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# State-owned Enterprises in Pakistan:

The Need for Corporate Governance  
and Private Investment

Muhammad Naveed Iftikhar



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# **State-owned Enterprises in Pakistan: The Need for Corporate Governance and Private Investment**

PRIME is a public policy think tank working for an open, free and prosperous Pakistan by creating and expanding a constituency for protective function of the state and freedom of the market.

The study titled “State-owned Enterprises in Pakistan: The Need for Corporate Governance and Private Investment” by Muhammad Naveed Iftikhar has analyzed current state of affairs regarding governance and operations of SOEs in Pakistan and suggested potential solutions to improve the situation. The study emphasizes the need to adopt corporate governance practices and attract private investment in SOEs.

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# Table of Contents

|   |             |
|---|-------------|
| <b>Acknowledgment</b>   | <b>IV</b>   |
| <b>Foreword</b>   | <b>V</b>    |
| <b>Executive Summary</b>  | <b>VIII</b> |
| <b>1. Introduction</b>  | <b>1</b>    |
| <b>2. Issue Analysis</b>  | <b>5</b>    |
| 2.1 Lack of Clarity on Role of the Government                   | 8           |
| 2.2 Multiple Layers of Accountability                           | 9           |
| 2.3 Lower Capital Investment                                    | 12          |
| 2.4 Weak Corporate Governance                                   | 13          |
| 2.5 Soft Budget Constraints                                     | 13          |
| 2.6 Evolving Regulatory Structures                              | 14          |
| 2.7 No Accountability through Markets                           | 14          |
| <b>3. Option Analysis</b>                                       | <b>16</b>   |
| 3.1 Corporate Governance of SOEs                                | 16          |
| 3.2 Private Capital Mobilization                                | 24          |
| <b>4. Implementation Challenges</b>                             | <b>28</b>   |
| 4.1 Heterogeneous Regimes for Governance of SOEs                | 28          |
| 4.2 Quality of BoDs of SOEs                                     | 29          |
| 4.3 Blanket Financial Support & Cross Subsidization             | 34          |
| 4.4 Enforcement and Supervision of Corporate Governance Rules   | 35          |
| 4.5 Evolving Regulatory Structure and Weak Contract Enforcement | 35          |
| 4.5 Negative Public Perception                                  | 36          |
| 4.6 Political Intervention                                      | 36          |
| <b>5. Conclusion</b>  | <b>38</b>   |
| <b>Bibliography</b>   | <b>41</b>   |

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## Foreword

### Corporate Governance: Reigning in the Business of State

It is not the business of the state to be in the business. We have heard it several times from the current Prime Minister, who is rightly credited with setting up economic reforms through liberalization, deregulation and privatization- about twenty five years ago. However, under his third time premiership, the government is looking elsewhere: improving corporate governance to fix SOEs. This volume surveys these efforts with a frank account of challenges as witnessed by an insider.

One of the fundamental objectives of corporate governance is accountability. Many SOEs suffer do not from lack of accountability; rather from an excess of it. Overkill accountability is a sure disaster. As the author of this monograph, Naveed Iftikhar brilliantly puts it: “the multiplicity of accountability checks in case of SOEs including ministerial controls, parliamentary oversights, investigation agencies, judicial scrutiny, media investigations, regulatory agencies and other transparency checks also enhances operational inefficiencies and creates confusion about public sector company’s strategies and policies.”

The accountability of management is the sole function of the board. For a SOE, one of the most important determinants of success is the independence of its board and freedom from political intervention. On 12th July 2015, in a landmark decision, Islamabad High Court upheld a fundamental principle of corporate governance: independence of the board. In November 2014, in the wake a major power breakdown, the federal government had removed the Managing Director of National Transmission & Dispatch Company. Adjudicating on a petition filed by a board member, the Islamabad High Court termed this decision illegal and ultra vires to the Companies Ordinance 1984 thus restraining the government from what it termed as an illegal intervention.

Naveed Iftikhar raises the importance of independence in these words: “[Boards] autonomy and independence need to be ensured in order to increase the efficiency and effectiveness of SOEs operations aimed at

achieving a set of clearly defined objectives.”

Government provides support to state-owned enterprises (SOEs) in five ways: equity injection, subsidies, grants, loans and guarantee on loans. Commenting on these losses, a recent Wall Street Journal said this: “Privatization of state-owned dinosaurs isn’t the sole solution, but the sooner Islamabad can stop haemorrhaging 500 billion rupees (nearly 5 billion dollars) annually on budgets, subsidies and bailouts for failing enterprises, the better.” In other words, the opportunity cost of sustaining these SOEs is almost equal to half PSDP budget in 2015-16.

As of March 2015, the total outstanding domestic debt and liabilities on SOEs was Rs. 632.4 billion, up by 17% in last two years, wherein the domestic debt on SOEs rose by 38% and liabilities were reduced by 11%. Similarly, as of March 2015, the external debt GoP contracted for SOEs stood at 2,424 million dollars, up by 21% in last two years. This hardly shows any trace of reforms in how SOEs have been managed under the current regime.

As a stopgap measure to avoid the increasing fiscal bind, the author calls our attention to “innovative solutions to attract private sector investment in these sectors e.g. rail, aviation, energy, road and commodity sectors.” However, as he himself cautions, “private sector investment can be mobilized in an enabling environment facilitated by robust regulatory structures and strong contract enforcement mechanisms.” These are certainly daunting conditions for a country which does not know robustness in regulations and reliability in contract enforcement.

One often quoted rationale of state presence in certain businesses is their perceived strategic and defence related importance, something conditionally allowed by the author. One example is Pakistan State Oil, the sole supplier of fuel to government entities like OGDC, Pakistan Army, PIA, Pakistan Railways, Navy, NLC, POF Wah and HIT. Besides supplying fuel to national power utilities like WAPDA and KESC, PSO is the sole furnace oil supplier to all Independent Power Projects (IPPs) in Pakistan with a share of over 80% in furnace oil market. However, by depending on a single entity, which is controlled by a cash-starved state, the strategic asset is actually compromised. The state may be better off strategically by placing its eggs in different baskets.



A key challenge to any reforms in the SOE situation is, ironically, the possibility of a judicial blockade that is counted by Naveed Iftikhar as one of nine layers of accountability. It can be interpreted positively as a sign of a thriving culture of rule of law, however a sheer lack of understanding of economic dynamics can lead courts to reverse reform. In 2006, Pakistan Steel Mills was valued at Rs. 22 billion, in the approved bid of privatisation, which was over-turned by the Supreme Court citing 'omissions and commissions.' Since that decision, fresh liabilities of Rs. 315 billion have been created, which will significantly reduce bidders' appetite. Pakistan Steel Mills may never be sold unless the government decides to start from a blank balance sheet!

Politically speaking, any restructuring of SOEs is likely to be accompanied by retrenchment and down-sizing, which will cause public uproar due to job losses. Fearing this public reaction, a democratic government will likely to choose inaction over action- and wait for a crisis.

Crises are good news for reforms. A dangerous consequence of giving up tough economic decision is not only that there is no reform; indeed there is no respite from the prevalent crisis. If adopted with complete political will, and with reasonable predictability and transparency, the reforms can actually increase the popularity of a government, rather than undermining it.

State hand-outs to sustain SOEs amount to welfare populism. Welfare populism ultimately destroys economy- that should be well understood. But it also destroys basic human values of pride, self-respect and hard work. As welfare populism needs a large government, it gives rise to authoritarianism and tyranny. Thus, welfare populism also disrupts the bedrock of an inclusive economy i.e. democracy. Not fixing SOEs is bad economics is bad politics.

Ali Salman  
Executive Director  
PRIME Institute

## Executive Summary

Most of the State-owned Enterprises (SOEs) in Pakistan are a huge burden on the public exchequer without delivering results. These SOEs also distort competition and crowd-out private sector through their inefficient operations and excessive commercial lending guaranteed by the government. The opportunity cost of public money in the case of few SOEs is alarmingly high. They SOEs have also posed risks to fiscal sustainability of the economy while leaving limited space for social sector spending and other core functions of the state. Current practices of managing and governing SOEs are not yielding intended results. The multiplicity of accountability checks in case of SOEs including ministerial controls, parliamentary oversights, investigation agencies, judicial scrutiny, media investigations, regulatory agencies and other transparency checks also enhances operational inefficiencies and creates confusion about public sector company's strategies and policies. It is utmost important for the SOEs in Pakistan to move towards a better system of governance in order to improve the current state of affairs.

There is need to review the current business interventions of the government with an aim to identify the areas where the state needs to leave the space for private sector for more efficient operations. SOEs operating in the sectors "without natural monopoly" or "having strong presence of private sector" will continue to underperform as compared to their private sector competitors. There are many sectors now having little or no rationale of the government's business interventions through SOEs e.g. producing steel, flying aero planes and centralized energy distribution. The government has already initiated a privatization program that needs to be implemented transparently and effectively. Similarly, there are certain areas where, some rationale for SOEs exists. But the style and form of current interventions are indefensible, which needs to be changed. Hence, a sense of clarity must be developed about medium to long term future of the current stock of SOEs. There are many SOEs that remain inefficient and loss making despite all efforts of the government through bailouts and restructuring initiatives. Perhaps this is the time to appreciate the fundamental and inherent flaws in their placement, es-

tablishment and operations. The government needs to come out of these sectors and encourage private sector to invest and operate in these areas.

