Georgian Young Lawyers' Association

Combating Corruption by the Increase of Transparency and Accountability in Public Expenditures

A Review of International Experience of State Owned Enterprises, and what Management Models and Strategies Reduce Corruption

Report

COMBATTING CORRUPTION BY THE INCREASE OF TRANSPARENCY AND ACCOUNTABILITY IN PUBLIC EXPENDITURES

A REVIEW OF INTERNATIONAL EXPERIENCE OF STATE OWNED ENTERPRISES, AND WHAT MANAGEMENT MODELS AND STRATEGIES REDUCE CORRUPTION

REPORT

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Kingdom of the Netherlands

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PROJECT DESCRIPTION & OBJECTIVES

This project was instigated in order to investigate ways of combatting corruption in State Owned Enterprises (SOEs) and to analyse specifically a number of factors, including:

- What criteria normally exist for an enterprise to be established?
- What type of enterprises are normally established by the state?
- What are typical management models and strategies for these enterprises?
- Which sectors are these enterprises normally focussed around?
- How are such enterprises regulated?
- How accountable and transparent are the enterprises?

It is recognised that many SOEs operating around the world are run and regulated in a very different way to privately operated companies, even those in the same countries. It is also true that it is the command economies and less well developed economies globally that often have a much higher percentage of state owned enterprises than do the more developed economies.

Perhaps the most important factor, and the primary focus of this report, is how all those different elements play a role in the undeniable fact that SOEs are often much less transparent and therefore often much more susceptible to corrupt practices than commercially run organisations.

The objectives of the research undertaken for this report are to better understand how state owned enterprises are operated and regulated around the world and then to analyse what lessons can be learned and how best to transfer best practises.

The information obtained, and the recommendations made, will enable Georgia to further improve the running and regulation of the SOEs in the country and, in so doing, to assist with continuing to reduce corruption in the sector and Georgia as a whole.

OVERVIEW

The supranational organisations that have done the most research into SOEs and issued the largest amount of guidelines and recommendations are the Organisation for Economic Cooperation and Development (OECD), the World Bank, and Transparency International. In addition many other institutions such as PricewaterhouseCoopers (PWC – the largest professional services firm in the world), and Global Integrity have also conducted much research into the sector over the years. Overall, SOEs play a significant role in the economy of many countries but are also often in need of reform.

There are three definitive works on the SOE sector that form the base of research into SOEs and are most often quoted in other research, and this report will also use data obtained from them. These research papers are: OECD Comparative Report on Governance of State Owned Assets (2005); OECD Guidelines for the Corporate Governance of State Owned Assets (2005); and World Bank, Held by the Invisible Hand – The Challenge of SOE Corporate Governance for Emerging Markets.

Each of these papers have been updated in parts,some on an almost annual basis, and have resulted in other research being undertaken. However, they still form the core of the knowledge and thus the basis of approach that leads to the spreading of international best practice in running and overseeing SOEs worldwide.

State Owned Enterprises are held in many different formats through many different structures around the world but the generally accepted definition of a State Owned Enterprise is the one given by the OECD which states:

"Enterprises where the state has significant control through full, majority, or significant minority ownership. In this definition we include SOEs which are owned by the central or federal government, as well as SOEs owned by regional and local governments"

As well as State Owned Enterprises, these organisations are often known by many other names including: government corporations; government business enterprises; government-linked companies; parastatals; public enterprises; public sector units; and many others.

The Oxford English Dictionary defines corruption as:

"Dishonest or fraudulent conduct by those in power, typically involving bribery"

A more specific definition in the context of this report is given by Transparency International which classifies it as:

"Corruption is the abuse of entrusted power for private gain. It can be classified as grand, petty, and political, depending on the amounts of money lost and the sector where it occurs"

Transparency International is the globally recognised independent international body that was established in order to fight corruption around the world in all its forms. The main tool that it uses to do this is in encouraging governments and organisations to become more transparentin every way,and its Mission Statement states:

"Transparency means shedding light on shady deals, weak enforcement of rules and other illicit practices that undermine good governments, ethical businesses and society at large"

The information used to write this report is the most recent and relevant available. However, due to the nature of the topic and the difficulty in obtaining information for the underlying research, this information can at times be some years old. Whilst this may alter any specific numbers quoted and not allow for the most recent trends to be reflected it is not considered to materially affect in any way the findings of this report or the underlying recommendations made on increasing transparency and the reduction of corruption.

By way of benchmarking, specific information will be used for the SOE sector in Georgia as well as for other countries around the world.

WHY DO SOES EXIST AND WHAT CRITERIA IS NEEDED?

State Owned Enterprises exist for a range of different reasons from defensive or protectionist through political and social considerations, to developing strategic sectors and boosting the national economy. Some SOEs can be purely politically motivated whilst at the other end of the spectrum can be SOEs that are purely financially motivated. Clearly this varies from one country to the next and often the higher the number of SOEs that exist in any one country the more politically motivated the decision making process is.

SOEs are, in general, far more prevalent in command economies and emerging markets than in more advanced or capitalist economies. The concept of the state directly controlling companies and dominating the economy, or even a specific sector, is far more in keeping with the communist ethos than with capitalism.

In the majority of countries these enterprises have always been in state control either for economic reasons or due to the non-capitalist approach taken by the governments. State ownership remains more significant in middle and lower income countries than it is in more developed economies despite the majority of emerging economies having sold off large numbers of previously state owned enterprises over the last 20 to 30 years.

