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TOWARDS A FRAMEWORK TO UNDERSTAND THE RELATIVE PERFORMANCE OF STATE-OWNED FIRMS

ABSTRACT: *This paper considers the factors influencing the comparative performance of state-owned and privately-owned enterprises (SOE/POE). The economics literature has argued that firm performance is influenced by governance arrangements, leading to expectations of inferior performance from SOEs. Meanwhile, a political economy literature classifies countries according to the model of state engagement, which also has implications for SOE performance. We combine these two frameworks to provide a taxonomy. The first framework relating to governance concerns the relationship between owners and managers, the relationship between large and small owners, and the functioning of the managerial labour market. The second framework considers three types of model of state engagement: the Welfare State, the Developmental State, and the Predatory State. Each of the six resulting taxonomies yields distinct outcomes in terms of SOE versus POE performance. In all models, SOEs perform better in a better governance environment than in a worse governance environment, and this ranking is the same in Welfare States and Predatory States. However, in Developmental States with strong governance, SOEs may outperform POEs if they can benefit from superior state resources.*

KEY WORDS: *state-owned firms, firm performance, governance, institutions, model of state engagement*

JEL CLASSIFICATION: L2, O1, P5

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1. INTRODUCTION

There is already a voluminous theoretical and empirical literature on the effect of state ownership on company performance (e.g., Vickers & Yarrow, 1991; Megginson & Netter, 2001; Megginson, 2017; Estrin & Gregoric, 2020). In general, the theory proposes that state-owned enterprises (SOEs) will perform worse in terms of economic criteria like profitability, return on assets, and productivity than comparable firms under private ownership (privately owned firms, POEs) (Vickers & Yarrow, 1988). In part, this is because the objectives of state enterprises may be broader to encompass the targets of their owner (the state), but it is also argued that the market disciplines that limit the exploitation of managerial discretion and rent-seeking are less effective when applied to SOEs compared with POEs (Estrin & Perotin, 1991). The view that SOEs are inherently less efficient was buttressed by the inefficiencies of the former socialist systems of Central and Eastern Europe, where the debilitating effects of state ownership were blamed (along with over-centralisation of resource allocation) for the poor productivity and long-term stagnation of these economies (Kornai, 1990). These perceived problems helped to justify a worldwide process of privatisation of SOEs, which began in the UK in the 1980s under Margaret Thatcher but became much more widespread, initially during the transition from socialism to capitalism after 1989 in Central and Eastern Europe, and then more broadly in emerging economies (Djankov & Murrell, 2002; Estrin et al., 2009).

However, in recent years there has been a trend towards increasing state ownership, especially – but not only – in emerging markets (see Bruton et al., 2015; Musacchio & Lazzarini, 2014; Aharoni, 2018); in January 2012 even The Economist had a front cover entitled "The Rise of State Capitalism". One reason explaining the rising prevalence of and research interest in SOEs is that the theoretical arguments about the inefficiency of SOEs are neither as straightforward nor as overwhelming as policymakers maintained in the 1980s and 1990s. The agency issues at the heart of poor SOE performance may also affect POEs if capital market disciplines are poor (Vickers & Yarrow, 1988). POE managers usually own relatively small proportions of stock, so ownership and control are separate in both types of firm. The effectiveness of the governance system therefore rests on the performance of the external market system and the quality of institutions in each type of firm. The state as owner may be poor at resolving agency problems because, for example, of corruption (Shleifer &

Vishny, 1998). However, POEs may have parallel issues: individual shareholders often hold too small a stake to be able to or to have an incentive to bear the cost of monitoring management, leaving considerable scope for opportunistic behaviour by management that can worsen business performance (Fama &Jensen, 1983). Thus, even at the theoretical level, the relative efficiency of SOEs versus POEs is contingent on governance arrangements (Estrin et al., 2016).

