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Ukraine — Improving the Efficiency and Management of State Enterprises

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For more than a decade, Ukraine, like most other transition economies, has been implementing a major privatization program for state-owned enterprises (SOE). Although the privatization program has many objectives, the key assumption is that private owners will improve the efficiency and productivity of former SOEs.

The evidence in many countries is that privatizations have indeed increased enterprise efficiency. But in many cases, some of the social objectives of state enterprises were lost. Furthermore, many privatizations resulted in the creation of private monopolies that behaved worse than public monopolies. It is therefore important that the privatization of SOEs be undertaken after consideration of means to preserve social objectives. Privatized enterprises could undertake social responsibilities if they are compensated for them in a fair and transparent manner. Furthermore, the privatization of monopolies should be undertaken only if either of two conditions is met. First, the government has the capacity to develop adequate monopoly regulations (particularly on pricing) that can ensure efficiency and fairness; or second, if the monopoly can be broken apart into competing elements.

Nevertheless, despite the progress in privatization, a large number of SOEs will remain in the hands of the state for many reasons, including their monopolistic characteristics, lack of interest by the private sector, strategic-political considerations, etc. Moreover, there is great concern in Ukraine regarding the transparency and honesty of many of the privatizations that have been concluded. Some have demanded that firms clearly "misprivatized" be taken back into state control, and then be correctly resold. If that should happen, the state would have the responsibility for the management of these assets while waiting for the second sale to take place. This note addresses the question of how best to improve the management of these "residual" state enterprises that are unlikely to be privatized in the near future, or that might find their way back into the state portfolio for at least some time.

Two parallel avenues have been used to improve the management of SOEs: the first avenue involves improving the "external" business environment under which state enterprises operate. The second avenue, involves "internal" corporate governance/management factors that would provide the incentives and motivation to the enterprises to operate efficiently. Both sets of measures aim to make the environment and behavior of the state-owned enterprise as similar as possible to those of a comparable privately owned firm.

In 1999, SigmaBleyzer initiated the International Private Capital Task Force (IPCTF) in Ukraine. Its objective was to benchmark transition economies to identify best practices in government policies that improve the investment climate and attract private capital. An Action Plan was developed and presented to the Ukrainian government which identified the economic policy actions necessary to improve the investment and business climate in Ukraine, attract additional flows of private capital to the country, support economic growth, and improve the quality of life for their citizens. In 2001, this effort was expanded to all countries of the FSU, and IPCTF ratings for all 15 countries of the FSU were developed. They are available from SigmaBleyzer and The Bleyzer Foundation.

The Bleyzer Foundation was established in 2001 in order to promote the IPCTF framework and help countries implement the policies necessary to successfully complete transitions to market economy.

The Foundation's Managing Director is Mr. Victor Gekker, who is supported by a team of economists and business analysts. The Advisory Board of The Bleyzer Foundation is chaired by Dr. Edilberto Segura and provides advice and guidance to the activities of the Foundation.

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External Business Environment

Experience in other countries shows that the general business environment is a major factor affecting the efficiency of state-owned enterprises. Improvements in the business environment include the following:

Competition. Competition is the most important driver for efficiency. State enterprises should be subject to competition from other state enterprises or from the private sector. Measures to foster competition include the removal of barriers to entry, the elimination of price controls, liberalization of foreign trade, the abolition of preferential regulations, and the break down of monopolistic structures.

Hard Budgets. State enterprises must generally learn to live within "hard budgets" under which their revenues are generated solely from their own market-based results. In most manufacturing-commercial state enterprises, this should be a hard and fast rule; few exceptions should be permitted. In cases where government imposes social, non-commercial objectives on state firms (for example, when for social reasons, the government decrees that energy prices must be set at a level less than marginal cost, or where a large firm is the only employer in a region or town) the costs to the firm should be transparently quantified, and the firm should receive compensation for the service from the government. The government should eliminate any monetary subsidies and privileges. State enterprises should not be allowed to accumulate tax arrears or arrears in the payment of utilities, and they should not enjoy preferential credit from commercial banks. As much as possible, state enterprises should operate on "a level playing field" with firms in the private sector.

