

## METHODS FOR RESOLVING PROBLEMS OF RESPONSIBILITY AND TRANSPARENCY IN THE ACTIVITIES OF SOES IN MARKET ECONOMIES: MODELS AND RESULTS

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### Abstract

This paper looks at some of the basic challenges and response options in developing good (or at least adequate) corporate governance structures for state-owned enterprises, and then reviews some specific country examples. The discussion concludes with an assessment of lessons for the Ukrainian situation. The government can reduce the range of objectives by focusing on specific priorities; shareholder value needs to be a core objective since it measures whether SOE management is achieving a real contribution to overall prosperity. All serious approaches to improving corporate governance for SOEs stress disclosure and transparency. These efforts go beyond detailed reporting to insist on *public* disclosure, with the SOEs setting standards for transparency, and ultimately accountability. Publication of financial and operational reports facilitates the task of monitoring and strengthening performance by expanding the group of monitors and analysts to all interested parties.

**Keywords:** SOE, transparency, accountability, disclosure, monitoring, private shareholders

### Introduction

Privatization has changed the structural characteristics of the Ukrainian economy, but the government remains a major owner of productive assets. It is a shareholder in some 2,200 joint-stock companies, with majority stakes in about 400 of them, and owns another 4,000 (non-corporatized) enterprises outright. Overall, the performance of these enterprises has been disappointing. Contributions to the budget have fallen short of expectations; while the aggregate figure is positive, it is mostly due to a few profitable operations among the many making losses. In the aggregate, the financial return on state-owned assets indicates widespread inefficiency that the Ukrainian economy can ill afford. At the same time, it is not clear whether the state-owned enterprises are in fact meeting any broader policy mandates to a degree that would warrant the costs implied in lower financial returns. The authorities have therefore been grappling with the challenge of developing systems to ensure better performance by state-owned enterprises (SOEs). For the non-corporatized SOEs, the government has imposed stricter financial reporting requirements, including the submission of annual financial plans for approval by the managing body,

either the Ministry of Economy and European Integration Issues (MEEI) or the respective line Ministry. The implementation of this scheme, alas, has encountered some difficulties, and it is now under review, with the preparation of a comprehensive concept as a first step.

For its joint-stock company shareholdings, the government has used different agents manage these state corporate rights, including the State Property Fund of Ukraine (SPFU), line Ministries, local administrations, and "authorized persons." There appears to be general agreement that neither of these models is producing the desired results, and the system of managing state corporate rights remains in flux. In the search for more effective approaches to encourage better performance in its joint-stock companies, the experience of managing state shareholdings in other market economies is of some interest. While the worldwide privatization movement since the mid-1980s has greatly reduced the size of the state-owned sector across the globe, significant pockets of state ownership remain, not only in transition economies and developing countries, but also in developed market economies. The measurement of

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the state presence in the economy is complicated, and available data do not necessarily reflect the actual situation. Even so, the following figures (for

1995) provide some impression of the continuing role of state-owned enterprises in market economies:

**Table 1.** Value Added by SOEs as Percent of GDP

United Kingdom	3.0%
Mexico	4.9%
Denmark	5.1%
New Zealand	5.2%
Korea	10.3%
Greece	11.5%
Austria	13.9%
Venezuela	23.0%

Reasons for retaining ownership in productive enterprises vary, but as a rule the decision reflects public policy interests, that is, they tend to be much more diverse than those of private shareholders. The quest for ensuring acceptable financial performance of state-owned enterprises, along with the pursuit of public policy objectives, has a long tortured history. In fact, this paper looks at some of the basic challenges and response options in developing good (or at least adequate) corporate governance structures for state-owned enterprises, and then reviews some specific country examples. The discussion concludes with an assessment of lessons for the Ukrainian situation.

### The state as a shareholder

#### The basic ownership challenge

Two fundamental differences between the state as a shareholder and a private investor shape the basic dilemma of corporate governance in the state-owned sector.

First, private investors acquire shares in an enterprise essentially to make money. Thus, the performance of enterprise management is gauged by a single measure: the creation of shareholder value. While investors differ in their appraisal of the underlying value, trading in an efficient stock market leads to the emergence of a “common expectation” of the future performance of the company as reflected in the share price. Governments, as a rule, hold an equity position for other reasons – to pursue social and distributional policy objectives, protect strategic interests, and more. Many of these objectives are only expressed as broad long-term goals. Assessing how well the enterprise (management) performs therefore has to take into consideration a broader range of indicators, diluting the focus of both management and monitoring. The effects of a range of objectives are magnified by the common experience that objectives shift as governments change.