In addition, the evidence does not always establish that POEs have a clear-cut advantage (but see Megginson, 2017). If SOEs are less efficient than POEs there should be strong evidence that privatisation leads to improved firm performance. In fact, the evidence is mixed (Estrin et al., 2009; Estrin & Pelletier, 2018). The literature suggests that the relative performance of SOEs and POEs is contingent on the quality of institutions: privatisation will only improve firm performance when governance arrangements in the private sector are superior to those in the state sector (Vickers & Yarrow, 1991; Bardhan, 2016). More recent work indicates that the relative performance of SOEs versus POEs also depends on the state's objectives (Cuervo-Cazurra et al.,2014; Musacchio et al., 2015). If governments pursue social and development goals and channel resources to support long-term SOE performance (Bruton et al., 2015), SOEs may be able to drive industrialisation and engagement in the global economy – so-called 'state capitalism' (Massuchio & Lazzarini, 2014; Mariotti & Marzano, 2019). This view is consistent with the growing evidence that state ownership can help development: a case in point is the rapid rise of the Chinese economy and other emerging markets like Vietnam.

In this paper we delve deeper into these issues, exploring whether these recent developments lead to a more nuanced view of the relative performance of SOEs and POEs, and try to identify if there are circumstances in which the latter type of firm might generate superior outcomes. We consider separately the impact on SOE/POE performance of agency factors and of what we term 'state orientation' – the attitude of the state towards economic development. First, we look at various elements of the principal–agent problem as it affects SOEs as against POEs by focusing on governance institutions. We propose three sets of relevant institutions, concerning the relationship between owners and managers (Fama & Jensen, 1983), the relationship between large and small owners (Young et al.,2008), and the functioning of the managerial labour market (Bruton et al., 2015). In the third section we discuss ways to classify state involvement in the economy, with special reference to the goals of the state as owner of SOEs. We define three groups of system, the Welfare State, the Developmental State, and the Predatory State. In the fourth section we combine these agency factors and state systems to produce six taxonomies, each of which yields distinct outcomes in terms of SOE versus POE performance. We draw conclusions in the final section.

2. INSTITUTIONS AND THE AGENCY PROBLEM: QUALITY OF GOVERNANCE

It is usually argued that SOEs will always perform worse than POEs. There are two broad and inter-related strands to this argument. The first relates to the potentially different objectives of private and state-owned firms. Private firms are assumed to focus exclusively on profit, which motivates close attention to efficiency and costs and the demand side of the market. By contrast, the objectives of the state as owner depend on the motivation behind public ownership in the first place. Profit may motivate SOEs to finance further investment or broader government activities, especially in 'hybrid' state-owned firms in which private firms, sometime foreign, own minority stakes (Bruton et al., 2016). But the state as owner may also expect the SOE to satisfy other, often social or political objectives. For example, the government may use SOEs to support or create employment, especially in key political regions, or to hold down the price of goods that have a significant effect on voters' budgets. Such demands inherently blur the incentive to minimise costs. SOE managers may exploit the ambiguity arising from conflicting objectives: when the owner's objectives are contradictory the resulting ambiguity makes it harder to monitor managerial performance, providing leeway for managers to pursue personal gain rather than organisational efficiency (Estrin & Perotin, 1991). When company objectives lack clarity, inefficiency and siphoning business resources for the private benefit of the management are harder to identify, and thus more difficult to prevent (Shleifer & Vishny, 1994).

The literature argues that the asymmetry of information held by managers and owners regarding firm performance is at the heart of this problem. Thus, outside owners, be they private or state, can never have full access to information regarding the true business performance, which instead is concentrated in the hands of its managers. When outcomes are poor, the owners cannot establish conclusively, based on the information they have, whether this is the consequence of an unfortunate external environment, unforeseen circumstances, or managers exploiting firm profits for private benefit. This is a generic problem in modern corporations that occurs because ownership and control are separated (Fama & Jensen, 1983). However, corporate governance literature asserts that private ownership places more effective limits on the consequence of these information asymmetries – private aggrandisement by managers – via constraints imposed by competitive processes on product, labour, and especially capital markets.

