A clearly defined legal and regulatory framework for state-owned enterprises (SOEs) is essential for communicating key expectations to SOE shareholders, boards, management, and all other stakeholders, including the general public. The underlying aim of such a framework is to make the broad policy directions of the state and the “rules of the game” clear for everyone. While no one-size-fits-all approach applies to all countries and contexts, the framework should set clear boundaries and define the relationship between the government as shareholder and SOE boards and management, separating legitimate government control and oversight for ensuring SOE accountability from the managerial autonomy necessary in commercial decision making.

This chapter describes various SOE legal forms and frameworks and the steps that governments are taking to improve and modernize their legal frameworks. It covers the following topics:

- Overview of SOE legal forms and frameworks
- Key issues in the legal framework
- Harmonization of SOE frameworks with private sector frameworks
- Development of a state ownership framework for SOEs
The SOE sector in any given country can be broadly defined. It includes SOEs that are government owned or controlled and that generate the bulk of their revenues from selling goods and services on a commercial basis, even though they may be required to pursue specific policy goals or public service objectives at the same time. Such SOEs are the focus of this particular toolkit. SOEs are distinguished from public agencies, quasi-governmental organizations, or other parastatal organizations in the broader state enterprise sector that carry out public policy functions at arms’ length from government line departments and earn a significant share of their own revenues. The definitional range with respect to SOEs is reflected in the three separate descriptions prepared by the Organisation for Economic Co-operation and Development (OECD), European Union (EU), and the Republic of Korea (see box 2.1).

**Key Concepts and Definitions**

The OECD’s Guidelines on Corporate Governance of State-Owned Enterprises. The guidelines focus on public entities that use “a distinct legal form (i.e. separate from the public administration) and [that have]... a commercial activity (i.e. with the bulk of their income coming from sales and fees), whether or not they pursue a policy objective as well. These SOEs may be in competitive or in non-competitive sectors of the economy. When necessary, the Guidelines distinguish between listed and non-listed SOEs, or between wholly, majority or minority owned SOEs since the corporate governance issues are somewhat different in each case.... [The guidelines] are also useful for non-commercial SOEs fulfilling essentially special public policy purposes, whether or not in corporate form....[The term SOEs refers]... to enterprises where the state has significant control, through full, majority or significant minority ownership” (OECD 2005).

**European Union.** The EC directive No 80/723 defines a public enterprise (the term used is undertaking) as “any undertaking over which the public authorities may exercise directly or indirectly a dominant influence by virtue of their ownership of it, their financial participation therein, or the rules which govern it.” Under the landmark case of
Where SOEs are concerned, the legal framework varies greatly across jurisdictions, as well as within the same jurisdiction depending on the legal form of the enterprise. Some SOEs are established as statutory corporations with their own legislative act or other distinct legal foundation. Others may be noncorporatized entities in the form of SOEs or government departments, which usually fall under an SOE or public enterprise law. SOEs that are corporatized typically take the form of joint-stock companies or limited-liability companies and may fall under SOE law, company law, or, in some cases, both. These varying SOE legal forms and frameworks present a challenge but make it all the more important to establish a clear and suitable legal and regulatory framework for SOE governance.

The legal basis for corporate governance in most countries is found in company legislation, which in many countries applies to corporatized SOEs. Company law lays out basic shareholder rights and board and disclosure requirements, often supplemented by legal requirements for accounting and auditing and standards and professional rules for listing and other capital
market requirements. While many governance practices are mandatory under the law, in certain instances they may be contained in a nonbinding corporate governance code, where the company is simply required to explain the reasons for the lack of compliance with the recommendations in the code (“comply or explain”).

Unlike listed companies, which have shares listed on a stock exchange and are subject to the legal and regulatory structure of the capital markets, unlisted companies tend to have simpler ownership structures and stakeholder arrangements and therefore simpler corporate governance requirements. Banks and other financial institutions usually have additional (and somewhat different) legal and regulatory requirements beyond those for listed companies, such as those applying to risk management and internal controls.

**Overview of SOE Legal Forms and Frameworks**

As noted above, SOEs come in many different legal forms and typically reside at the intersection of public and private law, with significant variation between and within countries. SOE legal frameworks range from a full-fledged application of public law to a private law framework or a mixed approach that places some SOEs under public law, others under private corporate law, and still others under both. In a few cases, constitutional and supranational law may both apply (box 2.2).

In some cases, an individual SOE may be set up as a statutory corporation established by an act of parliament and governed by its own special statute that gives it financial independence or certain special powers (for example, authority to collect specific fees). Often such SOEs are legally assigned a specific policy goal or tasks other than profit maximization. Such SOEs are typically wholly state owned and operate in sectors where public authorities are most directly involved, such as the supply of public services or utilities.

More typically, SOEs are in the form of public enterprises that may or may not be corporatized. In addition to their enabling legislation or articles of association, such SOEs may operate under a general public enterprise or SOE law (box 2.3), or regulatory requirements may be scattered in various decrees and regulations without any overarching law. General SOE laws aim to bring uniformity to SOEs as a whole and have been developed for a variety of reasons, including to ensure that these enterprises carry out specific objectives or meet social considerations, to provide greater flexibility and managerial independence to SOEs, to reduce direct administrative management by the state, to fund the operations of the public services by fees directly collected
BOX 2.2

**Application of Constitutional and Supranational Law**

National constitutions influence the role of companies, including SOEs, throughout a country and may significantly affect the subsidiary legislation that constitutes the legal framework under which SOEs operate. For example, in South Africa the 1996 constitution (section 27) confers a constitutional right to water, heightening the responsibility of government to deliver a universal service that can be limited only for compelling or urgent reasons. The 1998 National Water Act creates a comprehensive legal framework for the management of water resources, which is the responsibility of the government (see Gowlland-Gualtieri 2007 for a fuller discussion). Similar provisions exist in the constitution of Uruguay (Article 47), which includes the right to potable water and sanitation. Examples of other countries with a constitutionally recognized right to water include Ecuador, Ethiopia, Gambia, Uganda, and Zambia.

Supranational rules are an additional factor affecting the legal treatment of SOEs. For example, EU treaty obligations have effected SOE governance through the application of competition law in EU member states, particularly in sectors traditionally dominated by national monopolies (Albert and Buisson 2002). The Treaty on the Functioning of the European Union declares that “Member States shall adjust any State monopolies of a commercial character so as to ensure that no discrimination regarding the conditions under which goods are procured and marketed exists between nationals of Member States” (Art. 37; §1). Under the weight of EU competition law, most French SOEs, for example, are now regulated by the general company law rather than as individual public law entities (Établissement Public Industriel et Commercial). Provisions of the Treaty on the Functioning of the European Union, and their interpretation by EU courts, have driven the transformation of the public sector in EU member states. For a number of countries outside the EU, multilateral trade liberalization has lessened the influence of the state in SOE operations, even in countries where the political culture is supportive of state intervention for economic development.
from users and not solely through taxes, to link staff and users more closely to the delivery of a public service, and to provide for the dedication of expenses and revenues when a service is performed directly by the state as a legal person. SOE laws typically define the legal structure of SOEs, their administration, and the role of governing bodies such as boards and general assemblies (specific regulatory provisions with respect to these areas are covered in greater detail in the subsequent chapters of the toolkit).

In many countries, incorporated SOEs in the form of joint-stock companies or limited-liability companies are regulated by normal company legislation. In addition to company legislation, they may also be regulated by their own enabling legislation, by a general SOE law, or by SOE ownership policies, guidelines, and codes of corporate governance. Box 2.4 provides examples of countries where SOEs operate under company legislation or under SOE legislation as well. Where SOEs are listed on the stock exchange, they are also subject to the listing requirements of the exchange and to other securities laws.

In addition to SOE laws and company legislation, SOEs are also often subject to many other public sector laws and regulations. While these vary

---

**BOX 2.3**

**Countries with General Public Enterprise or SOE Laws**

Some countries have general SOE framework laws. While some laws cover all SOEs, others exclude large strategic SOEs such as utilities, natural resources, and defense, which may have their own separate laws:

- **The Arab Republic of Egypt**, where commercial SOEs fall under the Public Business Sector Law, and where under the law SOEs are also subject to the company law. Utilities and defense SOEs, however, have their own separate laws.
- **Korea**, where the government-owned companies and government-invested companies are all subject to the Act on the Management of Public Institutions.
- **Serbia**, where nonincorporated SOEs operate under the Law on Public Enterprises and where such SOEs are also subject to the company law.
- **Turkey**, where the bulk of national SOEs, including corporatized and noncorporatized SOEs, operate under Decree Law 233 on SOEs, while others have their own establishment acts or fall under the Privatization Law.
from one country to the next, and within countries by type of SOE, they often include public sector employment rules, investment and budgeting regulations, public sector procurement laws, public financial management laws, public sector audit requirements, and sector-specific laws and regulations.

