

An Operational Approach to the Performance of Public Sector Enterprises

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Abstract

Performance evaluation of public sector enterprises is an activity that if we were to ask what it should include, we would likely compile a long list of issues for investigation. A selected number of these would probably cover areas such as: financial performance, corporate planning, business control, employment practices, consistency between activities of enterprise and social goals of government policy, contribution of enterprise to economic growth, enterprise activity and preservation of environment, consistency between enterprise activity and political objectives, and enterprise activities and their long term impact on the sociological well being of the community. Yet when one is faced with the challenge of what can be done within governmental organization to develop a process for undertaking constructive evaluations of such enterprises, it becomes imperative to focus our efforts on a manageably small number of aspects of the problem.

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AN OPERATIONAL APPROACH TO THE PERFORMANCE EVALUATION OF PUBLIC SECTOR ENTERPRISES

by

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I. INTRODUCTION

Performance evaluation of public sector enterprises is an activity which if we were to ask what it should incorporate, we would likely compile a long list of issues for investigation. A selected number of these would probably cover areas such as: financial performance, corporate planning, business control, employment practices, consistency between activities of enterprise and social goals of government policy, contribution of enterprise to economic growth, enterprise activity and preservation of environment, consistency between enterprise activity and political objectives, and enterprise activities and their long-term impact on the sociological well-being of the community. Yet when one is faced with the challenge of what can be done within a governmental organization to develop a process for undertaking constructive evaluations of such enterprises it becomes imperative to focus our efforts on a manageably small number of aspects of the problem. If not done, it is highly probable that we will find ourselves immobilized.

The dilemma of where to start in evaluating activities is largely due to the fact that governments often have a number of short-term and long-run objectives in mind when such enterprises are established, some of which may even be conflicting. Around the world one often hears public sector managers lay the blame for a poor financial performance on the wide variety of social, political, and regulatory tasks they are given to perform which are in addition to their production or business activity. In many cases this is absolutely true. Yet there is a need to find ways of evaluation which will draw a distinction between the cases where this a legitimate reason for a poor financial performance and where this is but an excuse to avoid admitting a more fundamental business or economic difficulty.

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II. PUBLIC ENTERPRISE OBJECTIVES

To begin our examination of this issue we will group the many possible objectives into three categories which have fairly distinct characteristics. First, there are those which are financial, in that they deal with the revenues and costs of the firm or the budgetary relationship between the enterprise and the government. In short, the government may prefer that an enterprise generate enough revenue to pay its bills, or to produce a surplus to pay for other expenditures in this or another sector. Secondly, there are economic objectives which are related to the efficient allocation of the country's scarce resources and to the net contribution of the enterprise to the output and growth of the economy in general. Thirdly, public enterprises are usually given distributional or "social" objectives. Distributional objectives are usually related to the way in which any potential surplus of the enterprise is to be divided between the subgroups of the population. These might take the form of employment objectives for specific groups of people, services provided to specific people or communities, lower prices and thus income transfers to consumers in general or to certain categories of consumers, or transfers of wealth and privilege to particular individuals.

The financial objectives are distinct from the economic objectives as the former are related to the financial health of enterprise while the latter are concerned with the growth and economic prosperity of the whole country. An enterprise's ability to attain these two objectives might be related but this need not be so. If an enterprise is given enough subsidy either directly or indirectly it can usually be made financially viable. However, at the same time it might be making a negative net contribution to the growth of the country. For example, the vast majority of automobile assembly plants in developing countries are made financially viable because of the preferential tariff and tax treatment given to locally produced autos.¹ At the same time in many of these countries this industry is an economic drag on the country because the tariff and tax revenues given up by the government is often several times larger than the net income generated in the country by this activity.

On the other hand, if a commercial enterprise is not financially viable, it is very unlikely that it will be able to generate significant economic or distributive benefits. If an enterprise is to produce economic benefits effectively, it must be able to run with the minimum of abnormal constraints so it can produce output. Unless productive output of goods and services are generated economic benefits do not exist, and unless the enterprise is able to pay its financial bills (and on time) it is unlikely the enterprise will be able to produce at near its full capacity.

