Chapter 6.

State-owned enterprises in South East Europe

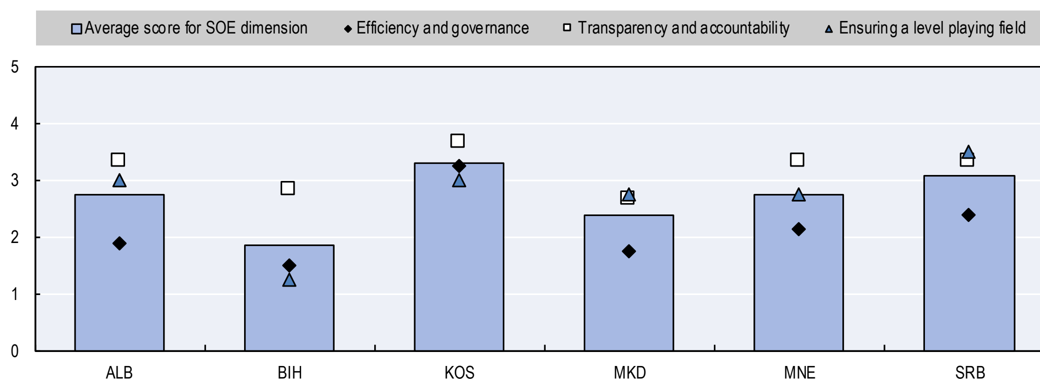
This chapter on state-owned enterprises assesses the policy settings, strategies, processes and institutions in six South East European economies. After a brief overview of the state-owned enterprise (SOE) landscape in South East Europe, the chapter then focuses on three essential sub-dimensions. The first sub-dimension, efficiency and governance, examines the degree to which the state acts as an active and informed enterprise owner, and whether boards of directors in SOEs are sufficiently professional and autonomous to oversee the enterprises according to good corporate governance standards. The second, accountability and transparency, assesses whether SOEs and their government owners disclose information according to internationally accepted standards, and whether SOEs are accountable to minority shareholders. The third, ensuring a level playing field, examines the extent to which SOEs may be subject to unfair advantages, or disadvantages, in the marketplace due to their ownership. The chapter includes suggestions for enhancing the policies in each of these sub-dimensions in order to improve SOE governance, which in turn would foster the competitiveness of these economies.

Main findings

The extent to which state-owned enterprises (SOEs) contribute to, or hamper, the competitiveness of an economy depends mostly on two factors: their efficiency and productivity. These determine the quality of the goods and services that they deliver to the rest of the economy, and the degree to which they compete unfairly with private enterprises and hence crowd out more competitive activities. In addition, the SOE sector should be transparent enough to provide competing enterprises with a fair overview of the prevailing market conditions. The present chapter assesses six South East Europe (SEE) economies – Albania, Bosnia and Herzegovina, the Former Yugoslav Republic of Macedonia, Kosovo,* Montenegro, and Serbia – according to these three performance categories.

Overall, SOE performance varies substantially across economies, depending mostly on the quality of public-sector governance and territorial cohesion, as well as on whether or not a given economy has engaged in recent SOE-related reforms. Two economies in particular have recently implemented reforms (Kosovo and Serbia) and, as a consequence, score above average (Figure 6.1). Conversely, Bosnia and Herzegovina[1] is less advanced in establishing a comprehensive approach to state ownership practices.

Figure 6.1. **State-owned enterprises: Dimension and sub-dimension average scores**



Note: See the methodology chapter for information on the *Competitiveness Outlook* assessment and scoring process.

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Comparison with the 2016 assessment

The present chapter marks the first time the *Competitiveness Outlook* has included a chapter on state-owned enterprises. A comparison with earlier assessments is therefore not possible. It is nevertheless worth highlighting that recent reforms in some areas have edged the assessed SEE economies towards internationally recommended good practices. Despite this progress, the overall quality of SOE governance and ownership practices among the six economies remains relatively weak by international standards – including compared to other European post-transition economies. To some extent this reflects the ongoing processes of privatisation in the region. Nevertheless, the fact that certain SOEs

* This designation is without prejudice to positions on status, and is in line with United Nations Security Council Resolution 1244/99 and the Advisory Opinion of the International Court of Justice on Kosovo's declaration of independence.

are slated for future privatisation should not stop governments from taking appropriate measures to ensure their ownership rights and good governance while they still operate as SOEs.

Achievements

Financial disclosure and audit practices have improved in a number of jurisdictions. Large and economically important SOEs are increasingly expected to file financial reports consistent with International Financial Reporting Standards (IFRS), as laid down in corporate laws or in specific SOE legislation.

The assessed SEE economies have raised their auditing standards. Some of the economies in the region apply high standards of external audit to their SOEs, consistent with private-sector practices, whereas others continue to rely mostly on their state audit functions.

The economies have taken the first steps towards improving co-ordination of state ownership. A couple of economies have taken steps to ensure that the ownership of at least part of their SOE portfolios is exercised on a whole-of-government basis rather than by individual ministers or political communities.

The economies have introduced measures to ensure a healthier competitive landscape between SOEs and other firms. Partly as a consequence of their efforts to align themselves with European Union (EU) legislation, the economies have made changes likely to contribute to levelling the playing field. These include measures to ring fence, or unbundle, monopoly elements of SOEs' value chains.

Remaining challenges and key recommendations

- **Professionalise the state ownership function as a priority in all six SEE economies.** Most SOEs continue to be run by individual line ministries as extensions of the political powers of these ministries, which arguably leads to inefficiencies and conflicts of interest. The ownership of SOEs should be entrusted to state units with specific knowledge of corporate economy and law, and shielded from conflicts of interest with other government functions.
- **Foster clarity in financial and non-financial objectives for individual SOEs.** State-owned enterprises' financial objectives are not fully outlined in the assessed economies; at best they are often basic (e.g. "not to lose any money") and they do not ensure that the state obtains a reasonable return on its invested capital. Non-financial objectives are in most cases opaque or weakly defined. This needs to be addressed if SOE managers and those exercising the state ownership function are to be held properly to account for SOE performance.
- **Ensure governments engage in aggregate reporting on their SOEs**. An essential first step will be a recurrent mapping exercise, making it clear to governments, parliamentarians and the public which enterprises are in public ownership and why, and how they are performing. In the absence of such information, at best only an ad hoc and piecemeal approach to reform can be realised.
- **Strengthen protection of non-state investors further.** The protection of minority shareholders is also of concern in the private sector in a number of the assessed economies. The state needs to go beyond the requirements established by ordinary company law in this respect: there is a temptation to use the state's

shares to vote in shareholder meetings in pursuit of public policy objectives rather than in the interest of all investors. Whether and under what circumstances this may occur should be made clear to non-state investors at the time of their investment.

Context

State-owned enterprises (SOEs) are in many of the SEE economies the sole, or the main, providers of key public goods and services, such as water, electricity, transport, telecommunications and postal services. They generally also account for major shares of other parts of the commercial economy. Ensuring that they are productive and efficient is therefore crucial for economic development, public service delivery and the competitiveness of the whole enterprise sector. When governed transparently and efficiently, SOEs can correct market failures, improve public service delivery and play a role in creating fairer, more competitive markets.

However, governments need to establish strong SOE governance arrangements in order to maximise their contributions to development. In particular, it is important that SOEs have well-defined objectives, professional and independent boards of directors, and clear lines of accountability for their performance. Furthermore, SOEs can be particularly at risk of corruption and they often operate in sectors with large potential environmental impacts. Ensuring that SOEs respect their legal obligations, apply good standards of responsible business conduct, and take into account the environmental and social objectives of development are important elements of a strategy for ensuring high levels of competitiveness.

A separate, but related, issue is the competition between SOEs and private-sector companies. If, for instance, SOEs are unfairly advantaged due to their ownership, this can create severe market distortions, ultimately leading to the more productive companies being crowded out by less productive state-run competitors. This may occur where SOEs are subject to concessionary financing from the state, are exempt from competition and other regulation, have an “inside track” to win public procurement contracts, or are allowed to continue operating with rates of return that private investors would not accept.

Around the world, many countries have taken steps to improve the governance and performance of their SOE sectors, often taking as a benchmark the *OECD Guidelines on Corporate Governance of State-Owned Enterprises* (OECD, 2015a; the “SOE Guidelines”). The remainder of this chapter makes frequent reference to the *SOE Guidelines*, which are used as the basis for this assessment. This is further discussed below.

