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Government involvement in the commercial sector: Best practice from an international perspective

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Government involvement in the commercial sector:

Best practice from an international perspective*

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BEST PRACTICE FROM AN INTERNATIONAL PERSPECTIVE

1. Introduction: The role of the government in market economies

In market economies, private business plays a dominant role in overall economic activity. Economic theory and empirical analysis have come to the conclusion that market processes generally produce the most efficient possible outcomes. Consumer demand is met at the lowest possible price and competition drives technical progress. Prices have the important function of informing market participants and influencing decisions on the supply and demand of goods and services and on employment of adequate factors for production, i.e. labour and capital. Rising prices signal scarcity, while falling prices indicate a dominance of supply over demand; while both set underway processes of adjustment toward market equilibrium. This mechanism works not only on separate markets but also for the economy as a whole because of the interrelations between the single markets.

This is true above all for perfectly competitive markets where the market participants have complete information and the adaptation to market changes takes place immediately.

Market interventions by the government can disturb the market process and can, therefore, hinder effective and efficient market solutions. Thus, public activities need proper justification, especially when the private sector has to provide the resources and when individuals have forego consumption benefits to finance these activities.

The main argument for government intervention is that markets are not perfect *per se* and that market failure could lead to severe problems and inefficiencies. The consequence is that public sector activities should concentrate on parts of the economy where market failures are likely. Textbooks on public finance specify two main causes for failures: market power and the non-existence of markets. In the first case, market participants try to use their market power to influence the prices in their own interest, so that as a general rule, insufficient quantities of resources are deployed for the production of the commodity in question. In the latter case, asymmetric information or externalities lead to an inefficient allocation of production factors. The same is true with respect to public goods, i.e. commodities which are complimentary and which no one can be excluded from using. In the following, the main characteristics of the various types of market failure are discussed. This leads us to a discussion of the rationale for government involvement in the commercial sector – the central topic of this study.

2. Market failure

2.1 Non-existence of markets

Market solutions exist only for those commodities where the market mechanism works in the following ways:

- There are private institutions interested in supplying the goods or services
- There is a price on the markets that is formed by individual supply and demand
- One individual’s use of the market goods rivals another individual’s,
- Someone who is not willing to pay the price can be excluded from use etc.

These conditions are not all fulfilled in every case. Thus some kinds of goods and services which – from the welfare point of view – are needed for a society would not be supplied at all or would be supplied in insufficient quantities. Thus markets are inefficient. This is mainly true for

- public goods such as lighthouses, whose consumption is complimentary and non-excludable
- a situation of asymmetric information, i.e. one side possesses information which is not available to the other, and
- a situation with externalities, i.e. the market price does not signal the social cost or benefit for producing certain goods and services.

In fact, there are only few pure public goods that fulfil the criteria of non-rivalry and non-excludability in the strict sense. They include traditional public services like defence and safety, a country's legal system and its guarantee of human rights, the provision of orderly market conditions for private economic activities and civil protection, etc. For other public goods, at least one of these criteria is not (fully) satisfied or the costs are too high to achieve rivalry or excludability for a given technology, for instance the use of city streets. Those goods are seen as impure public goods.

It is also important to note that public goods do not necessarily have to be produced by the public. Because of market failures or even the non-existence of markets, they will not be provided by private institutions, and therefore the public sector is responsible for their provision according to collective decisions about the kinds, quantities and quality needed. However, economically efficient provision could mean that the government pays private companies to produce specific public goods.

Moreover, public authorities produce services even in areas where the provider could theoretically exclude citizens unwilling to pay from using the services. Therefore, strictly speaking, these are private goods rather than public goods. However, there are arguments for providing these goods anyway: pure market solutions could lead to what is perceived by a well informed group as an insufficient supply of goods. Provision of such goods could have higher returns for the society than could be surmised based on individual preferences, especially of people who have limited information or are not risk-averse. Education, health services, and social insurance are examples. In addition to the presumed spillovers, distributive aspects are important in justifying the public's merit wants. However, because the consumers' sovereignty also plays a role, the provision of the merit wants is often discussed. In international comparison there are big differences between countries regarding the public provision of these goods, and over time, the public opinion about the necessity thereof has changed significantly in individual countries.

A further aspect of market failures is the existence of external effects. In general, the market prices fully reflect the changes in demand and supply. If the behaviour of market participants changes, e.g. caused by a shift of preferences, it leads to changes in relative prices and the market will tend toward a new equilibrium in which the welfare of some will be better while that of others will be worse. Externalities mean that changes in individual welfare are affected not only by market processes and price changes but also by external factors. A prominent example is air/water pollution. Since the use of these resources has no price, if they are used inefficiently this places a burden on those who want to take advantage of fresh air and clean water. While this example shows negative externalities, the contrary exists as well. Positive externalities occur when one person's transaction entails additional benefits for others.

A recipe for avoiding externalities is to internalise the external effects into the prices. This can be done by establishing property rights so that the use of previously free goods – e.g.

the use of free resources in the case of environmental pollution– would have a market price. Internalisation is appropriate as well by merging the groups with conflicting interest or by introducing social convention, so that activities which affect others shall be avoided as far as possible.

It is more common that the government intervenes. An adequate market solution is the introduction of a tax. The burden of the tax ideally would correspond to the social damage that goes along with the use of the good in question – even if the damage is difficult to quantify. The environmental tax reform is one example of this. Another is giving subsidies to prevent social damage, e.g. to encourage people to choose (or develop) resource-conserving technologies even if accompanied by higher costs. Further measures are creating a market where permits regulating the use of free goods or natural resources are traded. While the government reacts by producing or providing the desired public goods, in the case of externalities, the government intervenes into the markets so as to influence the behaviour of the private market participants.

2.2 Market power

Market solutions can be affected dramatically by the market power of individual actors. In theory, the most efficient allocation of resources is achieved in the absence of any market power. In the situation of perfect competition, all consumers and companies adapt their behaviour to the given prices, and no single actor can influence the price. If some have market power, they can determine the market price through their behaviour. This probably hinders efficient market results. In the case of monopoly, this is obvious. However, the phenomenon is more widespread because companies tend to reach a position of market power by segregation or regionalisation of their markets, by trademarks, by occupying niches, by innovation and introduction of new products, even if competitors exist. The more closed an economy is the larger the danger of market power coming into existence.

