Corporate Governance of State-Owned Enterprises

A Toolkit

WORLD BANK GROUP

CHAPTER 1

Context and Overview

Understanding the overall context—including the importance and benefits of good corporate governance—is a first and essential step toward reforming the governance of state-owned enterprises (SOEs). This chapter explains why countries the world over are seeking to improve SOE governance and provides an overview of the following topics:

- Past SOE reforms
- Role and importance of SOEs
- SOE performance and its impacts
- Governance challenges facing SOEs
- Benefits of good corporate governance
- Overarching framework for reform

Past SOE Reforms

Governments worldwide have long established SOEs with a variety of public policy goals in mind—building basic physical infrastructure; providing essential services such as finance, water, and electricity; generating revenue for the treasury; achieving self-sufficiency in the production of basic goods and services; controlling natural resources; addressing market failures; curbing oligopolistic behavior; and promoting social objectives such as employment generation, regional development, and benefits for economically and socially disadvantaged groups.

While SOEs have come to play an important economic role, evidence from the 1970s and 1980s from a number of countries shows that, on average, SOEs have performed poorly relative to private firms, partly because multiple policy goals proved difficult to reconcile.[1] SOEs often incurred substantial financial losses and became an unsustainable burden on the national budget and banking system. Government policies in support of SOEs slowed the development of the private sector, crowded out private firms from credit markets, and limited the potential for expansion of the private sector.

Since the 1980s, reforms have sought to improve performance by exposing SOEs to competition, imposing hard budget constraints, and introducing institutional and managerial changes. Many SOEs were commercialized and later corporatized into separate legal entities. In addition, governments developed performance contracts with SOEs to monitor performance and hold managers accountable for results.

Although these early reforms produced some improvements, they often fell short in implementation. The politicization of SOE boards made it difficult to provide greater autonomy in commercial decision making. The separation of commercial and social objectives was widely advocated, but few governments calculated the true cost of meeting public service obligations and transferred the necessary resources to SOEs. The achievement of financial discipline through a hard budget constraint proved difficult without corresponding restrictions on SOE borrowing from the banking system and from state-owned banks in particular. And while greater autonomy for SOEs hinged on having good accountability mechanisms, performance contracts were difficult to implement or were of mixed quality. Backsliding was common, and often reforms could not be sustained (Kikeri, Nellis, and Shirley 1992).

The modest outcomes of the reforms, difficulties in sustaining improvements in performance, and changing political systems led governments in the 1990s to turn to privatization as a way to remove SOE deficits from the national budget, to attract private investors with capital and managerial know-how, and to prevent backsliding and “lock in” efficiency gains from SOE reforms. During the 1990s and first few years of the 2000s, both financial and nonfinancial SOEs were privatized through various means, including strategic sales, auctions, vouchers, management and employee buyouts, leases and concessions, and public stock offerings.[2] Countries around the world witnessed a decline in the number of SOEs as a result of privatizations, mergers, and liquidations. Evidence also showed that privatization improved firm performance in competitive sectors and, when accompanied by proper policy and regulatory frameworks, in financial and infrastructure sectors as well (Kikeri and Nellis 2004; Nellis 2011).

However, when privatization was not done right and when the required institutional frameworks were lacking—often the case in low-income settings—privatization ended in failures and scandals that led to a backlash against the process (Nellis and Birdsall 2005). Privatization proved politically problematic, in large part because its economic benefits, while often substantial, tended to occur in the medium to longer term and were dispersed widely, in small increments, among a very broad range of stakeholders. Its costs, however, were concentrated, substantial, and immediate and felt by vocal and powerful groups. Moreover, privatization often raised sensitivities about foreign ownership of so-called strategic enterprises. It was generally unpopular with the public because of higher infrastructure tariffs, employment losses, and some corrupt transactions. Political opposition deterred many governments from privatizing large SOEs in complex sectors such as finance and infrastructure. Others privatized only partially, with the state remaining a majority or controlling shareholder, or governments imposed efficiency-diminishing conditions (for example, no layoffs) on new private owners.

Combined with the 2007–08 global financial crisis that led to turmoil in the capital markets and reduced investor interest, these factors further slowed privatization and brought it to a near halt after 2008. Indeed, the crisis itself triggered new debates on the role of the state in the economy. Together, these factors pushed governments the world over to refocus their attention on improving SOE performance.

Role and Importance of SOEs

Despite extensive privatization, governments continue to own and operate national commercial enterprises in such critical sectors as finance, infrastructure, manufacturing, energy, and natural resources. State-owned sectors in high-income countries, in major emerging market economies, and in many low- and middle-income countries have continued, and even expanded. Indeed, many SOEs now rank among the world's largest companies, the world's largest investors, and the world's largest capital market players. In many countries, SOEs in strategic industries are increasingly viewed as tools for accelerated development and global expansion.