An analysis of SOE performance and governance in the assessed SEE economies reveals significant links with other policy areas. For example, a well-functioning SOE-based economy can be an important determinant of foreign investment, offering efficient infrastructure and other public services (OECD, 2015b). Weak governance of SOEs can involve them in corrupt transactions, including as recipients of bribes destined for policy makers (OECD, 2014a). Furthermore, the question of whether SOEs are treated on an equal basis with other companies is of great importance to competition policy frameworks (OECD, 2012). This chapter is therefore particularly related to the following chapters of this *Competitiveness Outlook*:

- **Chapter 1. Investment policy and promotion** is closely related to the role of SOEs in the economy for a couple of reasons. First, if the state has already occupied certain “strategic sectors”, the scope for inward direct investment will be narrowed – which is of particular concern when the SOE incumbents are less

productive than their potential replacements. Second, the role of SOEs as infrastructure providers has direct repercussions for the quality of the investment climate in an economy.

- **Chapter 5. Competition policy** is particularly pertinent to SOE reform in the six SEE economies because they are implementing practices consistent with the EU Single Market. This has repercussions for the unbundling of economic activities in network industries (e.g. separating power grids from other functions), as well as the treatment of other market incumbents with lingering monopoly elements in their value chains.
- **Chapter 17. Anti-corruption policy** is directly relevant to SOE governance because poorly governed SOEs are particularly vulnerable to corrupt practices. OECD experience shows that a disproportionate share of bribes paid to public officials tend to pass via the procurement processes of large SOEs.

State-owned enterprise assessment framework

The state-owned enterprise dimension in the *2018 Competitiveness Outlook* analyses the policies and practices for SOEs in the assessed SEE economies. It considers three broad sub-dimensions based on the elements of the *SOE Guidelines* that are deemed particularly relevant for raising competitiveness in the regional context:

1. SOE efficiency and governance: does the state act as an active and informed enterprise owner, and are boards of directors in SOEs sufficiently professional and autonomous to oversee the enterprises according to good standards of corporate and commercial conduct?
2. Transparency and accountability: do SOEs and their government owners disclose information according to internationally accepted good practices? Are SOEs accountable to their minority shareholders (where such exist) as well as to the state?
3. Ensuring a level playing field: how does the state ensure that SOEs that are active in economic markets are neither advantaged nor disadvantaged by their ownership?

Figure 6.2 shows how the sub-dimensions and their constituent indicators make up the SOE assessment framework.

The six SEE economies' SOE frameworks were assessed by the public authorities as well as independent consultants in each of the economies. These actors were invited to score their performance on a scale from 0 (no implementation of the *SOE Guidelines*) to 5 (full implementation of the *SOE Guidelines*). The results were reconciled and processed by the OECD, and are summarised in Annex 6.A1. For more details on the methodology underpinning this assessment please refer to the methodology chapter.

State-owned enterprise performance in SEE economies

The SOE sectors of the six assessed South East European economies are broadly similar to those in some of the post-transition OECD member economies. While the quantitative information for these SEE economies is at best patchy, recent research suggests that the share of SOEs in total production and employment in most of these economies falls within the range of 3-7% (OECD, 2017). As in most comparable economies, most of the economically important SOEs are found in the infrastructure and network industries, and in some cases, the financial sector. An overview of the number of enterprises is provided in Table 6.1.

Figure 6.2. **State-owned enterprise assessment framework**

State-owned enterprises dimension

Sub-dimension 1
Efficiency and governance

Qualitative indicators
1. Ownership policy and rationales
2. The exercise of ownership
3. Nomination of board members
4. Board independence and professionalism

OECD Instruments
OECD Guidelines on Corporate Governance of State-Owned Enterprises
- Chapter I: Rationales for state ownership
- Chapter II: The state's role as an owner
- Chapter VII: The responsibilities of the boards of state-owned enterprises

Sub-dimension 2
Transparency and accountability

Qualitative indicators
5. Reporting and disclosure
6. Auditing practices
7. Equitable treatment of shareholders

OECD Instruments
OECD Guidelines on Corporate Governance of State-Owned Enterprises
- Chapter IV: Equitable treatment of shareholders and other investors
- Chapter VI: Disclosure and transparency

Sub-dimension 3
Ensuring a level playing field

Qualitative indicators
8. Legal and regulatory treatment
9. Access to finance

OECD Instruments
OECD Guidelines on Corporate Governance of State-Owned Enterprises
- Chapter III: State-owned enterprises in the marketplaces

Source: OECD (2015a), *OECD Guidelines on Corporate Governance of State-Owned Enterprises,* http://dx.doi.org/10.1787/9789264244160-en.

The SOE landscape is, moreover, influenced by a history of recent and ongoing privatisation. Several economies in the region (e.g. Serbia and Montenegro) maintain privatisation portfolios under central ownership, which in some cases are the legacy of now-disbanded privatisation agencies. To some extent this may have resulted in governance practices that are not considered optimal from the perspective of this chapter: most policy makers apparently have not considered it worthwhile to develop formal state ownership policies for, and improve the governance of, companies that they wish to sell off. However, in the late phases of privatisation governments tend to be left with complicated cases of companies that have proven difficult to sell. This implies that in practice the duration of state ownership will in many cases be longer than planned, which suggests that improving the ownership and governance of these companies is fairly urgent.

Many SOEs in the region are loss making. For this reason, recent reform efforts have focused on – in addition to finding buyers for some of the companies – stemming the ongoing fiscal haemorrhaging. Furthermore, the process of aligning the assessed SEE economies with the EU Single Market has also had implications for the SOE sector. This is most visible in the infrastructure sectors, where unbundling the service provisioning

aimed at separating legal and natural monopolies into separate companies has had implications for the way electricity and railway companies and their ownership are organised.

Table 6.1. **Number of state-owned enterprises held by (central) governments**

	Number of SOEs	Government institutions exercising ownership	Comments
Albania	37 (partial portfolio)[1]	Ministry of Economy	
Bosnia and Herzegovina			
– The Federation of Bosnia and Herzegovina	53	Ministry of Energy; Ministry of Transportation; Ministry of Finance; various line ministries	
– The Republika Srpska	38	The Share Fund of the Republika Srpska; various line ministries	An additional 44 companies have minority government shareholdings
Kosovo	17 (partial portfolio)	Publicly Owned Enterprise Policy and Monitoring Unit (co-ordination agency)	An additional 43 companies are held by local and municipal public authorities
Former Yugoslav Republic of Macedonia	129	Central government; Ministry of Finance; various public agencies	The figure includes an estimated 12 municipal enterprises
Montenegro	34	Three state funds (Unemployment Fund, State Pension Fund and Investment Development Fund)[2]	There are 26 partly (minority) state-owned enterprises, several of which are either under liquidation or subject to ongoing (or stalled) privatisation
Serbia	201 (partial portfolio)	Ministry of Economy	The figure includes public enterprises as well as the privatisation portfolio overseen by the ministry

Note: 1. Information on Albania concerns only the portfolio of enterprises under the shared purview of the Ministry of Economy's Directorate General for State Property and the relevant line ministries, which comprises the majority – but not the totality – of SOEs in Albania. 2. In Montenegro, the Ministry of Finance also acts as an owner in some SOEs, but it is not the predominant state ownership entity.

Source: Submissions from authorities and independent consultants.

For the reasons mentioned above, relatively little attention has been given in recent years to restructuring the ownership and governance of SOEs in the region according to internationally accepted good practices. However, there are some encouraging exceptions. For example, the government of Serbia has established a category of SOEs ("public enterprises") that are slated for continued state ownership. They are subject to specific legislation which, when properly implemented, will strengthen their ownership and governance subject to the oversight of the Ministry of Economy.

Efficiency and governance

If SOEs are to operate efficiently and contribute to the competitiveness of their home economy then the state needs to act as "an active and informed owner" (as the *SOE Guidelines* put it).[2] Unless the government ownership is as competent and engaged as would be expected from the majority owner of a similar private company, the SOEs they oversee are likely to underperform. Weak ownership discourages SOE management and introduces a risk of abusive self-serving behaviour by corporate insiders.

