THE EVOLUTION AND MANAGEMENT OF STATE-OWNED ENTERPRISES

Yair Aharoni

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BALLINGER PUBLISHING COMPANY
Cambridge, Massachusetts
A Subsidiary of Harper & Row, Publishers, Inc.

Manufactured in the United States of America.
10987654321

Library of Congress Cataloging-in-Publication Data

Aharoni, Yair.
The evolution and management of state owned enterprises.

Bibliography: p.
Includes index.
1. Government business enterprises. I. Title.
HD3850.A46 1986 351.009'2 86–91539
ISBN 0–88730–164–9

Credits:
Grateful acknowledgement is made to the following for permission to reprint previously published materials:
1. *The Columbia Journal of World Business* for extracts from Yair Aharoni, "The State Owned Enterprise as a Competitor in International Markets" in Vol. XV, No. 1, Spring 1980, pp. 14–22.
2. *Cambridge University Press* for extracts from Yair Aharoni, "State-owned Enterprise: An Agent, Without a Principal" in Leroy Jones (ed.) ENTERPRISE IN LESS-DEVELOPED COUNTRIES, pp. 67–76.
3. *The Leon Recanati Faculty of Management*, Tel Aviv University for granting permission to reprint the requested material.
4. *CIRIEC*, Universite de Liege for extracts from A. Phatak (1969), "Governmental Interference and Management Problems of Public Sector Firms," *Annals of Public and Cooperative Economy*, Vol. 40, No. 3 (July-September), pp. 337–350.
5. *World Bank* for tables from the World Development Report and extracts from Mary Shirley, *Managing State-owned Entèrprises*, Staff Working Paper No. 577 (Washington, D.C.: The World Bank, 1983).
6. *International Monetary Fund*, Washington, D.C. for extracts and tables from Peter Short (1984), "The Role of Public Enterprises: An International Statistical Comparison." IMF Occassional Staff Paper.

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BUSINESS AND PUBLIC POLICY

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PREFACE

Since the end of World War II, the SOE sector in all market economy countries has grown in size, increased in relative importance and diversified in activity. Many of these enterprises have expanded internationally, both by export operations and by foreign investments. They appear to have grown because of a shift in public opinion. The trend of establishing SOEs accelerated during World War II and mainly in the period after it. With time SOEs have come to control a large share of the GNP of many countries and are now to be found in all sorts of industries. They were established to maintain employment in declining industries, to foster the development of high-technology industries, to merge weak and diffused local firms, to prevent acquisition of local firms by large MNEs, to invest in industries for which private capital was not available and, mainly for ideological and political reasons, to exercise control over the national economy. They were also established to replace government departments.

The tremendous increase in government activities and its expansion to areas that may be considered competitive with private enterprise represent a major change in the operating of the free enterprise system. The state has become an economic actor in its own right and makes resource allocation decisions for the good of its citizens—or some of them. One result has been near-obliteration of the traditional distinction between private and public sectors (see, e.g., Smith, 1975, p. 8). Another has been the burgeoning use of hybrid organizations, namely, state-owned enterprises (SOEs). For a long time, the theory behind the creation of many SOEs, at least in English-speaking countries, has been based on Herbert Morrison's ideas (1933); these enterprises were expected to be commercial concerns delivering profits to the state instead of to capitalists. They were to be not only autonomous from political interference but also accountable to the public, represented by its elected officials. The SOE was to have an "arm's length relationship with government." It was to secure "a combination of public ownership, public accountability, and business management for public ends" (Morrison, 1933, p. 149). Experience, however, proved an arm's length relationship to be wishful thinking because ministers were unable to resist intervention. With time the point of view that the SOE should be used to implement any government policy has become widely held—less in theory but very much in practice. Most governments feel that the very fact that the government acts not only as a shareholder but also as a banker of SOEs imposes on them obligations toward the nation. The SOE is considered to be a tool for a variety of government policies and even a vehicle for political patronage.

The multiple goals by which an SOE is judged means that accountability is lost. Since objectives are unclear and ever changing, management can always blame losses on the various other policies it was asked to pursue. Management may also choose to pursue additional objectives, and this variation from policy is hard to detect. The problems of controlling the SOE are exacerbated, and the relations between managers and government become very unclear. Often, the results are that SOEs are not responsive to prescribed goals, and in many cases, the goals are not prescribed at all. Quite often, SOEs were asked to pursue objectives helpful to a government minister for political reasons. Carrying out such activities through an SOE has the dubious advantage of not subjecting them to rigid parliamentary scrutiny, and their costs are buried as being a result of ostensibly inefficient operations in the firm. This state of affairs had led to loss of public money and has weakened initiative and morale within SOEs.

