

Economic freedom and reform of state-owned enterprises

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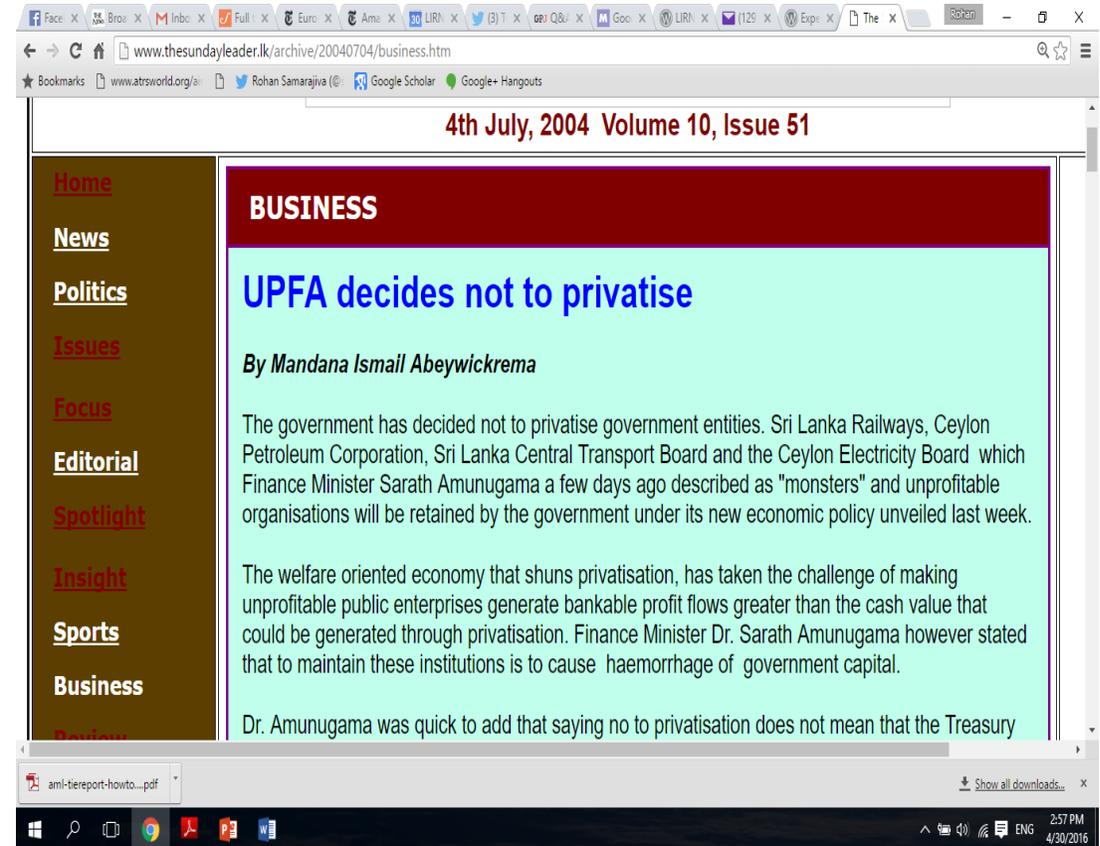
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Economic freedom

- The missing ingredient in Sri Lankan public discourse
 - Economic freedom is not part of the Feudal-Fabian mindset
 - Parlous state of economics education contributes
 - Over-emphasis on political rights as a manifestation of the 30 year war has sucked the oxygen needed for economic discourse
- Time is right
 - To bring economic freedom to the fore
- Advocata is emerging at the right time in the right place

Preconditions for economic freedom

- Individual initiative is stifled when the state occupies all the space → government should do a few things well and pull back from rest
- The state has expanded since 2005 by creating SOEs, government-owned companies, etc.
- Inefficient SOEs are aggravating debt crisis and fiscal deficit and destabilizing banking system



Name of the state own enterprise	 Ceylon Petroleum Corporation	 Ceylon Electricity Board	 Sri Lankan Airlines	 Sri Lanka Transport Board	 Mihin Air Ltd	Σ 5 out of 55 SOE's
Cumulative losses 2006-2015	LKR 244 Billion	LKR 172 Billion	LKR 112 Billion	LKR 61 Billion	LKR 16 Billion	605 Billion
As a Percentage of cumulative losses*	38%	27%	18%	09%	03%	95%

605 Billion = 18% of 2015 GDP in Sri Lanka = 81% of the current budget deficit in Sri Lanka

[*Cumulative losses of 55 strategically important SOE's as per treasury]

To complement, not replicate



- The numbers are clear, even if incomplete
 - But I will not burden you with more numbers
 - **Read the report**
- Instead, let us reason together
 - What can we do to rid ourselves of these “monsters”?
 - For that, we need to understand why monsters are created, fed and made even more monstrous

What do SOEs produce?