It can be said, therefore, that in many cases SOEs can be seen as a legacy from the past, as the world's economy moves ever more towards a capitalist model as even those countries that still have a predominantly communist ethos adopt a more market approach to the economy. The majority of SOEs themselves are also legacies of former structures with many more being sold off, at least in part, in some way than are being created. There is, however, a pattern to which sectors are either still being retained or are the focus of any new SOEs being established in more recent years.

Second only to the ideology of the government in power for the main reasons behind state ownership is the idea of protecting certain industries or sectors from potential foreign influence for a number of differing reasons. It is these sectors that are being retained or form the core of any new SOEs being established. These can typically be classified into three sections:

- Defence Related. This may be in companies directly or indirectly involved in the defence industry and their direct government ownership is seen to be crucial to the defence of the country. It is worth noting, however, that in the more capitalist and advanced economies even these companies are normally no longer state owned.

- Major Infrastructure and Public Services. Many countries that have no SOEs in the traditional commercial or manufacturing sectors do retain companies that are seen to deliver crucial public services and other related activities. These would typically include: the primary sector such as the oil and gas sectors and mineral extraction; public utilities such as the provision of energy and water supply; transportation such as the rail networks and bus services; media including television, radio, and often the press; telecommunications; and often the major banks and other companies involved in financial services.
- Supporting Manufacturing and Jobs. Government ownership of large manufacturing companies can provide financial support that otherwise might not be available or other protection such as import tariffs on certain goods. In supporting these industries it is possible for governments to run the businesses at a loss but ensure the employment of large numbers of people. This ownership or support can be either temporary in times of crises or simply part of the government's strategy. Industries that this applies to are typically heavy manufacturing or capital intensive such as steel, shipbuilding, aerospace, vehicle manufacturing, textiles, and even tourism and leisure.

The establishment of SOEs was originally often also seen as being more effective than simply trying to regulate and control privately owned businesses. However, there have now been so many examples of how poor government control and oversight of SOEs can be when owned directly, that this rather negates the original argument.

Indeed, the countries that have virtually no SOEs can demonstrate that in the majority of cases the companies are operated in a far more efficient manor, with better utilisation of financial and other resources. In addition, it can be seen that any regulation required can in fact very easily be applied by the government without the need to retain direct control.

The World Bank 2006 report entitled 'Held by the Invisible Hand – The Challenge for SOE Corporate Governance for Emerging Markets' states that at its peak SOEs accounted for 20% of output in Africa, 12% in

Asia, and 10% in Latin America and in some sectors, such as banking, the share was often over 50%.

The World Bank research, however, provided clear evidence that the performance of SOEs in general had been disappointing or worse. "SOEs have tended to be less productive than their private sector counterparts and have been used by politicians to create patronage and reward their supporters. In the process, SOEs have diverted resources from both the private sector and other state priorities. The need to find resources to prop up failing SOEs has also distorted financial systems and monetary policy, at time contributing to wider macroeconomic crises".

Such comments from such a well-respected institution after extensive global research is indeed a damning indictment on the SOE sector.

Perhaps the most common reason that many advanced economies decide to nationalise existing business and take them into state control is in time of economic need of a company or sector. During the 2008/9 economic crises, for example, many governments decided to intervene in order to prevent the collapse of certain companies, primarily in the financial services sector because of the impact such failures would have on the economy as a whole. There were many other companies that were saved and these were almost entirely for the reasons stated in the points above. What is of importance in these situations is that the governments see the action as temporary as they wish to re-privatise the company again as soon as practical, and that there is often no specific criteria or plan for the creation of an SOE as it is action that is taken in response to an emergency.

WHAT TYPE OF ORGANISATIONAL STRUCTURES ARE USED?

The type of structure used varies tremendously between countries and indeed between sectors. This is partly for historic reasons and partly for practical reasons. The most complete database on SOEs is compiled by the OECD, with the most recent dataset publically available being for 2012. Using some of the data from specific countries in this database can be very revealing as it demonstrates very clearly how big the variance can be from one country to the next.

As stated elsewhere in this report, the number of SOEs and the number of people employed by them, indeed the total scale of the SOE sector in the economy as a whole, is often related directly to whether the country has – or has had in the relatively recent past – a command economy, and how mature the economy is.

The examples taken for this report from the OECD 2012 database are Latvia, Hungary, Poland, United Kingdom and USA. The first three (Latvia, Hungary, and Poland) have less mature economies and over the last 25 years have undergone large privatisation programmes as part of the transition process from having had a command economy to moving towards a more capitalist approach. The last two (UK and USA) have well developed, mature economies.

The tables below show the total number of institutions for each country and in what type of structure they are held, as well as the number of employees in each type of structure.

Latvia

	Enterprises	Employees
Majority owned, listed	0	0
Minority owned, listed	1	32
Majority owned, non-listed	74	52,240
Other corporations	0	0

Whilst Latvia only has a small population it can be seen from the table above that the number of SOEs and employees in them is very small, demonstrating how effective the privatisation programme has been over the years. The enterprises still majority owned are predominantly in finance, telecoms, energy and other utilities, transport, and real estate.