Product market competition reduces the rent available for expropriation and weeds out inefficient organisations through bankruptcy: firms in which managers pocket profits rather than investing them are driven out of business (Schleifer & Vishny, 1998). The principal labour market effect is through the recruitment of managers: if POEs and SOEs recruit from the same pool, the poor performance of a manager in an SOE will damage their future recruitment prospects in the private sector, which acts to constrain their behaviour. When the managerial labour market is unified the cost of malfeasance on future earnings is serious for public sector managers. If instead the market is divided into public and private sector segments (Estrin & Perotin, 1991), poor performance may become entrenched in the public sector and the impact on future earnings will be more limited. However, it is usually argued that the key constraint in Anglo-Saxon economies is the corporate control of stock markets[1] (Megginson, 2005). In a stock market system, traders in the firm's equity monitor firm performance and sell the stock of firms perceived to be under-performing, so they are continuously and closely evaluating the quality of managerial decision-making and the extent of managerial discretion. This process is information-intensive and competitive. The equity trader's judgement of a firm's performance is summarised in its share price. If the managerial team is thought to be incompetent, inefficient, or privately benefiting from the company, the share price will go down and the managers will be pressured to improve their performance. A persistently poor showing by a quoted company may also generate external pressure by encouraging a take-over bid. Moreover, in the managerial market, individual

1 Parallel capital market constraints operate in bank-based systems in continental Europe (Franks and Meyer 1997)

performance and pay are largely assessed by the firm's share price, increasing the incentive for good managerial performance.

It is often argued (Estrin et al., 2009) that it is hard for the state to perfectly mimic these market-based constraints. State-owned firms are not subject to the same capital market disciplines; rather they are monitored directly by the state, often within a ministry or through board membership. The state often does not have the resources or the motivation to monitor businesses with the same energy as the private capital market, and has fewer tools for disciplining firms. Hence, in state-owned firms neither the competitively driven informational structure nor the market-based governance mechanisms that operate in private firms play much of a role in assessing and guiding firm performance. The softness of budget constraints (Kornai, 1990) that goes with politically determined resource allocation has been seen as a further source of incentive problems, since managers do not have to bear the consequences of their actions. Note, however, that in recent years this deficiency has been somewhat ameliorated as SOEs have begun to sell some equity to private owners (Bruton et al., 2015). Traditionally, SOEs, at least in developed economies, were found in monopolistic sectors because market failures were present; hence product market discipline was weak. At the same time, the managerial labour market was highly segmented because SOE managers were traditionally civil servants who did not compete in the wider managerial market. However, in recent years market discipline has become increasingly applied to SOEs as well as POEs; for example, competition has been introduced in the product market by franchising operating licenses and integrating the managerial labour market (Bardhan, 2016).

This brief description shows that the mechanisms underlying the advantages of POEs versus SOEs are context-specific and sensitive to institutional arrangements. For example, an effective market for corporate control relies on the depth and sophistication of the capital market. Capital markets are underdeveloped in many emerging economies because they are dependent on other critical institutional characteristics, such as the rule of law and the protection of private property rights (Khanna & Yafeh, 2007; Hoskisson et al., 2013). Thus, in emerging markets the principal mechanism underlying the proposed superior performance of POEs may not be operational and the relative performance of SOEs and POEs may instead depend on the details of governance arrangements. Incentives and governance may still be weaker in SOEs, but as a countervailing factor. The theory suggests that ownership concentration will enhance firm performance (by addressing the free rider problem in shareholder monitoring when holdings are unconcentrated), and state ownership is highly concentrated, while private ownership often is not. Furthermore, as Estrin et al. (2017) argue, the relative performance (in terms of internationalisation) of SOEs and POEs is contingent upon the institutional arrangements of the countries being compared. They find in a large sample of emerging economies that SOEs can perform as well as POEs in countries where formal institutions are strong, but POEs perform significantly better in contexts where there are serious institutional deficiencies.

In these contexts, the performance of SOEs relative to POEs will depend on how each is directed and controlled. As we have seen, governance institutions are key because they shape both the capabilities and interests of business managers and the owners' ability to influence the conduct of their firms. The severity of SOE governance problems relative to POEs varies depending on the extent of state ownership (fully state-owned, majority state-owned, minority state-owned) (Estrin et al., 2009), the ways in which ownership is exercised (direct or indirect state control) (Megginson 2005), the micro-level institutions that influence the performance criteria for resource allocation (Estrin & Pelletier, 2018), and the selection of SOE managers, their incentives, their values, and their perception of how to do business (Bruton et al., 2015).

