BOX 7
Restrategising State Owned Enterprises as Growth Facilitators

Since long, State Owned Enterprises (SOEs)[1] have played a key role in the socioeconomic development of countries. Healthy SOEs have made significant contributions to employment creation, poverty alleviation, fiscal stability, development of a sector or geographical area, environmental protection and even sector regulation as witnessed in several countries, including Asian peers such as Singapore, Japan, China and Korea.

Although during recent decades there has been a growing consensus in favour of privatisation and deregulation, the role of SOEs has not diminished, especially in developing countries. This is primarily because SOEs continue to be the providers of essential infrastructure and public services which have the highest impact on economic growth, development and overall wellbeing of the population. However, SOEs in the developing world generally tend to be straddled by low productivity, while distorting competition and being afflicted by corruption. This has resulted in them being a significant burden on the budget and the government, and in some cases leading to fiscal and economic crises. It is essential that Sri Lanka remains wary of the performance of its own SOEs in this context.

Evolution of SOEs in Sri Lanka

The development of public sector enterprises in Sri Lanka dates back to the Second World War period of 1939 – 1945, when several SOEs were set up to provide essential goods whose supply had been curtailed during the war. In the mid 1950s, the interest in socialism piqued with the successes in the Soviet Union and the adoption of a socialist ideology of development in India during the same time. Accordingly, the Government of the time considered central planning as essential for the development of the country.

During this period, two key enactments catalysed the development process of SOEs, i.e. the Government Sponsored Corporations Act No. 19 of 1955 and the State Industrial Corporations Act No. 49 of 1957, respectively. The former sought to incorporate existing industrial undertakings, while the latter empowered the Government to set up and carry out any industrial activity. By 1957, several important SOEs had commenced operations, including those related to cement, paper, ceramics, leather and footwear. Another key development during this period was the nationalisation of bus companies leading to the formation of the *Ceylon Transport Board* in 1958.

1 There is no commonly accepted definition for an SOE (European Commission, 2013; IMF 2014; OECD 2015). However, some characteristics of SOEs are as follows: (1) the entity has its own, separate legal personality; (2) the entity is at least partially controlled by a government unit; and (3) the entity engages predominantly in commercial or economic activities (IMF, 2020). The *Government Financial Statistics Manual 2014* (IMF, 2014) states that assessing government control of any entity involves judgment. Accordingly, a government may exercise significant influence over corporate decisions even when it owns a small number of shares.

In 1959, a *Ten Year Plan* which emphasised import substituting industrialisation was introduced – although the plan was not entirely operational, it closely guided the economic policies of the following years. Accordingly, 'basic industries' such as cement, steel, paper, tyres, mineral sands, salt, flour milling, plywood, petroleum refining and fertiliser, were to be undertaken by the Government. However, some areas which were of interest to the Government were also open for private enterprise participation, such as footwear, ceramics, textiles and leather products. This inward oriented development strategy was warranted by the persistent deficits in the balance of payments and the resultant introduction of a series of stringent import controls from 1960 onwards.

The 1970s saw a fresh slew of measures towards autarky, including the setting up of several monopolies in the public sector through both establishment of new enterprises and a series of nationalisations and acquisition of private ventures. The creation of SOEs was expected to be beneficial as it was premised that, as natural monopolies, they would supply services or products at costs which were below than what potential private players could offer and that they would also be able to meet the demand of the entire market, perhaps also with export potential. Accordingly, in subsequent years, there was nationalisation of privately owned business undertakings such as those engaged in port services, passenger transport and plantations, among others. By the mid 1970s, major economic and social activities such as banking, plantations, large scale industries, transport, insurance, telecommunications, postal services, ports, electricity, import and distribution of petroleum, roads, health and education were either public sector monopolies or were largely undertaken by public enterprises. The numbers of SOEs rose rapidly from 14 in 1962 to over 280 public enterprises by the mid 1980s.

