CORPORATE GOVERNANCE OF STATE-OWNED ENTERPRISES IN CHINA

WHY PERFORMANCE CONTRACTS FOR STATE-OWNED ENTERPRISES HAVEN’T WORKED
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WHY PERFORMANCE CONTRACTS FOR STATE-OWNED ENTERPRISES HAVEN’T WORKED
Governments in developing countries often negotiate contracts with state-owned enterprises in an effort to improve performance when privatization is not feasible or desirable. Many of these so-called performance contracts have been put in place with World Bank assistance. Research shows that they rarely work. This note summarizes the rationale for PCs and the evidence against them, and explores the reasons why performance contracts haven’t worked. It concludes with suggestions about when PCs might still be useful, and about other ways to improve SOE performance.

Written contracts between governments and state-owned enterprises (SOEs) have been widely used in World Bank projects since the first operation supported performance contracts (PCs) in Senegal in 1975. Our survey of developing countries found 565 such contracts in 32 countries, plus another 103,000 in China as of June, 1994 (World Bank 1995), many of these introduced with Bank assistance. Although these PCs go by various names (contrat-plan, memorandum of understanding, signaling system, etc.) they share common features. All are negotiated, written agreements between governments and the managers of their SOEs which specify explicit targets that management pledges to achieve in a given time frame, and where performance is measured at the end of a specified period.

*The Case for Performance Contracts*

Despite an upsurge in privatizations, SOEs still account for about 10 percent of GDP in developing countries. These enterprises are often the largest and most valuable or problematic firms, with monopolies in infrastructure, mining, petroleum, and heavy industry. For these firms, performance contracts have often seemed to make good sense. Before the contracts were put in place, most governments were trying to run their SOEs without any form of performance evaluation, which was, as one architect of performance contracts noted, like playing football
without rules, scoreboards or umpires. Good performers could not be rewarded nor bad performers punished. Instead, governments tried to direct choices that should have been left to firms’ managers. PCs seemed a logical solution to this problem, since similar contracts have been successful in the private sector. PCs were seen as a way to shift from ex ante control to ex post evaluation, giving managers the autonomy and incentives to improve efficiency and holding them accountable for results.

No one, including the proponents of PCs, minimized the problems governments would face in designing such contracts, however. An extensive literature analyzes the problems principals (such as owners or governments) face because they cannot measure accurately the effort expended by their agents (in this case, managers) or sort it out from other factors affecting performance. These agency problems are compounded in the public sector because agents serve multiple principals with multiple objectives, such as politicians with many points of view and bureaucrats with different agendas. Under such circumstances it is hard to judge performance and to motivate managers and hold them accountable for results. Moreover public principals, in contrast to private owners, may not benefit from better performance, and hence may try to make managers serve objectives which conflict with efficiency, such as rewarding political supporters with jobs or subsidies.

Proponents of performance contracts argue that they can be written in ways that clarify multiple objectives and make it easier to judge performance. For example, the contract can apply weights to the multiple objectives, spell out the obligations for which managers will be held accountable, and specify rewards, such as bonuses, and penalties, such as demotion or firing. Moreover, even where social or political objectives are being maximized, performance on efficiency measures can still be improved by setting appropriate targets. For example, even if a government requires an SOE to retain redundant workers, it could still achieve contractual targets aimed at improving quality. The fact that managers operate under such constraints could be
taken into account by judging performance against past trends. Thus, an over-staffed SOE could still improve the trend in labor productivity by making better use of plant and equipment.

The Evidence Against Performance Contracts

The logic of PCs is persuasive, but the reality has been disappointing. Two empirical studies, one analyzing the effect of PCs on profitability and productivity in 12 case study companies in six countries, and the other examining statistically the correlation between PCs and productivity in over 400 SOEs in China, found no evidence that performance contracts had improved efficiency. The first study analyzed the effects of contracts in monopoly SOEs (in electricity, telecommunications, water and oil and gas) in Ghana, India, Korea, Mexico, the Philippines, and Senegal, using a questionnaire and field trips as well as detailed information on each firm’s performance. There was no pattern of improvement in trends in productivity or profitability associated with the PCs (see figure 1). Regressions comparing the SOEs’ pre- and post-contract trends in return on assets, labor productivity and total factor productivity found PCs had no statistically significant, positive effects (controlling for the firm-specific pre-contract growth rates and levels of productivity and the growth in country-specific GDP, as well as for reverse causality). The only significant correlation was negative: PCs had a negative effect on total factor productivity growth rates.

The sample in the first study was small, and composed entirely of monopolies, although it did cover a very diverse set of countries. The second study used a much larger sample in manufacturing, but in only one country, China. This study again found no robust, positive association between PCs and productivity (again controlling for firm specific growth rates and economy wide shocks, as well as for regional effects, industry size, different levels of government subsidies and the effects of other reforms not related to the PC). The increasing use of PCs could not stem the fall in SOE productivity in China (Fig. 2).
Some readers might wonder if PCs failed to improve productivity because managers were told to maximize social benefits such as employment or development of backward regions. The studies do not measure social benefits, but the weights assigned to productivity targets (two thirds on average), and the stated goals of the participants suggest that improving operating efficiency was the prime PC objective. Most social and political goals imposed invariant costs on SOEs throughout the period and should not have affected the trends being measured.