These factors also mean that share prices may not be an adequate guide for assessing performance, even if some portion of the total capital of state-owned enterprises is traded in the market. Private

investors are unlikely to pay a premium for good performance above and beyond financial returns, nor lower their valuation because of the company’s failure to achieve certain social objectives. The value assigned to the equity stake as expressed in the share price captures only one dimension of enterprise performance. Another aspect is the tendency to under-value the equity capital. A common practice uses historical cost valuation rather than the market value of assets, thereby effectively inflating the rate of return on assets. Second, the state as an investor has far more limited options in efforts to resolve the principal-agent problem. With the separation of ownership and management, investors (stockholders) bear most of the risk, but have to rely on managers to achieve optimum performance in terms of shareholder value or other objectives. The challenge is to find efficient ways to ensure that the management acts in the stockholders’ best interest rather than just their own. The challenge comprises two aspects. First, managers need proper incentives to pursue the owners’ interests. Second, stockholders need the means to monitor performance, since they are unable to observe management actions directly. Monitoring typically relies on periodic reports and on market appraisals expressed in the share price, provided there is adequate trading in efficient markets.

#### Exercising control: Private shareholders

With respect to incentives, private shareholders have three principal means of aligning the management interests with theirs:

- they can withdraw assets by selling shares when the value they assign to the shares falls below the market price;
- they can dismiss management and replace it with a new team; in effective markets, a lower share price may indicate an opportunity to improve performance and create shareholder value with a new management team, for example, through a takeover by outsiders; and
- they can tie the remuneration of management to performance, as measured by shareholder value, through stock options or bonuses.

Finally, private enterprises that perform poorly go bankrupt, with a loss of jobs and damage to the reputation of managers.

The effectiveness of these instruments for aligning the objectives of owners and managers depends in part on the “weight” of the individual shareholder, and in part on market structure. Small investors face a disproportionate cost of obtaining the information needed for monitoring performance. Similarly, a decision by small investors to withdraw assets by selling shares is unlikely to have much of an impact on management. Wide share ownership therefore may have detrimental control implications (Empirical studies have confirmed that the positive association between ownership concentration and performance holds for the case of Ukrainian joint-stock companies).

Market structure matters by determining the availability of comparative information. In a competitive environment, the performance of other companies allows the investor to supplement information expressed in the share price. The fewer competitors, the more difficult it becomes to “benchmark” the performance of the enterprise. A monopoly makes it easier for managers to pursue their own interests.

#### Management oversight by the state

The state as a shareholder faces a different, and in many ways more difficult, challenge in seeking to align the interests of enterprise managers with its own objectives. Since the reasons for state ownership in the first place are tied to the nature of the business (such as strategic importance, location), withdrawing assets by selling the shares is not an option. Similarly, since there is no market for these shares, there is no effective threat of a takeover with subsequent replacement of the management. The introduction of positive incentives – remuneration linked to performance – may be hampered by the status of managers as civil servants. Typically, the policy importance of the enterprise also all but rules out bankruptcy. The “soft budget constraint” cushions the impact of bad management. In the face of often well-publicized efforts to impose budget discipline on enterprise management, governments have demonstrated remarkable ingenuity in continuing some form of financial assistance. A common option is to replace direct subsidies by guarantees of loans provided by banks (often with some prodding); the cost

of such guarantees may not show up for several budget cycles.

State-owned enterprises often dominate their respective sector (or region); many of them have commonly been regarded as natural monopolies – the reason for government ownership in the first place. As a result, “benchmarking,” the comparison with like enterprises to assess relative importance, becomes difficult.

The oversight issue becomes even more critical, since private holders of SOE debt have weaker incentives to monitor performance because of implicit or explicit government guarantees. Even if there are official disclaimers, there is usually ample evidence that governments are reluctant to let SOEs go bankrupt, greatly reducing the risk to private debt holders.