Hungary

	Enterprises	Employees
Majority owned, listed	1	1,920
Minority owned, listed	2	40,401
Majority owned, non-listed	370	123,004
Other corporations	0	0

The majority of employees working for SOEs are employed in the primary sectors, manufacturing, energy and other utilities, and transportation.The company which is majority owned but listed is RABA Automotive Holdings (73%). RABA is a vehicle / vehicle components manufacturer and the purchase by the government in 2011 was a strategic move to strengthen its involvement in the sector.

Poland

	Enterprises	Employees
Majority owned, listed	6	36,074
Minority owned, listed	10	64,525
Majority owned, non-listed	295	117,738
Other corporations	25	5,918

Poland has a much broader involvement in SOEs than the other countries highlighted here from the OECD database. The majority owned, listed companies are predominantly in the primary sectors whilst the minority owned, listed companies are in the finance industry even more than the primary sectors. However, the majority of employees working for SOEs do so in majority owned, unlisted companies and these are predominantly in the primary sector, manufacturing, energy and other utilities and transportation sectors.

The companies which were majority owned but listed were: ENEA (52%); JastrzebskaSplokaWeglowa (55%); GrupaLotos (53%); PGE PolskaGrupaEnergetyczna (62%); PolskieGornictwoNaftoweiGazonwictwo (72%), and; ZakladyAzlowePulawy (51%). Three of these companies are in the primary sector, two in energy and one is a chemical company.

United Kingdom

	Enterprises	Employees
Majority owned, listed	1	137,200
Minority owned, listed	1	97,091
Majority owned, non-listed	11	16,804
Other corporations	5	178,597

It is worth noting that both the listed enterprises are banks that were non state owned but were rescued during the financial crises in 2009 and the UK Government has already divested the majority of its stake in one of the banks and has publically stated that it will sell all of its shareholding in both institutions as soon as is practical. The UK Government owned 65% of the Royal Bank of Scotland Group. Outside of temporary involvement in the finance sector, the majority of employees are employed by one utility company.

USA

	Enterprises	Employees
Majority owned, listed	2	1,045
Minority owned, listed	2	214,490
Majority owned, non-listed	1	20,000
Other corporations	16	577,965

The vast majority of employees working for SOEs in the USA do so in just two organisations. The companies which were majority owned but listed were two banks, Carver Bancorp (63%) and Independent Bank Corporation (84%). In addition one of the minority companies was General Motors that was rescued as a result of the 2009 financial crises and has since been sold off back to the private sector and the other is in the utility sector.

When SOEs are listed, whether the government has a majority or a minority stake, they are always subject to much more stringent transparency, reporting and corporate governance requirements. These requirements generally ensure that listed SOEs perform very much like any other non-state owned company and are run on a profit driven, commercial basis by qualified and professional management. Listed SOEs are, however, only a very small percentage of SOEs as the tables above demonstrate. Listing an SOE can therefore be a very good way to encourage complete transparency but then an argument exists for why should the state retain any ownership at all in such a company when experience suggests that regulation can achieve the same results.

In a recent study, the OECD estimated that in developed economies the state held a stake in companies that represented 6% of the total market capitalisation, whilst in emerging economies this could be as high as a quarter of the total market capitalisation. It was also expected to rise as more governments seek to sell majority stakes in SOEs but whilst retaining a minority stake rather than making a complete divestment.

In countries that have undergone large privatisation programmes, generally the newly privatised companies are run much more efficiently and profitably than when under state control. Governments would typically sell part of their ownership in a company initially and then sell the rest at a later stage. With utility and other such companies that are required to provide certain services on a subsidised basisto certain segments of the population the government needs to agree alternative subsidies to the company in order to compensate them in their role as a commercial company that is nevertheless expected to perform certain social roles.

There has also been a growing trend in recent years for governments to 'recycle' capital by privatising one or more existing SOEs in order to raise funds which are then reinvested into existing SOEs or in establishing new ones or even to assist with funding major infrastructure and other capital intensive projects.

According to both the OECD and the World Bank, SOE ownership and control can be categorised into three formats, namely centralised, decentralised and dual ownership:

- Centralised Ownership. This is where just one government body, typically a ministry but perhaps a holding company, is responsible for all the stakes in all the SOEs held by the government.
- Decentralised Ownership. With this model different ministries or holding companies oversee different SOEs, most commonly on a sector by sector basis.
- Dual Ownership. Here, one ministry such as the Ministry of Finance would oversee certain ownership functions for all the SOEs but other functions would be performed for different SOEs by different ministries, again often on a sector by sector basis.

The differing models each have advantages and disadvantages and indeed often become more or less favourable over time. It can be argued that the centralised ownership approach is better for creating a highly competent staff and structure that are better able to run and regulate all the governments SOEs in such a way that makesthem both more efficient and avoids potential conflict between different ministries with differing goals. They typically also have a stronger financial orientation given that it is easier to assemble a more highly skilled team in one central base and that the centralised body is most commonly the Ministry of Economy of Ministry of Finance.

The main arguments against centralised control are that it can be more prone to corruption and if it is not competent and effective then it impacts on all government owned SOEs and not just some of them. Whilst the centralised function may be stronger in the financial aspects of SOE management, it is possible for it to lack the understanding of the specific sectors that the decentralised or dual ownership model facilitates.

Despite these possible negatives there appears to be a global trend in recent times towards the centralised ownership model. Evidence suggests that this may well be the result of the majority of countries reducing the number of SOEs held by them, and also the greater tendency to list SOEs which makes having one single agency a more obvious option.