Traditionally some economic activities within national economies have been regarded as “natural monopolies”, mainly because of the infrastructure, especially in the physical networks needed for their distribution. Railroad companies, telecommunication, post, financial services, utilities like energy and water supply as well as waste disposal are typical examples. An urgent need to regulate these sectors was perceived. Often, the government even organised the production of these services itself, often via state-owned enterprises, in order to hinder private companies from collecting monopoly rents and guarantee an adequate supply to all citizens.

Meanwhile, both the growing openness of the national economies and technical progress fuel the competition on the markets. Monopolistic positions are, therefore, much more difficult to hold. As a consequence, the attitude of governments to the necessity for providing a broad range of such services has changed over time. Privatisation and deregulation have taken place in many countries. Governments nowadays concentrate much more on controlling the private sector with regard to mergers and acquisitions, trusts, cartellising practices etc. than on being involved directly in commercial activities.

3. Government intervention into the markets

3.1 Public production

The most extreme form of public intervention is the public sector's own production of goods and services. This is most common for all the pure public goods, beginning with the traditional functions of the government in the classical role of a "night-watchman", i.e. securing the living conditions of the citizens by law and order, national defence, legal framework etc. The scope of the goods in question has to be defined properly, it depends on traditions and preferences of individual societies and has changed over time.

But as mentioned earlier, even in the case of pure public goods, it is never mandatory that the public produce the goods itself. From a theoretical point of view it would be sufficient to guarantee the production and therefore provide the society with these goods. For efficiency reasons, it could be appropriate to look for a private producer who is controlled by the public administration with respect to quantities and qualities delivered. Public finance textbooks tell us that many goods which formerly were believed to be unsuitable for private production meanwhile are seen as potentially outsourceable to private firms. Even in the field of safety, nowadays private and public production are at least partly complementary. However, they also compete with each other in part, a fact that can lead to greater efficiency in production.

If this argument already applies to pure public goods, then it is even more true for impure public goods. People could be excluded from using merit wants. Admittedly, sole private markets would not guarantee an optimal or even sufficient size of supply and demand. In the case that the government has good reasons for providing such goods in certain quantities and qualities, the production could be left to the markets anyway.

Economic reality presents a very differentiated picture of the provision and production of impure public goods in international comparison. One can currently identify a structural change taking place toward outsourcing or privatisation of activities, i.e. leaving production to private markets. In practice, however, very different habits exist. For instance, even in Germany, public authorities at the local level have organised the provision of the impure public goods in a variety of different ways, including the following:

- traditional public production under the guidance of public administration,
- state-owned enterprises (SOE) getting grants from public budgets to cover financial shortages,
- SOEs providing the services and covering the expenses completely on their own, as well as
- private companies under the supervision of local authorities or without any further regulation.

Water supply, energy production for private households, waste disposal, inner-urban public transport are typical examples of this diversity, but also institutions in the field of culture (theatres, opera) or education (schools, universities) and social facilities (kindergartens, hospitals, old peoples' home) etc. are organised with different forms of public involvement. With respect to utilities, more and more of the production has been shifted to SOEs or private companies instead of the government producing the goods itself. Here, prices or charges are generally set at levels where the costs are covered and no financing out of the budget is needed. In contrast, cultural institutions more often remain de-

pendent on public grants; and frequently are still part of the public budget with all their expenditures and revenues. But even when they have more financial freedom and responsibilities – e.g. SOEs –,a large proportion of the public is granted access by setting prices below cost and consequently financing the deficits with government grants. Education and social welfare are commonly produced by the public administration itself; while private kindergartens, schools, universities and even hospitals exist alongside the public institutions. In other countries, e.g. in the United States and in the United Kingdom, the tendencies to outsource and privatise are more pronounced in some cases than in Germany and other continental European countries.

For all other goods that do not have a public goods character , production (and provision) is left to the private markets.

3.2 Subsidisation of private firms

There is some rationale for giving subsidies to private firms. Generally speaking, subsidies are able to correct market failures by financial support of public goods' production and by internalizing external effects. This can increase social welfare. On the other hand, the negative effect of raising taxes to finance the transfer payments has to be taken into account, too. Because of administrative costs, a certain part of the tax revenue is not redistributed. Moreover, there is the danger that companies invest in lobbying to maximise the benefit from subsidisation, thus obtaining for themselves greater subsidies than they actually need to compensate for market imperfections. Subsidies tend to be granted permanently instead of being limited in duration. Therefore, they serve to keep branches alive and hinder the structural change of the economy rather than to support an adaptation process. For each subsidy it is important to prove that it serves to increase general social welfare and not just the particular interests of individual branches or professional groups.

From an economic point of view, it makes no difference whether a subsidy is paid as direct financial aid or granted in the form of a tax break; it is always a financial advantage that allows the goods to be supplied at a lower price than otherwise. In other words, subsidies positively influence the competitive position of a company – or a branch – in relation to others, sometimes even affecting companies and branches outside the borders of the country (or region) in question. Hence a problem of unfair subsidising practice among different countries could arise and impel competition in the granting of subsidies. To avoid this, codes of conduct were negotiated for international trade by the World Trade Organisation (WTO) that restrict the possibilities of granting subsidies to national industries.

Far-reaching legal regulations were established by treaties for the members of the European Union. According to theses rules, state aid granted by state authorities of a member state or through resources of these authorities in general is banned if the aid "distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods... in so far as it affects trade between Member States " (Article 87 (1) (former Art. 92(1)) EC Treaty). There are only a few exceptions: the treaties permit financial aid for social purposes to single consumers without any discrimination with respect to the origin of products supported, state aid to regions affected by natural disasters and aid to compensate economic disadvantages connected with the German political division before the nineties (Art. 87 (2) EC Treaty). Potentially acceptable state aid includes regional aid to close the gap between well-developed regions and backward regions or to support structural change of depressed regions, and aid to support projects of common European interest. The same is true for financial support to certain branches if the common European interest is not violated. Grants for fostering culture and the cultural heritage can be

accepted as well, but even in these cases, strict rules have to be followed and grants have to be announced by the member states, giving the European administration the opportunity to ensure that they comply with the treaties and the administrative rules and procedures.

