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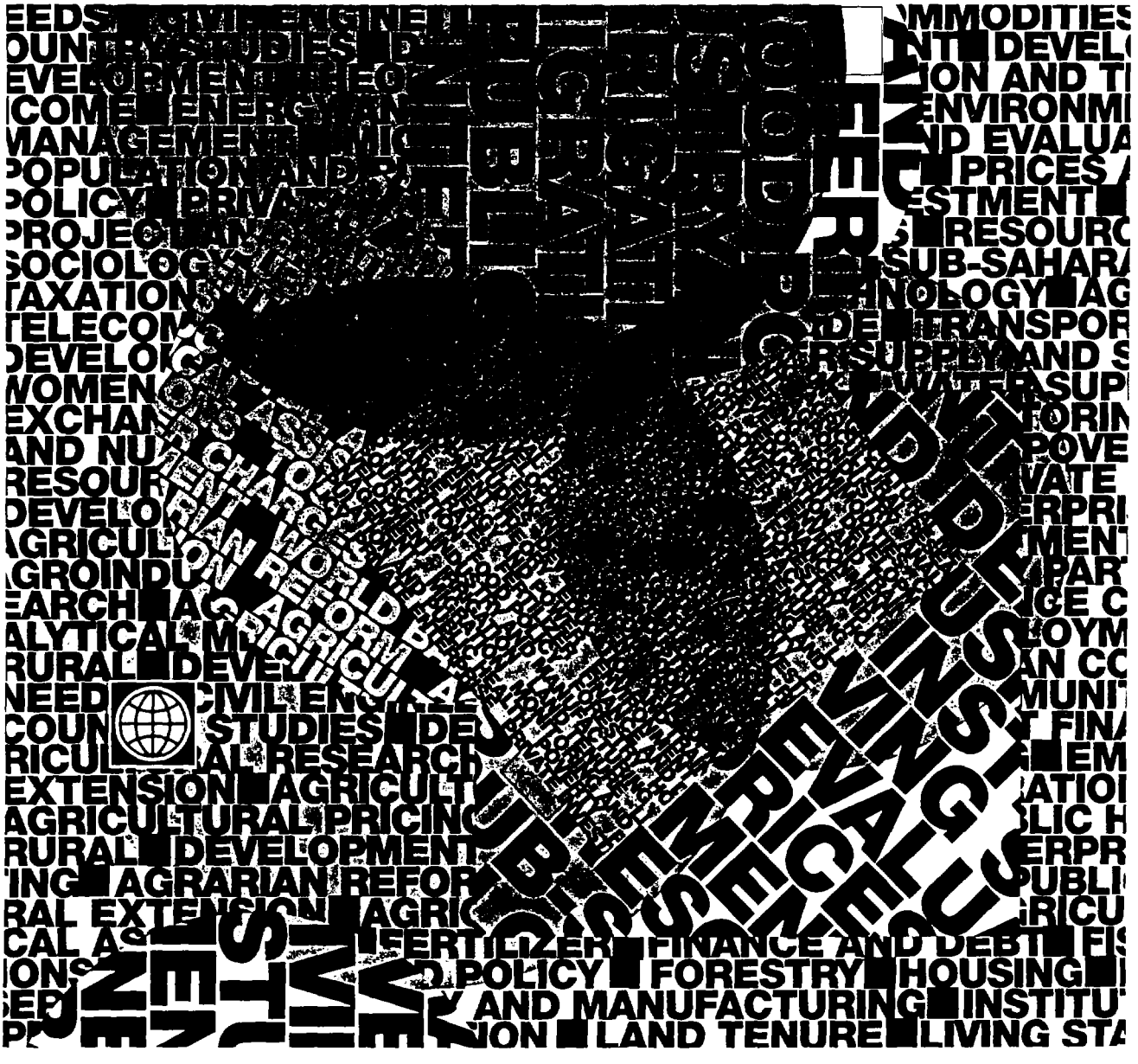
Improving State Enterprise Performance

The Role of Internal and External Incentives

Russell Muir and Joseph P. Saba



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Both authors work in the Private Sector Development Department of the World Bank. Russell Muir is senior industrial economist; Joseph P. Saba is principal private sector development specialist.

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FOREWORD

Disappointing State-Owned Enterprise (SOE) performance presents one of the major challenges for many governments over the next few years. Inefficient SOEs can have a significant impact on the macroeconomic framework by undermining the efficient operation of the financial system, fueling inflation and increasing public debt. In addition, they increase the cost of doing business for all firms in the economy. International experience indicates that poor SOE performance can account for direct and indirect losses equal to 5 to 8 percent of GDP. For countries that have a large public sector, the losses could be 8 to 12 percent of GDP—about 2-3 times the amount spent on education and health. As such, seeking ways to redress these problems has become a major challenge in developed and developing economies alike. This paper summarizes the international experience with SOEs and explores the options for, and limits to, reform.

The paper outlines how the corporate form has been developed internationally to become the most efficient institution through which commercial activity—in essence the transformation of inputs into outputs—can be carried out. Its success is due to the *dynamic interplay of internal and external incentives* which, in large measure, determine the performance of all corporations, whether private or state owned. Virtually all SOE reforms have aspired to transform inefficient SOEs into efficient modern corporations.

The focus of the paper is on how SOEs might be structured, governed, operated and financed as modern corporations. Based on the broad international empirical research of SOE reform combined with the analysis provided by eight case studies, a number of specific lessons are presented for policy makers and SOE managers. In addition, the paper explores whether there may be systemic limits to SOE reforms which do not address the role of increased private participation in terms of financing, management and ownership.

The World Bank's Private Sector Development Department provides specialized services in the fields of enterprise reform, privatization, the private provision of infrastructure and small and medium enterprise development. Both authors have extensive experience with issues of enterprise reform and corporate governance based on their work in the World Bank and in the private sector. This paper is designed to provide operational advice based on international best practices to enterprise reform practitioners and policy makers.

Magdi R. Iskander
Director
Private Sector Development Department

ABSTRACT

The central objective of the research summarized in this report was to explore the ways and means of reforming State-Owned Enterprises (SOEs) to achieve efficiency, profitability and accountability. Specifically, this project sought to: (i) survey international experience in SOE reform; (ii) develop models and identify key factors for successful reform; and (iii) formulate recommendations.

The research was two-pronged. First, eight case studies of large, industrial SOEs in the tradeables sector in OECD and non-OECD countries were developed. Second, since a key defining characteristic of international SOE reforms has been the reorganization of SOEs into the corporate form, considerable attention is given to analysis of the corporate form, in particular its fundamental attributes and the dynamic interplay of its internal organization and critical external market factors. In this analysis, the three most common international models of corporate organization are considered. Taking into account the case studies and the corporate analysis, the report focuses on how SOEs might be reformed as modern corporations; what incentives are needed to achieve the reform goals and the systemic limits to reform. Finally, recommendations for specific actions to enhance, sustain and lock-in reform gains are offered.

Chapter I details the worldwide evolution of the SOE. Chapter II sets forth an analysis of the modern corporation, various models and contrasts these to the SOE. Chapter III presents the international experience with reform and conclusions and lessons.

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EXECUTIVE SUMMARY

Introduction

Despite the wave of privatizations that have occurred over the past fifteen years, State Owned Enterprises (SOEs) continue to occupy a central role in many economies in terms of value added relative to GDP, employment and investment. Yet the performance of SOEs has been largely disappointing and the negative impact on macroeconomic stability severe. Inefficient public enterprises have undermined the operation of financial systems, fueled inflation, increased public debt while acting as an obstacle to private business. Seeking ways to redress these problems has become a major challenge in developed and developing economies alike. This paper reviews the international experience with SOEs and explores the options for, and limits to, reform.

In advanced economies worldwide—and in virtually all economies in transition—the corporation is the defining characteristic of the modern industrial enterprise. The modern corporate form has evolved over four centuries to become the most efficient institution through which large scale commercial activity—in essence the transformation of inputs into outputs—can be carried out. The focus of the analysis is on how SOEs might be reformed, i.e., structured, governed, operated and financed as modern corporations; what incentives are needed to achieve the goals of the reform program; and, why there may be systemic limits to SOE reforms which do not address the role of competition, factor markets and increased private participation in corporate finance, management and ownership.

The Worldwide Evolution of the State Owned Enterprise (SOE)

Chapter I details the rise of the SOE and the challenge it came to present to its owner, the State. Many countries established SOEs after 1945 to promote profitable and efficient economic growth by undertaking commercial activities that the private sector could not or would not perform. Over time, governments assigned to SOEs non-commercial objectives such as regional development and employment maximization. Many SOEs increasingly resembled governmental, not commercial, structures in their organization, governance and funding. Large holdings emerged with many of the negative features of inefficient bureaucracies (e.g., Italy, United Kingdom, Turkey, Egypt, Austria).

After a period of growth in the immediate post-World War II period, SOE performance declined in the 1970s and 1980s as global markets fueled competitive pressures. In response, governments often protected their SOEs from competition and provided direct and indirect subsidies. Although the residual risk bearer for SOE losses, the state had little effective means to monitor economic performance and often failed to develop mechanisms to discipline management. The combination of non-commercial objectives and related burdens, the difficulties of holding SOE management accountable and the continued blurring of governmental functions with SOE ownership and management, led to declining performance in most countries.

The result was increasing budget deficits, external debt, inefficient resource management and a "crowding out" of the private sector from many areas of business or finance. In response, by the 1980s, governments began to search for means to reform their SOEs through different modes of organization, governance and operation. The preferred option was to seek to "mimic the market" by organizing SOEs along the lines of enterprises in the private sector in the hope of achieving similar levels of efficiency and profitability. Almost universally, the corporation became the preferred organizational form for reform. In many cases, however, too much reliance was place on formalistic approaches. The characteristics inherent in the corporate form and the factors causing it to be successful in the private sector were often misunderstood or ignored. Many came to see the role of whole or partial divestiture as contributing to reform goals. Over the past fifteen years, the two most important reforms in the production of goods and services by the State are through policies aimed at the *corporatization* of SOEs and whole or partial *divestiture*. In a number of the more successful cases these policies have been viewed as points on a continuum with corporatization of SOEs leading over time to divestiture programs.

The Corporation as an Ownership and Management Structure

Drawing from international best practices, Chapter II establishes the analytical framework for the paper. Focusing first on the essential characteristics of the corporation and the ways and means corporations in the private sector are organized, governed and operated, it sets out models for reform.

Essential Attributes. The modern corporate form is characterized by four essential or fundamental attributes:

(a) Separate identity. The corporation is a legal person distinct from the shareholders, with clearly defined property rights and a separate accounting for its own assets and liabilities;

(b) Limited liability for shareholders. Shareholder's risk of loss is limited to their contribution to the corporation's capital;

(c) Centralized management. The day-to-day affairs of the corporation are conducted by one or more persons chosen by the shareholders; and

(d) Transferability of shares. The shareholders' ownership interests are transferable and a transfer by a shareholder of its ownership interest in the corporation does not, in itself, change the rights of the corporation with respect to its own assets and liabilities

These attributes combine to enable the corporation to mobilize resources and to undertake economic activity on a large scale with a clarity and singleness of purpose. The absence of one or more of the attributes would significantly impair the corporation as an effective vehicle for reform. In each of the eight case studies, achievement of reform objectives

was blocked or constrained when the reforms omitted one or more of these attributes in reorganization.

The Incentive Framework. There are specific key variables whose dynamic interplay determine and discipline the performance of all corporations, whether private or state owned. Although the variables are relatively few, many reforming states have had difficulty in recognizing their complex relationships and the importance of including each and every one as part of the reform. These key variables can be presented in two categories and summarized as follows:

(a) Internal Organizational and Governance Incentives. These include the internal structures and arrangements between the owner (the principal) and the corporate managers (the agents) by which the owner directs and monitors the managers' actions taken for the goals set by the owner; and

(b) External Incentives. These are variables relating primarily to market factors which, while not under the direct control of owners, discipline mangers and owners in performance.

Internal Organization and Corporate Governance. Throughout the world, as corporations grew in size, complexity and numbers of shareholders, corporate owners have faced the challenge of how to structure the corporate organization and regulate its operations in a manner which assures the attainment of the owner's corporate goals of efficiency and profitability as well as accountability for assets and performance. The key issue is how the shareholders—the "principal"—can achieve efficiency, profitability and accountability while also permitting the managers—the "agents"—the necessary degree of autonomy to operate the corporation in a competitive market environment.

This principal–agent problem has been a major focus of corporate development over the last 50 years. While the evolution of the corporate form has been eclectic over the past 15 years, there has been a significant degree of international convergence in the laws and forms for corporate organization and governance. These elements are relatively few.

Organizationally, the primary participants in the modern corporation are:

(a) the shareholders;
(b) a supervisory board; and
(c) the executive, sometimes referred to as officers, management or managing directors.

The shareholders provide risk capital for which they have certain governance rights:

(a) to elect and remove the board;
(b) to approve or disapprove fundamental or extraordinary changes (e.g., changes in the corporate charter, mergers, increase/decrease in capital); and

(c) to determine and receive dividends.

Boards manage the corporation on behalf of the shareholders through appointment and supervision of the executive, and by reviewing and ratifying all major decisions not reserved to the shareholders. The executive is usually a set of persons elected by the board, who undertake the day-to-day affairs of the corporation.

Three examples of different Board structures are summarized below as follows:

(a) German model. This system relies on a two-tier board model with strong labor representation—a legacy of post-WWII reconstruction. The two-tiered board is less in favor now. The model is more an "insider" model since a relatively few shareholders, banks (holding powers of attorney from shareholders) and labor appoint the main monitors of management;

(b) Japanese model. More an "insiders" model, the board normally includes representatives of management and, through extensive cross-holdings, informal influence is imposed by "insiders" such as suppliers, customers and the corporation's "main" bank; and

(c) Anglo-American model. This is often referred to as an "outside" control model. Shareholders either tend to be numerous and rely on exit to protect their investments or are often passive institutional investors such as pension funds which increasingly rely on directors drawn from outside corporate management. Banks play no direct role on boards but are very influential as an "external" factor in their role as creditors. Because shareholders are so often at a distance from management, the legal duties of board members to the shareholders ("fiduciary" duties) are now extensively delineated and clarified by law.