By the mid 1980s, it was noted that public enterprises were facing a multitude of issues. These included operational inefficiencies translating into poor financial performance, subpar quality of products and services and supply shortages, recruitments driven by political considerations rather than the needs of the SOEs, inability to mobilise resources to meet large investment requirements, and, excessive dependence on the government budget. The growing burden of SOEs on the budget alongside multilateral donor agencies highlighting the urgent need for macroeconomic stabilisation led to the Government announcing privatisation as a state policy in 1988. The divestiture programme commenced in 1989 and, over the period till 1993, partial or full divestitures of about 43 commercial enterprises were undertaken. However, this divestiture programme came under much criticism in the period thereafter. Many of Sri Lanka's experiences with privatisation highlight that the weaker the economy and governing institutions, the more arduous it is to reap the benefits of privatisation.

Current Status of SOEs in Sri Lanka

Over the last three decades, successive governments have alternated between attempts at privatisation and nationalisation. Currently, there are over 400 SOEs operating in several key sectors including power, energy, finance and insurance, water, aviation, health and education, among others. While a large majority of SOEs are regulated by the 'Administer Part II' of the Finance Act No. 38 of 1971, of recent times, several have been established under the Companies Act No. 07 of 2007. Of these, 52 SOEs have been identified as State Owned Business Enterprises (SOBEs) as they are regarded to be strategically important to the functioning and transformation of the economy. SOBEs in Sri Lanka include the Bank of Ceylon, People's Bank, Sri Lanka Insurance Corporation Ltd, Ceylon Electricity Board (CEB), Ceylon Petroleum Corporation (CPC), Sri Lanka Ports Authority, SriLankan Airlines, Sri Lanka Transport Board and State Pharmaceuticals Corporation, among others.

Despite their pivotal role in the economy across strategic sectors, the poor financial performance of SOEs has become a heavy fiscal burden with significant macroeconomic implications. The excessive reliance of SOEs on the banking system to fund their losses has not only crowded out productive investments but has also rendered the financial system vulnerable to their weak financial performance. Macroeconomic stability is also threatened as their burgeoning financial losses weigh down on their ability to smoothly fulfill domestic demand for essential goods and services. Recognising the issue, in recent years, the Government undertook several initiatives to reform SOEs. Key reforms in this regard are the introduction of a Statement of Corporate Intent (SCI) as a tripartite Memorandum of Understanding signed by the respective enterprise, line Ministry and Ministry of Finance and the introduction of a regulatory framework for SOEs that provides commercial freedom, while increasing their level of accountability. Policy reforms have also been identified to amalgamate or consolidate SOEs with similar objectives and those at similar stages of the value chain thereby creating 'economies of scale' for these enterprises. Further, the Government also recently formed *Selendiva Investments Ltd,* a fully state owned company, to manage and consolidate several high end real estate assets in a bid to capitalise on the success of 'holding company' models, as seen in Singapore and Malaysia.

In the post COVID-19 recovery process of the economy, where an urgent correction of the course of the economy has become necessary, there is a dire need to expedite such reforms and further focus on the rigorous and rapid transformation of SOEs as growth facilitators. This is essential to improve their efficiency, productivity and profitability and thereby empower them to contribute to the economy's recovery process in an effective and sustainable manner, without being a persistent economic issue. A few such key reforms that may be considered are discussed.

Proposed Major SOE Reforms

a. Introduction of Cost Reflective Pricing Policies

Often SOEs have to strike a fine balance between helping the Government achieve its socioeconomic objectives while ensuring the enterprise's financial viability. This challenge stems from the engagement of SOEs in the provisioning of essential products and services, which are sometimes not commercially viable; for instance, the provision of public transport to rural communities or electricity in geographically challenging areas such as in mountainous regions. Despite this element of 'essentiality' associated with the portfolio of goods and services provided by Sri Lanka's SOEs, establishing a cost reflective pricing mechanism is a key priority to ensure sustainable and uninterrupted provisioning of these goods and services.