In principle, any kind of aid is seen as affecting competition. Therefore, the crucial question is how it influences trade and competition between the member states of the EU. First of all, this depends on the amount of aid granted as well as on the company profiting from the aid. It is assumed that small amounts of aid granted to small and medium sized enterprises (SMEs) usually do not affect trade and competition between member states. To ease the administrative burden on national administrations as well as on the European Commission, the European administration developed the so-called "de minimis rule for State aid" in 1992 [1] in order to simplify procedures and restrict control to only the most important cases. With the de minimis rule, a ceiling is set for state aid which is not covered by the ban of Art. 92(1). It was introduced so that this kind of aid no longer needs to be announced according to Article 93 (3). In the most recent version, the conditions have been set as follows[2]:

- a ceiling for aid of 100,000 Euro over a period of three years,
- the aid comprises the total of public transfers, except that which is obtained under schemes explicitly approved by the Commission,
- state aid include all kinds of aid, irrespective of the form in which the aid is granted, and comprises transfers from national, regional and local levels of government, independent of the – national or supranational – financial source,
- state aid has to be calculated as cash grants before tax (irrespective of its form) is transferred to the recipient, and is to be discounted to the present value.

Consequently, the member states of the EU are severely restricted in their competencies for granting state aid to private companies and closely overseen by the European authorities.

3.3 Regulation of private activities by the state

Mainly in the areas of "natural" monopolies, where single providers monopolise networks to which the access is restricted for competing suppliers, governments often used to run such businesses themselves or regulate the market by setting and/or controlling the prices. Prominent examples are telecommunications, postal services, the railway systems and the energy and water supply for private households as well as financial services. Besides the intention of hindering market power and restricting extra monopoly profits, the governments often tried to achieve socially accepted prices so that people with low income could afford a reasonable share of consumption. However, because of a lack of operative markets and insufficient administrative capacities, there was nearly no incentive for the companies in question to engage in efficient production, and even the controlled prices tended to be higher than they would be within a competitive framework.

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[1] Community guidelines on State aid for small and medium-sized enterprises (SMEs). Official Journal (OJ) C 213, 19.8.1992, p. 2.

[2] Commission notice on the de minimis rule for State aid, OJ C 68, 6.3.1996, http://www.europa.eu.int/comm/competition/stae_aid/legislation/96c068_en.html

Therefore governments increasingly began with deregulation and privatisation, opening up markets to other competitors and creating a level playing field for all suppliers. The technological progress and the increasing integration of national economies into the world markets support this development. On the one hand, owners of networks were obliged to allow competitors the use the networks to earn money. On the other hand, natural monopolies partly disappeared because of the development of substitutes for the services in question independent of the networks, for instance in the case of telecommunications. Often within the deregulated markets, prices went down because of the competition created, so that in the end the consumer usually became the winner. As a consequence, financial support to regulated industries compensating losses caused by low prices set out of social policy reasons was cut. Even in the case that price reductions could not be realised and low productivity progress led to price increases in the absence of further subsidisation, new ways of supporting economically weak households were discussed. It was requested that the subsidy for the goods and services be shifted via low prices to financially supporting the needy by vouchers or cash so that even in the case of high prices they would be able to afford an acceptable level of consumption. In the wake of the European internal market, the European Union forced the trend toward deregulation. The intention was to remove the internal barriers to competition between the member states. The regulated national industries were the most heavily protected branches, and this was opposed to the idea of intensified competition within a large internal market.

An important form of public involvement in the private sector is the guaranteeing of sufficient market conditions for a competitive climate by controlling mergers and acquisitions and preventing the formation of cartels. In the USA and Germany, this kind of market control has a long tradition. However, mainly on the European level, the European Commission has strictly controlled markets for many years not only with respect to the financial aid of governments to national industries but also regarding the tendencies to create market power within European markets. The Commission has developed efficient instruments for controlling and fighting against those practices. Sometimes, however, competition policies conflict with the intentions of industrial policies. On the one hand, the model is atomistic competition with many suppliers and consumers, on the other hand, national champions are required to withstand competition with large multinational firms. One can find many examples of the administration deciding in the interests of industrial policies for the national champions and against growing market power by mergers. However, because of the integrated international markets, the market power of national champions – even in their home markets – is restricted by the competition of the main competitors. Therefore, the conflict between competition policy and industrial policy is less acute today than it was years ago.

3.4 State-owned enterprises

Instead of regulating private industries that operate in imperfect markets or do not produce pure private goods, governments often decide to provide and produce the goods and services in question by running state-owned enterprises (SOEs). A broad range of different activities can be found: industrial key technologies like coal and steel, chemistry or industries related to national defence; branches with central functions like the financial sector; network-based industries like utilities (energy, water supply, waste disposal etc.), transportation systems and communications (railway companies, telecommunication, post etc.). Often local or regional governments own the enterprises. In such cases, the activities mostly concentrate on the provision of services of a public character (utilities, local transport) and financial services. On the national level, governments more often hold equities of significant commercial enterprises in addition to their own national trans-

port and communication systems (railways, post, and telecommunication). In some countries of the European Union in the 1970s, SOEs formed large holdings dominating whole branches of industries. Italy and France are particular examples of this practice.

However, the attitude of governments against SOEs has changed fundamentally over time. As was described in the context of regulation[3], governments began by privatising SOEs. In Europe there has been heavy pressure by Europe-wide authorities like the European Commission to create a level playing field for private companies. SOEs running commercial activities endanger the competition within the European internal market if, on the one hand, they are driven by political motives, and if, on the other, financial deficits are covered by governments' budgets. Therefore, European legislation began to restrict the scope for sorting out national policies, prescribed strict transparency for all kinds of financial transfers and controlled the activities of national governments against SOEs more intensively.