To get more traction on these issues, we build on the three sets of institutions that are crucial in determining the relative effectiveness of POE and SOE governance: formal institutions, informal institutions, and the managerial labour market. The first two address the conflict of interest between managers and owners (principal–agent issues) and between large and small owners (principal–principal issues) that influence the incentives of managers and large owners in POEs and SOEs, and the ability of (large) shareholders to control and direct the corporations they own. The third set of institutions concerns the criteria and values that determine the selection of board members and CEOs and affect the incentives and competencies of corporate managers. Taken together, we can distinguish between strong governance institutions – arrangements that drive the actors' behaviour towards the maximization of firm value – and weak governance institutions –

arrangements that permit various forms of expropriation of corporate funds (by managers or large owners).

Formal institutions set the context for the resolution of agency issues in corporations, notably the content and enforcement of legal rules that shape management's accountability to shareholders and (minority) shareholders' ability to influence firms (La Porta et al., 2000). Legal arrangements concerning shareholder rights and obligations differ across countries; for example, the effectiveness of the market in both corporate control and managerial incentive schemes is contingent on shareholder protection rules (Armour et al., 2009). Shareholder protection is arguably stronger in common law than in civil law jurisdictions. Countries also differ in their interpretation of the duties of corporate directors and managers and their perception of accountability towards shareholders and stakeholders (Filatotchev et al., 2013). Thus, the association between the protection of shareholder rights and the development of capital markets underlies the mechanism whereby capital markets discipline managers through shareholder trading and takeovers.

Informal institutions are the norms that shape the identity and interests of private actors in society (e.g., North 1994; Berglof and Classens 1994), such as the extent to which nationals obey formal laws and regulations, and their inclination to take bribes. The level of enforcement of legal rules also depends on cultural and normative factors. A lack of enforcement leads, among other things, to inefficiently functioning courts, poorly qualified lawyers and judges, and vulnerability of the judiciary to bribes. In business governance, managers can establish good business behaviour by signalling commitment to good practice through support for institutions that collect and convey information about these customs and by creating credible punishments for transgressions. In time, intermediaries that support good governance, such as trade associations, self-regulatory organisations, employers' associations, stock exchange associations, and rating agencies, might emerge from these processes and behaviours. These informal institutions not only increase the effectiveness of formal institutions but also act as a substitute when formal institutions are weak (Estrin & Prevezer, 2011).

The third set of institutions shapes the functioning of the managerial labour market. For example, corporate hiring criteria might vary depending on a country's norms and values, such as meritocracy, power distance, and egalitarian tendencies. In meritocratic cultures the selection of individuals for top positions will be based on their performance rather than social connections and political power. Similarly, in countries with a low power distance a larger pool of individuals will have the opportunity to reach high-level management positions, leading to higher-quality executive teams. The perceptions of how to run a business will also vary depending on whether the CEOs of SOEs have been selected from individuals with only public sector experience or from those with work experience in the private sector (Bruton et al., 2015). In countries with strong egalitarian tendencies, owners' use of effective compensation packages to compensate managerial effort might be limited (Filatotchev et al., 2013); for example, it has been argued that in China the influence and culture of stakeholders and a strong focus on equality have curbed the use of material incentives in SOEs (Buck et al., 2008). This might in turn reduce firms' ability to attract highly qualified individuals to top positions, particularly highly performing individuals from abroad.

3. CATEGORISING STATE ENGAGEMENT

This paper proposes that the relative performance of SOEs versus POEs is also affected by how the state functions, and that this should be considered independently of the institutional environment. We focus on three models of state engagement in the economy: the Welfare State, the Predatory State, and the Developmental State.