In much the same way the distributive and social benefits are linked to the financial and economic performance of an enterprise. An enterprise may be financially profitable but not assisting in the attainment of the social objectives of the government. However, it is highly unlikely that an enterprise which is continuously in financial difficulties will be producing significant long-term social benefits. When a public enterprise gets into financial difficulties expenditures on such items as training programs for the disadvantaged workers, provision of housing and health care for the workers are usually the first things to be cut. The one common characteristic of all the distributive and social benefits is that they all cost money! If an enterprise has been set up in an activity where there is little hope that it will ever be able to generate a significant net economic output and if the government has also restricted its pricing and financing policies so that it frequently is short of cash, then it will become a very poor instrument for the government to use as a generator of social benefits.

A common social objective of most public enterprises in developing countries is to train indigenous management. At the same time a common problem is the high rate of turnover in the managerial personnel where people do not stay in one firm long enough to have a thorough knowledge of the firm and industry.² This problem tends to most severe in those enterprises which are financially weak and whose future is uncertain. The type of motivated men and women who are potential managerial personnel characteristically do not want to build their future careers in financially sick firms and industries.

III. INFORMATION REQUIREMENTS AND PERFORMANCE EVALUATION

To undertake meaningful evaluations of public enterprises certain basic information must be produced and made available on a systematic basis. The ordinary financial reports such as balance sheets, profit and loss statements, and sources and application of funds statements are essential but they are by no means sufficient. In fact they are of much less use in the evaluation of the financial performance of a public sector enterprises than they are in the case of private enterprises.³ This is because the financing of public enterprises is usually carried out under the umbrella of government guarantees on all the debt they borrow. Therefore, the usual market criteria concerning cost of debt, debt to equity ratios, and various ratios of assets and liabilities which apply to the financial situation of a private firm are largely meaningless. When government guarantees are introduced, it is not the financial state of the enterprise as reflected by its balance sheet but the willingness of the Treasury to continue extending the guarantee which will determine lenders' willingness to extend loans to the enterprise.

Of the traditional financial statements, the sources and application of funds statement is of particular importance when evaluating the present and future financial performance of the public enterprise. Such enterprises frequently face severe liquidity crisis for a number of reasons, viz: they usually function in an environment where their pricing policies are subject to more government restrictions than are private enterprises, often face delays in bureaucratic approval for short term financing, may experience wage increases determined by exogeneous government decisions and not by the market forces in the market in which the enterprises operate, and generally have too little investment in working capital. Careful construction of the historical and future proforma sources and application of funds statements and their subsequent analysis might draw attention to potential future liquidity difficulties and thus allow the management and the Ministries involved to plan corrective action. Because it is a public enterprise, liquidity crises generally do not end up as bankruptcies for

the government will come to the enterprise's rescue. However, by the time the Treasury and several other Ministries have carried out their requisite investigations and given their approval serious damages may have been inflicted on the enterprise's ability to compete and function in the market it is operating in.

If public enterprises are to be evaluated in terms of their economic and social performance, then additional information must be produced by the enterprises and analyzed in a systematic fashion. However, a large proportion of the information requirements should be met by the work done in the Ministry conducting the performance evaluations.

IV. ISSUES OF PERFORMANCE EVALUATION

In order to have completed a meaningful assessment of an enterprise's contribution to the economy and to the social objectives set out for it, at least the following six questions should be resolved:

- (1) Is the particular enterprise located in a sector where economic viability appears possible at the present or in the future?
- (2) Is the activity of the enterprise such that it could potentially contribute significantly to the distributive and social objectives of the government?
- (3) Under the existing pricing, financing, regulatory, and tax policies is the enterprise financially viable?
- (4) What government regulations have impeded the pricing, financing, and personnel policies of the enterprise?
How?

- (5) How does the quality of the marketing, internal cost control, and investment planning functions of the enterprise compare to that of private sector enterprises engaged in similar lines of business?

- (6) What measures have been undertaken by the enterprise to comply with the social objectives of the government? What have been the results and how much was spent on these measures?

The first question should have been initially answered at the time the feasibility studies were completed and before the investment by the enterprise in this activity was undertaken. However, if these studies were not done properly or market forces have since changed unexpectedly, the sooner the government faces the economic facts concerning a particular activity the better off will be the country. It is at this stage when the government is either considering the possibility of entering into an activity or later deciding whether or not to get out of a line of business where the greatest number of conflicts of interest arise.

