces with a larger proportion of state-owned enterprise industrial production have lower provincial economic growth rates.\textsuperscript{17}

With the increasing globalization of economic interaction across national borders, many countries with large numbers of public enterprises found that they inhibited both national development and international integration. By the early 2000s, the government of Vietnam, for example, explicitly recognized that most state-owned enterprises no longer met development needs due to their small scale and irrational structure and their failure to focus on key areas of the economy.\textsuperscript{18} The government reported that Vietnam’s SOEs have “backward technology and weak management capacity with low levels of autonomy and accountability in business and production,” weak management capacity, unclear objectives, weak accounting systems, and low levels of efficiency, rising overdue debts, and large numbers of underemployed and redundant employees.

An assessment of public enterprises in South Africa in 2000 pointed out that the establishment of SOEs skewed development aims and infrastructure and service delivery and that many of them have “unsustainable debt burdens, underinvestment in infrastructure and technology and unmanageable corporate structures.” The report pointed out that by continued public ownership of these enterprises, South Africa “…risks not only failure to achieve its broader policy objectives, but also a severe
depreciation in the value of these assets as the market discounts them owning to their present difficulties.” The study emphasized that the “total effect would be continued failure to ensure rigorous and directed interventions for ensuring that socio-economic development takes root both in those areas most sorely affected by the past and in the areas of the new economy. ¹⁹

POLICY ALTERNATIVES FOR IMPROVING THE MANAGEMENT OF PUBLIC ENTERPRISES

For all of these reasons, governments must justify the development contributions of public enterprises and rationalize their structure. Figure 1 suggests one approach to public enterprise reinvention in developing countries.
Public Enterprise Reinvention Process

Reinventing public enterprises in any country should begin with a comprehensive performance review and the formulation of a government strategy for reform. Governments are unlikely to be successful in restructuring public enterprises unless they develop a strategy that sets out a clear vision for how state-owned enterprises are expected to contribute to development and defines clear missions and performance criteria for each public enterprise.

In South Africa, for example, the government declared the goal of public enterprises would be to “contribute to sustainable economic and social development,” an objective that was “more likely to occur where there is a mixed economy, that is an economy that is responsive to market incentives within a framework of socially integrative institutional mechanisms.”20 The vision for reform of South African public enterprises at the macro-economic level was to attract foreign direct investment, contribute to the reduction in public borrowing and assist the development of an economy that promoting industrial competitiveness and growth and increased domestic savings. The South African government set social imperatives on public sector reform that included the need to increase employment and rationalize or develop new skills in the labor force as well as promote wider ownership and participation in the South African economy.

In any country seeking to reform public enterprises, strategy formulation should be preceded by an assessment of the performance of the public enterprise sector carried out by a government commission or agency that can identify SOE objectives, assets, and resources; assess their financial assets and liabilities; evaluate their performance in
meeting their objectives; and demonstrate their contribution to economic and social development.

Governments undertaking public enterprise reform must often revise the legal framework to clarify the ownership relationships between the state and SOEs, impose internationally accepted accounting and financial reporting standards, and outline governance options. Public enterprise reform should proceed in conjunction with the enactment of policies that strengthen the business climate and competitiveness within the economy; the creation of effective regulatory frameworks and corporate laws that protect the rights of businesses, consumers, workers, and citizens; and that impose hard budget constraints on those enterprises that remain in state ownership. Whether public enterprises remain in state ownership, or are commercialized or privatized, governments must create a balanced regulatory framework to ensure that neither public nor private enterprises abuse their power. At the same time, however, governments should not make regulations so overly restrictive that they prevent enterprises from achieving their objectives efficiently.

