

Everything about State-Owned Companies.

Reducing Corruption through Competitive and Transparent Privatization

Analytical Commentary

Author: Eugen Ghilechi

October 2018

The Role of State-Owned Companies

State-owned companies are entities through which the Government assumes the role of an active player in the economy. The Government can set up companies to achieve various objectives, such as providing a public interest service, managing resources in an industry prone to natural monopolies, investing in a strategic sector for the economy, etc. Due to various objectives that state-owned companies seek to achieve, their monitoring should be rigorous, going beyond the framework pursuing of profitability or loss, paying particular attention to the global value they create in society. Therefore, it is crucial to create a set of performance indicators, that are specific to the activity of each enterprise depending on the industry in which it operates and the strategic objectives that have been established by the founding institution. In addition to the financial sustainability of the company, these indicators could focus on the quality of the delivered service, level of citizens' satisfaction, environmental aspects, etc. A step forward in this direction was the adoption of the new Law on State-Owned Enterprise and Municipal Enterprise in November 2017¹ that established the need to develop performance indicators for state-owned enterprises, which had not existed until then.

The proximity of state-owned companies to policy makers fuels the risk of corruption in these entities. Appointing politically-affiliated persons in management of companies leads to political clientelism, in other words – by controlling companies 'fulfillment of the narrow interests by political parties'² takes place. A recent analysis shows that only 1% of the members of Boards of Directors of the largest state-owned companies are professionals, the rest being delegates from ministries and other founding institutions and representatives of companies³. According to the data of the Public Property Agency, in 2016 state-owned companies and joint-stock companies in which the Government holds at least 25% of the shares had assets

¹ Law No 246 of 23.11.2017: <http://lex.justice.md/index.php?action=view&view=doc&lang=1&id=373351>

² Budianschi, 2012 <https://www.expert-grup.org/ro/biblioteca/item/675-clientelismul-politic-manifestat-prin-%C3%AEntreprinderile-cu-cot%C4%83-de-stat-%C3%AEn-republica-moldova>

³ <https://www.expert-grup.org/ro/>

worth over MDL 53 billion (39% of GDP) and collected revenues of MDL 27 billion ⁴ (20% of GDP)⁵. However, high revenues do not necessarily mean that these companies are highly profitable. During 2013-2016, the aggregated value of losses of the state-owned companies amounted to over MDL 3.5 billion⁶.

The poor performance of state-owned companies could be also viewed as a tax on citizens, because if losses are perpetuated, companies need financial support from the state budget. On the other side, increasing profitability should not be the main objective of state-owned companies; it is only important that they generate some profit to have operational independence and flexibility in decision-making to achieve their performance indicators. Due to the difficulty of maintaining this balance, it is preferable for the Government to limit its participation as an active player in the private sector.

Corruption and political clientelism can be reduced in state-owned companies by implementing a comprehensive set of actions that include, amongst others: (i) limiting the role of the Government to setting up objectives for the companies it owns and delegating members to boards of directors, without subsequent involvement in daily work (ii) applying the best principles of administration and transparency, in strict compliance with the law on disclosure of information, (iii) establishing rigorous criteria and implementing transparent procedures for board members selection, with a focus on raising professionalism of boards (iv) establishing external state audits, independent of the internal audits carried out by companies, (v) making it mandatory for enterprises to develop Corporate Governance Codes, (vi) enhancing the responsibility of enterprise management, by limiting the possibility to hold the position if previously established performance indicators are not achieved repeatedly. Taking into account the complexity of these actions, the slow speed at which the Government usually implements reforms, as well as lack of political interest in many of them, privatization is an alternative solution to fight corruption and increase the efficiency of the state-owned companies.

Which companies should be privatized and how the process should be carried out?