SOEs that will continue to perform in public sector need to adopt and comply with Corporate Governance (CG) practices developed in the form of CG Rules issued by the Securities and Exchange Commission of Pakistan (SECP) together with basic laws enshrined in the Companies Ordinance 1984. There is a need to develop a formal process and a unit to appoint, remove and evaluate the performance of independent directors of SOEs. The quality of BoDs needs to be improved and their autonomy and independence need to be ensured in order to increase the efficiency and effectiveness of SOEs operations aimed at achieving a set of clearly defined objectives. There are many large scale SOEs which are yet not corporatized. The corporatization of these SOEs is essential to bring them under the ambit of good corporate laws enshrined in the Companies Ordinance and CG rules to improve their performance, financial management, transparency and disclosures.

Awareness and capacity building of all stakeholders including public servants, company executives, and members of BoDs and officials of SECP can play an effective role for supervision and enforcement of CG rules. The implementation of CG Rules will help clarify roles of different stakeholders involved in management and governance of SOEs and will also put effective accountability mechanisms in place instead of multiple and ineffective checks. Compilation and publishing of annual report on consolidated performance of SOEs (including “not for profits”, autonomous bodies, attached departments, authorities involved in commercial activities) can help policy makers to make evidence based decisions. Once this data is made available, the public at large as well as researchers can also assess the value for money, analyze the underlying factors and generate demand for reforms. Performance contracting between the government and the SOEs may also provide an objective framework for governance, operations and performance assessment. In the medium to long term there is need to devise policy or legislation for guiding the government on extent and forms of exercising ownership rights in case of SOEs.

There are many sectors dominated by SOEs that are struggling for capital investment in order to improve and sustain their operations and quality

of service. However, due to sheer neglect over the last many years and current fiscal constraints faced by the government, these sectors remain unable to attract capital investments from the public sector. This situation calls for innovative solutions to attract private sector investment in these sectors e.g. rail, aviation, energy, road and commodity sectors. However, private sector investment can be mobilized in an enabling environment facilitated by robust regulatory structures and strong contract enforcement mechanisms. The government needs to improve regulatory quality and contract enforcement in order to attract private sector investments in key sectors of economy and create conducive environment for moderating competing interests of all economic agents in those sectors. Privatization/disinvestment process initiated by the government needs to be pursued with full political zeal, professional capacity, transparent process and engagement of all stakeholders.

Many efforts to revive or privatize SOEs have failed repeatedly. There is need to be cognizant of the factors and challenges behind those failures and develop effective strategies to resolve those challenges namely outdated legislative frameworks for SOEs, ineffectiveness and poor quality of BoDs, multiple layers of accountability, flawed public perceptions, lack of transparency in public sector, weak regulatory structures, politics of clientelism, ineffective contract enforcement mechanism and poor compliance of corporate governance.

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## 1. Introduction

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Pakistan is facing a formidable challenge in the form of governance and performance of its State-owned Enterprises<sup>1</sup> (SOEs). The governance and service delivery of most of the SOEs have deteriorated significantly over the course of last few decades. There are around 150 entities under the Government of Pakistan that are involved in fully or semi commercial activities, either owned and controlled fully or having partial investments of the government. These SOEs largely fall in the key sectors of economy namely; energy, transportation, manufacturing and commodity trading.

Poor performance of SOEs has severely impacted Pakistan's fiscal landscape by putting additional burden on public exchequer in terms of losses, bail-outs and other forms of support by the government. For instance, Pakistan International Airlines (PIA) had an accumulated loss of over Rs. 250 billion as of end of FY 2014 which means it is virtually operating with negative equity. Similarly, by 2014-15 accumulated losses of Pakistan Steel Mills (PSM) had reached the level of Rs. 130 billion and its average annual capacity utilization is less than 30% since 2010. Likewise, the employee related expenses of Pakistan Railways are being provided as a grant by the Federal Government, which are around Rs. 35 billion – an amount higher than total budget of the Higher Education Commission of Pakistan. Moreover, development loan to National Highway Authority (NHA) by the government has reached the level of Rs. 200 billion during last 7-8 years and it seems unrecoverable, whereas commodity market operations have also incurred huge financial losses due to ineffi-

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<sup>1</sup> SOEs are also referred as Public Sector Enterprises (PSEs) and Government Business Corporation (GBCs) among others.

ciencies and flawed subsidy regime.

Power sector is another area where the fiscal drain is huge despite deteriorating service delivery. The government has paid circular debt (and/or assumed as public debt) in power sector which is over Rs 1200 billion since 2008, while tariff differential subsidy in the corresponding period has exceeded Rs. 2000 billion. Hence, the total cost born by the government in the power sector (including circular debt, TDS and development) is closer to the defense budget.<sup>2</sup>

There is also another perspective for evaluating performance of SOEs i.e. value for tax payer's money. Most of these SOEs are established and financed through taxpayer's money. However, many of these end up as employment hubs for redundant and nonproductive labor instead of contributing to economic growth through service delivery and asset development.

Suboptimal performance of SOEs has huge implications for national economy. Service delivery gaps by SOEs in aviation and rail sectors have negatively contributed to domestic, regional and international connectivity and trade activities. The business community is suffering due to unavailability of freight trains and exponential rise on cost of doing business due to alternative means of freight transport. Energy sector has been performing poorly due to dominance of SOEs among others and their inefficient operations in the country leading to massive unemployment, less than optimal GDP growth and perverse socio-political consequences. Hence, the state has miserably failed in producing steel, flying aero planes and distributing electricity especially during last two decades.

It is generally considered that providing productive assets to these SOEs is a viable solution to revive them. Hence, the purchase of aero planes for PIA and locomotives for Pakistan Railways and the establishment of new electricity generation plants are pursued with full political zeal. However, the underlying factors behind poor service delivery and financial mismanagement remain largely unaddressed, and therefore the problem of deteriorating quality and quantity of productive assets and working capital shortages keep reemerging. Bailout packages are pro-

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<sup>2</sup> *Financial numbers are author's estimates based on various company reports and other sources.*

vided frequently based on the rosy business plans and so called ambitious Key Performance Indicators (KPIs) that are seldom achieved. This cycle of crisis and bailout packages continues at the cost of taxpayers' money and marginalized service delivery to the masses. Lack of clearly defined vision and strategies, poor quality of human resource and financial scams continue to hamper financial viability and service delivery. The diagnostic of these SOEs reveals that the above issues are indeed a manifestation of poor corporate governance, legacy of extended commercial role of state, lack of appropriate levels of capital injection and embedded system of inefficiencies.<sup>3</sup>

Successive governments in Pakistan have made efforts to restructure and revive a few loss making entities. But they have failed miserably as those efforts have failed to address the fundamental issues relating to the state ownership of many of these entities. The proverbial question that needs to be raised is whether it is the government's job to run business entities in the long run.

Over the last few decades, it has been well established in most of the countries that the state needs to abandon what is no longer its job and needs to revisit the strategy where it is failing consistently. It requires an analysis of scope and functions of various SOEs with an aim to abandon most of the unnecessary, inefficient and market distorting operations through a robust privatization and disinvestment program.

The government may continue to retain a few SOEs in public sector considering their strategic importance and socio economic rationale if efficiency, transparency, value for money and viability can be maintained. However, most of the SOEs need to be transferred to the private sector to ensure efficient and effective management of such entities, instead of continuing to waste billions of rupees of taxpayers' money that could be spent on more productive areas for the welfare of the people. Moreover, if fiscal constraints limit the government's ability to inject the much needed capital into key sectors of the economy, then private investment mobilization may be considered as a viable solution instead of adding to sufferings of citizens.

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<sup>3</sup> *Planning Commission (2011), Pakistan Framework for Economic Growth and Khan, Ashfaq H (2010), Public Sector Enterprises.*

It is commendable that the current government has revived privatization program after an interval of almost a decade. The privatization list of about 40 entities (out of a CCI approved list of 65) is being pursued as approved by Cabinet Committee of Privatization (CCoP). However, a number of SOEs will continue to perform in the public sector even if the whole privatization list of 65 entities is exhausted. The government's fiscal constraints will continue to make it difficult to undertake capital investment to revive SOEs.

Moreover, lack of clarity over the role of multiple stakeholders involved in the governance of SOEs is another constraint that has contributed to the current state of affairs of SOEs. Considering the current challenges posed by SOEs and the government's principle stance to revive SOEs, it is important to focus on two key issues relating to SOEs, which will remain outside of the privatization program. These two are namely: (a) corporate governance and (b) private capital injection. It is also important to highlight that improved corporate governance and financial viability can help attract potential investors and get higher proceeds during disinvestment process.

The scheme of the remaining part of the study is as follows. Next section of the study provides an analysis of the issue, whereas the third section sheds light on option analysis. Implementation challenges have been described in fourth section, and the fifth section provides a conclusion to this study.