As well as the very obvious direct ownership of SEOs there is a growing global tendency to own organisations by way of some form of investment vehicle, whether this is through pension funds, privatisation funds, sovereign wealth funds or some other structure. Just as with centralised or decentralised structures there are benefits as well as drawbacks for owning SOEs through these differing types of vehicle.

The benefits are that often a much more commercial approach is taken by a more professional investment team with a view to maximise efficiency, value of the SOE, and profitability. The more detrimental aspects are that there is a potential to add a layer of bureaucracy and thus duplicate work, and that in instances where the aim of the government is to support an ailing industry or provide jobs then this can conflict with the more commercial approach typically taken by an investment vehicle.

In countries with a large number of SOEs it is even possible for one SOE to own another or indeed for there to be a very complex matrix of ownership between SOEs. This type of structure is much more difficult to defend as it often leads to conflicting goals, duplication of work, and slower and more bureaucratic decision making. There is also much wider possibility of being less transparent and with much higher levels of government interference and opportunities of corrupt practices.

There is also a danger when one country adopts differing forms of ownership of its SOEs as this can lead to reduced transparency and increased confusion from all the stakeholders. Other than within certain limitations, therefore, it is generally best to adhere to one form of ownership structure.

WHAT TYPE OF MANAGEMENT MODELS AND STRATEGIES ARE USED?

According to the 2016 Edelman Trust Barometer it is trust that is the most desired leadership quality in business and government in Europe, as it is in North America and the Asia Pacific region. It is also in the top five qualities in every other region. This quality is seen by the population as outranking competence and even transparency. However, being totally transparent is one of the cornerstones in obtaining trust and an honest reputation, and then retaining this reputation once it has been gained.

A privately owned commercial organisation is generally operated in such a way that it both returns as much as is prudent to the shareholders each year by way of dividends whilst also retaining sufficient profits to reinvest in the company to ensure that it survives and grows over the medium and long term. Given the nature of many SOEs, however, they are often not operated in this way, although the better ones adopting good corporate governance and being properly overseen by a responsible government are, as long as their operating mandate makes it possible.

If the above approach is seen to be operating in the middle of the spectrum by balancing good income now, and growth over the medium and long term, then other SOEs operate at both ends of the spectrum. Those that have much more of a social mandate to deliver goods or services at below market rates or operate to support industry or jobs clearly cannot perform this role and be expected to maximise profits and pay dividends. This is a perfectly acceptable strategy provided that the role of the SOE is clearly stated, as it is in effect a form of government subsidy.

At the other end of the spectrum from those that consume government money for social reasons are those that are operated by governments that see them simply as a way of producing the highest possible dividend without considering the longer term detrimental effects. This strategy is normally only employed in countries with a high turnover of government where there is no incentive for the individual government that is in power at the time to look beyond the short term of their office, and / or where it suits the government to allow connected individuals to benefit from unduly high payments at the expense of all the other stakeholders.

The management models and strategies used, therefore, are clearly dependent upon whether the SOE is free to operate completely without government interference, whether it is legitimately meant to provide some form of social role, or whether it is not only overseen by the government but the level of government interference is such that it effectively bypasses normal management. Where the state interferes for fraudulent purposes or condones corrupt activities then it is not possible to analyse management models or strategies as these are simply overridden to achieve the end required.

Even whether a country has specific legislation for the formation, ownership, and divestment of SOEs can be diametrically opposed. In studies undertaken by the OECD it was found that over half of the countries in the report had explicit legislation covering all aspects of SOE ownership and this included Poland and Hungary from the examples taken above. Of the remainder that did not have explicit legislation the majority of countries had sufficient other laws that were wide enough to encompass SOEs without the need for specific legislation, one such country was the United Kingdom.

The research also found that countries that had more SOEs were more inclined to have explicit legislation, whilst those with fewer SOEs or a less ideological and structured approach to SOE ownership tended towards using and adapting existing legislation. For those countries not intending to establish many new SOEs the first step is to investigate existing legislation with a view to using this rather than requiring new explicit legislation. Should it not be possible then specific legislation would need to be drafted and introduced.

WHICH SECTORS ARE SOES MORE COMMONLY INVOLVED IN?

Whilst it is true that that more advanced economies would normally have fewer SOEs, and that as economies emerge there are very good reasons for them to sell off the majority of their SOEs, nevertheless in recent years there has been considerable growth in major conglomerate SOEs operating on the world stage. This is largely due to the growth of the Chinese economy but it is seen by many other governments as a way of building and then protecting major companies. This has resulted in the proportion of SOEs among the Fortune Global 500 growing from 9% in 2005 to 23%in 2014.

These largest SOEs are predominantly in petroleum refining, utilities, and financial services but they are also in many other sectors as displayed in Figure 1 below.

