4. Fiscal Impact of Businesses of the State and Principles of State Support

Introduction

The fiscal implications of state ownership are significant. Businesses of the state (BOSs) are often tasked with providing services that generate important benefits (chapter 1). The fiscal costs of BOSs include regular fiscal injections from the budget, in theory to compensate BOSs for their social role. Fiscal risks from BOSs include explicit contingent liabilities—largely debt guarantees—and implicit contingent liabilities, such as when fiscal injections are needed to recapitalize state-owned banks. Liabilities generated by BOSs are a major concern for the overall debt exposure of governments (World Bank 2022a, 2022b).

Even before the recent COVID-19 crisis, many low- and middle-income countries had accumulated debt burdens, pushing them into high risk of debt distress and leading to underinvestment and slow growth. During the financial crisis of 2008, governments channeled resources into the financial sector and other hard-hit sectors to avoid an even worse economic downturn. The COVID-19 pandemic further expanded state support for specific sectors and firms, including BOSs, adding to the financial stress of governments (Freund and Pesme 2021).

Today, countries find themselves with limited fiscal space and greater macroeconomic vulnerability, in part due to state support provided during the pandemic. This chapter examines the fiscal impact of BOSs and illustrates the extent of state support to BOSs as part of the fiscal response to the recent COVID-19 crisis. It provides new evidence on state support and distills policy principles for the design of state support.

- BOSs can pose large fiscal costs and risks. BOSs in many countries have a significant share in public sector balance sheets, reflecting their important role in the economy and in development. Despite the significant fiscal risks posed by BOSs, measuring the scope, performance, and associated risks of BOS portfolios across countries is difficult, given the dearth of publicly available data and the heterogeneity of ownership structures and state support measures.
Examples of the fiscal impact of state support to BOSs and private firms during past crises show that such support comes with benefits but is also associated with costs and risks. When comparing the benefits of state support to BOSs and private firms, BOSs are more likely to maintain their employment during crises than private firms. The evidence is mixed about whether BOSs maintain investment better than private firms during crises. And there is little evidence that BOSs support growth, although the institutional environment affects whether BOSs have positive or negative impacts on growth. But state support to BOSs and private firms is costly and can exacerbate fiscal pressures; it can also hamper long-term growth by distorting competition, undermining corporate governance, and leading to collusion, corruption, and moral hazard.

State support to BOSs and private firms needs to be designed and implemented in a way that minimizes costs and mitigates downside risks and potentially distortive impacts. Key policy principles of such state support include having clear objectives and prioritizing support, selecting the least distortive instruments, improving targeting and transparency, and including explicit sunset clauses and exit strategies.

**Fiscal Risks Stemming from BOSs**

**Estimating Fiscal Costs and Risks**

In countries where state-owned enterprises (SOEs) represent a large share of economic activity, they can pose risks to public finances (IMF 2021b). The important role of SOEs in those economies is reflected in their substantial portion of public sector balance sheets. SOEs account for the lion’s share (66 percent) of publicly financed infrastructure projects in low- and middle-income countries, making up 83 percent of the total financing for infrastructure projects (World Bank 2017). The net liabilities of financial and nonfinancial public sector corporations in public sector balance sheets are equivalent to an estimated 12 percent of GDP in El Salvador, 21 percent in Indonesia, and 33 percent in Kazakhstan (IMF 2020a). For 14 countries in Sub-Saharan Africa, SOE revenues average 7 percent of GDP, SOE assets average about 34 percent of public sector assets, and SOE liabilities average about 20 percent of GDP (figures 4.1 and 4.2) (Harris et al. 2020).

When risks materialize, they often have major and lasting implications for fiscal deficits and debt as well as for the conduct of fiscal policy, and they can lead to economic and financial crises. Of 230 contingent liability episodes during 1990–2014 across 80 low-, middle-, and high-income economies, SOEs were the third most common source of contingent liability—with 32 episodes—that governments were called on to cover (Bova et al. 2016). The fiscal cost was equivalent to 3 percent of...
GDP, on average, reaching as high as 15 percent of GDP in some cases (Bova et al. 2016). For 17 countries in the Middle East and North Africa, including Pakistan (and excluding the Gulf Cooperation Council members), contingent liabilities amounting to 7.7 percent of GDP emanated from explicit or implicit government guarantees to SOEs, the financial sector, pension systems, and obligations under public-private partnerships (figure 4.3 and box 4.1) (Boukezia et al. 2023).
FIGURE 4.3  Budgetary Impact of Contingent Liabilities in Middle East and North African Countries, Cumulative 1990–2018

Source: Calculations based on IMF 2020c.

