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STATE-OWNED ENTERPRISES

State-owned enterprises have historically played an important role across the EBRD regions. Today, they account for almost half of all public-sector employment. In many economies, state enterprises have more or less disappeared from the manufacturing sector over the last 20 years or so. However, they remain important providers of energy and (often subsidised) services such as railway transport and municipal utilities. They are often tasked with providing such services to poorer and more remote sections of the population, especially in countries with limited capacity to involve the private sector in the provision of public services. State enterprises can also act as automatic stabilisers when faced with adverse economic and technological shocks, providing more stable sources of employment during downturns and in economically disadvantaged regions. However, significant challenges remain when it comes to improving the corporate governance of such enterprises.







Introduction

State-owned enterprises have historically played an important role in the EBRD regions, both in post-communist economies and in the southern and eastern Mediterranean (see Box 2.1). While state enterprises still account for almost half of all state employment in those economies (with the other half comprising employment in the broader public sector – including education, healthcare and public administration), their role has changed considerably since the 1990s.

This chapter starts with a brief discussion of the rationale for state ownership, before presenting a snapshot of what a typical state enterprise in the EBRD regions looks like today. Thirty years after the start of the transition process, such enterprises continue to play an important role in the manufacturing sectors of lower-income economies. However, in many other economies in the EBRD regions they have more or less disappeared from competitive sectors such as manufacturing. These days, state enterprises tend to be more concentrated in network industries (such as utilities), natural monopolies (such as the railway sector) and commodities.

There is a large body of literature comparing the performance of state-owned enterprises and similar private firms and raising concerns about inefficiencies at state enterprises. Such enterprises have often been found to employ too many workers relative to their output, with privatisation

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typically being found to improve firms' performance.¹ Similar trends have been observed for state-owned banks (see Chapter 3).

State enterprises' low levels of productivity and profitability may, to some extent, reflect the non-financial objectives of such entities, which go beyond the maximisation of profits and include things like the provision of subsidised services, support for economic activity in disadvantaged regions or in the face of economic and technological shocks, or the protection of the environment. These are all discussed in this chapter. State ownership is often also considered to be important in sectors of strategic interest, such as defence.

The inefficiencies of state enterprises also reflect weak governance, with recent studies finding that the performance gap between state and private enterprises tends to be narrower in economies with better governance and well-defined institutional arrangements.² The last section of this chapter provides in-depth analysis of the governance of state enterprises. Drawing on a comprehensive new review of the country-level legal frameworks governing state enterprises in the EBRD regions, as well as firm-level practices and lessons from the EBRD's work with state-owned clients, that section makes practical recommendations with a view to improving state enterprises' governance.

The rationale for state ownership

State intervention to address externalities

There are various reasons why a government might want to establish and maintain state ownership.³ A state presence is often justified, for example, by the need to address market failures – for instance, in natural monopoly scenarios and network industries, where a privately provided service could be incomplete or inadequate, or on account of significant externalities.

In the context of natural monopolies (industries with infinite economies of scale, such as water supply and sewerage), the initial cost of building the necessary infrastructure may be so large that private firms are reluctant to enter the market or unable to achieve efficiencies of scale. Many of these are also network industries (as in the case of the transmission and distribution of electricity). These sectors require fixed infrastructure and a high degree of standardisation in order to serve customers efficiently. At the same time, providing network services (such as train services or access to broadband) in sparsely populated areas may not be profitable from the service provider's perspective, but may be crucial for regional development and ensuring equality of opportunity among citizens. State intervention is also necessary where markets fail to internalise externalities such as pollution.

¹ See Megginson (2000, 2016), Estrin et al. (2009), and Estrin and Pelletier (2018). See also Matuszak and Szarzec (2019), Borkovic and Tabak (2020), and IMF (2019) for recent evidence from the EBRD regions.

² See Mühlenkamp (2013), Estrin et al. (2020) and Szarzec et al. (2019).

³ See OECD (2005, 2015) and World Bank (2006).

State ownership can also be used to lean against rising regional disparities by providing employment in areas that have been affected by adverse economic or technological shocks, or where private-sector employment is scarce, preventing a vicious circle of rising unemployment, emigration and further economic decline.

Alternatives to state ownership

In most of these cases, state intervention need not necessarily take the form of state ownership of enterprises. Services such as rail transport or broadband can be provided by private companies, with government subsidies and public service obligations ensuring universal coverage. Poor households facing large utility bills can receive targeted means-tested benefits. The state can lean against rising regional disparities through fiscal transfers, targeted investment and other industrial policy measures (see Chapter 1). Well-designed social safety nets can act as automatic stabilisers in the face of economic and technological shocks. And environmental objectives can be pursued through regulation and taxation.

Each of these policy alternatives involves costs and trade-offs. State-owned enterprises face unique governance challenges as a result of the multitude of objectives that they may have to pursue at the behest of the state, with those objectives often lacking clear definition. The state is typically able to maintain a tight grip on its state-owned enterprises – often doing so with multiple hands. However, lines of influence and accountability may be complex and blurred owing to the complexity of governments' administrative structures, with numerous government ministries and agencies exerting influence simultaneously. State support may be extensive, but not transparent, and politicians may interfere with state enterprises' appointments and operations. This may result in soft budget constraints, ineffective supervisory boards, weak management and poor performance. While these issues have been documented extensively in previous studies, the second half of this chapter revisits the question of state enterprises' corporate governance, drawing on a comprehensive new review of the country-level legal frameworks governing state enterprises in the EBRD regions.

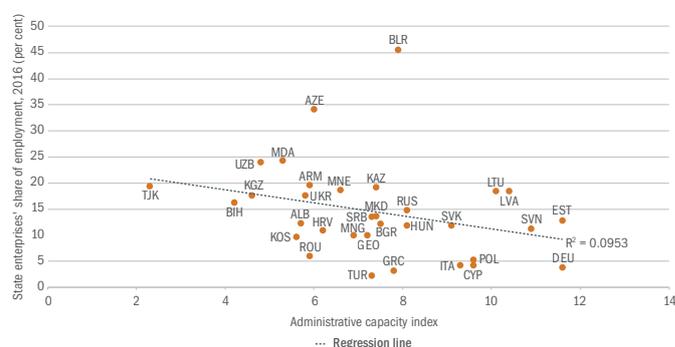
Alternative solutions involving the private provision of services under a public service obligation require a certain level of administrative capacity in order to set up such schemes and monitor their implementation. The same is true of targeted means-tested benefits providing support for the poorest households in society, as well as social safety nets aimed at tackling the adverse effects of economic and technological shocks at both household and regional level.

State enterprises are more prevalent where administrative capacity is lower

For these reasons, state-owned enterprises tend to play a somewhat greater role in countries with more limited administrative capacity (see Chart 2.1). In countries with

CHART 2.1.

State enterprises tend to step in where administrative capacity is more limited



Source: Global Findex Database, UN DESA, World Bank and authors' calculations.

Note: The administrative capacity index takes account of a measure of e-government (which looks at the scope and quality of online services, the development of telecommunication infrastructure and inherent human capital), a Worldwide Governance Indicator measuring the effectiveness of government, a Doing Business indicator assessing the distance to the frontier and an indicator measuring the routine use of bank accounts by the country's population. See Box 1.5 for details.

sufficient administrative capacity, alternative policies such as targeted social safety nets and public service obligations are often preferred, given the concerns about the inefficiencies and weak governance of such enterprises. Where administrative capacity is lacking, state enterprises may be seen as a suitable second-best policy choice. For instance, while low-productivity employment in the public sector may be costly for the taxpayer and the economy, an alternative that involves persistently high unemployment in a region that is lagging behind economically may be associated with even greater long-term costs. Those costs extend beyond the direct impact on individual households and include long-term externality costs caused by rising inequality and the erosion of social cohesion and trust. As noted in Chapter 1, differences in citizens' preferences across societies may also help to shape the landscape in terms of the role that state-owned enterprises play in the economy.

State-owned enterprises: a portrait

In the mid-2010s, the state accounted, on average, for about a quarter of total employment in the EBRD regions (see Chapter 1), of which around 44 per cent was accounted for by state-owned enterprises (based on the results of the 2016 round of the Life in Transition Survey). The contribution made by state enterprises was particularly large in Azerbaijan and Belarus, whereas the broader public sector (areas such as education, healthcare and public administration) accounted for the bulk of state employment in Turkey, Cyprus, Greece and the southern and eastern Mediterranean (see Chart 2.2).

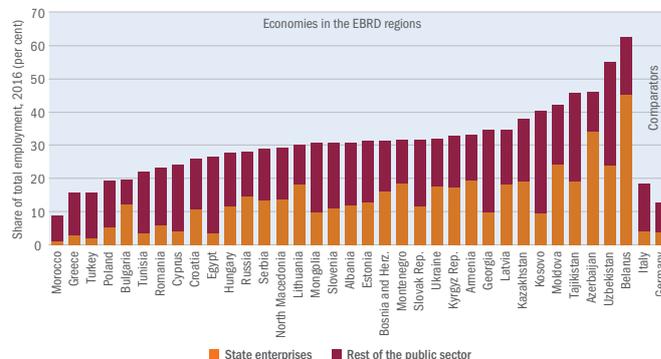
State-owned enterprises are typically larger than private firms, with the private sector being dominated by small companies: over a third of state enterprises in the EBRD regions have more than 100 employees, while 45 per cent of private firms have 10 employees or fewer (see Chart 2.3). A similar pattern can be observed in advanced economies. As discussed in the following sections, a single state enterprise (such as a railway company, a coal-mining firm or an oil company) can employ tens of thousands of people and dominate the labour market of an entire municipality, city or region.

State-owned enterprises are concentrated in the transport and utility sectors

While sectoral data for the early years of the transition process are scarce, state enterprises in the early 1990s were typically manufacturers (operating large plants in heavy industries, for instance). This picture has changed significantly, with many of those manufacturing firms being privatised or going bankrupt. Analysis based on a unique OECD dataset examining the sectoral composition of state-owned enterprises suggests that by 2015 those enterprises were concentrated in the transport and public utility sectors, often being owned locally rather than centrally (see Chart 2.4).⁴ In the eight EBRD economies covered by the OECD database (Estonia, Greece, Hungary, Latvia, Lithuania, Poland, Slovenia and Turkey), transport, electricity, gas and other utilities account for a combined total of 69 per cent of employment by state enterprises. This is similar to the picture observed in a sample of advanced economies. In comparator emerging markets (Argentina, Brazil, China, Colombia, Costa Rica, India and Mexico), state enterprises continue to play a more important role in primary sectors and manufacturing. This suggests that state enterprises' shares of competitive sectors – those where concerns about the unfair advantages of state ownership distorting the level playing field are the strongest – may be falling.

CHART 2.2.

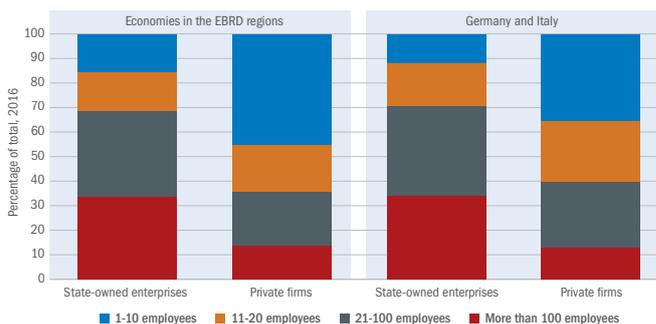
State-owned enterprises account for around 44 per cent of public-sector employment



Source: Life in Transition Survey 2016, ILO, OECD and authors' calculations.
 Note: These estimates are based on the answers of primary respondents in the Life in Transition Survey (except in the case of Egypt, Morocco and Tunisia, where estimates are based on ILO and OECD data).

CHART 2.3.

State enterprises are typically larger than private firms



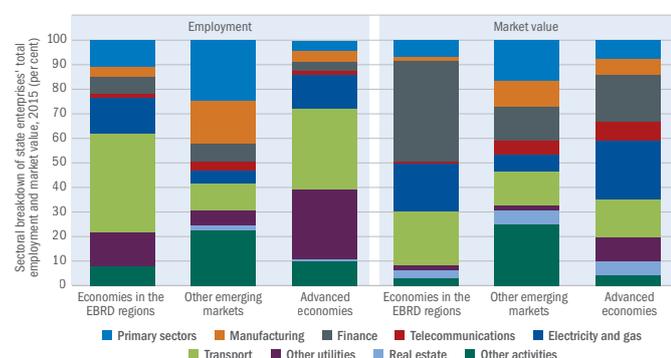
Source: Life in Transition Survey 2016 and authors' calculations.
 Note: These estimates are based on the answers of primary respondents in the Life in Transition Survey.

STATE-OWNED ENTERPRISES ACCOUNT FOR LESS THAN 10% OF MANUFACTURING EMPLOYMENT IN MOST OF CENTRAL EUROPE AND THE BALTIC STATES

⁴ See also European Commission (2018), IMF (2019), and Matuszak and Szarzec (2019).

CHART 2.4.

In the EBRD regions, state enterprises are concentrated in the transport and public utility sectors



Source: OECD and authors' calculations.

Note: These estimates are based on an OECD dataset on the size and sectoral composition of countries' state-owned enterprise sectors in 2015. "EBRD regions" refers to Estonia, Greece, Hungary, Latvia, Lithuania, Poland, Slovenia and Turkey. "Other emerging markets" refers to Argentina, Brazil, China, Colombia, Costa Rica, India and Mexico. These estimates only include enterprises that are engaged in economic activities in the marketplace, excluding entities that primarily perform a public policy or administrative function. "Market value" is defined as market equity for listed state enterprises and book equity for unlisted enterprises.

