

STATE-OWNED ENTERPRISES

Understanding their market effects and the need for competitive neutrality

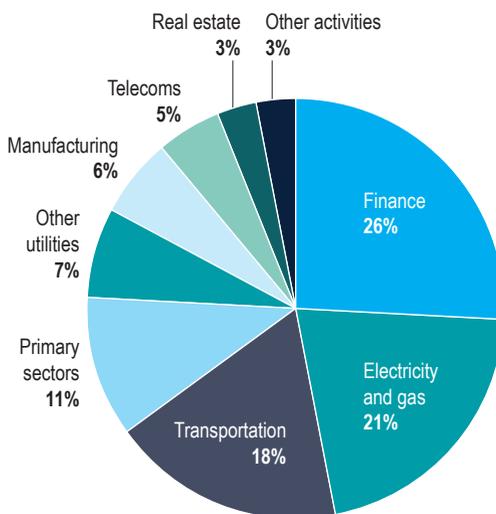
The Competition Policy Team of the World Bank Group works with governments to assess the role and market effects of SOEs in their countries with the ultimate goal of identifying reforms that will increase SOE efficiency, mitigate negative market effects, and encourage private sector growth.

SOEs play an important role in economic activity

State-owned enterprises (SOEs) rank among the world's largest companies in the world and have a potentially critical role to play in economic growth and development. SOE assets were valued at \$45 trillion in 2018, about half of global GDP, up from around \$13 trillion in 2000.¹ In a study of 40 countries (excluding China) for 2015, SOEs were valued at USD 2.4 trillion and employed over 9.2 million people.² Another estimate credits SOEs for 20% of investment, 5% of employment, and up to 40% of domestic output worldwide in 2018.³ In terms of their distribution across countries, SOEs are important market actors in both high- and low-income settings, although their economic weight is most significant in transition economies where their added value can be as high as 30% of GDP.⁴ Considered at the sectoral level, SOEs are common in network sectors, such as electricity, finance, telecommunications, transport and water, as well as resource extraction sectors (Figure 1).

SOEs are in a unique position to drive economic growth given their size, mission, and strategic objectives. For

FIGURE 1 SOEs dominate in network and primary sectors (equity value, 2015).



Source: OECD, *The Size and Sectoral Distribution of State-Owned Enterprises*, (2017). OECD Secretariat calculations based on questionnaire responses submitted by national authorities or other contributing institutions from a sample of 40 countries, excluding China.

Note: The figure includes Argentina, Australia, Austria, Brazil, Canada, Chile, Colombia, Costa Rica, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, India, Ireland, Israel, Italy, Japan, Korea, Latvia, Lithuania, Mexico, the Netherlands, New Zealand, Norway, Poland, Saudi Arabia, the Slovak Republic, Slovenia, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States. Sample area excludes China.