Note: Contingent liability realizations pertaining to SOEs include on-budget support measures and exclude off-budget subsidies. The impact of contingent liability realizations refers to the gross payouts associated with a contingent liability realization, which captures immediate budgetary pressures and excludes any asset recoveries that are associated with the realization. PPPs = public-private partnerships; SOEs = state-owned enterprises.

BOX 4.1  Fiscal Costs and Risks of SOEs in Middle East and North African Countries

Troubled state-owned enterprises (SOEs) can impose fiscal costs from budgetary transfers to compensate loss-making activities, poor dividend performance, nonrepayment of loans, calls on government guarantees, recapitalizations, or asset sales below book value. They frequently receive government support through the tax system, either through formal tax exemptions or through lax tax enforcement. Institutional weaknesses often exacerbate these risks via financial burdens stemming from uncompensated quasi-fiscal activities and poor governance and accountability. In the Middle

FIGURE B4.1.1  Direct Fiscal Support to SOEs as a Percentage of GDP, 2019

Source: Calculations based on information from national authorities.

Note: SOE = state-owned enterprise.

(Box continues on the following page.)
East and North Africa, fiscal costs and risks associated with SOEs are sizable. In 2019 alone, the 17 Middle East and North Africa countries provided, on average, 2.1 percent of gross domestic product in direct budget support to SOEs through transfers, direct loans, and on-lending (figure B4.1.1). In addition, SOEs have received substantial government guaranteed loans, either directly or through state-owned banks (figure B4.1.2), some of which have been called over the years.

SOEs often engage in risky projects on behalf of governments or charge below cost recovery for their services without being fully compensated from the budget. Although these types of activities may improve the fiscal deficit, they often result in SOEs having difficulty meeting their payment obligations to the government, social security funds, other SOEs, or private companies. They also lead to complex cross claims between government and SOEs, hindering transparency and sound fiscal management.

Source: IMF 2021b.
Despite the fiscal risks of BOSs, measuring the scope, performance, and associated risks of BOS portfolios across countries is difficult. Weak institutional capacity, reporting, and oversight mechanisms are key contributors to the scarcity of data. Heterogeneity in ownership and the diversity in sectors where BOSs are present reflect the wide range of government economic and social mandates. In addition, explicit and implicit mandates for BOSs may evolve and become ambiguous over time because of shifts in political and economic dynamics. For example, few countries have a formal state ownership policy that clarifies the state’s objectives for its BOS holdings. In the absence of clear objectives, it is difficult to assess their performance, especially with regard to public service delivery and value creation (PwC 2015).

Governance challenges in state ownership can also carry significant risks. For example, central government oversight of BOS borrowing activities is weak in many countries, especially in low-income countries. Because the legal framework is incomplete or is not being implemented, the institutional setup cannot capture liabilities stemming from BOSs, and limited institutional capacity constrains the ability to analyze and publish BOS debt and financial data. Evidence from 13 debt management performance assessments during 2021–22 shows that 11 countries do not have a framework for managing guarantees or on-lending operations, and the 2 countries with provisions have significant compliance gaps (World Bank 2021b). In 9 countries, reporting of borrowing activities to the central government by nonfinancial public sector entities is not enforced. In 10 countries, the requirement to report on nonfinancial public sector debt is not applied; in 12 countries, the legislation is silent on the role of the central government when authorizing nonfinancial public sector bodies to borrow.

**Key Transmission Channels of Fiscal Risks**

Macrofiscal risks tied to BOSs can emerge from different avenues, both domestic (unfunded mandates, heavy subsidization) and external (shifts in external demand, supply disruptions). They can entail large contingent liabilities and poor oversight, sizable and poorly governed state-owned banks, and negative productivity spillovers (Böwer 2017; Melecky 2021). Cross-BOS ownership structures and connected lending can lead to large payment arrears and systemic risks. Corruption can also pose sizable risks, given the close ties between BOS stakeholders and public officials and the size and scope of BOS services and balance sheets (Transparency International 2017a, 2017b).

Key channels between public finances and BOSs include direct loans (including on-lending), loans across BOSs (for example, from a state-owned development bank to a state-owned utility), loan guarantees, recapitalizations, bailouts, subsidies, transfers, tax waivers, capital spending, dividends, tax receipts, payment arrears, and implicit liabilities (table 4.1). Governments, for example, can impair BOS finances by not fully funding public service obligations or by accumulating payment arrears to BOSs as ways to
manage fiscal liquidity pressures. Such practices adversely affect BOS and public sector balance sheets and, over time, can erode the delivery of public services. For example, a BOS that has a monopoly can generate substantial revenues for the government, but its overall economic impact can still be negative. If a country’s fiscal position is heavily burdened by its BOS sector—say, through large net transfers and backstopping—interest rates for public sector borrowing could rise through a loss of confidence and elevated debt rollover risks. When BOSs are responsible for large capital outlays, they can also have macroeconomic impacts on employment and growth. If BOS policies crowd out the private sector, this crowding out weakens investment, job creation, and economic growth.