More state-owned manufacturers in lower-income economies

That being said, notable exceptions remain, with state enterprises remaining present in competitive sectors in some higher-income economies in the EBRD regions (such as the Hungarian, Polish and Slovenian chemical and pharmaceutical sectors). Meanwhile, the results of the Life in Transition Survey indicate that state enterprises are also still playing an important role in the manufacturing sectors of poorer countries (see Chart 2.5). Indeed, in Azerbaijan, Belarus and some countries in Central Asia, state enterprises account for 30 to 70 per cent of total employment in manufacturing, compared with less than 10 per cent in most of central Europe and the Baltic states (an estimate that is consistent across both OECD and LiTS data).

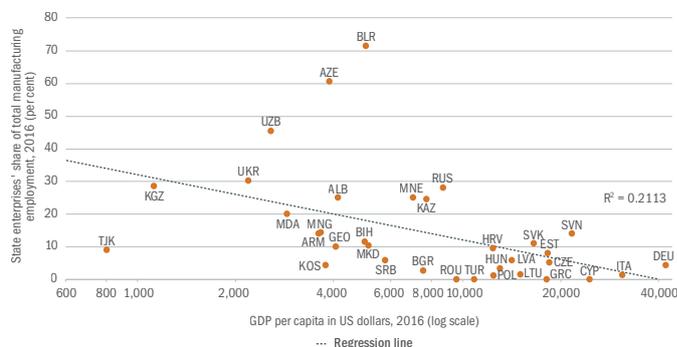
The rise of state-owned multinationals

Increasingly, state enterprises are also playing an important role at international level. National oil and gas companies, for instance (such as Rosneft and Gazprom in Russia), are often listed on major stock exchanges and operate internationally in ways that are similar to their private-sector counterparts.

Data from the United Nations Conference on Trade and Development (UNCTAD) indicate that there are around 1,500 large state-owned multinationals in the world, which represent just 1.5 per cent of all multinational enterprises but own about 10 per cent of all foreign affiliates and account for around 10 per cent of global greenfield investment.⁵ In contrast with their private-sector counterparts, state-owned multinationals are heavily

CHART 2.5.

State enterprises play a more important role in manufacturing in poorer economies



Source: Life in Transition Survey 2016 and authors' calculations.

IN AZERBAIJAN, BELARUS AND SOME COUNTRIES IN CENTRAL ASIA, STATE-OWNED ENTERPRISES STILL ACCOUNT FOR 30-70% OF ALL MANUFACTURING EMPLOYMENT

concentrated in natural resources and financial services (with the EBRD regions being no exception in that regard). In the EBRD regions, their ranks also include construction and engineering firms, as well as chemical firms and manufacturers of fertilisers.

Universal provision of affordable services

State enterprises pursue a wide range of objectives besides the maximisation of profits, with particular emphasis being placed on the universal provision of services at affordable rates. In a recent IMF survey, 90 per cent of governments in central, eastern and south-eastern Europe reported that their state enterprises had objectives relating to the provision of specific

⁵ See UNCTAD (2017).

public goods and services.⁶ Similarly, state-owned banks may pursue non-commercial objectives, such as increasing financial inclusion or improving access to finance for specific groups of customers (as discussed in detail in Chapter 3). This section looks at state enterprises providing transport services, utilities and broadband.

Railway companies: maintaining a service on unprofitable lines

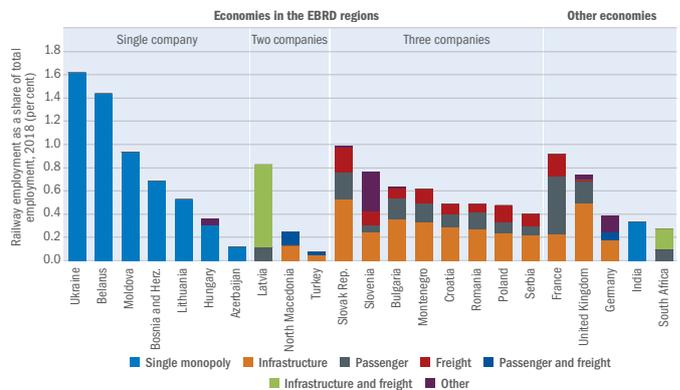
In most countries, railways have traditionally been run by monolithic vertically integrated entities, with those entities providing infrastructure, passenger and freight transport, and various related services. However, demand for reform has increased over the years, with a view to improving railways’ efficiency and financial sustainability, reducing the burden on government budgets and increasing the competitiveness of rail travel relative to other modes of transport.

Over the past 30 years, the European Union has encouraged the vertical unbundling of incumbent national railway companies, calling for (i) the establishment of separate providers responsible for passenger and freight transport and infrastructure, (ii) regulated access to the track for third parties, and (iii) policies to support competition. Such unbundling is intended to increase the transparency of the government support provided to railways. It also aims to boost competition between the railways and other modes of transport (although railways’ market shares have not generally increased following such reforms, and have declined in some cases).⁷ In the western hemisphere, meanwhile, reforms have focused on ensuring horizontal competition between vertically integrated private railway companies combining infrastructure, freight and passenger transport, with such companies often operating parallel services on routes with strong demand. In Japan, the privatisation of Japan National Railways has resulted in a system where passenger rail services are provided by vertically integrated regional companies. While the state-owned freight operator has access to their tracks, private freight companies can only enter the market by building their own infrastructure.⁸ Many countries in the EBRD regions (including most EU member states, some of the Western Balkans, Kazakhstan and Russia) have unbundled their state-owned railways into passenger, freight and infrastructure companies under the EU blueprint.

STATE-OWNED RAILWAY COMPANIES CAN ACCOUNT FOR UP TO 1.5% OF TOTAL EMPLOYMENT IN SOME COUNTRIES IN THE EBRD REGIONS

CHART 2.6.

Railway companies are large employers, particularly as national monopolies



Source: ILO, companies’ annual reports, national regulatory bodies and authors’ calculations. Note: All data in this chart relate to state-owned railway companies and joint ventures (with the exception of data for the United Kingdom and Germany). Data for the United Kingdom relate to 2019, rather than 2018. Hungary and Lithuania also have independent train path allocation and infrastructure-charging bodies (not included here). As of 2019, Lithuania has a holding structure with limited guarantees of independence.

IN SOME EBRD ECONOMIES IN THE EU, ONLY ABOUT A FIFTH OF RAILWAY COSTS ARE RECOVERED THROUGH PASSENGER FARES

Railway companies, which are still overwhelmingly state-owned in the EBRD regions, remain very large employers. Indeed, a single company can account for up to 1.5 per cent of national employment (with more than 260,000 people working for Ukrainian Railways, for example; see Chart 2.6). At the same time, unbundling often involves substantial job losses. In Serbia, for instance, 42 per cent of railway jobs were lost as a result of such reforms.⁹

Railway companies in the EBRD regions remain highly dependent on government subsidies (as do their counterparts in most advanced economies). Monopoly companies, in particular, often benefit from a range of direct and indirect subsidies (such as reduced fuel prices or tax breaks), which are often negotiated retrospectively. The writing-off of debts to banks and other state-owned enterprises supplying services (such as electricity companies) remains common. For example, Greece’s infrastructure management company and train operator benefited from debt cancellations totalling 7 per cent of GDP in 2011. And in 2016, prior to its unbundling, Serbian Railways had its debt to the state-owned electricity provider written off, with that debt totalling 0.1 per cent of GDP. By 2019, however, Serbian Railway Infrastructure, one of its unbundled successors,

⁶ See IMF (2019) and OECD (2018a).

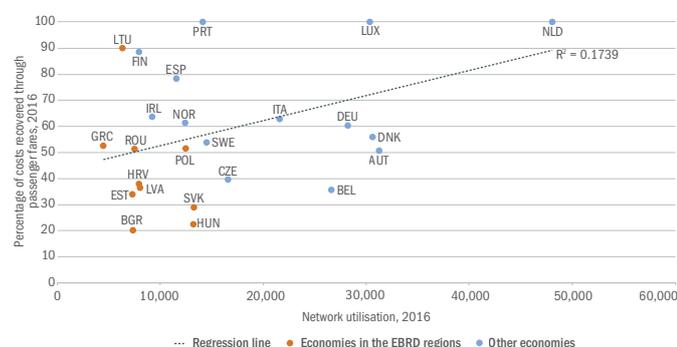
⁷ See, for instance, Laabsch and Sanner (2012), Mizutani (2019), Tomeš (2017), Van de Velde et al. (2012) and World Bank (2017).

⁸ See Working Party on Rail Transport (2012).

⁹ See IMF (2017).

CHART 2.7.

Network utilisation and cost recovery rates are low in EBRD economies



Source: European Commission.

Note: The vertical axis measures the percentage of the costs arising from public service obligations that are recovered through passenger fares. The horizontal axis measures network utilisation as the total number of kilometres travelled by trains for every kilometre of track. There are no data on cost recovery for France or Slovenia.

was again one of the largest debtors to the state electricity company.

Such subsidies typically aim to ensure the universal provision of affordable railway services. Information collected by the European Commission as part of its Rail Market Monitoring Survey reveals that few advanced European economies are able to recover all costs through passenger fares. This only tends to be the case in densely populated countries where rail networks are used intensively (such as Luxembourg and the Netherlands; see Chart 2.7). In sharp contrast, the EBRD regions are generally characterised by relatively low population density, low levels of network utilisation, and thus low recovery rates, resulting in a continued need for large subsidies. In some economies in central and south-eastern Europe, only about a fifth of costs are recovered through passenger fares.

Private competition remains limited in the EBRD regions' railway sectors. Where private operators exist, they tend to concentrate on the most frequently used and profitable lines, or on freight transport. Operating on less profitable and less frequently used routes, on the other hand, requires government subsidies or cross-subsidisation using the fares charged on other routes. In France, for instance, a group of regional lines account for 15 per cent of costs, but only 2 per cent of total users, and a similar pattern can be observed in the United Kingdom.¹⁰

While rail services are, in general, primarily used by the more highly educated and the better off, people with lower levels of education and income may be more likely to use regional routes. Indeed, they may often have few alternative travel options if such routes are cut. Where other options exist, commuting by rail tends to be more environmentally friendly than commuting by car.

PEOPLE IN THE POOREST INCOME DECILE IN THE EBRD REGIONS SPEND MORE THAN A FIFTH OF THEIR INCOME ON UTILITY BILLS

State ownership is just one way of providing an affordable service with universal coverage. As an alternative, universal provision can also be ensured by giving subsidies to private providers operating under public service obligations, and low-income households can be given targeted means-tested benefits to cover the cost of rail travel or utilities. However, these alternative approaches rely on the public sector having sufficient implementation capacity and entail their own costs. For example, ensuring universal provision through public service obligations requires clearly defined geographical areas, the careful calibration of payments, and the regulation and monitoring of providers.

Municipally owned utilities: targeting universally affordable services

Many municipal services in the EBRD regions are provided through state enterprises, which are often owned by local governments. As in the railway sector, universal access to affordable services is seen as an important economic policy objective, with lower-income households spending a larger percentage of their income on utilities. Evidence from the latest round of the Life in Transition Survey suggests that people in the poorest income decile in the EBRD regions spend more than a fifth of their income on utility bills – a significantly higher percentage than their counterparts in advanced economies.

As a result, utility prices are often set below the level that is required to recover costs. This leads to excessive consumption of energy with adverse environmental effects (see Chapter 4), and economic gains accrue primarily to the rich, who consume more electricity, gas and water. At the same time, however, increases in utility prices would have a disproportionate impact on the livelihoods of low income households unless such increases were offset by targeted means-tested benefits.

In countries with stronger economic institutions, state-owned utilities have the potential to be transparent and well-run. Indeed, a number of advanced economies have recently seen a wave of utility companies returning to

¹⁰ See Spinetta (2018) and Office of Rail and Road (2019).

municipal ownership (as witnessed, for instance, in the French water sector, the German energy services industry and the Norwegian waste collection sector) with the aim of increasing accountability.¹¹

In contrast, in countries with weaker economic institutions, subsidies tend to be larger and less transparent where utilities are provided by state-owned companies.¹² Large, non-transparent utility subsidies tend to go hand in hand with weak social safety nets, particularly in Central Asia and parts of the Western Balkans, suggesting that the two approaches are substitutes. Many EBRD economies with more limited administrative capacity have used price controls and utility subsidies as part of their economic response to the Covid-19 pandemic on account of their ease of implementation, despite such measures being a fairly imprecise way of channelling support to the individuals who need it most (see Chapter 1).

In countries with weaker economic institutions, well-defined private-sector participation may help to clarify contractual relationships between governments and service providers and increase the transparency of state support for municipally owned companies. By way of example, Box 2.2 discusses Romania’s experience of introducing private-sector participation in the area of district heating.

State intervention to ensure universal broadband services

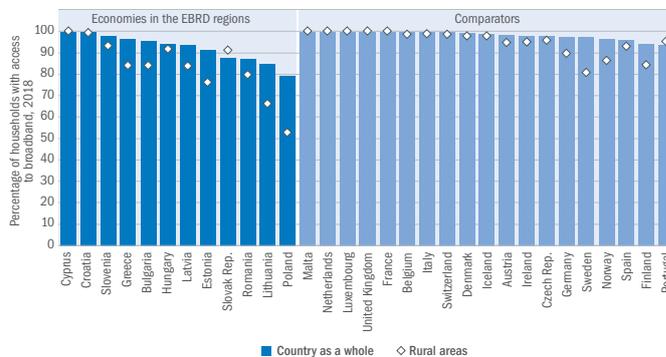
In most economies, the quality of broadband coverage in rural areas lags behind that seen in urban areas. In the EU, for example, only 88 per cent of rural households had access to broadband in 2018, compared with an average of 97 per cent across all households. That gap was more pronounced in central and south-eastern Europe. For instance, while 80 per cent of all Polish households had fixed broadband coverage in 2018, the figure for the country’s rural households was only just over half (see Chart 2.8). Such gaps have become even more problematic in the context of remote schooling and remote working during the Covid-19 pandemic, as discussed in Chapter 1.

