Bureaucrats in Business: The Economics and Politics of Government Ownership

Key findings from the recent Policy Research Report on the reform of state enterprises—with important implications for how the Bank can better assist countries undertaking reforms

Despite more than a decade of privatization, state enterprises account for nearly as large a share of developing countries' economies today as they did twenty years ago (figure 1). These enterprises are often inefficient and the resulting losses to the economy hinder growth, making it harder for people to escape poverty. This note summarizes the findings of Bureaucrats in Business: The Economics and Politics of Government Ownership (World Bank 1995), which analyzes experience with state enterprise reform and assesses why so few countries are reforming. It concludes with suggestions on how the World Bank can better assist countries reforming their state enterprises.

What worked?

Bureaucrats in Business ranked state enterprise reforms in 12 countries using 5 measures of state enterprise performance (operating surplus and profits before taxes as shares of sales revenues, real variable costs per unit of output, total factor productivity, and savings minus investment as a percentage of GDP) and asked whether this ranking improved between 1981–85 and 1986–91. Based on these quantitative measures Chile, Mexico, and the Republic of Korea were the most successful reformers: their state enterprise sectors ranked highest and improved performance most. India, Senegal, and Turkey were the least successful, and Egypt, Ghana, and the Philippines fell somewhere in between. The Czech Republic, Poland, and China could not be ranked using the same indicators because of data discontinuities; however, partial performance indicators showed that they had good to mixed success.

Successful reformers:

- Divested more, especially in competitive sectors and where state ownership was large;
- Increased competition by reducing protection from imports, encouraging state enterprises to export, and shrinking formal and informal barriers to entry;
- Made enterprises operate within their budgets and cut subsidies, especially operating subsidies;

Figure 1. Share of state-owned enterprises in gross domestic product, by region, 1978–91

Percentage of GDP

Reformed their financial sectors, in particular by curbing directed credit to state enterprises and making them borrow on commercial terms; and

Improved corporate governance by changing the contractual relationship between state enterprises and the state.

These findings suggest that the components of reform often recommended by economists and supported by World Bank projects are broadly right. But there were some surprises. Most strikingly, performance contracts, which the Bank has encouraged and supported, have not worked well. Our analysis of performance contracts in a sample of 12 state-owned enterprises in 6 countries found that total factor productivity did not change for most firms after the contracts were introduced, and as many enterprises deteriorated as improved (figure 2).

Why did performance contracts make so little difference? One reason is that state enterprise managers were able to use their information advantage to negotiate soft targets—in India, for example, negotiations sometimes dragged on for so long that contract targets were set ex post to match actual performance. Also, many governments did not reward managers who attained contract targets; where bonuses or other rewards were offered, soft targets frequently undermined their impact. Moreover, penalties for poor performance, such as firing or demotion, were seldom applied. Finally, governments demonstrated little commitment to the terms of the contracts, frequently reneging on key promises.

![Figure 2. Performance changes after the introduction of performance contracts](image)


Each of these problems was evident in the performance contract governing Senegal's Electricity. The contract included 22 criteria for judging performance but no rewards if managers attained them. Moreover, government regulators lacked the power to enforce penalties reliably. Although the government promised to take actions that would make it possible for the firm to meet its targets—such as forcing other state enterprises to pay their electricity bills—these promises were often broken. As a result the company has suffered declining productivity.

Why have so few countries been successful at reform?

State enterprise reform can cost a government its support base, because reforms almost invariably involve eliminating jobs and cutting long-established subsidies. Not surprisingly, politicians carefully weigh any change in state enterprise policies, preferring those that benefit their constituents and help them remain in power. *Bureaucrats in Business* found that reform occurs only when three conditions are met:

Reform is politically desirable. Reform becomes desirable when the political landscape is altered in such a way that those who might lose from state enterprise reform no longer constitute a significant part of the leadership’s support base. This change may be caused by a sudden shift in regime (as in Chile in 1973 or Czechoslovakia in 1989) or by a less dramatic shift in the governing coalition (Mexico in 1988). An economic shock may also make state enterprise reform more politically desirable by making it more difficult for the government to continue subsidizing state enterprises.

Reform is politically feasible. The leadership must be able to obtain the approval and support of other government entities whose cooperation is crucial to success (such as the legislature or provincial governments). It must also be able to withstand opposition from those whose welfare could be diminished by state enterprise reform (such as state enterprise employees). The successful reformers in our sample used compensa-
tion (such as share distribution or severance pay) and in some cases compulsion (such as curbing union powers) to overcome such opposition.

Reform promises are credible. Investors must believe that the government will not renationalize privatized firms; state enterprise employees and others must believe that the government will deliver on promises of future compensation. Government promises are credible when the leadership has a reputation for keeping promises, for example because it announced and implemented economic reforms. Governments may also be credible because they face restraints on policy reversal, such as constitutional restrictions and international trade treaties, that would make it costly to reverse reforms.