At the same time, national governments began to realise that SOEs often lacked economic efficiency. This was due partly to the fact that they monopolised markets which allowed them to set prices to cover all costs, partly reflecting the practice of public owners covering losses with transfers from the public budget. In sum, the incentives for profitable organisation of production were very weak. Often, financing of losses was justified by the argument that the industries were active because of national interest rather than commercial interest. However, there is more than one example of mismanagement of SOEs caused by political decisions regarding personnel, giving top management jobs to people with political connections but who were incapable of successfully managing commercial businesses. Moreover, they are forced to make decisions swayed by political interests or even pressure instead making decisions from a purely commercial point of view. However, the problems of public finances, larger public deficits in the context of lower economic growth and the shocks of the mineral oil price crises of the seventies and beginning of the eighties forced the governments to consolidate their budgets.

As a consequence, governments began with privatisation along a wide front. In doing this, the British Conservatives were the most consistent, and other governments followed. Commonly, the first step was giving the SOEs the legal status of a private corporation, but still holding the equity in public ownership. Then the equity was gradually sold to big private investors or to a large number of private households, in order to give incentives allowing low and medium income people to acquire commercial property. This process has not yet reached an end.

4. State-owned enterprises: tendencies and problems

4.1 Two different approaches

Keeping in mind all the different ways in which the public sector influences economic activities, the central question is, why should the public be involved in commercial business by running state-owned enterprises at all? For non-commercial activities such as producing pure public goods, there is a clear rationale for providing production directly by public administrations and institutions or by SOEs. The amount, variety and quality of goods covered by public provision have to be decided within the political process. From a theoretical point of view, in market economies there is only one main argument for public

[3] See the above paragraph.

involvement in commercial activities: severe market failure, which hinders a sufficient and efficient supply of goods that are needed for to adequately supply the citizens. Even in this case it remains up to governmental authorities to organise commercial businesses or to use other instruments for resolving or diminishing market failures. Inherent to this argument is the idea that SOEs tend to be less efficient than private companies.[4]

In centrally planned economies, the answer is different, but since political disintegration of the Eastern bloc in the late eighties, the transition to a market economy has been dominated by mass privatisation. This, however, created numerous problems of its own, related more to the process chosen than to the supremacy of SOEs compared to private corporations in those countries.[5] In the following, the review focuses not on the best practice for privatising commercial SOEs in transition countries, but on the question of the best practice for dealing with SOEs in general.

In developing countries, additional justifications for SOEs have been put forward: they could help free the economy from foreign influence and could support policy-oriented economic development.[6] Further arguments were to foster infant industries, promote domestic industry, increase employment or control key industries or the use of strategic resources.[7] Therefore, from the sixties to the eighties, the significance of SOEs in developing countries has even increased. This was the case not only in Africa, but also in several Asian and South American countries. According to estimates, in the eighties SOEs on average contributed roughly 10 % to GDP and even 35 % to gross capital formation.[8]

However, the concern increased both in the developed and in the developing countries that SOEs tend toward inefficiency and bad performance, resulting in losses rather than achieving a higher level of social welfare. These concerns are based both on theory and on empirical investigations. According to theory, within competitive markets private firms seem to outstrip SOEs. On the other hand, SOEs could thwart market failure if the government would strictly pursue the objective of maximising welfare. However, theories of public choice raise doubts about the altruistic, benevolent government, and corporate governance theories focus on the problem that the government could not afford to control SOE management sufficiently to meet the objectives of efficiency. Results of empirical research on the performance of SOEs in comparison to private firms confirm the doubts: In most cases, private or privatised firms performed better than SOEs; this was true for industrialised countries as well as for developing countries[9] and for transition countries[10]

Two different approaches can be identified for meeting the shortcomings that are seen as inherent in running SOEs:

- First, to continue the process of privatisation and divestiture
- Second, to improve the performance of SOEs.

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[4] Cf. Alchian, Armen (1995), Some Economics of Property Rights. In: Politico 30 (4).
[5] Cf. for instance Nellis, John (1999), Time to Rethink Privatization in Transition Economies? IFC (International Finance Corporation), Discussion Paper No. 38, The World Bank, Washington, D.C.; Shirley, Mary, Patrick Walsh (2000), Public versus Private Ownership, The Current State of the Debate. The World Bank, Development Research Group, Regulation and Competition Policy, Policy Research Working Paper 2420, Washington, D.C., August.
[6] Cf. Shirley/Walsh 2000, p. 3.
[7] Cf. Muir, Russell, Joseph P. Saba (1995), Improving State Enterprise Performance, The Role of Internal and External Incentives. World Bank Technical Paper No. 306, Washington, D.C., p.12.
[8] Ibid.
[9] Cf. Shirley/Walsh (2000), p. 53.
[10] Cf. Frydman, Roman, Cheryl W. Gray, Marek Hessel, Andrzej Rapaczynski (1997), Private Ownership and Corporate Performance, Some Lessons from Transition Economies. The World Bank, Development Research Group, Policy Research Working Paper No. 1830, Washington, D.C.

While most developed countries use the first approach, the second is more prominent among the developing countries. With respect to the transition countries, a mixture of both strategies could be appropriate, because even after mass privatisation SOEs still remain important.

4.2 Privatisation and divestiture

As already mentioned above, developed countries first began to privatise their SOEs in the sixties. During the decades previous to this, government involvement in economic activities had increased due to several factors. One main reason was to overcome the economic problems resulting from World War II ,which required a wide range of public and private investment. It was believed that market forces by themselves were not capable of remedying the wounds that had been left within a reasonable period of time. From a social point of view, urgent measures were required to create sufficient employment, an adequately balanced income distribution (and redistribution), and welfare. At the time, SOEs were believed to be much more suitable to take these objectives into account than private enterprises. Moreover, , the scope for sole private activities was quite narrow, as the economic framework had been weakened by poor infrastructure and restrictions within the financial system.