In many countries, regional and municipal governments have stepped in to bridge this digital divide, offering affordable high-speed internet services in small towns and rural areas where low population density renders investment unprofitable for private telecommunication companies. Meanwhile, in the United Kingdom’s 2019 general election, the Labour Party manifesto even went as far as promising to provide free universal broadband through a partially nationalised British Telecom.

State intervention to ensure the universal provision of affordable broadband services has taken many different forms. Most EU countries use an operator subsidy model, whereby the state subsidises a network provider with the aim of establishing or upgrading the country’s network, extending coverage to areas with low population density. In contrast, some regions (including parts of Croatia, Latvia and Lithuania) have a fully public network model, whereby a public authority builds and

CHART 2.8.

In many countries, rural broadband coverage lags far behind that seen in other areas



Source: European Commission.

WHILE 80% OF ALL POLISH HOUSEHOLDS HAVE FIXED BROADBAND COVERAGE, THE FIGURE FOR THE COUNTRY'S RURAL HOUSEHOLDS IS ONLY JUST OVER HALF

owns the network and may provide services directly. In some cases, new municipal and inter-municipal partnerships have been set up to provide broadband services, with significant financial support coming from the central government. In Germany, for example, this model is used in more than 200 rural municipalities. In other economies, the state builds the network and remains its ultimate owner, but leases it to a private network operator on the condition that service providers enjoy fair and non-discriminatory open access.¹³

In South Korea, meanwhile, universal service obligations were crucial to ensure the construction of broadband infrastructure in rural areas following the privatisation of Korea Telecom, with state support covering half of all investment costs through a matching fund. In contrast, the universal service obligation framework in Uzbekistan does not currently

¹¹ See Kishimoto et al. (2019).
¹² See Foster and Rana (2019).

¹³ See Kishimoto et al. (2019) and BEREC (2017).

guarantee the provision of services at affordable rates for all consumers.¹⁴

Thus, there are various different models that can successfully be used to ensure the universal provision of broadband services, ranging from full state ownership to no state ownership, but they all tend to require state intervention in one form or another.

Other objectives: leaning against rising regional disparities

Technological changes have been reshaping the geography of production and the skill-sets that are demanded in labour markets. In that context, the economic importance of large cities has been increasing even faster than their share of the population. Conversely, many smaller cities, particularly those that are far from other urban agglomerations, have seen their local economies shrink and their populations decline. This has led to rising income disparities across regions within individual economies.¹⁵

Governments can use a range of tools to address rising regional disparities. These include direct fiscal transfers to support disadvantaged regions, investment in infrastructure, and incentive schemes (such as tax breaks) that encourage companies to locate themselves in particular regions. At the same time, measures aimed at improving the local business environment can help to attract domestic and foreign private investment.¹⁶

State employment as a way of supporting disadvantaged regions

State employment can also be used as a way of supporting economically disadvantaged regions. In the United Kingdom, for example, HM Revenue and Customs has opened offices in Liverpool, the Department for Work and Pensions has offices in Newcastle, the Office for National Statistics has offices in Newport, and parts of the BBC – a state-owned broadcaster – moved to Salford in Greater Manchester. Similarly, the German government moved various public bodies east after reunification. More recently, the German state of Bavaria launched a large regional development programme, with more than 50 public bodies either moving to rural parts of the state or being established from scratch in those areas. Meanwhile, Denmark has moved thousands of government jobs to scores of different cities; Norway has moved its competition authority to Bergen, moved the Norwegian Polar Institute to Tromsø in the far north, and moved the Norwegian peace corps (Norec) to the small town of Førde; and South Korea has moved two-thirds of its government agencies away from Seoul (many of them to the newly built Sejong City). And in 2012 Georgia moved

its parliament to Kutaisi, although that move has since been reversed.

The distribution of state employment across regions can have a significant impact on the location of private-sector activity. The effects of such relocation are likely to be larger where the relocated jobs are more highly skilled and where spending by employees and procurement by public bodies will generate greater demand for goods and services supplied by the private sector. Those effects can, in turn, be further enhanced by improvements to the business environment and transport links.¹⁷

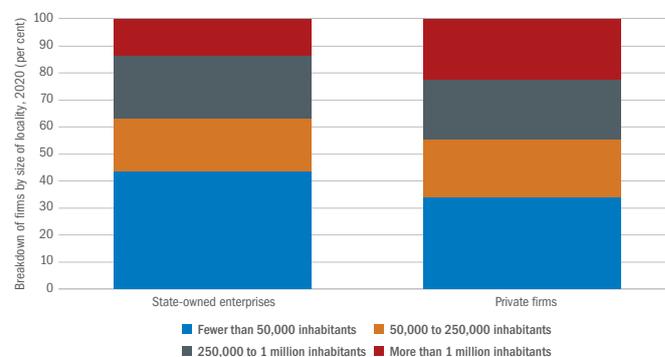
Against that background, this section looks at whether state-owned enterprises can help to support economic activity in disadvantaged regions. That analysis examines the spatial distribution of state enterprises using the latest round of Enterprise Surveys, which were conducted in 2018-20 by the EBRD, the European Investment Bank (EIB) and the World Bank Group and covered more than 25,000 randomly selected firms across the EBRD regions.

More state employment in smaller towns and rural areas

The results indicate that state enterprises are more likely to be located in smaller cities than private firms (see Chart 2.9). In the EBRD regions, 44 per cent of state-owned enterprises

CHART 2.9.

In the EBRD regions, state enterprises are more likely to be located in smaller cities than private firms



Source: Enterprise Surveys and authors' calculations.

Note: The Enterprise Surveys do not cover firms that are 100 per cent state-owned. In this chart, "state-owned" is defined as a firm where the state owns more than 50 per cent. These data represent simple averages. Very similar patterns are observed when using median eligibility sampling weights.

44%
OF STATE ENTERPRISES
IN THE EBRD REGIONS
ARE IN TOWNS WITH
FEWER THAN 50,000
INHABITANTS

¹⁴ See Saliency Consulting (2020).

¹⁵ See AfDB et al. (2019) and EBRD (2018a).

¹⁶ See EBRD (2019).

¹⁷ See Alesina et al. (2001), Becker et al. (2018), Faggio (2014), Faggio and Overman (2014), Institute for Government (2020), Schluter (2014), and Swinney and Piazza (2017).

are located in towns with fewer than 50,000 inhabitants, while only 13 per cent are found in cities of over a million. In contrast, only about a third of private firms are found in towns with populations below 50,000, while 22 per cent are located in cities of over a million. This pattern could, in part, reflect a legacy of central planning, under which secondary cities were consciously promoted and some state enterprises were sited without due regard for transport costs, as well as the fact that private investment is concentrated in large cities, benefiting from the presence of a large pool of highly skilled workers and a diverse range of customers and suppliers.

Disaggregated data on employment by type of ownership and sector for 380 Polish *powiats* (roughly equivalent to UK counties) allows for more detailed analysis of the spatial distribution of state employment (see Box 2.3). That analysis shows that the regions with higher unemployment in northern, eastern and south western Poland are also the ones with higher percentages of state employment (see Chart 2.10). Moreover, regression analysis can be used to link state employment (as a percentage of total employment) to the unemployment rate (unemployment as a percentage of the labour force) and various county-level characteristics (such as the sectoral composition of employment, the ratio of the working-age population to the total population, population density and NUTS 2-level regional fixed effects). That analysis reveals that a 1 percentage point increase in the county-level unemployment rate is associated with a

0.5 percentage point increase in state employment as a percentage of total employment. That relationship is not by construction to the extent that the two ratios have different denominators.

In regions with fewer private-sector employers, state employment (be it in public administration, education or healthcare, or in municipal utility companies, railway companies or post offices) becomes relatively more important as a source of local employment. In this sense, public-sector employment acts as an automatic stabiliser when regions experience adverse economic or technological shocks. Similarly, state-owned banks tend to be more important lenders in rural areas (see Chapter 3). Evidence from the latest round of the Life in Transition Survey confirms these findings. Residents of rural areas are more likely to work for a state enterprise or another public entity, even when taking into account individual characteristics such as their age, education or sector of employment.

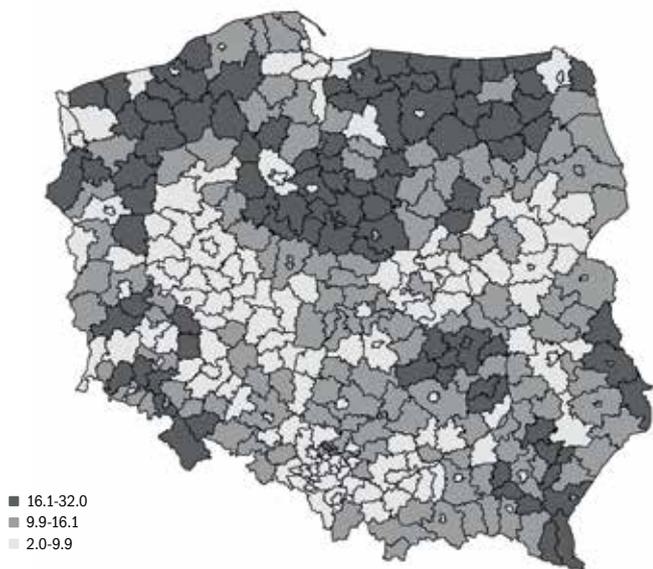
Residents of rural areas are more likely to regard the state as having primary responsibility for the creation of jobs

In line with those patterns, residents of rural areas also expect more from the state in terms of job creation. A survey conducted by the Austrian National Bank (OeNB) in 10 countries (nine of which are in the EBRD regions) asked respondents who they thought had primary responsibility

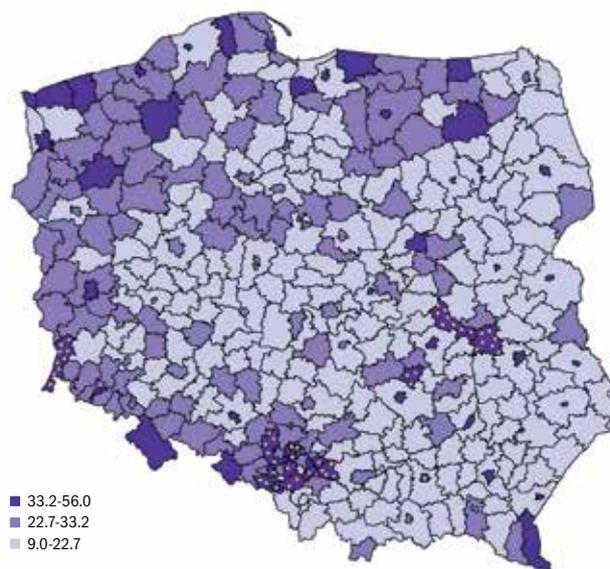
CHART 2.10.

State employment is higher in Polish regions with high unemployment

Average unemployment rate, per cent, 2012-18



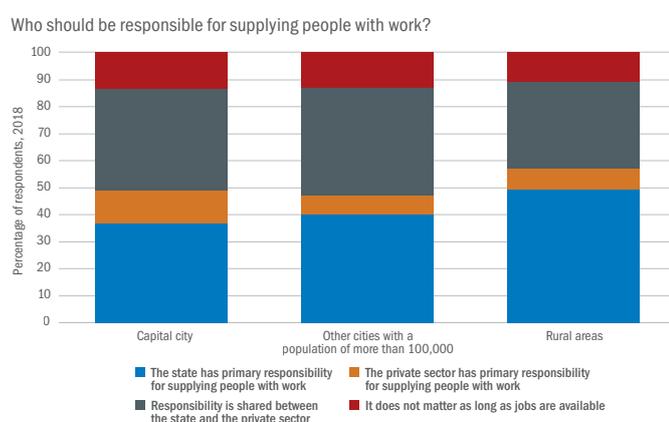
State employment as a percentage of total employment, per cent, 2018



Source: National Statistics Poland and authors' calculations.
Note: In the right-hand panel of this chart, "state employment" is defined as employment by a public-sector entity that is more than 50 per cent state-owned. Dots denote *powiats* in which industry accounts for a high percentage of employment.

CHART 2.11.

Residents of rural areas are more likely to regard the state as having primary responsibility for creating jobs



Source: OeNB Euro Survey and authors' calculations.

Note: Shares are weighted using census population statistics for age, gender, region, education and ethnicity (by country), before calculating simple averages across Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Hungary, Poland, Romania, North Macedonia and Serbia. Respondents who replied "don't know" or declined to answer are excluded.

for providing people with work. In the nine EBRD economies, almost half of all respondents living in rural areas thought the state should have primary responsibility for providing employment, compared with only 37 per cent of those living in capital cities. That difference remains statistically significant when controlling for individual characteristics such as age or education (see Chart 2.11 and Box 2.4).

Public-sector employment as an automatic stabiliser

Over the longer term, as discussed in Chapter 1, there has been an increasing tendency for the state to take on the role of insurance provider, establishing a safety net to protect against things like unemployment, ill health and disability. Recently, however, technological changes have been shifting some risks back onto individuals, with fewer permanent contracts, more subcontracting, the rise of the gig economy and more zero-hours contracts. The people who have been most affected by these developments are actually those who are least willing or able to tolerate risks – those with lower levels of income and education. Partly as a reflection of this trend, support for the expansion of public ownership has been rising, as public-sector employment is commonly regarded as a less risky choice, with more risk-averse individuals being more likely to work in the public sector.