Any reform strategy should assess the strengths, weaknesses and appropriateness of options for restructuring public enterprises. Among the potential policy alternatives open to governments are 1) internal management and governance reform; 2) commercialization or marketization; 3) outsourcing or contracting out; 4) public-private partnerships between SOEs and private companies or civil society organizations; and 5) privatization or liquidation. In pursuing any of these alternatives, governments retain important roles in creating conditions and adequate oversight to ensure that reforms work effectively and that they achieve development objectives.
Internal Governance and Management Reforms

Governments decide to keep poorly performing public enterprises in state ownership for a variety of reasons, including a strong belief that the goods or services they provide cannot be offered effectively by the private sector, because of strong political opposition to privatization, in order to protect what is considered a strategic industry or sector for economic development purposes, because of the fear of potential social or political backlash from the reduction or elimination of jobs, as a means of publicly subsidizing the provision of services to poor or low income people, or because of political inertia. Whether or not these reasons are deemed valid and legitimate, if governments decide to maintain state ownership, they should undertake internal governance and management reforms that increase the capacity of public enterprises to attain development goals effectively.

Governance reforms are among the most important ways to improve public enterprise performance. In order to operate effectively, public enterprises should be adequately supervised by a state agency or an independent board of governors. Enterprise governance includes those structures and procedures that ensure that the enterprise operates effectively, efficiently, accountably, and responsively in the public interest and that it is contributing to national development. Government’s role is to establish the policies, procedures, and organizational structures that guide public enterprise operations to achieving those goals.21 The most appropriate structure for governance differs among countries, but three options include 1) a politically objective and qualified Board of Directors composed of representatives of government and outside members who do not have a conflict of interest or potential for illegal personal gain from serving on the board;
2) a responsible government body such as a Public Enterprise Commission or Agency with the responsibility for supervising the enterprises’ activities, auditing its finances, and ensuring compliance with laws and regulations, and 3) a state enterprise holding company to which several state-owned enterprises report.

Whichever option is chosen, the governance structure should not mix operating, regulatory, and public enterprise supervisory responsibilities within government ministries. Governments should take measures to ensure that the operations and procedures of the public enterprise governance body are transparent and open to inspection. Adequate checks and balances should be created to limit inappropriate political interference in the governance body’s decisions and to protect it from cronyism, conflict of interest, corruption, and nepotism in the hiring of executives and workers.

Little change is likely to come about in poorly performing public enterprises unless the governance authority establishes procedures for ensuring the recruitment of professional and competent management and trained and skilled workers and support staff, and assists managers to set or clarify clear objectives for the organization. The government’s role is to establish effective and appropriate legal and regulatory frameworks that simplify and streamline legal structures for public enterprises’ operations, specify obligations, protect the rights of stakeholders, and create standards and procedures for effective internal and external audit, transparent and accurate accounting, and public financial disclosure.22

The governance body and senior management, together, can improve the operation of public enterprises by developing and applying performance criteria related to a clear mission and set of development objectives. This requires public enterprises to
formulate short-term operating and medium-term strategic plans and programs, evaluate organizational performance and the performance of executive officers or senior managers. The governance body should provide appropriate compensation standards and incentives needed to attract experienced, qualified, and professionally trained managers and staff. Where restructuring involves streamlining operations or downsizing or “right-sizing” the workforce, adequate provisions need to be developed for assisting laid-off workers or for retraining them for new functions within or outside the organization.

**Commercialization or Marketization**

In many developing countries internal governance and management reforms of public enterprises alone, while necessary, may not be sufficient to achieve development objectives. Once the governance body and senior management have been strengthened, governments may have to deregulate relevant sectors of the economy to allow for greater market competition in providing what had previously been considered purely “public goods.” Deregulation to allow market competition is often followed by “corporatization,” that is, legally making public enterprises independent corporate entities and requiring them to cover their costs and to generate revenues under hard budget constraints. A third stage of commercialization involves “marketization” -- that is, opening goods, services, and infrastructure provision to the private sector and requiring public enterprises to compete in the market with private or civil society providers.