Internal Incentives. Shareholders, usually on Board advice, have adopted many varying plans to provide incentives and discipline to management to assure attainment of shareholders' goals. These include share option plans, indexing of salaries to corporate performance and various other benefits/schemes.

External Disciplines. While internal incentives are necessary to achieve efficiency, they are insufficient. Far too many SOE reforms have begun and ended with formalistic, organizational changes—rearrangements of boards and bureaucratic structures. These changes, while often needed, do not in themselves yield significant returns. What is also required is the application of external incentives and disciplines—that is, influences outside the direct control of the corporation but which promote management efficiency and accountability to the shareholders. These must be allowed to play a central role in disciplining the performance of the firm. These external factors include:

(a) Product market competition. This forces the management to adopt the most efficient methods to maximize profits through market share and general

competitiveness. Failure to maximize profits in a competitive market exposes the firm to the prospect of bankruptcy and failure;

(b) Competitive capital markets. Both debt and equity impose substantial constraints on management. When the management must turn to equity markets, those markets quickly and continuously monitor and place an objective value on the company and, by reference, on the management. Debt markets impose additional and often more stringent constraints since the management must often agree with creditors on a plan which requires the maintenance of debt/equity ratios and a certain levels of cash flow;

(c) Labor Markets. These discipline corporations since managers not only compete with each other to attain the top positions *within* the modern corporation, but there also is an active market *outside* companies for managers to improve corporate performance. In addition, where labor markets function well, corporations must compete for the best trained, most efficient workers. In countries where labor has a management position on the Board, labor organizations in and outside the company also exert influence and thus constrain management;

(d) The Corporation's Legal Obligations. In most market economies, laws directly affecting corporate governance such as Company and Securities Laws set minimum norms and standards for management, aimed at protecting shareholder rights. These laws are enforced vigorously in most market economies; and

(e) Bankruptcy. The threat of surrender of day-to-day control to a trustee in bankruptcy or to a liquidator is a powerful incentive for managers to achieve the owners' commercial goals of profitability through financial discipline.

Use of the Corporate Form When the State is the Owner. Typically, many unreformed SOEs (even those nominally organized as corporations) lack one or more fundamental attributes and one or more of the organization and incentive structures of the modern corporation. Most lack a clear separate commercial identity, suffering from government interference in the day-to-day management of the enterprise and a lack of clarity between owner/manger functions. Many states have sought to impose accountability and achieve efficiency through the creation of large holding companies. Almost universally, these have failed to achieve their goals as a result of cross-subsidization, monopolistic behavior and insufficient, inadequate or erroneous information flows to the owner. The very complexity of the structures almost ensures that a distant and non-specific owner cannot hope to master and use, in a timely manner, available information to monitor and discipline the structure. In addition, the financial sector often provides debt on terms softer than commercial basis, particularly for the larger enterprises, relying on the state to bear losses. Thus the state as owner of the enterprise does not benefit from limited liability but bears all risks. Most significantly, external incentives such as product and labor markets are prevented from or are unable to function effectively, while economic legality is absent since there is no effective provision for the implementation of bankruptcy or liquidation.

Reforms. Faced with these challenges, a number of countries such as New Zealand, the UK, Chile, Sweden and Korea have tried, with some success, to reform SOEs through introduction of both internal and external incentives. SOE reform has had its most significant and lasting impact on the macroeconomic framework where priority was focused on tackling the large loss-making enterprises.

The common elements of all these reform programs include *simultaneous* action aimed at:

(a) Introducing into SOE reorganizations, all four basic attributes of the modern corporation, for the purpose of achieving commercial objectives;

(b) Introducing competition from the private sector international sources, and between SOEs in product and labor markets;

(c) Cutting direct and indirect financial subsidies from government to SOEs;

(d) Reforming the financial sector, including upgrading prudential regulations and banking supervision systems so that the financial sector can provide the necessary external incentives and discipline;

(e) Separating the role of owners (i.e., government) from the day-to-day management of the SOEs while also minimizing the number of bureaucratic layers between the company and the government, e.g., in a large state, allowing provincial bodies to represent their owner interests without interference from the central government;

(f) Unbundling non-core businesses from the SOEs;

(g) Transferring many of the social functions from the enterprise to municipal or central government authorities;

(h) Introduction of necessary social safety net, including pension system and unemployment services; and

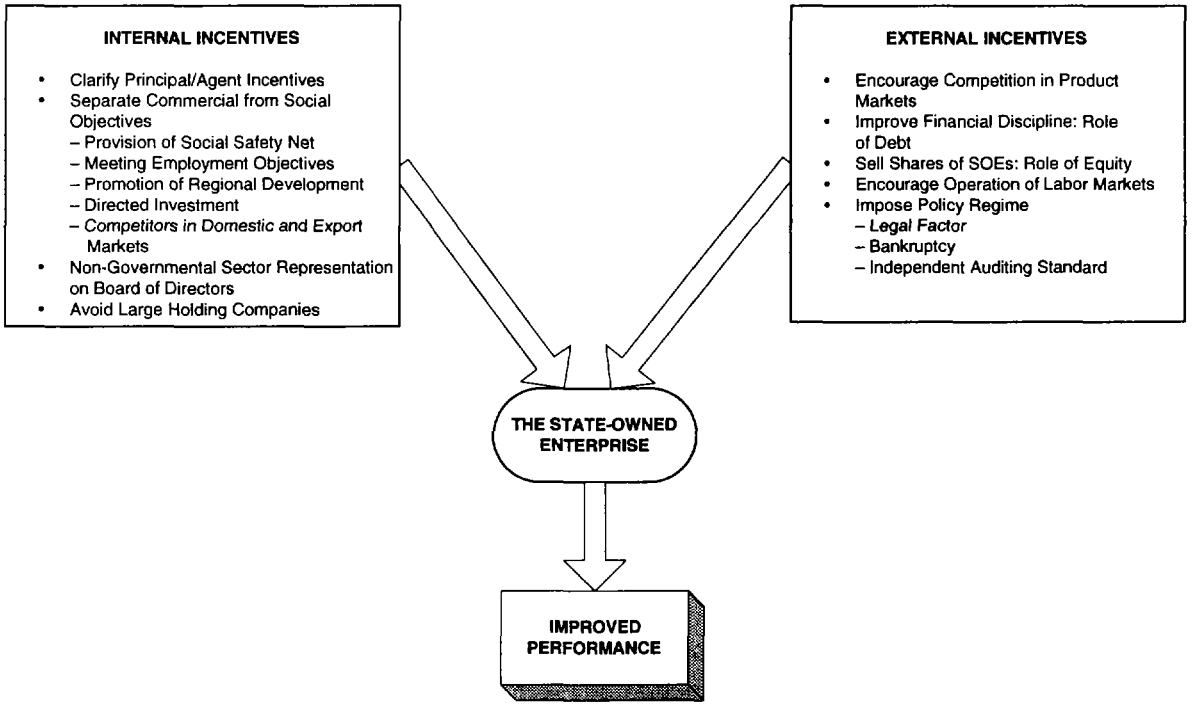
(i) Revision of state functions through the creation of an ownership neutral policy/regulatory framework for commercial enterprises, removing distortions (price controls) and correcting disincentives (tax policy and administration) for greater equity and efficiency.

If these conditions for effective reform can be met and sustained, the internal and external incentives will improve the performance of the SOE and it will begin to resemble more closely the form of the modern corporation.

The International Experience with SOE Reforms

Based on the broad international empirical research of SOE reform combined with the analysis provided by the eight case studies presented in the Appendixes, a number of specific lessons are presented for policy makers and SOE managers. These are summarized in Figure 1 below.

Figure 1. Internal and External Incentives: Key Lessons of Experience



Separate Commercial from Social Objectives. Many SOEs are faced with a complex agenda—that of pursuing a range of social and political targets that often conflict with sales or profit maximization objectives. The noncommercial roles of SOEs and their economic impact can be categorized under the following headings: (a) provision of a social safety net; (b) meeting employment objectives; (c) promotion of regional development; and (d) directed investment. Effective SOE reform requires assignment of clear and unambiguous objectives in which commercial profitability features prominently. In other words, SOEs should pursue commercial objectives and be given incentives to succeed similar to those that apply to private firms.

Clarify Principal/Agent Relationships. Clarifying the relationship between SOE managers and the firm's owner is one of the most fundamental issues for the State as owner of the corporation to address. How should the state interact with SOE management in such a way that the firm best achieves its commercial goals? What owner/manager framework for SOE control has worked? International experience to date offers several lessons based on the principal of recognition and application of the four basic attributes of the modern corporation.

First, the most effective SOE owner/manager regimes have been those where there has been a separate legal identity of the corporation from its owners with strict application of the principal of limited liability for the owners. Second, centralized, commercially motivated management is critical. However, international experience in countries as diverse as France, Italy, Norway, New Zealand, Korea and Indonesia, suggests that effective internal governance for corporatized SOEs has been achieved when the state has provided adequate incentives to boards, managers and employees to meet commercial objectives. Third, international experience also indicates that share transferability is a fundamental attribute of successfully reformed SOEs. This finding stems from the concept of residual risk—i.e., the risk accepted by the owners of the enterprise who take the ultimate risk of loss and also benefit from the ultimate gains. In private sector firms, the residual risk bearers must have effective control over management decision-making and/or be able to sell their ownership rights to new purchasers. In the case of SOEs however, the residual risk is borne by the population as a whole which in turn has no ready vehicle for either controlling the enterprise or for divesting its ownership rights. In these circumstances, the incentives to perform efficiently are weakened since residual gains or losses are not borne in full by the local, municipal or national authority which owns the enterprise but by the population at large. Therefore, while a corporatized SOE may be structured to look like a privately owned enterprise, if it lacks one significant attribute, such as transferability of shares, this deficiency will undermine the effect of other reforms. Many countries have confronted this problem by diversifying SOE ownership; in some cases, to secure the gains from ownership diversification, SOE divestiture has been pursued.

Appoint Non-Governmental Representatives to Boards. One of the key factors which has continued to frustrate the efficient operation of SOEs after corporatization, has been the failure to attain a clear separation of overt political influences from the commercial and business objectives of the enterprise. While it is important to establish a strong Board structure to develop the overall strategy for the SOE and to monitor the performance of management, the creation of a Board which facilitates undue political interference in the day-to-day operation of the business will achieve little by way of improved corporate governance. A more effective way of ensuring that Boards are able to perform their strategic and monitoring role is through the introduction of private sector representatives onto the Boards. This has proven to be a useful method of improving the performance of SOEs in a number of countries such as Korea and New Zealand. However, even in New Zealand the remaining SOEs that have not yet been privatized have begun to suffer from the re-emergence of escalating interference from politicians, prompting authorities to turn to divestiture as a way of "locking in" efficiency gains.

Avoid the Creation of Large Holding Company Structures. International experience suggests that the significant disadvantages of large holding companies outweigh any limited advantages: many of the aims of these structures can best be achieved by improving structures at the level of the enterprise and by ensuring that the external factors outlined in the section below are in place and free to impact SOEs. The country examples of Italy (IRI), France (Usinor Sacilor), Turkey (Sumer Holdings) and India (HMT) as well as the poor experience with these corporate forms in Algeria, Egypt and Kazakhstan amply demonstrate many of the drawbacks of these systems. The main disadvantages of holding structures can be summarized as:

(a) the creation of additional layers of bureaucracy with few benefits, in terms of increased efficiency, to the operating companies;

(b) a failure to shield the operating companies from undue political intervention;

(c) the propensity for cross-subsidization between operating companies in the Group and the concomitant distortion of signals and incentives to management that this practice promotes; and

(d) the difficulty in controlling the growth and longevity of these corporate forms once established.

External Incentives: Key Lessons of Experience

Encourage Competition. Perhaps the most important exogenous factor impacting the efficient operation of any firm—including SOEs—is the overall degree of competition in the enterprise sector. Economic theory and practice amply demonstrates that companies in a "contestable" market facing the full rigors of competition with freedom of entry and exit, are likely to react to these pressures in a manner which will foster and maintain high levels of efficiency at the level of the firm.

Yet, even when there are numerous SOEs operating in the same sector, governments have been known to prohibit competition between SOEs and/or restrict entry or competition from private sector firms in an effort to provide protection to potentially inefficient SOEs. International country experience varies from fierce competition in contestable markets with negligible interference from government—the UK and New Zealand—to overt protection by the State for heavily subsidized operations—Turkey and India. In all cases, the impact or absence of these external competitive forces on governance, and hence performance of the enterprises, has been marked and direct.

Improve Financial Discipline: the Role of Debt. When markets for debt finance operate according to commercial principles they induce corporations to demonstrate they can employ the debt profitably, by servicing it or covering the creditor's losses if it cannot be repaid. Thus, creditors exert a discipline on corporations akin to the discipline imposed by shareholders. However, where the state as owner protects its corporation from that discipline—usually by guaranteeing its debts—it removes a strong incentive for management to be efficient and to seek profit and introduces issues of "moral hazard." All too often in countries as varied as Italy, Japan, Turkey and Pakistan there is evidence that governments are unwilling or unable to impose debt market discipline on SOEs through the banking system.

Diversify Ownership of SOE Shares: The Role of Equity. In the private sector, the transferability of shares is a basic attribute of a successful corporation. Coupled with an active equity capital market, international experience shows that diversified sales of SOE shares or the dilution of government ownership through rights issues can have a major impact on improving a

company's performance. In the case of most SOEs, it is difficult to develop appropriate surrogates for these private sector capital market forces. However, experience has shown that it is possible to create some of the external pressures which can motivate improved governance by selling even a minority portion of the government's shares to the private sector. This is a trend which has accelerated internationally in recent years.