SOEs are one of the many tools used by governments to fulfill their expanded roles. The definition of SOEs, and their shares in the economy are discussed in Chapter 1. Since SOEs are owned by the state, they operate in a political environment. Private shareholders are assumed to want profits. State shareholders may want different things from different firms, in different countries or at different times. SOEs are, therefore, heterogeneous. The relationships of SOEs to government and the environment in which they operate and the many preconceived notions about them are discussed in Chapter 2.

The heterogeneity of experience with nationalization or the creation of SOEs suggests that there were many reasons for state ownership, some of them peculiar to a certain country. The origins of SOEs and the different motivations for their creation and continued existence are the topic of Chapter 3. Still, all SOEs appear to have encountered certain common problems and share certain identifying features, almost irrespective of the causes that brought them into being. Every SOE is expected to direct its operations on the basis of two somewhat contradictory orientations: being publicly owned, it is required to pursue social goals in the public interest. These goals may be to alter income distribution, to generate employment, to bring in foreign currency, to be a model employer, to promote new technologies or to create employment in laggard regions. At the same time, it is expected to be oriented to the achievement of strict economic goals: to be profitable and to attempt to achieve efficient operations and allocation of resources. Questions related to goals are the topic of Chapter 4.

When SOEs are profitable, they become an important source of capital accumulation. Whether these funds become available for other enterprises depends on organization and control procedures. In practice, most SOEs are not net providers of funds. Their record, if measured in terms of profitability, is rather dismal; most SOEs constitute a chronic burden on the public treasury. Profitability is only a partial and inadequate measure of SOEs' performance. After all, they were created to achieve national goals, not profitability. Many economists believe that "pricing of publicly supplied goods is the primary vehicle for embedding public enterprises adequately into a market economy" (Bös, 1981, p. 1). The questions of performance, efficiency and effectiveness and their measurement as well as a comparative analysis of these variables between SOEs and privately owned enterprises are addressed in Chapter 5.

Private firms, although they may be constrained by government regulations, are expected to seek profits. The task of state-owned firms is different. Instead of private gain, SOEs are supposed to seek social reward. A profit-making SOE need not be performing in the interests of society. How is the state to ensure that the SOE indeed seeks to improve social welfare?

SOEs, being publicly owned, are expected to be accountable to the public, as represented in democratic societies by the legislature. They have, therefore, to reconcile the business requirements of operating and financial flexibility and prompt reaction to a changing environment with the need to assure public accountability and consistency with government policy. These enterprises, being publicly owned, are also expected to disclose publicly details of operations and financial conditions; but, being business enterprises, they must enjoy the freedom to maintain a minimum degree of business secrecy. It would seem that all SOEs strive to achieve a considerable measure of autonomy and make a conscious move to achieve this goal. The central question faced by SOEs is how to preserve the advantages of independent operation through a distinctive entity, an enterprise, while being responsive to government and accountable to bodies that represent the state, the taxpayers and the political process. Some governments have coped with the problem of multiple goals by denying their validity (e.g., Chile or Pakistan). Others did not make any attempt to separate ministerial responsibilities from those of SOEs—often at a high price of efficiency loss and a lack of any sense of direction, frictions and resentments. The French government attempted to solve the problem by negotiating program contracts with its SOEs. Others—Canada, e.g.—attempted commercialization, "thus enabling management of government-owned business corporations to operate with less reference to government and with a greater degree of discretion in decision-making" (Sexty, 1980, p. 377). The relationships between governments and SOEs is a major determinant of the efficiency of their operations. It is not easy to achieve trust, continuity, and accountability. Elaborate regulations and detailed controls may choke managerial initiative, hobble activities, impair flexibility and reduce innovation. The challenge, therefore, is to design a method of social control that ensures adequate accountability, without the detailed and multiferous controls that may hamper managerial efficiency or cause too many resources to be diverted either to the controls or to ways to circumvent them. The manner, scope, character and mode of the interactions between governments and SOEs are the subjects of Chapter 6.

Parallel with the tremendous growth of SOEs, a major shift is discernible in the officially proclaimed attitudes of governments toward these enterprises. In one country after another, laws have been introduced and reports written, urging these enterprises to earn a return for the taxpayers and behave in a businesslike fashion. Although these official declarations are not always followed in practice, there has been a move toward more aggressive profit-seeking behavior by SOEs, making them direct competitors of private firms. The more they compete, the more SOEs are expected to behave like private enterprises. Such competition is often perceived as immoral and predatory. The relationships between SOEs and their counterparts in the private sector as well as the need for special rules of conduct for SOEs are analyzed in Chapter 7.