While systematic and recent data are hard to come by, a number of stylized facts have become clear.[3] First, SOEs continue to play an important economic role, irrespective of geographic region or degree of economic development:

- Globally, in 2006 SOEs accounted for 20 percent of investment and 5 percent of employment (Robinett 2006).
- According to a 2009 OECD survey, 25 OECD countries had a total of some 2,050 SOEs valued at US$1.2 trillion. These SOEs accounted for 15 percent of gross domestic product (GDP), as measured by the valuation of SOE sectors relative to GDP, and, in countries still undergoing the transition to a more market-based economy, for 20–30 percent of GDP (OECD 2011).[4]
- In less developed countries, SOEs produced about 15 percent of regional GDP in Africa, 8 percent in Asia, and 6 percent in Latin America in 2006 (Robinett 2006). In the Middle East and North Africa, SOEs account for 20–50 percent of economic value added across the region and close to 30 percent of total employment (OECD 2012). In Central Asia in 2005, they accounted for more than 50 percent of GDP in Tajikistan, Turkmenistan, and Uzbekistan and for 20–40 percent in others (Kikeri and Kolo 2006).
- SOEs remain central economic players in the major emerging markets of China, India, and the Russian Federation, even as the private sector share of GDP has risen over the years (box 1.1). In Indonesia, some 150 SOEs contribute 15–40 percent of GDP, mostly accounted for by the 22 largest SOEs (Abubakar 2010).
- In fragile and postconflict states such as Afghanistan, Iraq, Liberia, and others, SOEs play, and are expected to play, an important role in the transition to a sustainable economy.

Second, SOEs are especially prominent in sectors of the economy that provide critical services for businesses and consumers and that contribute directly to economic growth and poverty reduction:

- *Infrastructure*. In many if not most countries, SOEs continue to provide power, rail, and water services, as well as telecommunications services in some countries. Among OECD countries, SOEs in utility sectors account for 50 percent of total SOE value (OECD 2011).
- *Banking and other financial services*. State ownership in commercial banks has declined considerably over the past four decades, from an average of 67 percent of total banking assets in 1970 to 22 percent in 2009 (World Bank 2012). Yet, SOEs in this sector occupy a dominant

BOX 1.1

The Still Substantial Role of SOEs in Major Emerging Market Economies

In China, widespread reforms under the Ninth Five-Year Plan (1995–2000) greatly expanded the role of the private sector and reduced the size of the state-owned sector. The state's share in the total number of industrial enterprises fell from 39.2 percent in 1998 to 4.5 percent in 2010, its share of total industrial assets dropped from 68.8 percent to 42.4 percent, and its share of employment shrank from 60.5 percent to 19.4 percent. The SOE share of China's exports fell from 57 percent in 1997 to 15 percent in 2010. As a result, SOEs' share of GDP declined from 37.6 percent in 1998 to just about 30 percent today, while the number of SOEs dropped from 262,000 to 116,000. Nevertheless, the "commanding heights" of the economy—most notably the 120 or so large central enterprises in such sectors as electricity, petroleum, aviation, banking, and telecommunications—remain largely state owned. State ownership is still present in competitive sectors such as wholesale trade, retailing, and restaurants, and SOEs accounted for 27 percent of industrial output in 2010 (World Bank and Development Research Center 2013). Moreover, the share of SOEs in total investment has increased with the postcrisis stimulus in construction and infrastructure (although the SOE share in production has not risen and the long-term trend is a decline). While private enterprises substantially outpaced SOEs before the global financial crisis, since the crisis the state and private sectors have been growing at broadly similar rates. And while the weight of SOEs in production and assets (of large industrial companies) has declined markedly, the decline has bottomed out in recent years.

In Russia, the SOE share in industrial production fell from 9.9 percent in 1994 to 6.7 percent in 2004. But federal SOEs remain concentrated in sectors that were declared "strategic" in a 2004 presidential decree, including machine building, natural resource exploration and extraction, the military complex, radioactive materials, and radio, broadcasting, and newspapers with a circulation exceeding 1 million. The national government also owns stakes of 10–20 percent in joint-stock companies (Sprenger 2008).

In India, the SOE share of GDP (central, state, and local) declined from 17.5 percent in 1993–94 to 13.1 percent in 2006–07. This decline in the contribution of SOEs occurred across almost all sectors as a result of the removal of entry barriers and other policy measures. Yet, in 2006–07 SOEs still accounted for 67 percent of output in the utility sector; 39 percent in transport, storage, and communications; and 20 percent in banking, insurance, real estate, and business services (OECD 2009).

position in many cases. In 2010, state banks exceeded half the assets of the banking systems in Algeria, Belarus, China, the Arab Republic of Egypt, India, and the Syrian Arab Republic. In other major emerging market countries—such as Argentina, Brazil, Indonesia, the Republic of Korea, Poland, Russia, and Turkey—state banks do not lead the process of credit creation but still have an asset market share between 20 and 50 percent (World Bank 2012). In 2010, at least 10 of the 18 largest banks in emerging markets were state controlled (*Economist*, May 15, 2010).