Avoid Complex External Performance Monitoring Schemes. In a number of countries such as Korea, Pakistan, France, Indonesia, New Zealand and Mexico a great deal of effort has gone into designing systems to measure and monitor these targets, drawing both on the internal performance of the firm as well as applying international comparisons of sectoral performance. However, there is little hard evidence that these systems have been able to develop and, equally important, maintain objective performance benchmarks in such a way that the measures reflect decisions that can be controlled by management. In a number of instances, the systems are fraught with poor design parameters, distortionary incentives and lack the facility for enforcement.

Summary: International Lessons of Experience

The broader international experience, the cross-sectional data and the case studies examining SOE reform suggest a number of broad conclusions. The main lessons are:

(a) SOE performance can be improved measurably through reforms such that the enterprise, government and consumers *all* benefit from efficiency gains, even in the absence of divestiture;

(b) Improvement in internal corporate governance are a necessary but not sufficient condition for enhanced SOE performance. Equally, the external environment and policy framework must be allowed to operate effectively and to impact, in full, the performance of the SOE sector; ***but***

(c) International experience shows that these reforms may be politically and technically difficult for governments to implement;

(d) The whole package of reforms must be implemented—partial reforms are seldom sufficient—and they must be sustained over time;

(e) This is a challenging agenda for most governments and there are few examples of real success stories; ***and***

(f) Even where there are successes with SOE reform, governments have increasingly recognized that to sustain these reforms, there is a compelling case for increasing the role of the private sector in terms of financing, management and, most importantly, as equity shareholders.

I. THE WORLDWIDE EVOLUTION OF THE SOE

A. THE GROWTH OF SOEs

The rationale for the increase in State involvement in the production of goods and services stemmed from an amalgam of political and economic forces and philosophies which were prevalent in the immediate post-World War II period. Namely:

(a) a belief that the scale and range of investment required for sustainable economic regeneration was beyond pure market forces;

(b) a political commitment to multiple non-commercial objectives for enterprises such as employment generation, income redistribution and economic welfare which, it was argued, only the State could provide or direct through enterprises;

(c) the continued growth and subsequent electoral success of political parties founded on socialist principles emphasizing the State's control of the "commanding heights" of the economy;

(d) a conviction that widespread State ownership could protect their fragile economies from external shocks;

(e) the near collapse of banking systems and stock exchanges and the inability of these moribund institutions to provide medium and long-term finance for capital intensive projects; and

(f) the reluctance or inability of the equally devastated business communities to commit resources to capital-intensive sectors with long pay-back periods in the years immediately following WW II.

Against this background, a number of policies were implemented in the post-World War II period which shaped the economic profile of developed and developing economies alike. In Western Europe, socialist governments in the UK, France, Italy and elsewhere embarked on nationalization programs focusing primarily on energy, transport and other utilities but also extending into some of the tradable, heavy industry sectors. In a period when conventional wisdom emphasized the importance of economies of scale, these governments focused on the consolidation of a number of previously privately owned companies in sectors such as steel and chemicals under the control of large State-owned operations.[1] In some instances, these

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[1] In some countries such as the UK, the nationalization process began shortly after World War I when the State intervened as part of a bail-out operation to take-over mines and railways in situations where the existing private owners were facing financial ruin.

nationalized companies were transformed into entities which became part of Government Departments. In other cases, the nationalized company became a State Owned Enterprise retaining the broad corporate form of the formerly private firm, but taking on the attributes of an administrative bureau. In addition, many companies were created as new net investments by the State, either to fill a gap left by the private sector or to compete with existing private producers. In numerous countries, economic planning was predicated on the assumption that only the State had the political commitment and financial resources to promote the growth of mixed economies, economies where the balance of power would be shifted from the private to the public sector.

Some of the immediate post-War factors which obtained in Western Europe were felt with equal force in developing economies—particularly in these countries under colonial control. Private companies reluctant to invest in capital intensive projects in Europe were—with the exception of trade in raw materials—incapable of, or disinclined to, extend their exposure in these developing markets. Faced with rebuilding their home economies, colonial powers had little appetite and limited resources available for investment outside those minimal expenditures deemed essential to maintain the continuity of supply of traditional trade patterns.

During the past twenty five years, governments in developing countries have added significantly to the stock of SOEs, marketing boards, utilities and other enterprises which they inherited at independence. With the challenging objectives of fostering infant industries, promoting indigenization, creating employment and controlling strategic resources, many developing country governments responded by accelerating the role of the State from the late 1960s until the early 1980s. For instance, it is estimated[2] that between 1967 and 1980, more than half of Africa's extensive SOE sector was established by governments seeking a variety of these often conflicting economic and political objectives. During this same period, the number of SOEs continued to grow rapidly in most other parts of the world in countries as diverse as the Philippines, Mexico, Brazil, India, Bangladesh, Costa Rica, Portugal and Egypt. The most recent systematic estimates of public ownership in the 1980s indicate that, on a worldwide basis, SOEs accounted for an average of 10 percent of GDP while their average share of gross capital formation was much higher at 35 percent. In these circumstances, it is clear that SOEs have achieved such a degree of visibility in the economic landscape that their collective financial performance has had a decisive impact on the overall economic welfare of their respective economies.

B. THE IMPACT OF SOEs ON ECONOMIC PERFORMANCE

In the 1950s, higher overall growth rates in a large number of developed and developing countries masked some of the inefficiencies in SOE performance. Nonetheless, during the 1950s and the 1960s, many SOEs did perform relatively efficiently and served to support and complement the growth of the private sector. In this growth mode, the achievement of certain social objectives at high economic costs was tolerated. However, with the curtailment of growth

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2 See World Bank, *World Development Report 1988* (Washington D.C., 1989).

and the emergence of severe resource constraints that began to bite in the late 1970s and 1980s, many governments began to recognize that poor SOE performance was introducing rigidities into the labor market as well as contributing, in large measure, to their fiscal, foreign debt and inflationary problems. This resulted in disastrous spill-over effects on the banking systems rather than providing the solutions to economic development as originally intended. In both product and factor markets, SOEs were increasingly crowding out the private sector and raising the cost of doing business across the board.

At the same time, the business environment in which SOEs operated has changed markedly between the 1950s and the present. First, the 1960s began to see the emergence of consumer-driven markets where issues of consistent and increasing quality of goods and services became paramount. Second, technological change had the impact of fueling competitive pressures, forcing private sector firms to adopt new processes or upgrade existing product lines if they were to maintain sales and market shares. In contrast, many SOEs remained insulated from the objective market forces which were impacting the behavior of an increasing number of private firms, relying instead on direct or indirect protection from competition. In addition, in the absence of protection or subsidies, many of these SOEs were increasingly unable to compete with private enterprises in international markets. Over time, SOEs became unfocussed in their objectives and undisciplined in their operations with many firms lacking a clear owner and an advocate for capital. Governance and ownership issues central to the achievement of efficiency at the level of the firm became buried beneath other priorities in the rush to expand the scale and range of the State sector.

Based on the findings of an increasing body of literature and research, underlying trends of SOE performance have been largely disappointing; indeed, in many cases the negative impact on overall economic performance has been accelerating.[3] To illustrate:

- In the UK, the profitability of SOEs over the period 1970-85 was substantially lower than returns for comparable private sector firms—4.1 percent over the period for SOEs as against 17.6 percent in the private sector.

- In China, although annual total factor productivity for SOEs is rising, this growth is only about one third to one half the corresponding rate for non-state enterprises. SOE financial losses currently stand somewhere between 2.4 percent and 5.3 percent of GDP. It is acknowledged that over a third and perhaps up to two thirds of SOEs are loss-making despite absorbing at least 70 percent of all bank credit. These losses have required substantial fiscal and quasi-fiscal public subsidies which have impacted negatively on macroeconomics performance, resource allocation and social stability.

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[3] See World Bank, *Developing the Private Sector: The World Bank's Experience and Approach*, 1991; O. Bouin and C.A. Michalet, *Rebalancing the Public and Private Sectors: Developing Country Experience*, OECD, 1991; A. Galal, *Public Enterprise Reform*, World Bank, 1991; M. Shirley and J. Nellis, *Public Enterprise Reform: The Lessons of Experience*, EDI Development Studies, 1991.

- In Egypt during the 1970s and 1980s, the SOE sector was characterized by a large and growing overall deficit, mounting external debt and low rates of savings. Financial rates of return fell from a modest 7.8 percent rate of return on total net assets in 1975 to a meager 3.6 percent return by 1990. The overall deficit of the non-financial SOEs rose from about 1 percent of GDP in the early 1970s to around 4 percent of GDP in 1990—accounting for between 20 and 25 percent of the overall deficit of the central government.

- In Turkey, the borrowing requirements of the SOEs soared to 7.4 percent of GNP in 1991—more than 50 percent of the entire public sector's borrowing requirements. The increasing financing needs of the SOE sector not only crowded out the private sector from the domestic financial markets but also increased the burden on the rest of the public sector. The rise in the SOE sector's deficits was accompanied by a deterioration in financial performance with return on capital employed falling from an average of 17.2 percent in 1985 to 5.3 percent in 1991. Significantly, over the period 1985-91, SOEs on average earned only half as much as the private sector firms in the largest 500 industrial enterprises in Turkey.

- In India, an estimated 40 percent of the SOEs are currently loss-making; since independence in 1948 it is estimated that the government has spent (in nominal terms) $40 billion on SOEs while returns on capital employed have barely covered depreciation costs over the last two decades.

- In Vietnam, it is estimated that a sixth of the estimated 12,000 SOEs were loss-making despite receiving "soft budget" subsidies in the form of loans at rates up to 1 percentage point lower than private firms. Since 1990, the government has closed approximately 2,000 of these loss-making firms and merged another 3,000 SOEs.

- In New Zealand, prior to the major corporatization and divestiture program that began in 1987, many of the SOEs and firms operated as Government Departments were poor performers. In 1984, the public sector accounted for 22 percent of all economic activity and consumed 28 percent of all investment while the level of services provided to consumers in sectors such as telecommunications was well below comparable OECD standards. The aggregate figures of profit after tax/shareholders funds for four of the largest companies—Coalcorp, Electricorp, New Zealand Post and Telecom—stood at a disappointing 5.7 percent in 1988, a figure which improved to 11.9 percent in 1991 after the radical corporatization plans were implemented.

- In Kazakhstan, gross SOE losses rose from 14.1 percent of GDP in 1992 to 23.7 percent of GDP by 1993. SOEs experienced severe liquidity problems despite large transfers through credit subsidies and the non-payment of dividends to the State. Net inter-enterprise arrears increased twenty-fold over the first nine months of 1993 with

the new credit to the SOE sector running as high as 46 percent of GDP in the same period.

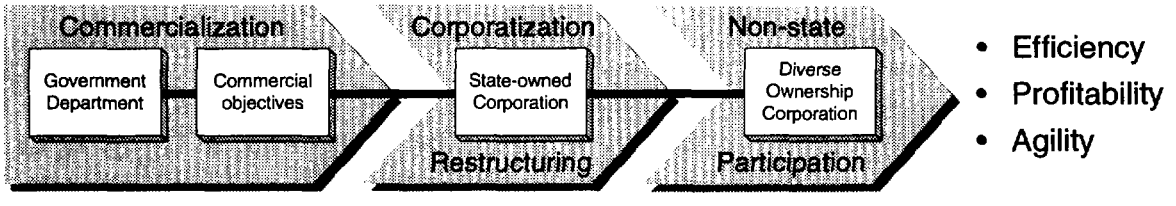
- In Mexico, the poor financial performance of the SOEs precipitated a wide-ranging divestiture program in that country. The Minister of Finance announced in 1991 that a fraction of the $10 billion in losses incurred by the steel sector that year—prior to the divestiture of the company—would have been sufficient to bring potable water, educational facilities, sewerage and hospitals to an entire region of the country.

- In Argentina, SOE losses reached an unacceptable level of 9 percent of GDP in 1989 with the SOEs' share of the total public debt standing at 50 percent. These alarming figures contributed to the decision to implement the subsequent divestiture program in Argentina.

C. GOVERNMENTS' POLICY RESPONSES TO POOR SOE PERFORMANCE

Over the past fifteen years, the two most important reforms in the production of goods and services by the State are through policies aimed at the corporatization of SOEs or through divestiture. In a number of the more successful cases these policies have been viewed as points on a continuum with corporatization of SOEs leading over time to divestiture programs in many cases.

Figure 1-1. Countries have moved along a reform spectrum



Corporatization. In an attempt to improve the performance of SOEs, some governments have sought reforms through initiatives which followed and copied private sector models of corporate governance—the process known as "corporatization." The UK and New Zealand were among the first countries to embark on widespread programs of this nature by tackling the fundamental issue of clarifying the respective roles of the owner (the Principal) and the management (the Agent). These corporatization programs were aimed at achieving major improvements in efficiency by:

(a) Allowing bureaucratic civil service administration to be replaced by commercial management;

(b) Facilitating the introduction of transparent, unambiguous financial and operational performance targets and introducing commercial accounting procedures;

(c) Distancing the enterprises as much as possible from undue political interference; and

(d) Permitting centralized production-orientated decisions to be replaced by consumer and market-driven ones.

However, a fundamental question posed by the corporatization process is whether state enterprises can be made to achieve the same degree of efficiency and profitability as bona fide private firms by taking on certain, but not all attributes of a private corporate structure while retaining public ownership. Equally importantly, is it possible for SOEs to sustain efficiency gains without "slippage" occurring through renewed government interference in the running of these enterprises? The next section examines different international models of corporations and governance and explores how best these approaches can be applied to SOE reform. The broader international experience with these SOE reforms is discussed in Section III of the paper.