In discussing the pros and cons of state ownership of enterprises or the achievement of public goals through nationalization, these enterprises are usually treated as uniform rational organizational units, attempting to maximize the achievement of their prescribed goals. The managers who coordinate and direct the pursuit of organizational goals are either ignored or implicitly assumed to be totally committed to these goals. However, organizations are not monolithic entities, and managers have a strong impact on the organizational goals actually pursued. The implications of variables such as managerial recruitment or managers' attitudes and their quest for autonomy are discussed in Chapter 8.

Unconstrained government action may result in a significant reduction of independent decision-makers in the society. Moreover, the total weight of the government on the economy and on citizens is viewed by many as having reached threatening proportions. Many economists see SOEs as a necessary evil, are hesitant to add to the responsibilities of governments and search for alternatives, including privatization. Problems of privatization are discussed in Chapter 9.

Since the 1960s, SOEs have been playing an increasing role in international trade and investment. The world in the 1980s is very different from that analyzed by Ricardo. In industries such as oil, petrochemicals, metals, automobiles, airlines, aerospace, shipping, shipbuilding, banking and agriculture, a growing percentage of international trade and production is carried out by SOEs or in government-to-government deals. As they pursue their national goals, governments use SOEs in ways that are regarded as injurious and unfair to the economic interests of other governments. The incidence of such cases seems to be increasing, generating a potential source of political friction of some consequence among advanced industrialized societies.

The implications of this new trend are not completely understood, but some of the contours of a theory to account for the presence of SOEs are beginning to come into view. The role of SOEs in the international arena and its implications for a more general analysis of the political economy is the subject of Chapter 10.

SOEs are a very heterogeneous group, varying both within and across countries. Some of them behave very much like a private enterprise operating in the same products and markets. Others, such as the French theater, the Austrian opera or the Mexican social security administration, share more of the characteristics of a traditional government unit and are beyond the scope of this book. Others, like most development banks, are essentially instruments of the government, transmitting governmentally supplied, subsidized, and often guaranteed credit to individuals chosen by government and for purposes determined by the bureaucracy.

In sum, state ownership is neither a panaca nor the only explanatory variable of behavior. Nationalizing the means of production does not change the necessity of management and does not necessarily lead to nationalization of the way managers think. Managing SOEs in today's complex world is an extremely difficult task. This task is more difficult than in private enterprises because of the necessity for catering to the needs of diverse publics. The problem of goal multiplicity is not easily solved. Managers must have enough rewards and discretion to make such a task meaningful rather than impossible.

To understand SOEs, a contingency theory is needed. In Chapter 11 the variables that seem to explain managerial behavior in SOEs are discussed. These firms are an emanation and extension of the state, and their behavior cannot be understood without understanding the role of the state and the groups that control its apparatus. Understanding the institutional setting and the perceptions of the different players will provide, it is hoped, a better picture of how decisions in the real world are reached and what are the magnitudes of different phenomena. This model may also suggest some of the contours of a theory of SOEs.

Yair Aharoni

ACKNOWLEDGEMENTS

Israel provides the researcher an ideal laboratory on the management of different sectors in the economy. I became interested in this topic in 1963, when I first compared the work of the boards of directors in the three sectors of our economy. Since then, I was fortunate to be a consultant to government, Parliament and enterprises—and learnt a good deal about the management and evolution of SOEs. My work with these different groups convinced me of the need to carefully examine the role of ideology, as well as to distinguish between myths and realities. This book summarizes lessons I have learnt from many managers, politicians, friends and colleagues, too many to be mentioned individually.

In 1978, I was invited to Harvard Graduate School of Business Administration to study state-owned enterprises. The time spent interacting with the members of the Boston Area Public Enterprises Group mainly provided intellectual support, stimulation and insights. In addition, I had the opportunity to observe management processes in action by working as a consultant to the Bolivian government and by working with groups of managers who came to Harvard for workshops on SOE management. I am sincerely grateful to my colleagues in Tel Aviv University and in BAPEG for the opportunity to learn from each other.

Ed Epstein, a long time friend, encouraged me to write the book and Bill Roberts was always eager to lend a hand during its production. I am deeply indebted to Christian Koenig, Leroy Jones, Ravi Ramamurti, Brian Levi and Zvi Adar for contributing ideas and suggestions and for providing penetrating insights. Christian Koenig and Eli Segev were especially helpful in critiquing drafts of several chapters. Raymond Vernon provided stimulation and useful ideas in the formulative stages of the project.

The task of putting the book together was made less onerous due to the help of many secretaries in the U.S. and Israel who struggled through piles of difficult handwritten pages. Most of this work was carried out by Dafna Baskin, Nava Ovadia and Diana Rubanenko who typed quickly and accurately many drafts of the book, meeting impossible deadlines with work of superb quality. Gerda Kestler and Shirley Gassner also provided excellent editorial assistance. Shira Bareli managed to check many obscure references and contributed as a research assistant in many other ways.