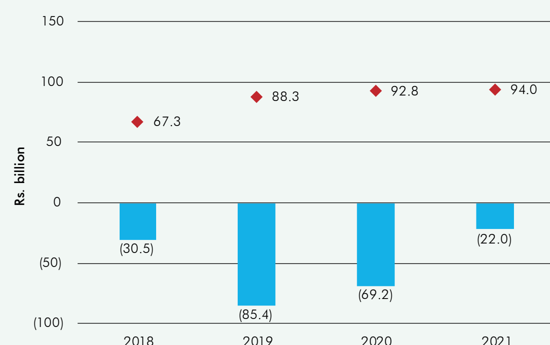
In the recent past, Sri Lanka has struggled with the implementation of cost reflective pricing policies, especially in relation to the pricing of fuel products and utilities such as water and electricity. Despite a brief episode of frequent price adjustments of fuel products in line with global developments, no price revisions were undertaken between September 2019 and June 2021, after which three rounds of upward price revisions were undertaken to compensate for both the rising global prices of crude oil and the financial losses incurred by the CPC over several years. Tariffs for water and electricity continue to remain unrevised since 2012 and 2014, respectively. It must be reiterated that, in the case of enterprises such as the CPC and the CEB that rely on imported intermediate goods, their exposure to changes in global commodity prices as well as exchange rate fluctuations warrants regular price revisions. Hence, long periods of unchanged prices or tariffs are unacceptable as evidently losses on account of these external shocks cannot be absorbed by the relevant enterprises.

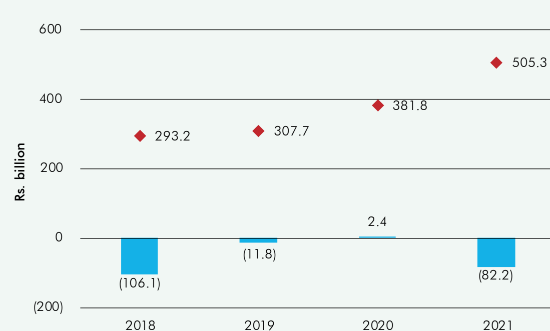
Accordingly, the implementation of transparent and depoliticised pricing rules are an urgent need. While subsidised prices may provide some financial benefits and leeway to consumers in the short term, it should be recognised that the related expenditure burden of below cost provisioning is borne by the Government. Subsidised prices cause price distortions and misallocation of resources that entail significant macroeconomic costs which could translate into insurmountable disruptions in the economy, as depicted by the power and energy crisis that emerged in early 2022. A cost reflective pricing mechanism will also ensure that SOEs pass on benefits of lower costs to consumers in a transparent and timely manner without negative implications on bottom line profits. Such a mechanism can greatly boost transparency and accountability of SOEs with positive spillover effects across the economy.

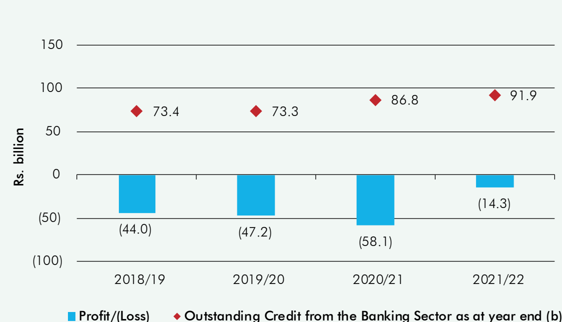
b. Improvement of Strategic Direction

The primary task of SOEs is not just to generate financial returns to the Government in the short term but also to deliver strategic value to all stakeholders of the economy by facilitating and uplifting their productive potential and overall wellbeing. Accordingly, it is imperative for

Figure B 7.1
Comparison of Profits/Losses and Credit Obtained from the Banking Sector for Selected SOBEs







(a) Financial performance of Sri Lankan Airlines is for the financial year ending 31st of March. Data for 2021 is for the nine months ending 31st March 2022.
(b) As per the Monetary Statistics compiled by the Central Bank of Sri Lanka

Sources: Ceylon Petroleum Corporation
Ceylon Electricity Board
SriLankan Airlines
Ministry of Finance
Central Bank of Sri Lanka

these entities to have a transparent and unambiguous strategy that is well connected to the overall vision of the Government. This will ensure a clear purpose and mission for SOEs.