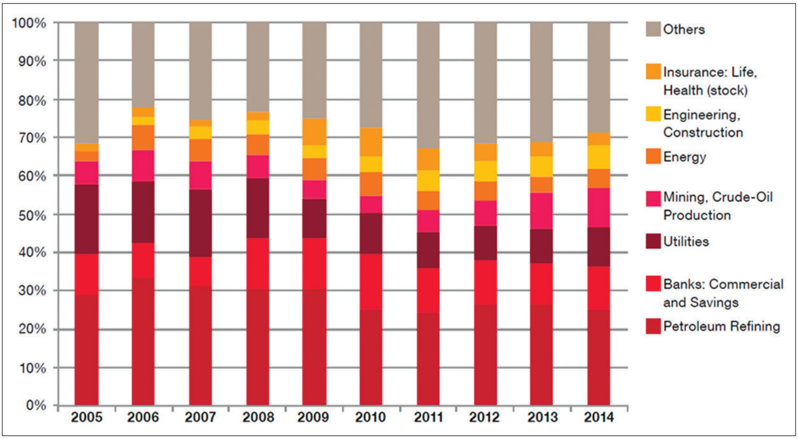


Figure 1. Dominant Sectors Among SOEs in the Fortune Global 500. Adapted from PWC Report 2014.

The emerging sectors that are seeing the biggest growth include: metals; motor vehicles and parts; trading; telecommunications; mail, packaging and freight delivery; and aerospace and defence. Whilst some of these are in the traditional areas in which SOEs have always been active a number are quite new. See Figure 2 below.

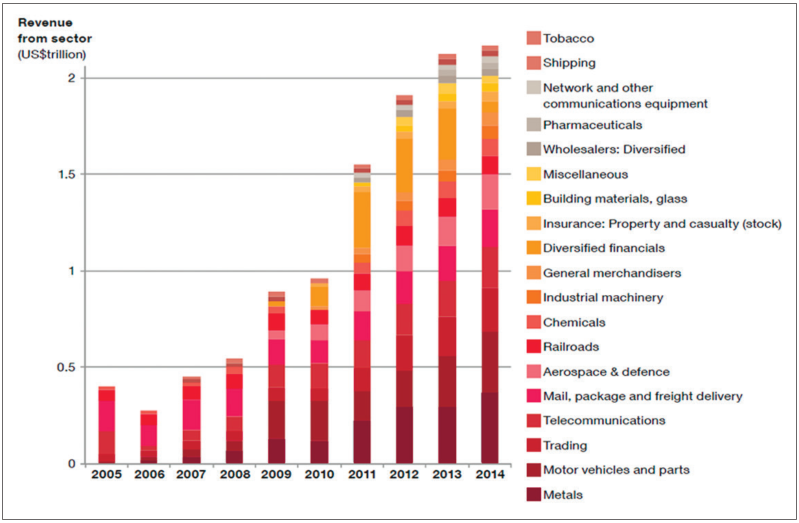
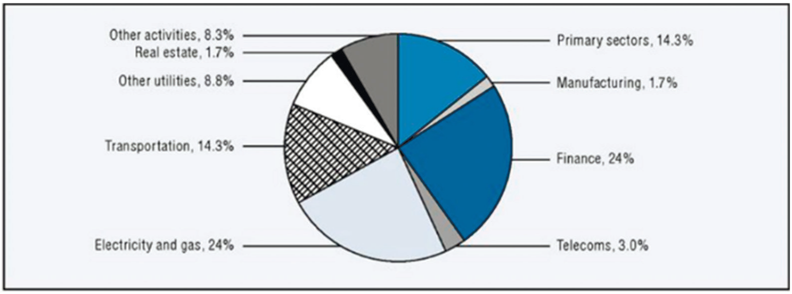


Figure 2. Emerging SOE sectors. Adapted from PWC Report 2014.

The sectors stated above are for SOEs appearing in the Fortune Global 500 and so by definition are for very large SOEs only. However, they reflect very closely the sectors listed for the whole of the SOE sector for the five countries compared earlier in this report, namely Latvia, Hungary, Poland, UK, and USA. In these countries the SOEs were predominantly in the primary sector such as mineral, oil and gas extraction; financial; manufacturing; energy and other utilities; transportation; and telecom sectors.

In countries that still have more of a command economy or a less democratic government it is also common to control television, radio, and other media such as the press. This is done more from the viewpoint of controlling the media and not allowing an independent media rather than for any economic or other reasons. In countries such as Russia and Turkey at present, the governments are taking ever more control in this sector.

In order to demonstrate what sectors SOEs are most prevalent in in general, and not just amongst the largest SOEs, one way of assessment can be based on the total company value of the sectors. Figure 3 below demonstrates this for countries within the OECD as well as many other countries worldwide.



Source: OECD calculations based on questionnaire responses submitted by national authorities.

Figure 3. Sectoral Distribution of SOEs by Company Value

Yet again this method of analysing the most common sectors shows the same results as for the Fortune 500 companies or for the specific 5 countries analysed above. The evidence suggests, therefore, that irrespective of the actual country or the size of the individual SOE, that the sectors in which SOEs are more commonly involved with are the same.

HOW ARE SOES REGULATED, AND HOW TRANSPARENT AND ACCOUNTABLE ARE THEY?

All of the major research undertaken by the OECD, the World Bank, Transparency International, Global Integrity, PWC, and many more, concludes that SOEs are much more susceptible to poor corporate governance and high levels of corruption than are equivalent non-state owned organisations.