Government’s responsibility in this aspect of public enterprise reform is not only to create a legal framework for deregulation, corporatization, and commercialization, but also to help make national markets competitive, allow prices to reflect true relative scarcities in the economy, and encourage public and private
enterprises to behave according to fair and equitable market rules. In most countries this means finding effective ways of implementing structural adjustment policies, liberalizing trade and investment, creating or strengthening property rights, and developing a legal framework for business activities.

By encouraging interaction through market competition governments establish a process in which firms are free to enter and leave the market based on their profitability. Policies promoting commercialization should end public enterprises’ monopoly status but also prevent -- through anti-trust laws -- excessive collusion among private businesses that would constrain competition or fix prices artificially for socially-beneficial services. Marketization policies aimed at commercializing public enterprises seek to reduce barriers to entry and eliminate marketplace impediments to competition.

One of the most important institutions for market development is a reliable system of property rights that facilitates property ownership and its transfer. Establishing and enforcing a “rule of law” -- that is, providing a reliable legal framework for business transactions -- gives participants in market economies the guidelines to operate efficiently and effectively and a framework for protecting natural resources and ecological systems. Without a transparent system of business laws, owners and managers of enterprises waste time and money negotiating each transaction with government officials – a process that opens the way for bribery and corruption. In addition, effective commercialization depends on legal institutions to establish and enforce product and pricing standards, and securities and exchange regulations, rights of access to credit and capital, regulation of bank operations, and guidelines for viable contracts and adjudication of disputes are all essential market institutions.23
Outsourcing or Contracting Out

In some circumstances governments choose to maintain enterprises in public ownership but to outsource or contract out the provision of some services, the construction or operation of infrastructure, or the management of some or all of a public enterprise’s functions. Contracting for infrastructure and services allows public enterprises to arrange with private companies to provide services or facilities that meet government specifications. Generally, public enterprises outsource to private organizations through three mechanisms: service, management and leasing contracts.

Service contracts allow a public enterprise to purchase services on a long-term basis from the private sector. Public enterprises have used outsourcing to modernize government housing projects, obtain defense equipment, and expand schools, prisons and hospitals. Contracting has become one of the most important methods of privatizing water and wastewater treatment services in many countries. In South America, the public utility enterprises in Chile and Guatemala offered territorial concessions in large cities to private firms that procure, purify, distribute, meter, and charge for water. In both countries, tariffs were approved by the national government, which also monitored water quality. In Peru, the public utilities contracted out to private companies many of the activities involved in water supply, such as meter reading, computer services and billing and collection.  

Public enterprises also use management contracts to arrange for private companies to provide services or produce goods more efficiently. They have contracted with international firms to privatize state-owned hotels in Africa and Asia, agro-industries in Senegal, Cote d'Ivoire and Cameroon, and mining operations in Latin
America and Africa. Management contracts allow a private firm to take over responsibility for operation and maintenance of public service facilities for a specified period of time with the freedom to make routine management decisions.

The Persian Gulf state of Abu Dhabi sought to bring commercial discipline and efficient management of its public utilities by contracting with the private sector to manage electricity generation. It competitively tendered long-term management contracts with a private firm while maintaining its majority stake in the partnership. Several francophone African countries began in the 1980s using the "affermage system" through which municipal utilities construct a facility and contract with a private firm to operate and maintain it. The government established rules for price setting and surcharges on water fees that the private company pays to the municipal utility to amortize the construction costs of the water system.

Lease contracts are also used extensively for both public services and commercial operations. In Latin America and Africa state-owned industries have been leased to private companies for long-term operation. The government has leased electricity and water supply enterprises in Cote d'Ivoire; steel mills and refineries in Togo; and hotels and farm holdings in Jamaica. Companies leasing facilities assume responsibility for operation, maintenance and replacement of non-fixed capital assets. The State Railway Authority of Thailand (SRT) successfully experimented during the 1980s and 1990s with contracts with private firms to provide service on three intercity rail routes that were incurring substantial losses. The private companies leased passenger rail-cars and railway lines from SRT and paid it a fee every 15 days. The private contractors covered the costs of rail-car maintenance and cleaning and optional concession services. SRT
provided the use of railway stations and the personnel to manage them, as well as train drivers and guards.