Selected country examples provide a sense of the order of magnitude of potential risks and macrofiscal costs:

- Facing a range of issues—such as insolvency, conflicting commercial and socioeconomic objectives, and inadequate oversight—SOEs in The Gambia have provided minor revenues in recent years but required significant budget support. At the end of 2020, their total liabilities were estimated at 19 percent of GDP (IMF 2023; World Bank 2021f). Risks from loan guarantees and on-lending have materialized in the past. For example, The Gambia signed a memorandum of understanding in 2018 that converted into capital SOE debt owed to the government (mainly pertaining to on-lent external loans) equal to about 4.5 percent of GDP in 2020 (World Bank 2020b, 2022a).
- In the Kyrgyz Republic, budget subsidies to SOEs roughly equaled their tax and dividend receipts, but energy sector BOSs entailed significant fiscal pressures and risks, given their high debt, large investment needs, and a backlog of reforms. Explicit risks included public investment on-lending equivalent to 16.9 percent of GDP at the end of 2018 (World Bank 2020a, 2021d).
- SOE cross-linkages contributed to Slovenia’s 2012–13 crisis, when the banking system dominated by three state-owned banks holding about 63 percent of the total banking sector’s equity (IMF 2016b, 2016c), faced widespread bankruptcies that ate up bank capital and resulted in government loss of market access (Böwer 2017).

### TABLE 4.1  Potential Financial Impacts of BOSs’ Flows on Public Finances

<table>
<thead>
<tr>
<th>Type of flow</th>
<th>Potential impact</th>
</tr>
</thead>
<tbody>
<tr>
<td>Receipts</td>
<td>Dividends; guarantee fees; taxes</td>
</tr>
<tr>
<td>Outlays</td>
<td>Capital spending; subsidies, transfers; recapitalization, bailouts; tax waivers, arrears</td>
</tr>
<tr>
<td>Assets</td>
<td>Capital stock; technology</td>
</tr>
<tr>
<td>Liabilities</td>
<td>Loans; guarantees; accumulated losses</td>
</tr>
</tbody>
</table>

Source: Original table for this publication.
Note: BOSs = businesses of the state.
For 60 countries, infrastructure SOEs required average annual fiscal injections during 2008–19 of 0.25 percent of GDP to remain afloat, illustrating that government support to SOEs can weaken their fiscal position and increase the risks of sovereign debt distress (World Bank 2023a).

Illustrating the Benefits and Costs of State Support to BOSs

During crises, governments assign unique roles to BOSs and to private firms, usually to stabilize economies. During the global financial crisis and the COVID-19 pandemic, many governments deployed vast fiscal responses that included support for BOSs and private firms to keep people employed and sustain businesses and investment.

Benefits

During a crisis, economies at all income levels use state support to BOSs and private firms alike to mitigate the impacts of the crisis. Governments are under pressure to provide fast relief and short-term stability and to stop the spread of the crisis (Pop and Amador 2020a; Qiang and Pop 2020). Governments resort to BOSs and private firms to provide relief, directing them either to provide emergency goods and services or to function as channels of government support to citizens and firms. They may also use BOSs or private firms to stabilize economies by countercyclically protecting their employment and investment and maintaining the demand for inputs and final goods and services. In addition, they use banks to inject liquidity into the economy. To enable BOSs or private firms to provide relief and function as economic stabilizers, governments often provide them with direct or indirect support.

For past crises, the evidence for whether BOSs support economic stability is mixed. BOSs perform worse in productivity or profitability than firms in the private sector during crises, particularly during the global financial crisis (Beuselinck et al. 2017; Lazzarini and Musachio 2018; Vitoria, Bressan, and Iquiapaza 2020). But they typically are better able than private firms to maintain employment during crises (EBRD 2020; IMF 2019, 2021b; Kopelman and Rosen 2014; Vagliasindi 2022). Still, when BOSs maintain employment during crises, they may crowd out private sector employment during the ensuing recovery. Evidence of the impacts of BOS investment during crises is also mixed (García-Sánchez and Rama 2022; Jaslowitzer, Megginson, and Rapp 2018; Jie et al. 2021; World Bank 2023a). In regard to growth, there is little evidence of whether BOSs support growth, although there is evidence that the institutional environment affects whether BOSs are positive or negative for growth (Coleman and Feler 2014; EBRD 2020; Szarzec, Dombi, and Matuszak 2021).