Divestiture. Since the late 1970s there have been attempts to reduce the role of the public sector either through privatization or other forms of private participation, such as concession agreements and leases—a trend which has continued into the 1990s with the divestiture of large numbers of enterprises in Eastern Germany, Russia and other parts of Eastern Europe. In parallel, a number of the larger SOEs in Latin America and East Asia have been sold to foreign and domestic private buyers; many OECD countries such as the UK, France, Italy, Germany, Spain, Greece and Sweden have accelerated their respective divestiture programs in an attempt to seek efficiency gains from private ownership and, at the same time, reduced the swollen fiscal deficits that poor performing SOEs have generated as a burden for the State. It is estimated that, internationally, the sums raised from divestiture reached approximately $328 billion since 1985; in recent years the value of divestiture transaction has grown rapidly—$60 billion worth of sales in both 1993 and 1994—with many analysts forecasting further growth in transaction values over the next five years. A growing body of evidence supports the net economic benefits to be obtained from privatization of public enterprises[4] but only when the process is well planned and implemented in the context of competition, an appropriate regulatory framework and a comprehensive safety net. See Appendix A "Summary of International Divestiture Experience."

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[4] See *Bureaucrats in Business: Economics and Politics of Government Ownership,* World Bank Research Report, forthcoming, October 1995; Galal et al, *Welfare Consequences of Selling Public Enterprises* 1992; Kikeri et al, *Privatization: The Lessons of Experience*, 1992; Ravi Ramamurti and Raymond Vernon eds., *Privatization and Control of State-Owned Enterprises*, EDI Development Studies, 1991; Pierre Guislain, *Divestiture of State Assets: An Overview of the Legal framework*, World Bank Technical Paper No. 186, 1992; Reason Foundation, *Privatization 1994: The 8th Annual Report on Privatization*; Frank Sader, *Privatization and Foreign Investment in the Developing World*, World Bank Working Paper, October 1993; W. Megginson, R. Nash and M. van Randenborgh, "The Financial and Operating Performance of Newly Privatized Firms: An International Empirical Analysis," *The Journal of Finance*, Vol XLIX, No. 2, June 1994; Ian Duncan and Alan Bollard, *Corporatization and Privatization: Lessons from New Zealand*, OUP, 1992.

II. THE CORPORATION AS AN OWNERSHIP AND MANAGEMENT STRUCTURE

A. THE INCENTIVE FRAMEWORK

Virtually all recent international SOE restructuring has employed the corporate form as a vehicle for seeking gains in efficiency, profitability, agility and accountability. While the corporate form is the most successful and universal form of organization for the large scale mobilization of resources for its production of commercial goods and services, it also presents particular problems for its owners chiefly concerning control and accountability for managers. Both the potential and the problems of the corporate form present challenges to the state reforming its SOEs through use of the corporation. Therefore to establish a standard and provide a basis to compare international SOE restructuring experience and to suggest how these experiences might best be applied to both transition and market economy circumstance, it is useful to analyze the attributes, structures and dynamics of the corporate form in the private sector. This analysis involves the review of models drawn from international best practice, models which focus on the ways and means corporations are organized, governed, and operated to achieve the owners' goals of efficiency and profitability. These models in turn, when considered against international experience, suggest practical means for achieving a modern enterprise system.

The Four Structural Attributes of the Modern Corporate Form

As a general principle, modern Companies Law in most countries requires that a large business corporation have at least the following four basic structural attributes:

(a) *Separate identity.* The corporation is a legal person distinct from the shareholders, with clearly defined property rights and a separate accounting for its own assets and liabilities;

(b) *Limited liability for shareholders.* Shareholder's risk of loss is limited to their contribution to the corporation's capital;

(c) *Centralized management.* The day-to-day affairs of the corporation are conducted by one or more persons chosen by the shareholders; and

(d) *Transferability of shares.* The shareholders' ownership interests are transferable and a transfer by a shareholder of its ownership interest in the corporation does

> not, in itself, change the rights and of the corporation with respect to its own assets and liabilities.[5]

These attributes combine to enable the corporation to mobilize resources and to undertake economic activity on a large scale with a clarity and singleness of purpose. *The absence of one or more of the attributes would significantly impair the corporation as an effective vehicle for efficiency.*

The separate identity of a corporation permits specificity, clarity and accountability for property rights. The corporation has its own assets and liabilities, clearly defined and expressed in a balance sheet. If the balance sheet is prepared in accordance with international accounting rules, then the corporation's property, at any time, can be valued, compared and controlled in relation to all other property. This clear definition of property rights affords owners a control mechanism. It also gives the corporation the possibility of significant growth, through independent access to capital markets, through reliance on its own, not its owners, assets and commercial potential.

The attribute of limited liability encourages widespread participation and mobilization of capital, while at the same time limiting losses to a specific sum, averting unquantifiable financial disaster for the owners. Limited liability also facilitates exit of non-viable corporations. Once a specific amount is lost, the corporation is without capital, and without a transfusion, can be left to liquidate without further loss to its owners. Since the owners' liability is known to be limited, creditors cannot expect the owners to clear arrears or otherwise suffer losses beyond their capital contribution.

Centralized management facilitates mobilization of the most specialized and efficient management. The separation of ownership and control permits hiring managers who are most skilled in the intended activity, and directing them to achieve the intended gains. Centralized management also permits owners to establish incentives and monitoring mechanisms for management linked to the attainment of the owners' goals.

Finally, *transferability of ownership* affords owners significant flexibility in allocating their capital and, in so doing, encourages corporate management to respond flexibly and rapidly to variables in the market which affect performance. Owners can lock in gains or express dissatisfaction by selling shares, thus creating incentives for keeping the corporation focused in achieving the shareholders' objectives. When an owner can transfer the risk of gain or loss that is part of share ownership ("residual risk"), managers have a powerful incentive to cause the corporation to achieve its goals efficiently. Unhappy owners may transfer the residual risk of shareholding to new owners who may appoint new management. Transferability creates a

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[5] In many countries, particularly those following the French corporate model, there are different forms of corporations, some of which limit the number and transferability of shares in small corporations to facilitate business forms more similar to individual partnerships.

market for corporate control which in turn also disciplines corporate management to satisfy their owners' goals.

B. INTERNAL ORGANIZATION AND CORPORATE GOVERNANCE SYSTEM

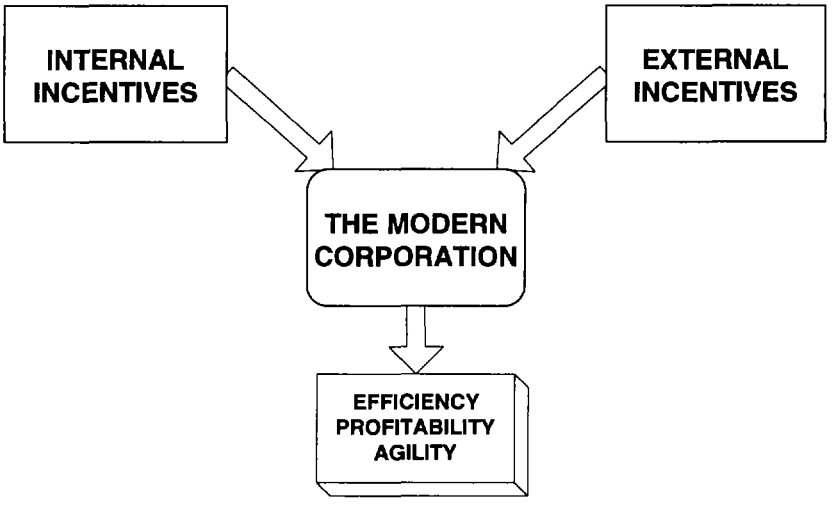
There are specific key variables whose dynamic interplay determine the performance of all corporations, whether private or state owned. These key variables can be presented in two categories and summarized as follows:

(a) *Internal Organizational and Governance Incentives.* These include internal organization and corporate governance—the internal structures and arrangements between the owner (the principal) and the corporate managers (the agents) by which the owner causes the managers to act for the goals set by the owner; and

(b) *External Incentives*: These are variables relating primarily to market factors, which, while not under the direct control of owners, discipline mangers and owners in performance.

These two categories are described below. Models drawn from increasingly converging international practice are detailed in the Appendixes.

Figure 2-1. The Modern Corporate System



Internal Organization and Corporate Governance. Throughout the world, as corporations grew in size, complexity and numbers of shareholders, corporate owners have faced the challenge of how to structure the corporate organization and regulate its operations in a manner which assures the attainment of the owner's corporate goals of efficiency and profitability as well as accountability to the owner for assets and for the enterprise's

performance. The key issue is how the shareholders—the "principal"—can achieve efficiency, profitability and accountability while also permitting the managers—the "agents"—the necessary degree of autonomy to operate the corporation in a competitive market environment.

Models of Governance

The effective use of the corporation then poses a dilemma: how to achieve a balance between strong managerial direction and accountability.[6] The difficulty is that many of the measures that foster one discourage the other. The dilemma is commonly referred to as the "principal-agent question." There is no single or "correct" solution to the principal-agent dilemma and solutions will vary according to many factors. The section that follows, based on international experience, highlights how different countries have addressed the challenges in reforming their SOEs.

While the evolution of the corporate form has been eclectic, there has been a significant degree of international convergence in the laws and forms for corporate organization. Consequently, a number of generic models—the Anglo-American, German and Japanese—can be considered as representative of the universe of arrangements for internal governance. These models and brief description are presented in the Appendixes. All the models follow the classic scheme for allocation of powers among the major participants in the corporation. Each model represents the reaction in each society to concerns about efficient organization and the principal/agent problem—that is, how shareholders manage the managers. Figure 2-2 below outlines a simple variation of the relationship between owners, the Board of directors and management of an enterprise.

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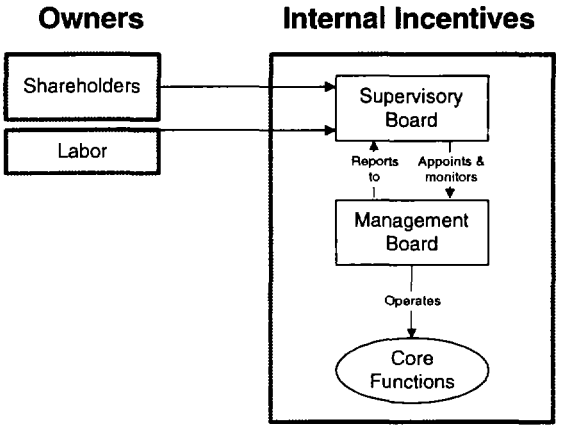
[6] Initially, concern focused on shareholders' financial interests and the agency problem in particular, the power of management to dilute shareholders equity through various means and the management's broad discretion over accounting rules and dividend policy. (See Berle & G. Means, *The Modern Corporation and Private Property,* 1932.) Berle & Means demonstrated how the separation of ownership and control brought with it an apparently inevitable divergence of interests, with shareholders seeking their benefit and managers seeking to entrench themselves and further their own interests:

> "It is therefore evident that we are dealing not only with distinct but often opposing groups, ownership on one side and ultimately to lie in the hands of the management itself, a management capable of perpetuating its own position. The concentration of economic power separate from ownership has, in fact, created economic empires, and has delivered these empires into the hands of a new form of absolutism, relegating "owners" to the position of those who supply the means whereby the new princes may exercise their power." (Id. at 124)

Figure 2-2. Modern Corporation has Common Structure



The primary participants in the modern corporation are: (a) the shareholders; (b) a supervisory board; and (c) the executive, sometimes referred to as officers, management or managing directors. The shareholders provide risk capital for which they have certain rights: (i) to elect and remove the board; (ii) to approve or disapprove fundamental or extraordinary changes (e.g., changes in the corporate charter, mergers, increase/decrease in capital); and (iii) to determine and receive dividends. Boards manage the corporation on behalf of the shareholders through appointment and supervision of the executive, and by reviewing and ratifying all major decisions not reserved to the shareholders. The executive is usually a set of persons elected by the board, who undertake the day-to-day affairs of the corporation.

Boards of Directors. Generally, shareholders exercise their interests in a large corporation through a Board of Directors. The functions of the board are threefold: representation, direction and oversight.[7] Concerning representation, most systems provide for the right of shareholders to elect board members and for certain minimum protection and representation for minority shareholders. Concerning non-owner representation, there has been significant debate and experimentation concerning the role of non-owners on the corporate boards. In some societies there is representation of labor, banks, creditors, suppliers and customers in corporate decision making even if they are not owners.

In Japan, the board is the least representative of shareholders in composition and is generally an extension of management. However, through extensive cross-shareholdings, informal influence is imposed on the boards and management through stakeholders or "insiders" such as suppliers, customers and the "main" bank. Germany has the most inclusive representation with its two-tiered board system; this includes strong labor representation (a legacy of its post-war reconstruction). The Anglo-American board is often referred to as a model based on "outside" control since shareholders are numerous or passive institutional

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7 An extensive discussion of the functions of the board is in "Board Directors and Corporate Governance," *Oxford Analytica*, 1992.

investors such as pension funds with little day-to-day interest in the corporation. Increasingly, the board representatives of these passive investors tend to be "outsiders." Banks play no direct role in the Anglo-American model, but are very influential as an "external" factor in their role as creditors.

In many jurisdictions, accountability to labor is mandated by law requiring labor presence in the body which monitors the performance of management.[8] In almost every nation, creditors can obtain the right to representation on the board or outright control of a corporation if it is unable to pay its debts.

The board function, that of providing direction over management, also varies somewhat from country to country but is generally focused on three major factors: strategic planning, including mergers and acquisitions; the appointment or dismissal of executives; and setting appropriate incentives for management. The oversight or monitoring functions of the board are taking on increasing importance as shareholders demand greater information and accountability. Board oversight is considered weakest in Japan, moderately rigorous in France and Italy and strongest in the US. However, more informed shareholder interests are resulting in changes and improvements to the oversight mechanisms. In the US and UK, the legal duties of board members to the shareholders ("fiduciary" duties) are now delineated and clarified by law, and are enforceable against both the company and the individual board members by the shareholders. Other trends are toward greater use of independent outsiders on boards coupled with the use of committees to deal with executive remuneration and audits. The effectiveness of these outside directors and committees is necessarily limited by management's control of information and insider conflicts of interest (e.g., the presence on the board of stakeholders, particularly customers, suppliers and banks raises serious conflict of interest issues and can diminish the oversight function).