Market-Based Controls and Discipline. State enterprises should be subject to the "discipline" that comes from the market, including the demands from the company's clients, suppliers of inputs, suppliers of credit and the public in general. They should not be alleviated from these market pressures by government regulations that give these enterprises preferential treatment or ad hoc exemptions. One good way of forcing market discipline on state firms is to require them to conduct their borrowing from private, commercial banks, without an explicit government guarantee of their debt. At the very least, this forces the firms to prepare and submit good quality performance information, and to think through their investment plans.

Restructuring. Unprofitable state enterprises should be restructured as part of the program to improve efficiency. For individual enterprises, only the public goods component of the enterprise should remain in the company. Other activities that are not core to the business, yet are competitive (or could easily become competitive) and generate revenues should be spun off and privatized. Also any policy or regulatory function of the state enterprise should be separated from operations and transferred to the corresponding government agency or ministry. No firm should be setting social policy in the economic sector it works in. Consideration should also be given to the possibility of breaking down a large state enterprise into smaller units that can compete among themselves.

Internal Factors of Corporate Governance

Improvements in corporate governance of state enterprises are essential to increase the efficiency of these enterprises. The measures should aim to create the "incentive" framework and the "control" mechanisms that would induce the enterprises to seek continuous improvements in efficiency. The attachment gives some examples of corporate management arrangements for SOEs in a number of countries. The key corporate governance elements include the following:

(a) **Corporatization.** State-owned enterprises should have a legal status under which there is clear separation between the enterprise and its owner (the state). For revenue-earning state enterprises, they should be governed by commercial law as any private enterprise. Given the deficiencies in the current joint stock companies law, the new draft Law on Joint Stock Companies should be approved as soon as possible. An additional step in corporatization is listing the enterprise on the local or, better yet, on an international stock exchange. Most capital markets laws require that listed firms have proper accounts, calculated according to GAAP; this adds to the transparency of the firm's operations.

(b) **Agent Representing the State.** The common practice that state enterprises are both owned and supervised by line ministries is inadequate as it involves conflicts of interest, possibilities of patronage, and offers opportunities for corruption. Experience in other countries suggests that a better approach is to give authority to represent the state to a semi-autonomous agency, both as holder of the stock and supervisor and controller of the state enterprise. The practice of separating these two functions has led to innumerable conflicts. Furthermore, there is no inconsistency between the share management and share sale functions. Indeed, since maximizing the value of state shares would help maximize the proceeds from any share sale, it makes sense to link these two from the holder of the state assets into a commercially-focused agency. This supervisory agency should not be in charge of regulatory functions of infrastructure firms, e.g. utilities. In Ukraine, there is a need to revise the role of the State Property Fund (SPF). The SPF's mandate should include both management of state shares and privatization of state equity. In performing its share management function, the SPF would be accountable for the value of state shares in SOEs. In organizing privatization, the SPF's goals would give priority to maximization of sale proceeds. To facilitate a commercial orientation of the SPF, it should report to the government and not to the Rada. The state interests in SOEs should be exercised through the appointments by the SPF of SOE board members and the control of the Board. The SPF should have broad authority to perform its share management and share sale functions and should have sole authority to vote the State's shares at SOE annual shareholder meetings and to make SOE director appointments (proportional to the State's shareholding). This would be consistent with a non-political, commercial, and professional approach to the efficient use of state capital.