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## 2. Issue Analysis

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SOEs are generally established to fill the investment gaps in key economic sectors where there may be natural monopolies. Governments also set up SOEs for redistributive purposes and, in some cases, for sheer profit motives.

However, many SOEs in Pakistan have failed to perform these functions, and instead continue to pose fiscal and economic growth challenges due to rapidly deteriorating governance and financial viability. The accumulated losses of PIA and PSM alone are currently around Rs 400 billion, which is over one percent of the GDP. Pakistan Railways has been given grant amounting to Rs. 200 billion since 2000, and this excluding the overdraft facility by the State Bank of Pakistan and development funding through Public Sector Development Program (PSDP). Yet, the performance of all these SOEs has not seen any improvement despite huge fiscal transfers and other supports provided by the government.

The continuous reemergence of power sector circular debt is also partly due to inefficiencies of power sector SOEs, including higher transmission and dispatch losses over and above allowed by National Electricity Regulatory Authority (NEPRA) and inability to recover billed amount by the power sector SOEs from the consumers. The circular debt of Rs. 480 billion was cleared by the government in June 2013 with tax payers' money which was not entirely owed to the public sector. However, it had reached Rs.350 billion by the end of June 2015, despite substantial periodic increases in consumer tariff on account of subsidy withdrawal and drastic decline in oil prices that has resulted in reduction in fuel cost. Various cosmetic efforts to clear the circular debt were also undertaken

during 2008-2015 but without addressing the fundamental challenges relating to inefficiencies of power sector, the results could not be achieved. The circular debt and tariff differential subsidy have been posing serious challenges to fiscal stability in the country.

Another significant risk posed by the SOEs is their debt from commercial sources, especially National Bank of Pakistan. By the end of FY14, the stock of outstanding debt of PSEs reached the level of Rs. 342 billion.<sup>4</sup> Poor governance of commodity market operations including wheat procurement, fertilizer distribution and international trading through Trading Corporation of Pakistan also adds up to commodity market circular debt in the country. State Bank of Pakistan's annual report on State of Economy for FY14<sup>5</sup> has narrated this problem as follows:

*"Despite the relatively lower increase during the course of the year, the outstanding stock of commodity financing has reached an all-time high of Rs 492.4 billion by end FY14. Although a major portion of this amount was disbursed during the year, around 30 percent of this amount was carried forward from the previous years. **Given the self-liquidating nature of commodity operations, the outstanding amount carried forward from previous years, is a clear indication of underlying problems in commodity operations.**"*

The central bank report also highlighted the slow progress of reforms:

*"However, the government's reluctance to take hard steps to deal with the underlying fault lines (especially in the energy sector), is pushing the PSEs debt stock back towards the level seen before the settlement of the circular debt."*

The author believes that the current government has undertaken various positive steps in the areas of disinvestment of SOEs, revival of railways and aviation sectors and investments in energy sector. However, a clear roadmap or SOEs reform strategy of the government has not been developed which constrains an informed debate on the subject and guidance to various stakeholders regarding governance and operations of the SOEs. The progress on corporate governance and other structural reforms has not been up to the expectations drawn from the manifesto of the ruling political party.

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<sup>4</sup> SBP (2014), Annual Report on State of Economy 2013-14.

<sup>5</sup> Ibid.

The state of affairs highlights the need to carry out an in-depth analysis of this predicament. A vast literature exists internationally on the unique set of challenges faced by SOEs as compared to their private sector counterparts. Wu (2006)<sup>6</sup> attributes poor performance, low profitability and inferior competitiveness of PSEs in China prior to transformation/reform process to:

- (i) Decision making power was excessively concentrated in the central government;
- (ii) The government implemented administrative interventions in business;
- (iii) The managers and workers of PSEs lacked initiative;
- (iv) The government departments chose inappropriate persons for top management or did not adequately supervise them;
- (v) The debt burdens of enterprises were too heavy;
- (vi) Enterprises lacked funds for technological up-grading; and
- (vii) Enterprises had too many redundant workers.

World Bank (1995)<sup>7</sup> has also highlighted the challenges and constraints faced due to state ownership and management of SOEs by the bureaucrats. Literature on performance and restructuring of Pakistan's SOEs is barely available. World Bank (1989),<sup>8</sup> Mehdi (1991)<sup>9</sup> and Husain (2009)<sup>10</sup> provide historical overview of performance and monitoring systems in place for SOEs in Pakistan.

Remaining part of this section is, hence, focused on key reasons for underperformance of SOEs in Pakistan.

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<sup>6</sup> Wu, Jinglian (2006), *China's Long March Toward a Market Economy*, Long River Press, China.

<sup>7</sup> World Bank (1996), *Bureaucrats in Business: The Economics and Politics of Government Ownership* (A World Bank Policy Research Report).

<sup>8</sup> World Bank (1989), *Evaluating the Performance of Public Enterprises in Pakistan*, Working Paper Series, 160.

<sup>9</sup> Mehdi, Istaqbal (1991), *Privatization-A device for reforming public enterprise sector in Pakistan*, *The Pakistan Development Review*, pp 895-905.

<sup>10</sup> Husain, Ishrat (2009), *Recent Privatizations in Pakistan and their Impact*.

## 2.1 Lack of Clarity on Role of the Government

The government continues to perform many functions which may have been considered justifiable at certain point of time but the current dynamics have turned them unviable or inefficient. SOEs performing in such sectors are facing tremendous challenges as they fail to compete with their private sector counter parts. All efforts to revive large loss making SOEs have repeatedly failed. Moreover, an increased private sector participation in certain sectors has undermined the rationale of their operations in the public sector. Steel production, other manufacturing concerns, aviation and trading vehicles have lost their utility and need due to increased participation of domestic and international private sector in these areas. Hence, the SOEs in these areas continue to underperform and exert huge burden on fiscal exchequer despite poor service delivery standards.

There are still certain areas where the state can contribute effectively but due to inherently flawed institutional design and poor management practices of SOEs, the performance has been consistently deteriorating, both in terms of service delivery and financial viability. A case in point can be Pakistan Railways (PR). The government does have a significant role but the current form of institutional design as well as the governance and management practices have resulted in a continuous decline in PR. It operates as an attached department of Ministry of Railways, with old-fashioned organizational and governance structure. Not only there has been consistent decline in quality of service delivery, but the level of operations of PR has also fallen substantially over the years. Further, in what could otherwise have sustained the viability of PR, its freight operations virtually collapsed in 2012, owing to a lack of viable strategy and leadership.

Hence, the government needs to abandon what it should not do and revisit the institutional design where it has failed to deliver despite a need for a supportive role in that particular sector. Without developing clarity on above discussed areas, SOEs in these sectors will continue to underperform. The government needs to strengthen its role to support private sector business activity through regulatory and facilitation role instead of running a business itself in a number of areas. A full debate on renewed role of the government is out of the scope of current study.

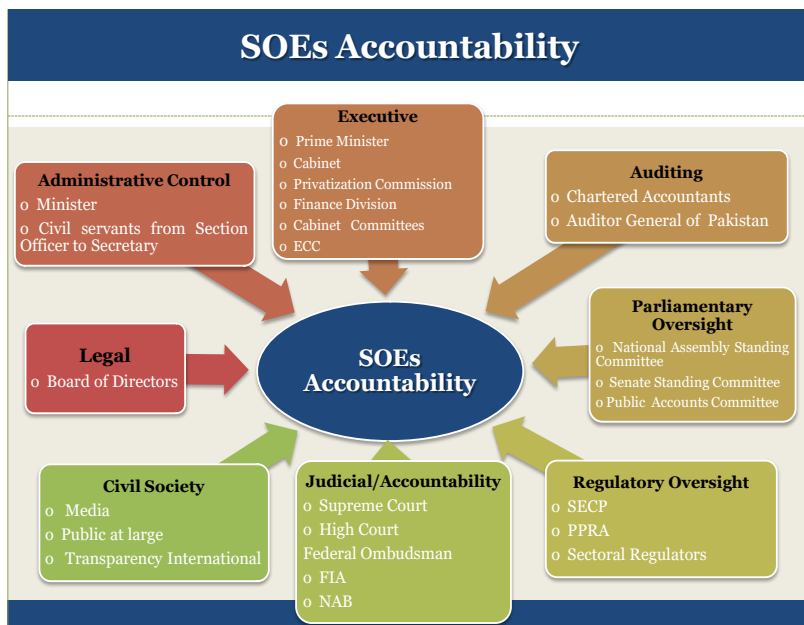
However, Ishrat Hussain's piece on "Managing Government Business Relations in Pakistan"<sup>11</sup> has eloquently captured the discussion on this area and highlighted the respective roles of government and businesses in order to generate growth and economic activity.