The World Bank Group Subsidy and State Aid Tracker shows that state support granted to private firms and BOSs during the COVID-19 period involved a wide
array of instruments, including subsidized loans, capital increases, deferrals of taxes and fees, direct grants, state guarantees of loans, and deferral in the payment of concession fees, illustrating the fiscal impact of BOSs and the extent of state support to them (figure 4.4).\textsuperscript{11}

New evidence comparing BOSs and private firms during the COVID-19 crisis shows that, although all firms lowered employment in 2020, BOSs shed fewer jobs and registered smaller declines in wages than private firms (box 4.2). There is also some evidence that BOSs registered smaller losses in revenue than private firms, but their productivity was the same as or lower than that of private firms.

**Costs and Risks**

State support to BOSs and private firms—during crises and normal times—comes at a cost and has risks. Such measures are costly and can exacerbate fiscal pressures when tax revenues fall and spending balloons. And they can bring higher inflation that hampers a speedy recovery. In addition to fiscal costs, other risks are associated with state support to BOSs or private firms. State support can create inefficiencies in resource allocation and market distortions, unleveling the playing field. It can also undermine corporate governance and foster corruption, moral hazard, and waste. If emergency state support is not withdrawn promptly after a crisis and if there is no clear exit strategy, state support can weaken incentives for a healthy recovery. The potential risks for anticompetitive behavior, corruption, and moral hazard due to state support arise when directed to both BOSs and private firms.\textsuperscript{12}
New Evidence on the Role of BOSs during the COVID-19 Crisis

New empirical evidence on the COVID-19 period that was compiled for this report indicates that businesses of the state (BOSs) maintained employment and wages in Brazil (Brolihato, Cirera, and Martins-Neto 2023); Ecuador (Ferro and Patiño Peña 2023); Estonia, Latvia, Montenegro, Poland, Serbia, and Slovenia (this report); Romania (Dauda, Pop, and Iootty 2023); and Türkiye (Akcigit and Cilasun 2023). The results hold when considering employment and wage trends for all BOSs compared with those of private firms and when considering BOSs operating in competitive sectors compared with private firms. The latter finding suggests that natural monopoly sectors are not driving the effect and that this trend may come at the cost of crowding out private sector employment and reducing allocative inefficiency during recovery periods.

For Türkiye (Akcigit and Cilasun 2023) and Europe and Central Asia countries (this report), the evidence is mixed for access to credit and investment behavior of BOSs compared with those of private firms during 2020. Of 14 Europe and Central Asia countries, BOSs have higher rates of asset growth in 5 countries, whereas the difference is positive but not statistically significant in 6 others. In Türkiye, when short-term and long-term credit growth of BOSs and private firms in 2019–20 are compared, BOS short-term credit growth was significantly lower, but there is no significant difference between long-term credit growth for private firms.

In Romania (Dauda, Pop, and Iootty 2023), BOSs registered smaller losses in revenues than private firms. This revenue effect is more prominent for BOSs operating in competitive sectors than for private firms in those sectors. The result is driven by majority-owned BOSs (including BOSs with 25.0–49.9 percent state ownership), directly owned BOSs, and local BOSs, suggesting that these categories of firms may have been less vulnerable to the pandemic effects in Romania.

In Ecuador (Ferro and Patiño Peña 2023), total factor productivity was lower for both BOSs and private firms during 2020. Total factor productivity growth was 41 percentage points lower for BOSs in competitive sectors than for private firms in those sectors. Although BOSs became less productive during the pandemic, workers employed in these firms were cushioned, as worker compensation grew. This finding suggests that, during economic downturns, BOSs are potentially less efficient (and more distortive) in competitive sectors.

In terms of fiscal cost, in high-income countries such as Australia, Germany, Japan, and the United Kingdom, support to firms during the COVID-19 pandemic accounted for more than 10 percent of GDP. In lower-middle-income and low-income countries, additional spending amounted to 3.4 percent of GDP, and equity, loans, and guarantees amounted to about 1 percent of GDP (figure 4.5) (IMF 2021a). The International Monetary Fund estimated in May 2020 that support by countries to their firms in the form of loans, equity, and guarantees totaled US$4.6 trillion (IMF 2020b). For example, the European Commission implemented a State Aid Temporary Framework for support directed to firms mirroring the framework implemented during the global financial crisis. Between March 2020 and September 2021, the European Commission
approved more than 650 measures providing more than €3 trillion in state support to firms. Measures included creating new BOSs and granting state support to BOSs and private firms through cash transfers, tax reductions, payment deferrals, and access to finance. This extensive state support, increased state ownership, and control of BOSs can amplify fiscal risks (OECD 2020a).