(c) **Role of Board of Directors.** The Board of Directors of each SOE serves as intermediary between the state and the enterprise managers. It protects state investments by ensuring management performance and accountability. It ensures an arm's-length relationship between the government and the state enterprise. To be effective, the by-laws of the enterprise should clearly spell out the objectives, responsibilities and authority of the board. Government officials should be barred from serving on the boards, to avoid political interferences in management. Some countries that have succeeded in increasing the efficiency and effectiveness of state-owned firms (e.g., New Zealand) have gone so far as to recruit board members not only from the private sector, but also from abroad. In an effort to reduce the political influence on board members, New Zealand directed board members to serve only the interests of the enterprise, and they linked board member compensation to firm performance.

(d) **Management Arrangements.** State enterprises should develop management arrangements that generate a combination of "returns and risks" similar to those confronted by private enterprise managers. In many cases, governments have introduced "private-public partnerships" (PPPs) that try to increase efficiency by bringing in private personnel as managers and financiers, but not as full owners of equity. The following PPP management arrangements have been used: (i) performance contracts, (ii) management contracts; (iii) leasing; and (iv) concessions. They are presented in the order of the amount of risk and control assumed by the private provider, with performance contracts at the low end, and concessions at the high. (Of course, full assumption of a majority stake of equity is the highest level of risk-control.)

(i) **Performance Contracts.** These are contracts between governments and managers that are "public" employees. The contracts specify the goals and results that should be achieved by the enterprise during a time period, normally one year, but sometimes longer. These results may include a given level of profits, a level of exports, service levels, timing for implementation of internal investments, etc. These goals are measured quantitatively. This requires the elaboration of transparent information systems, based on international accounting standards. Managers are often given increased power of hiring, firing and promotion of employees, control of production, procurement and maintenance, planning of capital investments, and preparation of work programs and budgets. Managers would be compensated in accordance with the results achieved, which are normally evaluated by independent auditors. Management compensation is normally in the form of a monetary bonus at the end of the year. If there is a consistent lack of positive results, managers could be separated. These performance contracts have been used by many countries (such as France, New Zealand, Romania, Pakistan, China, and South Korea) with uneven degrees of success. One of the major drawbacks is that there are clear limits to the potential gains for managers. Therefore the incentives for good performance are not comparable with the incentives enjoyed by private managers. Furthermore, governments find it difficult to fire poor managers since they are "public" employees. Finally, these performance contracts often fail because governments do not honor their side of the bargain. That is, they deny managers the right to hire and fire, to change suppliers, to end product lines, to change locations, etc.

(ii) **Management Contracts.** Management contracts are contractual arrangements between the government and "private" managers to operate the state enterprise. These private managers are compensated with a fixed fee plus, often, an incentive bonus whose size depends on performance. Therefore, this arrangement also involves the preparation of performance agreements, with specific goals and result targets. The achievement of these performance agreements sets the basis for the compensation of private managers. The main difference (and main advantage) compared to the previous performance contracts is that these private managers would be contracted on the basis of competition among outside experienced bidders (and selected based on their qualifications) and would be contracted only for a limited period of time, normally three to five years. At the end of this period, the management contract would be put to open competition or could be renewed depending on meeting agreed upon performance targets. Another advantage of this management arrangement is that it provides a lot of flexibility to the state. The state has the option to change the scope of the work of the management contractor, with little need to renegotiate the agreement. The state, through its Board of Directors, retains full control. Management contracts have been extensively used in the hotel sector, banking, food processing, sugar plantation, cement, mining, electricity, water supply, oil and gas, telecommunications, airport services, etc. in countries around the world, such as Poland, Romania, Colombia, India, Philippines, Sri Lanka, and many African countries.