Knowing how countries meet the conditions of desirability, feasibility, and credibility helps predict the outcome of reform. Political behavior is inherently complex and dynamic, making prediction difficult. Nevertheless, the methodology developed in Bureaucrats in Business allows us to formulate objective and transparent indicators that can be applied systematically to our entire sample (table 1). Countries that failed to meet one or more of the three conditions were less successful reformers.

### How can the World Bank better assist state enterprise reform?

Reducing the role of bureaucrats in business and improving the performance of the remaining state enterprises can bring a country substantial economic gains. Yet reform has been slow and rarely successful. A decision tree helps to untangle the many choices involved (figure 3). As this tree suggests, the first and most important step is to determine whether a country is indeed ready to reform.

Assessing a country’s readiness to reform is crucial. Countries that are not ready are more likely to pursue formalistic changes, such as performance contracts, that waste political and human capital and undermine the credibility of reform. Worse, aid intended to support state enterprise reforms may be counterproductive if it relieves financial pressures that might otherwise prod reluctant leaders into privatizing or reforming loss-making enterprises. The Bank’s economic and sector work could help countries avoid such problems by:

- **Analyzing readiness systematically.** Assessing the readiness to reform entails analysis of the leadership’s support base, the government agencies that need to agree for reform to succeed, the likelihood of opposition and the government’s ability to respond, and the credibility of the government’s promises to investors and reform opponents. Where this analysis is inconclusive, actions can provide a clear signal of readiness.

  - Laying off redundant workers, for example, can indicate that reform is politically desirable (the leadership proves it wants to reform state enterprises) and politically feasible (the leadership shows it is able to overcome opposition).

- **Tracking state enterprises over time.** A consistent time series of key state enterprise variables is essential if the Bank is to evaluate the impact of the reforms it supports. Much needs to be done to improve Bank data; we consulted many state enterprise sector reports during our research for Bureaucrats in Business but had to rely almost entirely on other sources to construct our database. Also important are data quantifying the performance of large state enterprises over time.

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**Table 1. Unmet conditions in unsuccessful state enterprise reformers**

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<tr>
<th>Country</th>
<th>Desirability</th>
<th>Feasibility</th>
<th>Credibility</th>
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<td>Egypt</td>
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<td>Ghana</td>
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<td>India</td>
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<td>Senegal, 1983–88</td>
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<td>Turkey, 1983–91</td>
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<td>1991–92</td>
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* Condition was not met.

Desirability: Met if a coalition change or exogenous crisis occurred and state enterprise reform losers were outside the government’s support base.

Feasibility: Met if reformers can secure approval and design sufficient compensation packages to defuse opposition.

Credibility: Met if government is known for keeping promises and faces domestic and international restraints on policy reversal.

Note: For the purposes of this table, Chile, the Czech Republic, and the Republic of Korea were used as benchmarks against which the other countries in the sample were compared. In general, countries that did worse on the two dimensions listed here and no better on others were judged not to meet the condition.

To ensure that meaningful data are available, economic and sector work should routinely include the following information for the state enterprise sector: value added, investment, employment, foreign and domestic debt, budgetary impact, productivity, and operating surplus or deficit.

Measuring the success of reform efforts by assessing performance. Many Bank reports attempt to measure the success of past state enterprise reforms, but they usually lack a bottom line. The additional initial effort required in establishing baseline measures (total factor productivity, profitability, deficits, and so on) would be repaid many times over if it enabled the Bank to help countries avoid costly mistakes and wasted effort.

What about countries that do not meet the readiness tests? Rather than push for immediate state enterprise reforms, which might end up being purely cosmetic, Bank assistance should help lay the groundwork for future real reforms. For example, reducing barriers to trade and entry can help, since exporters and new entrants can be an important constituency for reform. Similarly, changing policies that limit job opportunities in the private sector (such as making it hard to hire and fire) can increase job opportunities for state employees, reducing their opposition to reforms that may cause them to lose their jobs.

In countries that are ready to reform their state enterprises, the Bank's approach is already broadly right. *Bureaucrats in Business* shows the importance of distinguishing between countries that are ready to reform and those that are not, and adjusting the reform strategy accordingly.

—by Mary Shirley

**Further reading**


The full study, a 40-page summary in English, and a diskette with the statistical appendix are available from the World Bank bookstore. Summaries in French, Spanish, Arabic, and Russian will be published in 1997. A six-minute video with computer graphics and footage from state enterprises around the world is currently available; a 30-minute version suitable for policymakers and development practitioners is forthcoming. For further information about forthcoming materials, or to inquire about organizing a conference or seminar, call Luke Haggarty at extension 81681.