Key Issues in the SOE Legal Framework

In many countries, public enterprise or SOE laws are outdated and came into effect at a time when SOEs operated as vertically integrated enterprises with very little competition in the market. Many such laws have overlapping
and sometimes contradictory provisions that lead to inconsistent and conflicting frameworks and undermine the accountability of the state, boards of directors, and management. While the original intent may have been to put SOEs on a commercial footing and foster greater enterprise autonomy, instead they have often had unintended consequences:

• They may give powers and responsibilities to government owners that weaken the board of directors, such as the responsibility for setting company strategy or appointing the chief executive.
• They may require SOEs to be profitable and at the same time to carry out social objectives without any provisions for financing the costs of meeting those objectives.
• They may impose restrictions that reduce the operational autonomy of SOEs in key areas, such as budgeting, investments, pricing, and human resources.
• They may limit the means for altering the capital structure of SOEs or call for lengthy approval processes for budgets and investments that delay decision making.
• They may contain weak corporate governance provisions in areas such as boards, preferred rights, and disclosure.
• They may not stipulate how the state should behave as an owner or as a shareholder: for example, how it should vote its shares; how it should appoint, recall, and remunerate boards and management; and how it should monitor the companies.
• They may override general company law.

Shortcomings also arise when SOEs operate under private company law, especially in the absence of a proper framework that governs the state’s role as owner and its relations with SOEs:

• In the absence of a clear framework for board nominations, SOE boards may be composed of members, including government officials and sometimes ministers, who lack the necessary qualifications, skills, and experience for the job.
• SOEs may be responsible for social and policy obligations but without specific identification and adequate compensation for the provision of such services.
• Without a properly defined monitoring system, unsupervised SOEs may incur significant debts and acquire noncore assets, creating a source of financial and fiscal risk.

For these reasons, many countries are revamping and modernizing their legal and regulatory framework to create a strong foundation for improving
SOE governance and performance. Experience from a number of countries highlights two important steps in that effort: harmonizing SOE frameworks with private sector frameworks and improving or developing a clearly defined state ownership framework.

**Harmonizing SOE Frameworks with Private Sector Frameworks**

More and more countries are treating commercial SOEs just like other companies and are taking steps to harmonize their corporate governance frameworks with modern governance rules applicable to private companies. Unlike private companies, however, many SOEs, especially those providing public services and supporting other public policy goals, have to balance commercial and noncommercial objectives. Such SOEs are often explicitly established to carry out public service obligations, even though they operate in competitive markets. For such SOEs, additional measures (as discussed in greater detail in chapter 5) are required as part of a state ownership framework to ensure that noncommercial obligations are properly identified, compensated, and carried out in a transparent manner.

Eliminating or reducing differences between the rules governing SOEs and other companies aims to give companies greater operational flexibility and insulate them from political interference; to subject SOEs to the same corporate governance discipline as private firms, such as in financial reporting and disclosure; and to commit SOEs to improving their governance. Another important objective is to ensure that SOEs operate on a level playing field with the private sector. Creating a level playing field means ensuring that SOEs have neither an advantage nor a disadvantage on account of their ownership compared to private companies in the same market. It also requires that the participation of SOEs in economic activities not distort competition in the market. In OECD countries, *competitive neutrality* is the term applied to subjecting SOEs to the same laws and regulations as private firms, which is a key characteristic of a level playing field. Another important aspect is financial and fiscal discipline, which is covered separately in chapter 5.

The objectives above have led a number of countries to put SOEs on the same legal footing as the private sector to make them more commercially oriented and competitive. Important steps in the process include applying company legislation to SOEs, ensuring equal application of broader laws and regulations to both state and private sectors, and subjecting SOEs to capital market laws by listing them on the stock exchange.
Application of Company Legislation to SOEs

In many countries, SOEs are already operating under normal company legislation, while others are increasingly moving in that direction. Applying normal company legislation to corporatized SOEs is a relatively easy step. But bringing noncorporatized SOEs under the company law first requires a process of corporatization. Corporatization is the act of reorganizing an SOE into a legal entity with corporate structures similar to other companies, including a board of directors, management, and shareholders. The main goal of corporatization is to allow the government to retain ownership but still enable it to run SOEs efficiently and on a more commercial basis like other companies.

Larger SOEs typically take the form of a joint-stock company, while smaller SOEs may be organized in the form of limited-liability companies. The process of transforming or corporatizing an SOE into a separate legal entity with a company form varies across countries and within countries by type of SOE, but a few guiding steps can be mentioned:

- Determine if separate legislation is needed to change the status or ownership of SOEs, especially in the case of those established by a specific law. Some SOEs may be subject to specific legislation that may require statutory reforms.
- Determine the company’s mission and mandate.
- Define the government shareholding clearly.
- Identify noncommercial objectives and determine how to handle them. In some cases, they have been abandoned, while in others they have been costed out and financed separately (chapter 5).
- Identify and value the company’s moveable and fixed assets.
- Prepare balance sheets to determine the equity value of the company.
- Establish the reporting relationship to the shareholder.
- Determine the corporate governance structures of the company.
- Carry out internal reorganization and restructuring as required.
- Transfer assets and employees.
- Register the company in the company registry.

The state can be the sole shareholder or the majority shareholder in corporatized companies. In such cases, it exercises control over the SOEs by appointing the board of directors, voting its shares, and monitoring and reporting on SOE performance. In companies where the state owns minority shares, the state may exercise control through shareholder agreements or special legal provisions such as a “golden share” (chapter 8 covers issues related to minority state ownership in greater detail). A golden share refers to a special provision by which the state maintains a veto over corporate
decisions by holding onto special rights, notably through preferred stock holding retained by the state after privatization. Golden shares, however, are declining in use. For example, they were deemed illegal by European Union courts in 2000 and reconfirmed several times since.

Corporatization and the accompanying change in legal status are intended to reduce government interference, clarify SOE goals, provide operational flexibility, and bring better and more flexible governance standards and practices to SOEs. The goal is to move SOEs toward greater profitability and efficiency:

- A study of 25 Canadian SOEs examined the impact of corporatization on performance, covering the period 1976 to 1999 when corporatization took place. Performance is measured through a multicriteria approach, including indicators of profitability (return on sales and return on assets) and productivity (sales per employee, earnings before interest and taxes per employee, and asset turnover). The results suggest that corporatization had a significantly positive impact on the financial performance of SOEs. These effects are often perceptible as early as four years after revision of the firm’s mandate, with difference in performance caused by a fundamental difference in the firms’ objectives. Large SOEs performed better as they are better positioned to realize economies of scale. The main caveat involves the status of the SOEs, as they are often in monopolistic or oligopolistic sectors, which may make them profitable despite their special set of objectives and make comparisons with private firms difficult (Bozec and Breton 2003).

- A study using survey data from 442 Chinese SOEs over the period 1990–99 shows that corporatized SOEs performed better than noncorporatized SOEs in the sample (Aivazian, Ge, and Qui 2005). Improvements in profitability and efficiency are attributed to better monitoring of managers, better information-sharing channels, and less government interference. Unlike noncorporatized SOEs, corporatized firms set up a board of directors and chief executive officer (CEO) per the Corporate Law, as well as independent legal, financial, and marketing departments. The study also found that the influence of the Communist Party in selecting managers is weaker in corporatized firms than in noncorporatized firms (although the study shows that in most cases it was the government that issued the appointment letter, not the board as good practice dictates). It also found that corporatization did not fully instill financial discipline, with corporatized firms borrowing from state banks more than noncorporatized firms, and that there is significant room to reduce infringement on managerial autonomy even further.
However, experience also shows that corporatizing SOEs and bringing them under company law may achieve little in the absence of parallel corporate governance reforms as covered in the rest of this toolkit. For example, corporatization by itself may not eliminate SOEs’ protection from competition or subsidies. Board appointments may not be merit based. SOE managers may be government officials with salaries and job security on par with the public sector. And SOE performance may not be properly monitored. To achieve maximum results, the change of an SOE from a public entity to a corporate form must therefore be accompanied by the other reforms, as discussed in the rest of this toolkit.