The combination of these features, or constraints, with the existence of multiple performance criteria defines the basic corporate governance challenge for the state as a shareholder. Fundamental qualitative differences prohibit the state from acting like any other shareholder. This dilemma has dogged the search for effective approaches to improve governance mechanisms for state-owned firms. The disappointing record of most of the schemes that have been tried has of course been the driving force behind privatization. There is one final factor which complicates things even further: in principle, as a shareholder, the state is an agent for the people (the ultimate principal). The policy objectives governing the management of state corporate rights therefore should reflect the interests of the real principal. How the people can ensure that the interests of the state as the agent are aligned with their own is an issue that transcends the question of corporate governance. But there is a more operational principal-agent issue. The state per se is not the manager of its shareholder rights. It delegates this responsibility to individuals sitting on the board of directors of the companies, or to persons or organizations charged with direct supervision of the activities of management. The individuals or organizations charged with the management of state corporate rights are in effect agents themselves. In a very simple schematic, we therefore have the structure shown in Figure 1.

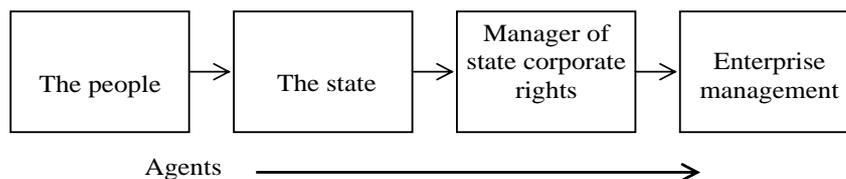


Figure 1. Principal-agent structure for state shareholdings

These relationships define in effect a second-tier corporate governance issue: how can the government ensure that managers of state corporate rights, charged with steering and monitoring the performance of enterprise management, really pursue the government's interests rather than their own? As it turns out, this issue has received relatively little systematic attention. This paper revisits this question in the conclusions, following the review of some real examples.

### Corporate governance options for SOEs

#### Principles of good corporate governance

Over the last decade or so, we have seen increasing interest worldwide in issues of corporate governance and a growing consensus on best practices. While there is no single model of good corporate governance, there is agreement on common principles. The OECD has played a leading role in this debate, and has articulated these common principles of good corporate governance in terms of five categories:

- Rights of shareholders: good corporate structures protect the rights of shareholders, which include access to relevant information on the corporation on a timely and regular basis. "Members of the board and managers should be required to disclose any material interests in transactions or matters affecting the corporation."
- Equitable treatment of shareholders: treat all shareholders equitably, including minority and foreign shareholders. All shareholders should have effective redress for violation of their rights.
- Role of stakeholders: recognize the rights of stakeholders – groups that do not own an equity stake in the enterprise, but whose interests in the performance of the company is recognized by law – and encourage active cooperation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises. "Where stakeholders participate in the corporate governance process, they should have access to all relevant information."
- Disclosure and transparency: ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, governance. Disclosure should not be limited to past performance, but should also address financial and operational plans.
- Responsibilities of the board: ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders. "The directors must have expertise in the company's industry and in finance; . . . should focus on new strategies, not just on reviewing past performance."

These OECD principles establish a framework for assessing the quality of corporate governance in a

given enterprise, and are in fact increasingly used by investors to evaluate companies, complementing the financial and operational assessment. They are relevant to the task of assessing best practices in SOE corporate governance, as long as the fundamental differences that characterize the state as a shareholder are understood.

#### Basic options and best practices in market economies

The quest for systems of corporate governance for state-owned enterprises to improve economic efficiency and greater responsiveness to policy concerns and objectives has largely relied on variants of two basic options:

- emulate corporate governance principles, structures and procedures that apply to private (publicly traded) companies; and
- conclude performance contracts with the management that spell out the objectives and targets and define incentives and disincentives.

In addition, governments have used various contracting mechanisms, including concessions, to introduce private sector incentives without ceding ownership. Another option has been the transfer of state shareholdings to a holding company that would be managed according to private sector governance principles.

Emulate private sector systems of corporate governance: This approach includes the establishment of the SOEs as private law commercial entities (corporatization), and the exercise of the state's shareholder rights through regular governance structures, in particular relying on a board of directors. To be effective, such an arrangement requires a clear set of rules for the appointment of the directors (with an emphasis on relevant expertise) and a clear definition of corporate goals and specific objectives. Observing the rules for the appointment of qualified directors can also provide greater stability and transparency by making changes in the makeup of the board less dependent on changing political fortunes.