As seen in the recent past, SOEs have been unable to leverage their resources to create value for stakeholders and catalyse growth. This has been evidenced by the lack of strategic planning causing bottlenecks in the economy wherein SOEs have often failed to proactively identify and address opportunities and challenges emanating, not only from domestic developments but also global developments. The poor strategic planning of SOEs is evident from the supply side shocks that the economy is experiencing in the wake of adverse developments in global energy and food commodity prices and the lack of any robust buffers to tide over such volatilities.

Therefore, to improve strategic direction, it is important for SOEs to minutely assess their operations. Breaking down the entire value chain of a product or service can enable enterprises to assess the areas in which they have natural advantages. Private sector participation can, therefore, be facilitated through such unbundling of activities. Accordingly, operational inefficiencies are borne neither by the Government nor consumers nor other relevant stakeholders.

c. Enhancement of Financial Transparency and Accountability

SOEs are often under pressure to be competitive and commercially viable, while trying to fulfil non-commercial objectives, the latter of which may necessitate compromising financial performance. In order to keep track of whether SOEs are effectively balancing their social obligations with their commercial obligations, it is important to establish a sound performance monitoring framework that incorporates principles of accountability, transparency and governance.

In this regard, one of the key aspects that is urgently needed is the identification and development of Key Performance Indicators (KPIs) to measure and evaluate results of SOEs. While such KPIs should assess financial results, it is also important to consider the impact on social, human and environmental capitals as SOEs have a wider purpose than simply being profit generators for the Government.

Another aspect that needs to be addressed is the improvement of disclosure and transparency of SOEs. Accordingly, SOEs must observe high standards and be subject to the same high quality accounting, disclosure, compliance, and auditing standards as listed companies. Time and again, concerns have been raised that numerous SOEs do not prepare year-end financial statements or annual progress reports in a timely manner; some entail delays of several years. A stringent mechanism is essential to ensure timely periodic reporting with disclosures of financial and nonfinancial information to assess the status of SOEs and whether they are performing in a financially viable and economically sustainable manner.

d. Strengthening Corporate Governance

The success of SOEs hinges on efficient and professional management by a competent Board. The Board needs to take full responsibility for stewardship and performance of the enterprise and should be competent enough to steer it in a strategic manner that is conducive to the vision of the Government and thereby, the progress of the economy. Inefficiencies on the part of the Board can result in a lack of strategic direction leading to the colossal mismanagement of state resources, as has been seen in the case of certain SOEs in Sri Lanka.

The composition of Boards plays a crucial role in the quality of corporate governance. It is vital that the Government promotes the appointment of competent, experienced and professional individuals to Boards to ensure strong accountability. Appointments should be on the basis of fixed term contracts that are independent of election cycles. This can ensure efficacious strategic planning suited for transformation over the medium term rather than the implementation of transient fixes.

It is also essential that Boards and the senior management of SOEs act diligently and with extreme care considering that the resources entrusted to them are ultimately the resources of the general public. The recent issuance of *Guidelines on Corporate Governance* and an *Operational Manual for State Owned Enterprises* in late 2021 by the Ministry of Finance is a timely initiative in this regard. Rigorous monitoring on the part of the Ministry of Finance to ensure that all SOEs are operating in line with these guidelines can catalyse the transformation process of these entities. Regular reviews of the guidelines are also necessary to continuously align SOE corporate governance standards in line with best international practices.