Some readers might also ask: Why not simply judge PCs on the basis of the firms’ attainment of the targets specified in the contract, especially since these presumably indicate what the firm is trying to achieve?” It is true that all of the sample SOEs in our first study achieved at least satisfactory ratings where some sort of score was assigned, and all of the contracts assign a high weight to economic goals. The problem is that many of the targets are soft or flawed measures of economic performance. For example, 30 percent of one of the
electricity company’s score (India’s National Thermal Power Corporation) in 1991-92 depended on the volume of electricity generated. The company achieved its target and received a score of excellent under its contract, yet its total factor productivity actually fell below pre-contract levels. Output went up, but inputs rose three times faster. The target was flawed: it could be achieved by increasing inputs, even if efficiency declined. The contracts exhibit many such flaws, for reasons which are explored below.

Why Haven’t PCs Improved Performance?

The contracting literature suggests that for PCs to improve performance they must:

• reduce the information advantage that managers enjoy over their owners;
• motivate managers to achieve the contract’s targets through rewards or punishments;
• convince managers that government promises contained in the contract (for example, to pay bonuses or apply punishments) are credible.

The PCs in the two studies described failed on all three counts. First, managers were able to use their information advantage to negotiate targets that were either hard for outsiders to evaluate, or easy for the firm to achieve. Performance is hard to evaluate, for example, when there are many targets (Korea’s telecommunication company’s contract had 40) or when targets change frequently (one third of targets for Ghana’s water company changed every year). Targets can also simply be soft, such as when negotiations dragged on so long in India that targets were set equal to ex post performance. The managers’ information advantage was compounded by government’s failure to give the bureaucrats responsible for negotiating the contract and evaluating results, the power, resources and status necessary to face SOE managers on a level playing field. Managers were thus able to achieve their targets without having to make additional efforts to improve their productivity.

Second, the incentives provided under the contracts failed to motivate managers. In the first study, only two of the 12 sample contracts paid a bonus or punished underachievement,
while in the second study of China the incentive (wage increases linked to profits) was set too low to motivate improvements in most of the firms and was aimed only at workers.

Finally, governments’ commitment to enforce the contract and keep promises were not credible. All the contracts lacked neutral, third party enforcement mechanisms (for example, the SOEs could not take government to court), and there was widespread government reneging on promises. For example, governments did not force public entities to pay their bills to the electricity companies in Ghana, India, and Senegal.

There is evidence that a PC which overcomes the three contracting problems can indeed improve efficiency. The study of China simulated what would have happened with a “good” PC – one which addressed the problems of information, incentives and commitment -- and found a statistically significant and large (10 percent) positive effect on productivity growth rates. Unfortunately only 2.2% of the PCs in the sample had such “good” PCs. In all the other PCs the productivity effects were either insignificant or negative.

Why did so few PCs contain the provisions necessary for success? Performance contracting assumes that government objectives can be maximized and performance improved by setting targets which take into account the constraints placed on managers. For this to occur, politicians and bureaucrats must state their objectives explicitly and agree to weights to reflect their priorities, empower a supervisory body to translate these objectives into monitorable targets negotiated with managers, punish and reward managers based on their achievement, and keep any promises made under the contract. Few of these actions materialized in the contracts studied.

Why would governments sign PCs and then not try to make them work? Some governments may have been motivated to pledge actions that were politically unrealistic because it enabled them to meet conditions under a World Bank project. That seems to have been the case in Senegal, for example, where the telecommunications company complained that the
contrat-plan “was never considered a binding document by the public powers.” Some governments may have underestimated the political costs of adhering to the PC, such as firing politically loyal but under-performing managers, paying incentives that might raise a manager’s salary to well above that of a minister, moving funds used for other purposes to pay electricity bills, allowing overstuffed SOEs to lay off workers, etc. All governments seem to have underestimated the extent of their information disadvantage vis-à-vis managers.

**What Can Be Done to Improve the Performance of SOEs?**

The experience of Chile, which successfully reformed its SOEs, points to actions that are central to improving efficiency: competition, corporatization, and an end to subsidies, overt and covert. Chile increased competition by ending any legally mandated state monopolies or barriers to entry, reducing tariffs to 10 percent across the board, breaking up monopolies in, for example, electricity, and pushing SOEs to contract out competitive activities under strict rules of competitive bidding. All SOEs were placed under private commercial law and members of the boards of directors became liable for their decisions. Private parties were named to boards and boards were kept small (5 people) to reduce the political value of keeping companies public. All subsidies, transfers and government guarantees for SOE debts were eliminated and banks were instructed to lend to SOEs under the same criteria as private enterprises. Moreover, SOEs were required to pay a 10% return on assets as a dividend; money losers were required to sell assets to pay their dividend. Almost all commercial and most utilities were privatized, which allowed the government to concentrate its supervision on relatively few firms (such as the water and sewerage companies).

Do these findings mean that Bank operations should not support or encourage PCs? The studies found few successful contracts, but did show that in those rare cases where a PC is properly written it can improve efficiency. But the negative correlations also imply that PCs can do harm. If targets are set too low, managers might actually reduce their efforts to improve
performance. And flawed targets could have perverse effects, as in the example above of India’s electricity company. Since a well designed and enforced PC can be as politically costly as a well designed privatization, PCs are not likely to be successful in countries that lack the political will to privatize, where they may be viewed as a soft alternative to privatization. The findings suggest that PCs should be used only where political conditions are right and the PC is part of a broader package of SOE reforms; (for a discussion of how to judge political readiness to reform see World Bank 1995).

**Sources:**


**Pull quotes:**

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