Neoclassical economics views the state as an independent and social-welfare-maximising agent in its own right, where its primary function is the provision of a legal basis for the market economy through a system of property rights and effective contract enforcement (Sappington & Stiglitz, 1987). In this framework, the justification for state intervention is market failure. In the case of state-owned firms, the relevant market failure is usually defined as a situation where private production cannot ensure a Pareto-efficient allocation of resources, such as in the case of natural monopolies, public goods, and widespread externalities (Bardhan, 2016). In most advanced market economies these provide the basis for state involvement. We denote it the Welfare State model, in which the state intervenes in the economy primarily to serve social welfare, and SOEs exist to internalise externalities and limit the negative welfare effects of monopoly power in sectors where entry barriers are high.

Our second model of state involvement in SOEs, the Predatory State, draws on the exploitation theory of the state, according to which the state's role is to increase the income and wealth of specific groups in the economy, from the President's personal entourage through vested interests that control key sources of power (e.g., the military) or natural resources, to particular ruling families or tribes (Shleifer & Vishny, 1998). In a Predatory State the primary role of the state in the economy is to extract income from other constituencies in the interest of one or more of these dominant groups (Vahabi, 2016; Acemoglu & Robinson, 2012). One of the key mechanisms for rent extraction is state ownership of highly profitable firms, especially those located in sectors like natural resources or utilities where the possibilities for such appropriation are great (Venables, 2016). Therefore, in the Predatory State model, state involvement in SOEs is driven primarily by private interests or rent seeking by state officials and connected private actors (Tihanyi et al., 2019). These private actors influence the political decisions of state officials, regulatory policies, and the direction of SOE firms, either directly (through illicit and non-transparent payments to politicians) or indirectly (through their influence on political votes) (Hellman et al., 2003).

The third model of state involvement, the Developmental State, draws on the economic experience of countries like Singapore, Taiwan, South Korea, Hong Kong, and Japan (Wade,2003; Onis, 1991). In these economies the function of the state goes well beyond securing the basic rules of exchange and mitigating inefficiencies and externalities, as in the Welfare State. Through strategic industrial policy, developmental governments actively guide the allocation of resources and cultivate domestic industries in the pursuit of economic growth and international competitiveness (Amsden, 1989). An important element of this model is the promotion of SOEs to spearhead industrial strategies, including internationalisation, and to assist in the creation of national champions in key development sectors (Cuervo-Cazurra, 2018). The mechanisms used include supporting selected industries by providing an environment that encourages risk-taking, including foreign direct investment in the search for new technologies and innovative capabilities and channelling funds to these industries, in exchange for high performance expectations that are often set with reference to competitors from developed Western economies (Cuervo-Cazurra et al., 2014).

The dominant model of state engagement depends primarily on a country's history and culture (North, 1994; Williamson, 2000; Acemoglu and Robinson, 2012). For example, the emergence of the Predatory State model might be associated with the discovery and exploitation of potentially appropriable assets in a country (Venables, 2016). Property, oil, and other national resources constitute the most appropriable assets: they do not require specific investment and are relatively immobile. By contrast, human-specific assets are highly specific and can be highly mobile; hence they are usually difficult to plunder. In between these two are firm-specific assets and financial assets. Firm-specific physical assets are difficult to move abroad, i.e., they are easier to expropriate (but see Witt & Levin, 2007); but they are also difficult to appropriate since the continuation of a particular investment usually requires specific capabilities. Financial capital is easier to appropriate but is also easily movable.

Geopolitical factors may also shape a country's model of state engagement. Continuous security threats and the potential for positive interactions with more advanced countries are both associated with the Developmental State. The relative power of the state compared to that of the largest private actors may also be important: for example, in some Latin American countries, powerful private groups have limited the role of the government and have provided a basis for the emergence of a Predatory State. By contrast, state control of the banking sector and financial resources in the immediate post-World War II period, combined with a relatively fragmented private sector and an egalitarian distribution of income, are important in explaining the emergence of Developmental States in some South Asian countries (Onis,1991).

4. A FRAMEWORK TO ANALYSE THE RELATIVE PERFORMANCE OF SOES AND POES

Table 1 presents our analysis of how institutions and state engagement models might be combined to explain the relative performance of SOEs and POEs.