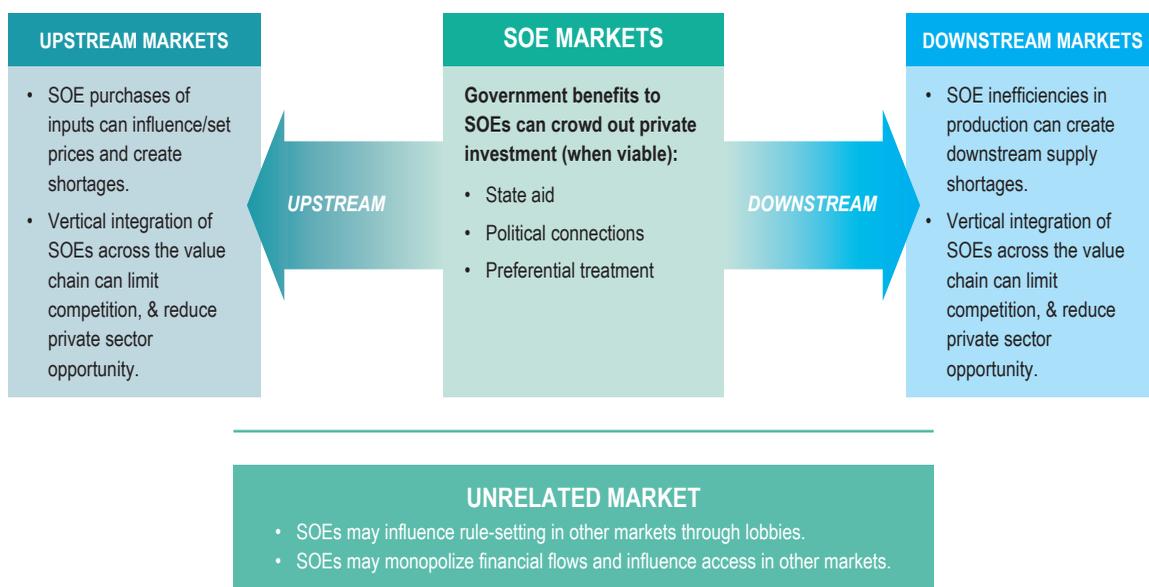
example, when SOEs are major players in a given market, they can drive the adoption of higher standards and production of higher quality goods and services along entire supply chains. Being located predominantly in network sectors also allows SOEs to generate significant spillovers to the rest of the economy.

Too often, however, SOEs distort markets and crowd out the private sector. SOEs frequently receive exclusive preferential regulatory treatment and/or state support as compared to their private sector counterparts. Common measures include subsidies, tax preferences or exemptions, in-kind benefits such as subsidized or fixed price inputs, and concessionary financing and guarantees. Exclusive benefits create an unlevel playing field between SOEs and private companies and can influence competition across entire value chains (Figure 2).⁵ Foreign investment is disincentivized in markets that demonstrate high levels of government ownership or intervention.

Evidence also suggests that preferential treatment to SOEs may facilitate anti-competitive conduct.⁶

The implications of inefficient SOEs for development are significant: studies have shown that if SOEs were just 5% more efficient, GDP could be 1–5% higher.⁷ There is also growing evidence that competition in network and services sectors is particularly important.⁸ Moreover, SOEs are likely to have the most distortive effects in developing country markets because they generally are smaller and private sector activity is already constrained by other factors, such as a poor business environment and limited human capital. Weak regulation, monitoring, and oversight—together with the absence of a well-developed competition framework—reinforce distorted markets and fail to deter anticompetitive behavior. Further, when government-backed SOEs in receipt of extensive support are active in foreign markets they face a higher risk of international disputes and higher tariffs.

FIGURE 2 SOEs and markets



Source: WBG Competition Policy Team.

Implementing procompetitive reform can reduce market distortions and spur private sector development

The Competition Policy Team of the World Bank Group (WBG) works with governments to assess the role and market effects of SOEs in specific markets, with the ultimate goal of identifying potential reforms to increase SOE efficiency, mitigate or eliminate their negative market effects, and encourage private sector growth. This work proceeds along three lines: (i) assessing market dynamics in sectors with SOE participation; (ii) assessing market discipline and competitive neutrality in markets with SOE participation; (iii) proposing SOE and other regulatory reforms to improve market contestability and encourage private sector entry (Table 1).

Assessing market dynamics in sectors with SOE participation

As an initial step, the WBG works to understand how SOEs are defined in the laws and regulations of the client country, as well as the rationale of the government in organizing activity through SOEs. Although the presence of SOEs may be justified in some cases in order to address a concrete market failure, it is important to understand whether private companies could provide the same good or service in a competitive and more efficient manner. The WBG maps the number of SOEs across the economy and their role in specific sectors in order to then analyze market structure where SOEs are present, including the degree of vertical integration, the level and form of government support provided, and market dynamics (Figure 3).

