POLICY BRIEF

Reforming State-Owned Enterprises in Central Asia

Private sector involvement in various industries can help reduce government expenditures. Photo credit: ADB.

Privatization and corporatization can reduce costs, raise productivity, and improve social welfare.

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Introduction

In key sectors of most Central Asia Regional Economic Program (CAREC) economies, state-owned enterprises continue to maintain a dominant role. They are significant borrowers and trade controllers of major exports and imports and command a sizable share of public resources.

Low productivity state enterprises, however, slow economic growth in countries where they have a significant share. In addition, they make the business environment more difficult for the private sector (Taghizadeh-Hesary, et al, 2019).

Privatization of state enterprises can introduce competition in the market, which can reduce costs and increase social welfare. Several countries have managed to adjust their inefficient economic structures through privatization. Each country, however, should identify the specific reasons for their economic challenges and opt for customized solutions.

The issue of state-owned enterprises' efficiency is relevant both for the central government and society since they provide various products and services. Thus, it becomes necessary to introduce holistic and transparent mechanisms for improving their productivity.

Context

State-owned enterprises actively provide social services (Forfas, 2010) and preserve social stability (Huang, et al, 2010). They often dominate sectors, such as finance and telecommunications. In 2015, 51% of global activity among these enterprises was concentrated in electricity, gas, transportation, telecommunications, and other utilities, which make up about 70% of total employment in state enterprises. In the People's Republic of China, financial firms hold over half of the state-owned enterprises' value, while manufacturing, electricity, gas, transportation, and other sectors each accounted for about 5%.

In Central Asia, the governments' large role in the economy is reflected in the dominance of state-owned enterprises in the local markets, which impedes efficiency and entrepreneurship. In Kazakhstan, for example, these companies account for about half of total value-added, one-third of employment, and hold assets equal to nearly half of the gross domestic product (GDP). In Uzbekistan, they account for about half of total value-added and 20% of employment. (World Bank, 2018; OECD, 2018a).

Inefficient state enterprises make the business environment tough for the private sector. While state enterprises find it easier to access state-bank loans, access to finance is challenging for private businesses.

In Central Asia, measuring the financial and economic performance of state-owned enterprises remains an issue. Politics prevails over economics. Civil society and other stakeholders do not necessarily have a platform to raise concerns about the effective management of these enterprises, which is why it is necessary to reform the public sector to improve productivity, provide a level playing field to the private sector, enhance competition, and boost innovation.

Policy Options

Practitioners involved in the reform of state-owned enterprises suggest privatization and corporatization as policy options. Privatization is a process where public sector facilities and functions are transferred to the private sector, while corporatization is the process of transforming state assets and government agencies into corporate entities. Their basic goal is to end the dominant and inefficient role of the government in the economy so that it can grow faster.

Turning state-owned enterprises into profit-making entities led by free-market rules will improve their efficiency. Competing with other firms for customers and market share may provide the required pressure to stimulate greater efficiency and profitability and identify competition as a major determinant of the post-privatization performance improvements (D’Souza, et al, 2007).

Benefits of privatization include a decrease in budget deficits caused by injecting government funds into inefficient state-owned enterprises; the end of costly subsidies; a smaller government workforce as part of rationalization; the release of public funds locked in non-profitable state enterprises; and an increase in revenues since the government no longer needs to provide large financial contributions to these enterprises.

Since privatization is a strategy, it should be applied to reach a balance between political and economic goals. However, privatization alone does not solve all issues and may not apply to all state-owned enterprises. While turning a profit is important, focusing on profitability as the sole assessment criterion for state enterprises will mislead policymakers. The nature of many state enterprises is to generate social welfare, not only profit.

Implementation challenges

Policies for corporatization and privatization often experience a set of challenges, including the following:

Lack of a price-setting mechanism

An important issue to be considered is the pricing of economic units to be privatized. Underpricing would generate a windfall for the private buyers while overpricing would scare off prospective investors. The government also needs a mechanism to prevent corruption.

Assets can be priced rationally by considering their income-generating potential, historical performance, and the amount of investment needed to make the assets operational and profitable. Evidence suggests that this approach was underestimated in many developing countries during privatization, leaving the door open for many flaws in the process.

Unrealistic goals

Thousands of large and small state enterprises cannot be privatized in a short period of time if the private sector does not have the capacity to absorb them.

Lack of comprehensive plan

Many Central Asian countries lack strategy and do not have comprehensive corporatization and privatization plan with a clear timetable.

Lack of public awareness

Market players do not know how they can engage in the privatization process. For example, if privatization takes place through the stock market, potential investors need to be informed. However, evidence shows, that majority of privatization in the region happens without creating awareness about the sale, which deprives potential investors of the opportunity to invest.

Lack of privatization expertise

Many governments do not have the expertise to devise a plan to meet the country's needs and realities and implement this accordingly. Without such expertise, governments miss the opportunity to reduce the size of the public sector and decrease their financial liabilities as well as increase their financial means and foster development of the private sector.

An example is the sale of stocks below market value due to a wrong valuation. This can result in corruption, loss of public assets to speculators, the bankruptcy of the privatized enterprises, and a worsening of the government's financial status.

Underdeveloped capital market

Central Asian economies are often characterized by bank-dominant economies (Yoshino and Taghizadeh-Hesary, 2015). The financial markets in developing Asia, including Central Asia, are dominated by bank loans. The share of capital market and non-banking financial institutions is insignificant.

Given that selling shares of state enterprises is the main form of privatization in many Asian economies, the underdevelopment of the capital market can be considered a serious challenge. On the other hand, if governments have a clear plan for developing the capital market, there could be a synergy between privatization and capital market development, as the sale of state assets provides a tremendous impetus to stock market activity (McLindon, 1996).

Recommendations

Drawing on the experiences of Central Asian economies in the corporatization of public assets and privatization of state-owned enterprises, the following policy recommendations are proposed both for countries in the region and other countries undergoing similar processes:

Start with small-scale privatization

Examples of unsuccessful cases show the privatization of large companies at high price tags, which the private sector could not afford. The process should have started with the privatization of small and less expensive companies to help the private sector generate the required capital gradually to afford the privatization of large companies.

The merit of this approach is evident in the case of Central and Eastern European countries, where they adopted separate privatization programs for small-scale enterprises. For example, the Czech Republic used auctions while Poland gave concessions to insiders.

Small firms proved easier to privatize than large ones. Most small firms in transition economies were concentrated in trade and services and used simple technologies, easy entry, and rapid returns. This helped reduce both uncertainty and risk for generally risk-averse post-transition investors. Large-scale privatization is often delayed because of high capital requirements, major restructuring needs, and regulatory weaknesses.

Managerial reform is a must

Often, existing personnel and management in state-owned enterprises resist privatization due to fear of lost privileges and benefits associated with their positions in companies. But it is critical to elect or appoint management with the right mindset and change managerial approaches for a privatized enterprise to spur quality and competitiveness of the privatized products and services.

Additional measures to consider

Privatization in Central Asia and similar economies can be made more effective through the following:

1. Provide transparency about the privatization policies to the public.
2. Consider the local culture and context; do not follow external advice blindly.
3. Draw lessons from previous attempts of privatization and other country experiences.
4. Liquidate nonproductive enterprises and find more productive use of their properties instead of privatizing them.
5. Establish an independent advisory body for the privatization of state-owned enterprises.

Resources

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