Good corporate governance helps to operate SOEs more efficiently, improve access to capital, and mitigate risk while safeguarding against mismanagement. Research findings reveal several direct advantages for SOEs that have undergone governance reforms. Such benefits include improved operational performance, increased access to alternative sources of financing through domestic and international capital markets, financing for infrastructure development, reduced fiscal burden of SOEs and increased net contribution to the budget through higher dividend payments, and reduced corruption and improved transparency.

Reforms in SOEs: International Experiences

Countries across the world have made attempts across several decades to turnaround the performance of their SOEs. Selected SOE reform experiences, as could be pertinent to Sri Lanka, are described below.

Singapore

In the case of Singapore, the investment holding company *Temasek* has seen much success. It was established in 1974 to own and commercially manage investments and assets previously held by the Government of Singapore. Following independence in 1965, the lack of raw natural resources drove Singapore to commence an aggressive industrialisation and economic development programme. As the Government established startups in several strategic sectors, *Temasek* was established to relieve relevant ministries from the commercial management of these enterprises in which the Government had a controlling stake. With time, the fund encouraged portfolio companies to expand into other markets as well as to pursue mergers and acquisitions to become more internationally competitive. Revisions to the charter over several rounds led *Temasek* to evolve into a global investment company with the mission of generating sustainable returns beyond the present generation. The portfolio value of *Temasek* stood at US dollars 283 billion as at end March 2021, having generated a group net profit of US dollars 42 billion during the same year. Notably, there are no government representatives on the Boards of portfolio companies under *Temasek*. Further, the Government of Singapore does not have any influence over the appointment of key personnel and operations of *Temasek* or other SOEs.

China

China's SOEs have seen a series of reforms since the 1970s, driven by market oriented economic reforms aimed at opening up the economy to foreign trade. In 2003, *the State-owned Assets Supervision and Administration Commission* (SASAC) was established to fund and regulate SOEs. From 2013 onwards, China focused on the merging of large SOEs and expanded mixed ownership programmes. Currently, China's SOE reform agenda is focused on making SOEs 'stronger, better and bigger'. Accordingly, SASAC's *zhuada fangxiao* (grasp the big, release the small) approach seeks to reduce the number of small SOEs through privatisation and asset sales, while strengthening SOEs that are deemed to be strategically important for the state economy. It is opined that the companies held by SASAC have superior governance even in comparison to their private sector counterparts. Chief Executive Officers and Directors are appointed under performance based contracts with detailed dividend targets. Boards also comprise professional independent Directors to improve accountability.

Brazil

Despite grappling with underperforming SOEs, Brazil has created extremely successful SOEs such as *Petrobras* which is featured on the *Fortune Global 500 list*. In *2010, Petrobras* was transformed from a purely state owned company into a mixed company. To date, the share democratisation that ensued this transformation is one of the largest capital-increase transactions in the history of capital markets. This created an increase in the market value of the company, while creating opportunities for the company to mobilise investments to support its growth. Listing of the company on the stock exchange also paved way for significantly improved corporate governance as the state's participation as a sole proprietor was significantly curbed, thereby preventing the risk of political influence and lack of commitment by the board and management.

India

India has followed a strategy of disinvestment in recent years to address the issue of inefficient SOEs. This has entailed the sale of a substantial portion of the government shareholding of enterprises, including transfer of management control. Today, India has the second largest number of SOEs, after China, in the *Fortune Global 500* list of companies. A recent move in its reform agenda has been the privatisation of *Air India* with the government of India receiving about US dollars 360 million in equity and a private conglomerate taking over US dollars 2 billion of debt. India is also to establish

a company, *National Land Monetisation Corporation,* to hold, manage and monetise surplus land and buildings of government agencies and public sector undertakings. This is to be set up as an entirely government owned company under the Ministry of Finance.