(iii) **Leasing Arrangements.** Under this management arrangement, the private manager is not compensated simply by a fee/bonus, which is the case under management contracts. On the contrary, in a leasing arrangement, the private manager pays a fee to the government. But the private manager keeps the profits of the enterprise, and is responsible for maintaining the health of the assets during the period of the lease, often five years or more. The state is responsible for new investments. But the revenue risk/return is transferred to the private operator. Given the incentives that the private managers have to increase profitability, this arrangement is closer to the risk-return profile faced by private sector companies. If the enterprise is unprofitable, he still needs to pay the fee to the government. But, on the other hand, there are no limits to the profitability it could enjoy. This type of leasing arrangement has been used in many countries. One advantage is that it provides significant incentives to the managers to perform. Under this scheme, the state has little control over the operations of the enterprise and is not active in the management of the company. Experience shows that leasing arrangements work better when the manager has an equity share, or at least an "option to buy" in the company. The problem with the lease is that toward the end of the lease period, if the lessor is not interested in renewal, he/she has an incentive to neglect the assets, run them down and take whatever can be gotten before departure. Careful construction and monitoring of the lease by the government is required. Leases are very common in a variety of manufacturing sectors and have been applied worldwide. They have also been used by water/sewerage companies in places where concession arrangements (described below) are hard to install; e.g., sub-Saharan Africa.

(iv) **Concession Arrangements.** A concession is a broader form of lease, wherein the "concessionaire" is given long-term control of an enterprise, and is responsible for the operation of the firm, and the health of the assets. Moreover, they are often given responsibility for investments in the firm and expansion of the service. They are widely used in infrastructure provision, e.g. water and sewage, electricity, railroads, telecommunications, ports, etc. By selecting a service and asking for private sector bids to manage and run the firm, governments can obtain competition for a market, even when there is little or no competition in the market. The concessionaire therefore has a strong incentive to increase revenues and minimize costs. A share ownership in the company will also increase the motivation of the manager to perform better. The state receives the rest of the revenues (after payment of the concession fee) and, sometimes, responsibility for long term investments. Normally a concession agreement is for extended periods of time, usually 10 to 30 years. Concessions have been widely used in the US, France, New Zealand, all over Latin America (Argentina, Chile, Mexico, Brasil, Bolivia, Peru, Costa Rica), and have spread widely in recent years into Asia and Africa. They have been used extensively in utilities and railways. Concessions are subject to the same problems as leases. There is also the "incumbency" issue. This means that at the end of a 20 or 30 year period of management, when the government may wish to rebid the concession to see if it can attract more efficient or lower-cost operators, the concessionaire is usually in a strong position to defeat any competitor due to insider knowledge, control of the information stream, experience and connections, etc. Despite the problems, concessions are likely to be the option of choice for many governments that wish to retain legal ownership of infrastructure assets, but are in need of the increased efficiency a private operator usually provides.

Attachment

International Experience in Management of State Equity in State Enterprises

International experience suggests that the common feature of successful management of state-owned enterprises (SOEs) is a clear distinction between the rights and the responsibilities of the government and those of the state enterprises. The government should ensure the efficiency of the institutions managing state equity. As a shareholder, the state must implement effective reporting and controls systems, emphasize strong boards for its SOEs, and follows best commercial practices. But the actual management of the SOE should be done by fairly autonomous entities working under clear performance targets. Although the systems of effective management of SOEs used by individual countries differs significantly from case to case, a strong commercial orientation approach is a condition of each successful system. Below are examples of some country cases.

New Zealand

In New Zealand, state enterprises are run as autonomous commercial entities with independent boards of directors. The shares of each state enterprise are divided between the Ministry of Finance and different sector ministries. The SOE Act regulates the relationship between the state and the SOE's boards. At the same time, the relationship between the SOE's board and its management follows commercial practice.

SOE directors are legally bound to act only in the SOE's best interest. They report to two shareholding ministries, which are accountable to parliament. The board appoints the chief executive officer (CEO) and senior management of the SOE, determines strategy, makes decisions on large investments and dividend changes, ensures that the Statement of Corporate Intent complies with existing regulations, sets management compensation, and approves financial statements.