ALMOST HALF OF ALL EURO SURVEY RESPONDENTS LIVING IN RURAL AREAS OF EBRD ECONOMIES THINK THAT THE STATE SHOULD HAVE PRIMARY RESPONSIBILITY FOR PROVIDING EMPLOYMENT, COMPARED WITH ONLY 37% OF THOSE LIVING IN CAPITAL CITIES

Public-sector employment responds less to the business cycle

There is a large body of literature showing that the investment and employment levels of state enterprises are typically less responsive to changing external conditions than those of private firms.¹⁸ Similarly, Chapter 3 shows that state-owned banks tend to be more stable lenders during crises. During the global financial crisis, for example, job losses and wage cuts at state-owned firms were smaller than they were at private firms.¹⁹ The EBRD's new survey of the legal frameworks governing state enterprises, which is discussed in the last part of this chapter, reveals that as many as a quarter of all economies in the EBRD regions explicitly restrict the dismissal of state enterprises' employees, over and above the job protection rules applicable to the private sector.

Public-sector employees less affected by the global financial crisis

Evidence from the Life in Transition Survey further corroborates these findings. Only 65 per cent of survey respondents who work for private firms in the EBRD regions have permanent contracts, compared with 82 per cent of people working for state enterprises (see Chart 2.12). Moreover, the crisis module in the 2010 round of the Life in Transition Survey also showed that public-sector employees were less likely to lose their job or experience delays in the payment of wages during the global financial crisis. These differences remain statistically significant when account is taken of individual characteristics such as age or gender, the size of the firm, and the sector and country of employment.²⁰ The employees of state enterprises

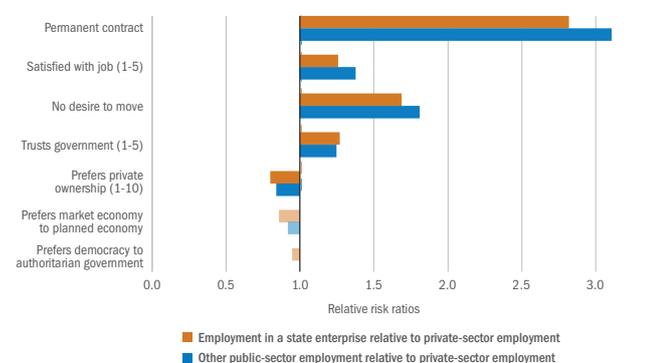
¹⁸ See Boeing-Reicher and Caponi (2016), Chen et al. (2017), Clark and Postel-Vinay (2009), Jaslowitzer et al. (2016) and O'Toole et al. (2016).

¹⁹ See IMF (2019), Jaslowitzer et al. (2016), Telegdy (2016) and Vladislavjević (2020).

²⁰ As one might expect, wage delays are determined primarily by the country and sector of employment, rather than individual characteristics.

CHART 2.12.

Public-sector employees are more likely to have a permanent contract



Source: Life in Transition Survey 2016 and authors' calculations.
Note: These estimates are derived from logit or ordered logit models with country fixed effects and country clustered standard errors. The sample is restricted to the EBRD regions. A coefficient larger than 1 suggests that being employed by a state enterprise or another public-sector entity increases the likelihood of the listed outcome relative to being employed in the private sector. Darker colours denote effects that are significant at the 5 per cent level. Regressions control for age, gender, marital status, urban/rural location, education and father's education.

and other public entities are also more likely to be satisfied with their jobs and less likely to want to move, even after controlling for household income, and they also trust the government more.

Public-sector employees less affected by the Covid-19 crisis

Early evidence also seems to suggest that, so far, people employed by the state have been more shielded from economic hardship during the Covid-19 crisis.

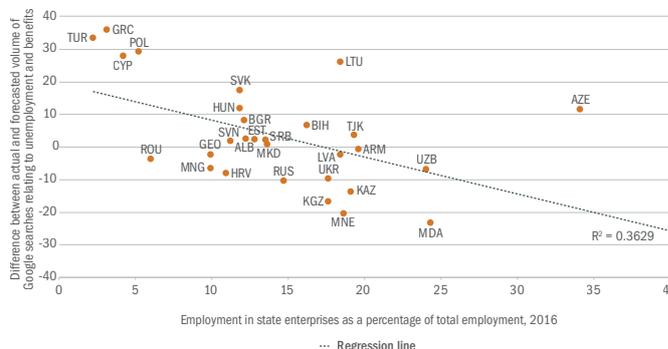
In August 2020, the EBRD and the ifo Institute (an economic think-tank) conducted a representative survey of 40,000 adults in 14 countries (Belarus, Egypt, France, Germany, Greece, Hungary, Italy, the Netherlands, Poland, Serbia, Spain, Sweden, Turkey and Ukraine) in order to track the impact that the Covid-19 crisis was having on people in the EBRD regions. As many as 72 per cent of respondents in the EBRD regions reported being personally impacted by the economic crisis, compared with 41 per cent in advanced economies. The burden of the crisis in terms of job losses, furlough arrangements, unpaid leave, reduced hours and pay cuts is being borne disproportionately by younger people and those with lower levels of education and income.

People employed by private-sector firms are significantly more likely to have been negatively affected by the crisis than employees of state enterprises or other public-sector entities. Those differences remain statistically significant when account is taken of various individual characteristics.

Furthermore, Google searches relating to unemployment and benefits have increased less in economies where state enterprises account for a larger percentage of employment (see Chart 2.13).

CHART 2.13.

Thus far, people employed by the state have also been more shielded from the effects of the current crisis



Source: Life in Transition Survey 2016, Google trends and authors' calculations.
Note: The vertical axis measures changes in the volume of Google searches over the 18 weeks starting on 22 March 2020 relative to forecasts based on previous trends. State enterprises' share of total employment is estimated on the basis of the answers given by primary respondents in the Life in Transition Survey.

82%
OF PEOPLE WORKING FOR STATE ENTERPRISES IN THE EBRD REGIONS HAVE PERMANENT CONTRACTS, COMPARED WITH
65%
OF THOSE WORKING FOR PRIVATE FIRMS

Over time, public-sector employees also appear to be able to accumulate larger savings buffers. Evidence from the latest edition of the Global Findex Database suggests that the percentage of respondents who say they can come up with emergency funds (equivalent to 5 per cent of gross national income per capita) over the next month is higher in countries with larger public sectors (see Chart 2.14). The more stable income streams that are associated with public-sector jobs may enhance an individual's ability to save, and this effect appears to outweigh the smaller need for precautionary savings among individuals with more stable sources of income. Individual-level evidence from the Life in Transition Survey confirms that people who are employed in the public sector are more likely to be able to come up with emergency funds than similar individuals (in terms of educational background, level of risk aversion and other characteristics) who work in the private sector, although the differences are smaller when household income is taken into account.

Trade-off between risk and growth

Thus, state enterprises can act as automatic stabilisers in the face of adverse economic shocks, providing more stable employment and income. To the extent that various well-documented inefficiencies in state enterprises lead to lower levels of innovation and weaker productivity growth, this points to a trade-off between risk and growth.

State enterprises innovate less

Evidence from the latest round of Enterprise Surveys confirms that state enterprises are indeed less likely to adopt new products and processes or invest in research and development (R&D) than similar private-sector firms (see Chart 2.15).²¹ These effects are large, with state enterprises only about half as likely to innovate as comparable private-sector firms. Similarly, Chapter 3 shows that enterprises that borrow from state-owned banks are less likely to innovate than those borrowing from private sector banks. While the state has a major role to play in supporting innovation,²² majority state ownership of enterprises and banks may not be an effective instrument for providing such assistance. Innovation can instead be supported by providing subsidies and grants for R&D, funding basic research, promoting effective links between public research institutions and the private sector, facilitating the supply of specialised skills and specialised finance and supplying high-quality information and communication technology infrastructure.

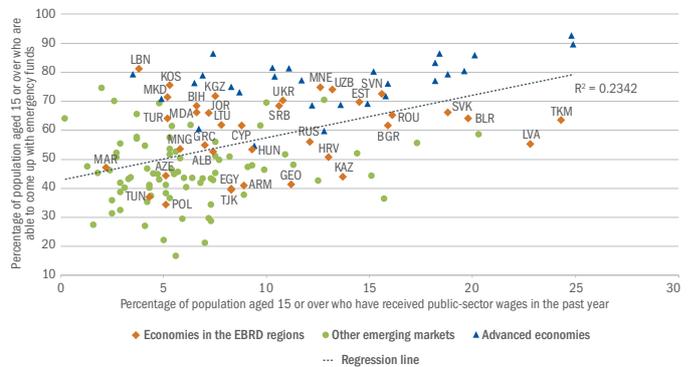
State ownership as a climate policy tool?

Some of the world's largest public companies are state-owned energy firms. This is increasingly giving rise to the question of whether state-owned enterprises could be used directly to support the transition to a green economy. Indirectly, the prevalence of state energy firms could potentially make it easier to overcome opposition to environmental regulations on the part of powerful (private) lobbies. At the same time, a few recent studies have highlighted state enterprises' greater environmental engagement in certain contexts and their importance for investment in renewable energy.²³

Thus far, state enterprises have not been used as an explicit environmental policy tool in the EBRD regions. A new review of the legal frameworks that govern state enterprises across the economies of the EBRD regions reveals that only 15 per cent of countries have legal frameworks that refer to board responsibilities relating to environmental and social objectives (and in some cases, those responsibilities are only applicable to listed companies).

CHART 2.14.

More households have buffers in countries with more state employment

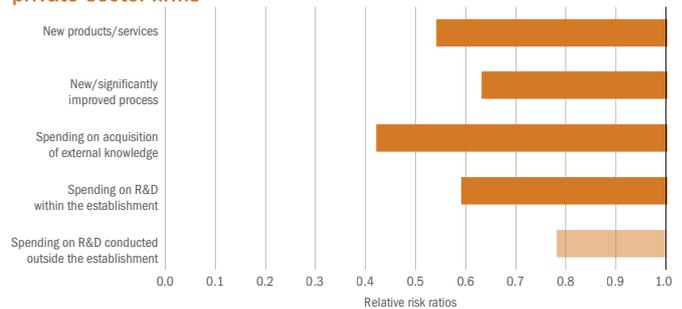


Source: Global Findex Database 2017 and authors' calculations.

Note: The required amount of emergency funds varies depending on the economy's income per capita, ranging from US\$ 50 in Tajikistan to US\$ 1,100 in Slovenia.

CHART 2.15.

State enterprises in the EBRD regions are less likely to innovate than private-sector firms



Source: Enterprise Surveys and authors' calculations.

Note: The Enterprise Surveys do not cover firms that are 100 per cent state-owned. In this chart, "state-owned" is defined as a firm where the state owns more than 50 per cent. However, the results are also robust to defining state-owned enterprises as firms where the state owns more than 25 per cent. Relative risk ratios are based on logit regressions, controlling for the logarithm of firm age, the logarithm of employment, city size, sector and country fixed effects, and whether the firm has a board or a business strategy. These estimates are derived from unweighted regressions, with similar results being obtained when using median eligibility sampling weights. A coefficient smaller than 1 suggests that state-owned enterprises are less likely to adopt the relevant measure than a private-sector firm. Darker bars denote effects that are significant at the 5 per cent level on the basis of country clustered standard errors.

ONLY 15% OF ECONOMIES IN THE EBRD REGIONS HAVE LEGAL FRAMEWORKS GOVERNING STATE ENTERPRISES THAT REFER TO BOARD RESPONSIBILITIES RELATING TO ENVIRONMENTAL AND SOCIAL OBJECTIVES

²¹ See also Bortolotti et al. (2019), and Kou and Kroll (2018).

²² See Mazzucato (2013).

²³ See, for example, Barnes (2019), Bergsager and Korppoo (2013), Hsu et al. (2017), Pan et al. (2020) and Prag et al. (2018).

Evidence from the Enterprise Surveys also suggests that while state enterprises are more likely to monitor emissions and have emissions-related targets, they are no more likely to engage in green investment than similar private firms. They are, for example, significantly less likely to invest in the upgrading of machinery, even when taking into account firms' sector, size and other characteristics. State enterprises also tend to consume more electricity, and more energy, per unit of output.

Detailed analysis of investment proposals submitted to the EBRD since 2010 corroborates these findings, suggesting that state-owned enterprises are no more likely to pursue environmental and social objectives than private-sector firms – and in many cases, less likely (see Box 2.5). It is clear, therefore, that if state ownership is to become a climate policy tool, policy action is required on the part of state enterprises' owners – national governments.

Winding down sunset industries: the example of coal

National governments and state enterprises are major players in fossil fuel markets. A few years ago, it was estimated that governments and state entities owned roughly 70 per cent of global oil and gas production assets, and around 60 per cent of the world's coal mines and coal power plants.²⁴ Moreover, the International Energy Agency (IEA) recently estimated that a group of 50 state enterprises in the power, oil and gas, iron and steel, and cement industries accounted for a combined total of more than 4 gigatonnes of greenhouse gas emissions in 2013 (CO₂ equivalent) – more than the national greenhouse gas emissions of all countries except the United States of America and China.²⁵ Against that background, this section looks specifically at state enterprises in the coal sector.

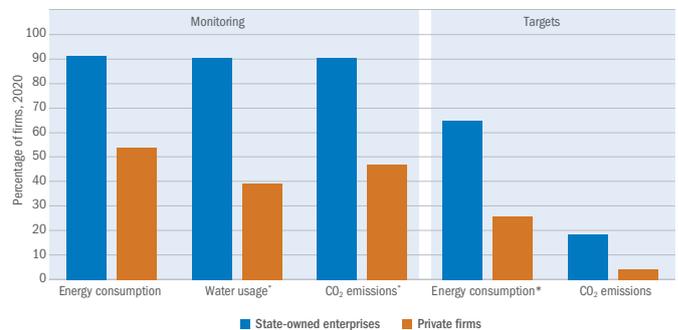
Coal still accounts for more than a third of global electricity generation and remains the second-largest fuel in the global energy mix after oil and the second-most-traded bulk commodity after iron ore.²⁶ In the EBRD regions, coal accounts for more than 80 per cent of electricity generation in Kosovo, Mongolia and Poland (see Chart 2.17). In countries which are both large consumers and large producers of coal (such as Kazakhstan, Poland and Turkey), coal is regarded as being important for energy security. Moreover, some countries in the EBRD regions (such as Mongolia and Russia) are major coal exporters.