All three forms of contracting -- service, management and lease arrangements -- allow the government to maintain ownership of public facilities and control over public services but also to benefit from private sector management and operation and derive revenues from leases, management fees, or service concessions. Under appropriate conditions, contracting with the private sector has increased efficiency, decreased vulnerability to employee actions and contractor failures, ensured protection against monopolistic behavior of contractors or government agencies, provided dual yardsticks for measuring and comparing performance, and provided more substantive knowledge and understanding of service delivery.

Public-Private Partnerships

Another potential means of improving the management of public enterprises is through public-private partnerships (PPPs). Public enterprises and the private sector cooperate in providing services and infrastructure through a variety of mechanisms including concessions, build-operate-and-transfer (BOTs) arrangements, joint ventures, and informal and voluntary cooperation. Public-private partnerships allow or encourage domestic- and foreign-owned businesses, community groups, cooperatives, private voluntary associations, small enterprises, and other non-governmental organizations (NGOs) to offer social services. In some countries PPPs are an intermediate phase in privatizing SOEs or an alternative to privatization.25

Joint ventures are one means by which public enterprises work with the private sector through mergers, partial acquisitions of SOEs (retaining some share of the stock in
profitable or politically strategic enterprises) or joint ownership by government and private investors. In Oman, for example, the government developed a joint venture between Omani public and private enterprises and Sealand to expand and maintain its Salalah container shipping port. In 2002, the municipality of Ajman in the United Arab Emirates formed a equal ownership joint venture -- the Ajman Sewerage Company--with a consortium of Black & Veatch, Thames Water, and other companies, to invest $100 million in a wastewater network that will deliver services to 300,000 people in the emirate. The government granted the joint venture a 27-year concession in which the company will recover its costs by levying tariffs for service to be paid by customers.

China has used joint ventures between foreign investors and state enterprises to obtain foreign technology and capital, learn foreign management and marketing techniques, increase foreign exchange-generating capacity, and promote joint research and development projects. The Chinese government also used joint ventures between SOEs and private foreign companies to make new investments in infrastructure and manufacturing facilities. The expansion of telecommunications equipment facilities in the Shanghai area, for example, was financed through joint ventures. Shanghai Bell Telephone Equipment and Manufacturing Company was taken over by a joint venture among China's Ministry of Posts and Telecommunications, Alcatel Bell, and the Belgian government to produces switches for telephone companies in China.

Governments around the world use turnkey projects with consortia of private companies to build telecommunications, transport, shipping, airport, utility, and water and sewerage infrastructure. Governments in countries with both advanced and developing economies use build-operate-transfer (BOT) agreements in which they buy or
lease completed facilities constructed by private investors after the companies have recouped their investment and a reasonable return by operating the facilities for an agreed-upon period of time.

The government of South Korea, for example, used a BOT arrangement to develop and operate the Seoul Beltway and Daegu-Pusan highway as toll roads. It gave the Pusan NewPort Company sponsored by the Samsung corporation, CSX World Terminals, and local Korean contracting companies a 50-year secured concession to develop a $900 million Pusan port expansion project using the PPP approach. The Private Infrastructure Investment of Korea (PICKO) organization sought financing and participation from private firms around the world in constructing, financing and operating infrastructure in Korea.

BOT or build-operate-own (BOO) arrangements have also been used extensively in Malaysia and Turkey to build telecommunications systems, highways, utilities, and water supply systems, and operate them under a concession from the government. Debt financing is usually highly leveraged and the private consortium takes a small equity position. The consortium usually seeks loans from international financing agencies and commercial banks using future revenues from the projects to repay them. Another approach, a build-operate-own-transfer (BOOT) arrangement, has been used to construct and operate independent power plants in China (Shajiao project) and Pakistan (Hab River project) as well as in the Dominican Republic and Costa Rica. These projects usually involve limited recourse financing in which capital is raised on the basis of cash flows and not on the collateral of project owners.