SOE	Intended product	Actual product
Ceylon Plywood Corporation	Plywood	Jobs for the boys
SriLankan Airlines + Mihin Lanka	Passenger & freight transport services	?
Sri Lanka Transport Board	Passenger transport service	?
Ceylon Electricity Board	Reliable, low-cost electricity service	?
Sri Lanka Port Authority	Port services	?

Incentives, though not all in sync, generally yielding dysfunctional outcomes

- Politicians may:
 - As agents of the public, wish to provide high-quality public services to constituents
 - They may want instruments they can directly control, rather than indirectly influence
 - Driven by the need to get reelected, wish to collect funds for that purpose and reward party workers essential for that task (Anthony Downs (1957), *Economic theory of democracy*)
 - Reflecting a feudal culture, want to support the ground troops needed for the political wars and obtain the wherewithal to live in a manner appropriate to his station and ensure succession by primogeniture
- Public officials may:
 - Wish to increase their budgets, and thereby their power (William A. Niskanen (1971). *Bureaucracy and Public Economics*)

In all cases, the state expands

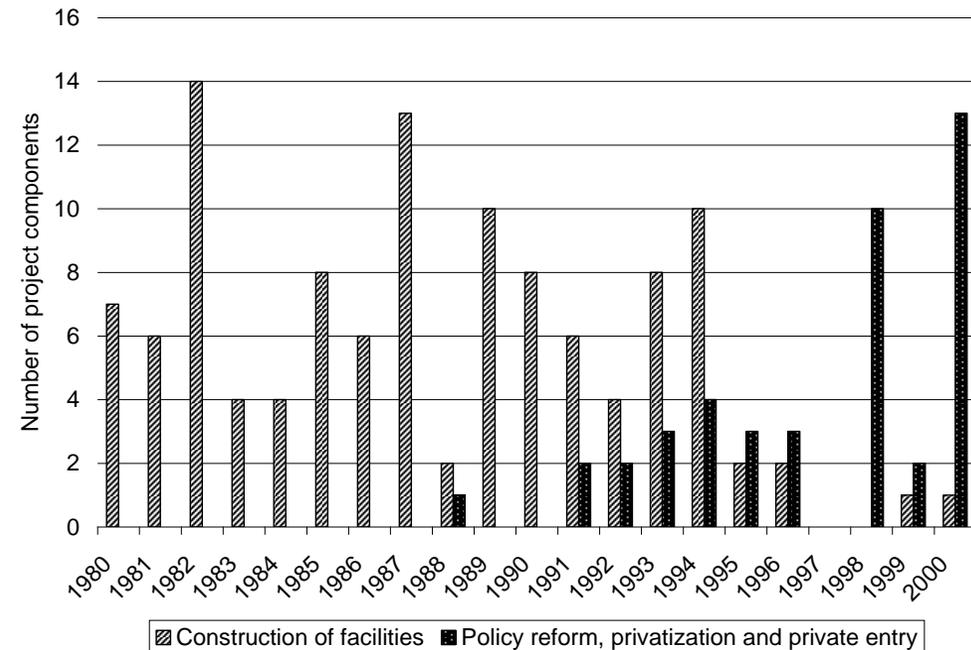
- Room for human initiative is constrained
- Opportunities for innovation are closed off

- Liberty is diminished

Is there any way things can get better?

- Case of one partially reformed SOE:
Sri Lanka Telecom
 - Pressure from investors in Export Processing Zones
 - 1984 telecom reforms in US, UK & Japan
 - World Bank's policy change starting in the late 1980s
 - First privatization effort failed in 1989, but some market entry was permitted
 - Partial success in 1997
 - Successful IPO in 2002; management contract was ended in 2003
 - Some policy heroes and villains; no discernible contributions from think tanks/civil society

Figure 3: Composition of World Bank loans in telecom sector, 1980-2000



Policy windows open when Iron Triangles get destabilized, but don't remain open for too long*

- *You never let a serious crisis go to waste. And what I mean by that it's an opportunity to do things you think you could not do before.*

Rahm Emanuel, 2009

- Asian Financial Crisis → IMF intervention → Indonesia's reforms
- Third nationwide blackout has put those safeguarding CEB status quo on backfoot . . .
- Present economic crisis may cause government to change how it manages SOEs; it has the mandate from 2015 elections

• With apologies for mixed metaphors, but these are serious policy-studies terms: Kingdon, J.W. (1984), *Agendas, alternatives and public policy*; Hecló, Hugh (1978). "Issue networks and the executive establishment," in *The New American Political System*, ed. Anthony King.