Despite being a major polluter, the coal sector continues to receive large subsidies in many countries. When account is taken of subsidies relating to tax treatment, as well as damage to public health and the environment, total subsidies can exceed 30 per cent of GDP (see Chart 2.18).

State enterprises can play an important role in the winding-down of sunset industries, where privatising firms may be difficult. In most EU member states, there has already been a clear shift away from coal as a result of the implementation of stricter emission standards, the rising price of emissions under the EU Emissions Trading System (EU ETS; see Chapter 4), and growing competition from renewables and, in some

CHART 2.16.

In the EBRD regions, state enterprises are more likely to monitor emissions and have emissions-related targets



Source: Enterprise Surveys and authors' calculations.

Note: The Enterprise Surveys do not cover firms that are 100 per cent state-owned. In this chart, "state-owned" is defined as a firm where the state owns more than 50 per cent. Asterisks denote differences that are significant at the 5 per cent level in logit models controlling for the logarithm of firm age, the logarithm of employment, city size, sector and country fixed effects, and whether the firm has a board or a business strategy. These estimates are derived from unweighted regressions, with similar results being obtained when using median eligibility sampling weights.

GOVERNMENTS AND STATE ENTERPRISES OWN ROUGHLY

70%
OF GLOBAL OIL AND GAS PRODUCTION ASSETS, AND AROUND **60%** OF THE WORLD'S COAL MINES AND COAL POWER PLANTS

COAL ACCOUNTS FOR MORE THAN 80% OF ELECTRICITY GENERATION IN SOME EBRD ECONOMIES

²⁴ See CPI (2014).

²⁵ See IEA (2016).

²⁶ See IEA (2020).

**THE COAL SECTOR
ACCOUNTS FOR
UP TO
2.5%
OF TOTAL EMPLOYMENT
IN SOME EBRD
ECONOMIES**

cases, natural gas. Meeting national decarbonisation targets in 2030 will require 80 per cent of coal power capacity to be retired – with the higher quality bituminous coal and anthracite produced in Kazakhstan, Poland and Ukraine (which is also used in industrial processes) being less affected, given the challenges of phasing out coal in processes such as steel making.²⁷ In addition, an increasing number of banks and institutional investors are placing restrictions on investment in coal.²⁸

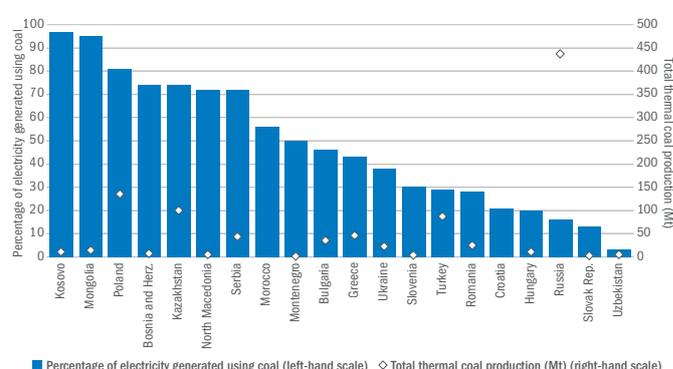
The fact that the Western Balkans countries and Ukraine are members of Europe’s Energy Community means that they are legally obliged to implement adapted versions of the EU’s energy and environmental legislation. While those economies’ implementation of environmental standards is not as advanced as it is in the EU, a number of existing mines have been closed, and plans to build new lignite plants have been cancelled, as these will cease to be profitable as soon as the EU’s Emissions Trading System is introduced.

As a result, the private sector is moving out of coal and other sunset industries, where state ownership often dominates. Thus, the state is left with the task of winding down large “stranded” assets and managing the decline in employment. Globally, companies with no state ownership own 14 per cent of operational coal power capacity, but account for only 3 per cent of the coal power investment pipeline.²⁹ Today, the coal sector is predominantly state-owned in most of central and south-eastern Europe. At the same time, significant private involvement in the coal sector can still be found in economies where environmental regulations remain less stringent, making operations more profitable (including countries such as Kazakhstan, Mongolia, Russia and Turkey).

The coal sector has traditionally been an important employer, both directly and indirectly, accounting for up to 2.5 per cent of total employment in economies such as Bosnia and Herzegovina and Kosovo. Furthermore, employment in the coal sector is also highly concentrated: it accounts for between 10 and 20 per cent of total employment in south-eastern Bulgaria and the region of Western Macedonia in Greece (see also Box 2.3 on employment in the mining industry in Polish counties).

CHART 2.17.

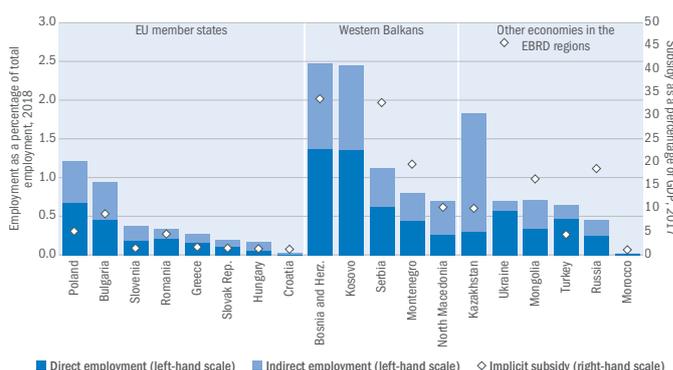
Coal plays an important role in the energy systems of many EBRD economies



Source: EBRD (2020).

CHART 2.18.

The heavily subsidised coal industry remains a major employer in many economies in the EBRD regions



Source: EBRD (2020), ILO, IMF Energy Subsidies Template, national authorities and authors’ calculations. Note: “Direct employment” refers to employees working at power plants and mines, as well as on-site contractors. “Indirect employment” includes off-site contractors, suppliers and their workers, and jobs created through the distribution of mining products (such as transport and accommodation for mine workers). These estimates do not include induced employment resulting from consumption by direct and indirect employees. Implicit subsidies exceed direct fiscal support and comprise both consumption and production-related subsidies (including damage to public health and the environment that is not reflected in the price of coal).

Active state policies can help to deal with the legacy of coal mining. In the Netherlands, for instance, state-owned mines were successfully turned into a diversified petrochemicals multinational in the 1970s. In Germany, meanwhile, public-sector jobs are being created at new agencies in coal-mining areas in the east of the country to compensate for concentrated job losses. Against that background, Chapter 4 looks at the EBRD’s “just transition initiative” in the EBRD regions.

²⁷ See EBRD (2020).
²⁸ See IEA (2019, 2020).
²⁹ See Prag et al. (2018).

State enterprises as energy giants: the example of national oil companies

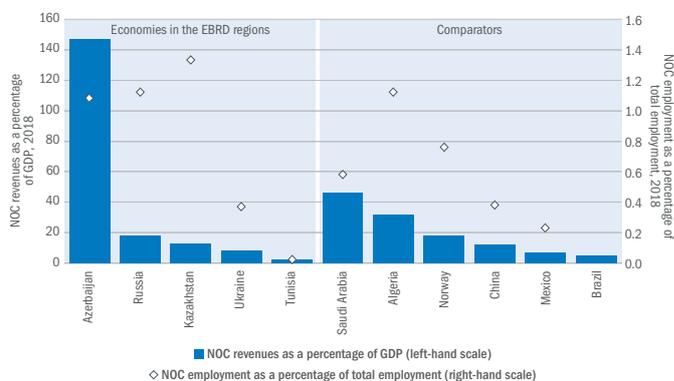
National oil companies (NOCs) produce approximately 55 per cent of the world's oil and gas and control up to 90 per cent of global oil and gas reserves.³⁰ They manage multi-billion-dollar portfolios of public assets, account for large percentages of government revenue, employ tens or even hundreds of thousands of people and make large investments in infrastructure (see Chart 2.19). A single NOC can account for more than 1 per cent of a country's total employment. In some cases (such as SOCAR in Azerbaijan), their revenues even exceed the country's GDP. Transfers from NOCs to national governments in the EBRD regions range from 2 to 18 per cent of total general government revenue (see Chart 2.20). In some cases, NOCs are also tasked with achieving public policy objectives (with Ukraine's Naftogaz, for example, providing subsidised energy to households).³¹

At the same time, some NOCs are highly indebted. Their long-term liabilities can be as high as 49 per cent of GDP in the EBRD regions (see Chart 2.20). NOC debt can take various different forms, such as corporate bonds, loans from banks, oil-backed loans from other NOCs or traders (as in the case of KazMunayGas, Kazakhstan's state-owned oil and gas company), or loans from a government entity. While their debts may not formally be guaranteed by the government, they are likely to be considered "too big to fail".³² Indeed, several NOCs have received large government bailouts in recent years. The bailout of KazMunayGas in 2015 (which had a total value equivalent to 2.2 per cent of Kazakhstan's GDP) had no bearing on the country's credit rating, consistent with pre-existing market perceptions of implicit state support for national oil companies.

Almost two-thirds of NOCs exhibit "weak" to "failing" performance in the area of public transparency, as measured by the Resource Governance Index. Disclosure is weakest in countries with weaker country-level governance and in the areas of employment and spending.³³ Transparency and accountability can be increased through initiatives such as the Extractive Industries Transparency Initiative (EITI), which seeks to strengthen the disclosure of information about transactions throughout the extractive industry value chain – from the awarding of extraction rights to the transferring of revenues to the government – as well as information about how transactions benefit the public. This is important, as NOCs' choices in respect of the management of climate-related financial risks have a significant bearing on their countries' economic resilience and levels of ambition under the Paris Agreement.³⁴

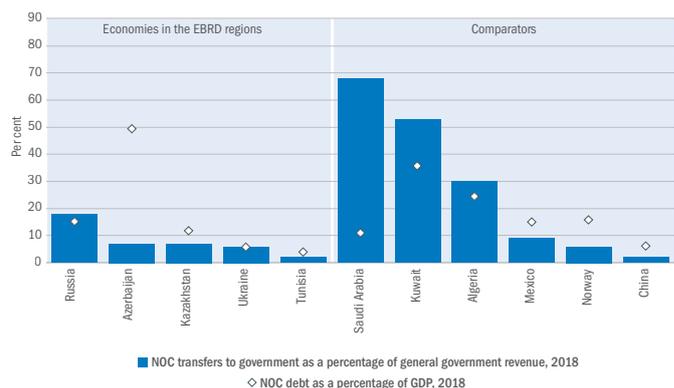
There have been a few examples of NOCs proactively integrating climate policy in their operations – for instance, through green procurement regulations and the mitigation of upstream emissions. This is often driven by commercial imperatives (including access to carbon finance), particularly where companies have minority private shareholdings. Meanwhile, NOCs in countries as diverse as Colombia, Nigeria

CHART 2.19.
NOCs are typically very large



Source: ILO, National Oil Company Database and authors' calculations.
Note: Employment data for Azerbaijan and Mexico relate to 2016 and 2017 respectively.

CHART 2.20.
NOCs are important sources of government revenue, but can also be highly indebted



Source: National Oil Company Database and authors' calculations.

and Saudi Arabia have turned their attention to investment in renewable energy. NOCs could further leverage their experience of managing complicated projects in cooperation with international partners in order to help foster the transition to a green economy. However, NOCs' strong reliance on fossil fuel rents (the difference between the international price of oil and gas and the cost of production) may make them reluctant supporters of alternative sources of energy.³⁵

³⁰ See World Bank (2011).

³¹ See Natural Resource Governance Institute (2019).

³² See Manley et al. (2019).

³³ See Natural Resource Governance Institute (2019).

³⁴ See Bradley (2020), Bradley et al. (2018), and Heller and Mihalyi (2019).

³⁵ See Manley et al. (2019).

NATIONAL OIL COMPANIES PRODUCE APPROXIMATELY

55%
OF THE WORLD'S OIL AND GAS AND CONTROL UP TO
90%
OF GLOBAL OIL AND GAS RESERVES

Improving state enterprises' governance

As previous sections have shown, governments often struggle to manage state enterprises effectively. While market competition and exposure to capital markets have triggered improvements in some cases, poorly run state enterprises still have the potential to pose significant risks to government budgets, divert labour and capital resources away from more efficient uses, and become conduits for corruption. Improvements in governance are key to ensuring that state enterprises are able to deliver value to their ultimate beneficiaries – the taxpayers.

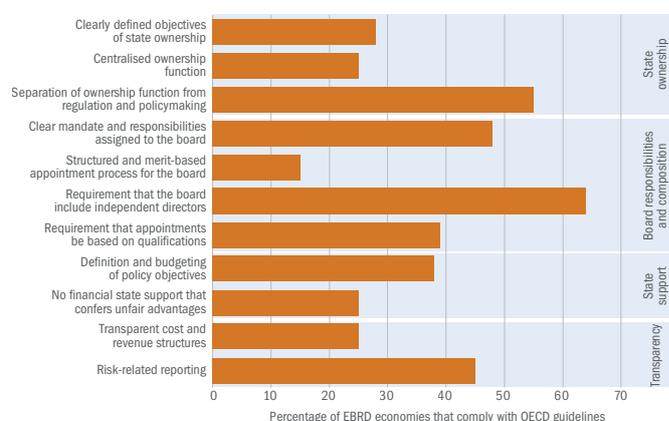
This section presents detailed analysis of state enterprises' governance, examining the existing governance frameworks in the EBRD regions and highlighting areas for improvement (see also the Structural Reform section). This analysis draws on a comprehensive new review of the country-level legal frameworks that govern state-owned enterprises in 36 economies in the EBRD regions. It is complemented by an in-depth examination of state enterprises' compliance with corporate governance rules, drawing on a review of the corporate governance disclosures of more than 100 state enterprises in 23 economies in the EBRD regions. Lastly, this section looks specifically at the lessons that have been learnt from the EBRD's work with state enterprises.