Emulating private sector approaches also places a premium on adequate reporting and monitoring of management performance. Transparency and accountability have characterized the more successful approaches to corporate governance for SOEs. Accountability implies the imposition of financial discipline. The state contribution to the capital of SOEs should be transparent. More importantly, the state should make it clear that it will not guarantee any liabilities of the enterprise – meaning of course that SOEs will be allowed to go bankrupt. Given all the constraints on effective corporate governance for SOEs, enforcing the bankruptcy of poorly performing enterprises is perhaps the clearest signal that the state can send about its focus on performance.

Even so, the emulation of private sector systems of corporate governance only shifts the problem of monitoring performance along several dimensions,

as a result of the typical multiplicity of objectives. The effectiveness of such schemes therefore also requires efforts to reduce the range of goals. Shareholder value should be the core objective, not because the government wants to make money, but because creating shareholder value means the most efficient use of resources, and thereby the greatest possible contribution to prosperity. Moreover, it has become increasingly clear that it is impossible to create value without responding to the needs and expectations of stakeholders – employees, customers and the community. Shareholder value is by no means synonymous with excessive attention to the bottom line. Clear rules for the appointment of directors and a clear statement of corporate goals and objectives are important tools for addressing the issue of second-tier corporate governance. Even so, these steps by themselves do not necessarily ensure that the directors adequately represent the interests of the state. They too need proper incentives and monitoring. The issue of incentives for directors is often complicated by the fact that they are civil servants, and are therefore not entitled to any share of the gains of improved efficiency. As a result, they do not have financial incentives to monitor the performance of management. While a civil servant may be highly motivated to do his or her share for greater prosperity, people do respond to incentives.

Performance contracts between SOEs and the state remain a popular means of establishing specific objectives, (dis)incentives and accountability. Many countries, including Ukraine, are relying on this device to define relations between the state and the management of SOEs, especially in industries that are monopolistic. In 1994, the World Bank found 565 such performance contracts in developing countries, and another estimated 103,000 in China. The experience with such performance contracts has been mixed. In fact, there is a large body of theoretical literature dealing with the issue of incomplete contracts – the inability of governments to write contracts in these situations that would actually cover all eventualities. Even so, the lessons of experience have borne some fruit. The learning process is reflected in the emergence of some common guidelines, as performance contracts have evolved since the 1970s. They now tend to focus on a narrower range of objectives, often including some measure of value creation, and are much more explicit and clear about financial relationships, including future dividends. Effective performance contracts also acknowledge the need and provide room for flexibility on the part of management in responding to changes in the operating environment.

The original idea behind the establishment of holding companies for state-owned enterprises was to create a portfolio of shareholdings that would be professionally managed in accordance with private sector governance principles. However, it typically proved impossible to transfer state corporate rights to a truly private-sector entity. As a result, the holding

companies themselves became in effect SOEs managing other SOEs. They became little more than another layer of bureaucracy between the state and the management of the SOEs, further reducing transparency and accountability, and introducing another set of interests. Ukraine is only too aware of the disappointing track record of state holding companies. Maintaining accountability and transparency, and reducing the danger of “regulatory capture” of holding company management demands narrow objectives, and a specific timeframe for accomplishing these objectives. Holding companies can perform useful functions as temporary entities with a clear focus, notably during periods of restructuring and privatization.

Management contracts, concessions and other forms of turning state assets over to private management without ceding ownership offer opportunities for improving accountability and transparency – provided of course, the contracts or agreements are properly structured. Properly structured means an explicit statement of goals and objectives, a schedule of incentives (both rewards and penalties), and a clear definition of the obligations of both parties, state and contractor. In many respects, the challenge in this option is very similar to that in structuring management performance contracts, but dealing with an independent contractor can expand the range of possible incentives. These general lessons form the backdrop for a brief review of approaches and experiences in selected market economies. The survey is by no means intended to be exhaustive, but rather to provide illustrations for broader conclusions in this section.