Although they offer governments in developing countries important means of
expanding services and infrastructure and the private sector commercial opportunities to expand their businesses, public-private partnerships are complex arrangements and can create potential problems for both the public and the private sectors if they are not properly designed and administered. They often displace public workers, thereby generating political opposition among public officials, labor unions, and public employee associations.

If PPPs are not well designed and supervised their services can become more expensive than those provided by government. Poorly designed and inadequately analyzed projects have failed in both rich and poor countries. Corruption can undermine public trust in PPPs if the contracting process is not transparent and carefully supervised. Lack of sufficient competition can turn PPPs into private monopolies that operate no more efficiently than SOEs. Overly restricting concessions or creating too many can deprive PPPs of economies of scale. If government regulation is too stringent it can lead to deficiencies in service provision and if it is too lax it may not hold private service providers sufficiently accountable. The cost of contract management can be substantial. In all cases, governments must compare carefully the costs of contracting out with the costs of providing services directly. The involvement of the private sector in providing services that were formerly free or that were subsidized by the government can increase their price and place poor segments of the population at a significant disadvantage.

**Privatization**

Increasingly, governments in developing countries have come to the conclusion that public enterprises cannot be reformed or restructured enough to ensure that they carry out their functions effectively, and have decided to liquidate or privatize them.
Governments in some countries turned to privatization as a way of reallocating the expenditures on subsidies to SOEs to more productive investments in infrastructure and social programs; for increasing the size and dynamism of the emerging private sector; for distributing ownership of state-owned enterprises more widely; and for promoting both foreign and domestic private investment. Moreover, privatization can generate the revenues needed to create new jobs for workers displaced by industrial restructuring, reduce the state's administrative responsibilities and the burdens of government intervention in enterprise management, and provide consumers with more-efficiently produced goods and services. As a result, governments around the world began, in the late 1970s and early 1980s, to intensively privatize their state enterprises and to elicit the participation of the private sector in providing services and infrastructure more vigorously. The World Bank reports that during the 1980s alone more than 70 countries experimented with some form of privatization and sold or liquidated more than 7,000 SOEs.

Given the static characteristics of state-owned enterprises, a change in ownership theoretically leads to organizational restructuring and behavioral changes that allow the privatized enterprises to operate more competitively and generate profits. Under appropriate conditions, the transfer of ownership to the private sector should change organizational characteristics so that privatized SOEs begin to operate in ways that are more innovative, that manage human resources more effectively, and that stimulate stronger work effort. The organizational performance improvements can then lead to improvements in financial management and higher returns to investors, better production of goods and services, more efficient and effective service delivery, and creation of more
employment opportunities. Table 1 summarizes the characteristics that inhibit effective performance in state-owned enterprises and that usually allow better management in private enterprises.\(^{31}\)