Table 1: A classification of private and state firms combining state model and governance institutions

	Welfare State	**Developmental State**	**Predatory State**
Stronger governance ↑	State ownership limited to industries subject to externalities SOEs performing well but possibly less efficient than POEs	State ownership spreading to several strategic sectors Low agency problems in POEs The relative performance of SOEs compared to POEs depends on the size of SOE advantage from better utilisation of and access to resources, versus the disadvantages due to inherently more demanding SOE governance	State ownership spreading across resource-rich sectors Limited state support for growth, expropriation rather than efficient use of resources in SOEs Low agency costs in POEs SOEs significantly underperform compared to POEs
↓ **Weaker governance**	State ownership limited to industries with externalities and strategic sectors where high uncertainty in transactions limits private initiative The performance of SOEs compared to POEs depends on the balance between private institutional failure and state institutional failure	State ownership spreading to several strategic sectors SOEs less efficient in utilising resources compared to SOEs in high institutional environment, but might outperform POEs due to SOEs' superior access to resources, and high agency costs hampering the efficiency and growth of POEs	State ownership spreading across resource-rich sectors Expropriation rather than efficient use of resources in SOEs, vast opportunities for such expropriation High agency costs in POEs Crony capitalism Both SOEs and POEs likely to perform poorly

We start in the upper left quadrant of Table 1, in which the Welfare State is combined with strong governance. In this configuration there may be SOEs, but their activities are limited to sectors with major market failures; for example, natural monopolies like utilities. The state ensures tight governance arrangements, perhaps via partial private ownership, board representation of the state as owner, and close monitoring and scrutiny. Managers are incentivised to ensure good SOE performance, including through the integration of public and private sector managerial markets and tight monitoring. Even if SOEs are given the financial resources and other support necessary to ensure their welfare-enhancing role, in line with the Welfare State model, this is subject to transparency and public scrutiny, and SOEs have no additional advantages in terms of access to strategic or government resources. Indeed, many advanced economy governments distinguish between SOE operations and the government's political/social objectives (which are explicitly subsidised) in order to give SOEs more strategic discretion and greater accountability (Estrin et al., 2009). In this situation, in principle the performance of the SOE may equal that of its privately-owned counterpart; there is empirical evidence of this in Canadian electricity generation (Caves & Christiansen, 1980; Boardman & Vining, 1989).

However, in practice, such an outcome will probably be uncommon. This is because in Welfare States the goals of SOEs may extend beyond economic performance to include social or political goals, such as preserving employment and granting public access to certain services. Consequently, SOEs may be more isolated from the capital market than POEs, less able to rely on purely financial incentives to motivate managers, and less attractive to highly qualified commercial management. Moreover, even in Welfare States the control of SOEs and the design of incentives may depend on the policies of the ruling political party and may therefore be subject to diverse and changing interests, hampering strategy formation and implementation (Sappington & Stiglitz, 1987). In good governance environments the potential advantages of POEs compared to SOEs will be reinforced because the POEs themselves will be well governed, their executives will be motivated with high-level incentives, and they will be exposed to the pressure of strong (external) owners and capital markets. Therefore, while in this configuration equivalence with the performance of POEs is theoretically possible, in practice SOEs in Welfare States may still underperform.

However, the disadvantages of SOEs compared to POEs may be less pronounced when a Welfare State model is combined with weak institutions in terms of firm-level governance and managerial labour market institutions. This is because in this context the relative performance of SOEs and POEs depends on the balance between private institutional failure and state institutional failure, and weak governance may disproportionately impact POEs. Thus, while both POEs and SOEs will perform relatively worse when institutions are weaker, SOEs may be less badly affected. For POEs, weak governance increases contracting risks and limits private actors' access to finance and risk diversification (Berglof & Claessens, 1994). Higher risk, high contracting costs, and other inefficiencies in the capital, labour, and product markets will undermine the performance of POEs compared to SOEs. When these costs are substantial, SOEs might actually have greater opportunities for high performance and growth than POEs, especially since SOEs may have a greater willingness to assume risk because the state as owner can diversify its risk more than most private owners (Vickers & Yarrow, 1991). These predictions are illustrated in the lower left hand corner of Table 1.