### Selected country examples

**New Zealand.** State-owned companies continue to play a significant role in the New Zealand economy, covering a range of activities, from infrastructure services to resource-based industries. Two separate pieces of legislation define their status and operating procedures, the 1986 State Owned Enterprises Act, and the 1993 Companies Act. The SOE Act requires that the government (the Crown) own all of the shares of an SOE. It also regulates the roles and accountabilities of Ministers, boards and enterprise management, assigning the responsibility for operational matters to the boards. The SOE Act sets the principal objective of an SOE: to operate as a successful business, with a successful business defined as being:

- as profitable and efficient as comparable businesses that the government does not own;
- a good employer; and
- an organization that exhibits a sense of social responsibility.

SOEs differ greatly in size and market power, with some natural or statutory monopolies and others facing significant competition. The sector is dynamic in the sense that its composition changes over time.

A Crown Company Monitoring Advisory Unit (CCMAU) provides guidance in the process of establishing and managing SOEs, and monitors their performance. The CCMAU seeks to balance the inherent tension between each company's objective to maximize profits and the government's risk aversion by providing the shareholding Ministries (typically the Ministry for State-Owned Enterprises and the Ministry of Finance) with advice on:

- ownership objectives for the Crown;
- the composition and performance of the boards;
- the implications of changing a company's core business definition;
- capital structure and dividend policy;
- business activities from a commercial perspective;
- performance measurement targets and performance against these targets;
- the impact of government policy on the value of SOEs and practical solutions for reducing any adverse consequences.

As in other countries, the core of the corporate governance structures for New Zealand's SOEs is an intensive reporting program and schedule, including annual outlook reports, business plans, Statements of Corporate Intent (SCI), as well as monthly, quarterly and annual financial reports. The monthly reports submitted to the CCMAU (due 15 days after the end of each month) are in effect limited to any deviations from monthly targets for revenue, net profit after tax and operating cash flow. The Statement of Corporate Intent is a key document. It sets the scope of business for the SOE, and identifies broad goals and performance targets. The shareholding Ministries have the right, subject to parliamentary scrutiny, to direct the SOE board to include or omit particular items or activities in the SCI. Should the shareholding Ministers direct an SOE to include activities in its scope off operations that are not part of a commercial arrangement, the government may have to compensate the SOE for any resulting costs.

**Greece.** In 1996, the Greek government adopted a new law regarding the operation and management of state-owned enterprises. Until then, most SOEs had been operating either as public sector entities, or as limited liability companies with one share, owned by the government. Management and supervision was the task of the respective line Ministries. The 1996 law required that most SOEs were to incorporate and to operate like private companies, but to focus on quality and satisfaction of demand rather than just profit (The focus on satisfaction of demand reflects in part a reaction to the then-dismal level of service in certain government monopolies, in particular the telephone company).

Operations of the SOEs are supervised by a board of directors, from seven to eleven persons: two of the board members are elected by the employees, one is appointed by the Economic and Social Committee, which represents the main "social and economic partners" of Greece, and the chairman and remaining board members are appointed by the gov-

ernment. The government also appoints the managing director for the SOE, typically for a period of five years. The appointment of the chairman and managing director are effectively subject to approval by the parliament.

The chairman of the board and the managing director sign a contract with the respective Ministry which sets annual targets for the implementation of an agreed-upon business plan. The contract specifies rewards for achieving targets; if the management misses the targets, and cannot provide adequate explanations, the contract may be terminated, that is, the government would replace the chairman of the board, the managing director or both.

The SOE regime places considerable emphasis on transparency. SOEs must publish quarterly and annual financial statements, and submit strategic plans to the parliament. The respective Ministry is responsible for monitoring the implementation of the business plan, but it hires the services of independent auditing companies to assess performance and monitor compliance with the business plan.

The experience with this approach has been broadly satisfactory, although some problems in the interaction between the board and SOE management have been reported. Even so, one of the remaining SOEs in the Greek economy, the telephone company OTE, has become a player in the privatization of telecoms in Eastern Europe.

**South Africa.** The South African government sees appropriate corporate governance structures for SOEs as a means of protecting consumers. To this end, it emphasizes adequate disclosure of information to ensure greater transparency and accountability. In 1997, South Africa adopted a Protocol on Corporate Governance for the governance of SOEs, which covers most aspects frequently found in international corporate governance frameworks. The four largest SOEs (Eskom, Transnet, Telkom and Denel) will have adopted the Protocol. In addition, the government has also developed shareholder compacts with each of these key SOEs. These shareholder compacts define relationships between the state and management of the enterprises, and addresses perceived limitations in the 1997 Protocol. The compacts include the critical assumptions about the operating environment, economic conditions and political relationships, as well as any specific obligations to deliver services.