On the other hand, the state also needs to abstain from ad hoc interventions in SOEs' operations and management. The prime means for active and informed state ownership are a clear and consistent ownership policy, the development of broad mandates and objectives for individual SOEs, a structured nomination process for boards of directors, and the effective exercise of established ownership rights. Moreover, one of the overarching principles in the consensus that underpins the *SOE Guidelines* is that the roles of overseeing and managing SOEs should be allocated to the most appropriate levels in a "chain of command" extending from the highest levels of government to the individual enterprises. The structure implied by the *SOE Guidelines* outlines the following four levels of decision making that should be involved:

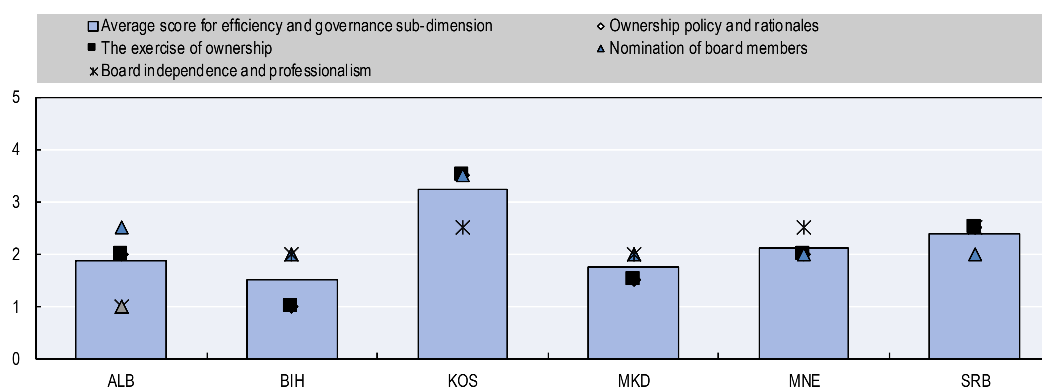
1. The government: to ensure a consistent approach (and to help avoid the "third agency problem" mentioned above), the government as a whole needs to develop an ownership policy. The ownership policy should normally communicate the rationales for enterprise ownership, how the government intends to exercise its rights as an owner, and any specific expectations (beyond commonly accepted commercial norms) that the state may have of its SOEs.
2. The ownership entity: the administrative role of exercising the ownership rights (further detailed below) is delegated to one or numerous state institutions charged with defining the operational and financial performance objectives of individual SOEs (or classes of SOEs) and with monitoring their implementation.
3. The board: the board of directors is the highest corporate authority within each SOE. It formulates (or approves) corporate strategies, monitors each SOE's executive management and generally holds overall responsibility for the company. SOE boards should be composed of qualified professionals who are able to exercise independent and objective judgement.
4. The management: the management may, according to corporate law and tradition, consist of an executive board of directors chaired by a chief executive officer (CEO), or of one CEO alone who is given freedom to compose his/her management group. The CEO is appointed, and can be dismissed, by the board of directors.

Every SOE operates within a specific legal, institutional and economic context, and any attempt to improve its governance needs to be tailored to those circumstances. SOEs are subject to varying degrees of enforcement and restrictions depending on their regulatory environments, as well as the sectors in which they operate. Nevertheless, there are key messages and lessons on SOE governance reform, both general and focused on information disclosure and accountability, which economies can garner from internationally agreed standards such as the *SOE Guidelines*.[3]

The efficiency and governance sub-dimension comprises four qualitative indicators (Figure 6.3): 1) ownership policy and rationale; 2) the exercise of ownership; 3) board independence and professionalism; and 4) the nomination of board members.

As the overall scores for the sub-dimension indicate, the ownership practices and corporate governance of SOEs in the six SEE economies can still be improved. In a number of economies, SOEs still tend to be, in the words of a recent review, "treated as political prizes to be divided up among political parties in the ruling coalition" (US Department of State, 2016).[4]

Figure 6.3. **Efficiency and governance: Sub-dimension average score and indicator scores**



Note: See the methodology chapter for information on the *Competitiveness Outlook* assessment and scoring process.

StatLink http://dx.doi.org/10.1787/888933703903

One exception is Kosovo, which has enacted important reforms in recent years including a corporate governance code for SOEs (EBRD, 2016a). In Serbia too there has been recent progress with the passage of a law on public enterprises. However, it is only applicable to a segment of the SOE sector.

Ownership policies and objectives have been developed to different degrees

According to the OECD *SOE Guidelines*, the **exercise of ownership** rights should be clearly identified within the state administration, centralised in a single ownership entity or, if this is not possible, co-ordinated by a centralised body, which should have the capacity and competencies to carry out its duties effectively.

In most of the assessed economies, state **ownership policies and rationales** have not been developed. Although in many cases a degree of "ownership policy" can be gleaned from laws, cabinet decisions and other secondary legislation, these are rarely consolidated into one concise document. Similarly, few governments have outlined a rationale for state ownership of enterprises, except for those economies (e.g. Serbia) which have created a special category of SOEs charged with operating in the public interest. In those cases, ownership rationales can be derived from the explanation of the nature of "public interest".

Table 6.2 gives an overview of the explicit or implicit ownership rationales in the six economies. Above-average practices are found in Kosovo, where a law on SOEs defines the state's overall ownership objectives, outlines (albeit not fully) the mandate of the ownership entity and clarifies its main functions, spelling out the main principles to be followed by the ownership entity in exercising ownership rights.

In general, the overall objectives for state enterprise ownership put forward by OECD and non-OECD governments fall into the following categories: 1) supporting national economic and strategic interests; 2) ensuring continued national ownership of enterprises; 3) supplying specific public goods or services (after deeming that the market cannot supply the same goods or services); 4) performing business operations in a "natural" monopoly situation; and 5) other operations such as creating or maintaining a state-owned monopoly (or oligopoly) where market regulation is deemed infeasible or inefficient (OECD, forthcoming).

Table 6.2. **Rationales for state ownership of enterprises**

	Supporting economic and strategic interests	Ensuring continued national ownership of enterprises	Supplying specific public goods or services (in the absence of private suppliers)	Performing business operations in a "natural" monopoly situation	Other
Albania	√		√		
Bosnia and Herzegovina	√ (FBiH & RS)	√ (RS)		√ (FBiH & RS)	
Kosovo	√	√	√		
Former Yugoslav Republic of Macedonia	√		√		
Montenegro	√				
Serbia	√		√		√

Note: FBiH – the Federation of Bosnia and Herzegovina; RS – the Republika Srpska.

Source: Submissions from authorities and independent consultants.

Likewise, the organisation of state ownership practices is generally not highly developed. As mentioned above, enterprise ownership should preferably be exercised on a whole-of-government basis rather than left to the discretion of individual ministries. This approach is considered good practice for a couple of reasons.[5] First, it helps avoid situations where a single line ministry is simultaneously tasked with the roles of ownership and sectoral regulation, which can be a source of considerable conflicts of interest. Second, as SOE portfolios shrink, governments often see a need to create a specialised administrative unit which brings together staff with a knowledge of commercial economics and law.

The SEE economies that have gone the furthest in this direction have put in place elements of a "dual ownership model",[6] where one central ministry or agency exercises ownership rights jointly with a line ministry. For instance, Kosovo has established a co-ordination agency, but it is not particularly large or well resourced. Serbia has allocated similar roles to its more influential Ministry of Economy, but only for a subset of its SOE portfolio.

In Albania, the ownership function for the majority of SOEs is exercised jointly by the Ministry of Economy's Directorate General for State Property and the relevant line ministries. In the Former Yugoslav Republic of Macedonia there is also an element of centralisation of the ownership function, in the sense that the ownership of most SOEs is exercised jointly by three state funds. A similar arrangement is in place in Montenegro, where three state funds share the ownership function. In a number of the assessed SEE economies, there are some exceptions to the prevailing ownership model, with a small subset of SOEs remaining outside of the remit of the main ownership entity/ies. This is by no means unique to the assessed economies, however: even in some OECD countries with predominantly centralised ownership arrangements, some large SOEs remain under the control of line ministries.

Politicised boards of directors continue to hamper the performance of many SOEs

To safeguard **board independence and professionalism**, and ensure that boards of directors are (in the words of the *SOE Guidelines*) "capable of objective and independent judgement", it is important that they include a sufficient number of independent members and that they do not include serving politicians (e.g. ministers, vice ministers, members of parliament). The board members of an SOE should ideally see themselves as agents of the

company rather than as representatives of the ministry that appointed them. This is, however, far from the reality in most of the assessed SEE economies.

