European Department

Reassessing the Role of State-Owned Enterprises in Central, Eastern, and Southeastern Europe

Christine Richmond, Dora Benedek, Bobana Cegar, Peter Dohlman, Michelle Hassine, Beata Jajko, Piotr Kopyrski, Maksym Markevych, Jacques Miniane, Francisco Parodi, Gabor Pula, James Roaf, Min Kyu Song, Mariya Sviderskaya, Rima Turk, and Sebastian Weber, in collaboration with EBRD staff

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Executive Summary

The Central, Eastern, and Southeastern European (CESEE) region is ripe for a reassessment of the role of the state in economic activity. The rapid income convergence with Western Europe of the early 2000s was not always equally shared across society, and it has now slowed dramatically in many countries of the region. Moreover, past privatizations have not always lived up to their promise. In this context, it is pertinent to ask to what extent state-owned enterprises and banks (SOEs and SOBs, respectively) can be a source of economic growth and stability or instead impose a significant drag on the economy, and if so why. This paper draws on original surveys of country authorities, large micro-level databases, and corporate case studies (with European Bank for Reconstruction and Development involvement) to answer some of these pressing questions.

SOEs and SOBs account for a significant share of economic activity in the CESEE region, though with large variation across countries and sectors. In most countries in the region, SOEs account for *at least* 5 percent of total employment or total value added, but in countries such as Poland or Russia this share rises to some 15 percent, and to 30 percent in the case of Belarus. Not surprisingly, SOEs are concentrated in natural monopoly sectors, but they are present to varying degrees in other sectors as well, such as mining and quarrying, agriculture, manufacturing, and services. In the financial sector, SOBs are nonexistent in some countries but very large in others, accounting for more than half of banking sector assets in Russia, Belarus, and recently (following supervisory actions) also Ukraine.

SOEs systematically underperform relative to their private sector counterparts. Statistical analysis in the paper finds that SOEs (1) generate less revenue per employee, (2) pay higher wages than private companies, and, not surprisingly, (3) are significantly less profitable. These results hold to varying degrees in every country in the region and in every sector of the economy. A

related concept of efficiency, namely total factor productivity, is also found to be lower in SOEs. The key reason for this underperformance is the inefficient use of resources, most notably labor; SOEs use too much labor for the output they produce. In countries where SOE presence is material, the paper finds large potential output gains from boosting SOE efficiency up to the level of their private counterparts.

A similar picture emerges in the financial sector. Consistent with previous literature on the subject, our study finds that SOBs (and development banks) are overall less profitable than private banks, though there is significant heterogeneity across countries. Lower net interest margins and net fees but also higher provisioning costs (related to higher nonperforming loan ratios) explain the difference in profitability. And, surprisingly, SOBs do not perform worse solely because they focus their lending on weaker SOEs; their lending decisions are poorer whether lending to SOEs or to the private sector. Finally, the study points to risks from the government–SOE–SOB nexus, such as when government ownership of a bank leads to relaxed oversight over poor lending to SOEs, which in turn can lead to a significant financial stability shock with fiscal consequences.

Poor governance of SOEs is at the root of the problem. Be it in the area of ownership policy—in particular, the balance between active government engagement and delegation to independent SOE supervisory and management boards—or in the way governments oversee these companies' finances and manage the links between SOEs and national budgets, CESEE countries fall short of international best practice. There is, granted, significant cross-country variation, but no country comes close to best practice in all areas. This matters because the paper finds a clear correlation between how well a country ranks in terms of SOE governance and how close this country's SOE performance is to the private sector benchmark.

There is little evidence that inefficiencies arising from state ownership can be justified by noneconomic objectives. Countries in CESEE and elsewhere report a variety of rationales for state ownership that go beyond economic efficiency. However, state-owned entities tend to disappoint even against some of these objectives. For instance, we find only partial evidence that SOEs shed less labor (or protected real wages better) during the global financial crisis. Similarly, there is mixed evidence that a higher share of state ownership in the banking system is good for financial inclusion, though we do find some evidence that it correlates with more stable credit flows. Finally, economies with a larger SOE footprint tend to have a lower public capital stock and a lower quality of infrastructure even after controlling for income levels.

The balance of evidence in the paper strongly suggests that larger state ownership is not the way to achieve faster growth and convergence. Rather, the opposite seems to be the case. In this context, a good first step—which some CESEE countries are taking or have taken in the past—is to triage state-owned companies and SOBs on the basis of their viability, and on whether the rationale for state ownership is strong (natural monopoly, strategic interests, etc.). For the latter group in particular, there has to be a frank, transparent, and data-driven assessment of whether these companies are fulfilling their stated objectives, and at which cost to the state and to the economy.

Improving SOE governance is urgent unfinished business, but it is not enough in itself. The scope for SOE governance improvements is large in the region, be it more independent and professional boards in the companies, stricter financial reporting and auditing, or greater clarity on the fiscal links to SOEs. This being said, the paper offers cautionary tales against simple de jure improvements that do not translate into real implementation changes; the latter often requires dogged determination to go against vested interests. Moreover, the paper shows through various case studies that improving governance, while necessary, is typically not a sufficient condition for lifting performance. This requires hard choices such as shedding employment or divesting noncore assets, choices that create tension between the need for the state to manage at arm's length and the need for it to get behind these hard choices. In short: state ownership is seldom the answer to an economy's ills, but fixing problems in the state-owned sector is a complex, often long-winded process that may require sustained commitment over several years. But if there is something that this paper shows, it is that it can be done, typically if not always to the benefit of the sector and the economy.

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