Privatization of state-owned companies should not be seen as a panacea for solving all problems in these entities. International evidence supports this hypothesis: privatizations are successful when they are done in an appropriate competitive environment and have specific objectives⁷. Privatization could have different objectives: moving to a market economy, eliminating inefficiencies within companies, reducing tax pressure in case of loss-making companies, etc. The privatization process started in the 1990s in post-Soviet countries aimed at transition from planned economy to a market economy. Analyzing the list of nearly 120 enterprises and companies put up for privatization by the Government, it seems that Moldova is still in the transition phase⁸. Lack of success, demonstrated by the low number of privatizations carried out over the

⁴ <http://date.gov.md/ckan.ro/dataset/15184-rezultatele-activitatii-economico-financiare-ale-s-a/resource/e5822861-0b7c-47ce-afee-3b01ee6b73c9>

⁵ Statistics, <http://www.statistica.md/category.php?l=ro&idc=191&>

⁶ <https://www.expert-grup.org/media/k2/attachments/yantreprinderile-de-stat-La-Punct.-Despre-glurile-negre-ale-economiei-moldoveneuti.pdf>

⁷ https://assets.publishing.service.gov.uk/media/57a08977ed915d3cfd000264/Topic_Guide_Privatisation_Nov.pdf

⁸ According to the Government's list of assets put up for privatization, the authorities are ready to privatize nearly 120 enterprises and companies in which they hold a stake. This list includes large companies, such as Barza-Alba, Tutun-CTC, Red-Nord, Red-Nord-Vest, Air-Moldova Company, MoldTelecom, and small enterprises, some of which are not operating:

<http://www.app.gov.md/ro/advanced-page-type/bunuri-supuse-privatiz%C4%83ri>

past years, emphasizes the need to rethink the objectives and process of state-owned companies privatization.

At the global level there is consensus that states need both, strong public and private sectors. In particular, the presence of the state is welcome in sectors that are prone to natural monopolies. These sectors require massive investment in infrastructure, the number of potential players able to make them is very small. Therefore, maintaining a state monopoly in sectors such as distribution of electricity, water resources, etc. is not regarded as a policy against market economy, but is rather interpreted as Government's intention to maintain the quality of basic services delivered to citizens. However, if enterprises operating in natural monopolies are privatized, it is important that authorities implement tariff setting and production policies that will not allow maximizing profits, resulting from the monopolistic position, to the detriment of public welfare.

Information Box: What goals can be achieved by privatization?

Case study: IS 'Transport' and SA 'Telecomunicatii'	
<i>An imaginative exercise with two hypothetical companies to highlight the objectives that could be achieved by privatizing state-owned enterprises</i>	
'Transport' State-Owned Enterprise operates in the transport sector and is known for operational inefficiencies. Its staff does not meet the needs of the company, many of whom are retained in their positions in exchange for support provided to the governing political party. In addition, procurements made by the enterprise raise some questions, enterprise's largest suppliers are companies owned by government-affiliated persons. Enterprise's Board of Directors is dominated by people from the founding ministry; which, in turn is led by a party member. 'Transport' is often in a more advantageous position compared to its competitors, as the sector's supervisory authorities are more indulgent towards its violations than the violations of its competitors from the private sector. The obvious political clientelism in multiple areas has a negative impact on its performance. The enterprise has been generating considerable losses for a number of successive years. Despite this fact, managers are not removed from office and are not even required to present any rehabilitation strategies. In order to prevent the company's bankruptcy, the Government decided to increase its share capital, reallocating a considerable portion of the funds, which were previously provided for infrastructure development projects.	The joint stock company 'Telecomunicatii' was formed as a result of the privatization of a state-owned telecoms enterprise. Prior to privatization, the investor made a detailed assessment of company's assets and financial statements, as well as a market analysis, identifying considerable growth potential. After a competitive privatization process, new owners undertook a range of reforms, namely: - replaced company's management, bringing competent people with experience in the field of telecommunication; - dismissed some of the staff that did not correspond to the job description, increasing the average salary for the qualified staff remaining in the company; - introduced customer satisfaction rating mechanisms to increase service quality and implicitly the ability of company to compete with the strongest competitors; - invested considerable resources in company's technological modernization in order to become the company with the largest market share. As a result of privatization*, the Government received a sufficient amount of money, some of which will be used to digitize all public services. At the same time, as a result of the privatization, the ministries' human resources, which were previously

involved in monitoring the enterprise's activity, were redirected to the public policy-making process.

**Between 2016 and 2017, the Government received about MDL 1.4 for each MDL 1 of assets owned by privatized enterprises.*

Although hypothetical, this case study highlights that a number of objectives can be reached through privatization, which impact both the authorities and the society, as a whole. Among the objectives we can include: improving market competition and resulting lower prices for goods and services; increasing the quality of services provided to the population; streamlining Government spending and releasing resources to invest in strategic projects.