Because the benefits of any project tend to be concentrated on a relatively small number of individuals and the costs are usually widely dissipated the beneficiaries will often be enthusiastically in favour of the project while the bulk of the population who bear the costs will not perceive the costs to be large enough on an individual basis to warrant protest. Therefore, projects which will not yield a positive net economic return may develop a significant amount of public support from the potential beneficiaries even though the overall impact of the project is to make the country worse off.⁴

The groups which tend to be put in the greatest danger of having a conflict of interest are the engineering consultants and the private partners which are often given the job to prepare the feasibility studies for the public enterprise. It is a common characteristic among developing

countries to try to get these studies done by either asking the private partner to pay the entire cost of the feasibility study or else asking the engineering firm to do the job at a discount and in exchange, if the project looks promising, it will receive favourable consideration when it places its bid (if there is any bidding) to undertake the detailed design work of the project. It has actually occurred, far too often, that engineering and architect firms have been asked to bear the full costs of feasibility studies on the strength of the promise that they will have the first chance to do the design work if the project appears to be viable. Is it any wonder that frequently public enterprises and governments experience situations where projects which appeared attractive at the feasibility study stage turn out to be financial and economic disasters after they are designed and built! The only way for a public enterprise to avoid such a trap is to hire a reputable engineering and investment analysis firm who has a proven record in the industry and to make it clear from the start that the firm in question will be ruled out of any future design or construction work involving this project. It should be paid its full consulting fee and if its work proves to be accurate it will likely receive favourable recommendations for design and construction work on other projects for which it has not been employed to undertake the feasibility studies.

The starting point of an evaluation of a public enterprise which has in the past 5 years been engaged in significant investment activities is the examination of the feasibility studies for these investments to compare the forecasts made in these studies with actual performance. If the feasibility study has been constructed to provide the essential information which can be used as budget data for the first few years of the project this is the first sign that the project has been well planned. Should the actual performance be widely different from that projected in the feasibility study then one has a basis to probe further to identify the causes for this divergence. If the project has been approved on the basis of feasibility studies which do not allow one to

compare projected with actual performance, this is a sure sign that a number of people and organizations have been negligent. First, there are the Board of Directors and Ministries who approved the project; secondly, there are the individuals who commissioned and supervised the completion of the studies; and thirdly, there are the consultants or employees who have completed the work and who at minimum have displayed a lack of professionalism. Until public enterprises and government ministries learn how to identify, plan, evaluate, and implement commercial investment projects it is highly unlikely that these enterprises will come near their potential for improving the level of well-being in the country.

The feasibility study for a public sector enterprise must not only pass judgement on the financial viability of the project but also on how this activity will affect the growth of the economy. The inputs used to manufacture an item or provide a service are not costless to the country. Therefore, the value to the economy of the output must be greater than the economic cost of the inputs if the public enterprise is to have a positive impact on the development of the country. Particular attention must be given to those activities which require tariff protection, monopoly privileges or other forms subsidy to be financially viable. In these cases the economic value of the output from this enterprise does not include the subsidy element; thus, it may be financially viable but economically wasteful to continue the production of some of these items.

It is in such situations where there is an obvious conflict of interest between the role of the managers and board of directors who as officers of a particular public enterprise are concerned about the growth and financial health of their own organization (including its employees) and their role as public servants who should be concerned with the economic welfare of the country. It has been a common observation that the officers of public sector enterprises almost always identify with the financial interests of their firm and its employees, and

totally disregard the economic welfare of the country as a whole whenever these two objectives do not coincide.⁵ The common pleas by public sector managers around the world for preferential freight rates for their firms' products, or requests for higher and higher tariff protection so that they will be able to charge higher prices (which the consumers will be forced to pay) for the output produced by their firms, or arguments for preferential treatment to be given to public enterprises with respect to government procurement policies, or demands for sole rights to produce and sell a good or service in the country, all provide evidence that the officers of public sector enterprises can not be counted on to protect the economic interests of the average (or below average) resident of a country. The decision of what sectors or products are economically appropriate for public sector enterprise activity must be made by the economic ministries in the government. If public enterprises were limited to the same degree of financial support and had no more access to government privilege than private enterprises, then perhaps this constraint on choice of activity would not be necessary. However, in the vast majority of countries with public sector enterprises these firms do enjoy advantages not provided to the private sector.

The second question outlined above is concerned with the potential of the project to contribute significantly to the distributive and social objectives of the government. It is a rather obvious point, but often ignored, that some industrial activities are much more suited to produce the desired social benefits than are others. Sometimes when employment creation and the development of labour force skills have been the social objectives of governments we find public enterprises investing heavily in such activities as petrochemicals, cement plants, aircraft construction, and steel plants where the expenditure required per job created is a multiple of the capital/labor ratio in the rest of the country.⁶ In addition, most of the jobs often require a level of skill and education which can not be obtained through on the job training. Thus, a major recruitment effort usually follows to employ people from other regions within the country or from overseas to operate the plants and market the

output.⁷ It is very doubtful if these types of industries are ever cost effective ways to promote employment and upgrade the level of skills in the labor force.