In a lot of countries, for example in France, Italy and the UK, socialist governments forced through the nationalisation of industries. Energy, transport and utilities were the main focus of nationalisation, along with heavy industries and the chemical industry, all key branches for economic development. The perception that economies of scale were essential for economic dynamism/success helped to support this strategy.[11] During these years, a belief in the efficiency of the political direction of macroeconomic development and structural change strongly influenced how economic policy was approached.

According to information collated by the “Centre européen des entreprises publiques”, the public sector was of remarkable importance for the economies of the European Community’s most important member states in the mid eighties:

The extent of the public sector in selected EU-countries, 1983
as a % of gross domestic product

Country	Public sector
France	22,8
Italy	20,0
UK	16,7
Germany	14,0

Source: Bilger (1992).

The public sector’s influence was even higher in some individual sectors. For instance, in France 80 % of the value-added in the banking and insurance industry was accounted for by the public sector, 68 % in the transport services sector, 50 % in the energy sector and

[11] Cf. Muir/Saba (1995), pp. 11f.

23 % in overall manufacturing; its share in exports amounted to 33 %, in investment 34 % and in the employment in manufacturing 20 % (roughly 2 m people).[12]

However, when the post war business cycle, marked by the dynamics of reconstruction, ended, scepticism about this strategy grew. It became more and more obvious that the structures created did not guarantee satisfactory economic results. International competition increased and the practice of protecting nationalised industries from foreign competitive pressure was increasingly restricted by international conventions. And it became obvious, that the government and the well equipped public sector administration it had created were too overwhelmed to manage the structural change needed by the whole economy properly with the means available to them: political targeting, financial incentives for the private sector and instructing state-owned enterprises in key sectors. SOEs, and in particular large state owned holdings, are often characterised by worsening economic performance, a lack of flexibility and inadequate control mechanisms. As a consequence, they created heavy financial burdens for the state who had to cover the SOEs' deficits and refinance them on the capital markets. Therefore, governments began to change their strategies. To overcome these difficulties, governments first created incentives for higher economic efficiency through several reforms: the SOEs were obliged to meet stricter commercial objectives; the big companies were restructured using the examples of the private sector; the bureaucratic management and administration structures were commercialised; political influence on SOEs was reduced and, ultimately, through privatisation and divestiture in different ways. The UK was the first European country to start with the equity sales of SOEs at the end of the seventies, other countries followed in the eighties and, the majority in the nineties.

The great bulk of the British privatisation programme took place from 1981 to 1991. Both small and large industries were privatised, even though large enterprises can be considered to be natural monopolies. Various methods were used: privatisation by flotation, i.e. sale of shares to (single) companies or to (small) private shareholders, by management buy-outs and by employee shares.[13] This process comprised – among others – the large utilities companies (like gas, water and electricity supply), oil extraction and refineries (like Britoil and British Petroleum), important manufacturing industries (like the car industry: British Leyland and Jaguar, British Steel, British Aerospace, British Shipbuilders), and the communications and transport sector (like British Telecom, British Airways, British Ports, Sealink, Scottish Bus).

While the British government was beginning to privatise state-owned enterprises, a last wave of nationalisation of industries took place in France: eight key industrial groups (Usinor-Sacilor (Steel), CGE, Thomson (Electrical and electronical appliances), SGPM (Materials), Rhône-Poulenc (Chemicals), Péchiney (Metals), Matra, Dassault (Machinery)) and nearly the whole financial sector was involved.[14] This took place during a period of weak performance for the French economy as a whole and in particularly for French industry. Low competitiveness on an international level, high inflationary pressure and high unemployment were typical. ‚The government hoped to overcome these shortcomings through nationalisation with its increased research and development expenditures, the rehabilitation rehaul of industries lagging behind, investment into key future technologies, specialisation of industries and protection of national industries against international take-over. Some were achieved following nationalisation. Using high subsidies and public procurement practices, R&D was helped to reach international standards. Specialisation in national industries was achieved through restructuring. Progress was made in the rehauling of industries even going as far as to lay off employees. Nevertheless the em-

[12] Cf. Bilger (1992).
[13] Cf. Buck, Thompson, Wright (1991), pp. 186ff.
[14] Cf. von Aufschnaiter (1993), p. 86.

ployment in state-owned industries had a stabilising influence on the labour market; according to estimates, the unemployment rate in the public sector was 7,2 %, remarkably lower than that in the private sector (11,5 %), which increased during this period.[15]

However, in the meantime the government spent large amounts of its budget on the nationalised industry, mainly to cover losses. From 1982 to 1986, the government transferred 62 Bill. FFrs as an allocation of funds, the largest part of which was paid to Sacilor, Usinor and Renault which had all realised heavy losses prior to 1985. This increasingly obvious non-productive use of limited public funds – instead of fostering investment and R&D – and budgetary constraints, forced the government to revise its strategies. Additionally, France also came under international pressure to do so, mainly from within the European Union, because of fears France would use unfair subsidisation practices under the cover of state-owned enterprises. Therefore, in early 1986 France initiated a programme for privatising its national industries, which focussed on the following objectives[16]:

- separating companies competing on the national and on international markets from bureaucratic advice and influence and from direct state interventions
- reducing public debt
- supporting the effectiveness of financial markets by attracting the savings of private households as small share-holders
- securing employment by creating enterprise and ownership structures that were able to resist involuntary take-overs.

Within a very short time a substantial proportion of state-owned enterprises were privatised; the share of the public sector in the ownership of commercial business decreased remarkably. Around half a million workplaces were transferred to the private sector. The privatised industries coped well in the stock markets. The population's readiness to buy stocks in privatised industries was high, more than a quarter of private households representing nearly all social classes as well as the younger generations – although mainly middleclass households –took part. Due to the increased demand for shares in such companies on the financial market, companies were able to build up their capital through selling an increased number of shares. The public debt was reduced, although only slightly. All in all privatisation was considered to have been a success.[17] In contrast to British privatisation, which included all types of enterprise, the French government only privatised the companies which operated in a competitive business environment, excluding national "natural" monopolies like the railway company, Air France and the electricity utilities – partly to take the French constitution into account and partly to respect the prevailing view in the French parliament .