- *Oil and gas.* The 13 largest oil companies, controlling 75 percent of global oil reserves and production, are state owned, while conventional multinationals produce only 10 percent of the world's oil and hold just 3 percent of known reserves (*Economist,* January 23, 2010).
- *Industry and services*. The presence of SOEs has generally declined in these sectors, with notable exceptions. In Vietnam, for example, SOEs enjoy near-monopoly status in the production of several goods and services, including fertilizer (99 percent), and have maintained a large presence in such consumer goods as cement (51 percent), beer (41 percent), refined sugar (37 percent), textiles (21 percent), and chemicals (21 percent) (World Bank 2011).

Third, many large SOEs, based in developed and major emerging market economies, are now global players:

- *SOEs are among the world's biggest companies*. In 2009, four state-controlled companies made it to the top 25 of the 2009 Forbes Global 2000 list (*Economist*, January 23, 2010). Almost 25 percent of the top 100 multinational corporations from such countries as China, India, and Russia were state owned in 2006, predominantly in the primary sectors (oil, gas, and mining) and resource-based manufacturing (metals, steel) (UNCTAD 2007).
- *SOEs are among the world's biggest investors*. Many large SOEs from countries such as Brazil, China, Russia, and India are actively investing abroad, in green-field ventures, as well as in cross-border mergers and acquisitions.
- *SOEs are among the world's biggest capital market players*. Recent years have seen a noticeable trend of listing large and important financial and nonfinancial SOEs on stock exchanges as a way to raise capital, impose capital market discipline on the enterprises, and dilute state ownership. Between 2005 and 2007, initial public offerings of SOEs in China and Russia were among the largest in history (Kikeri and Burman 2007; Kikeri and Phipps 2008). In turn, initial public offerings of SOEs in these and other countries contributed to capital market development, with SOEs

accounting for about 30 percent of total market capitalization in Malaysia; 30 percent in Indonesia (Abubakar 2010); 20 percent in India (OECD 2009); and 45 percent in the Middle East and North Africa, taking into account 32 of the 100 largest listed companies, 29 of these based in the Persian Gulf area.

Fourth, some countries are establishing new SOEs to develop strategic industries and compete in an increasingly globalized economy:

- Russia has created state-owned holding companies and state corporations, such as the United Shipbuilding Corporation and the Joint Stock United Aircraft Corporation (Sprenger 2008).
- In the Middle East and North Africa, the Gulf Cooperation Council (GCC) countries have established new SOEs—often with explicit or implicit industrial development agendas—both planned and through state rescue of companies in the aftermath of the global financial crisis (OECD 2012).
- In Vietnam, the steady decline in the number of majority or wholly owned national and local SOEs—from 5,800 in 2000 to 3,300 in 2010—was reversed in 2009, when 175 new SOEs were added by the central government. These include large economic groups and general corporations that were created to develop strategic industries and carry out welfare and social responsibilities (World Bank 2011).
- Following the crisis, in a number of countries state development banks (that have explicit policy mandates and are funded primarily by deposits) and development finance institutions (funded mainly by nondeposit resources) played a countercyclical role by providing credit to private firms that were unable to access funding through private banks and the capital markets. New development banks are also being established in countries such as Malawi, Mozambique, and Serbia among others (de Luna-Martinez and Vicente 2012).

Fifth, a few countries have expanded state ownership through nationalization and through the acquisition of stakes in private enterprises:

- Beginning in 2006, Argentina, Bolivia, Russia, and the República Bolivariana de Venezuela nationalized companies as a matter of policy to increase the state presence in selected sectors (box 1.2).
- More recently, the 2007–08 global financial crisis led to an increase in government ownership as governments of developed countries, such as Iceland, the Netherlands, the United Kingdom, and the United States, bailed out financial institutions through capital injections and partial or full nationalizations—although these interventions were primarily temporary rescues rather than permanent takeovers.

BOX 1.2

Expanded State Ownership through Nationalization and Acquisition

In 2006, the government of the República Bolivariana de Venezuela took over majority control of 32 marginal oil fields managed by foreign oil companies and the following year adopted a decree giving the state-owned oil company PDVSA a majority equity share and operational control of four joint ventures. The government also declared energy and telecommunications "strategic." As a result of recent agreements, the government now controls the country's telecommunications company (CANTV) and electricity company (EDC).

Bolivia adopted a decree for the nationalization of oil and gas resources in May 2006, and the government renationalized the two refineries acquired by Brazil's Petrobras during an earlier privatization program. It is now moving to take over ENTEL, the telecommunications company that was privatized in 1996.