## 2.2 Multiple Layers of Accountability

It is commonly believed that SOEs underperform due to lack of accountability. However, this paper argues that SOEs are suffering from multiple layers of accountability with overlapping jurisdictions. Indeed it is the plethora of accountability layers that contributes to the ineffectiveness of accountability process and inhibits commercial decision making. There is lack of clarity between their respective roles, jurisdictions and limitations. It is often reported that the oversight organizations tend to give operational directions to SOEs instead of giving a broader framework of ownership expectations and rights. These accountability and oversight organizations often give contradictory directions that further complicate the business strategy and its implementation by SOEs, leading to confused visions and roadmap. The following diagram<sup>12</sup> reveals the multiplicity of accountability organizations / forums and mechanisms:

<sup>11</sup> [iba.edu.pk/...drishrat/Managing\\_Gov-Business\\_Relations\\_in\\_Pak\\_MAP](http://iba.edu.pk/...drishrat/Managing_Gov-Business_Relations_in_Pak_MAP).

<sup>12</sup> It is taken from author's presentation in 15<sup>th</sup> Sustainable Development Conference, held in December 2012, [https://www.sdpi.org/publications/files/Vol.%2019,%20No.%204%20\(October%20-%20December%20%202012%20\).pdf](https://www.sdpi.org/publications/files/Vol.%2019,%20No.%204%20(October%20-%20December%20%202012%20).pdf).

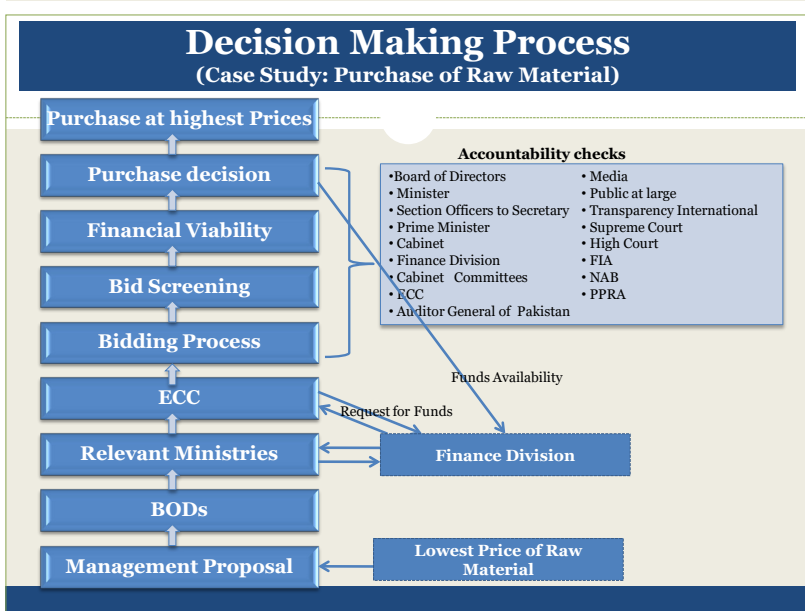


The above diagram indicates that there are numerous organizations / platforms exercising the rights of ownership and oversight starting from its Board of Directors to various executive, parliamentary, judicial, regulatory and civil society organizations and offices. The state of affairs further exacerbates in an environment where there is ambiguity in the roles of various stakeholders due to weakly enforced corporate governance. The management of SOEs spends a significant time in attending and responding to all those offices/organizations and often finds itself struggling with contradictory guidelines coming from various accountability platforms and organizations. The proceedings of various such accountability forums are publically available especially in case of prominent SOEs including PIA, Pakistan Railways, Pakistan Steel Mills, National Highway Authority and Power sector companies among others.

It is evident that the current form of ownership structure and oversight mechanism is contributing to inefficiencies and poor performance of SOEs. Disaggregated ownership forms and policies have not been supportive to commercial operations and financial viability of the SOEs.

Without addressing these fundamental problems, the SOEs may not be revived through further public investment and the so-called better administration.

Similarly, the following hypothetical case of public procurement process for a SOE explains the cumbersome process of checks and cobweb of processes, leading to inefficiency in overall process. An SOE decides to purchase raw material when prices are at a lower rate but due to lengthy process and multiple checks, including the requirements of PPRA rules, they often end up purchasing at much higher level of prices or otherwise fail to capitalize on the opportunity as low prices do not last forever.



The procurement process of SOEs remains questionable despite excessive checks and oversights. Inefficiency and corruption during procurement process by SOEs often become headlines at national media. Indeed, these layers and checks distort efficiency and prudence of procurement process. The Public Procurement Regulatory Authority (PPRA) rules do not allow negotiation with a lowest bidder, which leads to higher cost of products and services for SOEs as compared to private sector counterparts. A number of watchdogs including media and Transparency

International keep an eye on the process to ensure that PPRA Rules are followed completely. This pressure often results in a huge cost to public in terms of excessive time and amount spent on procurement.

The preceding paragraphs clearly show that no commercial business can thrive in this environment, let alone SOEs. Commercial strategies are developed based on clear leadership mandate given to the relevant staff at different hierarchical levels in an organization, timely decisions and prompt implementation of such decisions to ensure efficiency and effectiveness of commercial operations. Since these benchmarks cannot be achieved by SOEs in Pakistan in the above discussed environment, they will continue to struggle with business as usual.

## **2.3 Lower Capital Investment**

Due to lack of clear incentives, many SOEs fail to keep pace with the need to invest for the development of new productive assets and the maintenance of existing assets. This observation can be validated by taking a cursory look across the SOEs in Pakistan. For instance, lack of capital expenditures (CAPEX) in electricity and gas distribution and transmission network, rolling and non-rolling infrastructure of rail sector, technological up-gradation of Pakistan Steel Mills and modern facilities on Pakistan airports. Consequently, electricity transmission network has faced severe breakdowns during last couple of years whereas the length of rail tracks is decreasing continuously. Similar examples can be found in almost all sectors, currently dominated by SOEs. CAPEX forms the basis of productivity enhancement, operational profit and sustainability of businesses. However, it is often neglected in SOEs and resultantly, they suffer from bad performance and fail to take benefit from rising demand for services due to increased population and well-being standards in the country. Every time an SOE is at the brink of operational collapse the governments allocate meager amounts for CAPEX without addressing the governance structure, without which the assets get eroded with passage of time. This situation has led to current inefficiencies and unviability of many SOEs.



## 2.4 Weak Corporate Governance

There has been little awareness in Pakistan about the improvement of corporate governance of SOEs. Corporate governance provides a framework for clarity on roles and responsibilities for the players involved in governance and management of an organization. This is the most neglected area in the case of SOEs in Pakistan. SOEs operate under different regimes in Pakistan e.g. Companies Ordinance 1984 (for and not-for-profits), special enactments as authorities or corporations and even as attached departments (as is in the case of Pakistan Railways). This variance in the legal frameworks cause uncertainty, unpredictability and inconsistency in SOEs management.

International experience suggests that corporate governance has helped improve the state of affairs in SOEs. Pakistan has recently issued Public Sector Companies (Corporate Governance) Rules 2013 under Companies Ordinance, applicable to Public Sector Companies registered under Companies Ordinance 1984. However, many companies enacted under special legislation such as PIA, National Highway Authority, WAPDA, Port Qasim Authority, and Pakistan National Shipping Corporation will be out of purview of these rules. How can PIA be expected to compete with international airlines while remaining under an enactment of 1956 where the law mandates that chairman of the Board of PIA is also its Chief Executive? The Board of Pakistan State Oil (PSO) is suspended by the government since last of couple of months and the delay in reconstitution has led to the firm's inability to finalize audited accounts and compliance of other corporate governance aspects. The weak corporate governance will continue to pose challenges in terms of transparency, lack of clarity of roles, political interference and ineffective oversight by the Board of Directors (BoDs) that create difficulties for the SOEs to operate efficiently and vibrantly.

## 2.5 Soft Budget Constraints

Another problem with the SOEs is that they do not seem to have any budget constraints. That is because they can always tap on their last resort i.e. the government which makes fiscal allocation and otherwise provides guaranteed commercial loans in order to meet the losses or so-called business expansion of the SOEs. This inherent flaw undermines

the efforts to operate and sustain commercial activities through prudence and innovative business solutions. For instance, PSM has got six bail-out packages since 2006. Yet it has been operating at minimal capacity since then, and has remained at the verge of closure for last many years. Soft budget constraints for SOEs, therefore, contribute significantly to their deterioration in Pakistan.

## **2.6 Evolving Regulatory Structures**

A number of independent sectoral and cross-cutting regulators were established in Pakistan during 1990s and 2000s. They are still at a nascent stage and have yet not realized the intended objectives of market making, confidence building and sectoral oversight<sup>13</sup>. The institutional design of many regulators does not allow independence and autonomy. Moreover, they face severe challenges in the sectors dominated by SOEs. They remain unable to exercise oversight over SOEs leading to continuity of inefficiencies in the sectors. The regulators have also been unable to gain synergies with the government and other stakeholders to develop the regulated sectors. Some of the key regulators, such as OGRA which regulates the important oil and gas sector, has itself remained under investigation on the charges of corruption since several years, and as a consequence, both the regulator as well as the sector has remained largely dysfunctional. Owing to this, both the gas transmission and distribution companies have not been able to get their tariff approved from OGRA; and consequently, they have not been able to even prepare and publish their annual financial statements since the last three years.