**Equal Application of Other Laws and Regulations**

Equal application of broader laws and regulations helps create a level playing field and achieve competitive neutrality between state and nonstate companies so that “no business entity is advantaged (or disadvantaged) solely because of its ownership” [emphasis in the original] (Capobianco and Christiansen 2011, 3). It also aims to ensure that the participation of SOEs in all kinds of economic activities does not distort competition in the market.

When SOEs compete with private firms in markets for goods and services, the application of all laws and regulations equally to SOEs and the private sector becomes important for leveling the playing field. Yet, SOEs are often exempt from certain laws, such as competition and bankruptcy laws, and that exemption creates market distortions and reduces management accountability. At the same time, the imposition of other public sector laws and regulations on SOEs, such as human resource regulations and procurement regulations, can undermine their ability to compete. Apart from legal and regulatory barriers, an uneven playing field can also arise from financial and fiscal policies that give SOEs access to so-called soft budget constraints or require them to carry out public service obligations without adequate compensation (covered in chapter 5).

**Competition Law.** With the dismantling of monopolies, SOEs frequently compete with private firms in markets of goods and services, and this requires the application of competition law to offset the advantages that SOEs may enjoy:

- Outright subsidization, in the form of favorable tax regimes or exemptions (such as from customs duties, social security payments, or environmental standards) or in-kind benefits such as land-use rights and rights of
way at below-market prices, along with concessionary financing and guarantees—that is, situations in which SOEs enjoy borrowing directly from the government or from state-owned or state-controlled financial institutions at below-market interest rates.

- Preferential treatment by the state, in the form of loose regulatory regimes containing exemptions from antitrust regulations, building permits, or zoning regulations; favorable tax treatment; more lax corporate governance requirements than private firms; and preferences to SOEs in public procurement.
- Monopolies and advantages of incumbency (for example, in postal services, utilities, and the like).
- Captive equity, resulting from the nontransferability of SOEs’ equity, which implies that SOEs are relatively impervious to the forces of capital markets, which could lead to hostile takeovers, for instance. If SOEs are less constrained to generate dividends, they can more easily engage in exclusionary pricing strategies.

To offset these advantages, effective neutrality may be achieved through different regulatory pathways. For example, within the EU, competition law includes antimonopoly rules and limitations on state aid (which restrict injections of capital and grants), tax holidays, and reductions in social security costs and warranties. Under Article 87 of the EU Treaty, “Any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favoring certain undertakings or the production of certain goods shall, insofar as it affects trade between Member States, be incompatible with the common market.” The EU Treaty also gives enforcement powers to the European Commission, which can require member states to apply competition rules to SOEs and even take measures directed at the SOEs that infringe these rules. Another implication of extending competition rules to SOEs is that these enterprises are then subject to sectoral regulators (for example, banking, insurance, electricity, telecommunications, and the like), which impose fair treatment of all competitors.

Australia has adopted a policy not based strictly on competition law but on competitive neutrality guidelines backed by complaint units established within the Treasury, the National Competition Council, and the Independent Productivity Commission. The policy requires companies subject to competitive neutrality to have cost structures based on tax neutrality, debt neutrality, regulatory neutrality, rate of return, and costing of shared resources. Other legal tools frequently employed to promote competitive neutrality include merger control rules that carefully
scrutinize transactions involving foreign government–controlled entities. If a merger or acquisition is likely to produce a detrimental effect on consumers (higher prices, lower quality, or less choice) or to increase market concentration in a way that could permit price-fixing agreements among market participants, the competition authorities can block the transaction unless the parties offer sufficient safeguards and remedies such as divestiture commitments or a grant of access to key infrastructure or network technologies and the like.\(^5\)

**Bankruptcy Law.** Many SOE laws contain no provisions for bankruptcy or may exempt SOEs from general insolvency rules, giving them an advantage over private companies. Although in more and more countries, particularly in the OECD, SOEs are subject to insolvency laws, they may still remain subject to special laws (as in Poland). Alternatively, they may not be subject to the application of insolvency and bankruptcy procedures but have specific systems in place for the protection from creditors of the SOE assets used to further public service (as in Belgium and Turkey). The international standard on insolvency, embodied in the World Bank Principles for Effective Insolvency and Creditor/Debtor Regimes, recommends that state-owned enterprises be subject to general insolvency law.\(^6\) It also recommends that exceptions to this general rule be clearly stated in legislation.

**Labor Law.** SOEs fall under a wide variety of labor regulation, from the full application of the civil service regime to the application of private sector labor law. Hybrid regimes combine aspects of both. With corporatization, SOE labor legislation often becomes aligned with the general labor law regime, but many results are possible, as the example of France shows (box 2.5).

In general, however, SOEs face a number of labor restrictions that reduce their operational autonomy and disadvantage them vis-à-vis the private sector. In many if not most countries, SOEs’ limited flexibility to hire employees or to pay market salaries restricts their ability to attract and retain talent, especially for board membership and senior management positions. In addition, SOE employees are often protected from dismissal to a greater degree than their private sector counterparts. This often leads to overstaffing and reduced labor productivity.

Some countries apply private labor laws to SOEs to enable them to attract and retain higher-level technical and managerial positions, particularly where government pay scales for those positions are considerably lower
than the private sector. Accurate comparisons between SOEs and private companies need to consider full compensation packages to determine the competitiveness of SOE pay structures, especially since the private sector typically provides fewer benefits and nonwage rewards such as greater job security and more generous retirement benefits.

**BOX 2.5**

**Employee Outcomes during Corporatization in France**

During the corporatization process in France, four different outcomes took place for SOE employees:

- The legal instrument organizing the transformation of the SOE may provide a transition period during which the employees may decide to accept the employment contract proposed by the new entity (regulated by general private labor law) or keep certain rights derived from their original status. All new hires are subject to the general private labor law (for example, corporatization of the Groupement Industriel des Armées Terrestres in 1989).

- If a new entity is created, the usual outcome is the immediate application of the general private labor law to all employees (for example, when the French Atomic Energy Commission was broken up to separate the regulatory and production activities, a new national company, Compagnie générale des matières nucléaires, was created).

- The contracts of workers subject to public law may be assigned without modification to the new entity, and the workers must accept those terms (such as those affecting salaries, leaves of absence, rights to retirement, work weeks, and the like). If the employee refuses the assignment, termination of the employment relationship is regulated by public law.

- When employees are civil servants at the time of the corporatization, the transferred employees may remain under the same regime until they retire (as when France Telecom was privatized). In the case of France Telecom, a law was adopted by Parliament in 2003 allowing the 104,000 civil servants still working at France Telecom at that time to retain civil servant status in the company until their retirement.

*Source: Berne and Pogorel 2004.*
Others are moving toward a more neutral position on dismissal rules. In Brazil, for example, the Supreme Court ruled that SOE employees are not protected by civil service labor rules and could therefore be laid off; only those hired prior to 1988 were grandfathered in and are thus protected from layoffs (Cordeiro 2007). Staffing may need to be reduced as part of broader reform programs aimed at improving performance; but SOE layoffs may be difficult in practice even when permitted by the legal framework. The World Bank’s *Labor Issues in Infrastructure Reform Toolkit* (World Bank 2004) sets forth a menu of approaches and options that can be used for SOE labor restructuring.

The process of aligning public with private sector labor law is not without tensions and trade-offs, however. A gradual process may be warranted. New Zealand Rail provides one example where, through a number of stages, employment practices were progressively brought into line with private sector norms (see box 2.6).

**BOX 2.6**

**New Zealand Rail: From Civil Servants to Private Employees**

The status of workers in the New Zealand rail sector has changed several times. In 1982, New Zealand Rail was converted from a departmental enterprise in which workers had civil servant status to a statutory corporation (New Zealand Rail Corporation, or NZRC) in which workers were public servants. In 1990, the entity converted from a statutory corporation to a public limited-liability company; staff continued to be public servants. Finally, in 1993, shares of New Zealand Rail Ltd. were sold to private interests. The employees’ status then changed from public sector employee to private sector employee. There were also changes in the labor contracts. Until 1986, employees of NZRC served under the central civil service conditions of employment. In 1987, NZRC came under the legislation applicable to SOEs, which made NZRC independently responsible for bargaining over its own labor relations contract. Several key changes followed:

- Simplification of the collective labor–government agreement and removal of artificial distinctions among job categories.
- Removal of the state service seniority and appeals system for the appointments and promotions process.
BOX 2.6 continued

- Removal of senior management from the collective bargaining agreements to individual contracts with incentive-based performance measures.
- Simplification of the allowance structure and an increase in the base pay to absorb some of the allowances as well as the introduction of incentive-based compensation to most of the white-collar employees.