TABLE 1 WBG assessment of market dynamics, market effects, and competitive neutrality¹¹

<p>PHASE 1</p> <p>Market dynamics and the likelihood of adverse market effects</p>	<p>STEP 1 <i>Assessment of the importance of SOEs in the economy and the potential of having adverse effects.</i></p> <ul style="list-style-type: none"> ✓ Identifying SOE's presence in the economy. ✓ Identifying sectors where SOEs are operational and understanding the rationale for direct participation of the State. ✓ Understanding the degree of SOE influence in the market, based on the characteristics of the industry, demand, countervailing buyer power, network effects, and the level of integration in the value chain. <p>STEP 2 <i>Identification of preliminary concerns about unequal treatment of SOEs.</i></p> <ul style="list-style-type: none"> ✓ Assessment of SOE regulatory framework, exceptions to the general rules, legal monopolies v. natural monopolies, tax advantages, bailouts etc. <p>STEP 3 <i>Understanding the relationship between the State, SOEs, and politically connected firms.</i></p> <ul style="list-style-type: none"> ✓ Examination of commercial links between State participation and private firms, potential conflicts through minority shareholding, and screening competitive neutrality.
<p>PHASE 2</p> <p>SOEs effects on the market and competitive neutrality</p>	<p>STEP 1 <i>Mapping value chains and markets in which priority SOEs participate, and competitive neutrality assessment</i></p> <ul style="list-style-type: none"> ✓ Analysis of the position of the SOE in the market. ✓ In-depth evaluation of competitive neutrality gaps in regulation and policy. ✓ Assessment of potential options for private sector delivery. <p>STEP 2 <i>Identifying negative market effects of SOEs</i></p> <ul style="list-style-type: none"> ✓ Anticompetitive risk assessment: potential for collusive conducts and abuse of dominance. ✓ Analysis of negative effects of regulation in the market (e.g. barriers to entry).
<p style="text-align: center;"> Formulate SOE and other regulatory reforms to improve market contestability.</p>	

FIGURE 3 Example of SOE Mapping—The Case of South Africa

PRIMARY SOE	SUPPLY/VALUE CHAIN	MARKETS ALONG THE SUPPLY CHAIN	ECONOMIC RATIONALE
ACSA	Airport development and management		Natural monopoly
Alexkor	Diamond mining		Management of scarce resources; Negative externalities
CEF	Oil		Management of scarce resources; Negative externalities; Natural monopoly in transmission segment
	Gas		
	Coal		
	Solar		
	Wind		
DBSA	Development finance		<u>Positive externalities</u>
Eskom	Coal		<u>Natural monopoly</u>
	Gas		
	Nuclear		
	Wind		
	Hydro		
	Solar		
	Financial services/Insurance		
	Ancillary services		

LEGEND

- SOE presence may be justified by an economic rationale/market failure
- There does not appear to be a clear economic rationale based on correction of a market failure (note, the government may have a strategic rationale for its presence)
- Mixed or unclear (e.g., there may be situations, geographies of areas where SOE presence has an economic rationale and others where it does not)
- Market where a conflict of interest resulting from vertical integration and the presence of a key supplier or offtaker may raise the risk of exclusionary behavior

Note: Where rationales are underlined, the government has explicitly provided one through the Presidential Review Committee.

Source: World Bank, *The Role of SOEs in South African Markets and their Impact on Competition*, (2017).

Based on this information, the WBG then assesses the market effects of SOEs using a two-phase analytical framework: (i) first, an assessment is made of the likelihood of adverse market effects, based on market dynamics (Phase 1, Table 1); and (ii) second, an in-depth assessment of

current SOE effects in the market is carried out, including an assessment of competitive neutrality (Phase 2, Table 1). Evaluating current SOE market effects involves empirical research and quantitative analysis of data on the drivers of market power, including ownership and other firm characteristics (box 1).

BOX 1 Measuring firm-level markups—examples from China and Romania

The rarity of firm-level price data and data on marginal costs generally makes direct measurement of markups challenging. Where sufficient data exist, however, it may be possible to estimate firm-level markups and thus gain insight into industry-specific levels of competition and into markup differences between SOE and non-SOE firms. Itoyy and Dauda (2017) provide an estimation of markups in the Chinese manufacturing industry. The analysis showed that SOEs solely-owned by the state had significantly higher markups (a proxy for the level of competition) than other firms, even after controlling for other firm characteristics.