In Russia, the state began increasing its presence in key sectors of the economy in 2007 through the acquisition of private company assets by government-related companies (those that are directly controlled by the state and in which the state owns more than 50 percent of common stock). Examples include Rosneft's purchase of a small private oil company, Gazprom's purchase of Sibneft, and the purchase of smaller competitors by five big state-owned banks.

In Argentina, the government took over the troubled airline and the private pension system in 2008. Because the pension funds had big shareholdings in many companies, the government, through the National Social Security Administration, now has the right to nominate directors to the boards of the firms, which it has done in 20 companies. The social security administration also ramped up spending on public works and the unemployed ahead of the congressional elections (*Economist*, February 27, 2010).

Finally, beyond directly owning SOEs, governments also hold indirect shares in companies through state-owned financial institutions and pension funds (data on this category of companies are scarce). In Brazil, for example, the state-owned oil company Petrobras raised its stake in Braskem—a private sector chemical company—by US$1.4 billion in early 2010, while the state-owned development bank BNDES and the pension funds of big state companies have increased their holdings in many of Brazil's largest private sector firms (*Economist*, April 3, 2010).

SOE Performance and Impacts

Available evidence suggests that the financial performance of many SOEs and their contribution to the state budget have improved in the past decade as a result of budgetary reforms, restructuring measures, improved governance practices, and exposure to greater competition and capital market discipline:

- In China, SOE profitability has increased since the expansion of competition, corporatization, and the creation in 2003 of the State-Owned Assets Supervision and Administration Commission to exercise authority over state enterprises. The reported average return on equity rose from 2.2 percent in 1996 to 15.7 percent in 2007, before slipping back to 10.9 percent in 2009 (World Bank and Development Research Center 2013).
- In India, the 24 largest nonfinancial SOEs generated a 17 percent return on equity in 2010, and profits almost doubled in the past five years.
- In Indonesia, following restructuring and governance improvements, SOE profits grew at a compound annual rate of 18.9 percent between 2004 and 2009, while contributions to the state budget through dividends and tax payments amounted to 12 percent of budget revenue (Abubakar 2010).
- In Malaysia a program aimed at transforming government-linked companies (GLCs), now in the seventh of the 10-year program, has helped improve performance. The return on equity of 20 larger companies rose from 7.7 percent in 2009 to 10.5 percent in 2010, while total shareholder return grew by 16.4 percent from 2004 to 2011. Indicators such as operating cash flow and debt-to-equity ratios have also improved (Putrajaya Committee 2011).
- In the Middle East and North Africa, many countries in the Persian Gulf have created profitable and well-run SOEs in strategic industries. These include the Saudi Basic Industries Corporation, Emirates Airlines, Dubal, and Etisalat, all of which have made their mark domestically and internationally (Hertog 2010; OECD 2012).

However, SOE performance is not uniformly positive. Notwithstanding performance improvements, a disproportionate share of SOE profits often comes from a few large firms that earn high rates of return through limits on competition and access to cheaper land, capital, and other inputs. Moreover, even those SOEs that are performing well often lag behind private and other nonstate firms in financial, economic, and operational performance. Compared to the private sector, many state-owned banks suffer from a number of vulnerabilities, including weak balance sheets and low capitalization, poor underlying profitability, and high nonperforming loans:

- In China, nonstate firms had an average return on equity 9.9 percentage points higher than that of SOEs in 2009 (World Bank and Development Research Center 2013).
- In Vietnam, although SOEs registered healthy returns on equity (17 percent), their returns were below the economy's nominal growth rate (19 percent) and well below the returns of foreign firms (27 percent). Rapid growth in the capital and fixed-asset base of SOEs has not been accompanied by higher productivity: in 2009, the average ratio of turnover to capital was 1.1 for SOEs but 21.0 for all enterprises; the ratio of turnover to employees was 1.7 for SOEs and 16.3 for all enterprises; and the ratio of turnover to fixed assets fell for SOEs between 2000 and 2008, while remaining unchanged for all enterprises (World Bank 2011).
- In Malaysia, a 2008 study showed that government-linked companies tend to score lower than private sector companies on metrics of economic performance or economic value added (measured as the difference between cash flow returns on investment and the weighted average cost of capital) (Issham et al. 2008).
- A study of nine Middle Eastern countries found that state-owned banks have much lower profitability than private banks due to their large holdings of government securities, larger ratios of overhead costs to assets (because of much larger ratios of employment to assets), and higher ratios of loan-loss provisions to outstanding loans (reflecting much larger shares of nonperforming loans in their portfolios) (Rocha 2011).
- A recent survey of 90 state-owned development banks from 61 countries shows that their financial performance is mixed; 15 percent report nonperforming loans exceeding 30 percent of their total loan portfolio, while nearly 60 percent indicate that without government budget transfers their self-sustainability is a major challenge (de Luna Martinez and Vicente 2012).
- SOEs tend to perform particularly poorly in low-income countries, although there are exceptions. A study in Burkina Faso, Mali, and Mauritania found that of the 12 SOEs that provided information, 8 reported losses while 3 were operating at close to breakeven. Only one reported significant profits: Mauritania's Société Nationale Industrielle et Minière, a mining company (Bouri, Nankobogo, and Frederick 2010).