In writing the book, I used several of my previous publications on the topic. I am grateful to Gomeh publications for allowing me to use part of my Hebrew book on SOEs, to the Israel Institute of Business Research for providing support to several works comparing state and private enterprises, to Columbia Journal of World Business and to Cambridge University Press for allowing me the use of previous publications.

Writing such an ambitious work has taken a heavy toll on family life. To my wife, Nili and my daughters, Maia and Orna go that special thanks of love for bearing with me through many agonies. Their support, tolerance and encouragement during these years providing a loving home life, has made the task so much more enjoyable.

CONTENTS

CHAPTER 1
An Overview

INTRODUCTION

State-owned enterprises (SOEs) are becoming quantitatively as well as qualitatively more important in the economies of developed as well as developing countries. The state has come to own or participate in an increasingly large number of trading bodies. The ubiquitous presence of SOEs across a broad ideological spectrum, their rapid expansion and increased significance, and the wide-ranging implications of their performance for achieving economic, political and social objectives have generated a great deal of interest in the methods they use to set priorities for resource allocation and in the way these enterprises are managed to achieve their objectives.

SOEs are an ancient phenomenon, with a history that stretches back thousands of years. In Renaissance times mining and metallurgy in several countries were dominated by SOEs. France's Maisons Royales produced many articles, the most famous of which were Saint Gobain glass, Sèvres porcelain and Gobelin tapestries, and many countries used fiscal monopolies and operated the postal services. In the nineteenth century SOEs were created to build railroads, construct canals and run municipal gas and water undertakings and telephone systems. In countries such as Belgium and Canada, SOEs have come to play a major role in pursuing nation-building objectives: forging a unified and integrated nation from the widely dispersed and diverse peoples and regions was a reason for governmental provision of certain services–notably, rail transportation. Nevertheless, SOEs were a minor phenomenon until World War I.

Since the 1930s the share of mixed economies controlled by SOEs has been on the rise and it accelerated after World War II. Until the 1950s, such enterprises were concentrated mainly in fiscal monopolies, monopolistic public utility-type industries (such as port authorities, railroads, bus transportation, water or electricity) or in direct services to government (such as a government printing office), or they were acquired to ensure that the commanding heights of the economy remained in public hands and subject to government direction. In some countries, like Italy, SOEs were also created to salvage private firms that were going under. In Spain, INI was created in 1941 to help develop the industrial sector. Although Turkey, Japan, Germany and Mexico also established SOEs in the manufacturing sectors in the 1930s, the proliferation of SOEs in that sector is a relatively recent phenomenon. In many developing countries—notably in Africa—industry itself is of recent origin.

From 1946 to 1970, an increasing number of LDCs (less developed countries) gained independence, and seventy-five new nations joined the United Nations, sixty-one of them from Africa, Asia and Latin America. Some of the LDCs reserved certain sectors exclusively for SOEs, as industrial policy enunciations show in India, Bangladesh or Trinidad and Tobago. In the 1950s and 1960s many governments in the developing countries, anxious to accelerate the rate of growth of their economies, created SOEs as part of their national programs of import-substituting industrialization. They also used SOEs to achieve control of major industries, previously owned by foreign investors—in particular, when these firms were considered symbols of political and social repression and economic domination. In the same period, developed countries created SOEs to promote high-technology industries, to develop certain regions of the country or to direct long-term credit for purposes deemed of national importance.

In the late 1960s and early 1970s, developing countries (and Canadian provinces) expropriated foreign-owned properties on a massive scale, especially in oil and minerals, and developed countries created SOEs to avoid selling domestic firms to foreign nations. Governments have also created SOEs to increase capital formation, to augment the information government has on private business operations or to influence output and pricing decisions in crucial sectors of the economy. The share of financial institutions in SOEs' value added has increased in nearly all countries. SOEs have been used to protect workers against the risk of unemployment and to save private entrepreneurs in declining industries who are suffering from losses. Thus the hard coal industries in the United Kingdom, Canada, France, Italy, Spain and West Germany were brought under state ownership or control to avoid closure: three-quarters of the Swedish shipbuilding industry was brought under government control. In many more cases, governments decided to bail out firms to avoid the political repercussions of lost jobs, despite the heavy drain on the public purse.

Existing SOEs, anxious to expand their operations, despite the heavy drain on the public purse, have created subsidiaries or acquired more business firms at home or abroad. In France, the Mitterrand government nationalized in early 1982 thirty-six major private banks, and six large multinational industrial concerns, and bought control stakes in three other companies.