Unique governance challenges

State enterprises face unique governance challenges as a result of the array of financial and non financial objectives that states seek to achieve through their operations – a situation that is further compounded by the complexity of states' administrative structures. As a shareholder, the state aims to run its enterprises in the interests of society as a whole. In so doing, it should act as an “informed and active owner”,

CHART 2.21.

Few economies in the EBRD regions comply with the OECD Guidelines on Corporate Governance of State-Owned Enterprises



Source: EBRD and authors' calculations.

Note: These data are based on a review of the country-level legal frameworks that govern state enterprises in 36 economies in the EBRD regions. The assessment of compliance for the purposes of this chart is loosely based on key recommendations set out in the OECD guidelines, and was prepared after the aggregation of findings across multiple components within each jurisdiction.

THE LONG-TERM LIABILITIES OF NATIONAL OIL COMPANIES IN THE EBRD REGIONS CAN BE AS HIGH AS

49%
OF GDP

setting high-level objectives and giving state enterprises a clear framework to operate within, while also giving enterprises sufficient autonomy to draw up their own business strategies and pursue those objectives in their preferred manner.³⁶

State ownership policies remain uncommon

The OECD Guidelines on Corporate Governance of State-Owned Enterprises encourage countries to draw up state ownership policies that set out, among other things, the rationale for state ownership and the state's overall objectives as an owner. In general, however, the objectives of state ownership are not clearly defined in the economies of the EBRD regions (see Chart 2.21), with the state's ownership often simply a legacy of central planning. Less than a third of all economies in the EBRD regions have formal documents, policies or laws specifying the overarching objectives of state ownership, very few of which qualify as a state ownership policy as such (see also Box 2.6, which looks at the development of a state ownership policy in Uzbekistan).

³⁶ See OECD (2015).

Lack of transparency around public service obligations

The OECD guidelines also call for public service obligations to be clearly mandated and disclosed. Costs relating to their performance should be funded by the state and subject to high levels of transparency in terms of cost and revenue structures. Such public service obligations are very common, being observed in around 90 per cent of the economies in the EBRD regions. They typically involve providing a universal service (such as postal or railway services) for less than the total cost of delivering it, providing services to specific categories of client at artificially low prices (for instance, supplying electricity or gas to households on the basis of regulated tariffs), or providing subsidised services in specific regions (such as transport services in remote areas). It is typically the case, however, that public service obligations are not clearly defined in regulations and are not explicitly budgeted for. This is true (with exceptions relating to specific enterprises, sectors and services) of almost two-thirds of the economies in the EBRD regions. At firm level, more than 85 per cent of state enterprises do not explicitly disclose the existence of public service obligations or associated budgeting.

Weak or ad hoc budgetary governance creates fiscal risks and cycles of dependence between state enterprises and governments: state-owned enterprises are used to provide subsidies, but they incur losses, accumulate debt and need to be bailed out.³⁷ Subsidies and grants to state enterprises can be observed in almost all EBRD economies (being subject to EU rules on state aid in EU member states). What is more, such subsidies are typically calculated after losses have been incurred. Determining the level of subsidies in advance on the basis of objective measures capturing public service obligations (for instance, per end-user of the service) could strengthen accountability and increase incentives to improve the operational efficiency of state enterprises. Subsidised or targeted loans to state enterprises are slightly less common – and where they are used, they tend to be channelled through state-owned banks or development banks (see Chapter 3).

**IN ALMOST
45%
OF ECONOMIES IN
THE EBRD REGIONS,
ENTITIES EXERCISING
OWNERSHIP DUTIES
ARE ALSO RESPONSIBLE
FOR SECTORAL POLICY
DECISIONS**

Tax exemptions and tax benefits are rare, being observed in only 22 per cent of the economies in the EBRD regions. The majority of the economies in the EBRD regions do not normally allow state guarantees to be provided, although more than 65 per cent allow exceptions subject to parliamentary legislation or government approval.

Strengthening the disclosure of information

In more than a quarter of all economies in the EBRD regions, information on the loans, grants, subsidies and guarantees that are received by state enterprises is not publicly disclosed in any way. Even in situations where disclosure is legally required, disclosed information is often limited and difficult to access. Corporate governance disclosures are only very limited in 63 per cent of state enterprises in the EBRD regions, and are especially limited in municipally owned companies. Many state enterprises (especially fully state-owned or unlisted enterprises) have no clear audience for this information, so disclosure needs to be a legal requirement. Box 2.7 looks at the successful introduction of a public disclosure system in South Korea, where public institutions are obliged to disclose a range of financial and non-financial information on a regular basis.

Multiple agencies representing the state as owner

In general, the state keeps a firm grip on state enterprises, frequently doing so with multiple hands. The centralised state ownership function that is recommended by the OECD as a best practice – whereby all or most state enterprises are overseen by a single entity – exists in only a quarter of all economies in the EBRD regions. A centralised ownership function can contribute to the streamlining of oversight efforts in the event of multiple state enterprises and can help to draw a clear distinction between the state's ownership of the enterprise in question and its policymaking and regulatory functions.

Even in the economies where a centralised ownership function exists, that entity often lacks the powers that are necessary to adequately scrutinise state enterprises. In 36 per cent of economies ownership is exercised by means of a dual model, whereby responsibilities are shared between two authorities, such as the line ministry and the government, or the line ministry and the ministry of finance. The remaining economies operate a decentralised model, whereby multiple authorities (mainly line ministries) supervise state enterprises in their own respective areas of competence. In practice, state-owned enterprises are heavily influenced by line ministries. Indeed, in almost half of all economies in the EBRD regions, line ministries hold shares in at least some – and in some cases, all – state-owned enterprises. Moreover, firm-level analysis confirms that most key state enterprises are owned by line ministries. Municipal or regional authorities, ministries of finance and economic affairs, national holding companies or funds, other state enterprises and the cabinet or parliament can also play a role when it comes to exercising ownership functions.

³⁷ See IDB (2019).

MORE THAN HALF OF ALL STATE ENTERPRISES IN THE EBRD REGIONS HAVE BOARDS THAT DO NOT HAVE THE AUTHORITY TO APPROVE THEIR ENTERPRISES' STRATEGIES OR BUDGETS

Separating ownership and regulatory duties

Conflicts of interest are widespread. The ownership function needs to be adequately separated from the state's regulatory and policymaking functions in order to ensure a level playing field and avoid undue interference in the operations of state enterprises. However, in almost 45 per cent of economies in the EBRD regions, entities exercising ownership duties are also responsible for deciding on industrial and regulatory policy. Meanwhile, in 19 per cent of countries there are state enterprises that have their own regulatory powers (in the electricity and gas sectors, for instance).

In line with the low-risk, low-return model discussed earlier in the chapter, the management of state enterprises often focuses mainly on compliance. State enterprises are often governed by very detailed legal frameworks, with only limited autonomy to make decisions. Indeed, they can often be thought of as operating in an environment where “everything is prohibited unless it is explicitly allowed”, as opposed to “everything is allowed unless it is explicitly prohibited”.

Strengthening the role of state enterprises' boards

Less than half of the economies in the EBRD regions confer extensive responsibilities on the boards of state enterprises. Strikingly, almost 50 per cent of all state-owned enterprises in the EBRD regions have boards that do not have the authority to approve their enterprises' strategies or budgets. Boards often lack independence, and it is frequently the case that the composition of boards is not adequate to ensure effective and independent supervision of state enterprises. Moreover, as many as 70 per cent of the economies in the EBRD regions allow high-level and elected officials to sit on the boards of their state enterprises, in contravention of OECD guidelines. It is often the case, too, that the process of appointing people to the board is inconsistent and lacks transparency, with only 15 per cent of the economies in the EBRD regions having a requirement for a nomination policy. While 64 per cent of economies require boards to include independent directors, only 39 per cent have specific requirements relating to the composition of boards which cover all state enterprises, and even these are typically insufficient to ensure balance and diversity of qualifications and backgrounds.

State enterprises also conduct very little risk analysis. Their strategies are rarely assessed from a risk perspective, with specific risks and mitigating measures not generally being set

out in budgets. Most state enterprises reviewed in the study have no risk department, so there is no organisational framework for acting on external risk analysis, and more than 50 per cent of the economies in the EBRD regions do not impose any risk-related reporting requirements. Those that do only require the disclosure of general risk factors in the context of annual reports, rather than obliging state enterprises to report on the way that they deal with the risks they face in their operations.

The way forward

The EBRD's work with clients in the context of corporate governance action plans provides some indication of how state enterprises' governance can be improved. Clear state ownership policies should be established at country level, while state enterprises need assistance in order to develop strategies that (i) are anchored to their budgets and any public service obligations, (ii) explicitly incorporate potential risks and (iii) can be monitored using measurable key performance indicators (KPIs). Board responsibilities should be strengthened, with boards being granted the authority to carry out strategic planning and oversight, as well as being given control over the use of resources. And the composition of boards should be improved, with greater transparency regarding appointments, disclosure of qualifications and selection processes, and measures to ensure the independence of board members. (Against that background, Box 2.8 looks at how connections affect the effectiveness of both state enterprises and private firms.) Internal control functions should also be improved, with a focus on the reporting of risks to the board.

Fiscal risks need to be managed by making state support more transparent and requiring analysis of the key risks faced by state companies. Transfers to state enterprises (in relation to public service obligations, for instance) should be based on concrete formulae. And state enterprises' budgets should include sensitivity analysis, using a variety of macroeconomic and operational scenarios and stress tests to inform estimates of contingent liabilities for the government (particularly in the context of large capital projects). More generally, governments need to track the financial performance of state-owned enterprises, both with and without government transfers, and perform risk analysis in respect of such enterprises' liabilities (including adverse scenarios involving declines in output prices or increases in input prices).³⁸

**AS MANY AS
70%
OF ECONOMIES IN THE
EBRD REGIONS ALLOW
HIGH-LEVEL AND ELECTED
OFFICIALS TO SIT ON THE
BOARDS OF THEIR STATE
ENTERPRISES**

³⁸ See IDB (2019).

Conclusion

State-owned enterprises account for about half of total state employment in the EBRD regions. They dominate the energy and transport sectors, where they are important providers of services such as railway transport and municipal utilities, which are often subsidised to ensure that services are affordable for people living in remote areas and low-income households. While the private sector is able to provide such services under public service obligations with the support of various compensation schemes, countries often rely on the direct provision of services through state enterprises, particularly where their administrative capacity limits their options in terms of the delivery of services.

State enterprises can also act as automatic stabilisers, providing more stable sources of employment during downturns and in disadvantaged regions. For example, the results of a representative household survey conducted by the EBRD and the Ifo Institute in August 2020 suggest that employees of state-owned firms were less likely to lose their job or see their income reduced in the early months of the Covid-19 crisis, in line with the developments seen in the aftermath of the 2008-09 global financial crisis. Against that background, public-sector employment tends to play a more important role in regions with higher unemployment rates. More stable employment in the face of adverse economic and technological shocks can help to reduce negative externalities associated with rising inequality and the erosion of social cohesion and trust. Moreover, state enterprises can also play an important role in the winding down of stranded assets in sunset industries such as coal, mitigating the highly localised adverse shocks to employment that result from such developments.

On the other hand, however, governments often struggle to manage state enterprises effectively. For instance, survey evidence suggests that state-owned firms are only half as likely to innovate as equivalent private firms. Moreover, the objectives of state ownership are often not clearly defined in the EBRD regions, and responsibilities relating to state ownership may be spread across multiple state entities with conflicting interests. At the same time, the management of state enterprises is often seen as an exercise in compliance, with little attention being devoted to strategy or risk management. Meanwhile, the fact that the extensive state support provided to such enterprises is not transparent reduces their accountability. And as far as environmental objectives are concerned, there is little evidence that state-run firms are more environmentally friendly than private companies with similar characteristics.

A country's broader institutional context also matters. Where economic institutions are weak, private firms may become heavily embedded in the networks of state enterprises and politicians, giving rise to rent-seeking behaviour and inefficient allocation of resources. Where economic institutions are strong, however, state companies can be run efficiently while delivering on public service obligations and other non-financial objectives.

As discussed in Chapter 1, the Covid-19 crisis may boost demand for state involvement in the economy and increase support for the expansion of state ownership. This will make it even more important to improve countries' institutional frameworks and the governance of state enterprises – particularly in terms of setting out the objectives of state ownership, clarifying the ownership responsibilities of state agencies, separating ownership and regulatory functions, and strengthening the independence of state enterprises' boards.

BOX 2.1.**State-owned enterprises in the southern and eastern Mediterranean**

State-owned enterprises in the southern and eastern Mediterranean region are a legacy of the inward looking socialist policies that were adopted in those economies in the early years following independence. Those enterprises played an important role in the formation of the state, being set up to support industrial and social development in the late 1950s and the 1960s. Firms in the natural resources sector and other strategic sectors were nationalised, with major investment in infrastructure, education and healthcare supporting industrialisation and growth.

As a result of the expansion of social services, the public sector has become the dominant employer in many of those economies.³⁹ While state-owned enterprises only account for around 17 per cent of total state employment in the economies of the southern and eastern Mediterranean, compared with an average of 44 per cent in the EBRD regions as a whole, over-employment in state-owned enterprises has, nonetheless, been widely documented.

