

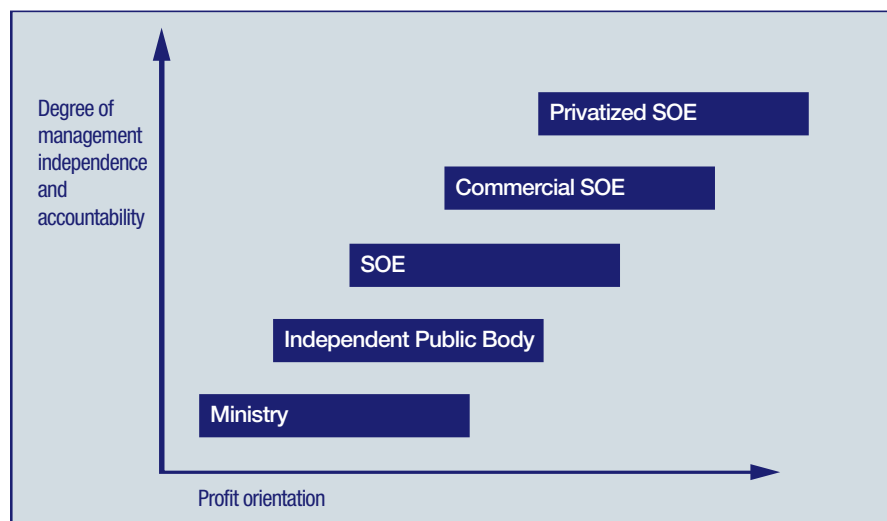
STATE-OWNED ENTERPRISE REFORM

Why commercialize state-owned enterprises?

Throughout the world, the commercialization of state-owned enterprises (SOEs) has led to increased efficiencies, reduced costs, improved service delivery, and better outcomes for the economy in terms of resource allocation and productivity. Why? Because commercialization allows SOE performance to be better measured in terms of results. Commercial governance structures bring about greater transparency and accountability, and create incentives for managers that are aligned with maximizing the value of an organization in behalf of its stakeholders. The next step beyond commercialization is full or partial privatization. While not a necessary outcome of commercialization, privatization can, among other benefits, ensure that gains achieved through commercialization are not reversed.

In Pacific island countries, unprofitable SOEs are the norm rather than the exception. Many of them generate operational losses, leaving negative returns on their capital. And since SOEs often constitute a large proportion of the capital stock of these economies, they are a severe drag on economic growth. Budget resources that could be used for education and health are instead diverted to supporting non-commercialized and inefficient SOEs.

Economic growth stems from the productive use of capital. If, for example, assets in the SOE sector have low rates of return, the private sector would have to earn a correspondingly higher rate of return on its investments to generate a high growth rate for the economy as a whole. Reform of the SOE sector is, therefore, essential for economic growth in the region.



Stages of commercialization

Commercialization of SOEs involves the introduction of robust corporate governance practices, hard budget constraints, and accountability for financial results. In short, commercialized SOEs should operate using the same principles as efficient private sector companies—with full accountability to their ultimate shareholders (i.e., the taxpayers).

Commercialization can be seen as a process, with increasing accountability, management independence, and profit orientation at each stage, as illustrated in the following diagram. The key actions in the commercialization process are to:

- Strengthen corporate governance;
- Create arms-length relationships with government oversight bodies;
- Develop robust strategic business and budget planning processes;
- Introduce a purchaser/provider split with government for the delivery of government services;
- Introduce transparency and accountability (e.g., provide sufficient information to enable stakeholders to measure performance); and
- Create the right incentives for managers to seek to maximize the value of the business.

Corporate governance

Commercialization without strong corporate governance is akin to a moving car without a driver. Good corporate governance requires that the SOE's board of directors is comprised of the best qualified for the position. The board's main roles are to set the strategic direction of the SOE, appoint its CEO, and establish regular SOE and CEO performance reviews. The board is also accountable to the responsible minister in government.

Good corporate governance also requires a clear separation between the roles of the board and the minister as government representative. While the board is responsible for representing the interests of the shareholders (i.e., all taxpayers), the minister represents the interests of the current government. Both are equally important but very different roles. If they are mixed, and political objectives take precedence over commercial considerations, the effective operation of SOEs could be jeopardized.

Business planning and profitability

Well run, commercialized SOEs typically adopt an annual budgeting and business planning cycle—all within a medium- to long-term strategic plan. SOEs should also be adequately capitalized and required to operate on commercial terms (i.e., generate an adequate return on investment without any preferential access to markets or finance). Indeed, most establishing legislation in the region requires SOEs to be as profitable and efficient as comparable private enterprises. The reality in Pacific island economies, however, is that they are not.