In Italy, the steps towards privatisation began even later than in France. In 1992, the legal framework for privatisation was set.[18] First, the main big state-owned holdings IRI (Industrial and financial sector), ENI (Petrochemical), ENEL (Energy) and INA (Insurance) were transformed from public sector companies into joint-stock companies owned by the treasury. Second, these holdings were restructured. Then, step by step companies were released into private ownership in different ways, following the British and the French example. The government reserved the right to hold a "golden share" in the companies – for example in utilities – to secure public influence in politically or socially important fields of

[15] Cf. ibid. p 86.
[16] Cf. ibid. p.89; Fels (1987), pp. 74ff.; Bilger (1992), p. 2.
[17] Cf. Bilger (1992), pp. 3f.; von Aufschnaiter (1993), pp.90ff.
[18] Legge 35/92 and legge 359/92.

activity.[19] In the example of savings banks for instance, which were restructured into joint-stock companies, the ownership was transferred to specially established foundations of civil law as the first step.[20] In the second step, these foundations were forced to sell their shares to private shareholders. To this end a further law was passed in 1998.[21] According to this law, by 2005 the foundations should no longer be the majority share holders in the savings banks. To maintain their tax privileges, the foundations have had to release their shares even earlier.[22]

The privatisation process in Italy is far from being completed. However, this is the case in most countries. On national and regional levels, privatisation is still going on, exposing more products and services to competitive forces. Even in those fields, which were previously regarded as the main fields of public production, the opinion that functioning markets with free access for private firms increase efficiency and benefits for the consumer and public budgets is increasingly prevalent.

Therefore, divestiture and privatisation can still be considered to be of importance in Western Europe as well as in Eastern Europe and in third world countries. It is considered best practice to leave commercial activities to functioning markets, to avoid crowding out private firms, to reduce the financial risks for the government budgets and to concentrate on public activities as far as possible.[23] However the issue remains of which method for privatisation minimises friction and transaction costs. This could be seen as a best practice question; there are several studies covering this issue.[24] However, this question goes beyond the limitations of this study and is not discussed further.

4.3 Improving the performance of SOEs

Another alternative option, or indeed a complementary strategy, is to improve the performance of SOEs through ensuring an efficient management. In the course of time, it became obvious that most SOEs did not perform well economically. This was attributed to combining non-commercial tasks (with respective financial consequences) with commercial activities, protecting SOEs from competitive pressure and the of omission of the governments to implement instruments to control and monitor performance and to discipline management.[25] Muir/Saba cite a long list of bad examples from different countries, where the public enterprises were characterised by low profitability or even high losses, even when receiving substantial subsidies.[26]

As a consequence, governments began to reform the public sector not only through privatisation but also through restructuring. The main approach was to to give the enterprises a legal entity as private corporations in order to separate the function of ownership from that of management and to provide the management with more decision-making ability . This approach went hand in hand with a replacement of the bureaucrats governing the companies by commercial management, with the introduction of rules and procedures commonly used in commercial firms like accounting standards and financial and operational targets, with detaching companies from political influence and with a reorien-

[19] Cf. Stecher, Böckmann (1994), p.200.
[20] "Legge Amato", legge 218/90
[21] Legge 462/98.
[22] Cf. Larch, Schröder (2000), pp. 4f.
[23] Cf. Nellis (1999), pp. 28f.
[24] Cf. Candoy-Sekse, Ruiz Palmer (1988), Ewing et al. (1997), The World Bank (1995), Nellis (1999), Shirley, Walsh (2000); Kikeri, Nelllis, Shirley (1994).
[25] Cf. Muir, Saba (1995a), pp. 1f., 12ff.
[26] Cf. ibid. p. 11f.

tation towards market mechanisms rather than central decisions governing the production of goods and services.

According to existing studies, which try to evaluate the different governments' strategies for improving the performance of SOEs, three different factors are important:

- Corporate governance aspects
- External incentives
- Contracts and control.

Corporate governance issues are often focused on when discussing the efficiency and profitability of SOEs. The following principles support the market oriented behaviour of management. First, a clear distinction between the owner as a shareholder and the corporation as a legal entity with own assets and liabilities; second, the limitation of the owners' liability so to restrict the obligation to finance potential losses; third, a fully responsible central management with the necessary decision-making power for operational activities, and last but not least, the opportunity to transfer shares from one owner to another so as to allow increased control of management through the mechanisms of financial markets.[27] Modern corporate structures for private companies contain all these elements even if the institutional regulations themselves differ from country to country. Usually, the owners control the management with the help of a supervisory board that they elect. The supervisory board's main task is to appoint and supervise the management on behalf of the shareholders. Reforming SOEs in this way improves performance as it provide strong internal incentives for management to run the commercial business efficiently. The case studies discussed elsewhere in the study provide more insight into theses topics from a company's point of view.

Moreover, external incentives are seen as important for supporting the efficiency of SOEs' management.[28] These incentives stem from functioning markets forcing the SOEs to adapt to market mechanisms and to compete with other companies mainly for consumers and clients, but also for financial resources, labour, and the support of shareholders.[29] Competition in the product markets, through which the SOEs supply their goods and services, forces them to be more efficient, so that they can maintain or even improve their market share relative to their competitors. Competition in financial markets ensures that the suppliers of loans and equities control and monitor companies effectively.; investors penalise poorly managed or not very profitable companies through higher risk premiums or through reluctance to lend money. This also applies to the stock markets as well. Trends in the value of a company's shares relative to the market as a whole reflect the reputation of a company and its management.