Besides fiscal costs, other risks are associated with state support to BOSs or private firms—during periods of crisis or normal times. State support affects the way firms interact with their competitors and reduces competition and economic efficiency. First, when resources are channeled to inefficient BOSs or private firms, state support may prolong their life span and help them to gain market share, while more productive peers face pressure to shrink and eventually exit the market. Second, support may distort their incentives to invest in productivity-enhancing activities, given the expectation that the state would provide additional support to failing BOSs and private firms in the future (soft budget constraints). Third, state support might help a single BOS or private firm (or a group of BOSs or private firms) consolidate its market power or even take over (existing and potential) competitors. Through these channels, state support can distort the market selection process, which in turn may hamper productivity growth while generating allocative, technical, and dynamic inefficiencies (box 4.3). In the long run, these distortions could reduce market competitiveness (see also Pop and Connon 2020).

The type of state support affects the level of distortions. Using the example of state support during the COVID-19 period, the World Bank Subsidy and State Aid Tracker shows that state support targeted BOSs and private firms alike, but BOS support was

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**FIGURE 4.5  Discretionary Fiscal Responses to the COVID-19 Crisis, by Country Income Level, 2020–21**

Source: IMF 2021a.

Note: Based on data for available countries, including 15 lower-middle-income and 5 low-income countries.
BOSs were more likely to receive deferrals of fees, costs, taxes, and payments, which are less distortionary than other measures. BOSs were more likely to receive equity injections, which can be stickier than measures such as grants or loans, particularly if they are not linked to performance targets are not limited in time and are not accompanied by sunset clauses.

In the provision of state support, there is always the potential for corruption. However, irrespective of the type of firm ownership, this risk is more acute during crises, given the large scale of fiscal stimulus being disbursed in a short period and with limited oversight. The resources allocated to crisis emergency response and recovery can offer significant opportunities for illicit gains, given the need for speed and flexibility. Although BOSs face corruption risks similar to those of private companies, the risks are compounded by the scale of assets they control, the considerable value of public contracts, and their proximity to governments. During a crisis, this privileged position also may put some BOSs in a position to secure preferential support when bailouts are decided and funds are limited. BOS procurement is vulnerable to corruption and collusion during crises, as it is in normal times. Crises exacerbate the corruption risk,

**BOX 4.3**

**Does State Support during Crises Distort Competition?**

There is limited evidence on whether support during crises is more or less distortive than during non-crisis periods. For the global financial crisis, many studies review the effectiveness of liquidity injections in improving credit conditions, but there is limited evidence of the support’s distortions in markets. For example, studies find that the US Troubled Asset Relief Program had limited impact on the activities of firms or local economic conditions (Berger and Roman 2015; Sheng 2019). But research also finds that the program allowed banks to obtain competitive advantages (Berger and Roman 2015), with politically connected banks being more likely to receive capital injections (Duchin and Sosyura 2012).

For the responses to the COVID-19 pandemic, data are limited on the actual disbursement of support to firms, and it is hard to assess the possible competitive distortions with precision. The European Commission published a study suggesting that state support disbursed during the crisis had a limited effect on competition because support measures implemented by member states were proportionate to the economic damage suffered (Mathieu Collin et al. 2022). But the analysis did not cover sector or firm distortions. For COVID-19, fiscal measures to firms provide limited information about how beneficiaries were selected. Because the schemes were largely horizontal, covering all sectors (except financial services), the actual distribution could be expected to be demand determined and directed to sectors that suffered most. But World Bank (2021e) finds that 20 percent of firms that were not affected by COVID-19 reported receiving public support, compared with 26–29 percent of firms that were affected.

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a. The same result was found when studying the effects of subsidies for small and medium enterprises following the Great East Japan Earthquake of 2011. Kashiwagi (2019) finds that, although subsidies were effective in the retail sector, they made no significant difference in the manufacturing and service sectors.
Support to BOSs and Private Firms during COVID-19

Governments most frequently purchased equity in businesses of the state (BOSs) as part of their support (32 percent of schemes), which can be more distortionary in the long term. Private firms, by contrast, received a wider variety of less distortionary measures, such as grants (about 22 percent of schemes) (figures B4.4.1 and B4.4.2). Capital injections, share purchases, and debt alleviation were typically directed to BOSs with high state ownership. Loans and grants more often targeted BOSs with lower state ownership, with levels similar to those of private firms (figure B4.4.3). Some countries created new BOSs during the COVID-19 crisis.

FIGURE B4.4.1  State Support to BOSs, by Type of Measure, April 2020 to June 2021

Source: World Bank Subsidy and State Aid Tracker.
Note: BOSs = businesses of the state.

FIGURE B4.4.2  State Support to Private Firms, by Type of Measure, April 2020 to June 2021

Source: World Bank Subsidy and State Aid Tracker.