Successful SOE Turnaround in Sri Lanka: *Case of Sri Lanka Telecom PLC*

The telecommunications sector is one of the most successful service sectors in Sri Lanka, in terms of quality, reliability and pricing of services. Today, Sri Lanka boasts mobile penetration of over 135 per cent and has one of the lowest mobile and internet charges in the region. A key player in this industry is Sri Lanka Telecom PLC which has emerged as a successful SOE over the last two decades.

Following economic liberalisation, in the early 1980s Sri Lanka took a significant step in restructuring the telecommunications sector by instituting the Department of Telecommunications, which later handed over the operational functions to a public corporation, namely *Sri Lanka Telecom*. In 1996, *Sri Lanka Telecom* was reconstituted as a government owned Limited Liability Company. A turning point for the SOE was the sale of 25 per cent of the share capital to *Nippon Telegraph & Telephone Corporation* for US dollars 225 million in the following year. This was followed by the successful listing of *Sri Lanka Telecom PLC* on the Colombo Stock Exchange in 2003. As at end 2020, the two major shareholders of *Sri Lanka Telecom PLC* were the Government, holding a 49.50 per cent stake through the Secretary to the Treasury and, *Global Telecommunications Holdings N.V.* with a 44.98 per cent stake and the remainder being held by other shareholders and publicly traded on the Colombo Stock Exchange. Accordingly, dividends from *Sri Lanka Telecom* stood at approximately Rs. 947 million in 2020 and dividends amounting to Rs. 1.4 billion are expected in 2022 and beyond.

The case of *Sri Lanka Telecom* highlights the innate potential that exists in SOEs and how the undertaking of timely reforms, such as through divestiture can help the economy harness this potential. It is also important to note that in this case, the setting up of the *Telecommunications Regulatory Commission of Sri Lanka* as an independent regulator facilitated the progress of Sri Lanka Telecom as it ensured the overall dynamic development of the sector through the creation of a regulatory environment that is committed towards ensuring competition and contestability.

Considering the success seen with *Sri Lanka Telecom,* going forward, the Government may consider the sale and/or divestiture of SOEs. In this regard, it is vital for successive governments to maintain a consistent policy stance in relation to the sale of government assets, while also addressing the concerns of stakeholders in a timely and proactive manner during such processes.

Way Forward

Going forward, as Sri Lanka progresses on its post COVID-19 recovery journey and transitions to the upper middle income status, it is crucial that the Government expeditiously implements the reforms that are underway, especially in relation to mergers and consolidation and the strengthening of corporate governance, which have also been proposed above. Reforms relating to the implementation of a transparent pricing mechanism, improvement of strategic direction and enhancement of financial accountability are also imperative to improve the performance of SOEs in the short term. These not only ensure improved government revenue but also reduces the need for loss financing through budget transfers or as borrowings from the banking system. This can help release substantial volumes of resources to be channeled to more productive income generation or asset creation by households and enterprises. Accordingly, there will be a multiplier effect on government revenue in the short run and on growth in the medium to long run.

With due consideration to the key role that SOEs play in the economic development process, especially with their wide presence in strategic sectors, it is crucial that these enterprises perform effectively and deliver favourable socioeconomic outcomes without financially burdening the state. In this regard, the Government must conduct individual feasibility studies of SOEs and initiate timely action regarding the sale of some of their assets to domestic or foreign entities. Subsequently, the Government may also consider restrategizing these SOEs without politicizing them to ensure sustainable and viable operations. The Government must also recognise that although such reforms may require some unpopular policy initiatives at the outset, these can pave way for the creation of SOEs that are financially viable and economically beneficial over the medium to long run. The transformation of existing SOEs from 'fiscal burdens' and into 'value creators,' through such reforms, is vital for them to emerge as facilitators of Sri Lanka's progress onto a high growth trajectory, rather than serve as stumbling blocks.

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