Additionally, forms and procedures are discussed which would oblige SOEs to be more commercially orientated and more efficient. Contracts and agreements with the government upon respective topics, fixing targets and implementing agreed criteria, were sometimes proposed as a way of overcoming the problems.[30] Ramamurti even presents a "Performance Contracting System", once tested in a developing country, which he compares to similar systems used in France, Pakistan and South Korea. Sometimes, contraction is used as a solution when privatisation is not feasible or is even used as a preparation by the SOEs for being privatised later on. This is the case for improving control of SOEs' performance, as well. As in private companies, control procedures should first be

[27] Cf. Muir, Saba (1995a), pp. 17ff.
[28] Cf. Shirley (1983), pp. 42ff., Kumar (1991), pp. 330ff.
[29] Cf. The World Bank (1995), p. 46.
[30] Cf. Kumar (1991), pp. 330ff., Ramamurti (1987), pp. 105ff., Pannier (ed., 1996), pp.20f.

organised internally. The more effectively a control systems works, the less an external control – by independent monitoring institutions or by the government itself – is needed. Internal control has to include the decision processes for transactions and the factual procedures authorising the disposal of both financial and real assets and impose consistency between accounts and actual real and financial assets.[31] Based on the results of the internal control and accounting, external auditors put together reports, which reflect whether procedures and operative results meet the general targets of the SOE in question. As a result, an effective control system would ensure the effectiveness of public enterprises.[32] However, there is also some scepticism about the effectiveness of contracts and control caused by lack of motivation, asymmetric information and poor commitment of governments, and respective public administration, in enforcing closed contracts.[33]

All in all the international experiences with the SOE reform in the direction of corporatisation are summarised by Muir and Saba as follows[34]:

Positive effects in corporate governance resulted from

- separation of commercial objectives from social considerations
- clear distinction between responsibilities of the management and the owners
- orientation of salaries towards the level in private industries rather than that in the civil service
- Inclusion of union and private sector representatives on the boards of a corporation
- reduction of bureaucracy in the organisation.

On the other hand, the avoidance of conflicting objectives, political influence, the inclusion of politicians and representatives of the public administration in the boards and the forming large holdings for SOEs was also recommended.

The following factors helped to provide incentives for the successful operation of SOEs:

- competitive framework and open markets
- hard budget constraints
- trading of the shares on financial markets
- external auditing

International experience showed that reforming SOEs to incorporate the above had an encouraging outcome. However, one cannot pick and choose between these measures and only implement the most feasible and politically acceptable one. Improvements in the corporate governance of SOEs have to be complemented with external incentives to increase the performance of SOEs and make it an alternative to privatisation. In this framework, SOEs can assume political economic and social tasks as well; however, they do this explicitly and on the basis of explicit agreements and contracts and are paid for by the government. This would be more transparent, too, compared to the blurring of commercial and political objectives which often characterise SOEs.

[31] Cf. Bokhari (1985), pp. 366f.
[32] Cf. ibid., p. 377, Ramamurti, Vernon (ed., 1991), pp. 4ff.
[33] Cf. Shirley (1998).
[34] Cf. Muir, Saba (1995a), p. 47.

4.4 Rules for non-discrimination and transparency

The legal framework is of great importance in the area of public sector involvement in commercial activities as it can restrict the scope of public intervention. Intervention also affects competition between private and state-owned enterprises within one country or between countries.

In the European Union, strict legislation exists on state aid and other subsidies as well as on state-owned enterprises. It is laid down in the European Treaties and within legislation derived from the treaties; its aim is to provide a level playing field for commercial activities. The World Trade Organisation (WTO) is following a similar approach for international trade, so to avoid unfair trade practices favouring firms in certain countries at the expense of those in other countries. Special regulations in competition laws are devoted to state trading enterprises.

The rules are based on

- transparency
- and non-discriminatory practices.

In general, transparency is needed so that it can be judged whether public sector involvement in commercial activities is in line with the legal framework. State aid is usually banned, if it affects external trade either within the European Union or between member countries of the WTO.

The EC treaty includes a general ban on discriminatory state aid in the EU; there are only a few exemptions for regional policy, for projects of common interest or for the promotion of certain branches and regions with special circumstances (Art. 87 (ex Art. 92) EC Treaty)[35]. Special rules exist for aid following horizontal objectives. Here, conditions for approval are “softer”, because the objectives are in line with the EU‘s common interest; this applies to research and development aid, to environmental aid, to aid for rescuing and restructuring firms in difficulty, for small and medium-sized enterprises, for employment, training, risk capital and aid for firms in deprived areas.[36]

State aid has a broad base: it comprises all kinds of aid, not only direct monetary transfers, but also tax allowances, capital injections, guarantees, public land sales and export credit insurance. To measure the aid component of the different forms of interventions, a cash grant equivalent is calculated as a gross figure, i.e. before tax if the grant is taxable. For instance, the cash grant equivalent of a soft loan is seen as the difference between the reference interest rate – oriented at the market rates – and the factual interest rate paid. A risk factor –the probability of default – can be taken into account for loan guarantees. The equivalent of a tax allowance is calculated as the value of the tax saved by the taxpayer.[37]

The European Commission has to continually review the existing procedures in cooperation with its member states (Art. 88 (ex 93) EC Treaty). Therefore, EU member countries have an obligation to report regularly on their provision of state aid to the commercial sector. However, the European Commission also has the right to initiate a formal investigation procedures, to judge whether the measure in question is compatible with the common market and to authorise the granting of state aid by member states.[38] If the de

[35] In the version of the Amsterdam treaty.
[36] Cf. Rules on the assessment for approval of State aid with horizontal objectives. http://www.europa.eu.int/comm/commission/state_aid/legislation/aid3.html
[37] Cf. European Commission (ed., 1996), p. 2.
[38] Cf. Council Regulation (EC) No 659/1999.

minimis rule on state aid is applied, it is usually assumed that the grant in question does not affect trade between member states. State owned enterprises come under particular scrutiny.