Underperforming SOEs bring high financial and economic costs. In many countries, these enterprises remain a fiscal burden and a source of fiscal risk. In Indonesia, for example, subsidy payments to three SOEs alone—those producing fuel, electricity, and fertilizer—averaged 4 percent of GDP between 2003 and 2006; yet the subsidy still fell short of what was needed to cover all quasi-fiscal obligations and arrears with other SOEs (Verhoeven et al. 2008). In Vietnam, many large SOEs receive subsidies and their capital investment funds from public sources, including state banks. Their growing size and the complex cross-holdings of charter capital across and within enterprises make it difficult to assess the inherent risks involved in their activities and the contingent liabilities they give rise to. Some SOEs acquire noncore assets and companies, saddling themselves with large debt burdens. The total liabilities of SOEs exceed the government's own debt, posing a significant fiscal risk (World Bank 2011). In Vietnam, as elsewhere, the financial and fiscal risks from SOEs can spill over into the broader economy, especially if SOEs have strong links with state-owned banks.

Poor performance by SOEs can also impede competitiveness and growth. In many countries, SOEs continue to crowd out or stifle the private sector, while lack of competitive markets or a level playing field creates inefficiencies and limits the expansion of the private sector. Numerous surveys and studies show that the shortage of key infrastructure capacities, due in part to SOE inefficiencies and underinvestment, is ranked as one of the top three constraints on competitiveness and growth. One study shows that investment by many infrastructure SOEs is 50–120 percent lower (depending on the country group) than required to meet service delivery needs (Estache and Fay 2007). Achieving higher levels of economic activity will therefore require substantial improvements in the productivity and performance of existing infrastructure SOEs, along with private sector investments and public-private partnerships.

Loss-making and ineffective financial SOEs weaken the financial system as a whole, and, by lending mainly to unprofitable SOEs, they can create contingent liabilities that become a source of fiscal risk. By underpricing risks and engaging in business practices that displace commercial financial services of the private sector, financial SOEs hinder new private entry and undermine competition, which in turn retard financial market development, diminish access to financial services, and weaken the stability of the financial system (Scott 2007). Financial SOEs provide most of the financing for the great majority of enterprises and individuals, particularly in emerging markets, and weak institutions can harm economic growth and erode public trust.

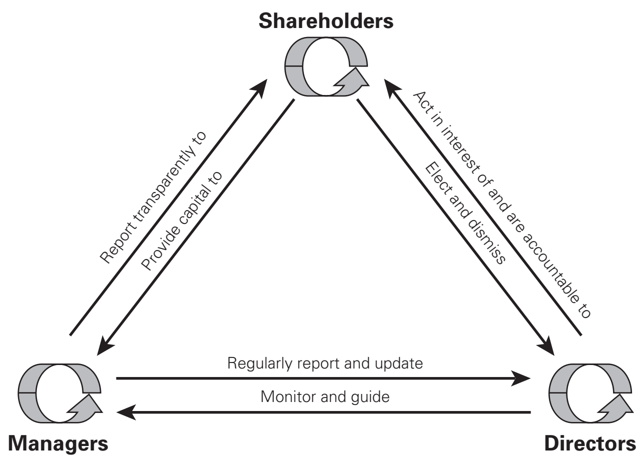
The underperformance and high opportunity costs of SOEs are symptomatic of a number of underlying problems. Exogenous factors, such as shifts in commodity prices, may play a role, as do sector-specific factors such as public service obligations and regulated prices. But there is increasing recognition that poor corporate governance of SOEs is at the heart of the matter. Understanding the governance challenges and addressing them in the SOEs that play significant roles in an economy are thus a central concern for economic growth and financial sector development.

Corporate Governance Challenges in SOEs

Corporate governance refers to the structures and processes for the direction and control of companies. It specifies the distribution of rights and responsibilities among the company's stakeholders (including shareholders, directors, and managers) and articulates the rules and procedures for making decisions on corporate affairs (figure 1.1). Corporate governance therefore provides the structure for defining, implementing, and monitoring a company's goals and objectives and for ensuring accountability to appropriate stakeholders. Good corporate governance systems ensure that the business environment is fair and transparent, that company directors are held accountable for their actions, and that all business contracts made by the company can be enforced. A company committed to good corporate governance has strong board practices and commitment, effective internal controls, transparent disclosure, and well-defined shareholder rights.

Compared with private sector companies, SOEs face distinct governance challenges that directly affect their performance. A useful lens through which to view these differences is the classic distinction between the

FIGURE 1.1 Key Stakeholders in Corporate Governance



Source: IFC 2008.

interests of a firm's owner (its principal) and its managers (the agents). In any principal-agent relationship, the principal confronts two distinct tasks: to set the goals that the agent is to pursue and to manage the moral hazard problems associated with delegation of responsibility to an agent whose private incentives are likely to differ from those of the principal.