In Albania, vice ministers serve on some SOE boards. Although this is not the case in the other five SEE economies, there are generally no rules to ensure the presence of independent directors, and in most cases boards are dominated either by civil servants or by people politically connected to the national executive. In Montenegro, most SOE board members are either current or former public officials with professional experience in those SOEs' sectors of operation. While there are no explicit nomination or qualification criteria in place for board members, a provision in Montenegro's Anti-Corruption Law does prohibit ministers and vice ministers from serving on SOE boards. Across the region, it is not uncommon for directors to act and vote subject to ministerial instructions and to report corporate information back to the government institutions that they represent. An encouraging recent development is Serbia's 2016 Law on Public Enterprises, which establishes criteria for board qualifications and the independence of certain board members. However, it applies to only a subset of SOEs that are designated to act in the "public interest".

One reason for the lack of autonomy of SOE boards of directors in the assessed economies is that the process for **nomination of board members** is strongly politicised. Good practices for nominating board members in other economies include formal qualification criteria for potential board members; inter-ministerial nomination committees; reliance on executive search companies and/or pre-screened "pools of directors"; and, crucially, rules ensuring that no serving politicians or persons directly related to them serve as directors in SOEs. Box 6.1 provides an example of board nomination practices in the United Kingdom. In the assessed SEE economies few such safeguards are found, and the *de facto* power over board nominations is commonly at the discretion of either line ministers or the head of government. Kosovo has established an inter-ministerial recommendation committee, which in terms of statutory rules is a good practice, but in reality this institution is broadly considered ineffective.

The way forward for improving efficiency and governance

State ownership practices among the assessed SEE economies are not particularly well developed, and reforming them would lead to significant efficiency gains for the economies. Sequencing reforms is, however, important. Experience from other economies suggests that the three priority areas for reform that should be addressed in the six SEE economies early in the process are the following:

The way forward for improving efficiency and governance

State ownership practices among the assessed SEE economies are not particularly well developed, and reforming them would lead to significant efficiency gains for the economies. Sequencing reforms is, however, important. Experience from other economies suggests that the three priority areas for reform that should be addressed in the six SEE economies early in the process are the following:

Box 6.1. **Good practice: Board appointment process in the United Kingdom**

The general appointment process of the Office of Commissioner of Public Appointments (OCPA) is as follows (although this may vary slightly depending on the size of the SOE and the specific requirements of the post):

- The central ownership advisory unit, the UK Government Investments (UKGI), and the SOE Chair agree on the mix of skills and experience required on the board leading to agreement on a strategic plan of public appointments. A timetable for recruitment is then agreed between the SOE, the lead director in UKGI and an independent assessor (IA).
- A specification setting out the role and requirements for the board appointment is drafted and agreed with the government's human resource unit and the SOE. The role and person specification is then agreed with the body or minister making the final decision.
- A candidate search is undertaken with the vacant position being publicly announced (i.e. advertised) and often involving the use of recruitment agencies to ensure a more thorough search of potential candidates.
- On the basis of applications received a long list of potential candidates is produced. An initial sift involving UKGI, the IA and the SOE is conducted to produce a shortlist of candidates to interview.
- An interview panel is established comprising the lead UKGI policy official, the IA and the SOE Chair.
- The panel will then reach agreement on the preferred candidate and submit a panel report with recommendations to departmental ministers.
- Once ministers have agreed the recommendation the appointment can be made.
- An appointment is normally for a fixed period of three years, at which point the position is subject to re-election.
- The remuneration of the successful candidate, if over a certain threshold, needs to be agreed with the Chief Secretary to the Treasury.

Where the post is not OCPA regulated, the SOE runs the process but follows the OCPA guidelines in most instances. UKGI is closely involved in the process if the post is important (e.g. CEO or finance director), for example by joining the interview panel. In this way, UKGI is able to make suitable recommendations to give consent to appointments.

Source: OECD (2013), *Boards of Directors of State-Owned Enterprises: An Overview of National Practices*, http://dx.doi.org/10.1787/9789264200425-en.

The economies should strengthen the co-ordination of the ownership function. If centralising the ownership of SOEs into one single, specialised agency is not feasible, then governments should at least establish co-ordination functions to ensure that the enterprises they control are overseen on a whole-of-government basis. Co-ordination could notably involve harmonising the corporate governance and disclosure requirements placed on SOEs (e.g. concerning the criteria and nomination process for SOE board members).

All the assessed economies in the SEE region should undertake aggregate reporting and disclosure for the entire SOE sector. Governments should issue annual reports allowing parliaments, stakeholders, the public and press easy access to information about the size, composition and performance of the entire SOE portfolios. Some governments limit themselves to providing public access to individual SOE disclosure, for instance via an Internet portal. This can be a useful first step, but it should be complemented by the government communicating its activities as an enterprise owner. Through such transparency the public becomes aware of the state ownership issues and, in consequence, constituencies for reform are created and the reform process is itself facilitated.

SEE economies should set objectives for individual SOEs. In the absence of clear (financial and non-financial) objectives, SOE performance cannot be credibly monitored, leading to a situation of weak accountability and inefficiency. Governments need to specify what SOEs are expected to achieve in addition to earning money and how the costs of such "non-commercial objectives" are to be covered. Without this, managerial accountability in SOEs is very hard to establish.[7]

Once these reforms are progressing, the next issue to address would be **reorganising SOE boards of directors**. Nomination procedures should be established to ensure that all board members have the requisite skills and are capable of independent judgement. In practice this means shifting the balance away from civil servants and towards independent, outside directors, as well as establishing safeguards to ensure that individuals do not get nominated solely because of their association with government ministers or other politicians. In order to empower boards to fulfil their role as the highest decision-making body within each SOE they should have decisive influence over the employment and removal of the CEO.[8]

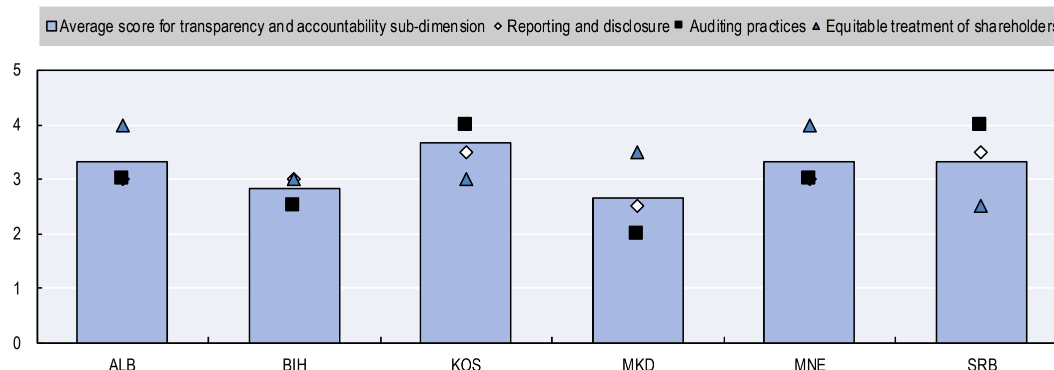
Transparency and accountability

Ensuring a high level of transparency and accountability is the very basis of any sound corporate governance regime. Information disclosure and higher standards of accountability in SOEs, when accompanied by other governance reforms – such as centralising state ownership, listing on stock exchanges, board improvements and financial restructuring – can help to improve their efficiency and performance. Information disclosure, including of both financial and non-financial data, is essential for the government to be an effective owner. It also helps parliament evaluate the performance of the state as an owner; the media to raise awareness of SOE efficiency; and taxpayers and the general public to have a comprehensive picture of SOE performance.

The transparency and accountability sub-dimension comprises three qualitative indicators (Figure 6.4): 1) reporting and disclosure, such as traditional measures of reporting and disclosure by the state individual SOEs; 2) auditing practices; and 3) the equitable treatment of shareholders, i.e. corporate accountability toward shareholders other than the state.

Most of the assessed SEE economies score around the average for the transparency and accountability sub-dimension (Figure 6.4). Overall scores for Bosnia and Herzegovina and the Former Yugoslav Republic of Macedonia are somewhat weaker than the others, largely explained by the relative weakness of their auditing practices.

Figure 6.4. **Transparency and accountability: Sub-dimension average scores and indicator scores**



Note: See the methodology chapter for information on the *Competitiveness Outlook* assessment and scoring process.

StatLink http://dx.doi.org/10.1787/888933703922

Reporting, disclosure and auditing practices are improving

Generally, transparency should be ensured both at the aggregate and the individual company level. The *SOE Guidelines* recommend that the state, or an ownership entity empowered to act on behalf of the state, engages in aggregate annual **reporting and disclosure** – providing an overview of the financial and other performance of its entire portfolio of SOEs, as well as more detailed information on individual enterprises.