(Box continues on the following page.)
particularly when oversight and accountability measures are limited during an emergency response or when coupled with weak institutional frameworks.

State support can create moral hazards because it can raise expectations of future support, which may weaken market discipline. For example, recipients may take on more risk in the future if past support during crises leads them to believe that they will be bailed out in the event of a crisis. Particularly in the case of recapitalizations of banks, bailouts may encourage risk-taking behavior. Several studies find that bailouts result in higher risk taking. If state support is targeted toward larger firms that are deemed essential for systemic stability, they may have more access than smaller firms to other support. There is also concern that state support disbursed during the crisis may lead to “zombie firms,” which are economically unviable but continue to operate thanks to government support. So state support should not be available to firms that were failing or had structural issues before a crisis.
Principles of State Support

State support represents a significant amount of fiscal resources with a large opportunity cost, requiring a careful weighing of benefits against risks. Based on the implementation of state support during previous crises for which relatively good data are available, key policy principles for the design of state support to BOSs and private firms—especially during crisis periods—including the need to undertake the following: 18

- **Prioritize competing demands.** With scarce public resources, governments need to consider if support to BOSs and private firms is feasible. Given limited budgetary resources, such support may result in fewer resources for other critical areas, such as health care.

- **Clarify objectives.** Support to BOSs and to private firms must have clear objectives. If the mandate is to provide public services or critical goods and services, BOSs must be properly funded to fulfill their objectives in the same way as private firms.

- **Ensure proportional support and competitive neutrality.** BOSs should not be overcompensated to meet specific objectives, because doing so could result in market distortions, especially when BOSs compete with private peers in the same market. Governments should avoid soft budgeting and create separate budgets for assigning temporary and special public policies for BOSs. Competitive neutrality should be embedded in BOS governance and operations and be an overall requirement for targeting state support to maximize the effectiveness of public interventions given limited fiscal space and to minimize market distortions. It is important to identify BOSs’ commercial and noncommercial activities through separation of accounts, careful methodologies for calculating compensation for public service obligations, and requirements to earn market-consistent rates of return in line with those of the private sector under similar market conditions.

- **Minimize selectivity and maintain incentives.** Governments should consider clear criteria for the design and disbursement of state support to minimize distortions, applicable in the same way to BOSs and private firms. At the same time, state support needs to incentivize the recipient of that support to meet stated objectives. For example, if the aim of the support is to protect jobs, the support can be tied to rules for maintaining a certain level of employment during times of crisis.

- **Select the least distortive instruments.** The level of distortion introduced by state support depends on the instrument. Governments should design support measures and associated instruments considering the objective pursued in conjunction with the risk of distortions. For example, deferrals (of taxes, contributions, interest, or payments) are less distortionary than other measures. In general, one-off and time-limited subsidy measures are less likely to have harmful effects. A loan typically leads to less distortion than a grant because it will ultimately need to be paid back by the beneficiary (table 4.2). The risk taken by
the state in guaranteeing loans can be capped at a certain percentage, and a minimum premium can be required. Recapitalizations can generate market inefficiencies and are a sticky form of support. When situations require distortive measures, such as recapitalizations, governments can also provide incentives for private sector buy-in to limit competitive distortions. For example, equity injections can be combined with bankruptcy proceedings.

- **Target support based on viability and exposure to financial distress.** Targeting beneficiaries, whether BOSs or private firms, is equally important to ensure that support measures are effective (table 4.3). State support to BOSs can be more distortive if BOSs in competitive and partially contestable markets are targeted and if targeting is based on select firms rather than clear objectives.

- **Set sunset clauses, and articulate exit strategies.** Support to BOSs should embed clear phasing-out mechanisms to prevent long-term sticky support that distorts markets. Sunset clauses for support can also minimize the cost of the intervention for taxpayers if they are transparent about the timing and process for terminating support, which may include reversing equity participation stemming from bailouts and BOS exits. If state support includes restrictions on long-term state ownership, an exit plan should detail how government will divest the company over a specified period.