The second column of Table 1 explores the implications of alternative governance arrangements in the Developmental State. In this model the authorities provide significant resources through a strategic industrial policy and other mechanisms, and actively cultivate selected companies, often SOEs, in the pursuit of higher productivity and international competitiveness. SOEs may enjoy preferential access to resources and thereby have advantages relative to comparable POEs. However, corporate governance institutions might affect the comparative advantage of SOEs in relation to POEs in various ways. On the one hand, in strong governance environments (i.e., top quadrant in column 2, Table 1) the state might face legal limits when providing resources to SOEs though the competitive pressures of the capital, managerial, and labour markets, and the diffusion of good governance practices may still entrench efficient resource utilisation by SOEs. Moreover, in the case of strong governance, SOEs in Developmental States may outperform SOEs in Welfare States because of their superior access to resources and state support. They may also perform better than SOEs in Developmental States with weak governance rules, due to agency problems and lower efficiency of resource utilisation in the latter.

However, the relative performance of SOEs and POEs in Developmental States is less straightforward to predict. Let us consider first the case of strong governance institutions. On the one hand, SOEs have a comparative advantage in relation to POEs due to the support of the state; SOEs are likely to use state resources efficiently because institutional arrangements are robust. However, strong governance also lowers the agency issues in POEs; the marginal impact of institutional quality on agency costs is probably stronger for POEs than for SOEs. This is because, as noted above, even when governance institutions are strong, SOEs are likely to have goals other than profit maximization, are less likely to reward managers with incentives, and, being majority-owned by the state, are to some extent isolated from capital market pressures. The balance of the advantages of SOEs and POEs in strong governance environments thus hinges on whether the SOE advantages of better utilisation of and higher access to resources outweighs the disadvantages of their lower effectiveness in implementing good corporate governance and pursuing shareholder-value maximizing policies.

When the corporate governance environment is weak in Developmental States, SOEs' utilisation of state-provided resources is likely to be worse because the alignment of the managers' and the state owner's interests will be poorer. Hence, SOEs will perform worse than SOEs in Developmental States with strong governance institutions.

However, the comparison of the performance of SOEs and POEs depends on the impact of weak institutions on both types of firm. Agency issues in POEs will be higher in countries with weak legal enforcement, low private litigation, and a poorly performing managerial labour market. Moreover, these agency problems mean that POEs' access to financial resources might be restricted in comparison with SOEs that the Developmental State provides with resources. Moreover, with lower investor protection, POEs might be inclined to influence state policies to ensure their survival, regardless of economic performance and competitiveness. Thus, the performance of both SOEs and POEs in this configuration will be worse than in the previous configuration. Once again, the balance of advantages largely depends on the significance of state ownership's inherent governance issues, as opposed to the additional resources the state might provide the companies and how effectively these are used.

Finally, in column 3 of Table 1 we consider the implications of the Predatory State for the relative performance of SOEs and POEs. A Predatory State is oriented towards securing private gains for selected actors within the public sector or for those connected to the state; hence it will at best provide limited resources to support the growth of SOEs. However, when combined with strong governance institutions, such predatory opportunities might be limited by externally generated rules and regulations; for example, via WTO membership or free trade agreements. Competitive pressure from product and labour markets might also help to drive SOEs to pursue profit-oriented policies. Yet, due to the predatory motives of the state as the main owner, these SOEs are likely to perform worse than, for example, the SOEs under the Welfare State or the Developmental State models with strong governance. We also expect that SOEs will perform worse than POEs in Predatory States because SOE activities will likely be chosen to provide rent to the ruling elites. Endemic corruption in Predatory States will affect POEs and SOEs alike, but nevertheless in some cases POEs may be operating in a more competitive market environment. These performance differences between POEs and SOEs will probably be reinforced when the Predatory State is combined with strong governance institutions that disproportionately affect the behaviour and performance of POEs. Then POEs will seek profit for their owners, while the political elites will tunnel out surpluses from SOEs.