Purchaser/provider

The mandate for SOEs often includes the provision of community service obligations (CSOs) on behalf of the government. Often, SOEs are required to provide these CSOs below cost. This undermines SOE profitability and reduces accountability. Moreover, CSOs can also be used by SOEs to request excessive budget support to compensate for operational inefficiencies. For these reasons, it is important to ensure that CSOs are fully costed and fully funded, so that any cross-subsidization between activities is fully transparent.

The statement of corporate intent (SCI) puts into public record the SOE's objectives, business activities, performance measures, key strategic and operational targets, and any CSOs that the government is purchasing. The board of the SOE usually drafts the SCI in consultation with the responsible minister. The process of developing the SCI provides greater clarity around business goals and a common understanding of what constitutes "success." SCIs are, therefore, a key planning and accountability document.

Transparency and accountability

A key factor in achieving gains from commercialization is the increased level of transparency and accountability in the SOE's decision-making process. With greater transparency, stakeholders can determine SOE board and management performance, particularly through regular review of financial

outcomes against SCI targets. Moreover, increased transparency facilitates monitoring of SOE performance, not only by representatives of the state, but more importantly, the media and the general public. Such scrutiny encourages greater accountability in SOEs, especially among its key decision makers.

Monitoring

Just as large institutional shareholders and professional investors monitor the performance of companies in which they have invested, so must governments monitor the performance of SOEs—including performance in service delivery. In the state sector, the monitoring role is usually performed by a specialist unit, which can build up considerable expertise and, therefore, add substantial value to the ongoing performance of SOEs.

Privatization

Fully commercialized SOEs operate much like private companies, but with one important distinction—as public companies, they remain vulnerable to possible interventions such as government shareholder representatives making non-commercial decisions. Privatization, which involves the transfer of at least part of the SOE's ownership to the private sector, therefore, locks in the gains from commercialization and significantly reduces the risk of inappropriate political intervention.

The role of competition

Where possible, SOE commercialization should be conducted in parallel with market liberalization to introduce competitive pressures that would force SOEs to operate efficiently. In particular, SOEs should not be given monopoly privileges in order to make them profitable. SOE monopolists are no better than private sector monopolists, and should be subject to the discipline of competition and an effective legal and regulatory environment. Recent experience in several Pacific island countries shows that the threat and reality of competition results in SOEs reducing prices and improving services to the great benefit of consumers.

Has SOE commercialization succeeded in the Pacific region?

Yes, but most countries are still in the early stages of implementing reforms.

The first step in commercializing SOEs is to introduce supporting legislation. A number of Pacific island countries now have an SOE Act or equivalent, and a number of state operations have already been corporatized and commercialized. This has led to improved governance, greater efficiency and accountability, generally improved performance, and more transparency around defining CSOs and contracting for them. Almost 5 years ago, the Ministry of Works, Transport and Infrastructure in Samoa corporatized and privatized its road maintenance activities. The Ministry now reports a 400% increase in productivity since the reforms were introduced.

In most Pacific island countries, politicians are still appointed to SOE boards. This is not consistent with best practice governance as it can create significant conflicts of interest. In the past, this has been justified by the perceived lack of depth in the pool of directors from the private sector. However, progress is being made in developing a larger director pool (e.g., in Samoa) and progressively removing politicians from the boards of SOEs (e.g., in Tonga).

Key elements such as transparency and regular audit reviews are missing or varying in quality in a number of Pacific island countries. This issue needs to be addressed to gain the full benefits of the commercial SOE model. While SOEs are being commercialized at different speeds throughout the region, the tangible benefits of comprehensive and robust SOE reforms are irrefutable.

In 2003, the Government of Papua New Guinea privatized the Bank of the South Pacific (BSP), and retained a minority interest. The capitalized value of BSP has since risen by a factor of 20, and now the value of the Government's minority equity is much higher than the value of its full ownership of the bank before divestiture. In New Zealand, the commercialization of Transportation Auckland Corporation Limited (TACL) in 1991 resulted in a dramatic increase in profitability and a NZ\$19 million reduction in annual subsidy payments. Prior to commercialization, the bus operation had negative net assets, but after 7 years of commercial stewardship, TACL was sold for NZ\$111.6 million.

As demonstrated within the region and around the world, all Pacific island countries have the potential to reap substantial gains from comprehensive and sustained SOE reform.

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