For private companies, the goal-setting challenge is relatively straightforward: the primary goal of owners is to achieve the best financial performance. Consequently, much of the focus of private sector corporate governance is to align the incentives of managers with those of the enterprise's owners and shareholders. SOEs face the same challenge of aligning the incentives of managers and owners. However, they can encounter additional governance challenges arising from several sources:

- Multiple principals
- Multiple and often competing goals and objectives
- Protection from competition
- Politicized boards and management
- Low levels of transparency and accountability
- Weak protection of minority shareholders

Multiple Principals

The owners or principals of private companies play key roles in corporate governance. They seek to elect or appoint the best people they can find to the board of directors, set clear goals, monitor company performance, and provide capital to fund expansion. However, SOEs often lack a clearly identified principal or owner. Instead, the state frequently exercises its ownership responsibilities through multiple actors—such as line ministries, the ministry of finance, and a number of other government bodies. As a result, conflicts between the state's ownership functions and its policymaking and regulatory functions can arise and leave the company vulnerable to being used to achieve short-term political goals to the detriment of its efficiency. Moreover, in carrying out its ownership functions, states often set inconsistent goals, fail to monitor company performance closely, and cannot supply sufficient capital. In the absence of clear legal frameworks or the proper implementation of laws and regulations, the state also often assumes functions that should be carried out by the board, such as appointing and dismissing the chief executive officer and approving budgets and investment plans. This provides scope for political interference and inconsistencies in direction and approach and can open opportunities for corruption.

Multiple Goals

While many private sector companies have the objective of increasing "shareholder value," SOEs typically have multiple and potentially competing goals. In addition to profitability, SOEs are often subject to broad mandates and public service obligations (such as providing rail, mail, or telephone service at stipulated prices) and to broader social and industrial policy goals. Some of these objectives may be explicit; others, implicit but no less important in practice. State financial institutions such as development banks and development finance institutions can also have broad and general mandates that are not well defined, providing room for government direction. When SOEs have multiple, ambiguous, or conflicting objectives, a practical consequence is that managers may aim to achieve all of the objectives and end up achieving none. Others may have substantial latitude to run the firm in their own interests. Governments may also interfere in company affairs for political gain under the cover of their different policy goals and mandates. Without clear goals, assessing managerial performance is difficult, and opportunities for political capture of the SOE and its resources are increased.

Protection from Competition

Although SOEs may be burdened with multiple objectives, they do not always operate on a level playing field with the private sector. They often receive preferential treatment through access to subsidies, bank credit, procurement contracts, and, in some cases, special tax or customs rates. Preferential treatment may give SOEs advantages that crowd out the private sector and lead to anticompetitive behavior with other market participants. Concerns about a level playing field have also grown on the international front as SOEs have expanded and become investors in ventures outside their home region or country. Perceptions about how SOEs operate—including the extent of political backing, implicit government guarantees, preferential procurement practices at home, less severe regulations, and lack of transparency—have led private sector companies (foreign and domestic) to demand that SOEs be subjected to stronger governance and transparency requirements.

Politicized Boards and Management

SOEs often lack a board of directors with the required experience and range of competencies to perform the classic corporate governance roles: to guide strategy, oversee management, and ensure a robust internal control system. Instead, SOE boards often represent different stakeholders, all of whom may have agendas that conflict with the interest of the company and that interfere with commercial decision making. Conversely, SOE boards may act purely as a “rubber stamp” for government decision making, exercising no oversight over managers (who in practice report directly to the government). Board members are often government employees without experience in managing companies and are appointed for political reasons rather than on the basis of technical and financial expertise. Independent directors are usually underrepresented on the board, and, where they do serve on boards, their independence is often called into question. Board-level committee structures are nascent, and board expertise in important areas such as audit and risk management remains weak in many SOEs.

Little Transparency and Accountability

Although publicly owned, many SOEs often have weak internal controls and processes, inadequate accounting and auditing practices, and weak compliance procedures, with low levels of financial and nonfinancial disclosure and few if any requirements to publicly report their accounts or other information. Many of these problems stem from the lack of a clear performance-monitoring system to ensure accountability and responsibility for performance, particularly of the board and the chief executive officer. Moreover, where such systems exist, they are often rudimentary, and aggregate reporting may not be carried out. A lack of transparency and disclosure can undermine SOE performance monitoring, limit accountability at all levels, conceal debt that can damage the financial system, and create conditions that increase the likelihood of corruption. Sectors such as extractive industries, natural resources, and infrastructure may be particularly prone to corruption risks.