The main reasons behind this can be divided into the following:

- Unclear or Conflicting Goals. As has already been noted, unclear or conflicting goals can easily exist when the SOE is owned or regulated in any model other than the centralised model as each of the ministries can often be trying to follow its own agenda. Likewise, unclear or conflicting goals can easily arise even within the centralised model when the government is using that SOE for a number of conflicting purposes, for example to support ailing industry and protect jobs but also trying to maximise profit.
- Politically Appointed Senior Management. In any normal com-

mercial organisation, that is not under any political influence, the senior management are appointed based purely on their relevant experience and ability to do the job required. However, with SOEs in many countries, the senior management are either appointed directly by the government or at least the decision on the appointees is influenced politically. In the worst case this can lead to relatives or friends of the president or other senior government figures being given roles in which they have no experience or ability to carry out. When this happens this is normally the biggest individual indicator that the SOE is being run in a totally non transparent and corrupt way. Regrettably, there are still far too many examples of this around the world today.

- Financial Management. Irregular financial management can be caused either by incompetence due to lack of adequately trained and qualified staff, or by deliberate fraudulent misstatement of the accounts. The latter might be done at SOE level for personal gain of the management and because the regulation is either too slack to notice or to invoke any penalties on the culprits, or because the government colludes with the management in order to divert funds from the SOE, again for personal gain. As with the political appointment of close family or friends to manage SOEs, the practice of poor financial management, deliberate or otherwise, remains widespread.

- Accounting / Auditing Requirements. Accounting is of course part of the financial management but all accounts of any large SOE anywhere in the world should be prepared to IFRS standards and not simply to any local or otherwise reduced requirements. Auditing should always be done by fully independent external accountant and for larger SOEs this should ideally be by large international firms with good reputations. Again, it is critical to ensure that adequate systems are in place to ensure that there is no collusion between the SOEs and the auditors, nor is any political influence bought to bear in any way on the auditors.

- Reporting. The first steps in running an SOE in accordance with international best practice and adhering to corporate governance guidelines is to ensure that there is no undue political influence, appoint the best senior management, establish systems to provide good and timely management and financial reporting, and get the accounts audited by a reputable firm as soon as possible. Once these steps have been taken the basis for providing reliable information in a timely manner has been set. However, transparency cannot be judged unless that information is made available as quickly, widely and as easily as possible. Only then can the full function of reporting be seen to be doing the job which it is intended to do. If the information is only made available within the government then the true owners of the SOE, that is the tax paying public, still do not know how efficient they are or whether any corruption exists. Indeed the very knowledge that reporting must be made widely available is in itself a deterrent to corruption.

- <u>Regulation</u>. The purpose of any form of regulation is to ensure that those being regulated perform within the laws, guidelines or other barriers set for them and to measure their performance against any specific targets set and benchmark them against other similar entities. However, regulation is perhaps the weakest link in ensuring transparency and reducing corruption as so many regulators are themselves incompetent, unduly influenced by senior government figures, or simply colluding in corruption. Whatever the reasons, poor regulation would be evidenced by whether or not it ever does any or all of the following: independently initiatesinvestigations; conducts effective investigations; cooperates with other investigative agencies; successfully completes any investigations that are started; successfully detects any offenders; and, actually penalises offenders. If a regulator is not performing these duties then it is failing in its role.

- <u>Corruption</u>. In the majority of cases if the organisational structure and the financial and management reporting is good, together with an experienced and able senior management then the opportunities for corruption are instantly greatly reduced as long as there is no undue influence from the government. If truly independent auditors are instructed and there is an efficient regulator then any irregularities that there are within any given SOE should quickly and easily be identified and rectified. Furthermore, if any offenders receive appropriate penalties then this can often be the biggest single deterrent in the fight against corruption.

Global Integrity is a highly regarded independent international body that supports progress to open and accountable governance around the world. They produce periodic reports into certain aspects / regions and the 2009 report investigated the legal structures in Georgia and a number of other countries. Georgia has made great progress since 2009 as its economy continues to be reformed and legislation improved and corruption reduced. However, using the data from the 2009 Global Integrity report and comparing this with Ukraine and some other countries nevertheless serves to underline some important factors.

The report scored numerous aspects of media, elections, government accountability, administration, and oversight and regulation, all based on how transparent and accountable they were. In 2009 Georgia received a very commendable overall legal framework score of 89% for these areas and whilst this would give a very good initial impression, the Actual Implementation Score of only 58% was classed as very weak. So whilst the laws and structures existed they were being either blatantly ignored or at the very least not being properly upheld. The same report showed Georgia ahead of Ukraine on both scores.

When it came to oversight and regulation of SOEs the overall score for Georgia was only 47%, demonstrating that the SOEs were much weaker than any other aspect measured in the report, thus reconfirming all the major research undertaken over many years that SOEs were often more badly run than other sectors of the economy. Despite the fact that Ukraine had lower scores overall it did achieve 53% for SOEs, whilst Germany by way of an example from a developed economy achieved a score of 95%.

Even more revealing are the scores for specific aspects of SOE oversight. The effectiveness of oversight received an even lower score of 35%. It was deemed that regulation was not protected from political interference despite having professional full time staff. The reason for this was because it did not initiate independent investigations into financial irregularities or it may start the investigations but either not complete them or fail to detect offenders. Furthermore, even when offenders were found they were not effectively penalised. In almost every aspect even Ukraine scored more highly with the overall effectiveness of oversight in SOEs in Ukraine obtaining a rating of 50%; still very poor but markedly better than the 35% achieved by Georgia at the time of the report.

The score for transparency of SOEs in Georgia was significantly lower than that of oversight as it was rated at only 5% as SOEs were not obliged by law to disclose accounts, the financial records were not regularly updated and as such it wasconsidered by Global Integrity to be superficial and have no value. Whatever accounts were made were not audited to international standards with many companies using flawed or deceptive procedures or even deliberately producing false accounts. Again Ukraine did better, but still achieved a very poor score of only 10%.