In practical terms, how do we go about determining which activities are cost effective in promoting the social objectives of the country? First, we will have to translate the policy statements of government into variables which are measureable. If employment of specific groups of people is the objective, then we have to make a list of the groups and regions in order of preference and the skills which are most appropriate to the labor force in question. The next step is to identify those activities which are most suitable to meeting these requirements, while still remaining financially and economically viable. This same reconciliation of social objectives and the suitability of the enterprise as an instrument to attain these objectives should be carried out when evaluating existing public sector enterprise operations. Worldwide it is the norm to find that politicians, bureaucrats, aid agencies, and engineers are extremely impressed by the most modern, the biggest, and the most technical plants and processes. Yet the activities with these characteristics may not be those which will help the country most in reaching its social objectives.

The third issue to be dealt with in a performance evaluation is whether or not the enterprise under the existing government policies is financially viable. This question can only be answered by close examination of the financial statements of the enterprise including its projected or proforma statements. These latter statements will be based on the production, investment and marketing plans and budgets of the enterprise. If such plans do not exist, then a valuable byproduct of the performance evaluation effort will be to start the public enterprise management thinking about the usefulness of such plans and budgets which are at the heart of the financial management of any progressive business organization.

It is sometimes the case that the nature of the public enterprise activity requires it to run continuously a financial deficit. For example, governments have often required bus fares in rural areas to be kept low as a way to assist the rural poor. This may be a very good policy, but if it is imposed, then it should also realize that it must provide for a regular subsidy to be paid to the bus company if proper service is to be expected. Sometimes the government relies on cross subsidization practices between urban and rural users of the service. In any event the financial needs of the enterprise have to be met in a systematic and orderly fashion. For such activities the time to plan for subsidization is not when the firm is driven into near insolvency from the lack of financial resources.

The fourth question to be answered by a performance evaluation is related to the previous one and deals with the quantification of how government policies have restricted the pricing, financing and personnel policies of the enterprise. Often many of the financial problems incurred by public enterprises stem from the fact that they are being run more like government departments than businesses. They are sometimes restricted in their pricing policies so that they can not gear the price of their products to market conditions. They usually are not as free to promote or terminate employees as the circumstances warrant. Often financing arrangements are difficult to make through the government ministries where the allocation of funds might be more determined by political forces or government budgets than business opportunities.

Often the management of public enterprises are blamed for what appears to be a poor performance, while the root of the problem is the constraints imposed by government and the bureaucracy. A performance evaluation is only useful as an instrument to improve the operations of public enterprises if it also identifies the causes for both satisfactory and unsatisfactory achievements.

The fifth question we consider in a performance evaluation is the quality of the management practices followed by the enterprise. In the private sector the quality of the management is judged by its financial performance. However, the diffuse set of objectives and the additional constraints imposed on public enterprises seriously weaken the usefulness of this criterion. On the other hand, if public enterprises hope to become successful as productive forces in the economy, the same standard of management excellence must be strived for in the areas of marketing, internal cost control, and investment planning as exist in the most successful of private enterprises. Waste caused by bad management practices is seldom beneficial to anyone! As a practical matter it would appear that the only standard for measurement of business practices in an enterprise is to compare those employed in a public enterprise to those used by successful private enterprises operating in the same or similiar countries. Such an evaluation is certain to be somewhat subjective, but no other operational way to evaluate the business practices being followed appears to exist.

The sixth and last issue we raise for consideration in the evaluation of the public enterprise performance is concerned with the measurement of the progress made by the enterprise in attaining the social objectives laid down by the government. Usually public enterprises make little or no attempt to quantify the social activities they undertake which would not be required as a normal part of the business activity. However, if we follow the basic principle that "there is no such thing as a free lunch", the public enterprise should be able to identify expenditures which have been made in order to attain the social objectives or to point to increase in manufacturing and other operating costs which have occurred because of the social obligations. It is sad but true that often the enterprises which blame "social obligations" most for their poor financial performance often do the least by way of social expenditures.

In a comparison of public and private pulp and paper mills, and steel plants in Canada there is little doubt that the private enterprises are more safety conscious, provide better training programs, and give more financial support for general education, have better pension plans, and offer more promising careers.⁸ Many of these same conclusions hold when a comparison is made of public and private mining enterprises in Bolivia.⁹ Yet in all of these cases the plants were either taken over or set up with the goal of improving the social well-being of the workers.