So broadly, privatization contains two important stages: identification of areas where the Government wishes to be present in the economy and the privatization process per se. The first phase must include an inventory and assessment of public assets to determine which companies should be privatized and where the presence of Government is absolutely necessary. This could be the case for enterprises that operate in natural monopolies, provide services of public interest or fulfill some non-commercial objectives. Among others, the inventory should identify companies that are managed inefficiently, these having the biggest chances to be privatized. Taking into account that the Government is negotiating privatization with representatives of the private sector, the latter inevitably need an incentive to invest in public companies. In other words, privatization will be successful when state-owned companies which operate inefficiently, including due to corruption and political clientelism, once handed over in private hands can deliver goods and services in a more efficient way than the State. A successful privatization can have positive results for both citizens and authorities. In a competitive environment, citizens can benefit from higher quality goods and services at lower costs and the Government can obtain resources that can be directed to other initiatives (Information Box).

Subsequently, special emphasis must be paid to the privatization process, that can be an important source of corruption. In the context of a weak institutional framework, there is a danger of privatizing enterprises at a price lower than the real value of companies' assets. In order to mitigate this risk, it is vital to approve a well-defined strategy that includes, inter alia, the following:

1. **The time frames and objectives of the privatization process must be established in advance**, and the responsible institution should be empowered with sufficient tools to carry out this process in an independent manner, imposing at the same time clear conditions of objectivity and transparency.
2. **Transparent communication with the public is a key element in the privatization process.** The announcement of privatization should be communicated clearly by inviting stakeholders for a constructive discussion on this process (including employees, potential investors, beneficiaries among citizens, authorities). Preliminary announcements, communicated in an efficient manner, could provide an incentive for investors to analyze their investment potential. At the same time, the disclosure of information also refers to the publication of valuations for each company subject to privatization. World Bank studies on privatization in emerging countries prove that in order to

achieve higher returns, the valuation and establishment of the minimum price for which a company may be privatized should be outsourced to competent institutions⁹.

3. **In order to reduce the risk of privatization below market price, some states created inter-ministerial committees in charge of approving the minimum threshold for which companies could be privatized**¹⁰. As a rule, the involvement of too many institutions in the privatization risks to reduce the dynamics of the process. However, this element could be essential to mitigate the risk of companies being seized by power-related parties.
4. **Communication with private investors.** Due to the lack of an efficient capital market, privatizations via the capital market are not a realistic option, and the method of attracting private investors is more advantageous. Under these circumstances, special efforts should be devoted to communicating with private investors, both from within the country and from abroad. For the privatization of large companies, the Government could hire consulting companies or investment banks experienced in asset sales to ensure effective mediation with potential investors. Such companies usually have sufficient knowledge and a network that can be used to raise the interest of investors, who otherwise wouldn't have manifested any interest.
5. **A thorough analysis of potential buyer's profile.** In order to ensure the continuity of goods and services delivered by companies subject to privatization, also taking into account the large number of staff they employ, it is important to carry out a preliminary analysis of potential purchasers. At the same time, privatization-related negotiations should result in a set of commitments that the buyer will assume in case of privatization.
6. **Improving the business environment.** A privatization can have remarkable results when it is part of wider efforts to improve the business climate and competitive environment.

Maintaining the status quo when the Public Property Agency repeatedly and consistently puts up more than 100 enterprises for privatization without visible results is not an efficient privatization model. These companies use scarce public funds and resources for purposes that otherwise might not be a priority for citizens. Privatization could release some of these funds, which could be allocated to important objectives, such as education, health, infrastructure, etc. In order to reduce the pressure on the public budget and to allow a more efficient allocation of resources, while limiting corruption in state-owned companies, a re-evaluation and relaunching of privatization is required. At first stage, it must include an assessment and inventory of all public assets, defining Government's objectives in terms of the active role it wants to have in the economy. The Government could maintain an active role in industries prone to natural monopolies or in areas of public interest, where delivery of services does not always involve economic benefits, but rather follows social objectives. Lastly, an active, transparent and dynamic privatization process that adheres to principles of communication, transparency and objectivity must then be implemented.

⁹ <http://documents.worldbank.org/curated/en/571161468740204469/pdf/multi-page.pdf>

¹⁰ <http://documents.worldbank.org/curated/en/571161468740204469/pdf/multi-page.pdf>