## **2.7 No Accountability through Markets**

Traditionally, the businesses are held accountable through market phenomenon. Efficiency and innovation are rewarded while inefficiency and poor business practices get penalized by the markets. However, in case of SOEs they usually remain outside of such mechanism. The governments try to hold them accountable through bureaucratic channels as explained in section 2.2 but it leads to ineffectiveness and distortions.

This chapter has shed light on the various dimensions of weak performance of SOEs. These dimensions can be broadly categorized in four

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<sup>13</sup> *Planning Commission (2011), Pakistan Framework for Economic Growth.*

areas namely entity, sectoral, oversight mechanisms and the government. Entity level problems include lack of autonomy to operate commercial basis, weak corporate governance and poor human resource practices. Multiple layers of accountability have rendered them totally ineffective, devoid of any innovation and progress. Also, consolidated financial information of SOEs, which could act as an effective monitoring and accountability tool in the form of public scrutiny, debate and voice for reforms, is not publically available. Sectoral inefficiencies and flawed policies also lead to less than optimal operations of SOEs. Energy sector can be considered a suitable example in this regard. The sectoral inefficiencies worsen the performance of SOEs in energy sector. The government level problems include slow privatization process leading to retention of various SOEs in public sector which have little, social, economic or even political rational in present day and age. Moreover, the general issues relating to public service, complex government procedures and lack of clear framework for incentive and punitive actions, also hinder the performance of SOEs.

## 3. Option Analysis

The previous section narrated a host of factors responsible for the current state of affairs of SOEs. However, the writer believes that two fundamental options emerge from the above analysis that can improve the state of SOEs: (a) enhance the level of Corporate Governance and (b) Private Capital Mobilization.

Improvement in these two areas can generate direct benefits and also lead to a positive spillover in the economy. These two factors are also mutually reinforcing. Improved corporate governance will help mobilize private sector investment and later may also exert pressure for the former through a demand driven process. This section shed light on the potential solutions mainly in the two above mentioned areas.

### 3.1 Corporate Governance of SOEs

#### 3.1.1 A Case for Corporate Governance

It is evident from the performance of SOEs in Pakistan that traditional ways of accountability are no more effective and are not yielding intended results in terms of holding SOEs management accountable for delivering results. The current accountability system is not creating value for shareholders, which are the government and ultimately the citizens of Pakistan being tax payers. Despite excessive number of accountability organs of the government, the stories of transparency and poor performance of SOEs are heard on a daily basis in Pakistan. It can be easily inferred that all the multilayered accountability checks discussed in

the previous chapter are only exacerbating the SOEs crisis. Commercial businesses need be operated in totally different environment than a routine public service department of the governments being headed by bureaucrats. There is a need to introduce corporate governance practices in SOEs in order to ensure accountability, transparency and clarity of roles of different stakeholders involved in governance and management of SOEs in Pakistan. Before moving to the discussion on corporate governance for SOEs in Pakistan, it is important to understand the underpinnings of this concept.

### 3.1.2 Objectives of Corporate Governance

There are generally four fundamental objectives of corporate governance namely: (a) accountability; (b) fairness; (c) transparency and (d) independence. However, SOEs face a unique set of challenges while pursuing the twin objectives of commercial viability and public service obligation. A clear and effective mandate of accountability of commercial organizations is of immense importance. Lack of clear ownership structure hinders the coherence between SOE and the shareholder to deliver the intended results. Fairness is another important dimension of corporate governance. The decisions and operations are based on principles instead of arbitrary practices. Corporate governance framework lays out all such principles and values that a company need to pursue. Transparency is an area which is compromised substantially in SOEs as compared to private sec-

#### Understanding Corporate Governance

Sternberg (1998) has described corporate governance as a mechanism by which corporate actions, assets and agents are directed at achieving corporate objectives established by the corporation's shareholders. Properly understood, corporate governance refers simply to ways of ensuring that a corporation's actions, agents, and assets are directed at the definitive corporate ends set by the corporation's shareholders. The need for corporate governance arises because the advantages of corporate form are typically achieved at the cost of separating ownership from operational control. World Bank (2014) has described corporate governance in following words;

tor companies. Transparency of information and data can inform public debate and exert pressure on decisions makers. The independence of commercial entities is essential to carry out decisions in a timely and appropriate way.

Essentially, it is Board of Directors (BoDs) that is the governing body responsible for overall governance of the SOE under the law. However, the immense authority of line ministries and other public office holders, drawn from the government, hinders the BoDs in exercising effective oversight role, carry out strategic planning and hold CEO and management accountable as they are often directly appointed by the government instead of BoDs.

Considering these challenges, many countries have created buffers through independent central bodies to oversee and supervise affairs of SOEs in the forms of holding companies (Singapore's Tamasak Holding); central shareholding (Malaysia's Khazana model), dedicated departments (India's Department of Public Enterprises); and central monitoring authorities (New Zealand's Crown Monitoring Authority) among others. Performance contracting between the government and SOE is another best practice that has yielded immense benefits particularly in India.<sup>14</sup> Performance contracting also provides an objective framework for roles of different stakeholders and performance of assessment of the organization. Such performance monitoring systems ensure periodical review of financial numbers and service delivery of the SOEs and also make it public in the form of annu-

*“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. Corporate governance therefore provides the structure for defining, implementing, and monitoring a company's goals and objectives and for ensuring accountability to appropriate stakeholders”.*

Sternberg E. (1998), *Corporate Governance: Accountability in the Marketplace*, London: Institute of Economic Affairs.

<sup>14</sup> India is implementing an MoU system developed by its Performance Management Division. Pakistan had also implemented such system in 1980-2000 with the name of signaling system and it was managed by Expert Advisory Cell under Ministry of Industries and Production.

al reports. However, in Pakistan, SOEs continue to operate under line ministries, which further complicate governance and induce external influence.

Many countries have introduced sound legal and regulatory frameworks for corporate governance of SOEs. Finland's Management of State Capital Act 2007, Hungary's State Asset Law 2007, New Zealand's State-Owned Enterprises Act 1986 and Philippines's Government-owned and Controlled Corporation Act 2010 are some relevant examples in this regard.<sup>15</sup> These laws are aimed at separating the government's regulatory functions from business operations, improvement of corporate governance, strengthening service delivery and ensuring value for public money and assets. The implementation of corporate governance practices is more important in case of SOEs as compared with private enterprises since they are established and financed through public funds. An effective corporate governance framework for SOEs, therefore, may entail the following:

- (i) Clear mandate of enforcement through legal and regulatory regime
- (ii) Clarity of ownership rights and jurisdiction of the shareholder authority
- (iii) Professional and competent people appointed as Board of Directors (BoDs) who can exercise independent and objective judgment; the BoD is collectively empowered to exercise its statutory mandate
- (iv) Roles and authorities of BoDs and its committees are clearly defined
- (v) Effective compliance with international accounting, auditing and financial reporting standards
- (vi) Appropriate provisions for transparency, disclosure and rights of minority shareholders

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<sup>15</sup> World Bank. 2014. *Corporate Governance of State-owned Enterprises: A Toolkit*. DOI: 10.1596/978-1-4648-0222-5. Washington, DC: World Bank.

### 3.1.3 Pakistan's Corporate Governance Rules

Pakistan has also recently developed Public Sector Companies (Corporate Governance) Rules 2013. Issued under the provisions of the Companies Ordinance 1984, these rules came into effect on 8<sup>th</sup> of August, 2013.<sup>16</sup> The development of these rules may be considered as a first major step towards the improvement in corporate governance of SOEs. These rules have helped clarify roles and responsibilities of different stakeholders involved in governance and management of SOEs. Salient features of the said rules are listed in following Box.

**Salient Features of Public Sector Companies (Corporate Governance) Rules 2013, approved by Federal Government of Pakistan**

These rules are applicable on all public sector companies, directly or indirectly, owned and controlled by the government.

**I. Board Composition and Dynamics**

- The Board shall have 40% of its total members as independent directors within two years of the notification of the Rules and shall have a majority of independent directors subsequently.
- The Board shall recommend at least three individuals to the government for appointment as chief executive, and shall appoint the chief executive after receiving concurrence of the government in line with the provisions of the Ordinance.

**II. Formation of Special Committees of the Board of Directors**

- The Board shall form separate human resources committee, nomination committee, procurement committee, risk management committee and audit committee.

**III. Separation of the Chair from the CEO**

**IV. Chief Financial Officer, Company Secretary and Chief Internal Auditor**

<sup>16</sup> [http://www.secp.gov.pk/CG/SRO\\_180\\_PublicSectorCompanies\\_CGRules\\_2013.pdf](http://www.secp.gov.pk/CG/SRO_180_PublicSectorCompanies_CGRules_2013.pdf) accessed on 16<sup>th</sup> July, 2015.



- Every Public Sector Company shall appoint a chief financial officer, company secretary and chief internal auditor, as per prescribed criteria.

#### **V. Formulation and compliance with a ‘Code of Conduct’**

- The board shall prepare & implement a code for its directors and employees, based on following three fundamental principles: (i) Probity and propriety; (ii) Objectivity, integrity and honesty; and (iii) Relationship with the stakeholders.