**Table 1. Characteristics of State-Owned and Private Enterprises**

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<th>General Characteristics</th>
<th>State-Owned Enterprises</th>
<th>Private Enterprises</th>
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<td></td>
<td>- Embedded in government</td>
<td>- Embedded in market</td>
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<td>- Goals influenced by national politics</td>
<td>- Owned by private investors</td>
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<td></td>
<td>- Objectives diverse or not well articulated</td>
<td>- Clear profit maximization goals</td>
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<td>- Boundaries vague</td>
<td>- Accountable to shareholders or private owners</td>
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<th>Innovative Orientation</th>
<th>State-Owned Enterprises</th>
<th>Private Enterprises</th>
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<td></td>
<td>- Political and bureaucratic restrictions on innovation</td>
<td>- Market opportunities provide freedom to innovate</td>
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<td>- Weak incentives to deviate from standard operating procedures</td>
<td>- Financial incentives for managerial risk-taking</td>
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<td>- Civil service protected managerial positions</td>
<td>- Managers’ employment depends on profitability</td>
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<td></td>
<td>- Organizational and technological changes driven by state budget resources</td>
<td>- Salaries supplemented by opportunities for ownership stake</td>
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<tr>
<td></td>
<td>- Able to survive as “loss makers” because of soft budget constraints</td>
<td>- Extensive interaction with external environment</td>
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<td></td>
<td>- Fixed pay salary ranges</td>
<td>- Potentially high levels of technological change</td>
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<tr>
<td></td>
<td>- Limited interaction with external environment</td>
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<td></td>
<td>- Low levels of technological change</td>
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<thead>
<tr>
<th>Human Resource Management</th>
<th>State-Owned Enterprises</th>
<th>Private Enterprises</th>
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<tbody>
<tr>
<td></td>
<td>- Formalization and standardization in hiring</td>
<td>- Firm determines rules of recruitment</td>
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<td>- System-wide rules for promotion and removal</td>
<td>- Differentiated pay rates</td>
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<td></td>
<td>- Limited ability to reward unique roles or performers</td>
<td>- Promotion and removal determined by performance</td>
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<td></td>
<td>- Limited incentives to use technology to increase labor productivity</td>
<td>- Strong ability to reward unique roles and performers</td>
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<td></td>
<td>- Managerial behavior drive by civil service rules</td>
<td>- Strong incentives to enhance labor productivity with technology</td>
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<td></td>
<td>- Difficult to remove or reassign employees</td>
<td>- Behavior driven by incentives and firm strategy</td>
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<td></td>
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<td>- Easy to remove or reassign employees</td>
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<th>Work Effort</th>
<th>State-Owned Enterprises</th>
<th>Private Enterprises</th>
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<tbody>
<tr>
<td></td>
<td>- Difficult to provide feedback on performance</td>
<td>- Freedom to set goals and provide employee feedback</td>
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<td></td>
<td>- Limited freedom to design jobs</td>
<td>- Flexibility to design jobs</td>
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<td>- Limited control over group norms</td>
<td>- Strong control over group norms</td>
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<td></td>
<td>- Standardized pay and limited opportunities for extra rewards for effort</td>
<td>- Strong work motivation driven by uncertain job security and opportunity for financial rewards</td>
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Studies of privatization indicate that ownership transfer alone, however, does not always yield the expected results, either in terms of organizational restructuring or in competitive and financial performance.\textsuperscript{32} The performance benefits of privatization seem to depend not only on the transfer of ownership but also on the type of privatization used, on the degree of concentration of ownership, and on the ability of governments to enact and implement policies that promote competition and effective regulation. Increasing evidence suggests that the transfer of SOE ownership to the private sector through direct sales is more likely to bring organizational change and performance improvements than continued state control or mixed ownership. Partial privatization or privatization through means that simply transfer ownership to former SOE employees and managers or to a dispersed set of small shareholders who cannot effectively exercise independent governance may not lead to organizational restructuring or performance improvements.

Similarly, privatization through any means in countries that do not create competitive conditions may simply substitute private monopolies for state monopolies resulting in little or no performance improvement. Performance improvements are less likely in countries that have not developed effective systems of business law and regulation and that fail to enforce rules by which privatized firms can fairly compete in domestic and international markets.