Around half of the 52 countries[9] surveyed in the OECD *Compendium of State-Owned Enterprise Governance Practices* produce and make some form of aggregate reporting on SOEs available online (OECD, forthcoming). Most of them include all, or the majority of, their SOEs in the reports. In countries with well-developed aggregate disclosure practices, aggregate reports sometimes also include information on the state's ownership policy and its implementation, any recent changes in the state's overarching objectives for state ownership, and significant evolutions in the legal or corporate governance arrangements for SOEs (for example, introducing requirements for independence applicable to board members). To facilitate access by the general public, it is considered good practice to make such aggregate information available online.

Governments in the assessed SEE economies generally do not engage in aggregate reporting on SOE ownership and performance. This is partly due to the multitude of institutions (mostly ministries) involved in exercising the state's ownership rights. Countries in other regions have overcome this problem by establishing state co-ordination agencies to oversee the various line ministries' SOE portfolios. In some of the SEE economies, ministries overseeing one category of SOEs (e.g. the "public enterprises" found in several economies) issue reports for their own portfolio, for instance in the context of fiscal budgeting procedures. There are no publicly available overviews of the state's SOEs in a single published source in any of the six economies. This is problematic in the context of future SOE reform. A number of countries – and especially post-transition economies – have found that preparing aggregate reports is an essential first step in comprehensive SOE reform (in many cases these provided politicians with an overview of the state's financial engagements via SOEs for the first time).

Also in line with OECD good practice, the state should mandate detailed reporting by individual SOEs (OECD, 2015a). With due regard to enterprise size and capacity, this reporting should include: 1) a statement of enterprise objectives and their fulfilment;

2) financial and operating results; 3) corporate governance; 4) remuneration of board and executive management; 5) board composition; 6) foreseeable risk factors; 7) financial assistance received from the state; 8) material transactions with the state or related entities; and 9) stakeholder relationships. Moreover, the SOEs' financial statements should be subject to independent external audits based on high-quality auditing standards. The latter point is important because until relatively recently, a number of OECD and other governments relied largely on their state audit institutions for auditing SOEs. This kind of audit has, however, turned out to be insufficient when SOEs operate commercially.

The quality of reporting and disclosure varies across the assessed SEE economies, as well as according to how the SOEs are incorporated. As a general rule, SOEs that are subject to ordinary company law have higher standards of financial reporting than special-purpose entities. In some economies (e.g. Serbia) company law requires SOEs to report according to internationally recognised standards such as the International Financial Reporting Standards (IFRS). Kosovo and Serbia are considered to be performing better than the other economies, mostly because they subject parts of their SOE sectors to specific SOE laws that impose additional reporting requirements.

A challenge in a number of economies, however, is implementing these rules. SOEs (and other companies) do not necessarily respect their reporting requirements, preferring instead to incur penalties imposed by tax and other authorities. This is the case, for example, in Montenegro, where SOEs that are incorporated as joint stock companies have disclosure requirements that are of a reasonably high standard but do not consistently implement them. According to monitoring by the Securities Commission, only an estimated half of state-owned joint stock companies respect the applicable disclosure requirements.

Also, whereas financial reporting is in most instances reasonably good across the six economies, reporting about non-financial performance is in many cases rather incomplete. This is particularly problematic given that SOEs in the economies are regularly charged with undertaking public policy tasks. If there is no reporting on the fulfilment of these tasks, there is a serious risk that the fact that SOEs "are not only expected to earn money" becomes a smokescreen behind which managerial accountability suffers and corporate insiders are able to engage in self-serving behaviour. The Lithuanian authorities' approach for estimating – and reporting on – the costs and funding of SOEs' public policy objectives offers potential inspiration for these SEE economies. The related information is made public in the state's annual aggregate report on SOEs (Box 6.2).

The quality of **auditing practices** differs significantly among the six SEE economies. Some are largely reliant on state auditors (e.g. Bosnia and Herzegovina, and the Former Yugoslav Republic of Macedonia) and, at most, subject only their large and commercially oriented SOEs to independent external audits. This is contrary to the *SOE Guidelines*, which note that "specific state control procedures do not substitute for an independent external audit". This applies equally to SOEs that are not commercial in nature, since the fact that they are expected to operate in the public interest demands higher rather than lower standards of disclosure. It should, however, be recognised that some SOEs are so small that more limited ambitions can be set for their reporting and auditing. The highest scores, ranging from 3-4 out of 5 (Figure 6.4), are achieved by Albania, Kosovo and Serbia as they apply auditing standards to their SOEs that compare favourably with the average OECD country.

Box 6.2. **Good practice: Aggregate disclosure in Lithuania**

Since 2010, the Lithuanian authorities have published an annual report on the characteristics, operations and performance of the state-owned enterprise portfolio. The report is produced by a central co-ordinating body, the Governance Co-ordination Centre, which is tasked with monitoring and reporting on SOEs' compliance with the state's policies and guidelines bearing on corporate governance and transparency. The report is available online and is notably produced in both Lithuanian and English (VKC, n.d.). Among the main elements included in the report are the following:

State ownership policy. The report gives an overview of the Lithuanian state's ownership policy and disclosure requirements for SOEs, enshrined in two policy documents, *Ownership Guidelines* and *Transparency Guidelines*. It also references the key legal acts bearing on SOEs' operations. It furthermore communicates the state's overarching objectives for SOEs, based on sorting enterprises into three categories according to whether they are primarily commercially oriented, primarily public service oriented or a mixture of both.

Corporate governance index. The corporate governance index rates all SOEs according to the quality of their corporate governance in three dimensions: transparency, boards of directors, and strategic planning and implementation. This section of the report is also used to highlight significant recent developments or issues of concern, such as major changes in the functioning or composition of SOE boards of directors.

SOE executive remuneration. This section reports on the average remuneration of high-level SOE executives by sector and by corporate form.

SOEs' non-commercial objectives. This section reports on the costs associated with SOEs' non-commercial objectives ("special obligations" in national nomenclature), as well as their related funding arrangements. It provides a breakdown by individual enterprise, including any losses incurred for funding non-commercial objectives. The related information is requested annually from line ministries by a central co-ordinating agency.

Value and performance of SOEs. This section provides an overview of the value of SOEs, their annual aggregate financial performance and their contributions to national employment, all broken down by sector. It also reports on SOEs' rates of return and highlights significant related evolutions since the preceding year.

Reporting on individual SOEs. This section provides detailed reporting on recent financial and corporate governance developments in Lithuania's largest SOEs. It also provides information on their board composition, identifying which board members represent ministries and which are considered independent.

Source: OECD (2015c), *Review of the Corporate Governance of State-Owned Enterprises: Lithuania,* www.oecd.org/daf/ca/Lithuania_SOE_Review.pdf; VKC (n.d.), "State-owned enterprises", http://vkc.turtas.lt/en.

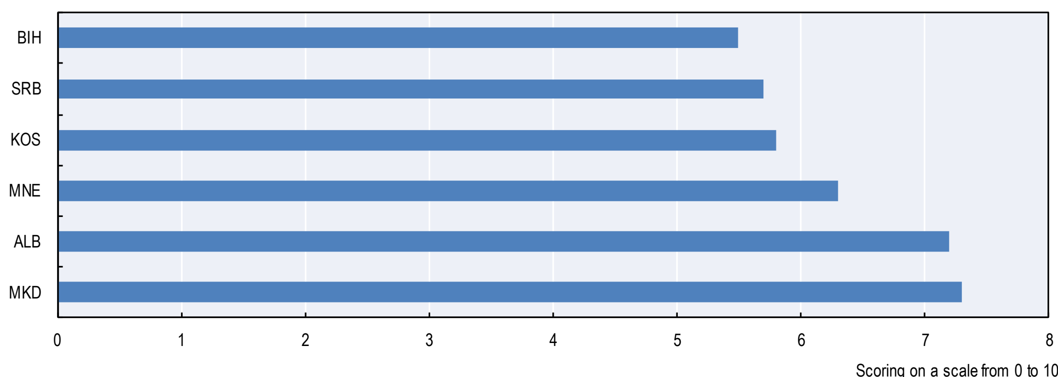
The protection of minority shareholders remains a concern in some economies

The concept of accountability in this *Competitiveness Outlook* has two dimensions: 1) "democratic accountability" towards the general public and the elected bodies that represent them; and 2) accountability towards individuals and firms that have invested in SOEs' activities. Democratic accountability is often achieved by preparing aggregate reports, which in many countries are prepared by the government and presented to parliament, then disseminated to the wider public. Accountability toward stakeholders, whether individuals or firms, relates to the *SOE Guidelines*' recommendations on

protecting minority shareholders and maintaining good stakeholder relationships. The point about minority protection is of particular importance when SOEs are tasked with carrying out public policy functions in addition to their commercial operations. This can result in considerable losses for the companies and their non-state investors, and it is important that all investors are aware of any such obligations at the time of undertaking their investments. Ad hoc interventions in SOEs to make them undertake politically expedient projects are a bad practice which significantly undermines these SOEs' (and the state's) accountability.