Nevertheless, the contract still retained many aspects of the state sector model in respect to work hours, overtime payments, and penalty payments. Following privatization in 1993, however, a privately owned company was able to make further changes to the labor contract: (1) more flexible work hours, including overtime after 80 hours each fortnight instead of after eight hours per day, were instituted; (2) fewer penalties on work outside the conventional eight-hour day, Monday to Friday, were imposed; (3) a change from one collective contract to five contracts was accomplished; and (4) no weekend or night work penalty payments for new employees were permitted.

A lump-sum payment was also made to those workers who lost out from the changes to the overtime, penalty, and allowance payments.


Procurement Law. SOEs in many countries are bound by public procurement laws to guard against corruption and misuse of public funds. Such rules can be cumbersome and pose a constraint on the ability of SOEs to operate and invest in a timely manner to meet the competition. Complex, time-consuming procedures that are not commercially oriented can have a significant negative impact, especially when SOEs are purchasing commodities from world markets where speed and flexibility are paramount. In recognition of these factors, and with increasing competition between SOEs and the private sector, the European Union is drafting new procurement rules for transport, energy, water, and postal sectors where SOEs are prevalent. During the preparation of this toolkit, these rules were not yet finalized. Short of reforming public sector procurement laws more broadly, some countries such as Turkey exempt SOEs from the procurement law for purchases below a certain threshold, although such thresholds are so low that they cover only a fraction of total SOE procurement.

When institutions are weak and monitoring is lax, SOE procurement provides scope for corruption. Thus, a careful assessment of the procurement
regulations and practices of SOEs should be carried out since any inefficiencies will directly affect their governance arrangements and their ability to procure in an efficient, timely, and transparent manner. The weaknesses can then be addressed either through SOE laws, through separate procurement laws for SOEs, or through improvements in the existing procurement law.

At the same time, states may also favor SOEs in procurement contracts, creating a different kind of market distortion in countries where public procurement accounts for a significant fraction of economic activity. Notwithstanding the care exercised by many public authorities in designing competitive tenders that try to prevent public sector entities from benefiting from advantages in the bidding process, distortions frequently arise in both design and implementation.8

Some countries, such as the United Kingdom, have specifically addressed competitive neutrality in procurement contracts through a set of principles of competition put together after consultation with stakeholders (box 2.7). As many possible adverse effects are possible—both advantaging

---

**BOX 2.7**

**The United Kingdom’s Principles of Competitive Neutrality in Procurement Processes for Custodial Services**

The Ministry of Justice has separated its regulatory, commissioning, procurement, and bidding functions into different departments to try to avoid any conflicts of interest that arise when assessing public, private, and third-sector bids. The ministry also aims to provide all relevant information in a timely manner to try and reduce any incumbency advantages. The principles focus on five areas:

- **Costing.** A formula is given that must be applied to all public sector bids to reflect the allocation of indirect costs. Transition, contract administration, and monitoring costs will not be allocated to any bid unless they are additional costs arising out of a particularly novel approach in one bid.

- **Grant funding.** All bidders must declare any grant funding, including any received by subcontractors. Bidders must attest that no grant will be used to subsidize their bid, including the indirect costs.

- **Pensions.** Information is given about the Cabinet Office’s Statement of Practice on Staff Transfers in the Public Sector. It addresses pensions
and providing guidance on the broader issue of the treatment of staff who are transferred from the public sector. When there is a public sector incumbent, all public sector bids must apply an uplift of 3 percent per year to all payroll costs.

- **Risk.** A list of risks considered insurable is given, and the principles require that each bid include a limit of liability for each of the listed risks irrespective of bidder type. Any public sector bidder is required to obtain a quotation for commercial insurance coverage. Bidders must identify all other risks contingent on the contract and clearly attribute their true commercial value. These risks include contractor performance, asset and property maintenance risks, and pension costs and liabilities. If a part of the service does not meet the service level stated in the contracts, the contractor incurs a penalty; while a public sector bidder may not ultimately be subject to such financial deductions, its bid shall be evaluated as if these deductions were to apply.

- **Tax.** Special mention is made of the value-added tax, the corporation tax, and the different liabilities faced by different bidders. The evaluation of bids excludes both types of taxes, although bidders are required to provide details of expected liabilities for both.

Source: BIAC 2011.

and disadvantaging SOEs—public authorities should reflect on what competitive neutrality means in relation to procurement. Recent efforts have been made to analyze the problems resulting from private and public incumbency advantages in procurement and to identify the characteristics that a competitively neutral procurement policy should have.

**Listing of SOEs on the Stock Exchange**

Many countries are subjecting large SOEs to capital market discipline by listing shares of corporatized SOEs on the stock markets and applying the more stringent governance requirements under securities laws. Such laws contain stronger requirements for independent directors on the board, treat minority shareholders fairly, and mandate comprehensive and timely financial and nonfinancial reporting. Listing also exposes SOEs to capital market scrutiny, through oversight of expert analysts, rating agencies, and the financial media.
Major emerging market countries such as Brazil, China, India, Indonesia, Malaysia, and the Russian Federation have listed large SOEs on both domestic and international capital markets. Large SOEs have also been listed on stock exchanges in such diverse countries as Colombia, Kenya, Pakistan, Peru, South Africa, and Vietnam. Indeed, several successful listed SOEs are recognized as world leaders, such as Petrobras, Ecopetrol, Sabesp, and ISAGEN in Latin America.

Listing large SOEs on the stock exchange gives SOEs access to alternative sources of financing and provides greater flexibility for adjusting their capital structure, while contributing to the development of the capital markets. Listing also exposes SOEs to market dynamics and provides a measure of market valuation of net worth. It is also a powerful starting point for strengthening SOE commitment to corporate governance, as the case of Petrobras shows (box 2.8).

Listed SOEs come under the same regulation and scrutiny as other listed companies, including the oversight of the securities regulator, the stock exchange, and, for financial institutions, the central bank or

**BOX 2.8**

**The Listing of Petrobras on the Brazilian Stock Exchange**

Petrobras is one of the world’s major oil companies and is currently listed on Brazil’s largest stock exchange. In 2010, Petrobras was transformed from a purely state-owned company into a mixed company, through a process of share democratization that represents even today one of the largest capital-increase transactions in the history of capital markets.

The process provided an increase in the market value of the company and an opportunity for the company to access the necessary resources to support its growth strategy. Stock exchange listing also allowed to limit the risks associated with the participation of the state as the sole proprietor through strengthening its corporate governance.

When the state was the sole owner, the company faced the risk of political influence, of vulnerability to hijacking by interest groups, and of an absence of commitment by the board and management. The numerous new shareholders of the company now act as pressure groups that promote and supervise the performance of the company.
supervisory authority. Exercising regulatory oversight over very large and prominent SOEs can be difficult, however, and requires support and capacity from the relevant parts of the government. Through a stock listing, minority shareholders may also apply pressure and monitor the firm in ways that complement monitoring by lenders.

**Developing a State Ownership Framework for SOEs**

In many, if not most, countries, the basic objectives of state ownership are found in SOE laws and regulations that define the legal structure of SOEs; their administration, control, and regulation; and the role of governing bodies such as boards and general assemblies. Together, these laws and documents establish the overall legal and regulatory framework for SOEs.

But the *ownership* policies of the state—that is, the policy direction for SOEs, the institutional arrangements for exercising the state’s ownership rights, and governance practices of SOEs—are often scattered among a variety of documents. In addition to SOE laws and regulations, these may include the founding documents of SOEs or articles of association as well as formal and informal policies and guidelines. This dispersion can lead to unclear objectives; confusion about the roles and responsibilities of SOE shareholders, boards, and management; and inconsistencies in implementation of ownership policies across the SOE sector. It can also make it more difficult to identify policy gaps—gaps that would be more apparent in a single reference document.
Many countries are establishing new and improved rules to bring greater clarity and consistency to ownership issues. They are doing so through the development of different and sometimes overlapping instruments, including ownership laws and regulations, ownership policies, and codes of corporate governance.

Ownership Laws and Regulations

A number of countries have revised their existing SOE laws or have developed new, more modern laws and regulations to provide strength and legitimacy to the government shareholder; to codify relations among the shareholder, board, and management; and to outline reporting functions (box 2.9 provides some recent examples).