Transparency can reduce distortions to competition, prevent misuse of public funds, and inform fiscal risk analysis (IMF 2016a; OECD 2016; Polackova Brixi and Schick 2002; World Bank 2023b). For example, during crisis periods, public awareness of state support facilitates take-up by businesses and reduces distortions when firms would otherwise miss out on needed relief, particularly in rural areas. Data on beneficiaries and levels of support can limit the ability to target support unfairly or to politically connected firms. Transparency can be combined with anticorruption monitoring and enforcement stipulations. Transparency measures are critical for strengthening public financial management of BOSs and include identifying BOS-related fiscal risks and mitigation measures as part of state ownership policies. Governments should require BOSs to publish financial statements and all support

### TABLE 4.2 Distortions of Different State Support Instruments

<table>
<thead>
<tr>
<th>Type of financial support</th>
<th>Competition distortions</th>
<th>Moral hazard</th>
<th>Additional transaction costs required for unwinding</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deferrals (of taxes, contributions, payments for inputs)</td>
<td>Low</td>
<td>Low</td>
<td>Not required</td>
</tr>
<tr>
<td>Guarantees</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Loans</td>
<td>High</td>
<td>High</td>
<td></td>
</tr>
<tr>
<td>Grants</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equity (or asset purchase)</td>
<td></td>
<td></td>
<td>Required</td>
</tr>
</tbody>
</table>

*Source: Original table for this publication.*
given to various beneficiaries, both private and state owned. Information should be provided on the roles of state-owned banks and commercial banks in allocating credit. Transparency and clear communication of support measures also help to manage business expectations and build public support.

**Notes**

1. Contingent liabilities can be either explicit (that is, legally grounded, such as government loan guarantees) or implicit, with a public expectation of government responsibility that is not established in law (for example, bailing out troubled subnational governments or state-owned enterprises). Different contingent liabilities frequently are realized in tandem, either because they are caused by the same underlying shock or because the realization of one risk triggers that of another, for instance, if the financial troubles of a BOS firm put its lenders into difficulty.

2. State support can take different forms. Such support to BOSs and private firms can include access to credit through grants, loans, or guarantees and indirect support through payment deferrals and tax relief, cash transfers, fee reductions, or wage subsidies. Governments can also provide support through equity and debt finance, especially if companies are deemed strategically important.

3. Public sector balance sheets combine all of the accumulated assets and liabilities that governments control, including public corporations, natural resources, and pension liabilities, and account for the entirety of what the state owns and owes.

4. State-owned banks often play an important role in the financial sector—for example, the Bhutan Development Bank accounts for 25 percent of total assets of the banking system, and Uruguay’s Banco de La Republica Oriental Del accounts for 43 percent. Some state-owned banks account for a significant share of their markets—for example, the Viet Nam Bank for Social Policies provides 60 percent of all the country’s micro loans, and Mexico’s Fideicomisos Instituidos en Relación con la Agricultura accounts for 67 percent of total lending to the agriculture sector (World Bank 2018).
5. For example, given their dominance in network and primary sectors, BOSs are vulnerable to climate change risks, including decarbonization transition risks, that can affect public finances through dividend and asset losses (see chapter 5).

6. Most standard statistics and definitions of debt focus on the nonfinancial public sector debt, which would include BOSs and exclude state-owned banks.

7. In the past, two SOEs did not have the resources to repay their credits, and the government made payments on behalf of those two SOEs.

8. In the case of the European Union, the European Commission (2016) finds that, although the profitability and productivity of BOSs tend to be lower than those of private firms, the difference in performance between BOSs and private companies became smaller (or statistically insignificant) during the global financial crisis, suggesting that BOSs were potentially stabilizing during the crisis.

9. Jaslowitzer, Megginson, and Rapp (2018) find that state ownership is associated with stability-seeking investment policies. García-Sánchez and Rama (2022) find that BOSs in Spain outperformed other firms during the global financial crisis in their ability to cooperate with partners on innovation. However, Ljie et al. (2021) find that investment fell more for BOSs than for other listed firms during the COVID-19 crisis, suggesting that they may have exacerbated the impacts of the crisis. Bortoloti, Fotak, and Wolfe (2022) find that government ownership did not mitigate research and development investment during crises. Further, the World Bank (2023a) finds that, although infrastructure BOSs that faced a negative shock received additional fiscal injections equal to 3.5 percent of average assets, average capital expenditure declined by 40 percent of average assets the year after the shock.

10. EBRD (2020) finds that the presence of state-owned banks had a positive impact on income growth and other outcomes after the crisis in the Caucasus, Central and Eastern Europe, and Türkiye. Coleman and Feler (2014) find similar results in Brazil. Szarzec, Dombi, and Matuszak (2021) investigate the effect of BOSs on economic growth in 30 European countries in the period of 2010–16 and find that BOSs are per se neither positive nor negative for growth but that their impact on growth depends on the country’s institutions. With good (bad) institutions, the effect of BOSs is more beneficial (detrimental), turning significantly positive (negative) in the right tail (left tail) of the sample distribution of institutional quality.