Over time, corporate governance problems have been addressed in several ways in different countries but several of the most common solutions are sought through diverse board composition, management compensation, board committees and improved accounting rules, practice and enforcement.

C. EXTERNAL DISCIPLINE

While internal incentives are necessary to achieve efficiency, experience demonstrates they are insufficient. Rather, external incentives—influences that are outside the direct control of the corporation but which promote management accountability to the shareholders—also must play as role. These external factors are:

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8 In the Anglo-American model, accountability to the community is enforced not through participation in internal corporate governance but through external legal constraints imposed on management through a well developed legal and regulatory system. These constraints vary over time and are subject to constant and intense public debate--see discussion on external constraints.

(a) *Product Market Competition.* Product market competition forces the management to adopt the most efficient methods to maximize profits through market share and general competitiveness. Failure to maximize profits in a competitive market exposes the firm to the prospect of bankruptcy and failure. Where ownership is dispersed or where the owner does not have the capacity to monitor the management closely, the company's market power is a clear indicator of its performance. Managers have a strong incentive to protect their positions, their own source of wealth (particularly if compensation includes stock or stock options) by maintaining market power. Failure to maintain that power will result in below-average return on investment and also will be reflected in the dividends and price of shares.

(b) *Competitive Capital Markets.* Both equity and debt markets impose substantial constraints on management. An all-equity structure gives substantial discretion to managers to use the corporate assets for their own benefit, subject only to the internal governance controls. However, when the management must turn to equity markets, those markets quickly and continuously monitor and place an objective value on the company and, by reference, on the management. This value permits shareholders to make quick and rational decisions as to management performance; constrains management in its ability to dilute existing shareholders equity; and also provides an incentive to managers to minimize the costs of equity since failure to do so will make them vulnerable to takeover in large markets. Debt markets impose additional and often more stringent constraints. In order to raise debt capital, the management must often agree with creditors on a plan, (usually embodied in an agreement with creditors in the form of positive and negative covenants) which requires the maintenance of debt/equity ratios and a certain levels of cash flow.

(c) *The Market for Corporate Control.* The public stock markets provide effective discipline mechanisms for management. This discipline is dependent on the corporate attribute of share transferability—manifest in tender offers, takeovers or other actions triggered by management failure to maximize the shareholders' value in their stock as signaled by the share price.[9] This effective constraint on management presupposes freely transferable shares and a market through which existing shareholders can exit and new ones enter—purchasing shares at a perceived discount when management fails to maximize shareholder value. This creates the possibility of acquiring shares at a discount, replacing management with more efficient management and taking other necessary steps to maximize value. In the US this is often characterized as "hostile takeovers." However, in Europe and East Asia, the failure of management to keep up the share value has resulted in a growing market for corporate control engineered among friendly,

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[9] See Manne, "Mergers and the Market for Corporate Control," 73 J. Pol. Econ. 110 (1965).

related shareholders who accomplish their goals through management replacement.

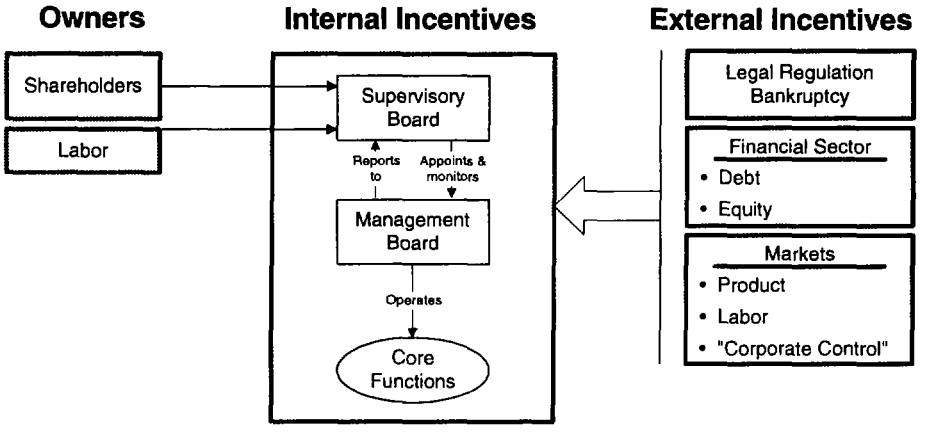
(d) *Well-Developed Labor Markets.* Not only do managers compete with each other to attain the top positions *within* the modern corporation, but there also is an active market *outside* companies for managers to improve corporate performance. In addition, middle and lower level management can and often do leave a company when they perceive that it is poorly managed. Thus management is disciplined from inside and outside the company by well-developed labor markets. In countries where labor has a management position on the Board, labor organizations in and outside the company also exert influence and thus constrain management.

(e) *The Corporation's Legal Obligations.* In most market economies, laws directly affecting corporate governance such as Company and Securities Laws set minimum norms and standards for management, aimed at protecting shareholder rights. These laws are enforced vigorously in most market economies. Such legislation normally details shareholders rights and mandates a high degree of disclosure of corporate affairs, permitting easier shareholder monitoring. Other laws on anti-monopoly, fair trade, and competition impact management in varying degrees in different countries. The net effect of these laws is to force management to adhere to competitive norms. In the Anglo-American case, there is heavy reliance on the legal system, an approach which is gaining currency in Europe as well. In East Asia and Japan, long established social constraints which might be expressed in law in America operate to reduce agency costs

(f) *Bankruptcy.* The threat of surrender of day-to-day control to a trustee in bankruptcy or to a liquidator is a powerful incentive for managers to achieve the owners' commercial goals of profitability through financial discipline. Bankruptcy, and perhaps more relevant, the threat of bankruptcy imposes a strict discipline on corporate management, monitored by creditors, generally to the benefit of owners. Conversely, the lack of credible bankruptcy facilitates asset stripping and rent seeking since there is no credible end or exit for the poor performing enterprise.

Figure 2-3 below illustrates how the modern corporation is disciplined by both internal and external incentives.

Figure 2-3. Modern Corporation is Disciplined by Internal and External Incentives



D. USE OF THE CORPORATE FORM WHEN THE STATE IS THE OWNER

Typically, many unreformed SOEs display the following features:

(a) Government interferes in the day-to-day management of the enterprise—lack of clarity between owner/manger functions;

(b) The financial sector provides debt on terms softer than commercial basis, particularly for the larger enterprises—state does not benefit from limited liability but bears all risks;

(c) There are often too many unrelated non-core businesses;

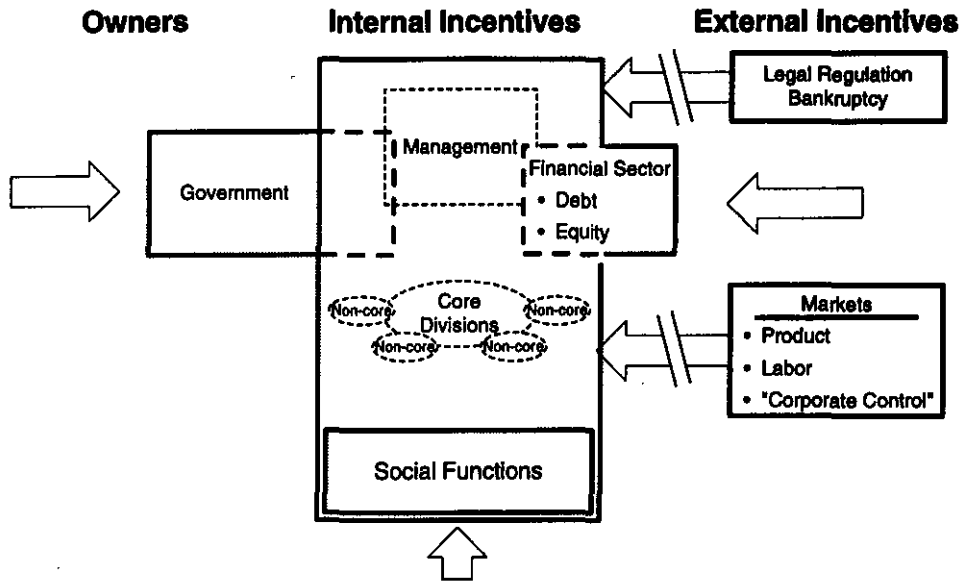
(d) Social responsibilities are a major feature of the SOE's objectives, taking up management time;

(e) External incentives such as product and labor market are not able to function effectively;

(f) Economic legality is absent and there is no provision for the implementation of bankruptcy or liquidation.

These features are illustrated in Figure 2-4 below.

Figure 2-4. Typical State-Owned Enterprise (SOE)



As a result there is no level playing field—i.e., competition in the market or for the market is limited and there is widespread "crowding out" of the private sector. The subsidies to SOEs from the financial sector and the absence of hard budget constraints dampen the impact of other external incentives. These influences come most sharply into focus in the case of large loss-making SOEs, given their negative impact on the financial system.

However in the past decade, many governments have transformed public enterprises into modern corporations and, to varying degrees, exposed them to external market forces with the objective of increasing enterprises' efficiency. The question posed now is whether the state, as owner, can reform SOEs and capture both the key corporate attributes and create the environment for maximum impact of best practice in corporate governance and the discipline of the variable external factors.[10]

The success of the modern corporation rests on the four attributes described above. Remove one and the result is instability, a loss of effectiveness. The attempted use of the corporate form to restructure SOEs in several reforming states has often failed due to an absence of one or more of these attributes in their corporations. For example, in some cases there is an absence of transferability of shares. In many, the separate identity of the corporation and its property rights from the government and its constituent parts is not clear due to a lack of strong

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10 In the case studies discussed in Section III below and in Appendix B, corporatization has been a major vehicle for reform in a number of the companies reviewed. See also "Corporatization: the Solution for State Owned Enterprises?" Peter McKinley, Institute of Policy Studies, Victoria University Press, 1987.

accounting rules and practice. In others, the identity of the corporation and its owners is blurred administratively with resulting unclear objectives, incentives and accountability. Still in others, management or board supervision may be disbursed among different agencies or distant holding company levels with the result that no one in particular can be held responsible for assets and performance. Finally, there have been cases where the limited liability of the owner is in fact non-existent because the state explicitly or implicitly guarantees all creditors of the corporation.

The evidence from international experience in transforming SOEs into corporations suggests that certain preconditions must exist if reform is to be successful. These include:

(a) Separation of Ownership and Government Functions. A private shareholder has clear, commercial objectives. Reforming the role of the state as shareholder of a modern corporation requires the state also to separate its various functions in respect of the corporation it owns, including its functions as: (i) owner; (ii) contractor for (potentially unprofitable) public services; and (iii) regulator and protector of public safety, environment, competition and fair trade.

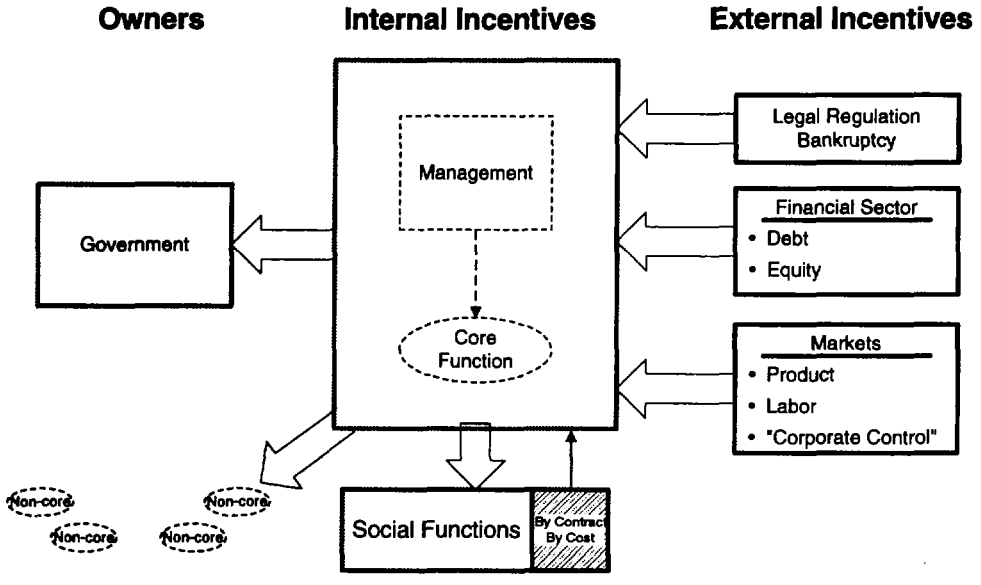
(b) Designation of an Ownership Agency. One of the first tasks in the corporatization process is to define which state agency should represent the state as owner/shareholder. Best practices based on international experience suggest the separation of powers of the line ministry from the government supervisory body of the corporation. This is done to limit the leverage the Minister and his/her staff have on the corporation's management. Ministers are often politically rather than commercially motivated and thus ministerial interventions can often result in adverse effects on profitability.

(c) Clarify and Finance Social Objectives. Early reform decisions must be made as to responsibility, means of payment and accountability for the corporation's social objectives as assigned by the state. Best practices suggest that this be accomplished by contract. However, many of the functions such as education and health should be transferred to municipal or national authorities.

(d) Clarification of Regulation and Ownership Roles. The state's motives as regulator and shareholder are quite different. If these functions are performed by the same actor (e.g., a ministry) then mixed signals or even conflicts of interest are likely to occur resulting in the SOE's financial loss or lack of competitiveness. Consequently, without separation of the state's ownership and regulatory roles, distortions are likely to appear at the outset of the reformed SOE's corporate life.