Demand for better performance in the SOE sector has provided the impetus for adopting more modern legislation. Such laws generally aim

---

**BOX 2.9**

**Examples of Countries with Modernized State Ownership Laws**

- **Finland.** In 2007, Finland replaced an older law from 1991 and passed the Act on the Management of State Capital, which was instrumental in separating the state’s ownership function from its regulatory functions, clarifying decision-making authorities, and setting legal standards on corporate governance and management of state holdings. In addition, the most important document for the daily operations of the SOEs is the state’s ownership policy that was issued in the same year.

- **Hungary.** In Hungary, the State Asset Law issued in 2007 specifies the rights of the state as owner, the management and use of state assets, and the structure and conditions for the consolidation of organizations managing state assets.

- **Philippines.** In 2010, the Philippines passed the Government-Owned and Controlled Corporation Governance Act. The act aims to rationalize the structure, existence, and operations of these corporations and is designed to reform the government corporate sector, improve the corporate governance of government-owned and -controlled corporations, and ensure efficient and effective delivery of public services.

*Source: World Bank staff.*
to recast the state’s role as owner rather than as policy maker and manager of state assets and are typically based on several key principles: operation of SOEs on a commercial basis; separation of the state’s ownership functions from its policy-making and regulatory functions to avoid conflicts of interest, real or perceived; professionalization of corporate governance bodies; and greater transparency and accountability of the SOE sector.

The details of more modern SOE laws differ from one country to the next, but in general they contain several common elements:

- Designation of the state’s shareholder representative or ownership entity, including its structure, composition, functions, and accountability framework (covered in chapter 3).
- Broad outlines of a performance-monitoring system to hold SOEs accountable for results (chapter 4).
- Clarification of SOE objectives and, in some cases, the identification and separation of the costs and financing of specific public service obligations or noncommercial goals (chapter 5).
- Establishment of criteria and processes for the appointment of qualified and competent SOE boards, as well as processes for dismissal of board members and for identification of the rights and responsibilities of the board of directors and the management in guiding and managing SOE operations (chapter 6).
- Financial reporting and disclosure requirements for SOEs, which are often in line with private sector practices (chapter 7).

Development of better or new SOE laws and regulations provide the needed weight and legitimacy for improving SOE governance. But passing such laws may not be easy. It requires strong political support and broad consultation with stakeholders to build consensus and buy-in for reforms. A recent example is the 2010 Government-Owned and Controlled Corporation Governance Act in the Philippines. The key features of the act and its development are summarized in box 2.10.

Where the passage of a law is not feasible, new decrees or regulations can be issued to improve SOE governance. Romania and Tunisia provide two examples:

- In 2011, Romania passed an emergency ordinance for improving the process of appointing SOE boards and management. While the new law does not separate ownership from policy making and regulation, it defines in broad terms how ministries should act as owners and focuses on the requirements for the appointment of SOE boards and management.
The Philippines Government-Owned and Controlled Corporation Governance Act was passed in 2010 to institutionalize reforms in the public corporate sector. The urgency in reforming the sector came about because the total expenditures of government-owned and -controlled corporations (GOCCs) reached the equivalent of 28 percent of the total expenditures of the national government in 2009 and GOCCs accounted for 91 percent of total interagency receivables of the national government. Previous attempts to monitor and coordinate the activities and functions of the GOCCs were carried out through executive issuances that changed along with changes in government. The act aimed to ensure long-term reforms in the public corporate sector.

The act creates a full-time centralized oversight body called the GOCC Commission on Governance (GCG) to formulate, implement, and coordinate GOCC policies. The GCG is headed by a chairman with the rank of cabinet secretary and is authorized to evaluate the performance of GOCCs and ascertain whether they should be reorganized, merged, privatized, or abolished. It is tasked with creating an ownership and operations manual and corporate governance standards for GOCCs that are comparable to those required for banks and for companies listed on the stock exchange and with establishing an objective performance evaluation system and assessing performance periodically.

The act addresses the selection process for GOCC boards of directors, mandating the president to select directors from a shortlist of candidates prepared by the GCG based on fit and proper criteria adopted by the private sector. It empowers the GCG to set compensation, per diems, allowances, and incentives for board members. The law provides a clear definition of the fiduciary duty of board members and executives and requires them to act in the best interest of the GOCCs. All GOCCs are required to maintain a publicly accessible website with their latest financial statements, corporate operating budgets, and summary of borrowings and other relevant information.
It also covers performance management, transparency and disclosure, and relationships with nonstate shareholders.

- In Tunisia, a new decree for amending the governance of state-owned banks has been recently issued (box 2.11). With this decree, banks can begin to apply new governance practices. The decree should also aid in speeding up the restructuring of state banks.

In addition to reforming general SOE frameworks, countries are also reforming company-specific laws with a view toward modernizing their corporate governance practices. One such example is Chile’s state mining company, Codelco (box 2.12).

As discussed below, SOE laws and regulations are sometimes supplemented by ownership policies and SOE corporate governance codes. While they do not carry the same weight and legitimacy as laws and regulations, such policies and codes can be an alternative means for articulating and promoting good corporate governance practices where development of laws and regulations is not feasible.

Ownership Policies

To bring greater clarity and consistency to ownership issues, some countries have developed comprehensive ownership policies as a tool for communicating expectations and good practices to shareholders, boards, and
The three state-owned banks in Tunisia suffer from an unfavorable strategic positioning and a weak operating environment. For several years, public banks have been following unsustainable strategic directions. Leveraged to serve economic development policies (agriculture, housing, hotels) and also sometimes used for easy access to finance for cronies of the prerevolutionary regime, the public banks must at the same time meet profitability targets (as listed companies), be financially sound (to guarantee the safety of their depositors), and be in compliance with the prudential norms of the central bank. In addition, as public entities, these banks are subject to Law 89-9 on State Owned Enterprises, which imposes on them significant bureaucratic constraints, notably on procurement and staffing.

The ownership function is absent from the banks, as in other state-owned enterprises in Tunisia. The role of any majority shareholder is to influence the running of a company based on a strategic plan and key performance indicators (financial and, in the case of public companies, social and economic). The legal and regulatory framework for SOEs does not contradict these principles; however, neither of the two criteria mentioned above is applied in practice in Tunisia. The contrat programme, which is the counterpart of the strategic plan in the private sector, is not implemented in public banks, while performance indicators appear very limited. In contrast, the presence of the state is particularly strong in the administrative control of its banks as in the rest of the SOEs.

The degree of professionalism of the banks’ boards of directors is insufficient: the boards lack seasoned experts in the relevant areas (banking, finance, audit, accounting, and information technology) and autonomy, given that the vast majority of the decisions taken by the board are valid and enforceable only after approval of the minister of finance.

All these constraints are directly and indirectly responsible for most of the financial difficulties the banks currently face:

- **Insufficient capital base.** Solvency ratios remain positive to the extent that the central bank has kept lax the prudential rules on classification of nonperforming loans and provisioning ratios. Public banks have
greatly benefitted from these rules and have avoided the materialization of financial losses.

- **Degradation of the loan portfolio quality.** Alongside the gradual tightening of prudential norms by the central bank, it is expected that nonperforming loans, which are already nearly twice as high as among private banks (18 percent against 10 percent), will continue to grow rapidly, resulting in new provisioning (and therefore deeper financial difficulties) and a decrease in cash flow (and therefore additional pressure on liquidity).

- **Regular loss of their market share vis-à-vis private banks.** This share has decreased from 42 percent in 2007 to 36 percent today (despite the increased funding of public enterprises by public banks since the revolution). It is expected that, other things being equal, the loss of market share will continue at a rate of 1–1.5 percent per year.

Improving the governance of SOEs is the urgent initial step in addressing these issues, as a radical change in governance must accompany the recapitalization of the banks. Indeed, in the short term, a new governance framework is necessary for improving management practices and reducing financial losses, as well as for ensuring better implementation of the restructuring plan to be decided by the Ministry of Finance. In the absence of governance reform, the state would likely need to make new and larger recapitalizations in the future.

In view of the urgency, the minister of finance issued a decree in December 2013, which does three things: it excludes banks from most of the administrative burdens imposed by Law 89-9 (for example, human resources policies and procurement rules); it delineates clearly the division of responsibilities among the banks’ management, board of directors, and the state as shareholder; and it establishes a transparent and competitive process for the hiring of future board members. This measure is expected to improve banking sector competition and access to finance in the long run. In the medium term, it will stop further deterioration of the banks’ financial soundness and facilitate the implementation of restructuring.