Itoyy, Pop, and Pena (forthcoming) conducted a similar analysis of markups in Romania between 2008 and 2017, showing that, among firm characteristics, ownership is the most relevant in explaining differences in markup. State-controlled companies tend to exert the highest markup premiums when compared to domestic privately-owned companies across the economy and especially in the manufacturing sector: 29% higher for minority state owned companies and 20% higher for fully state owned. Capital intensity and export activity are also particularly relevant, with greater intensity for either characteristic corresponding with higher markups.

Itoyy, M., Pop, G., Pena, J. "Corporate market power in Romania: assessing recent trends through firm level lenses." (forthcoming)

Itoyy, M., Dauda, S. "Assessing firm markup in China: First Insights into the Manufacturing Industry." (2017) Background paper for World Bank Group; Development Research Center of the State Council, The People's Republic of China, (2019). *Innovative China : New Drivers of Growth*.

Assessing competitive neutrality in markets with SOE participation

As an important complement to the core SOE analysis, the WBG assesses the state of competitive neutrality in client countries and explores ways to strengthen market discipline.

Competitive neutrality is the degree to which all enterprises, public or private, domestic or foreign, face the same set of rules and conditions (in fact or law), and whether any actors are accorded an undue competitive advantage.⁹The World Bank's Competitive Neutrality Gap Analysis is divided into the following eight building blocks, the first four of which focus on firm-level principles and the last four of which focus on cross-cutting policy:

- i. Streamlining the operational form of government business:* identify where commercial and noncommercial activities should be structurally separated, and provide advice on vertical unbundling of accounts, functions, legal form, and/or ownership where feasible and efficient.
- ii. Identifying the costs of any given function:* determine whether there is a need for improved cost allocation mechanisms to ensure public funds do not finance commercial activities in the market.
- iii. Achieving commercial rates of return:* assess whether SOEs achieve commercial rates of return in their operations and recommend strategies to enforce and monitor such a requirement.
- iv. Accounting for Public Service Obligations:* assess compensation for the provision of public services in terms of transparency and accountability, and recommend mechanisms that are market-based.
- v. Regulatory neutrality:* determine the extent to which SOEs receive preferential treatment in the law, e.g., SOE exclusions from bankruptcy and antitrust obligations and enforcement.

vi. **Public procurement:** assess whether public procurement is transparent, encourages competition, and minimizes opportunities to discriminate against certain

enterprises, be they state-owned or private.

vii. **Tax neutrality:** within the broader tax system for corporate commercial activities, identify any exemptions or