Transparency International is perhaps the largest and best known independent organisation that exists solely to increase transparency and reduce corruption around the world. Every year they produce the Corruptions Perception Index that compares 168 countries around the world and then ranks them. This table therefore provides the opportunity to benchmark one country against another and to mark whether a country is getting more or less corrupt. The scores quoted above from Global Integrity are focussed specifically on SOEs but they are nevertheless from data from 2009. The Transparency International rankings are for the economy as a whole but are more recent.

It is a testament to the progress that has been made in Georgia in recent years that the country is ranked as the 48th least corrupt country out of the 168 ranked. This puts it ahead of many countries in the EU and a long way ahead of Russia with a ranking of 119th. The comparative figures used for Georgia from Global Integrity were for Ukraine which was marginally better than Georgia on most aspects in 2009. However, the Transparency International report for 2015 ranks Ukraine at 130th showing that they have not made the same level of progress since 2009 that Georgia has.

In another real mark of the progress made in Georgia is the fact that by 2015 the majority of SOEs had been privatised, with successful privatisation projects including major deals in energy generation and distribution, telecommunications, water utilities, port facilities, and real estate assets.

In line with other countries that seek to encourage transparency, Georgia now particularly encourages its SOEs to adhere to the OECD's Guidelines on Corporate Governance for SOEs as they are considered sufficient to ensure that a level playing field exists between SOEs and private sector enterprises. These guidelines also help to ensure many other aspects of how the SOEs are run and to use international best practice.

In many countries the regulator is given the responsibility of oversight of all aspects of the SOEs including performance and financial strength, through to future viability. However, this depends on whether the centralised, decentralised or dual ownership model is adopted, as previously discussed.

COUNTRY CASE STUDIES

In order to further compare the approach of different countries to SOEs it is useful to use two countries from the former USSR – Belarus and Ukraine. Whilst these case studies focus on two specific countries that are taking quite different approaches, and the majority of data is taken from reports from 2009, nevertheless the experiences shown can be applied to any country anywhere in the world.

Belarus – A Case Study

Originally Belarus had some 2,700 SOEs but a decision was taken to greatly reduce this number. By mid 2009 there were only approximately 800 remaining and this has continued to reduce since that time. There is very clear direction and strategy and very specific timescales established for the required actions and this is all being implemented and on time. A target was set to convert 500 companies to Joint Stock Companies in 2009 alone and this was achieved and these companies were then sold in a variety of different ways.

Belarus has also understood the need to build up the SOEs in order to maximise their value. This means not stripping them of assets by way of very high dividends but allowing them to reinvest. In addition, the need for transparency and good corporate governance is understood if the companies are to attract foreign buyers. The Belarus Government has now gone even further by working with western advisers including investment banks and public relations experts in order to assist with preparing these companies for sale and ensuring that they are sold at the best possible price for the government. They have understood the benefit of investing some time, money and effort in the short and medium term in order to maximise the revenue to the government in the medium and longer term.

The list of 'Strategically Important' enterprises is relatively small and even some of the companies on this list are to be encouraged to seek external investors.

A clear strategy, with defined targets that are being met, and a medium term view have enabled Belarus to make good progress. If Ukraine were to adopt a similar strategy it would undoubtedly increase the level of funds generated not only in the sale of SOEs but also on an ongoing basis for those SOEs that are retained.

Ukraine – A Case Study

In comparison, the experience of Ukraine has been very different. In 2005 Ukraine had some 6,000 central government SOEs that were held in a very complex array of status and oversight arrangements. At that time oversight and regulation was weak and fragmented and this has not improved significantly. The dual ownership model is generally used with the State Property Fund having formal managerial responsibility and the Ministry of Economy having responsibility for evaluating the financial performance but that has not been done consistently or thoroughly. The Ministry of Economy recognised its shortcomings.

The problems in Ukraine were:

- Ukraine still has very many SOEs and the large number, together with numerous different ownership structures, make them difficult to regulate and oversee in a cohesive way. Most emerging economies realise the need to reduce the number of SOEs to a manageable number – normally numbered in the tens or possibly hundreds of enterprises but not in the thousands as in Ukraine.
- There is no clear policy as to what the future aims of the government are with regard to privatisation or indeed how best to maximise the value of these assets. This leaves different

sections of the government pursuing different objectives but often those that were most beneficial to them directly rather than the government as a whole.

- Different parts of the government appear to have conflicting targets with regard to maximising ongoing dividend income or income from sales of SOEs and this leads to different departments following diametrically opposed strategies. Specifically the State Property Fund being tasked to sell off enterprises whilst other departments are trying to retain as many enterprises as possible.
- Many SOEs are on a list of "Strategically Important" companies but the criteria for this list is very vague and can easily be manipulated, leading to many enterprises appearing on this list that should not be. These enterprises may be on this list simply because the criteria is too wide or because the management have engineered for their enterprise to be included as it offers protection from sale in the future.
- Guidelines appear to be very vague and implementation of any guidelines appears to be poor and in some cases easily manipulated for political or other reasons. These guidelines need to be tighter, better defined and better implemented with a common and agreed strategy.
- The government's desire to maximise dividend income from SOEs appears to be harming ongoing investment and thereby the future viability of many of the enterprises. This is the usual problem of raping the SOEs for income in the short term which kills them in the medium or long term.
- The quality of the supervision seems to vary and the criteria for assessing efficiency seems to be applied rather subjectively.
- The level of corporate governance at all levels could be improved. This includes how senior management are selected, appointed and remunerated, as well as the transparency and all other aspects of how SOEs are operated.
- The financial information received, whilst quite detailed, is not used as well as it could be in order to improve the efficiency of the individual enterprises or to foreworn of potential

problems in the future. The information received, how it is analysed and how this information is used can be improved.