*Source:* World Bank staff.
BOX 2.12

New Legal Framework for Chile’s Codelco

Chile has been making corporate governance improvements in its SOE sector, including in one of its most important companies, Codelco. Founded in 1976 after the merger of major copper mines in Chile and a government takeover of its administration, Codelco has become one of the largest mining companies in the world.

In 2010, the Chilean government enacted Law 20.392, which introduced important changes to Codelco’s corporate governance. The new corporate governance law established, among other things, a professional board of directors without the presence of the ministers of mining and finance and representatives from the armed forces. It also established rules on the rights, obligations, responsibilities, and prohibitions as set forth in the corporations law, which governs private companies.

These efforts had several specific aims: to make Codelco more a state company than a government entity; to break the dynamics of political business cycles; to establish a board without public officials; to establish requirements for the selection of board members; to secure a long-term decision-making structure; to establish adequate mechanisms for the capitalization and funding of projects; and to strengthen the financial reporting and transparency of the company.

After implementation of the law, a number of changes to the Codelco board took place. The board went from seven to nine directors. Before the law, the board consisted of the minister of mining (who served as chairman), the minister of finance, two presidential representatives, one armed forces representative, and two union representatives. Today, the board is composed of four directors appointed by the Public Management Council, three presidential representatives, and two union representatives. Board terms have gone from the “presidential term” to four years. Before reform, the board had established general policies, approved investments over US$50 million, had no liability (civil or criminal), and was not regulated by corporate law; after reform, it adheres to good practices, including designating and appointing the CEO; it has approval authority over the company’s strategic plan; it has both civil and criminal liability for its decisions; and it is governed by corporate law.

The new corporate governance law resulted in a new, independent, and technical nominating process for the selection of the CEO; a new
management. Less common than corporate governance codes, ownership policies are found in a few countries that have a centralized ownership entity charged with SOE oversight and able to drive the process. Table 2.1 provides some examples of countries that have developed ownership policies. In some countries, such as Finland, ownership policies have been developed to supplement SOE laws.

Ownership policies usually cover several relevant subjects:

- **Purpose of state ownership**. This section may describe the justification for state ownership and both short-term and longer-term goals. Common justifications include addressing social problems, promoting social goals, correcting market dysfunctions, encouraging development where the private sector is absent, and economic diversification. Justifications express desired outcomes and indicate which enterprises should be state owned.

- **Types of enterprises covered by the ownership policy**. Enterprises are usually categorized into two broad groups: commercial enterprises providing a product or service, that is, enterprises that could be subject to competition and could operate under private ownership; and enterprises with sectoral policy objectives that operate in a regulated environment (such as water and electricity). These categories are often revisited periodically to determine whether ownership criteria continue to be met and to adjust portfolio practices accordingly.

- **Criteria under which SOEs operate**. These criteria might address the commercial sustainability of SOEs; the importance of shareholder code of corporate governance and a code of ethics; a renewal process for the senior management team; clear definition of the strategy and long-term development plan; corporate restructuring and strengthening of environmental and social responsibility; market alignment of executive salaries; a 10 percent workforce reduction; and a capitalization process of US$376 million (20 percent of net income). These factors have had a positive impact on Codelco by making it a more competitive and efficient enterprise and have promoted value creation and long-term growth. The improvement in its corporate governance required active state involvement, which allowed for the implementation of a new legal framework aligned with good practices.

Source: Bernal et al. 2012.
value, or equity value, relative to social objectives; associated performance measures; and the calculation of (and compensation for) costs of noncommercial objectives. SOEs are usually expected to operate on a commercial basis and to be capable of generating enough cash and profit to replace spent assets and maintain the company’s equity value.

- **Roles and responsibilities of specific institutions.** The respective roles of the state, the ownership entity, the SOE board, SOE management, and independent regulators should all be specified, as well as the separation of financial and policy oversight. Clear definition of roles is a key part of the ownership policy. Management is responsible and accountable for operations. The board is responsible for the strategic direction of the SOE and, ultimately, for performance. The state is responsible for establishing the broad outcomes expected of the SOE and negotiating these with the board. Within government, departments that set policy objectives are usually separated from those that oversee financial performance. Where a centralized ownership entity exists, its role as a source of professional governance practices is described.

- **Requirements for transparency and public disclosure.** Both the state and SOEs are held accountable for their financial and social performance. Financial reporting requirements are established. Public disclosure covers both financial and nonfinancial information and describes the means of dissemination (including the Internet).

Norway, with a significant SOE sector and commitment to longer-term state ownership, has a detailed ownership policy that aims to insulate SOE operations from unwarranted government interference in operations, while at the same time ensuring that fundamental government objectives are met (box 2.13). Norway’s policy focuses, in particular, on the following elements:

### TABLE 2.1 Examples of SOE Ownership Policies

<table>
<thead>
<tr>
<th>Country</th>
<th>Ownership policy</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bhutan</td>
<td>His Majesty the King, <em>Royal Charter for Druk Holding and Investments</em>, 2007, and DHI Ownership Policy, 2010</td>
</tr>
<tr>
<td>Finland</td>
<td>Prime Minister’s Office, <em>Government Resolution on State Ownership Policy</em>, 2011</td>
</tr>
</tbody>
</table>
• **Role separation.** The functions of the state, the board of directors, and management are distinguished.

• **Autonomy in operation.** Government is removed from operational decision making. SOE (political) direction control can be exercised only through official channels.

• **Fiduciary duty.** Decisions by boards and management executives must be made consistent with the common legal obligation of board members to exercise a duty of loyalty to the company.

• **Role conflict.** Important guidance is provided to boards in cases where an SOE’s commercial and noncommercial objectives conflict.

**BOX 2.13**

**Summary of Norway’s Ownership Policy**

Norway’s ownership policy contains the following sections:

• **Foreword by the minister.** The foreword discusses the role of state ownership, sets out general principles of governance, establishes certain social goals, mentions prior studies, and underscores the importance of transparency and competent boards.

• **Scope of the state’s direct ownership.** The scope of the state’s direct ownership includes the list of companies covered by the ownership policy, the state’s shareholding in the companies, and the ministry with which companies are affiliated. The ownership policy covers companies for which the state has mainly commercial objectives and important companies with sectoral policy objectives.

• **The government’s objectives for state ownership.** The objectives cite the relevant SOEs, note that the ownership policy is based on a broad political consensus, and identify as key goals the continued presence of important companies in Norway as well as state ownership and control of revenues from natural resources. Other social objectives relate to infrastructure, culture, equality, and health issues.

• **Requirements of the companies.** The requirements cover the need for a positive return to shareholders, a positive rate of return for commercial SOEs, and efficient operation of social SOEs. They also cover the need for a rational, predictable, and flexible dividend policy; the role of share repurchases; and SOE reporting requirements in line with those for the private sector.

*(box continues on next page)*
The state’s expectations of the companies. This includes the government’s expectations of sector-independent considerations that companies must take into account, social responsibility considerations, and the objectives for the ownership of individual companies.

The government’s policy on the remuneration of leading personnel. Remuneration must be competitive but not market leading, with opportunity for capped incentive compensation but no stock options. Responsibility for approval of compensation plans lies with the boards and shareholders.

The division of roles in the state administration. The roles of the state as policy maker and regulator are separate from its role as owner. The role of central ownership entity as well as line ministries and other government bodies is described.

The framework for the state’s administration of its ownership. The framework describes the legal structure of SOEs as corporations, the applicability of normal company law including stock exchange requirements, and laws relating to state subsidies. The legal framework, executive and ministerial authorities, control of wholly owned as compared to mixed enterprises, voting thresholds, and equal access to information and insider trading are also covered, along with subsidies, freedom of information, principles of good governance and financial management, and the need for transparency of ownership.

The relationship between the board of directors, the management, and the shareholders. The relationship of the state to the SOE is equivalent to that of an outside shareholder, responsibility for management of the company resides with the board and the executives, and ministerial decision making on operations is prohibited—even for unusual or controversial issues. Board and executive decision making must be based on the SOE’s interest, with the board and executive liable for proper management and defense of SOE interests. Boards nominate CEOs. The state exercises its authority through the annual shareholders’ meeting and the nomination committee, with nominations based on competence and a prohibition on ministers and civil servants serving as board members. The terms and remuneration for board members are specified. Performance-based pay, which is thought to compromise independence, is ruled out.

Noncommercial objectives. Noncommercial goals to be achieved through state ownership are specified in writing—mainly environmental protection, gender equality, and health objectives.