Weak Shareholder and Stakeholder Protection

Many SOEs, especially listed SOEs, have minority shareholders. And like other controlling shareholders, the state may ignore minority rights, including carrying out transactions that benefit management or other SOEs at the expense of outside shareholders. Because SOEs also often have a powerful array of stakeholders, including employees, consumers, local communities, and state-owned creditors, balancing their competing interests can be a challenge.

The Benefits of Good Corporate Governance

As the toolkit shows, a number of governments in developed and developing economies alike are taking concrete actions to address the above challenges in order to: (1) enhance the competitiveness of SOEs and the economy as a whole; (2) provide critical infrastructure, financial, and other services in a more efficient and cost-effective manner; (3) reduce the fiscal burden and fiscal risk of SOEs while improving their access to external sources of finance through the capital markets; and (4) strengthen transparency and accountability.

A good corporate governance system in general is associated with a number of benefits for all companies, private or state owned. As documented by Claessens and Yurtoglu (2012), good corporate governance leads to a number of positive outcomes:

- *Better access to external finance by firms*, which in turn can lead to larger investments, higher growth, and greater employment creation.
- *Lower costs of capital and higher firm valuation*, which make investments more attractive to investors and thus also lead to growth and more employment.
- *Improved strategic decision making and operational performance,* through better allocation of resources and more efficient management, which create wealth more generally.
- *Reduced risk of corporate crises and scandals*, a particularly important outcome given the potentially large economic and social costs of financial crises.
- *Better relationships with stakeholders*, which improve social and labor relationships, help address such issues as environmental protection, and can help further reduce poverty and inequality.

Many, if not all, of these benefits apply to SOEs. While few empirical studies specifically analyze the direct impacts of corporate governance on SOE performance, anecdotal evidence shows that better governance benefits both individual companies and the economy as a whole:

- *Improved operational performance of SOEs.* A recent study of 44 SOEs in the water and electricity sectors of countries in Latin America and the Caribbean finds a positive correlation between six dimensions of corporate governance reform and the operational performance of the utilities (Andrés, Guasch, and López Azumendi 2011). The dimensions include the legal and ownership framework, the composition of the board, the performance management system of the enterprise, the degree of transparency and disclosure of financial and nonfinancial information, and the characteristics of staff (for example, education, salary, and benefits). The study shows that the composite index of these dimensions is strongly correlated with labor productivity, tariffs, and service coverage.

- *Increased access to alternative sources of financing through domestic and international capital markets, while helping develop markets*. As governments face continued budget constraints, better-governed SOEs are more easily able to raise financing for infrastructure and other critical services through the capital markets. In turn, SOE issuances can help develop capital markets. Malaysia's government-linked companies, for example, account for about 36 percent of the market capitalization of Bursa Malaysia and about 54 percent for the benchmark Kuala Lumpur Composite Index. In India, 41 centrally owned SOEs account for 20 percent of the market capitalization of the Mumbai Stock Exchange.
- *Financing for infrastructure development*. Most public spending on infrastructure passes through SOEs (Akitoby, Hemming, and Schwartz 2007). By reducing internal inefficiencies, SOEs can make that spending go farther. For example, a recent study suggests that of the roughly US$93 billion annual infrastructure investment gap in Sub-Saharan Africa (equal to 15 percent of the region's GDP), nearly US$17 billion could come from savings produced by improving internal efficiencies through better governance and other means (Foster and Briceño-Garmeñdia 2010).
- *Reduced fiscal burden of SOEs and increased net contribution to the budget through higher dividend payments.* The Lithuanian government, which is working to improve the governance of its major SOEs, has estimated that annual dividends from better governance could be increased by 1 percent of GDP, helping reduce its budget deficit as part of efforts to join the Euro Area in 2014. In 2010, the Chinese government announced that it would start extracting more in dividends from its SOEs with the aim of forcing them to compete more fairly with the private sector and allocating resources to social expenditures. Improved governance also increases transparency of the contingent liabilities associated with SOEs, thereby reducing fiscal risk.
- *Reduced corruption and improved transparency.* Corruption remains a serious problem in SOEs and can influence the financial strength and valuations of the companies, negatively affect investor perceptions, lead to the misallocation of scarce government resources, and constrain overall economic and financial growth. Better-governed companies with integrity and accountability mechanisms are likely to be less corrupt and more transparent.