Given the above examples of where SOEs and their regulation are falling short there would be some obvious steps that could be taken that would greatly improve the situation. These would include:

- Reduce the number of State Owned Enterprise
- Reduce the number of reporting agents and greatly simplify the reporting structure
- Produce clear strategic guidelines for the future of SOEs
- Produce clear, simplified, criteria for qualifying as a 'strategically important' enterprise
- Improve corporate governance issues – primarily in selection and ongoing performance of senior management but in many other areas also
- Improve 'objectivity' of reporting agents and their accountability for accurate assessment
- Improve the depth of financial analysis to include trend analysis and other techniques
- Improve the efficient use of assets

RECOMMENDATIONS

Drawing on the major research undertaken by the OECD, the World Bank, and others specifically into SOEs, as well as considering the reports produced by Transparency International and Global Integrity, and the overviews of SOEs using this primary research, it is possible to draw some very clear conclusions. From these clear conclusions it is then possible to make a number of very specific recommendations for how governments and SOEs can use international best practice to combat corruption – but all these recommendations require the political will of the government in power to actually want to reduce corruption and this can, on occasion, be lacking.

- <u>Clear Purpose</u>. By their very nature it can be easy for an SOE to be required to operate as commercially and profitably as possible but, for example, at the same time to be required to provide goods or services at reduced prices for social or other reasons. This is clearly a conflict of purpose and whilst many SOEs operate perfectly well on this basis it is important that the exact purpose and how the SOE will be measured is very clearly defined.

- <u>Clear Ownership and Regulation Structure</u>. Whether the SOE is owned by way of a centralised, decentralised, or dual ownership model or whether it is owned directly or through a pension fund or sovereign wealth fund it is important that the ownership structure is clear. It is then crucial that the individual responsibilities of each of the owners are also clearly defined. These two stages will then enable the regulatory structure to also be clearly stated and understood by all the stakeholders. These steps should ensure that there are no conflicts of interest between ministries and that they all work together for the common good.

- <u>Clear Reporting and Financial Monitoring</u>. No company can be expected to operate without accurate and timely management and financial reporting to the senior management. In the case of SOEs this information should also be provided to the regulatory authority. Whilst it is important that the information is relevant to the individual SOE it is also important that the regulatory body receives information in a standardised format in order to make their job much easier, which in turn will lead to fewer errors and greater efficiency. One shortcoming that is often seen in regulators in emerging economies is that they diligently collect any reports required but then fail to analyse them in any meaningful way. Using trend analysis and other techniques commonly used in the finance industry it is possible to get forewarning that a particular SOE is heading for difficulties and action can be taken to prevent this, or at least lessen the impact, and this is far better than waiting until problems occur before attempting to deal with them.

- <u>Clear from Political Influence</u>. This is the biggest individual factor in how well any SOE is able to perform its given duties, as political influence can, and too often does, impact on most other aspects from the day to day running, to reporting, to corruption. As this report demonstrates, SOEs are owned by the state for many different reasons and the objectives they are expected to achieve also differ greatly from one country or sector to another. Clearly the SOE needs to fulfil the legitimate functions placed upon it by government but it is crucial that they are not subjected to any incorrect political influence with regard to appointing management, reporting and financial management, transparency, or in any other way that either make corruption more possible or indeed is solely intended to assist corruption.

- Clear, Transparent and Accountable. Whatever SOE ownership structures are used and whatever reporting and other systems are put in place it is paramount that all is totally transparent and that the management are accountable. For larger SOEs at least, accounts should be produced to international standards and independently audited and these and other information should be made easily available to the public as soon as possible. Any shortcomings should be publically acknowledged and urgent steps taken to resolve any issues and management or political figures that are seen to have acted inappropriately or fraudulently should be identified and suitably punished. By being clear, transparent and accountable the SOE, and by extension the government as a whole, is able to build up trust in the operation and maximise long term financial benefit for the people.

- Clear from Corruption. Lastly, corruption is responsible for bankrupting many companies, SOEs and even countries around the world. But corruption can simply be opportunistic or almost the reason for continuing to be in existence when it comes to SOEs. If the recommendations contained in this report are enacted upon then it greatly reduces the potential for corruption at any level as it ensures good reporting and transparency together with mechanisms to uncover and then to punish any fraudulent activity. Countries that do not put such systems into place and then ensure that they are properly carried out often do so with the express intention of enabling the diversion of funds from the SOE for personal gain.

State Owned Enterprises can play an important part in an economy and certain sectors seem more suited to direct government control than others, although the level of SOE involvement in an economy is directly linked to the ideology of the government and the maturity of the economy.

What is most certain is that in order to maximise the value of the SOE in both the short term and the longer term, as well as ensuring that opportunities for corruption are kept to a minimum at every level, is that all aspects need to be fully transparent and very high levels of corporate governance should be adhered to at every stage.