It is not adequate just to have created the public sector enterprise for the purpose of attaining social objectives, to be assured that such social activities will be forthcoming. A performance evaluation of public enterprises must attempt to quantify at least what has been done by way of expenditures on social programs. Spending money to reach social objectives is certainly not the same as realizing these objectives. However, in terms of developing an operational guide to performance evaluation for public enterprises, such an accounting of expenditures represents a significant advance.

V. ORGANIZATION OF PERFORMANCE EVALUATION

It is not realistic to expect a government ministry or department by itself to undertake performance evaluations of public enterprises on a systematic and recurring basis unless there is an agreement between the individual firms and the central agencies that such evaluations are part of the normal business activity. With this agreement it must now be decided which of the issues discussed above can best be examined at the level of the firm or holding company, and which should be the responsibility of the central agencies. Of course, a high degree of consultation between firm and central agency will be required on most issues.

The first two issues outlined above, which deal with the potential of the enterprise to be economically viable, and its potential to contribute significantly to the distributive and social objectives of the government, are questions best studied by the central agencies. In order to do their work the officers will have to rely heavily on the financial and technical information available primarily at the firm level.

For pre-evaluations the overseeing ministry should provide the guidelines for the type of feasibility studies required and to insure that the facts of the case are accurately stated. For post evaluations, the ministry officials will have to provide the analytical framework for which the appropriate information should be prepared by both the firm and the ministry for study by the ministry.

The third and fourth issues are concerned with the financial viability of the enterprise and the identification of the government regulations which may be impeding the activities of the enterprise. These areas can best be examined by the firm or holding company in question. The role of the ministry in this case is that of an auditor, whose job is to check to see if an accurate picture of the financial position of the firm has been drawn by the enterprise, and to determine the validity of the enterprises' identification of governmental constraints.

A joint effort is required to evaluate both the management practices of the enterprise as well as to measure the impact of the enterprise on the social objectives of the government. Both of these issues are a continuing processes. It is not realistic to rely on the enterprise itself to evaluate its own management techniques, however, new techniques from accounting procedures to marketing strategies are not introduced simply by having an expert write a report. Evaluation which leads to change will only come about if there is an understanding and an appreciation, at the enterprise level, of the gain to be realized by introducing more appropriate management practices.

The central agencies must play a very active part in assisting the enterprises in evaluating the progress they are making toward the social objectives. A common frustration expressed by enterprise managers across countries arises because they do not know, at an operational level, what they should be doing to help achieve the social objectives. The central agencies can assist greatly by both helping to quantify the social functions the public enterprises are expected to perform as well as apply uniform measures across enterprises.

This outline of the issues of public enterprise performance evaluation and the approach suggested here for implementing such practices is neither complete nor inflexible. It is rather meant to serve as a preliminary guide for obtaining answers to some of the most important questions facing public enterprises in many countries around the world.

FOOTNOTES

1. Jack Baranson, "Automotive Industries in Developing Countries, Johns Hopkins Press, Baltimore, 1969.
2. Arvind Phatak, "Governmental Interference and Management of Public Sector Firms", Annals of Public and Cooperative Economy, Vol. 40, No. 3, July/September 1969.
3. Y.H. Malegam, "Performance Evaluation of Public Enterprises", Lok Vdyog, July 1970.
4. Arnold C. Harberger, "An Operational Approach to Social Cost-Benefit Analysis" University of Chicago 1974.
5. An observation also shared by George G. Maniatis, "Managerial Autonomy in Public Enterprises: Fact and Anti-Fact", Annals of Public and Corporate Economy, October 1968.
6. It is not unusual in these sectors to have capital investments in the order of U.S. \$200,000.00 per job created.
7. A classic case of this result is the Mechlin tire plant which was subsidized so that would locate in a poor area of Canada. This not only gained the disapproval of the U.S. which was the market for the tires, but the plant had to actively advertise accross the country for the next three years to obtain sufficient skilled employees.
8. This review was completed when feasibility studies were being undertaken to examine further investments in the public sector enterprises.
Staff Reports by Project Assessment and Evaluation Branch, Department of Regional Economic Expansion, Government of Canada, 1976.
9. Malcolm Gillis et. al., Taxation and Mining (Cambridge, Mass: Ballinger Press 1977).

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