The equitable treatment of shareholders in SOEs is an area with scope for further improvement. Public authorities would in many cases argue that most of their SOEs have a corporate form which does not allow for outside investors, and the rest are joint stock or limited liability companies, which are subject to general company laws, including the protections for minority shareholders that they provide. However, this gives rise to two problems – first, that several of these laws do not provide a particularly high level of protection, even for private firms. Figure 6.5 shows an assessment drawn from the World Bank's *Doing Business* reviews, which indicates that investor protection is an area of general concern in economies like Bosnia and Herzegovina and Serbia, whereas a recent reform in the Former Yugoslav Republic of Macedonia has led to significant improvements.

Figure 6.5. **Protection of minority shareholders, general corporate sector**



Source: Doing Business (2017), *Doing Business 2017: Equal Opportunity for All*, www.doingbusiness.org/reports/global-reports/doing-business-2017.

Second, the question arises whether the state, given the powers it has, may either weaken implementation of the law or decide to disobey it. An example of the latter was found in Serbia, where the Belgrade Beer Industry (51% state owned) reportedly changed its articles of association despite court rulings, instigated by the minority shareholders, that the changes were unlawful.[10] However, more generally it is difficult to assess the implementation of minority shareholder protection in many of the assessed SEE economies, because they either do not have minority shareholdings in any SOEs or there have been no recent cases of minority shareholder complaints.

The way forward for transparency and accountability

While there has been progress in improving financial reporting and audit practices in several economies, further progress in this area would be useful.

The six economies **should apply good practices for financial reporting, such as IFRS, to all SOEs above a certain size threshold**, regardless of whether or not they are considered principally commercial operators.[11]

The quality of non-financial reporting should be improved significantly in all six SEE economies. SOEs that either receive public-sector support or operate at a loss due to public policy objectives that they have to fulfil should be expected to fully disclose these objectives and their fulfilment.

Governments in the assessed economies should **engage in aggregate reporting on a whole-of-government basis**. It is not sufficient to induce individual SOEs to disclose their operating results; the government itself should take responsibility for a consolidated evaluation and reporting on the state's enterprise portfolio. As mentioned earlier, this is seen as an essential element in deepening and broadening the reform of SOE sectors.

The protection of minority shareholders in SOEs should be strengthened in the six SEE economies. In the course of reforming their SOE sectors, governments often choose to list minority stakes in individual companies on stock markets. This strategy can lead to improvements in corporate governance, among other areas, because it subjects the SOEs in question to stock-market listing rules and securities regulation. However, the success of this approach depends on whether non-state investors can be certain that their rights will be respected and, in particular, the state does not vote its shares in the SOEs purely as a matter of public policy.

Ensuring a level playing field

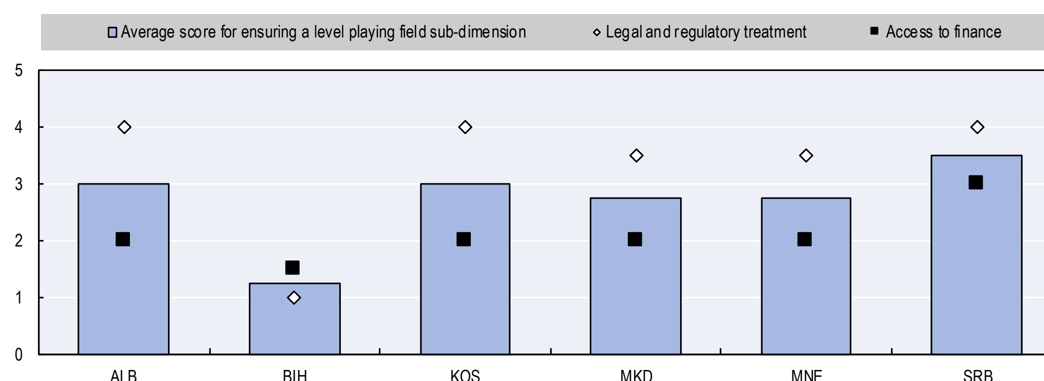
When SOEs engage in economic activities, it is commonly agreed among OECD countries that those activities must be carried out without any undue advantages (or disadvantages) relative to other SOEs or private enterprises. In addition to specific challenges, such as ensuring equal financial, regulatory and tax treatment, come some more overarching issues including identifying the cost of public-service activities and, where feasible, separating economic activities and public policy objectives. This topic is covered in the *SOE Guidelines*, and the OECD has developed further guidance, providing best practices intended as inspiration for regulators and policy makers (OECD, 2012).

The sub-dimension on ensuring a level playing field comprises two qualitative indicators (Figure 6.6): 1) legal and regulatory treatment; and 2) access to finance. To understand the evenness of the playing field between SOEs and private companies in the assessed economies, the starting point must be the corporate form of SOEs in each. State-owned enterprises, in the form of joint stock or limited liability companies and subject to ordinary company law, will (all other things being equal) be operating on a more equal footing. This applies to both elements of the scorecard: both the legal and regulatory treatment of SOEs and their access to finance will depend on their corporate profile. Where SOEs, or segments of SOE sectors, are incorporated pursuant to specific overall legislation (such as the Public Enterprise Law in Serbia) the competitive landscape depends on the specifics of this legislation and, in particular, its compatibility with ordinary corporate law. Weakly incorporated entities operating essentially as an extension of government ministries are – insofar as they operate in competitive markets at all – unlikely to compete on a level playing field.

With the exception of Bosnia and Herzegovina the assessed SEE economies score around the average for ensuring a level playing field (Figure 6.6). In other words, they have as a general rule obtained a level playing field for SOEs and other firms but with

some non-trivial exceptions. Bosnia and Herzegovina performs more weakly in this respect, with an average score of around 1.3, mostly because its SOE landscape contains numerous statutory corporations which are subject to treatment that may differ from ordinary corporate norms. Most other economies have incorporated their SOEs either under ordinary company law or under specific SOE legislation that expressly addresses issues such as competition rules, tax obligations and insolvency procedures.

Figure 6.6. **Ensuring a level playing field: Sub-dimension average scores and indicator scores**



Note: See the methodology chapter for information on the *Competitiveness Outlook* assessment and scoring process.

StatLink http://dx.doi.org/10.1787/888933703960

An interesting finding from the analysis is that (again with the exception of Bosnia and Herzegovina) the economies score markedly higher for establishing equal legal and regulatory treatment of SOEs, than for ensuring that they obtain their financing on market terms. This is discussed further below.

SOEs operate in similar legal and regulatory frameworks as other firms

A central tenet of competitive neutrality is the equal legal and regulatory treatment of SOEs and private companies. Among other things, this implies that the state ownership function should be carried out independently of, and separate from, state institutions that exercise regulatory functions in the sectors where SOEs operate. To maintain a level playing field, SOEs should be subject to equal or equivalent tax treatment to private competitors in similar circumstances. Moreover, both SOEs and the state as shareholders should not be protected from challenge via the courts if they are accused of infringing the law or disrespecting contractual obligations. Stakeholders should be able to challenge SOEs and the state as an owner in courts and/or tribunals and be treated fairly and equitably in such cases by the judicial system.

In comparison with a number of OECD countries, the assessed SEE economies have made good progress in ensuring that SOEs are subject to equal legal and regulatory treatment compared with private companies. This is in large measure due to the fact that they are incorporated in a similar form to their private competitors and subject to the same bodies of corporate law. This is not universally the case, as some economies have established a class of SOEs (generally called “public enterprises”) tasked with acting in the public interest and subject to a separate law. However, these public enterprise laws generally establish safeguards of their own that go some way toward maintaining a level playing field.