Macroeconomic difficulties resulting from falling oil prices, high levels of government debt, weak private investment and inefficiencies at state-owned enterprises triggered a wave of market liberalisation, deregulation and privatisation in the late 1980s and the 1990s. While that privatisation process generated significant revenue in some countries (such as Egypt, Morocco and Tunisia), it also encountered administrative challenges and popular resistance, culminating in demonstrations and strikes. Institutions' weaknesses created space for widespread corruption, and people with political connections benefited disproportionately from privatisation.⁴⁰

Today, state enterprises in the southern and eastern Mediterranean continue to play a major role in primary sectors (such as phosphate mining), certain branches of manufacturing (such as chemicals, but also consumer goods), finance and real estate. Some have monopoly rights in sectors that could otherwise be competitive, often operating using regulated tariffs – as is the case, for instance, in the cereal, olive oil, meat and sugar sectors in Tunisia.⁴¹

State enterprises and the broader public sector remain important elements of the social contract in those economies, being viewed as a source of jobs, part of the social safety net and a vehicle for public investment. When the state enterprise sector was downsized in Egypt, it resulted in the culling of unproductive but relatively well-paid employment, but was not accompanied by sufficient strengthening of the social safety net or job creation in the private sector. That was arguably one of the factors that contributed to the unrest seen in 2011.⁴²

State-owned enterprises remain important providers of subsidised services. In Egypt, for instance, the military has historically used state-owned enterprises to build affordable housing for the country's security forces, and that mandate has recently been expanded to include the provision of social housing more generally. In Morocco, meanwhile, the national electricity company has implemented a 15-year electrification programme, and the national highway construction company has been busy building new rural roads.⁴³ However, compensation for such non-financial objectives does not tend to be transparent and is typically only regulated in a few sectors. In some cases, such payments constitute a significant drag on countries' budgets.⁴⁴

The governance challenges discussed in this chapter are a significant issue in the southern and eastern Mediterranean. With the exception of Egypt, which has set out broad objectives governing state ownership, no country in the region has a state ownership policy. Most of the region's economies have complex decentralised ownership arrangements, with managerial responsibilities being undertaken primarily by line ministries. Jordan, the West Bank and Gaza, and Morocco have elements of a dual system, with the ministry of finance playing a key role, while in Egypt, Tunisia and Lebanon there is some limited coordination by central bodies. In many cases, entities exercising ownership responsibilities also have regulatory powers or are responsible for sectoral policies, although in some cases independent regulators have been set up (notably in the telecommunication, transport and electricity sectors) with the aim of introducing competition in previously monopolised markets.

The boards of state-owned enterprises only have strategic responsibilities in half of the region's economies. Moreover, there are limited regulatory requirements ensuring that boards have an appropriate composition. Most countries have rules requiring the publication of information on state enterprises' ownership, their performance (in the form of annual reports, for example) and the regulatory arrangements governing things like state assistance. However, such rules are not always followed in practice – neither by the companies themselves nor by regulators. Even if information is collected, it is not generally aggregated or made easily accessible to the public, thereby reducing transparency and accountability.

³⁹ See OECD (2013), OECD (2018b) and World Bank (2015).

⁴⁰ See World Bank (2015).

⁴¹ See Morsy et al. (2018) and OECD (2018b).

⁴² See OECD (2013).

⁴³ See OECD (2013).

⁴⁴ See OECD (2013) and Morsy et al. (2018).

BOX 2.2.**Private-sector involvement in district heating in Romania**

In socialist times, district heating was provided as a public service and treated as a natural monopoly for regulatory purposes. That remains the case in many of the economies in the EBRD regions, although some central European countries (such as Poland) have substantially deregulated their district heating sectors. Unlike water or electricity, district heating can potentially face some degree of competition from alternative heat sources (such as individual gas boilers, electric heating or individual stoves fuelled by coal or biomass). Customers can, in theory, opt out of district heating, reducing the revenues of service providers and potentially resulting in inefficient distribution networks.

District heating services are relatively costly and can account for a significant percentage of a household's income during the heating season, making the removal of heating subsidies politically difficult. Indeed, the results of the latest round of the Life in Transition Survey indicate that around 30 per cent of households in the EBRD regions' poorest income decile are unable to afford adequate heating of their home. This could help to explain why district heating is more likely to be state-owned than other utilities.

At the same time, investment needs in the area of district heating are particularly large in the EBRD regions following years of under-investment. Those economies' distribution systems were not designed for individual metering or user control, making the introduction of consumption-based billing costly and difficult. In addition, many secondary cities in the EBRD regions have falling populations and industries that are in decline. In the past, for instance, industrial plants were often major consumers of heat, surrounded by residential neighbourhoods. In such circumstances, heating networks and production facilities may need to be re-scaled and re-routed, as oversized systems are unable to operate economically.

Tariffs are typically set below cost-recovery levels to ensure universal access. Thus, while the poor spend a larger percentage of their income on utilities, larger percentages of subsidies accrue to richer households who consume more energy. Under-pricing also results in excess consumption of heating and under-investment in energy-efficient buildings, with adverse implications for the environment.

From a service provider's perspective, municipal subsidies often lack predictability. In Romania, for instance, municipal subsidies are common in the district heating sector, while the water sector only receives investment grants. At the same time, however, the revenue stream is often uncertain, hindering long-term investment planning and encouraging utility companies to spend time lobbying city authorities rather than focusing on providing a high-quality service for users.

Many district heating utilities in the EBRD regions are effectively in a downward spiral of managed decline. Those downward spirals typically start with a heating utility struggling with a legacy of under investment and poor maintenance, which results in heating being provided at unpredictable temperatures. As dissatisfied customers

disconnect, revenues fall and unit costs increase as the distribution network becomes oversized, exacerbating under-investment and further undermining the quality of the service. In many cases, this results in the service being withdrawn entirely. In Romania, for example, the total number of district heating systems has fallen from 315 in 1989 to just 43 today.

Most remaining district heating utilities struggle with their cash flow, despite public subsidies. They often accumulate debts to their energy suppliers, unpaid tax bills or other forms of debt and end up receiving government bailouts. Such soft budget constraints – which are prevalent in the district heating sector, but not the water sector – hamper the planning of investment, as well as the management of government budgets. Over time, they may also foster an implicit acceptance of the notion that state enterprises do not need to honour contractual agreements.

It is not impossible for state-owned district heating utilities to be financially sound and well-run, with positive examples typically being found in countries with mature commercial and governance frameworks, such as the Nordic countries. In countries with weaker public governance frameworks, well-defined private-sector participation in the form of public-private partnerships or management contracts may help to clarify contractual arrangements, achieve an arm's-length relationship between the utility's management and local authorities and do away with soft budget constraints. The district heating utility in the Romanian city of Iași experienced most of the challenges described above, including a persistent failure to pay key suppliers. When it filed for bankruptcy in April 2012, the city signed a 20-year concession contract with a private operator, Dalkia Termo Iași. District heating remains subsidised and significant investment is still needed, but transfers from the city budget have become predictable. The accumulation of debt has slowed and the disconnection rate has fallen, reflecting improvements in the quality of service – a major step towards breaking the vicious circle of persistent underfunding and a shrinking customer base.

BOX 2.3.**Regional distribution of state employment in Poland**

This box examines the spatial distribution of state employment in Poland using disaggregated data on employment by type of ownership and sector for 380 Polish *powiats* (units of local government that are roughly equivalent to UK counties). State employment accounted for about 21 per cent of total employment in Poland in 2018, with that share ranging from about 10 per cent in counties in the regions of Łódzkie (in central Poland) and Mazowieckie (around Warsaw) to 55 per cent in some counties in the coal-mining region of Śląskie.

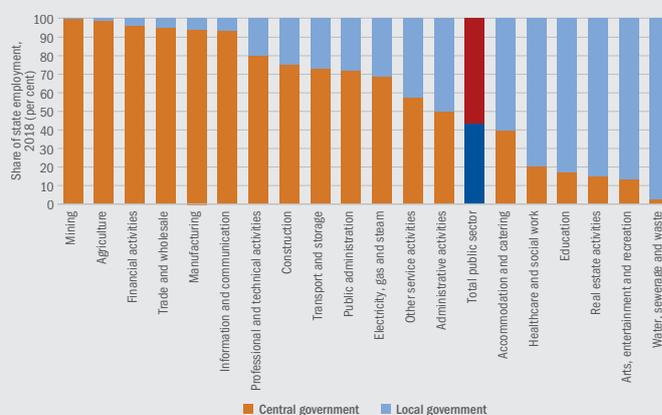
Much of that employment is in public services, including public administration, education, healthcare, social work, utilities (water supply, sewerage and waste, as well as electricity, gas and steam), transport and storage. The public sector also accounts for around three-fifths of all employment in the mining sector, which primarily involves the extraction of coal. While mining only accounts for around 1 per cent of total employment in Poland, that employment is highly concentrated. In the southern regions of Śląskie and Małopolskie, for example, it accounts for 3 per cent of total employment, and 85 per cent of the mining employment in those regions is in the public sector.

Almost half of all state employment in Poland is in entities that are run or owned by local governments (see Chart 2.3.1), including most public-sector employment in the areas of education, healthcare, social work, water supply, sewerage and waste. In contrast, state employment in sectors such as mining, agriculture and manufacturing is overwhelmingly in entities that are owned or run by the central government.

State employment tends to be higher in disadvantaged regions, where unemployment rates are higher (for instance, in northern, eastern and parts of south-western Poland). Indeed, the public sector's share of employment is, on average, 3 percentage points higher in counties with unemployment rates of around 20 per cent (the 90th percentile of the distribution of unemployment across counties) relative to counties where unemployment is around 6 per cent (the 10th percentile). Those differences are even more pronounced when account is taken of other county-level characteristics, such as demographics, the sectoral composition of the economy or regional effects. Overall, a 1 percentage point increase in a county's unemployment rate is associated with a 0.5 percentage point increase in the public sector's share of employment.

CHART 2.3.1.

Almost half of all state employment in Poland is in entities that are owned or run by local governments



Source: National Statistics Poland.

Note: "State employment" is defined here as employment by an entity that is more than 50 per cent state-owned.

STATE EMPLOYMENT AT LOCAL/MUNICIPAL GOVERNMENT LEVEL ACCOUNTS FOR AROUND HALF OF TOTAL PUBLIC-SECTOR EMPLOYMENT IN POLAND

That relationship is driven by the fact that the public sector accounts for a larger percentage of total employment in "non-business services" such as public administration, education or healthcare. In counties with less private-sector employment, post offices, train stations, municipal utility companies, hospitals and schools become more important as local sources of employment. Thus, public-sector employment is able to act as an automatic stabiliser in regions that experience adverse technological and economic shocks.

BOX 2.4.**Demand for state-led job creation in economically disadvantaged regions**

This box looks at people's views on whether employment creation is primarily the responsibility of the state or the private sector and the ways in which those views vary across regions within individual countries. It is based on the results of the 2018 Euro Survey conducted by the Austrian National Bank, which covered 1,000 randomly selected adults in each of Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Hungary, North Macedonia, Poland, Romania and Serbia.⁴⁵

Those respondents were asked whether responsibility for providing people with work should fall primarily to the state, be shared between the state and the private sector, or fall primarily to the private sector, or whether it does not matter as long as jobs are available. Around 46 per cent of respondents across those nine economies believe that the state should have primary responsibility for providing jobs.

Views vary substantially within individual countries. While only about 37 per cent of those living in capital cities think that the state should have primary responsibility for providing jobs, that rises to around 49 per cent in rural areas (with the difference between the two being statistically significant). Support for state-led job creation in rural areas is particularly strong in Albania, Bosnia and Herzegovina, North Macedonia and Romania, with shares of between 54 and 66 per cent. Regression analysis taking account of various individual-level characteristics (such as age or gender) confirms that people living outside capital cities are more likely to think that the state should have primary responsibility for job creation.⁴⁶ People living in rural areas are also more likely to think that the state should have primary responsibility for providing education and medical services, building roads and organising the collection of waste.

People in poorer regions are also more likely to think that the state should have primary responsibility for job creation – both when looking at regional GDP per capita and when data on the intensity of night-time lights (which are available at a more disaggregated level) are used instead. That effect remains statistically significant when controlling for a range of household-level characteristics and the country of residence.

That effect could be driven by the fact that there are fewer alternative (private) employment opportunities in disadvantaged areas, as well as demand for the state to get involved in the local economy to help it catch up with the country's more prosperous regions. Personal exposure to public-sector jobs may also play a role, since (as shown in Chapter 1) people in rural areas are more likely to work in the public sector.

As noted elsewhere in this chapter, the direct provision of employment is just one of various ways that the state can support disadvantaged regions. In line with that, demand for state-led job creation in rural areas appears to be lower in EU member states, which benefit from EU structural and cohesion funds earmarked for low-income regions within countries. Conversely, the percentage of respondents who favour increased state spending on regional economic development is significantly higher in the Western Balkans economies (at an average of 64 per cent) than it is in the EU member states in the sample (where it averages 53 per cent).

⁴⁵ For country-level results based on this survey, see Box 3.2 in EBRD (2019).

⁴⁶ See Eller and Scheiber (2020) for details.

BOX 2.5.**ESG objectives of state-owned and private firms: evidence from project proposals submitted to the EBRD**

This box analyses the key features of investment proposals submitted to the EBRD in the period 2010-19, with a particular focus on firms' environmental, social and governance (ESG) objectives. It examines the frequency with which ESG objectives featured in investment proposals, comparing private and public-sector clients,⁴⁷ with objectives being identified on the basis of textual analysis of economists' reviews of investment proposals presented to the EBRD's investment committee.

Data on proposed investment projects

Green energy and energy efficiency are both considered to be environmental objectives. These have been identified on the basis of official statements on the percentage of investment targeting green objectives.⁴⁸ Social objectives include work aimed at fostering skills and economic inclusion, as well as work on deepening supply chain linkages (typically involving smaller companies). Developing domestic supply chains is a commonly cited objective of industrial policy.⁴⁹ Large state enterprises, in turn, tend to be important consumers of products and services supplied by other firms or important suppliers of key production inputs. Governance objectives include work on corporate governance and initiatives targeting governance at sector or country level (legislation governing private-public partnerships or tariff reforms, for instance). Social and governance objectives have been identified on the basis of manual coding of a subsample of investment proposals and software-based textual analysis.