#### **VI. Capacity building of board of directors:**

- Directors are encouraged to have certification under an appropriate director training/education program offered by any institution, local or foreign.
- External Audit.
- Every public sector company shall ensure that its annual accounts are audited by an independent external auditor in line with requirements of Companies Ordinance 1984.

The development of the Rules received positive response from different circles. A Lahore High Court Judgment<sup>17</sup> has emphasized the need to comply with corporate governance rules for the improvement of affairs of SOEs. The LHC was hearing the case against the removal of a CEO of a power sector SOE; who had been removed by the government without following the due process described in the law. The following extracts from that judgment are relevant to this discussion:

*Para: 12. “There is no doubt that compliance with duties imposed by the Ordinance and other corporate governance legislation would foster management independence and accountability and therefore bring efficiency and transparency in the affairs of such DISCOs. This observation stands reinforced by a recent regulatory framework enforced by the Securities & Exchange Commission of Pakistan (“SECP”) to control governmental involvement in the management of public sector companies. The Public Sector Companies (Corporate Governance) Rules, 2013 (“Rules”) are tailored for regulating governance of companies that are directly or indirectly controlled by the Government or any instrumentality, agency or statutory body thereof.”*

<sup>17</sup> <http://www.lhc.gov.pk/appjudgments/2013LHC4563.pdf> accessed on 12<sup>th</sup> July, 2015.

While commenting on the fit and proper criterion for appointment of independent directors and process of appointment of CEOs through BoDs, as prescribed under the rules, the judgment noted the following statement (para 16);

*“Therefore, the Rules purport to promote both efficiency and stability of management in public sector companies.”*

Para 29 of the same judgment further highlights the need to ensure implementation of fit and proper criterion for appointment of independent directors;

*“The implementation of fit and proper person test given in the Annexure to the Rules for evaluating candidates for appointment as directors and chief executives of public sector companies would bring merit and dynamism to the senior management positions in such companies.”*

The Public Accounts Committee (PAC) of the National Assembly has also adopted a resolution<sup>18</sup> of its subcommittee on May 15, 2014 which entailed recommendations for implementation of rules. The PAC directed:-

*“Within 3 months all directors of Public Sector Companies should sign off that they have read the Public Sector Companies Corporate Governance Rules 2013 and that they will comply with the guidelines provided.”*

Similarly, a number of pieces have appeared in the print media about usefulness and effectiveness of corporate governance rules for the improvement of performance of SOEs, articulated by the experts and professionals across the country. Corporate Governance Rules are now being taken as a roadmap for improvement of corporate governance practices in SOEs.

### **3.1.4 Implementation of Corporate Governance**

The implementation of Corporate Governance requires following actions;

- Awareness and capacity building of senior most functionaries of the government, including civil servants, political parties, top

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<sup>18</sup><http://www.pac.na.gov.pk/sites/default/files/reports/PAC%20Report%20on%20Financial%20Powers%20of%20the%20BoDs.pdf> accessed on 24<sup>th</sup> June, 2015.

management and the BoDs of SOEs.

- Development and implementation of a robust board nomination process, including development of a database of qualified individuals who can be appointed on the boards of SOEs.
- Ensure professionalism, autonomy, independence and diversity of BoDs.
- Eliminate unnecessary excessive and multiple forums of accountability that impede the decision making processes and pre-audit requirements of the government.
- Empowering the BoDs to appoint the CEO, who should also be accountable to the BoDs.
- Strengthen supervision and enforcement capability of SECP to ensure compliance of Corporate Governance Rules.
- SECP to submit annual report to the parliament on compliance of corporate governance rules of SOEs and it should be made available for the public on website of SECP.

In addition, the following actions are also required to improve corporate governance of SOEs:

- Corporatization (converting them into companies registered under the Companies Ordinance, 1984) of autonomous bodies, authorities, corporations and attached departments of the government involved in commercial activities.
- Compilation and publication of annual report on consolidated performance of PSEs and investments of the government.
- Effective process of annual evaluation of BoDs, and performance evaluation of the CEO by the board on annual basis, as provided in the Rules.
- Initiate performance contracting between the government (as a shareholder) and BoDs and CEO (as management) to provide an objective framework for assessment of performance and clarity on roles between stake holders.
- Eventually, develop appropriate legislation to clarify ownership rights, responsibilities, authorities and jurisdiction.

## 3.2 Private Capital Mobilization

This paper has already highlighted the deficiencies in capital expenditures due to lack of incentive framework for public sector and fiscal constraints of the government (Section 2.3). An analysis of the government's fiscal constraints will highlight the limitations to incur capital expenditures for development of new assets and maintenance/operations of existing productive assets of SOEs.

Given the government's weak fiscal position, there is a need to take a decision to mobilize private capital for SOEs. This can be achieved through various modes including O&M contracting, infrastructure usage, outsourcing and listing on the stock exchanges. There is a need to create value for depleting public assets and deciding amongst "no service" or "service at a cost". Private sector investment in key sectors of economy may lead to more job creation and contribution towards economic growth. However, this view is rarely understood in the country. In few cases, there may not be any feasible solution other than privatization as it was discussed in section 2.1. The structure, sequencing and process of engaging private sector are certainly debatable but considering

### **A Case for Private Sector Capital Mobilization in Pakistan Railways**

Pakistan Railways is struggling with scarcity of locomotives, aging non-rolling infrastructure including tracks and signaling, surplus labor force and rising level of debt stocks. Service delivery and performance standards have been continuously deteriorating. Resultantly, commuters and businessmen (due to sub-optimal freight operations) alike are the victims of poor performance of Pakistan Railways alongside the misuse of scarce state revenues. Recent steps taken by the current government have started yielding modest improvement but the sustainability of such actions remains questionable. The government is sponsoring salaries and pensions amounting to Rs 35 billion annually alongside investment through PSDP. The government may not be able to enhance further assistance to Pakistan Railways beyond the existing support. The private sector has the capacity and the motive to invest in train operations but the institutional framework, bureaucratic and political rigidities and the monopoly of

the current performance of SOEs in Pakistan, it is evident that there are a host of SOEs which cannot be revived by public sector investment. Hence, mobilization of private capital for such entities is unavoidable.

Most of the SOEs established in the past were set up on account of scarcity of resources by the private sector for investment in key economic sectors. However, the situation has now drastically changed. It calls for private sector capital mobilization to improve service delivery and contribute towards economic growth and development.

Private sector participation leading to market evolution needs at least four preconditions: (a) robust regulatory framework (b) credible and expeditious mechanism for contract enforcement (c) level playing field and (d) secured property rights.

As highlighted in the section 2.2, the government needs to realign its role and priorities considering the changing dynamics of the economy and its capacity. The above areas need to be improved and strengthened by the government in order to mobilize domestic and international private investment in key sectors of economy, dominated by the SOEs.

The first priority should be accorded to the strengthening of key economic regulators e.g. Securities and Exchange Commission of Pakistan, Pakistan Telecommunication Authority, National Electric Power Regulatory Authority and Oil & Gas Regulatory Authority among others. Ex-

Pakistan Railways (that is also a train operator alongside exercising regulatory and policy role) on the track has failed to attract investment in sector. The government can consider owning and maintaining the rail track but the private sector train operators will have to be allowed to use the track along with the public sector trains. Similarly, private sector investment can be mobilized for optimal utilization of redundant real estate assets in consultation with provincial governments. Priority for private sector investment mobilization may be accorded to freight sector considering its potential impact on business activity and revenue generation for Pakistan Railways. In addition to revenue generation, this transformation will support private sector in two ways i.e. business opportunities through partnership with Pakistan Railways and reduce cost of business through freight transportation on rail network instead of roads.

cept for the State Bank of Pakistan, Pakistan's economic regulators are still at a nascent stage. Sound, robust and credible regulatory framework is essential for ensuring level playing field for all economic agents in an economy. The better the quality of regulatory framework, the more it will help investors form expectations and play a constructive role towards job creation and spurring economic growth. The institutional design of regulatory bodies has direct impact on the quality of regulations. Hence, it is essential to review the design of federal regulatory bodies in order to improve their institutional and operational capacities. The procedure of appointing members in these bodies critically influence the regulatory capacity and it must be improved. Operational and financial autonomy of the regulators is another key area for deliberations. While ensuring autonomy, it is imperative to review the current accountability frameworks and suggest improvements. The regulators also face challenges on the front of human resource quality as there is lack of trained professionals in this area. Therefore, the regulators also need to play a dynamic role for the development of regulated sectors. To that effect, it can take a leaf out of SBP's experience, which has played a key role in the overall development of financial sector of the country. Regulatory

### **Need for Private Sector Mobilization in Aviation Sector**

Aviation sector of Pakistan has also been performing sub-optimally partly due to lack of capital investment in infrastructure, weak regulatory structure and insufficient technological development. Pakistani airports have been ranked poorly amongst international airports of the world. Airports are owned, operated and regulated by Civil Aviation Authority, which makes it difficult to mobilize public or private sector investment for the development of airports. Recently, Aviation Policy of Pakistan 2015 has initiated addressing these issues by providing enabling framework to attract private sector investments in facilities of airports, maintenance units for aircrafts and ground handling services. The policy also envisions separation of regulatory and operational role of CAA. This process needs to be rolled out in order to attract private sector investment for operational improvement of existing airports and building new facilities to cater to the growing demands of a growing population.

