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Session 2: The State as Shareholder

CORPORATE GOVERNANCE OF SOEs IN CENTRAL ASIA: A COMPARATIVE VIEW

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I. STATE SECTOR IN CENTRAL ASIAN ECONOMIES

1.1 Large state sector

% Share of state, non-state and private sectors of GDP

EBRD estimates	"Private"/Non-state)		State	
	2002	2005	2002	2005
Azerbaijan	60	60	40	40
official data: 2004		*73.5*		*26.5*
Kazakhstan	65	65	35	35
Kyrgyz Republic	65	75	35	25
Tajikistan	50	50	50	50
Turkmenistan	25	25	75	75
Uzbekistan	45	45	55	55
official data: 2003		*74.5*		*25.5*
Czech Republic	80	60	20	20
Russia	70	65	30	35

Author's estimates	Non-state	(Private)	State
China (2005)	65	(35)	35

1.2 Dominant role of state in national economy

Most large and major medium-sized enterprises, especially in strategic industries, under state ownership

Significant state shareholdings in major “private”/non-state enterprises

State monopoly in financial sector

State share of banking sector assets*, 2004 (in %)

Azerbaijan	56.1
Kazakhstan	3.7
Kyrgyz Republic	4.1
Tajikistan	12.2
Turkmenistan (2003)	96.1
Uzbekistan	67.6

*Excludes state shares in non-state sector banks (which may be controlled by the state)

Source: EBRD Transition Report 2005

State control of resource allocation

1.3 Impacts of dominant role of state sector

Inefficiencies and sluggish growth of SOEs, crowding-out effects on private sector, resulting in weak supply responses and slow output recovery

Weak policy and institutional environment for corporate governance: underdeveloped role of competitive factor and product markets as external mechanisms for corporate governance enforcement

Weak corporate governance => weak microfoundations => undermine creation of dynamic, internationally competitive corporate sector that serves as engine for stable and sustainable long-term growth

Corporate Governance Imperative: state ownership of key industries has disproportionately large and strategic impact on national economy

2. PECULIARITIES AND CHALLENGES IN CORPORATE GOVERNANCE OF SOEs

Key issue: how well does the state exercise its ownership and governance rights?

Ambiguity of property rights: ownership by everyone, by no one in particular = > Problems in alignment of bearing of residual risk and control

Complexities in setting and evaluating corporate performance targets given mix of commercial and public policy objectives

Insulation from market discipline and soft-budget constraints

Restrictions on incentives for and recruitment of directors and management

Moral hazards: abuse of market power, arbitrary political interference, rent-seeking, patronage, cronyism and corruption

Central Asia (and other transition economies): legacy of command economy mindset

3. STYLIZED FEATURES OF CORPORATE GOVERNANCE IN SOEs IN CENTRAL ASIA

3.1 Property rights clarification through corporatisation only a necessary first step; ambiguities remain

Insufficient efforts to address corporate governance in corporatised SOEs = old wine in new bottle

Ownership and governance functions performed by administrative bodies and bureaucrats, not by professional, commercially-based investment managers

Effectively, multiple control by various government departments => diffused and dispersed responsibility and accountability

Paradox of diffused “ownership”, responsibility (residual risk bearing) despite a single, powerful owner

Propensity to micro-manage SOEs

Weaknesses in external, independent oversight (e.g. parliament, media, markets) and in balanced representation of public interest

Who monitors the monitor?

3.2 Inadequate legal framework for corporate governance

Either separate SOE law or special clauses and exemptions for SOEs in company law

Provisions often inadequate or militate against effective corporate governance

Fiduciary duty of care typically not stated

> Can a member of the public sue SOE or its Board for misfeasance, or not operating in the best interests of the firm or the public?

Issues in adopting international best practice in corporate governance within a Civil Code law framework and two-tier (Continental European/German) system

Insufficient importance attached to rule/role of law, and company charters

3.3 Features of SOE corporate governance system and practice

Subordinated voice and interests of non-state shareholders

State often (i) the largest/controlling shareholder through cumulative direct and indirect shareholding; and (ii) has disproportionately large voice in governance and control even if minority shareholder, due to either legal or extra-legal means.

Inadequate delineation and definition of respective rights and responsibilities of AGM, BoD, SB and EM

- SOEs often lack operational and financial autonomy
- Difficulties in determining (i) responsibilities and accountability for performance, (ii) incentives
- Lack safeguards against related party transactions, conflicts of interest and collusive practices

3.3 Features of SOE corporate governance system and practice (continued)

Weak, passive role of SB and BoD in oversight; concentration of power in CEO ("captured" by line ministry)

Lack of SB and BoD board balance and independence. Typically:

- No provision for INEDS; reluctance to appoint "outsiders"
- No provision for Nomination and Remuneration Committee;
  appointments not a transparent, open and competitive process (BoD chairman, CEO usually appointed directly by state)
- Weak incentives for members of SB, BoD senior executives (on civil service pay scales)

3.3 Features of SOE corporate governance system and practice (continued)

SB not equivalent to Audit Committee: problems in creating an effective Audit Committee within BoD or SB

Weaknesses in systems of internal control, risk management (state and/or CEO can override systems and controls)