11. The World Bank State Aid Tracker presents the state support schemes implemented by governments across all continents in the context of the COVID-19 pandemic. The tracker includes a sample of 1,075 approved COVID-19-related measures in 167 countries from April 2020 up to June 2021 based on criteria that would qualify them as subsidies according to the World Trade Organization definition. A subsidy is a financial contribution by a government or public body conferring a benefit to its recipients, which are firms (not individuals or households). According to the World Trade Organization Agreement on Subsidies and Countervailing Measures, Article 1 subsidies may include grants, tax exemptions, capital injections, loan guarantees, accelerated depreciation allowances, and other in-kind benefits (https://www.wto.org/english/docs_e/legal_e/24-scm_01_e.htm). In the European Union context, state aid is defined as “any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favoring certain undertakings or the production of certain goods shall, insofar as it affects trade between Member States, be incompatible with the internal market” (Article 107 (1) of the Treaty on the Functioning of the European Union). The tracker includes approved schemes but does not include data on the disbursement of funds at the recipient level. Data included in the tracker were collected through a desk research exercise using publicly available information from countries’ ministries of finance (annual budget information for 2020/21; published lists of COVID-19-related measures and press releases), the European Commission, the European Free Trade Association, the International Monetary Fund, and other organizations, such as KPMG, Deloitte, White and Case, and Ernst and Young. They were updated regularly.
during April 2020–June 2021. Overall, data from all the regions covered were publicly available and accessible, with some exceptions in a few countries from the Middle East and North Africa and East Asia and Pacific regions.

12. The role of state-owned financial institutions in a crisis warrants particular attention, separate from that of BOSs in the real sector (Gutierrez and Kliatskova 2021).

13. Although the 2008 and 2020 frameworks were similar regarding the type of aid (grants and soft loans) and the conditions for granting them (existence of a ceiling on the amount of subsidy per company), the framework adopted during the 2008 crisis focused mainly on the financial sector—the 2020 framework largely concerned the real economy.

14. For example, an analysis of US congresspersons regarding the Emergency Economic Stabilization Act in October 2008 revealed that “higher campaign contributions from the financial industry increase the likelihood of supporting the Emergency Economic Stabilization Act” (Mian, Sufi, and Trebbi 2010, 1967). In the health care sector, approximately US$2 trillion of procurement expenditures are lost to corruption globally per year, and rapid processes during crises likely exacerbate these losses. Single-source procurement, implemented by many countries during the COVID-19 crisis, created not only risks of corruption, but also risks of collusive behavior among all types of firms (United Nations 2021).

15. See, for example, OECD (2010, 34): “The financial crisis of 2008 is an extreme instance of the damage wrought by the existence of a soft budget constraint. One ingredient that contributed to excessive risk taking by banks was the implicit government guarantee they felt to be enjoying (and that they indeed were enjoying, as has been revealed by the various, costly rescue plans). The damage caused by the excessive risk taking was not caused by the granting of aid, but by the expectation that aid would be granted should the need arise.”

16. Dam and Koetter (2012) focus on German bailouts in which banks received capital injections from their responsible banking association’s insurance fund. Those authors find that a higher probability of bailout increases banks’ risk taking significantly, consistent with increased moral hazard. Hryckiewicz (2014) investigates the effects of bailouts on bank risk using data on banks rescued during 23 systemic banking crises in 23 countries, finding that bailouts increase bank risk significantly and that blanket guarantees, nationalizations, and asset management companies contribute the most to increased risk. Using a sample for 53 countries, Brandao-Marques, Correa, and Sapirza (2018) also find that more government support is associated with more risk taking. In the case of the East Asia financial crisis, Poczter (2016) finds that recapitalization of banks in Indonesia increased the long-term risk taking of banks.

17. Under the European Union COVID-19 Temporary State Aid Framework, aid could be granted only to undertakings that were not already in financial distress before the start of the pandemic. Indeed, this was the case for the Portuguese €1.2 billion rescue loan in favor of a Portuguese airline (https://ec.europa.eu/commission/presscorner/detail/en/ip_20_1029).

18. This section builds on recommendations regarding the design of support and literature on the level of distortion of different support measures, including Blanchard, Philippon, and Pisani-Ferry (2020); Copenhagen Economics (2020); European Commission (2022); Freund and Pesme (2021); Manuilova, Burdescu, and Bilous (2022); Motta and Peitz (2020); ODI (2020); OECD (2009, 2020a, 2020b, 2020c); Pop and Amador (2020b); Qiang and Pop (2020); Vitale et al. (2020); and World Bank (2021a).

19. Criteria for recapitalization measures should include (a) evidence that the viability of the company would be at risk without state intervention; (b) proof that no other measures were available to raise capital; (c) recapitalization measures that are limited in time; (d) establishment of appropriate remuneration; and (e) adoption of structural or behavioral commitments, notably in the form of prohibitions on misuse of financial support.
References