First Best: Competition wherever possible, regulation where necessary . . .

- For effective competition, state cannot own some of the competitors because it has power to tilt the playing field, even if in unregulated industries (e.g., preferential access to credit; taxation)
- Regulation only necessary for infrastructure industries or those with serious information problems
 - Regulation is only partially effective with state ownership
 - What is the point in fining a state-owned company?
 - How practical is the cancellation of a license?
- → **First-best solution includes privatization**

What is the second-best solution?

Originally proposed by Ven. Athuraliye Ratana, M.P.; included in 2015 January Common Candidate's Manifesto; also in UNP's 2015 August Manifesto

- The Government is the largest owner of business institutions. The ownership is held in trust for the people. Unfortunately these businesses have not been properly managed for the last 50 years. Therefore those institutions have incurred severe losses. As a remedial measure, all public enterprises will be placed under a Public Business Enterprises Holding Corporation Ltd. Trustees of the corporation will by law be appointed through a scheme based on consensus reached by the political parties and civil society. Further, laws will be introduced to regulate this institution on the same principles as a limited liabilities company.

Temasek model, as explicated before a simplistic understanding got entrenched (*FT, 29 January 2015*)

- Temasek owns SOEs that can be treated as normal business enterprises (not those that have other objectives such as the provision of housing or welfare) and can be subject to normal regulatory oversight. **The companies make commercial decisions and do not supply services below cost.**
- The SOEs are **managed by professionals whose only mandate is to run the companies efficiently and produce adequate profits for the owner**, Temasek Holdings. Depending on how they do on the defined performance indicators, they hold their positions. The assistance they provided to the ruling party or who they are related to by blood or which school they attended are not criteria for selection.
- How are the performance indicators set? No one can be asked to produce ever increasing amounts of profit, especially under competitive conditions. Without doubt, the ups and downs of the economy as whole will also impact return on investment.
- **The solution is to list the companies on the stock market.** So the performance of the Board members of companies such as Singapore Airlines that face competition are judged by metrics that include share price. **If the holding company determines that the investment is yielding inadequate returns, it can sell down its stake, in addition to getting rid of the directors.**

Good solution, but with some problems . . .

- **How is performance of the directors of Temasek Holdings assessed?** They are the final decision makers regarding how much equity is held in the various government-owned companies (they also hold equity in other companies such as Standard and Chartered (18%) and Bharti Airtel (3%)). What is their accountability with regard to the investments and appointment and oversight of directors?
- **Temasek performance is judged in relation to benchmarks connected to the performance of its companies.**
- Yet, one cannot have purely objective criteria. However well the company is managed, there will be years when it will perform badly. That is just the way it is when one invests money. **In any democracy, sovereign wealth funds will come under pressure when times are tough.**
- For that, you have the final safeguard. Since 2002, **Temasek's CEO has been Ho Ching, who just happens to be the spouse of Lee Hsien Loong, the current Prime Minister and a member of the first family.** It also has a strong and empowered Board that includes several truly independent directors, including the former head of the World Bank.

What is to be done?

- Engage with the government's "Temasek" solution while policy window is open to prevent sub-optimal implementation
- Use RTI requests to extract as much information as possible about SOEs to show how bad things are in terms of
 - Performance
 - Accountability of Boards
 - Incompetence of managers

In a feudal culture overlaid with Fabian thinking, it's going to be a long game: **persistence based on principle** is needed

"public authority" means –

- (a) a Ministry of the Government;
- (b) any body or office created or established by or under the Constitution, any written law, other than the Companies Act No. 7 of 2007, except to the extent specified in paragraph (e), or a statute of a Provincial Council;
- (c) a Government Department;
- (d) a public corporation;
- (e) a company incorporated under the Companies Act, No. 7 of 2007, in which the State, or a public corporation or the State and a public corporation together hold twenty five *per centum* or more of the shares;

To end on an optimistic note . . .

*In the real world, a policy
win is the avoidance of the
worst outcome*