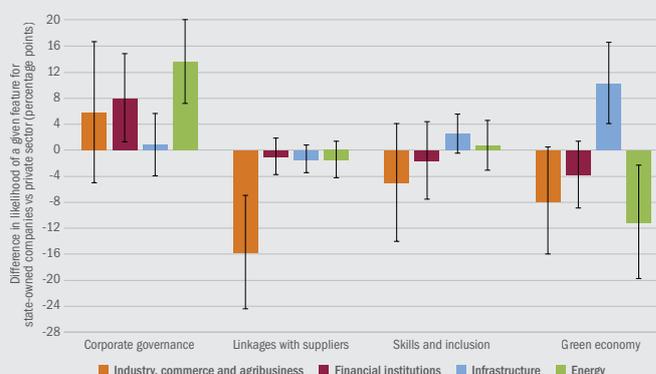
This analysis looks at the expected characteristics of an investment project when it is first reviewed by the EBRD's investment committee. Such snapshots, taken before in-depth due diligence has been conducted, are a good indicator of the client's initial interest in the various ESG objectives (as distinct from the final features of the project, which are a product of joint work by the EBRD project team and the client). For instance, at the concept stage, environmental elements are expected, on average, to account for 20 per cent of the funding invested, compared with an average of 39 per cent when projects are finally agreed. The analysis also takes account of various project-level characteristics, including the country, the industry, the expected amount of financing and a measure of the commercial risk involved in the transaction.

State-owned clients are more likely to target corporate governance objectives

First of all, this analysis shows that proposed work with public-sector counterparts is more likely to target corporate governance.⁵⁰ This difference is statistically significant at the 5 per cent level (see Chart 2.5.1). This is also true of sector and country-level governance, as private-sector clients and their owners have more limited scope to engage with sector-level issues. It is worth noting, however, that these findings on governance related objectives are based only on domestic state-owned companies, not those with cross-border state ownership.

CHART 2.5.1.

Project proposals involving public-sector clients are more likely to target corporate governance, less likely to focus on linkages with suppliers and off-takers, and less likely to focus on the green economy



Source: EBRD and authors' calculations.

Note: Based on 2,935 project proposals considered by the EBRD in the period 2010-19. All regressions are estimated using ordinary least squares and control for the country, the sector and various project-level characteristics. The 90 per cent confidence intervals shown are based on robust standard errors.

Mixed evidence on environmental and social objectives

Second, state enterprises are significantly less likely to explore issues relating to linkages with their suppliers and off-takers. Projects with those kinds of objective typically seek to train small and medium-sized suppliers, work on quality assurance and standards, or broaden supply chains using smaller local companies. Intuitively, the largest differences between state and private enterprises in this regard can be observed in the industrial and service sectors, and they can be observed for both companies with domestic state ownership and those owned by foreign states. There are no significant differences between state and private enterprises when it comes to issues relating to skills and inclusion (for instance, training programmes, human resources policies or inclusive procurement).

Third, state enterprises also appear to be less likely to want to engage with environmental issues, particularly in the energy and financial sectors. In the area of municipal infrastructure, on the other hand, state-owned companies are significantly more likely to explore green issues.

In conclusion, therefore, there is little evidence that state ownership necessarily makes enterprises more likely to target policy objectives in the area of the green economy or develop local supply chains and skills. State-owned companies are no more likely than private companies to actively engage in these areas (and in some instances, they are less likely to do so). Using state enterprises as an ESG policy tool will therefore require more action on the part of their owners – national governments.

⁴⁷ This analysis is based on the background work reported in Gamtkitsulashvili et al. (2020).

⁴⁸ See EBRD (2018b) for a discussion of how the Bank determines which percentage of a proposed investment will support the transition to a green economy.

⁴⁹ See, for instance, Rodrik (2005).

⁵⁰ See also Hsu et al. (2017).

BOX 2.6.**Developing a state ownership policy in Uzbekistan**

State-owned enterprises play an important role in the Uzbek economy, with 100 per cent state-owned firms accounting for 19 per cent of GDP. At the same time, establishing effective governance structures and privatising state firms are seen as key objectives in Uzbekistan's economic reform programme. A new strategy drawn up by the country's State Assets Management Agency – a government body with a mandate to manage state-owned assets and execute privatisations – sets out the main principles governing the management of state assets, in line with the OECD Guidelines on Corporate Governance of State-Owned Enterprises, and is expected to become law.

That strategy stipulates that state ownership of enterprises is only appropriate for (i) natural monopolies, (ii) the provision of essential infrastructure services or public services that are not commercially viable, and (iii) areas of strategic interest such as defence and other specific industries (including precious metals and nuclear power plants). Other enterprises should be earmarked for either privatisation, liquidation or conversion into government agencies.

State-owned firms are also expected to set out their commercial and non-commercial objectives (in their company charters and annual business plans, for example). This is expected to lead to increased transparency when it comes to the provision of government subsidies, which are widely used to compensate state enterprises for delivering on their non-commercial objectives.

The strategy also aims to reduce conflicts of interest by separating the state's ownership and regulatory functions by 2023, since it is often the case that government bodies both own and regulate state firms. At present, Uzbekistan's Cabinet of Ministers is the central decision-making body as regards state enterprises. It represents state interests at annual meetings, decides on restructuring and privatisation, appoints the members of supervisory boards, and approves the appointment of senior managers. The strategy essentially intends to transfer those powers to a stronger State Assets Management Agency, adopting a more decentralised approach to state ownership. In order to create a level playing field, state unitary enterprises – which are not subject to bankruptcy procedures – will be converted into either joint-stock companies or limited liability companies.

Currently, supervisory boards often consist of civil servants representing the various government bodies that regulate the relevant sectors. The strategy aims to improve state firms' overall governance structures, with an objective of having independent members make up at least 30 per cent of state enterprises' supervisory boards by 2025, as well as establishing audit, appointment and remuneration committees, and introducing appropriate risk management and internal control systems. Moreover, civil servants will no longer be able to serve as the chief executives of state firms.

The strategy also aims to introduce transparency and disclosure obligations for state enterprises. While many state firms have websites, these typically contain little information. State enterprises will be required to publish their company charters, their organisational structures, quarterly business plans, annual financial reports (with the aim of reporting in line with the International Financial Reporting Standards (IFRS) by 2024), risk reports and information on large transactions with affiliates, as well as details of the CVs and remuneration of supervisory and executive board members. The website of the State Assets Management Agency will, in turn, provide annual reports on the performance of state enterprises.

STATE-OWNED ENTERPRISES PLAY AN IMPORTANT ROLE IN THE UZBEK ECONOMY, WITH 100% STATE-OWNED FIRMS ACCOUNTING FOR
19%
OF GDP

BOX 2.7.**Increasing transparency at state enterprises: the experience of South Korea**

In 2005, the South Korean government established a public disclosure system – subsequently branded ALIO (All Public Information In-One) – whereby public institutions are obliged to disclose a range of financial and non-financial information on a quarterly or annual basis. By 2019, the initiative had been expanded to cover a total of 339 public corporations, quasi-governmental institutions and other public institutions, with those organisations having a combined budget of around 34 per cent of GDP and accounting for around 1.5 per cent of the country's total employment. Disclosed data for the last five years are available online at www.alio.go.kr.

This disclosure system was established in response to concerns that public institutions were inefficiently managed and insufficiently accountable, gave excessive bonuses to executives and lacked transparency when it came to major appointments. By 2018, there were 42 separate items that were subject to disclosure requirements, including standard financial information, the minutes of company boards' weekly meetings, information on purchases of gifts with a value above the recommended threshold, international business travel, the hiring of retired staff, and recommendations by the Board of Audit and Inspection. Moreover, this information is highly disaggregated (making it possible, for example, to trace the corporate credit card usage of individual employees). ALIO also provides comprehensive information on procurement contracts and suppliers, including details of the duration and value of each contract, the contracting entity, the contract type (direct selection or competitive selection, for instance), the purpose of the contract, and the law that governs it. The Ministry of the Economy and Finance, which is responsible for overseeing the ALIO system, can issue penalties for failing to disclose information correctly. Meanwhile, the public disclosure of organisations' environmental performance is managed separately by the Ministry of the Environment.

Public satisfaction with state institutions has increased strongly following the establishment of ALIO, indicating that the initiative has been a success (see Chart 2.7.1).

CHART 2.7.1.**Public satisfaction with state institutions has increased since the establishment of the public disclosure system in 2005**

Source: Ministry of the Economy and Finance (2020).

BOX 2.8.**Well-connected firms**

When governments adopt explicit industrial policies, state-owned enterprises often play a major role, especially when those policies target particular sectors or areas of activity. However, in many emerging economies, public policy – including industrial policies – may proceed more stealthily, being shaped by connections between *private* businesses and the political sphere. Chosen firms thrive by virtue of their close links to power, politicians or political parties. Such links secure privileges for them, whether in terms of finance, assets or resources, or market power. Moreover, a nexus of private companies closely connected to power may work in tandem with large and politicised state-owned enterprises to extract benefits and contracts, including in ways that are tendentiously touted as furthering public interests. Consequently, a simple distinction between private and state firms can be misleading.

Connections are complex in nature and have a strong network dimension. Connections between politicians, political parties and firms are typically assessed on a binary basis, involving a judgement as to whether two entities or people are connected or not. However, *where* a firm or individual is located in a network will affect how privileges are acquired and, potentially, the scale of those privileges. Although networks are ubiquitous in social and economic life, their role in providing access to assets, markets, finance, public contracts and other resources has been difficult to document thus far.

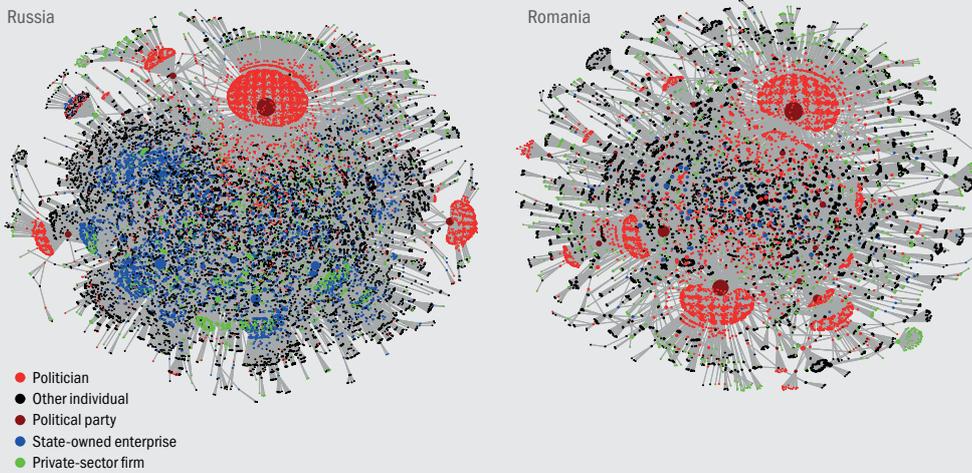
The analysis in this box demonstrates a novel way of measuring complex connections, using a detailed dataset (PEPData) which contains publicly available information assembled by major commercial providers of business intelligence on politically exposed persons (PEPs) in each country, the connections among them, and links between PEPs and political parties and firms.⁵¹ In order to identify links between firms and PEPs, that information has been combined with data taken from Bureau van Dijk's Orbis database, which provides information on firms' ownership and shareholders, as well as financial and balance sheet information.

Networks differ substantially depending on the relevant country's political system and associated institutions (see, for example, the network maps for Russia and Romania in Chart 2.8.1). The nodes in those network maps are firms (either private or state-owned), individuals, political parties and politicians; the links between them denote their connections. Russia's network has relatively few political parties, but many state-owned and private companies. Further analysis shows that state enterprises – unlike politicians and other individuals – consistently occupy strategic or central positions in that network.

Romania's network has a rather different composition and shape, being characterised by a multiplicity of political parties and their associated clusters. In addition, state and private firms are both less likely to occupy central locations than politicians and political parties.

As regards political systems, democracies consistently have far more integrated networks. In countries with weaker democratic

⁵¹ See Bussolo et al. (2018) for details.

CHART 2.8.1.**The networks in Russia and Romania differ substantially**

Source: Bussolo et al. (2018), using PEPData.



institutions, the formation of networks is often impeded so as to ensure that the political sphere – and thus potential opposition – is fragmented. As a result, power tends to be concentrated in clusters, and network connections mostly run to and from those clusters.⁵²

What are the consequences of these networks of connections? Connected firms, including state-owned ones, are unequivocally larger than non-connected firms, whether in terms of revenue or employment. This difference tends to be even greater if they have a more central position in the network. Although connections may provide access to cheap finance or preferential contracts, and may even increase market power, they may also dilute incentives to invest and raise productivity. Indeed, when looking at firms' performance, as measured by the return on the assets or capital employed, connected firms perform relatively poorly. This is true of both state-owned and private firms, and the finding holds when a binary approach is used instead of one where network features are included. This effect is even stronger when looking specifically at the firms with the most connections. Where firms have large numbers of connections – including a connection with a politician – their return on capital is around 85 per cent lower than that of a non-connected firm. In this case, the difference is substantially smaller if it is measured on a binary basis that does not take account of network features.

Such networks of connections have proven to be highly resilient, despite major changes to the political and economic regimes of transition countries in recent decades. State-owned enterprises continue to occupy prominent positions in most networks, with a high degree of centrality but poor performance. When combined with the presence of newer – but highly potent – politically connected private firms, this raises concerns not only about productive inefficiencies, but also, more generally, about inequality and the integrity of political and institutional frameworks.

⁵² See Commander and Poupakis (2020).



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