If these pre-conditions for effective reform can be met and sustained—as they have been in countries such as New Zealand, Austria, Chile, Sweden and Korea—the internal and external incentives will improve the performance of the SOE and it will begin to resemble more closely the form of the modern corporation. Figure 2-5 below illustrates these relationships.

Figure 2-5. How to Reform SOEs: Change Internal and External Incentives



III. THE INTERNATIONAL EXPERIENCE WITH SOE REFORMS

The analytical framework outlined in Chapter 2 argues that enhancing the efficiency of SOE performance is determined by establishing a corporation with four key attributes and applying a set of internal and external incentives. All of these actions are necessary. Establishing commercially oriented governance systems and related internal incentives—i.e., corporatization—is a necessary but not sufficient condition for achieving efficiency gains in SOE performance. External incentives must also be in place if improved SOE performance is to be realized.

International experience teaches that the financial and economic performance of SOEs are not uniform; they vary between and within countries as well as across sectors. The differences in broad country experience are mirrored in eight case studies, as detailed in Appendix E.[11] Such variation is to be expected given the diversity in sector coverage, size of operations and the country context and legal frameworks in which SOEs operate. Nonetheless, there are a number of broadly consistent lessons from international experience. These lessons are examined below in detail and summarized in Figure 3-1.

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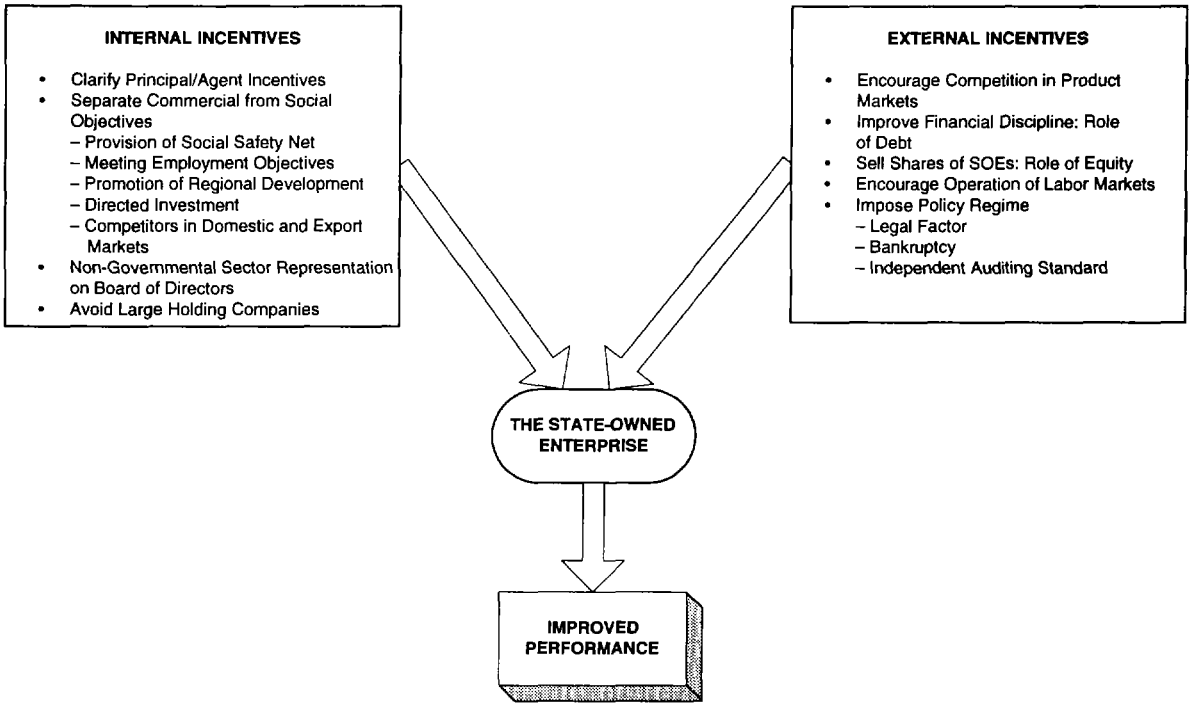
[11] The case studies include the following SOEs: Semen Gresik, Cement (Indonesia); Usinor Sacilor, Steel (France); Statoil, Oil & Gas (Norway); Coalcorp, Coal (New Zealand); IRI, Holding Company (Italy); Sumer Holdings, Holding Company (Turkey); Hindustan Machine Tools (India); and Ksiaz Porcelain Factory (Poland).

Figure 3-1. Framework for Analysis of SOE Performance



A. INTERNAL INCENTIVES: KEY LESSONS OF EXPERIENCE

Separate Commercial from Social Objectives

Many SOEs are faced with a complex agenda—that of pursuing a range of social and political targets that often conflict with sales or profit maximization objectives. Whenever possible, the temptation to mix social with commercial objectives should be avoided. SOEs should be reformed in such a way that they are be assigned clear and unambiguous objectives in which commercial profitability features prominently. In other words, SOEs should pursue commercial objectives and be given incentives to succeed similar to those that apply to private firms.

The noncommercial roles of SOEs and their economic impact can be categorized under the following headings: (a) provision of a social safety net; (b) meeting employment objectives; (c) promotion of regional development; and (d) directed investment.

Provision of a Social Safety Net. In many formerly socialist export economies, SOEs were expected to provide employees and their dependents with a broad range of social services, services normally provided in most market economies at the national or local level by the State. These services ranged from free or subsidized housing to childcare facilities, schooling, occupational healthcare, hospitals, recreation facilities and company pension plans. Although

less prevalent in market economies, there are also some examples of SOEs in Europe and developing countries which also shoulder the burden of social assets such as housing—particularly in regions where the SOE is the main employer.

However, for many SOEs in Central and Eastern Europe (CEE) or the Former Soviet Union (FSU), social assets represented very significant levels of capital investment and maintenance costs which had to be funded from the company's operating budget. In addition to the financial burden which the provision of these services placed on the individual enterprise, the operation of these facilities represents a significant drain on the scarce managerial resources within the enterprise. In a number of countries, there has been some progress on tackling these enterprise-level constraints with reforms focusing on two main solutions: (a) the transfer of assets such as schools, hospitals and housing to municipal or national level civil authorities; and (b) the sale and privatization of services such as transport, hotels, holiday resorts and housing directly to employees or to other bidders from the private sector. See also Box 3-1 "Social Assets: How Russia is facing up to the Burdens of SOE Housing." In the case of pension schemes in Central and Eastern Europe (CEE), most countries have now transferred and consolidated enterprise level funds into national level programs normally administered by the State. Increasingly these schemes are being supplemented by private pension funds offered by newly privatized companies.

Box 3-1. Social Assets: How Russia is facing up to the Burdens of SOE Housing

The former Soviet government relied heavily on larger SOEs, particularly those located in single-industry towns, to finance and manage substantial housing programs. In some cases, SOEs were even responsible for generating electricity, water and heat. It is estimated that by mid-1992, enterprise (sometimes referred to as "departmental") housing comprised some 40 percent of all housing in Russia; municipal authorities owned 38 percent of the total stock with cooperative and private housing accounting for the remainder. As enterprise reforms began to accelerate in 1992 and SOEs were required to adapt increasingly to the demands of a market economy, it was recognized that their responsibility for housing—and other social assets—was impeding enterprises' attempts to restructure their core business activities. A typical enterprise in Russia might have up to 10 percent of its labor force involved in maintaining housing stock. Although there is broad agreement in principle that housing should be removed from the responsibility of recently privatized enterprises either through privatization to incumbent tenants or through transfer of ownership and management to municipal authorities, the implementation of this policy is still fraught with obstacles. On the divestiture front, only an estimated 25-30 percent of enterprises housing has been privatized to date. Similarly, despite the passing of the Presidential Decree requiring SOEs to divest their responsibilities for housing to municipal authorities, these authorities are generally reluctant to accept the housing for the same reasons that SOEs and recently privatized companies want to divest themselves of it. Under the current practices, most cities would face rapidly escalating costs of maintaining these houses and, as importantly, cities would simply be unable to manage the additional stock adequately. To address these problems, initiatives are underway in a variety of areas including:

- Acceleration of Privatization. Since many tenants fear that as private owners they would have to pay higher maintenance charges and property taxes, the pace of divestiture could be increased by: introducing a rent payment for non-owners equivalent to the property tax for owners; clarifying owners' rights to receive the same (albeit declining) level of subsidization for maintenance and utilities as non-owners; and, setting a clear time limit on privatization of housing.

- Improving the Management of Housing. A number of cities in Russia have begun to establish condominium associations and to delegate to them the authority to contract for their own maintenance. However, progress has been hampered by the absence of a national level legal enabling framework. Where this solution is not feasible in the short run, other municipal authorities are contracting out the management of former enterprises housing to newly privatized maintenance organizations which have demonstrated a facility to improve standards without an increase in costs.

- Reforms in Financing and Taxation. One way of financing the municipal authorities' responsibilities for housing maintenance will be to utilize the provisions of the current tax regime as a means of raising revenues for city governments. These provisions require enterprises to pay taxes equivalent to the decrease in their direct expenditures on housing following divestiture. A central principle of the proposed reforms is that additional revenues be realized from increased cost recovery from tenants in both municipal and enterprise housing. However, the ability of enterprises to increase wages will determine, in large measure, the pace at which this cost recovery can be increased. This in turn will require further reform of the pattern and level of taxation. Finally, successfully raising cost recovery from the bulk of the population will require implementation of the federally mandated housing allowance scheme, a process which is already underway in many cities.

- Reducing Housing Maintenance Costs. Since it is estimated that the Russian housing stock is four to five times more energy-intensive that in Western Europe, there are considerable incentives and opportunities for decreasing the cost of maintaining housing. It is anticipated that modest investments in insulation, weatherproofing, thermostatic controls, meters and related measures will assist tenants in sharply reducing their energy usage. Russian authorities are also exploring other small investments in the physical housing stock that may yield substantial returns in terms of lower routine maintenance costs.

Meeting Employment Objectives. In addition to meeting financial targets, many SOEs face implicit, but nonetheless real, pressures to generate significant levels of employment or, at

least, to protect existing jobs. On the one hand, SOEs do have an opportunity to act as model employers by honoring labor legislation such as equal pay requirements and providing comprehensive benefits to employees. While in theory SOEs may set an example for labor practices in the private sector, actual experience is less encouraging. In fact, typically, SOEs are often overstaffed to such a degree that the financial objectives set by the government for the firm are unattainable in the face of excess labor costs. International examples abound in developed and developing countries of SOEs with unacceptably low levels of productivity, absenteeism rates well above the average for comparable firms in the private sector and unbridled growth of non-monetary benefits. Notable examples from the case studies are Hindustan Machine Tools, Sumer Holdings and Ksiaz Porcelain Factory.

Yet despite these inefficiencies, governments are often unwilling to liquidate or even downsize SOEs precisely because of the impact on employment levels. Incumbent politicians view the short-term costs of downsizing or closure as exceeding the medium-term economic benefits—benefits that may be diffuse and that may often accrue only after their tenure in office is complete. This dynamic has created systemic market rigidities which, in turn, have impacted adversely on the performance of SOEs.

Where governments have been willing to address downsizing of SOEs—such as the restructuring of British Steel in 1981 or the reforms in IRI (See Box 3-2 below) in the mid-1980s—they have been successful largely because they have put in place social safety nets which have explicitly addressed the twin issues of redundancy payments and retraining. In the British Steel case, the UK government and the European Coal and Steel Community developed substantial retraining grants and redundancy packages (an average of 26 weeks pay) with further financial and technical assistance from the company itself through a specially created subsidiary known as BSC (Industry) Ltd. BSC (Industry) was able to offer subsidized loans, training and leasing facilities to retrenched employees.[12] The success story of Corby New Town in the heart of the traditional steel industry in the British Midlands and the thriving private sector that developed on the back of newly established small businesses opened by former steel workers, is testimony to the potential of well planned, adequately funded and imaginatively implemented regeneration schemes.

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[12] See Christopher Beauman, "The Turnaround of the British Steel Corporation," EBRD, unpublished manuscript, October 1994; and, Susan Housemen, *Industrial Restructuring with Job Security*, Harvard University Press, 1991.

Box 3-2. IRI: Changing Policies on Employment

Over the period 1974-80 nearly 70 percent of the losses of the IRI Group came from the declining industries in the steel and engineering subsectors. These losses peaked at US$2.4 billion in 1980, equivalent to 9 percent of its consolidated sales. During the same period, employment at IRI reached 530,000—this has been reduced to 385,000 by 1992—or one percent of the Italian population. Yet despite mounting financial losses and poor industrial relations, the maintenance of employment was a critical government objective over this period and labor shedding was difficult.

However, by the mid-1980s IRI embarked on a major restructuring of loss-making firms and, where necessary, a concomitant redeployment or downsizing of the labor force. In some instances, the Holding Company was able to transfer blue collar workers in the industrial north out of the production facilities of one IRI subsidiary company to another. But where redundancies were inevitable, IRI did not operate a special fund to assist laid-off workers but instead relied on the government's CIG (Cassa Integrazione Guadagni) scheme. Established originally in 1947-48 as a vehicle to assist with temporary problems, the fund—financed largely from employer contributions— was extended in 1977 from temporary stoppage to reconversion and then to closure. Without the benefit of the GIG, it is unlikely that IRI could have achieved the extensive labor-shedding that took place from 1985-1990.