New Zealand's Crown Companies Monitoring Advisory Unit (CCMAU) supports two shareholding ministries in overseeing each of New Zealand's 16 SOEs. Set up in 1993, this advisory unit is owned by and administratively linked to the State Treasury. For example, the Secretary of the Treasury appoints the CCMAU's executive director. But the CCMAU is operationally independent and functions like a private consulting business. It has separate purchase agreements with each shareholding ministry to consult with the ministry of SOE issues. Many of the CCMAU's consultations are oriented toward balancing SOE profit maximization goals against broader social goals.

Norway

The Norwegian government owns and regulates only a few SOEs, of which the biggest is Statoil. Statoil owns and exploits the country's oil resources. The Ministry of Energy ensures that exploration and production conform to official resource policies. However, legally the state has no power over Statoil other than the shareholder rights it exercises at annual general meetings. By law, the directors and CEO of Statoil have a fiduciary duty to the company and all shareholders. Each manager of the company is individually liable for any damage caused to the company. The compensation of the management is based on the company's performance.

Sweden

There are 59 SOEs registered in Sweden. These enterprises produce about 7% of the Swedish GDP and secure 5% of the country's total employment. The largest SOEs include holdings in telecomm, the energy sector, armaments, paper and pulp, the pharmaceutical industry, and transport.

In Sweden, governance of SOEs reflects the division of labor set out in the Swedish Companies Act, with the board of directors responsible for providing oversight and guidance and the managing director in charge of day-to-day administration. The managing director is appointed by the board and accountable to it. His compensation is fully dependent on the SOE's performance. Some matters, such as company closures and dividend policy, are considered a part of normal administration. This is a prerogative of the government and the SOE board. All other matters (i.e., changes in SOE ownership or capital) are considered a disposition of state property and require consultation between the government and parliament.

The Swedish Ministry of Industry, Employment, and Communications administers the country's SOE. The Ministry has a special division with a staff of 13 people staff in it, which is responsible for such administration. The team of this division includes 7 senior investment managers, 3 analysts, 2 assistants, and a director. Responsibility among senior investment managers is divided according to industry sectors in order to encourage focus and understanding of each holding. For example, the senior investment manager responsible for transport holdings maintains contacts with relevant bankers and consultants, tracks global competitors, etc. Senior investment managers also represent the state shareholder as a non-executive director on SOE boards.

Poland

Poland's 512 SOEs were assigned to 15 national investment funds (NIFs) for management supervision and control. These SOEs include those that had not yet been privatized, were in the process of being sold, or were deemed in urgent need of restructuring. Each NIF became the lead shareholder in SOEs by receiving 60% of shares, while the remaining shares were distributed among the state treasury (25%), and enterprise employees (15%).

Management of each NIF was outsourced to professional asset managers based on the results of a public tender. NIFs were expected to reorganize the supervisory boards of portfolio companies and take a number of steps to turnaround SOEs in their portfolio. The portfolio of SOEs, which these NIFs inherited, were relatively distressed and in need of restructuring. Unfortunately, the NIFs were not particularly effective in driving the operational restructuring of distressed corporations. Needed operational restructuring included some very painful measures (such as sales of non-core assets, discontinuation of unprofitable products/services, plant closures, and workforce reductions) which the NIFs were unable to carry out, principally for political reasons. The lack of a strong legal mandate and political interferences were the main causes of the failures.

Singapore

The SOEs in Singapore are fully incorporated and controlled by a holding company, the emasek Holding. The Temasek Holding has shares in 20 major companies with a market capitalization of $55 billion (about 20% of the country's market capitalization.) These major Temasek companies produce around 12% of Singapore's GDP. Temasek Holding is a relatively small company. Its Corporate Division, which manages the company's portfolio, has a staff of 53 people. Its annual operating cost is less than $30 million.

The Temasek Holdings was established in1974 and is fully owned by the Ministry of Finance of Singapore. The ministry appoints the chairman and members of Temasek's board. Every year, Temasek submits audited financial statements to the ministry for review. Every six months, the Ministry of Finance schedules meetings with Temasek executives to discuss the Holdings' performance.