When governance institutions are weak in the Predatory State, POE and SOE owners (families or oligarchs on the one hand; the state and its cronies on the other) will both be strongly motivated to pursue private objectives (e.g., rent-seeking or expropriation of minority shareholders) that go against firm value maximization and undermine firm performance. SOEs will perform the worst in this configuration compared to other configurations. Moreover, they will also underperform relative to POEs, despite the higher agency problems faced by the POEs when the governance environment is weak. This is because of the selection effect whereby firms will be placed in the state sector to facilitate and maximise rent extraction. However, in this dispiriting environment, both POEs and SOEs will perform worse than in any other configuration in Table 1 and there may not be much difference between them.

5. CONCLUSIONS

In the past, the notion that state ownership of firms will always generate a worse economic performance than private ownership has been widely accepted in the economics literature. However, this paper suggests that this argument is insufficiently nuanced. We propose that the relative performance of SOEs and POEs is contingent on two broad factors: the institutional arrangements underlying the governance of firms and the political arrangements of the host country. The former we categorise as simply 'strong' or 'weak', while in the latter countries are classified into three models of state engagement: the Welfare State, the Developmental State, and the Predatory State.

Welfare States are usually advanced economies where the performance of SOEs depends primarily on the strength and effectiveness of governance arrangements, leading to the conclusion that SOEs perform worse than POEs. We illustrate this in the first column of Table 1. This approach has provided the intellectual basis for the policy advice that privatisation and strengthening underlying governance institutions will improve the performance of SOEs. The institutions underlying governance include laws and regulations concerning governance, the culture of the public sector, and a managerial labour market that is not segmented into public and private sectors. The results can be generalised across contexts: in all three models, SOEs will perform better in a good governance environment than in a bad governance environment. This supports policy advice that says that governance arrangements must be improved in order to achieve good SOE performance.

When we expand our focus to include developing and transition economies, we must also consider the model of state engagement when considering SOE performance. Some developing and transition economies follow the Welfare State model; for example, most transition countries that were early aspirants to join the European Union (Poland, Hungary, the Czech Republic, Slovakia) accepted the logic of the Welfare State model, and the rules of EU accession aided the effective enforcement of these market-based principles. These countries implemented widespread privatisation and have improved the performance of their SOEs and POEs (Estrin et al., 2009), the key factor driving SOE performance being the quality of the institutions of governance. However, for many emerging economies the model of state engagement has been developmental or predatory. SOEs and

POEs face inherent agency issues in both state models, and performance outcomes depend on the quality of the governance institutions. In these contexts the SOEs still have an inherent disadvantage relative to the POEs because the state always finds it hard to replicate the disciplining mechanisms of the capital and labour markets. However, in Developmental States the relative inefficiency of SOEs may be offset by the fact that the state can concentrate its resources, including governance and monitoring, to guide and assist SOEs. Moreover, in some situations the deficiencies of private sector institutions are more serious than the failure of the state, leading to POE failures that more serious than SOE failures.

In this contingent analysis of SOE performance, while state-owned firms usually perform worse than privately owned firms, this is not necessarily the case. State ownership will lead SOEs to perform worse than POEs in Welfare States and Predatory States, but state ownership will not always be deleterious to firm performance. In Developmental States with good governance institutions, SOEs can outperform POEs. This analysis may explain the recent rise of state capitalism in certain institutional contexts (Musacchio & Lazzarini, 2014).

Furthermore, we argue that the outcome in Developmental States with weak governance institutions, as in some transition economies, is ambiguous. On the one hand, standard agency issues may lead SOEs to underperform their private competitors. On the other hand, if institutions are weak and governance ineffective, agency problems will also beset private firms, which may suffer from managerial aggrandisement and dominant shareholders expropriating minority shareholders, to the detriment of business performance. The balance between these forces is affected by the model of state engagement. In a Predatory State, SOEs will likely be highly inefficient and a vehicle for rent-seeking, even compared to poorly governed private firms. But in Developmental States, SOEs may instead be the vehicle for strategic development policies, and may therefore be better governed and benefit from additional state resources and favourable regulatory treatment. However, the combination of a Predatory State and weak governance institutions is particularly damaging to firm performance in both the private and state-owned sectors.

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