FIGURE 4 Example of Competitive Neutrality Gap Analysis—Ukraine

COMPETITIVE NEUTRALITY				
Subsidiarity analysis: the role of the State in the economy				
Firm-level principles: Separation of SOE commercial and non-commercial activities				
	1 Streamlining the operational form of government business	2 Identifying the costs of any given function	3 Achieving a commercial rate of return	4 Accounting for public service obligations
Ukraine	<ul style="list-style-type: none"> No provisions in Ukrainian legislation requiring business separation (legal developments underway in electricity and gas) 	<ul style="list-style-type: none"> Draft methodology for separating commercial and non-commercial activities of SOEs to be adopted SOEs do not disclose their performance 	<ul style="list-style-type: none"> No requirement to show: a positive NPV in investments; market consistent rate of returns in sales No private sector benchmark of SOE transactions 	<ul style="list-style-type: none"> Lack of transparency and objective criteria in the compensation of PSOs delivered by SOEs
Benchmark	<ul style="list-style-type: none"> Legislation requires business separation of SOEs 	<ul style="list-style-type: none"> Accounting for separating commercial and non-commercial activities of SOEs SOEs objectively assessed based on transparent performance reports 	<ul style="list-style-type: none"> SOEs commercial operations and investments are required to have positive NPV, market consistent rate of returns and to be measured based on private sector performance 	<ul style="list-style-type: none"> Compensation paid to SOEs for the provision of PSOs is based on transparent accountability and objective criteria. Cross-subsidization is avoided.
Principles embedded in cross-cutting regulatory frameworks and sectoral policies				
	5 Regulatory neutrality	6 Public procurement	7 Tax neutrality	8 Debt neutrality and outright subsidies
Ukraine	<ul style="list-style-type: none"> Preferential access to trade protection and state assets for politically connected firms Legal monopolies established by law; sectors exempted from the privatization law 	<ul style="list-style-type: none"> Preferential access to public procurement for politically connected firms Design facilitates bid rigging practices 	<ul style="list-style-type: none"> SOEs receive tax exemptions, subsidies and debt guarantees (tax exemptions and subsidies are also available to private sector) Preferential access to subsidies, tax exemptions, state guarantees and others, for politically connected firms. 	
Benchmark	<ul style="list-style-type: none"> Companies compete on a level playing field, with no trade protection and market based competition for rights to invest in state assets Sectors where competition is feasible are open to private investment 	<ul style="list-style-type: none"> Market based competition in public procurement Bids/auctions designed to reduce the risks of bid rigging 	<ul style="list-style-type: none"> Tax exemptions, subsidies and debt guarantees granted following competitive neutrality principles 	
Control of state support measures to SOEs and private sector operators				
Level playing field in the market between SOEs and privately owned operators				

Source: World Bank, *Reducing Market Distortions for A Prosperous Ukraine: Proposals for Market Regulation, Competition and Institutions*, (2018).

preferential treatment that benefit SOEs, e.g., reduced rates, rights of deferral.

- viii. **Debt neutrality and outright subsidies:** evaluate whether SOEs have access to credit on the same terms as private sector operators, and whether they receive subsidies without a clear economic justification or policy objective.

Analyzing each of these issues to assess competitive neutrality for SOEs in the relevant market involves an in-depth analysis of applicable laws, regulations, and policies against a benchmark of best practices (Figure 4).

Proposing SOE and other reforms to improve market efficiency and encourage entry

Policy recommendations can be formulated for the government's consideration to reduce the distortive market effects of SOEs and crowd in private sector participation. Before proceeding with reforms, it is important to assess the ability and willingness of the private sector to (efficiently and competitively) perform the economic activities of the SOE(s) in question (Box 2).

Policy recommendations are tailored to the particular circumstances in each case, especially the market dynamics and market effects of SOEs, as well as the likelihood of the private sector entering the market. Reform strategies may involve privatization, but significant improvements in market functioning can be achieved by other means, such as removing exclusivity in cases of a legal monopoly or facilitating private sector entry in cases of a *de*

BOX 2 Incorporating the principle of subsidiarity into domestic law: the case of Kazakhstan

With the passage of a 2008 competition law—Law of the Republic of Kazakhstan No. 112-IV ZRK “On Competition” of 25 December 2008—Kazakhstan formally adopted a subsidiarity approach in its SOE legal framework. In particular, the law limits government participation in business activity to that in which there is “absence of private entrepreneurs performing production and (or) sale of similar or substitutable products at a relevant commodity market” (Art. 31, subpara. 4).

The World Bank provided recommendations on the implementation of the subsidiarity principle. Specifically, the recommendations suggested that both *ex ante* and *ex post* reviews could be useful. Ultimately, these recommendations were adopted into law. *Ex ante*, the law requires the Antimonopoly Authority to review the creation of SOEs where the state is a majority owner and if “such creation leads to competition limitation.” (Art. 31, para. 5). *Ex post*, the law requires the Antimonopoly Authority to review existing SOEs and identify those that are engaged in activities that could potentially be privatized. (Art. 47 para. 2-1).

facto monopoly. Where SOEs are already dominant, privatization may not lead to efficiency gains unless it is accompanied by effective regulation to level the playing field between public and private actors, as well as additional measures to support private sector development.¹⁰ Policy recommendations can be formulated to guarantee that, following the adoption of a trade agreement, SOEs compete on a level playing field and cause no distortion in the market. The World Bank’s *Integrated State-Owned Enterprises Framework* (2019), especially the Overview and Module 1 (*SOEs and the Market: Considerations for Policy Makers*) provide more guidance on SOE reforms.