Promotion of Regional Development. A sub-set of these employment objectives is the role given to SOEs as vehicles for regional employment. In situations where governments (or groups of governments such as the European Union) view the promotion of underdeveloped regions as a core element of their economic strategy, there has often been a predilection for direct intervention by government in regional employment through the creation of SOEs. In some instances, such as Hindustan Machine Tools and Sumer Holdings, these firms have been able to make a contribution to employment generation. However, unless there is an explicit subsidy from the government to the SOE to cover the full financial costs of operating in development areas, there will be significant constraints in the firms' ability to meet financial targets. In the case of Statoil, the development plans of the company had to be approved by the Ministry of Industry and Energy in the early days of the company's operation. These procedures led to the establishment of plants at sub-optimal economic locations throughout the Norwegian territory with the explicit intention of creating employment opportunities in less developed regions. However, after the second major dip in international oil prices in the mid-1980s, government's proclivity for utilizing Statoil as a compliant vehicle for the implementation of regional development objectives was replaced by harsh financial pressures on the company and a move towards internal Statoil Board decisions driven primarily by commercial objectives. Regional development programs in southern Italy (the mezzogiorus) were imposed by the government of Italy on IRI Group, which adversely affected the financial performance and commercial objectives of its sub-holdings and operating companies. The law passed in Italy in 1959 required all SOEs to ensure that at least 40 percent of total and 60 percent of incremental investment directed towards new projects is located in Mezzogiorus.

Directed Investment. In several countries, governments direct SOEs to invest in sectors that are viewed as essential to national security, or in economic activities that the private sector might neglect, such as the provision of essential foodstuffs or infrastructure. In these latter cases, the investment is often accompanied by pricing decisions designed to provide subsidized goods and services to consumers or targeted groups of consumers. Unfortunately, uneconomic prices or tariffs will result in financial losses for the companies operating in these sectors, and without a resolution of this conflict through full and transparent financial compensation for these

subsidized goods and services, the result will be widespread underinvestment and misallocation of resources.

Lessons on Separation of Social and Commercial Objectives. A critical element contributing to the poor performance of many SOEs has been the diverse, ill articulated and often conflicting roles set by the owners for the management of the enterprises. It has, as a result, been difficult for many SOEs to achieve and to sustain the productive, allocative and dynamic efficiencies required for maximizing economic benefits

Where governments are nonetheless determined to utilize SOEs to achieve non-commercial objectives, two principles should be applied with rigor and with consistency. First, it is essential that the non-commercial objectives be clearly and explicitly identified and agreement reached between the shareholders and its agents on the nature and the timing of the measures. Second, the costs—in financial and human resource terms—of achieving these objectives should be delineated in full and timely and transparent arrangements should be made to compensate the enterprises for the provision of these non-commercial objectives. Such an attempt was made in IRI, where close attention was paid to calculations of costs of non-economic investments at the beginning of the 1980s. These calculations were taken into account when payments from the government endowment (equity) funds were made.

Whenever possible, the temptation to mix social with commercial objectives should be avoided. It is strongly recommended that SOEs be assigned clear and unambiguous objectives, in which commercial profitability features prominently. Specifically, SOEs should be set commercial objectives and given incentives to succeed similar to those which obtain in the private sector.

Clarify Principal/Agent Relationships

Clarifying the relationship between SOE managers and the firm's owner is one of the most fundamental issues for the State as owner of the corporation to address. How should the state interact with SOE management in such a way that the firm best achieves its commercial goals? What owner/manager framework for SOE control has worked? International experience to date offers several lessons.

First, the most effective SOE owner/manager regimes have been those where there has been a separate legal identity of the corporation from its owners. Nonetheless, too often the state tends to blur its function as owner and manager. One of the most common features associated with inefficiently run SOEs has been the predilection for the state's designated representative as owner to intervene repeatedly in day-to-day management (to achieve noncommercial goals) to the detriment of the enterprise's profitability. International examples abound throughout the developed and developing world of undue political influence by governments in the running of SOEs. This is a dominant theme in countries as varied as India (e.g., Hindustan Machine Tools), Turkey (e.g., Sumer Holdings), and Italy (e.g., IRI). In many such cases, the property rights of the corporation were not clarified and accounting systems were weak. In Turkey for instance, accountancy followed state agency rules, not the principles applicable to commercial enterprises.

Audited accounts were sent to a government agency, but were not used to evaluate management's commercial performance. This blurring of the functions of owner, shareholder and manager has contributed in large measure to the poor performance of SOEs.

Second, international experience in countries as diverse as France, Italy, Norway, New Zealand, Korea, Indonesia, India and Turkey suggests that effective internal governance for corporatized SOEs has been achieved when the state has provided adequate incentives to boards, managers and employees to meet commercial objectives. In countries where this has not been the case and actions have been taken to redress the problem—such as New Zealand, Norway and Korea—SOE performance has improved. However, underpayment for outstanding performance and failure to discipline non-performers are common errors. All too often, state-owned corporations have not made the rewards commensurate with the risks in reformed SOEs. Incentives to managers for profit and efficiency gains are notably missing. In many socialist systems, rewards were given for quantitative production achievements, but usually without regard to quality, cost, efficiency or return to the owner. In many cases, managers are civil servants, and performance evaluation, dismissal, compensation and benefits are all tied to the government's noncommercial standards.

One of the features which has most consistently distinguished efficient from inefficient SOEs has been the introduction of salary and benefit incentives for managers which reflect market conditions. Most SOEs were originally established with human resource models based on the terms and conditions offered to civil servants. On the one hand, SOE managers and workers enjoyed implicit assurances that they would receive the security of tenure offered to employees in the civil service. On the other hand, they were constrained in their performance by the lack of incentives manifest in pay scales and benefits designed for government administrative employees.

In these circumstances, it is difficult to reward or to sanction the performance of managers and that the ability of the State, as owner, to provide incentives for their "agents", i.e., management, is severely circumscribed. Since one of the central tenets of sound internal governance is the creative tension necessary between the principal and agent, efforts to seek efficiency gains through increased managerial autonomy in the day-to-day operation of the SOE will inevitably fail if there are insufficient financial rewards available to management. International experience, including the case studies in the Appendixes, shows that some of the most efficient reformed SOEs—Statoil, Semen Gresik, Usinor Sacilor and Coalcorp—have all recognized that, in order to attract and retain top level management which is willing to assume the full responsibilities of their positions of authority, the link with civil service pay and conditions must be severed. In its place, these companies have offered terms and conditions more akin to the risks and rewards available in the private sector and have sought to compete with private firms in the market for experienced and competent management.

Incentives for employees can also be devised and, in this regard, profit sharing and some equity distribution have proved effective. Employee positions on boards may serve some social ends, but rarely, if ever, constitute the necessary incentives to increase productivity.

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The board of directors' role vis-à-vis management's decisions also lies at the heart of clarifying owner/manager relations in SOEs. International experience and research demonstrate that the most effective SOEs are those where the board's compensation is tied to managerial performance. The board must thus receive incentives to monitor and control the corporation's executives, including the right to hire, fire and monitor their decisions and set their compensation. In turn, the board's success is monitored by the shareholders, and disciplined or rewarded by shareholders' actions.

International experience also suggests that share transferability is a fundamental attribute of successfully reformed SOEs. This finding stems from the concept of *residual risk*—i.e., the risk accepted by the owners of the enterprise who take the ultimate risk of loss and also benefit from the ultimate gains. In private sector firms, the residual risk bearers must have effective control over management decision-making and/or be able to sell their ownership rights to new purchasers (e.g., through the sale of shares or to a strategic investor). In these circumstances the private owners of the enterprise have powerful incentives to be efficient since they bear the full consequences of their own decisions. In the case of SOEs however, the residual risk is borne by the population as a whole which in turn has no ready vehicle for either controlling the enterprise or for divesting its ownership rights. In these circumstances, the incentives to perform efficiently are weakened since residual gains or losses are not borne in full by the local, municipal or national authority which owns the enterprise but by the population at large. Therefore, while a corporatized SOE may look like a privately owned enterprise it lacks one significant factor and this deficiency will undermine the effect of other reforms. The efforts to incentivize management and Boards within the State structure will ultimately be undermined since the monitoring government institution does not bear the residual risk—the population as a whole does.

Many countries have confronted this problem by diversifying SOE ownership; in some cases, to secure the gains from ownership diversification, SOE divestiture has been pursued. The case of the UK provides an instructive example. Despite the clear intention that, through ownership diversification, SOEs in the UK should operate at arms-length from government as commercial organizations, this did not occur. Poor SOE performance was due primarily to the lack of incentives for greater efficiency; over 1970-85, there were few rewards or penalties for management or employees if profits of SOEs were unsatisfactory. After several years of disappointing reform efforts, the UK government concluded that sustained improvement of SOE performance would be brought about by divestiture. As a result, the government embarked on a program to divest most of the larger SOEs.

Appoint Non-Governmental Representatives to Boards

One of the key factors which has continued to frustrate the efficient operation of SOEs after corporatization, has been the failure to attain a clear separation of overt political influences from the commercial and business objectives of the enterprise. While it is important to establish a strong Board structure to develop the overall strategy for the SOE and to monitor the performance of management, the creation of a Board which facilitates undue political

interference in the day-to-day operation of the business will achieve little by way of improved corporate governance.

International evidence suggests that a more effective way of ensuring that Boards are able to perform their strategic and monitoring role is through the introduction of private sector representatives onto the Boards. (See also discussion in Section II.) Experienced and civic-minded representatives with strong private sector and technical backgrounds can provide the substantive and motivational underpinnings necessary for improved corporate governance. In Norway, Statoil has had representatives from the private sector on its Board for some time as has the French steel firm Usinor Sacilor, all of the large Korean SOEs (known as Government Invested Enterprises) and, more recently, Semen Gresik in Indonesia. However, even the most private sector oriented SOE Board such as Coalcorp in New Zealand has struggled with the ability to "lock in" the positive impact of good governance that comes from these appointments. Significantly, the remaining New Zealand SOEs that have not yet been privatized have begun to suffer from the re-emergence of escalating interference from politicians seeking objectives that are often at variance with the agreed strategy of the SOEs. Indeed, the New Zealand government has explicitly recognized that the most effective way to deal with these relapses in governance is to consolidate the gains by permitting market forces to operate with minimal interference through the divestiture of many of its corporatized SOEs.

Box 3-3. Private Sector Leadership on Coalcorp's Board Structure

In New Zealand, the government transferred commercial operations from conventional Government Agencies to nineteen SOEs as part of a wide-ranging corporatization program which began in 1984. The shares of Coalcorp, transformed into an SOE in 1987, are held by two Ministries—the Ministry of Finance and the Ministry of State Owned Enterprises. The duties of the shareholders are primarily to monitor and to control the commercial performance of the SOE through the Board of Directors. Other Ministries of the government are responsible for ensuring the achievement of social objectives and the SOEs are not responsible for broader social objectives that impact profitability unless compensated by a payment from the State.

The Coalcorp shareholders, in turn, have appointed a Board of Directors comprised of five to seven directors from the private sector which normally meet monthly and operate on a part-time basis. It is the New Zealand government's view that the appointment of private business men and women will ensure that there is sufficient commercial and business experience to determine broad strategy and to monitor the performance of the SOE managers. The Board members are appointed and removed by the shareholding ministries, often after recommendation by the State-Owned Enterprises Unit and the Treasury.

Avoid the Creation of Large Holding Company Structures

The debate over the efficacy of holding company structures as an efficient vehicle for enhancing corporate governance in groups of companies has been the subject of heated deliberations for some time.[13] This issue is of particular interest to economies in transition

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[13] For discussions of holding companies in Italy (IRI), Egypt, and Algeria see Anjali Kumar, *State Holding Companies and Public Enterprises in Transition*, St. Martin's Press Inc, 1993; Andreja Bohm, *The State Holding Corporation: An Incomplete Divisional Form of Organization*, Public Enterprise, Vol 10, No.1.

where economic forces have dictated the need to seek radical forms to deal with the governance of SOEs in the interregnum leading to private ownership.

However, international experience suggests that the significant disadvantages of large holding companies outweigh any limited advantages: many of the aims of these structures can best be achieved by improving structures at the level of the enterprise and by ensuring that the external factors outlined in the section below are in place and free to impact SOEs. The country examples of Italy (IRI), France (Usinor Sacilor), Turkey (Sumer Holdings) and India (HMT) as well as the poor experience with these corporate forms in Algeria, Egypt and Kazakhstan amply demonstrate many of the drawbacks of these systems. The main disadvantages of holding structures can be summarized as:

(a) the creation of additional layers of bureaucracy with few benefits, in terms of increased efficiency, to the operating companies;

(b) a failure to shield the operating companies from undue political intervention;

(c) the propensity for cross-subsidization between operating companies in the Group and the concomitant distortion of signals and incentives to management that this practice promotes; and

(d) the difficulty in controlling the growth and longevity of these corporate forms once established.

Various country experiences illustrate each of these points

In the cases of both IRI (Italy) and HMT (India), the "apex" institution has been unable to provide many of the efficiencies and economies of scale that the structure was purported to deliver in terms of strategic planning and improving centralized functions. Indeed, in IRI the structure of vertical links involves cumbersome, multiple layers of decision making comprising the apex holding company with sub-holding companies and affiliated companies below this. The HMT structure is similar. This top heavy decision making and reporting structure has created additional and expensive layers of bureaucracy which elongates the chain of decision makers representing the State's often multiple and conflicting objectives.

The IRI structure has also palpably failed in one of its prime objectives—to shield the Sub-Holding Companies and the operating companies from interference from politicians and political parties. Instead, the recent political problems in Italy have pointed to widespread and deep-seated involvement by political parties in many financial and operational aspects of IRI's operations. On the other hand, in Sumer and HMT, the centralized management has shielded the operating companies from external market factors, which otherwise would provide the incentives for competitiveness.

The centralization of profit allocation, revenue and expenditure decisions at Holding Company levels have distorted the messages and incentives to management on the need for

emphasizing resourcefulness, flexibility and efficiency at the operating level. For instance, in Usinor Sacilor, the management and Board of the profitable stainless steel division, Ugine, have long complained that the decision to use profits from their operation to cross-subsidize the loss making long-products company—Unimetal—has the effect of sending the wrong signals and incentives to the management of both companies. This arbitrary reallocation of surplus funds by the Apex institution is a dangerous practice which has the very real effect of minimizing the incentives for Ugine management to improve profitability while reaffirming Unimetal's belief that their financial shortfalls will be met from external sources. Equally, any legitimate transfers from the Italian government go directly and only to the IRI apex holding company which has the power to decide how these funds are to be disseminated to Sub-Holding groups.