The treatment of SOEs and other enterprises also seems to be equal when it comes to standard corporate obligations such as compliance with tax rules or competition regulation. However, SOEs in all six economies – whether or not formally classified as operating in the public interest – are subject to significant non-commercial expectations from their government owners. In some cases the state compensates the SOEs by granting them a privileged market position and/or favourable price regulation. SOEs are in most cases (with the exception of statutory corporations) formally subject to the same insolvency and bankruptcy regimes as other companies, but it is unclear whether the threat of bankruptcy is credible in the case of systemically important SOEs.

Not all commercially operating SOEs obtain their funding on market terms

When SOEs raise financing (whether from the state budget or the commercial marketplace) the state should implement measures to ensure that the terms of both debt and equity financing are market consistent. Creditors sometimes seem to assume that there is an implicit state guarantee on SOEs' debts. This situation has in many instances led to artificially low funding costs disrupting the competitive landscape. Moreover, in those economies where state-owned financial institutions tend to be among the main creditors of SOEs involved in economic activities, there is great scope for conflicts of interest. In addition to the points raised above, there should also be no expectation that SOEs may benefit from their near-government status to run up tax arrears or be subject to lenient enforcement of tax rules. SOEs also should generally not benefit from "off market" funding arrangements from other SOEs, such as trade credits. Such arrangements, unless they are fully consistent with normal corporate practices, amount to preferential lending. The state should implement measures to ensure that inter-SOE transactions take place on purely commercial terms.

SOEs in the assessed economies generally do not obtain their financing on market-consistent terms. In some economies (e.g. Kosovo and Montenegro) many SOEs are loss making, so the fact that they obtain government finance and loans from international development banks would not in itself confer a privileged position in the marketplace. However, the continued "life support" for such companies could well hamper private-sector development in the longer term. In other economies in the region (e.g. Albania, Bosnia and Herzegovina, and the Former Yugoslav Republic of Macedonia) government guarantees for borrowing by large and economically significant SOEs is either commonplace or occurs regularly. It is not uncommon to combine this with the direct provision of credit lines from the state to smaller SOEs.

Even in economies that normally expect SOEs to raise financing on market terms (e.g. Serbia), a couple of problems persist. First, the idea that SOEs, if operating on a commercial basis, should earn market-consistent rates of return has not gained hold among policy makers, and therefore many SOEs may effectively remain in the marketplace while earning lower returns on their capital than investors in private companies would require. Second, even in the absence of government guarantees for specific loans, the financial sectors in the economies widely perceive implicit government guarantees for the largest and most important SOEs. For this reason these SOEs are, even when raising finance from commercial lenders, effectively able to obtain better rates than private companies in like circumstances. It should, however, be mentioned that the latter departure from competitive neutrality is also found in the SOE sectors of numerous other economies, including in the OECD area. The European Union offers examples of measures for ensuring competitive neutrality (Box 6.3).

Box 6.3. **Good practice: Measures for ensuring competitive neutrality in the European Union**

Countries that are members of the European Union or use the EU model often have a provision like Article 106 EC, setting the rules for entities that perform services of general economic interest or are granted special or exclusive rights. Broadly, Article 106 EC provides that the services performed by government entities, or private entities on behalf of the government, should be subject to the competition provisions of the EC Treaty – unless applying these rules obstructs the performance of the particular tasks assigned to them under the law. Article 106 EC states:

1. In the case of public undertakings and undertakings to which Member States grant special or exclusive rights, Member States shall neither enact nor maintain in force any measure contrary to the rules contained in this Treaty, in particular to those rules provided for in Article 18 and Articles 101 to 109.
2. Undertakings entrusted with the operation of services of general economic interest or having the character of a revenue-producing monopoly shall be subject to the rules contained in this Treaty, in particular to the rules on competition, in so far as the application of such rules does not obstruct the performance, in law or in fact, of the particular tasks assigned to them. The development of trade must not be affected to such an extent as would be contrary to the interests of the Community.
3. The Commission shall ensure the application of the provisions of this Article and shall, where necessary, address appropriate directives or decisions to Member States.

The first characteristic of the EU approach is that the principle of neutrality was recognised in the Treaty of the European Union for more than 50 years. Article 106 of the Treaty clearly establishes that public companies fall under the scope of competition law, and that EU Member States are not entitled to do anything contrary to this rule. Public companies are also subject to rules on monopolisation and state aids (subsidies). The second characteristic of the system is that the Treaty empowers the European Commission with the tools to tackle problems concerning the economic activities of public-sector companies. The Commission can require Member States to apply competition rules to public companies. And, if a public company infringes competition rules, the Commission itself can issue a decision against that company requiring it to stop the conduct, and can impose fines. If the public company infringes competition law with the assistance of the government, or due to governmental influence (for example the government requiring the company to charge abusive prices), the Commission can address a directive or a decision to the Member State, requiring it to stop these practices.

In addition to Article 106 EC, the European rules on state aid and subsidies apply to all subsidies and state aids that Member States or other public bodies provide to any company, public or private. They are particularly important in the context of public companies, given the specific relationship public bodies have with public companies. State aids cover not only capital injections or grants, but also tax reductions or tax holidays, reductions in the social security costs and warranties. State aids are generally forbidden, though there are exceptions. The Member States are obliged to notify the Commission if they plan to grant state aid to any company. The Commission then scrutinises the planned measure and decides whether to authorise it. Another tool used by the Commission to achieve competitive neutrality between public and private firms is the Transparency Directive, 13, which concerns the financial relationships between public bodies and public companies. The Transparency Directive requires separate accountability. Public companies that have both commercial and non-commercial activities need to separate their accounts to demonstrate how their budget is divided between commercial and non-commercial activities. These tools have been used in many sectors, including the postal, energy and transport sectors.

Source: Capobianco and Christiansen (2011), "Competitive neutrality and state-owned enterprises: Challenges and policy options", http://dx.doi.org/10.1787/5kg9xfgjdhg6-en.

The way forward for ensuring a level playing field

Most of the assessed SEE economies have made good progress in simplifying and standardising the corporate forms under which their SOEs operate. However, more can be done.

The six SEE economies should, in line with the consensus broadly shared among OECD governments, as well as recent reform efforts in numerous economies, **continue the conversion of statutory corporations into joint stock and limited liability companies**. The reliance on specific corporate forms such as "public enterprises" may be justified by the non-financial objectives with which these SOEs are tasked, but it should be kept to a minimum. A strong driver for a level playing field is having SOEs that operate according to the same corporate and commercial legislation as any private-sector enterprise.

Transparency is a priority area for reform in the six SEE economies. A large number of SOEs in the SEE region mix commercial and non-commercial objectives, and are active in both competitive markets and "niche activities" conducted in the public interest. OECD experience shows that competitive neutrality can be significantly enhanced when, first, governments clarify the non-commercial objectives that SOEs are expected to fulfil and, second, ensure a degree of separation of these activity areas within the SOEs.

Ideally the assessed SEE economies would **operate commercial operations in the marketplace in separate corporate vehicles from the public interest activities**, but such a separation is often not feasible in practice. At a minimum, separate accounts should be kept, which will allow policy makers to ascertain the exact nature and cost of the SOEs' departures from normal commercial practices.

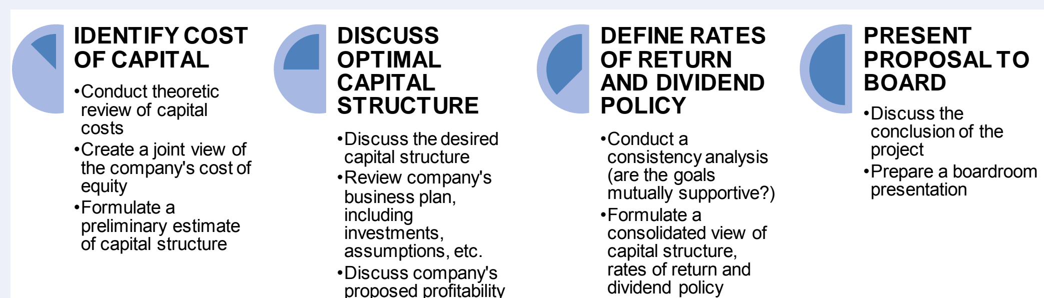
The funding and financing of SOEs among the assessed SEE economies need to be better aligned with commonly agreed good practices. SOEs that are commercially viable should be funded on market-consistent terms, should be expected to earn realistic returns on the state's invested capital and should pay regular dividends to the national treasury. A recent report by the OECD takes stock of national practices aimed at aligning SOE financing with private-sector practices (OECD, 2014b). Box 6.4 provides an overview of what is considered good practice for approaching SOE financing decisions.