Particular attention is also reserved for the financial relations between member states and public enterprises. A directive was passed by the Commission at the beginning of the eighties, prescribing transparency for the financial relations between member states and SOEs.[39] The main purpose of the directive was to create transparency in the public funds granted by the state, regional and local authorities either directly or through intermediaries, such as financial institutions or public holdings etc, as well as in the use of these funds by public enterprises. The criteria for public enterprises were precisely defined. The directive concerns a bundle of financial relations like setting-off operating losses, the provision of capital, non-refundable grants, loans on privileged terms, forgoing profits etc. The directive was originally not applied to public enterprises supplying services which did not affect trade between member states and those with activities in public utilities, post and telecommunications, transport and public credit institutions or to very small enterprises. However, the directive was amended several times over the course of the years.[40] Finally, in its present version, the directive limits the scope available for public intervention in public enterprises in a stricter way: proper and transparent accounting for public enterprises is made obligatory; the exemptions are not dependant on certain areas of activity but rather on the services supplied not affecting trade to an appreciable extent. Moreover, central banks are exempt, as well as public financial institutions as long as they operate under normal market conditions. Companies are also exempt if their turnover does not exceed certain fixed limits. Member states are obliged to supply the Commission with all the information required.

The Treaty and the corresponding legislation clearly define the concept of state aid in the EU: any practices which negatively affect the competitive position of trade partners are to be avoided by member states (including regional and local authorities); moreover, public sector companies who are active in competitive markets are not allowed to gain privileged positions through financial flows from the public budgets, if there is the danger that they could edge out competitors. The member states are left to run their own non-commercial or commercial activities. However, they have to ensure that these companies are not favoured against other competitors, usually those from other member states.

A similar approach is taken by the WTO to international trade. At first, the agreements concentrated on world-wide tariff reductions, then efforts started to remove non-tariff barriers and to support anti-dumping practices. This included discussions on the practices used to subsidise trade and enterprises. Under the WTO system, special regulations also exist for state trading. The relevant articles (mainly Art. XVII) of the GATT 1994 state that

> "such enterprises – in their purchases or sales involving either imports or exports – are to act in accordance with the general principle of *non-discrimination*, and that *commercial considerations* only are to guide their decisions on imports and exports."[41]

Moreover, WTO Members are required to notify the WTO annually of their state trading enterprises. The main aim of this regulation is to hinder (potential) distorting effects on (international) trade, which could be caused by state trading enterprises. However, there is still a lack of transparency, because the compliance of the WTO members with this regulation remains poor and state trading enterprises tend to be used as an instrument for trade policy measures, mainly regulating market access to protect the home market,

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[39] Cf. European Commission (ed., 1980).
[40] Cf. European Commission (ed., 1985, 1993, 2000).
[41] Cf. WTO (2001), p.1.

but also providing financial support for exports; both violate the WTO regulations agreed upon by WTO members.

Therefore, transparency is a condition sine qua non in creating a level playing field for international trade.

4.5 Public Enterprise Management Information System

One approach to transparency in state owned enterprises involves implementing an information system database which provides information on public enterprises in a standardised format to be used by the government itself and by other bodies interested in the data, like planning and regulatory agencies, statistical offices, financial institutions etc.

Such a system, the Public Enterprise Management Information System (PEMIS), was detailed in a project run by the United Nations Organisation on Information Network on Public Enterprises in Developing Countries (INPENDEC). PEMIS is a prototype model for a centralised computerised system, which provides access to standardised data, supports institutions in meeting different demands for information on public enterprises and encourages the use of internationally compatible and consistent definitions and standards .[42]

Annual enterprise data or aggregated data on a sectoral or even a country level are required as inputs to the system, as well as national accounting data and other information on a macroeconomic level. Individual and aggregate data outputs are available as long as the access does not breach confidentiality requirements. The benefits from the system are expected to include an improvement in the performance of SOE, more efficiency in monitoring, better information for performance contracts and assistance for strategic planning; moreover, the privatisation process could also benefit.[43]

The following data tables are an integral part of the data base:

- Basic data on enterprise: name, status, main activities, subsidiaries, ownership etc.
- Basic data on the sector in the respective country including value-added components, financial flows from government, investments, assets, foreign trade etc.
- Performance data on type of products, purchases, production, sales and stocks
- Personnel: different categories of employees, the respective costs and hours worked etc.
- Balance sheet of the enterprise
- Income statement on operating revenues and expenses, surplus/deficit, subsidies, taxes etc.
- Foreign exchange with inflows (export revenues, foreign direct investment, loans etc) and with outflows (payments for imports of capital goods, raw materials etc., interest and repayment of foreign loans, royalties etc.).

The main output derived from the PEMIS is listed in the following:

- Inventory of public enterprises with selected main characteristics for individual enterprises

[42] Cf. Bennett (1992), p. 306.
[43] Cf. ibid., pp. 307f.

- Production and productivity according to several statistical indicators
- Personnel with regard to comparable indicators per employee
- Comparisons of the financial structure and liquidity for several enterprises
- Profitability analysis comparing selected enterprises.

All in all, the system offers , data ,on SOEs presented in a consistent way; it contributes to transparency in this important area and facilitates comparisons and strategic considerations of the state and development as well as the budget risks of public involvement in the commercial sector by state-owned enterprises.

5. Conclusion

The review evaluated aspects of best international practice for public involvement in the commercial sector. It gives an overview of the general trends in developed countries for coping with subsidising practices and the respective legal framework. Special emphasis was put on the activities of state-owned enterprises. the following conclusions can be drawn from the review:

- Commercial activities should be left to private activities as far as possible for reasons of economic efficiency
- When supporting private activities with financial flows from public sources, discrimination against other domestic and foreign firms has to be avoided
- State aid should be strictly limited to certain clearly stated objectives or should be banned completely, so as to secure a level playing field for enterprises and to avoid endangering competition
- Full transparency in the financial relations between public budgets and enterprises, whether private or public, has to be ensured. The use of the information system discussed earlier would support efforts to supply the necessary data
- Even in the areas where non-commercial and commercial aspects desperately need government support, the public influence should concentrate on financing social objectives, for instance within certain contracts
- Corporate governance aspects should be taken into account when SOEs are considered; the decision making process should be structured along the lines of private corporations and enterprises insulated from political influence
- Privatisation processes should be continued to ensure competition in functioning markets
- On the national and international level, institutions should be responsible for the effective monitoring and control of regional, local and national government practices and their commercial activities to prevent trade distortions and unfair subsidising practices favouring single domestic enterprises at the expense of the private sector and – owing to the loss of efficiency –the national economy and ultimately a nation’s welfare.

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