Analyses of privatized and state-owned enterprises in Romania, for example, show that privatized firms perform better than SOEs and pursue more aggressive or competitive strategies, but are not much more adaptable and flexible than SOE.\textsuperscript{33} Tendon found many cases where privatization did not lead to efficiency improvements, mostly in situations where there were no changes in competition before or after privatization.\textsuperscript{34}
Other studies indicate that improvements in the performance of privatized SOEs depends to a great degree on the ability of governments in their home countries to create an appropriate institutional structure for competitive market economies that support a viable private enterprise sector. A review of experience in Russia concluded that to attain performance improvements in privatized firms, especially those privatized by means other than public or private sale, requires the creation of formal “governance chains” – independent boards and multiple independent monitoring, auditing and accounting institutions – to constrain the “grabbing hands” of insiders. Analyses of telecommunications firms privatized between 1984 and 1997 in 30 African and Latin American countries found that performance improvements (measured by per capita number of mainlines, payphones, and connection capacity, and by the price of local calls) correlated with privatization and effective independent regulation. Without effective regulation, privatization alone led to few improvements and to lower connection capacity.

Experience suggests that in order to be effective, governments must take the following actions to manage privatization effectively: 1) clearly identify goals and objectives of privatization and embody them in an official set of privatization laws; 2) develop a strategic management plan for privatization; 3) create an effective privatization agency; 4) select appropriate methods of privatization; 5) develop clear and transparent privatization procedures; 6) apply appropriate assessment and valuation methods; 7) create effective financial structures for private sector participation; 8) establish an effective system of government supervision and regulation, especially for natural monopolies; 9) help strengthen private sector management capacity; and 10) create employment protection measures for current government employees in organizations that
CONCLUSION

More than a quarter of a century of experience with public enterprise reform suggests that, for a variety of reasons outlined earlier in this paper, many SOEs have become ineffective instruments of economic and social development. Some public enterprises may be well governed, efficiently managed, and financially sound, but the vast number that have been liquidated or privatized over the past two decades suggests that they were either loss-makers or delivered public services ineffectively.

Governments seeking to achieve the Millennium Development Goals or other indicators of economic and social progress must carefully reassess the performance of public enterprises in achieving development. The performance of some can be improved through extensive governance and management reforms that give them a clearer and more focused development mission; strengthen the governance body; ensure the recruitment and retention of professional, competent, and well-trained senior managers and of highly skilled employees; require internationally recognized audit, accounting and financial reporting procedures; develop and implement clear and appropriate performance targets; and impose hard budget constraints.

In other cases, performance improvements require not only internal governance and management reforms but also commercialization or marketization. Public enterprises may need to be corporatized and given a legal business status to operate according to market criteria and to compete with private and civil society service providers. Government’s responsibility is to create an effective regulatory environment for both
public and private enterprises providing social services and infrastructure and the market institutions and policies that ensure open and fair competition.

The performance of public enterprises in meeting development objectives and providing socially-beneficial goods, services and infrastructure may also be improved in some developing countries by allowing them to outsource some or all of their functions. Contracting out can bring the benefits of private production and distribution while maintaining enterprises in public ownership. Similarly, public-private partnerships can help some SOEs overcome the inherent weaknesses of state ownership while taking advantage of the benefits of private management. In many cases, however, public enterprises cannot or will not provide social services and infrastructure effectively because of the limitations of state ownership. Government’s responsibility in this case is to create the conditions that lead to effective privatization and to assume a facilitating and regulatory role rather than one of service provider.

Because of their history of poor performance in meeting development goals, the burden of proof should be on governments to verify the viability of state enterprises in achieving development targets. Public enterprises that can no longer demonstrate a strong record of achievement in countries where the private sector can provide services effectively should be liquidated or privatized. Where performance can be improved by strengthening some aspects of their operations, public-private partnerships or contracting may be acceptable means of leveraging the benefits of private management. When government decides that public enterprises must remain in state ownership, a comprehensive and objective performance assessment should be carried out to determine
how to strengthen their governance, management, operation, and integrity and to ensure that SOEs achieve economic and social development goals.

REFERENCES


11 R. Ahrend and J.O. Martins “Creative Destruction or Destructive Perpetuation: The Role of Large State-Owned Enterprises and SMEs in Romania During Transition,” Post-