Among developing countries, Bhutan is one of the few with an ownership policy (box 2.14). Its policy defines four objectives of state ownership: (1) to make SOEs more efficient (many are loss making); (2) to address public frustration with the quality of services provided by SOEs; (3) to adapt SOEs to challenges posed by increased global competition; and (4) to clarify social mandates and costs. It also specifies the tasks of Druk Holding and Investments (DHI)—the centralized body responsible for exercising the state’s ownership rights—and provides guidance for DHI on how to translate high-level ownership goals into operational practice. DHI is directed to focus on maximizing the return to shareholders (the people of Bhutan), to separate ownership and management, and to promote the growth of the private sector.

Bhutan and Norway both seek to improve the efficiency and effectiveness of their SOEs through better governance, both set out similar principles of separation of policy oversight from shareholder oversight, and both opt for a centralized body to help the government exercise SOE oversight. Yet, these

BOX 2.14

Summary of Bhutan’s Ownership Policy

Bhutan’s state ownership policy is contained in two documents: the 2007 royal charter that establishes the centralized ownership entity Druk Holding and Investments, revised in 2008, and the more detailed ownership policy developed by and for DHI in 2010, updated in 2013. DHI also introduced a corporate governance code in 2013, which provides a set of guidelines for its SOEs based on internationally accepted good practices, as well as guidelines on corporate social responsibility.

The royal charter sets out the overall goals and objectives of state ownership: to accelerate socioeconomic development to achieve the goals of “gross national happiness” (social welfare); to safeguard, manage, and enhance national wealth through prudent investments; to build a strong, dynamic economy as the foundation for a vibrant democracy;

(box continues on next page)
to enhance international economic partnerships; to lead and stimulate private sector development through a culture of innovation, creativity, and enterprise; to prevent corruption; and to promote the economy’s competitiveness by making SOEs more efficient and productive.

The charter establishes the objectives and tasks of DHI. Its main purpose is to ensure that SOEs meet the challenges of the corporate sector in a competitive global economy. DHI is to act as the holding company for SOEs transferred under a share transfer agreement entered into between the Ministry of Finance and DHI. It seeks to maximize returns to its shareholders (the people of Bhutan). In addition, its role is to strengthen corporate governance by ensuring clear separation of the ownership and management of SOEs, enhance the performance of SOEs by making them responsible and accountable for their performance, raise funds for investment, and promote the growth of a dynamic private sector.

DHI appoints the boards and directors of companies in its portfolio, tracks company performance, invests in companies, divests shares of SOEs, raises funds, and provides managerial and other support services on a fee basis to both the public and the private sector.

DHI’s ownership policy addresses in greater detail the interface among the government, DHI, and the companies; the roles and authority of company boards, chairs, and CEOs; and their appointments and terms of reference. The ownership policy is based on generally accepted principles of corporate governance as outlined in the OECD’s *Guidelines on Corporate Governance of State-Owned Enterprises*.


National policies differ in ways that reflect differences in the local context. Bhutan is undergoing economic and social change to facilitate integration into the global economy, and Norway is a developed economy with an established private sector and a history of SOE governance. Bhutan’s use of a royal charter to outline the overall goals of state ownership may reflect the socioeconomic changes envisioned and the attendant need for high-level political direction. Norway’s ministerial-level document suggests that its ownership policy, while important, does not imply profound socioeconomic change but is established mainly to provide guidance on the institutional and technical aspects of SOE governance.
The process of setting formal ownership policies is easier when there is a centralized ownership entity in place that can drive and manage the process of developing the policy. Where ownership responsibilities are fragmented among different line ministries, building support and managing the process can be more difficult and time consuming, especially when parliamentary approval is required. Developing a coherent policy can also be more difficult when there is a large and diverse portfolio of SOEs, with many different legal forms.

Corporate Governance Codes and Guidelines

As in private sector codes, SOE codes are of three main types: 11

- **Voluntary codes.** Some SOE codes are voluntary, encouraging but not forcing SOEs to comply with their provisions. Voluntary SOE codes are found in Bhutan and Egypt, for example.

- **Comply-or-explain codes.** Some codes are applied on a comply-or-explain basis. In the Seychelles, SOEs are expected to note their compliance with the 2009 Guidelines on the Good Governance of Public Organizations (equivalent to a code) and explain any areas of noncompliance. Another example is the Moroccan code developed in 2011. Like voluntary codes, comply-or-explain codes provide greater flexibility and scope for application of a more customized approach by company.

- **Mandatory codes.** Given the wide range of SOEs and the need to align commercial, political, and public policy goals, a mandatory or rules-based code is less common, as it may not allow the flexibility needed by different types of companies. (Listed SOEs, however, are required to follow the listing rules and codes of the stock exchange.) One example is found in Pakistan, which issued the Public Sector Companies Corporate Governance Rules in 2013. The rules apply to all public sector companies that fall under the Companies Ordinance of 1984. In India, the Guidelines on Corporate Governance for Central Public Sector Enterprises were issued in 2007 as voluntary guidelines but based on the experimental phase, and after due interministerial consultations they were made mandatory in 2010. They were also modified based on experience gained and were improved with additional provisions on the formation of remuneration committees and on monitoring compliance (discussed in further detail below).

One school of thought argues that SOEs should always follow private sector corporate governance practices and that no SOE-specific codes with
potentially weaker practices should be developed. But developing an SOE code can be a way of increasing awareness of governance issues not only within SOEs but also within the government and the ownership entity (where one exists) and among the public. A variety of SOE codes are in effect in a number of countries around the world:

- Many countries—such as Germany, Kenya, Malawi, Mauritius, Mozambique, Poland, and South Africa—have adopted SOE governance codes as a first step toward developing more substantive regulation, especially where the legislative process takes time or the issue of SOE governance is politically contentious.
- Estonia, Latvia, and Lithuania have developed a shared code, the Baltic Guidance on the Governance of Government-Owned Enterprises, which contains general policy recommendations directed at both government and SOEs on how to bring local practices close to the OECD’s Guidelines on Corporate Governance of State-Owned Enterprises.
- In Malaysia, the Putrajaya Committee on GLC High Performance, formed in 2005 to oversee the GLC Transformation Program, developed policy guidelines, rather than rules, in a GLC Transformation Manual, to be followed by government-linked corporations. The guidelines clarify the GLC mandate in the context of national development, upgrade the effectiveness of GLC boards, enhance the capabilities of government-linked investment companies as professional shareholders, adopt corporate best practices within GLCs, and implement and enforce the GLC Transformation Program.

In some countries, SOE codes have been inspired by private sector governance codes. In South Africa, for example, the Protocol on Corporate Governance in the Public Sector was influenced by the country’s well-known King Code. Like in private sector codes, SOE codes typically focus on board composition, the roles and responsibilities of board members, and reporting and audit requirements. In some countries, such as the Baltic countries and Egypt, SOE codes draw from the OECD’s Guidelines on Corporate Governance of State-Owned Enterprises, which are directed principally at the state as owner but also include the boards. These codes tend to be broader in scope, covering the regulatory framework for SOEs, the obligations of the state as owner, the equitable treatment of shareholders, the state’s relations with stakeholders, transparency, and the responsibilities of the SOE board.

Although a number of different bodies have developed SOE codes, for these codes to have the authority they need, it is usually best that they be developed at the behest of the government departments or ownership
units responsible for SOEs with the capacity to promote and monitor implementation. In India, Morocco, and South Africa, the government ministries responsible for SOEs developed the codes, while in Germany, the Netherlands, and Poland the equivalent of a ministry of finance created them. In Peru, the SOE code was developed by the state holding company, FONAFE, which acts as the ownership authority for SOEs. In some cases, third parties develop these codes. For example, in Egypt, the Egyptian Institute of Directors developed the SOE Code of Corporate Governance but under the auspices of the Ministry of Investment, which had ownership responsibility for SOEs. In Latin America, CAF—the development bank of Latin America—developed a set of regional corporate governance guidelines for SOEs, based on the OECD guidelines, aimed at encouraging the discussion of corporate governance in the region.

While voluntary codes and guidelines are meant to encourage SOEs to improve their governance practices, ensuring compliance can be a challenge, as companies face few incentives or pressures to comply—especially when codes are developed by third parties. In some cases, SOEs simply lack awareness of the code. Or they may lack the knowledge and practical guidance to implement the code, especially when it contains many aspirations but no clear priorities. In other cases, once the code is in place the ownership entity itself may take only modest steps to disseminate, promote, and monitor compliance with the guidelines, even though promotion of good corporate governance practices should be a key function of such agencies.