Insufficiency of audit by government auditors, yet often no independent external audit

Inadequate disclosure rules

3.4 Underdeveloped external mechanisms for CG enforcement

Weaknesses in legal and regulatory framework, accounting/audit standards, financial reporting rules

Weak financial market discipline (reliance on internal funds, rather than on external finance)

Debt market discipline

Equity market/market for corporate control

Weak product market competition

Weak managerial job market and contestability of managerial jobs

4. ILLUSTRATIVE EXAMPLE FROM UZBEKISTAN

Industrial organisation and management through industrial associations (IAs, also called production and trade associations) and state joint-stock companies (SJSCs)

- IAs = (“voluntary”) associations of SOEs, partially and fully divested enterprises previously belonging to a line ministry. Established by government resolution, which specify their mission and objectives
- SJSCs = SOE with subsidiary SOEs and partially divested SOEs; membership of SJSCs determined by Cabinet of Ministers.
- IAs and SJSCs established by and report to Cabinet of Ministers

IAs and SJSCs usually have considerable sectoral regulatory powers and set sectoral development policies

4. ILLUSTRATIVE EXAMPLE FROM UZBEKISTAN (CONTINUED)

IAs entrusted with state shareholdings in member enterprises

Government resolution (No. 361) gives a shareholder with a 25% stake the power to veto any strategic or important decision made by the enterprise's shareholders meeting.

- State usually holds at least 25% of divested member enterprises in IAs.
- Cumulative state's share (direct and indirect holdings) in IAs usually 51% or more.
- State therefore has rights to appoint and dismiss directors and management.
- Resolution of shareholders' meeting also invalid if state representative/trustee did not attend.

State control of IAs poses conflict between interests of state and non-state member enterprises

Weak institutional capacity of Control and Revision Committee (government auditor) in MOF; no requirements for independent external audit except for JSCs

5. ILLUSTRATIVE EXAMPLE FROM AZERBAIJAN

Corporate Governance of AzerSu – national water supply company corporatised as a fully state-owned JSC (ownership under MoF; control by MOED)

Operate under:

- Sections of Civil Code relating to JSCs, with special clauses on JSCs with small number of shareholders
- Presidential decree establishing the company
- Conflicting provisions: Presidential decree takes precedence
- Various ambiguities (definitions and concepts) in JSC law relating to corporate governance

5. ILLUSTRATIVE EXAMPLE FROM AZERBAIJAN (CONTINUED)

Difficulties in incorporating best practice in corporate governance in company charter (articles of association). Legal and “business culture” impediments to:

- Establishment of Nomination and Remuneration Committee (and where do they belong – in SB or BoD?)
- SB (Revision Committee) analogous to Audit Committee, but very limited rights and responsibilities:
- Independence and power of SB relative to BoD and executive management not specified
- Allowance for non-executives on SB and BoD, but not for INEDs

5. ILLUSTRATIVE EXAMPLE FROM AZERBAIJAN (CONTINUED)

- Ambiguities and conflicts in certain respective rights and responsibilities of shareholders meeting and CEO (president) over appointment and dismissal of members of SB
- No statements on fiduciary duties of directors and senior management, or safeguards against related party transactions and conflicts of interests
- Lack of detailed provisions on objectives, scope and processes of internal controls and risk management systems
- Lack of detailed provisions on external audit and disclosures

6. IMPLICATIONS AND OPTIONS FOR CORPORATE GOVERNANCE OF SOEs

Corporate governance of an enterprise is only as good as the shareholder wants it to be. Emphasis must be on role of the state as owner.

Corporate governance in an SOE is an analogue of political governance. Corporate governance of SOEs depends on the quality of governance of the state administrative apparatus.

Virtuous circle of improvements in corporate and political governance

6.1 Implications

Limit size of state sector; outside/private investors where possible

Improve role of government as owner

- Purpose and objectives of state ownership of enterprise
- Arms-length relationship between government and enterprise
- Commercialisation and professionalism – of both shareholder and enterprise management

Need to rely on very strong internal mechanisms, amidst underdeveloped external enforcement mechanisms

Corporate governance in state enterprises indivisible from that of corporate governance in private firms: Requires robust private sector to develop competitive markets necessary for external enforcement mechanisms – especially financial market discipline

6.2 Options: Improving State's Ownership and Governance Functions

Strengthen legal and regulatory basis for SOE corporate governance

Corporatised SOEs operate under generic company law, adhere to national corporate governance code based on international best practice

Arms-length relationship between politicians/government and enterprise

- Independent commercialised state holding/investment/asset management company, operated by professionals and fully accountable to parliament
- Clear commercial and financial objectives and mandate for holding company and for enterprises

6.3 Options: Improving Corporate Governance System/Practices in SOEs

- Operational and financial autonomy; subject enterprises to market discipline
- Clear delineation of rights and responsibilities of AGM, SB, BoD and management
- Strengthen role of SB and BoD in oversight, through board balance and independence (INEDs)
- Open and competitive recruitment with market-based incentives
- Rigorous regulatory standards on systems of internal controls and risk management,
- External audit and improved transparency, disclosures

Examples and lessons from Singapore, Sri Lanka, China

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