Impact Assessment is an important tool for regulatory quality improvement. However, regulators lack capacities in this regard.

The second important factor for mobilizing private capital is the mechanism of contract enforcement. Complex and delaying system of contract enforcement deter investors from entering into public-private partnership operations. Alternate Dispute Resolution (ADR) and specialized commercial courts can help improve contract enforcement mechanism that can contribute towards enhanced private sector capital mobilization.

Pakistan's capital markets also need to be deepened and further strengthened through enabling and credible regulatory framework. Well-developed capital markets can help the government raise equity for SOEs.

The third precondition for mobilizing private capital investment is level playing field. It is very important that neither any private sector player, nor an SOE is given preferential treatment in any sector of economy. This is because preferential treatment suppresses innovation, distorts efficiency and deters the entry of new and small businesses into the sector leading to less than optimal gains and efficiency.

Fourthly, secured property right regime can motivate businesses and individuals to invest time and capital in research and development activities and innovative solutions. Property rights play fundamental role in facilitating business transactions and economic activity. Hence, in order to attract private investment in SOEs, property rights regime of Pakistan will have to be strengthened.

In summary, following steps are needed to be undertaken in order to mobilize private sector investment mobilization:

- Improve corporate governance including disclosures by SOEs
- Advocacy and communication for benefits of private sector capital mobilization through various modes including modes
- Improve quality of regulatory framework
- Strengthen contract enforcement for commercial disputes
- Separation of policy, regulations and operations in selected transport sector including aviation, shipping and rail sector
- Deepen and strengthen capital markets

## 4. Implementation Challenges

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This section highlights the challenges to implement the above mentioned solutions including corporate governance and private capital mobilization. It also suggests measures to resolve the challenges to steer implementation process.

### 4.1 Heterogeneous Regimes for Governance of SOEs

SOEs are registered under heterogeneous regimes namely Companies Ordinance 1984 (for and not for profits), corporations or authorities established under special statutes and attached departments. Since Corporate Governance Rules 2013 are applicable only to the PSCs registered under Companies Ordinance 1984, several large SOEs such as PIA, NHA, Karachi Port Trust (KPT), Port Qasim Authority (PQA), PNSC, PR and Pakistan Post remain out of the ambit of these rules. Compared to the individual special statutes, the Companies Ordinance 1984 provides a comprehensive framework of laws that are consistent with international good practices of governance and transparency. Consequently, one key reform required for improving the governance of these large SOEs is to corporatize them by converting them as companies under the Companies Ordinance 1984. The precedent for this already exists as the government had corporatized entities like Oil and Gas Development Corporation Limited(OGDCL), Pakistan Telecommunication Limited (PTCL), National Insurance Corporation Limited (NICL) and power sector entities of WAPDA among others in past, which has helped in enhancing their governance to a large extent.



## 4.2 Quality of BoDs of SOEs

BoDs is considered the most important factor behind any improvement in corporate governance entailing oversight, accountability, strategic leadership and overall management of the organization. Iftikhar (2014)<sup>19</sup>, while analyzing underperformance of SOEs in Pakistan has observed; “although not always acknowledged to the requisite degree, this situation can largely be attributed to lack of corporate governance in the form of lack of clearly defined roles and professional capability and autonomy of the board of directors (the board).” The challenges and solutions relating to quality and autonomy of boards of SOEs described in the Iftikhar’s study are summarized in table below<sup>20</sup>:

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<sup>19</sup> Iftikhar, M.N. (2014), *Corporate Governance of State-owned Enterprises in Pakistan, Board Leadership: Innovative Approaches to Governance, July-Aug 2014, Wiley Periodicals, www.boarleadershipnewsletter.com.*

<sup>20</sup> *The views of the author of this study are also included in the summary and footnotes.*

| <b>Challenges</b>   | <b>Issues</b>  | <b>Potential Solutions</b>  |
|---|--|---|
| <p><b>Process of appointment and performance evaluations of board members</b></p> | <p>No formal mechanism for the appointment process or establishing the fitness and propriety of the nominees exists for these appointments.</p> <p>There is no repository of suitable potential directors, the selection of members is arbitrary and involves discretion of those in authority. Further, the evaluation of board members is not formally documented or updated for future consideration.</p> | <p>The CG rules have prescribed fit and proper criteria for consideration by the appointing authorities while making board-level nominations, their enforcement is required. Further, the CG Rules also require annual evaluation of the Board, which is expected to bring significant improvement once implemented.</p> <p>Board Nomination Commission or Unit may be established to make recommendations for appointments and removal of independent directors. There is also need to carry out performance evaluation of members.</p> <p>In order to ensure appointment of more suitable and appropriately qualified individuals, the Board Nomination Commission may also maintain list of potential candidates, who are individuals with appropriate board experience and reputation.<sup>21</sup></p> |

<sup>21</sup> Those who have completed director training courses being delivered by institutions approved by SECP should be included in such a list.

|  |  |  |
|--|--|--|
| <p><b>Divergence between de jure and de facto roles of the board</b></p> | <p>Companies Ordinance and CG Rules contain provisions that provide autonomy and empowerment of the Boards for overall management of the affairs of the companies, including their direction and control. However, the line ministries and other public office holders often undermine the authority of boards by giving direct instructions to SOEs management. In some cases CEOs are appointed directly by the government. Without the involvement of the Boards, the ability of the Board to exercise effective oversight and accountability of management is seriously compromised.</p> | <p>There is a need to develop the clarity that the government can appoint professional boards and then let them govern and control the company, including their inherent power to hire and fire the CEO in accordance with basic laws enshrined in the Companies Ordinance</p> |
|--|--|--|

|   |   |   |
|---|---|---|
| <p><b>Lack of professionals and qualified individuals on BoDs of SOEs</b></p> | <p>Most of the competent and well reputed individuals are generally unwilling to serve on the boards of SOEs owing to risks arising from ad hoc and arbitrary government actions. They are also averse to excessive media scrutiny and potential risk of investigations by multiple anti-corruption organizations.<sup>22</sup></p> | <p>A Board Nomination Unit or Commission, which could build a repository of potential directors from the private sector and help develop a transparent process for their appointment and evaluation, could make a significant contribution.</p> |
| <p><b>Remuneration of board members</b></p>                                   | <p>Remuneration of board members is arbitrarily decided since no definite policy is in place in this regard. It seems that current remuneration packages of board members typically fail to attract suitably qualified and competent professionals.</p>   | <p>Develop a criterion for determination of board meeting fees based on size, complexity, risks and financial position of the company, and trends in comparable private-sector organizations.<sup>23</sup></p>                                  |

<sup>22</sup> here should be appropriate framework to redefine the role of administrative ministries and divisions with respect to their oversight of SOEs. Furthermore, appropriate amendments are required in legal framework as well as government policy so as to ensure that investigating agencies will only initiate investigations based on proper evidence, and any significant interference must necessitate due professional care and high degree of due diligence.

<sup>23</sup> There is need to carry out board remuneration surveys in comparable companies and sectors through independent advisors. Fixing market based remuneration is considered very essential to attract and retain competent and well reputed individuals in the SOEs.

|   |   |   |
|---|---|---|
| <p><b>Divergence between ex-officio (public servants) and independent board members</b></p> | <p>Independent directors of SOEs maintain that ex-officio members of the board often seek to exert influence and authority in the board's decision making process rather than allowing the process to be one of democratic and objective deliberation. There is a perception amongst ex-officio directors that independent directors cannot be held accountable like public servants, so they often misuse the authority.</p> | <p>There is a need to enhance awareness that all directors have equal fiduciary responsibility and accountability as members of the board. The same can be achieved by means of director training programs. A behavioral change amongst the stakeholders is also needed for accomplishing harmony, democratic values and good governance practices.</p> |
|---|---|---|

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| <p>Ownership rights of the government</p> | <p>There are cases in which conflicting guidelines are issued to an SOE by various agencies in exercise of the legitimate ownership rights vested in them by the constitution and other laws.</p> <p>The Companies Ordinance 1984 and Corporate Governance Rules give autonomy to the board for overall governance and supervision of the affairs of the company. However, in practice the controlling ministries and other executive branches of government often override SOE board decisions.</p> | <p>The authority and office(s) entrusted to exercise rights must be designated with respective scopes instead of giving every branch of the executive/legislature the same kind of oversight role. There is also a need to provide orientation to government officials and legislative committees about relevant corporate laws and regulations, as many of the directives issued could be arbitrary and inconsistent with relevant statutes.</p> <p>There is a need to build advocacy and awareness among the public sector that instead of installing defunct boards, all efforts should be made to ensure good-quality boards and then let them govern their companies.</p> |
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### 4.3 Blanket Financial Support & Cross Subsidization

SOEs face a soft budget constraint as compared to their private sector counterparts, leading to lack of financial prudence and non-commercial decision making in many instances. Successive governments continue to provide blanket support in the form of subsidies, investments, bail-out packages, public sector loans, grants, and guarantees to enable SOEs to obtain loans from commercial banks. This has resulted into fiscal chal-

lenges and exposed the government to risks of fiscal instability along with financial mismanagement in a number of SOEs. The government continues to provide salaries and pensions of all employees of Pakistan Railways instead of providing support to the extent of public service obligations. This inability to moderate between commercial and public service obligations pose serious challenges to any reform efforts for SOEs. Separate accounting for commercial and public service obligations needs to be carried out by the SOEs in order to target and quantify the support needed from the government. Moreover, the pricing regime in many cases, particularly energy sector and commodity operations, carry out cross subsidizations, which result into inefficiencies and less than optimal outcomes. There is a need to improve targeting of subsidies by the government and develop clear policy on public service obligations by the SOEs.