An interesting element in the South African approach to corporate governance for the country's state-owned enterprises is reliance on "self-regulation." The management and boards of the SOEs are expected to uphold "appropriate standards of ethics and probity." The government, however, approves these standards and monitors compliance. Many of the SOEs have already established codes of conduct.

**Sweden.** Sweden may have gone as far as a government can in treating its state-owned companies according to private sector corporate governance

principles, characterized by an explicit emphasis on the SOEs' ability to create value. A key element is a comprehensive system for external reporting, which "constitutes the most important source of information for assessing [the SOE's] capacity for creating value, i.e. future cash flow, earning capacity and capital structure and also with regard to the degree to which it has met its specific objectives." (Ministry of Industry, Employment and Communications: "Guidelines for external reporting by government-owned companies," May 2000) In fact, the government stresses the obligation of SOEs to set standards for transparency and accountability through their reporting.

Comprehensive financial reports to be published on a quarterly and annual basis (and made available on the company's and Ministry's web sites) include such items as total sales, earnings before interest and taxes, assets, liabilities, shareholders' equity, cash flow before investments, and net investments, for the company and its business segments. These reports are due within two (quarterly) or three (annual) months from the end of the period to which they refer. The Ministry's guidelines also require a press release summarizing the performance during the preceding financial year within two months after the year ends. The annual report is designed as a comprehensive instrument to enable the government – and anybody else – to assess the past performance of the enterprise and assess its prospects for the future. Thus, the annual report should contain a brief narrative of the company's development over the past five years, highlighting the achievement of objectives and any shifts in strategy. With respect to the future, it should describe the business strategy, specify measurable objectives, and identify factors of importance for meeting the objectives. This discussion should also include a balanced description of any opportunities or threats which are of importance to the assessment of the company's future ability to create value.

**China: Performance contracts.** China has extensive experience with a range of approaches to improving corporate governance for SOEs. In our context, it may be useful to highlight briefly some aspects of the experience with performance contracts, based on a comprehensive evaluation carried out by two researchers at the World Bank (Mary Shirley and Lixin Colin Xu, "Empirical effects of performance contracts: Evidence from China," Washington, DC: The World Bank, October 1997). Performance contracts are regarded as variants of pay-for-performance or incentive contracts used in the private sector to motivate managers. As mentioned above, they have been widely used in China. The

government began experimenting with this approach to corporate governance for SOEs in the mid-1980s and rapidly expanded the coverage to the vast majority of the country's SOEs. The contracts included a range of variants, including:

- the traditional Manager Responsibility System, typically with vague performance targets,
- the Contract Management Responsibility System, consisting of multi-year targets and introducing a reward system, linking wages and realized profits;
- leasing, with the management becoming the residual-claimant to any surplus after the leasing fee, and
- the Asset Management Responsibility System, which involved the selection of management through open bidding, and a link between managerial compensation and appreciation of assets as measured by the price obtained in the next round of bidding.

The evaluation for the case of China looked at the experience with performance contracts in over 400 SOEs. The researchers concluded that performance contracts "did not on average improve the productivity of state enterprises in China; they may have even reduced it." They therefore conclude that political determinants "may preclude the design of incentive contracts for government actors that produce the sort of productivity gains they have achieved in private firms." Part of the explanation for these findings is likely to be the tendency to consider objectives other than just value creation.

### Some implications for Ukraine

The experience with different approaches to improving corporate governance for state-owned enterprises in a market economy may provide little specific guidance, but two principles stand out:

- While the rationale for government ownership may preclude a focus on a single measure of performance, the government can reduce the range of objectives by focusing on specific priorities; shareholder value needs to be a core objective since it measures whether SOE management is achieving a real contribution to overall prosperity.
- All serious approaches to improving corporate governance for SOEs stress disclosure and transparency. These efforts go beyond detailed reporting to insist on public disclosure, with the SOEs setting standards for transparency, and ultimately accountability. Publication of financial and operational reports facilitates the task of monitoring and strengthening performance by expanding the group of monitors and analysts to all interested parties.