The WBG accompanies its client countries during the reform process, monitoring the outcomes to ensure that the result is a competitive environment.

Endnotes

¹ IMF (2020). *IMF Fiscal Monitor*, at Chapter 3.

² China's SOEs were valued at USD 29.2 trillion and employed 20.2 million people. See OECD, *The Size and Sectoral Distribution of State-Owned Enterprises*, (2017).

³ International Finance Corporation, *State-Owned Enterprises*, (2018), available at: https://www.ifc.org/wps/wcm/connect/topics_ext_content/ifc_external_corporate_site/ifc+cg/topics/state-owned+enterprises.

⁴ For example, see World Bank, *A Review of Competition-Related Regulatory Restrictions in Bolivia*, (2017).

⁵ OECD, Corporate Governance Working Papers No. 1, *Competitive Neutrality and State-Owned Enterprises, Challenges and Policy Options*, (2011).

⁶ Recent studies in South Africa, Ukraine, Philippines and Romania confirm that the lack of competitive neutrality, the absence of fully-fledged procompetitive provisions in regulation, and a combination of vertical integration and dominance act as incentives for SOEs to engage in anti-competitive practices. See: World Bank, *The Role of SOEs in South African Markets and their Impact on Competition*, (2017); World Bank, *Reducing Market Distortions for A Prosperous Ukraine: Proposals for Market Regulation, Competition and Institutions*, (2018); World Bank, *The Philippines: Embedding Competitive Neutrality Principles in State Owned Enterprises*, (2018); World Bank, *Romania-Country Economic Memorandum 2.0, Markets and People*, (2019).

⁷ For example, in one study a 5% increase in SOE efficiency could have increased GDP by 2% in Turkey, 1.5% in Tanzania, 1.4% in Bolivia and 2.2% in Mali. See World Bank, *World Development Report 1983* at 75. Another slightly more recent study produced similar results: a 5% increase in SOE inefficiency could increase GDP by 1% in Pakistan, 5% in Egypt, and 1.7% in South Korea. See Jones, L. P., "Performance Evaluation for State-Owned Enterprises" in Ravi Ramamurti and Raymond Vernon, eds., *Privatization and Control of State-Owned Enterprises* (World Bank) (1991) at 179; Jone, L. P., *Efficiency of Public Manufacturing Enterprises in Pakistan*, (1981), Prepared for Pakistan Ministry of Production, and Pakistan Division, World Bank.

⁸ See, for example: Hoekman, B., Shepherd, B. *Services Productivity, Trade Policy, and Manufacturing Exports*. European University Institute Robert Schuman Centre for Advanced Studies Global Governance Programme RSCAS 2015/07, 1–26, (2015); Barone, G., Cingano, F. *Service Regulation and Growth: Evidence from OECD Countries*. *The Economic Journal* 121, 931–957, (2011). doi:10.1111/j.1468-0297.2011.02433.x.

⁹ OECD, *Roundtable on Competition Neutrality: Issues by the Secretariat*. OECD Internal Working Document, DAF/COMP(2015)5.

¹⁰ For example, in South Africa, 20 cases of abuse of dominance before the Competition Commission of South Africa until 2012, 15 involved companies that were previously state-owned or benefited from government support.

¹¹ For more detail, see World Bank, *Integrated State-Owned Enterprises Framework (iSOEF): Overview*, (2019).

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www.worldbank.org/en/topic/competition-policy

Information on the World Bank's *Integrated State-Owned Enterprises Framework (iSOEF)* is available upon request.