#### **4.4 Enforcement and Supervision of Corporate Governance Rules**

The SECP is mandated to carry out enforcement and supervision of corporate governance rules for compliance by the SOEs. Reportedly, compliance rate of CG rules have reached at the level of 37% in FY 15 due to efforts of SECP which is appreciable. However, the enforcement poses serious challenges for SECP in terms of holding government functionaries accountable and directing the government to comply with the requirements of the Rules. The SECP needs to upgrade its professional capability for performing effective regulatory role to ensure compliance and enforcement of CG Rules. A dedicated team needs to be created with SECP to perform this task. Moreover, the SECP will have to start publishing annual compliance report of all SOEs that sheds light on the extent to which each SOE as complied with CG rules. This practice will help exert public pressure on stakeholders for the compliance of CG Rules.

#### **4.5 Evolving Regulatory Structure and Weak Contract Enforcement**

Robust regulatory structure and strong contract enforcement mechanism are the prerequisites for mobilizing private sector investment. Pakistan is still struggling with these two issues. There is a need to focus

on these two important drivers of investment. It may help attract private sector capital for revival of SOEs and other investment initiatives to spur growth and increase job creation in the economy.

## 4.5 Negative Public Perception

Many reform efforts fail due to lack of appropriate communication and outreach strategy to ensure buy-in and ownership of participating stakeholders. People at large are still unaware about the consequences of current state of affairs of SOEs, and its exorbitant cost on the taxpayers. The public perception about private sector involvement and corporate governance frameworks is still unclear. There is a need to devise a coherent strategy by the government to inform all stakeholders about current state of affairs of SOEs and strategy to engage private sector capital and improve corporate governance. The current mess is obviously not only due to any single regime; rather, it owes its existence to policy imbalances and inefficiencies during successive governments. So, a well-planned communication and outreach strategy will help government build consensus for tough reforms in the area of SOEs governance.

## 4.6 Political Intervention

SOEs are also perceived as tools to achieve political objectives of the government and individuals politicians in some instances. The politics of clientelism gives immense importance to the idea of keeping SOEs in traditional structures, instead of well governed entities, because it allows a general influence in employment process and service delivery towards respective political constituencies. For instance following extract of proceedings of a meeting of the National Assembly Standing Committee on Finance regarding review of a National Bank of Pakistan's (NBP) decision is relevant to this aspect:

*"The Committee discussed the planned merger of Jhang District NBP region with Faisalabad Zone and directed the Senior Vice President of NBP to resolve the issue with the consultation with the parliamentarians belonging to Jhang District."<sup>24</sup>*

Purely commercial and strategic decision of the NBP regarding merger

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<sup>24</sup> <http://www.brecorder.com/taxation/181/1157520/> accessed on 26<sup>th</sup> July, 2015.



of its regional offices was deliberated in the above said meeting of the parliamentary committee and instructions were issued to take this decision in consultation with parliamentarians. It is important to note here that it was not about closure or merger of bank branches which can affect residents of that area. If an internal management reorientation of public sector commercial organizations can be challenged by the parliamentarians, how can we expect merit based and rational decisions for service delivery by the SOEs in current environment of political interference?

There are many such instances when human resource rationalization initiatives by SOEs have been derailed by political leadership on account of potential political loss. Thousands of employees of SOEs were regularized in 2011 without taking into account their collapsed operations and financial inability at that time<sup>25</sup>. There were many SOEs which were at the brink of closure at that time including for e.g. PIA, PSM, and PR. No commercial organization can sustain such interference. This tradition may pose challenges to SOE reforms. There is a need to generate debate around the theme that short term political gains through inefficiencies and privileges lead to huge cost to public exchequer and even political careers in the long run. The history of developed nations indicate that they all suffered this issue but their leadership and broad mass of citizens had to stand up to build state capacity and take rational decisions. Transparency in operations and governance of SOEs and clear demarcation of jurisdictions through legislative frameworks (such as SOEs or Public Financial Management Laws) can also help circumvent unnecessary political influence in operations and reform process of SOEs.

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<sup>25</sup><http://www.brecorder.com/business-and-economy/189:pakistan/1170554:regularisation-of-60000-employees-from-2008-13:-ppp-government-burdens-national-exchequer-by-rs-25-billion-yearly> accessed on 26<sup>th</sup> July, 2015.

## 5. Conclusion

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- a. The study has analyzed current state of affairs regarding governance and operations of SOEs in Pakistan and suggested potential solutions to improve the situation. The study emphasizes the need to adopt corporate governance practices and attract private investment in SOEs.
- b. The first finding of this study is; “business as usual is not sustainable” regarding operations and governance of SOEs in Pakistan. The study observes that no business can thrive in the current environment of excessive, yet ineffective, accountability checks. There is need to review the current business interventions of the government with an aim to identify the areas where state needs to leave the space for private sector for more efficient operations. SOEs operating in the sectors “without natural monopoly” or “having strong presence of private sector” will continue to underperform as compared to their private sector competitors. There are many sectors now having little or no rationale of the government’s business interventions through SOEs e.g. producing steel, flying aero planes and centralized energy distribution.
- c. The study holds following issues responsible for current state of affairs in SOEs; lack of clarity on role of the government, multiple layers of accountability, lower capital investment, weak corporate governance, soft budget constraints, evolving regulatory structures and no accountability through markets.
- d. SOEs that will continue to perform in public sector need to adopt and comply with corporate governance practices developed in the

form of CG rules together with basic laws enshrined in the Companies Ordinance. There is a need to develop a formal process and a unit to appoint, remove and evaluate the performance of independent directors of SOEs. There are many large scale SOEs which are yet not corporatized. Corporatization of these SOEs is essential to bring them under the ambit of good corporate laws enshrined in the Companies Ordinance and CG rules to improve their performance, financial management, transparency and disclosures.

- e. The implementation of CG Rules will help clarify roles of different stakeholders involved in management and governance of SOEs and will also put effective accountability mechanisms in place instead of multiple and ineffective checks.
- f. Compilation and publishing of annual report on consolidated performance of SOEs (including “not for profits”, autonomous bodies, attached departments, authorities involved in commercial activities) can help policy makers to make evidence based decisions. Performance contracting between government and SOEs may provide an objective framework for governance, operations and performance assessment of SOEs. Public and researchers can also assess the value for money, analyze the underlying factors and generate demand for reforms. In medium to long term there is need to devise policy or legislation for guiding the government on extent and forms of exercising ownership rights in case of SOEs.
- g. There is a need for innovative solutions to attract private sector investment in SOEs operating in key sectors e.g. rail, aviation, energy, road and commodity sectors. The government needs to improve regulatory quality and contract enforcement in order to attract private sector investments in key sectors of economy and create conducive environment for moderating competing interests of all economic agents in those sectors. Privatization/disinvestment process initiated by the government needs to be pursued with full political zeal, professional capacity, transparent process and engagement of all stakeholders.
- h. There is need to be cognizant of the factors and challenges be-

hind those failures and develop effective strategies to resolve those challenges namely outdated legislative frameworks for SOEs, ineffectiveness and poor quality of BoDs, multiple layers of accountability, flawed public perceptions, weak regulatory structures, inefficient contract enforcement mechanism and poor supervision of corporate governance.

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## About the Author



**Mr. Muhammad Naveed Iftikhar** has professional experience of twelve years with public, private and international development organizations in the areas of public policy, economic governance and private sector development. He has served as Governance Specialist at Economic Reforms Unit (ERU) of Pakistan's Ministry of Finance and has been actively participating in design and implementation of policy reform initiatives in key sectors of Pakistan's economy. He has been instrumental in introducing corporate governance rules for public sector companies, sustainable energy for all (SE4All) and doing business reforms in Pakistan along with contribution in other public sector management and governance reforms in the areas of state-owned enterprises, performance management systems, investment climate, fiscal policy and regulatory governance. He has also provided consulting and advisory services to international development organizations including World Bank, Asian Development Bank, United Nations Development Program and Japan International Cooperation Agency among others. Naveed has taught economics and public policy courses at various universities and has been contributing to journals and conferences. He has also served on various task forces and reform committees formed by the Government of Pakistan.

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