Governments can take a number of steps to promote and monitor compliance:

- **Disseminating** the code to build awareness.
- **Developing tools and manuals** to help SOEs adopt good governance practices from the code.
- **Providing training** on the code to companies, owners, and regulators to build understanding of the provisions and how to apply them: in Egypt, for example, the Egyptian Institute of Directors played a vital part not only in preparing and disseminating the SOE code but also in training SOE directors on the code's implementation and developing a manual for implementation.
- **Focusing on companies** that understand the importance of good governance and use them to demonstrate an active commitment to applying the code, which can be a powerful inducement.
- **Developing the capacity** of SOE owners and regulators to monitor and evaluate compliance and elevating their role and profile in promoting compliance.
• Including compliance with the code as a critical part of the performance-monitoring and disclosure systems. In India, for example, the corporate governance guidelines mandate that the annual reports of companies contain a separate section on corporate governance with details of compliance, with a certificate on compliance from auditors or the company secretary. Companies are also required to submit quarterly compliance or grading reports in a prescribed format to their line ministries, which in turn submit a consolidated annual report to the Department of Public Enterprises. Initially, only few companies submitted reports, but the department’s reminders and follow-up meetings with line ministries led to higher compliance rates over time (Department of Public Enterprises 2013).

Ownership entities can also use their own codes to encourage change in their portfolio companies. In Peru, for instance, the state holding company FONAFE developed the Framework Code of Good Corporate Governance of SOEs and then required individual SOEs to draw up their own governance code based on that framework. Once SOEs had developed their code, they were asked to evaluate their performance against it.

More and more, countries require SOEs to report on how they comply with the provisions of their code; if not, to explain why they are not complying; and to highlight steps they are taking to improve compliance. In Pakistan, for example, the Securities and Exchange Commission has developed a template for monitoring compliance with its corporate governance rules. The compliance statement is required annually. It requires companies to indicate for each rule and subrule the extent to which they are fully compliant, partially compliant, or noncompliant, with explanations provided. The statements must be approved by an independent external auditor and be integrated into the SOE performance-monitoring framework. Companies will also be required to report on compliance with the rules in their annual reports. By evaluating SOE compliance regularly, the Securities and Exchange Commission—and ownership units in general—will also be better prepared to revise and update the code as needed.

Corporate governance scorecards are also growing in use. Scorecards use international standards as a benchmarking tool to assess corporate governance practices in a given country. While scorecards are commonly used in the private sector, they are catching on in SOEs as well. The Philippines, for example, developed a scorecard in 2009, and its experience shows how benchmarking by an independent external body—in this case the Philippines Institute of Corporate Directors—in collaboration with the government can professionalize the process and give it greater credibility (box 2.15).
In 2009, the Department of Finance of the Philippines, in partnership with the Philippines Institute of Corporate Directors (ICD), undertook the development of a corporate governance scorecard to benchmark the governance of 30 or so government-owned and -controlled corporations, virtually all of which were wholly owned by the national government. The initiative used the OECD’s 2005 *Guidelines on Corporate Governance of State-Owned Enterprises* as a benchmark and drew from the ICD’s experience with scorecards for all public companies in the Philippines. The goal was to raise awareness on corporate governance issues among GOCCs and to identify areas for improvement.

The ICD worked closely with the Office of the President, the Department of Finance, and key stakeholders to develop the scorecard and gather data. A survey was carried out to complement information gathering from available documents. Benchmarking initially fell under two categories: board responsibilities and disclosure and transparency. A questionnaire was developed based on these categories. The benchmarking relied on self-rating by GOCCs, which compared their practices with the questionnaire. Volunteers were then asked to validate the self-ratings, using documents submitted by the GOCCs to substantiate them. The results were then tabulated and analyzed.

GOCCs scored significantly lower than their private sector counterparts in the two areas rated. The gaps in good practice revealed by the benchmarking exercise helped identify many opportunities for improvement in the boards. The benchmarking was widely considered a useful tool for encouraging GOCCs to evaluate and improve their governance practices.

The scorecard was subsequently expanded to include all six OECD guidelines: the legal and regulatory framework, the state as owner, equitable treatment of shareholders, relations with stakeholders, disclosure and transparency, and boards of directors. Corresponding weights were 10 percent for the first four guidelines and 30 percent for the last two guidelines. The goal is to help raise the standard of GOCC corporate governance practices in the Philippines.

*Source:* Moreno 2006; OECD 2010.
The approaches used in Peru and the Philippines rely on SOEs to engage voluntarily in self-evaluation against the code (in the case of Peru) or against international standards (as in the case of the Philippines). In both countries, the codes and standards have served as tools of persuasion, and through monitoring instruments the government was able to engage the SOEs.

Given the voluntary nature of codes and guidelines, noncompliance carries few if any consequences. But this does not mean that voluntary codes should simply be made mandatory. Although some core parts of a voluntary code may find their way into compulsory formal rules and regulations, the objective of governance codes is not just to ensure compliance but also to motivate change in the governance culture and encourage SOEs to embrace the true spirit of corporate governance and not to view it as a mere box-ticking exercise.

Countries considering the development of an SOE code might follow the steps outlined in box 2.16.

Finally, measuring the impact of the code on SOE corporate governance practices through surveys, corporate governance assessments, and scorecards is important. But broader impacts can also be considered through measures such as the number of references to the code in the media, number of official endorsements of the code, and impact on broader corporate governance frameworks such as the passage of new laws and regulations.

**BOX 2.16**

**Steps in Developing an SOE Governance Code**

SOE governance codes come in different forms. Who develops them, how they are developed, and what their purpose is differ from country to country. But any country seeking to develop an SOE code might consider these basic steps:

- Reach agreement within the government on the need for and purpose of the code and the desired outcomes. High-level support for developing and implementing a code is useful.
- Take time early on to consider the purpose of the code and develop an implementation plan. For example:
  - Consider whether the code should be used as a benchmarking tool, as a model for individual SOE codes, or as a formal requirement.
BOX 2.16 continued

- Identify an appropriate backer or champion for preparation of the code.
- Nominate a leader or champion to be the public face of the code.
- Garner commitment from leaders (administration officials, board members, SOE executives).
- Design complementary training and awareness-raising activities.
- Identify key contributors to the code:
  - Line ministry and finance ministry officials.
  - Ownership entity where one exists.
  - SOE executives and board members.
  - Academics.
  - Private sector board members, executives, and other experts.
  - High-level political supporters.
- Form a working group and define its terms of reference.
- Analyze and discuss existing codes.
- Develop a first draft.
- Disseminate the draft among relevant stakeholders, including the general public, for comment.
- Collect and publish the comments.
- Formally adopt the code.
- Roll out the code according to the implementation plan.
- Periodically examine the impact of the code and adjust it and its implementation as needed.

Notes

1. The term SOE here is used interchangeably with other terms that are commonly used in different countries, such as public enterprises, government-owned corporations, government business enterprises, public sector undertakings, and parastatals.

2. For instance, public entities that perform essential state functions—such as environmental protection or aviation administration—may generate significant revenues from compulsory licenses or user fees. And they may have a formal legal status similar to SOEs. Yet, these entities are not generally categorized as SOEs.

3. Company legislation may also apply to SOEs in other legal forms, such as foundations, limited or general partnerships, and limited partnerships with shares.
4. Several OECD countries as well as the European Union have established specific competitive neutrality frameworks. These frameworks go beyond addressing the anticompetitive behavior of SOEs to also establish mechanisms to identify and eliminate any competitive advantages that may exist, including with respect to taxation, financing costs, and regulatory neutrality. The experience so far with such formal arrangements shows that jurisdictions that have them have generally been successful in rolling back state subsidies and, on the evidence to date, have obtained significant economic efficiency gains.


7. The toolkit (World Bank 2004) provides detailed information on each aspect of a labor-restructuring program, from program design to execution and monitoring and evaluation, as well as on the importance of engaging with stakeholders throughout the process.

8. In other cases distortions arise from a true lack of commitment to a fair procurement policy by different levels of government (central, regional, local).

9. For example, sometimes direct purchase is used to facilitate contracting instead of public procurement. This happens when public authorities request delivery of products or services directly from the organizations they own instead of putting them out to tender.

10. Examples are provided by Julius (2008); Sturgess (2006); and Comisión Nacional de la Competencia (2010).

11. Use of the word code varies and sometimes leads to confusion. Code is often understood to mean a statute, particularly in civil law countries. In the usage employed in the toolkit, however, code means a voluntary document that provides guidance on best practices and is often “enforced” through disclosure requirements.

References