Box 6.4. **Good practice approach to SOE financing decisions**

One of the fundamental policy tenets of the *OECD Guidelines on Corporate Governance of State-Owned Enterprises* is that SOEs should create value for their ultimate owners, the general public, through an efficient allocation of resources. For a good practice listed company, value creation implies that the returns on invested capital exceed the related costs of that capital (i.e. the returns required by shareholders and other providers of capital). Achieving such capital efficiency within SOEs can be challenging, in particular when there is insufficient clarity on the financial returns on SOEs' commercial activities and the non-financial – or "social" – returns on public policy activities. Good practice calls for structural separation between both types of activities and transparent compensation from the state budget for any public policy objectives that SOEs are expected to achieve (for example, universal service provision by the state-owned postal service operator).

Box 6.4. Good practice approach to SOE financing decisions (*continued*)

Other challenges occur when SOE financing decisions are no longer guided by the objectives of capital efficiency and value creation, but by state budgetary needs or ad hoc political objectives. Good practice calls for all decisions affecting SOEs' capital structure – ranging from rate-of-return requirements, to dividend pay-out levels, to the provision of state subsidies – to be taken with a view to achieving an optimal capital structure. The figure below illustrates what is considered a "good practice" process to guide decisions related to SOEs' capital structure. This approach notably takes into account the interdependence between capital efficiency, rate-of-return requirements and dividend pay-out levels.



Source: OECD (2014b), *Financing State-Owned Enterprises: An Overview of National Practices*, http://dx.doi.org/10.1787/9789264209091-en.

Conclusions

The assessed SEE economies have implemented some recent SOE reforms that have edged them towards internationally recommended good practices. Nevertheless, the efficiency and, hence, the contribution of SOEs to the competitiveness of these economies could clearly be enhanced. Many companies are loss making and few are currently expected to turn a profit comparable to private companies in similar circumstances. The options available to governments in this position are: reform the governance of SOEs to make them perform according to high corporate and commercial standards; privatise those SOEs that do not imperatively need to remain in state ownership; and, failing the above, liquidate certain companies. The current situation is complicated by the fact that several SOEs are still in the process of privatising, while some SOEs that remain in state ownership have been left over from from previous complicated privatisation programmes. The case for SOE reform is strong. First, privatisation often takes longer than envisaged, during which period the enterprises concern remain under public control and, as the case may be, a burden on public finances. Second, experiences from other post-transition economies indicate that the outcomes of privatisation processes are often better when governments establish specialised agencies – or empower specific ministerial departments – both to exercise ownership rights in SOEs and to spearhead privatisation processes. Third, restructured and well-functioning SOEs are often easier to privatise. With the possible exception of SOEs slated for trade-sale to a preferred buyer, enterprises that display good managerial, operational and transparency practices attract more bidders and higher revenues to the public purse.

Since the six SEE economies appear to be headed in the same direction as most OECD countries, namely towards SOE sectors that are strongly biased towards infrastructure and network industries, a priority area is to separate the state's ownership from other

functions. For instance, government ministries that are in charge of sectoral legislation and regulation bearing on the performance of SOEs should not also be responsible for the financial performance of these companies. If they are, onerous conflicts of interest may arise. A solution recommended by the OECD is to centralise government ownership into a specialised unit, or co-ordinating agency, which can exercise the ownership rights on behalf of the whole government rather than individual ministries.

Finally, SOEs' competitiveness is greatly enhanced by high levels of transparency. One aspect of transparency is the quality of financial reporting by individual SOEs – an area in which the assessed economies have made headway in recent years. Another important element is disclosure by the state as an owner, providing an overview of an economy's entire SOE portfolio and allowing third parties to assess its financial and non-financial performance as well as its governance arrangements. This aggregate reporting should include information about any requirements that SOEs are expected to fulfil in addition to commonly accepted corporate norms, as well as the cost and funding of such non-financial objectives. This is important both to ensure that SOE managers and their government owners can be held accountable for corporate performance, and to allow an informed assessment of whether or not SOEs compete with private enterprises on a level playing field.

Notes

1. There are four main administrative levels in Bosnia and Herzegovina: the State, the Federation of Bosnia and Herzegovina, the Republika Srpska and the Brčko District. The administrative levels of the State, the Federation of Bosnia and Herzegovina and the Republika Srpska are taken into account in the *Competitiveness Outlook 2018* assessment, when relevant. The Brčko District is not assessed separately. It should be noted that, here and in the following, the scores for Bosnia and Herzegovina have been developed by scoring the Republika Srpska (RS) and the Federation of Bosnia and Herzegovina (FBiH) individually, and subsequently creating a combined score as an unweighted average of the two.

2. Ownership and control: the *SOE Guidelines* apply to enterprises that are under the control of the state, either by the state being the ultimate beneficiary owner of the majority of voting shares or otherwise exercising an equivalent degree of control. Examples of an equivalent degree of control would include cases where legal stipulations or corporate articles of association ensure continued state control over an enterprise or its board of directors in which it holds a minority stake. Some borderline cases need to be addressed on a case-by-case basis. For example whether a "golden share" amounts to control depends on the extent of the powers it confers on the state. Also, minority ownership by the state can be considered as covered by the Guidelines if corporate or shareholding structures confer effective controlling influence on the state (e.g. through shareholders' agreements). Conversely, state influence over corporate decisions exercised via bona fide regulation would normally not be considered as control. Entities in which the government holds equity stakes of less than 10% that do not confer control and do not necessarily imply a long-term interest

in the target company, held indirectly via independent asset managers such as pension funds, would also not be considered as SOEs. For the purpose of these Guidelines, entities which are owned or controlled by a government for a limited duration arising out of bankruptcy, liquidation, conservatorship or receivership, would normally not be considered as SOEs. Different modes of exercising state control will also give rise to different governance issues. Throughout the Guidelines, the term "ownership" is understood to imply control (OECD, 2015a).

3. Important additional insights can be gleaned from guidance publications such as OECD (2010).

4. The concrete citation relates to Montenegro, but it would apply equally to the other assessed SEE economies.

5. The *SOE Guidelines* go further in recommending the creation of an actual state ownership agency. However, this is often not politically feasible in practice and, at any rate, the recommendation depends on the economy in question having high standards of public-sector governance.

6. For a further description of alternative ownership models, see OECD (forthcoming).

7. For example, if non-commercial objectives are unclearly specified (and/or financed) the SOE management will be able to argue that almost any weak financial performance is due to the imposition of these objectives.

8. Provisions to this effect already exist in corporate or SOE laws in several SEE economies, but in actual practice politicians continue to have great powers over the hiring and firing of management in many SOEs.

9. Which did not include the six SEE economies.

10. This information was provided by a Serbian consultant working with the OECD Secretariat. It has not been independently verified.

11. EBRD (2015) made a similar point: SOEs and financial institutions, due to their role in the economy, should be expected to apply particularly high standards of transparency and disclosure.

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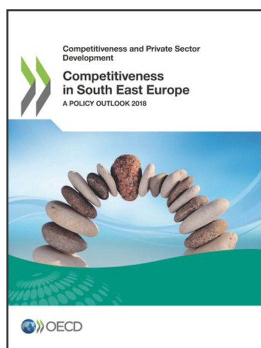
Annex 6.A1.
State-owned enterprises: Indicator scores

Table 6.A1.1. **State-owned enterprises: Indicator scores**

	ALB	BIH	KOS	MKD	MNE	SRB
Efficiency and governance						
Ownership policy and rationales	2.0	1.0	3.5	1.5	2.0	2.5
The exercise of ownership	2.0	1.0	3.5	1.5	2.0	2.5
Nomination of board members	2.0	2.0	3.5	2.0	2.0	2.0
Board independence and professionalism	1.0	2.0	2.5	2.0	2.5	2.5
Transparency and accountability						
Reporting and disclosure	3.0	3.0	4.0	2.5	3.0	3.5
Auditing practices	3.0	2.5	4.0	2.0	3.0	4.0
Equitable treatment of shareholders	4.0	3.0	3.0	3.5	4.0	2.5
Ensuring a level playing field						
Legal and regulatory treatment	4.0	1.0	4.0	3.5	3.5	4.0
Access to finance	2.0	1.5	2.0	2.0	2.0	3.0

StatLink http://dx.doi.org/10.1787/888933703979



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