Framework for Corporate Governance Reform

In view of the above, many countries are pursuing fundamental governance reforms to improve the relationship between the companies and the government as owner. Such reforms have focused on improving both the role and the behavior of the state as an owner and on instigating corporate governance reforms within the SOE sector. As discussed in the subsequent chapters of the toolkit, the main elements in improving the overall corporate governance framework are the following:

- Developing a sound legal and regulatory framework for SOE governance (chapter 2)
- Improving the state's ownership role (chapter 3)
- Establishing a performance monitoring system for accountability (chapter 4)
- Enhancing financial and fiscal discipline of SOEs (chapter 5)
- Professionalizing SOE boards of directors (chapter 6)
- Enhancing transparency and disclosure (chapter 7)
- Ensuring shareholder protection in mixed-ownership companies (chapter 8)
- Building support and capacity for implementation (chapter 9)

In undertaking reform of their SOEs, governments often look toward the OECD's *Guidelines on Corporate Governance of State-Owned Enterprises,* which serves as the international benchmark of good practice. Established in 2005, the guidelines provide a framework for assessing and improving the governance practices of SOEs that have a distinct legal form, are commercial in nature, and are controlled by the state through full, majority, or significant minority-share ownership. They cover six main areas: the legal and regulatory framework for SOEs, the role of the state as owner, equitable treatment of shareholders, relations with stakeholders, transparency and disclosure, and the responsibilities of SOE boards (box 1.3).

Governments have also sought to learn from a growing body of knowledge and the many practical reform experiences that have unfolded in recent years, both in OECD countries and in emerging market countries. These show that while many technocratic solutions are available, implementation is not an easy task. Corporate governance reforms can be politically challenging. Entrenched groups may oppose reforms or find ways to resist them. And the wide range of political and institutional circumstances in different countries, as well as differences between sectors and types of SOEs, means that there can be no one-size-fits-all approach to reform.

BOX 1.3

Summary of the OECD's *Guidelines on Corporate Governance of SOEs*

- *Ensuring an effective legal and regulatory framework for state-owned enterprises.* To avoid market distortions, the legal and regulatory framework for SOEs should ensure a level playing field in markets where SOEs and private sector companies compete. Such a framework implies clear separation between the state's ownership function, simplified operational practices for SOEs, uniform application of general laws and regulations to all enterprises including SOEs, and no privileged access to SOEs for factors of production, including finance.
- *The state acting as an owner.* The state should act as an informed and active owner and establish a clear and consistent ownership policy, ensuring that the governance of SOEs is carried out in a transparent and accountable manner, with the necessary degree of professionalism and effectiveness (for example, no involvement of government in the day-to-day management of SOEs; the state should let SOE boards exercise their responsibilities and respect their independence).
- *Equitable treatment of shareholders.* The state and SOEs should recognize the rights of all shareholders and ensure their equitable treatment and equal access to corporate information (for example, SOEs should be highly transparent with all shareholders, develop an active policy of communication and consultation with all shareholders, and protect the rights of minority shareholders).
- *Relations with stakeholders.* The state ownership policy should fully recognize the SOEs' responsibilities toward stakeholders and request that they report on their relations with them (for example, large SOEs, and SOEs pursuing important public policy objectives, should report on stakeholder relations).
- *Transparency and disclosure.* SOEs should observe high standards of transparency such as developing consistent and aggregate reporting and an annual independent external audit based on international standards.
- *Responsibilities of SOE boards.* SOE boards should have the necessary authority, competencies, and objectivity to carry out their function of strategic guidance and monitoring of management. They should act with integrity and be held accountable for their actions (for example,

(box continues on next page)

BOX 1.3 *continued*

SOE boards should be assigned a clear mandate, responsibility for the company's performance, and be fully accountable to the owners; they should be constituted in such a way that they can exercise objective and independent judgment).

Source: OECD 2005.

For these reasons, successful reform implementation requires that close attention be paid to the local context and to the process of reform itself. Implementation of the corporate governance framework as a whole can be a daunting task for both governments and SOEs, especially in low-income settings where institutional and financial capacity are limited. Finding the right entry points for change and adopting a flexible, step-by-step approach for improving corporate governance will be required. The pace and sequencing of reforms will need to be calibrated to the economic, political, and institutional realties on the ground, as well as to the needs of individual enterprises. As the rest of the toolkit shows, reform is also a long-term process that requires constant attention to building political will, mobilizing public support, and strengthening implementation capacity.

Notes

1. Comparing the performance of state and nonstate enterprises is not straightforward, as the former often pursue a multiplicity of goals—including equity and service coverage—and not only profit maximization. Moreover, as noted in chapter 2, SOEs are often faced with disadvantages such as those related to labor market rigidities.
2. Early privatization efforts were concentrated in Latin America and the formerly centrally planned economies of Eastern and Central Europe. In Eastern and Central Europe, tens of thousands of small and medium enterprises were transferred to the private sector through voucher privatization.
3. A systematic inventory of SOEs worldwide by size, type, and economic weight is lacking. Many countries do not have centralized bodies that track SOEs as a whole or produce consolidated SOE reports. Where such data exist, they are often outdated or incomplete. These constraints are especially severe in low-income countries with little capacity to collect and analyze data.
4. The survey covers SOEs at the federal level, including publicly listed SOEs with majority or minority ownership, unlisted SOEs, statutory corporations, and quasi-corporations. Missing from the survey are such countries as Japan, Turkey, and the United States, which also have substantial SOE sectors.

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