Experience in countries as varied as Austria, Zambia, Germany and Sweden indicates that holding companies have a propensity to grow in size and influence, and that, once established, become the enemies of reforms that involve any reduction in their longevity or influence. In socialist countries, the holding companies have tended to replicate the vertical monopolies of the old system, locking in inefficiencies and resisting change mandated by external market factors. In Kazakhstan, the government has taken the unusual step of annulling the 1993 decree which established the Holding Companies in light of the negative influence that these structures imposed on the government's reform program.

Finally, even in the private sector where many holding companies were established in the 1970s and 1980s, a large number of the larger companies such as ITT, Kodak and Volvo have announced that they are "unbundling" their conglomerates to allow for a greater focus at the operating level on individual lines of business.

B. EXTERNAL INCENTIVES: KEY LESSONS OF EXPERIENCE

There are powerful factors, external to the corporation and not within the normal control of shareholders, which encourage corporate managers to act in ways which are consistent with the shareholders' interest of efficiency and profitability. In order to create the conditions where SOE performance can be optimized, these external forces must also be allowed to operate as a complement to the package of internal governance forces discussed above. This section reviews the nature of these external factors and their significance in impacting SOE reform.

Encourage Competition

Perhaps the most important exogenous factor impacting the efficient operation of any firm—including SOEs—is the overall degree of competition in the enterprise sector. Economic theory and practice amply demonstrates that companies in a "contestable" market facing the full rigors of competition with freedom of entry and exit, are likely to react to these pressures in a manner which will foster and maintain high levels of efficiency at the level of the firm. Conversely, companies in a monopolistic or oligopolistic market protected by barriers to competitive entry and exit will be in a position to extract economic "rents" from their position, with few incentives to seek cost reductions; indeed, the more likely outcome is higher prices, losses in consumer welfare and restrictions in output.

Even when there are numerous SOEs operating in the same sector, governments have been known to prohibit competition between SOEs and/or restrict entry or competition from private sector firms in an effort to provide protection to potentially inefficient SOEs. Equally importantly, governments have seldom displayed a willingness to liquidate persistently poor performing enterprises. Instead they have sought to provide direct financial subsidies or indirect subsidies such as concessionary credits from the banking sector, debt for equity swaps and exemptions from the payments of customs duties, dividends, taxes and supplier credits. International country experience varies from fierce competition in contestable markets with negligible interference from government—the UK and New Zealand—to overt protection by the State for heavily subsidized operations—Turkey and India. In all cases, the impact or absence of these external competitive forces on governance, and hence performance of the enterprises, has been marked and direct.

Statoil, the fully integrated Norwegian oil company, is a firm which has had to compete vigorously in the production and sale of a homogeneous product in international oil markets with large multinational companies. As a consequence, both the owner—the State—and its agents in Statoil have been united in their resolve to match the efficiency levels of their larger competitors from the private sector in order to survive commercially, particularly in the absence of large subsidies from the State. Similarly, Coalcorp in New Zealand has maintained acceptable levels of financial performance despite the imposition of hard budget constraints in line with the recent policies of the government of New Zealand and competition from other energy sources. In large measure, this has been due to the very real pressures that Coalcorp faces within the domestic market from forty to fifty privately owned coal mining companies; in the international market, the company is a small player in a highly competitive environment. The increases in export sales in 1993 and 1994 are testimony to Coalcorp's relentless emphasis on commercial practices and productive operations. In the case of the French steel producer, Usinor Sacilor, the company competes freely for the French and European market against other European SOEs and private steel producers although the European Union does monitor steel prices. However, competition is constrained to the extent that, in recent years, the European Union has invoked restrictions on imports from Central and Eastern European steel producers operating at low levels of capacity utilization and willing to undercut prevailing market prices.

Where these competitive forces are kept in abeyance by direct government actions, the result has led to a stifling of the incentives and rewards for efficient operations with negative impacts on consumers. The example of Semen Gresik and the Indonesian cement industry is a case in point. The Indonesian cement industry is comprised of nine companies, of which five—including Semen Gresik—are in the public sector. The Indonesian government intervenes in the domestic market by setting regional benchmark prices and by allocating regional markets based on proximity ("defined regional markets"), installed capacity and projected cement demand. Export of cement must also be authorized and is only done so when domestic cement demands have been met. This market control system which has presented Semen Gresik and the other producers with, in effect, captive regional markets, is realized by the Ministries of Industry and Trade in consultation with the Association of Cement Producers. However, this reliance on cumbersome administrative controls and minimal competition has led to supply bottlenecks from

time to time and shortages in the market for consumers. Significantly, the government is actively considering the deregulation of cement pricing and marketing both to improve the efficiency of existing producers and to provide incentives for investment promotion in the sector.

Improve Financial Discipline: the Role of Debt

When markets for debt finance operate according to commercial principles they induce corporations to demonstrate they can employ the debt profitably, by servicing it or covering the creditor's losses if it cannot be repaid. Thus, creditors exert a discipline on corporations akin to the discipline imposed by shareholders. However, where the state as owner protects its corporation from that discipline (usually by guaranteeing its debts), it removes a strong incentive for management to be efficient and to seek profit and introduces issues of "moral hazard." To guarantee a state owned corporation's debt is to acknowledge that the external and internal governance of that corporation is insufficient to cause its management to achieve the goals of efficiency and profit. The existence of such guarantees has undermined discipline, and in some cases, contributed to serious financial difficulties for the State.

Turkey's Sumer Holdings is a case in point. Most of the borrowing by Turkey's SOEs has been backed by a government guarantee of some form or another. This debt has had a major adverse impact on the government's finances.

Other examples of the negative impact of the absence of debt market discipline is IRI in Italy. Here loss-making enterprises were permitted to continue with debt financing, backed by government guarantees. The lessons learned from these reforming enterprises are that undisciplined borrowing—that is at no risk to the corporation's assets, management or labor—leads not only to poor SOE efficiency but also to a rapid rise in public debt.

In addition to abuses of the debt markets, many SOEs have also been able to by-pass governments attempts to impose hard budget constraints. For instance, where direct subsidies to SOEs are stopped, these enterprises have still been able to turn to non-bank financial institutions for credit or continue their operations by running up large inter-enterprise arrears. Equally, companies such as HMT and Sumer Holdings went unpunished when they failed to pay taxes, customs duties or dividends. Even in cases such as Japan (Japanese National Railway), New Zealand (the NZ Post Office) and Pakistan (many of the industrial SOEs), there has been recent evidence of backsliding in the application of hard budget constraints over time as politicians buckle to the demands of the inevitable short-term political crises.

Diversify Ownership of SOE Shares: The Role of Equity

In the private sector, the transferability of shares is a basic attribute of a successful corporation. Coupled with an active equity capital market, international experience shows that diversified sales of SOE shares or the dilution of government ownership through rights issues can have a major impact on improving a company's performance. When a company's shares are listed on a stock exchange, the day-to-day performance of these shares is a transparent reminder to the managers and owners of the perceived viability of the company. Threats of takeovers,

fluctuations in stock prices—particularly for managers with share options—and the influence of non-state shareholders are pressures that effectively concentrate the minds of management on the need for corporate efficiency and commercial success.

The international experience with divestiture has yielded a number of lessons about the different methods to implement these initiatives. However, there is little doubt that—well planned and properly executed—the positive economic benefits of divestiture programs in terms of consumer welfare and economic productivity outweigh any of the costs. See Appendix A for a Summary of International Divestiture Experience.

In the case of most SOEs, it is difficult to develop appropriate surrogates for these private sector capital market forces. However, experience has shown that it is possible to create some of the external pressures which can motivate improved governance by selling even a minority portion of the government's shares to the private sector. This is a trend which has accelerated internationally in recent years. IRI for instance, has embarked on a flexible ownership interface with the private sector; there are many companies in the Group which have some measure of private shareholding and acquisitions and sales of smaller companies have occurred frequently. However, until 1990 full divestiture was not an option although ownership dilution did occur mostly through share issues and issues of convertible bonds and warrants up to 49 percent of the companies' value. Similarly, both Statoil and Usinor Sacilor have a number of joint ventures and strategic alliances with private sector investors which have proved to be significant and positive external pressures on enterprise behavior. Overall, the trend of non-state minority ownership of SOEs has accelerated in recent years.

Box 3-4. Semen Gresik: The Impact of the Initial Public Share Offering

In recent years, the Indonesian government has become increasingly reluctant to increase its capital participation in SOEs and has encouraged companies to seek long-term investment financing from the capital market. As a consequence, in July 1991 Semen Gresik became the first Indonesian SOE to issue shares on the Jakarta Stock Exchange in order to finance a major capital investment project. This Initial Public Offering (IPO) comprised 27 percent of total share capital and generated about Rp.280 billion ($140 million equivalent). Of the new shares sold, about 85 percent of the total are held by foreigners, mostly institutional investors.

Following the successful listing of the company, the management and oversight of the enterprise have been affected in significant ways. First, as a result of Indonesian government Regulation 55/1990, the company is exempt from cumbersome regulations on government supervision and monitoring as well as onerous government procurement rules, while enjoying greater flexibility in sourcing of funds. Second, a very significant impact of the IPO has been the much greater scrutiny of company performance by the (minority) private shareholders. Public reporting now takes place every three months while company finances are audited in line with international accounting standards by a reputed international audit firm. Company performance is also scrutinized by external financial analysts who publish periodic recommendations on the attractiveness of Semen Gresik's shares for current and potential investors. Management and government officials agree that the much closer scrutiny and the external pressures which accompany the listing of shares, have led to greater transparency of the company's performance and have created a greater sense of accountability by company management for efficiency improvements. While Semen Gresik's performance in 1994 remained satisfactory, further efficiency improvements leading to improved financial performance is anticipated as a result of the new capital investments coming on stream.

Encourage the Efficient Operation of Labor Markets

For an SOE to operate efficiently, it must be free to use, and be disciplined by, the availability of all its inputs, including labor. This implies the right of the corporation to hire and fire the labor it needs, freedom to optimize the labor factor of production as well as the right and freedom to change managers and skilled technicians. A key advantage of the corporate form is its ability to mobilize the labor skills needed to achieve the corporate goals. This fact also provides incentives to both labor and management to increase productivity to maintain or improve their positions.

Efficiency gains have been severely limited in a number of enterprises where state interference has separated SOEs from labor markets and denied them freedom to optimize this factor. In Sumer Holdings, for example, the management and most staff have civil service or equivalent status. Dismissal is almost impossible, while at the same time, offering monetary or other incentives for extraordinary performance is illegal. In HMT, rigid rules applicable to SOEs similarly freeze the labor patterns, resulting in overmanning and an inability to attract the most promising technically skilled labor.

Avoid Complex External Performance Monitoring Schemes

To a greater or lesser degree, SOEs operate at the formal level within recognized parameters such as target rates of return on assets, return on sales as well as acceptable financial performance measured by standard key operating ratios. In a number of countries such as Korea, Pakistan, France, Indonesia, New Zealand and Mexico a great deal of effort has gone into designing systems to measure and monitor these targets, drawing both on the internal performance of the firm as well as applying international comparisons of sectoral performance. However, there is little hard evidence that these systems have been able to develop and, equally importantly, maintain objective performance benchmarks in such a way that the measures reflect decisions that can be controlled by management. In a number of instances, the systems are fraught with poor design parameters, distortionary incentives and lack the facility for enforcement.

In the Indonesian performance monitoring systems, there have been several reforms aimed at reflecting technical differences among sub-sectors and a number of non-financial indicators were added to the long list of financial indicators in 1993. Financial performance indicators now account for 70 percent of enterprise evaluation and technical indicators tailored to each sub-sector or enterprise make up the balance. However, once Semen Gresik's shares were listed on the Stock Exchange, the company was exempted from this cumbersome scheme—an explicit recognition by government that a strong Board and capital market pressures are a more effective method for monitoring the company's performance. In Pakistan, the once innovative annual monitoring program with rewards and sanctions for management has deteriorated from its influential role in the 1980s to a point in 1993 where officials now indicate that the system was no longer being energetically applied.

One of the key lessons from international experience appears to be that such external performance monitoring systems are successful only when the monitoring units—as in Mexico and Korea—are directly linked to bodies with real policy-making and political influence. However, even in these cases, the solutions involve significant costs in terms of the bureaucracy required to perform the external monitoring functions.

Improving the Policy Regime

Legal Factors. Companies and securities laws, laws setting out the scope of fiduciary duties, and general business legislation covering the creation, incorporation, management and liquidation of companies determine the rules by which corporations live. Importantly, they also constrain managerial opportunism and protect each of the participants in the corporation. If these laws are absent or deficient, or if these laws, in whole or part do not apply to the SOE, then the SOE is deprived of important elements of governance which provide incentives to managers for the state shareholder commercial goals.

In many states, SOEs are exempt from various legal or regulatory provisions otherwise applicable to corporations, such as tax, customs, competition laws or labor laws; in other cases, special privileges such as tariff protection or government procurement preferences are granted. These exemptions and privileges are intended to confer competitive advantages on the SOEs aimed at their improved performance. In each of the case studies reviewed, such exemptions and privileges were conferred to some extent. While these favors to SOEs may constrain competitors, there is no evidence that such measures improved SOE performance. On the contrary, there is some evidence (Sumer Holdings, IRI, New Zealand Coal, HMT), that the grant of legal protections or exemptions deprives the enterprises of incentives to improve efficiency, technology and profitability—outside the laws applicable to private enterprise. SOEs will tend to grow complacent. HMT receives numerous legal benefits including high tariff protection and government procurement preferences. Yet, it continues to lose market share, its technology level is precariously low, and its cost of production now exceeds world market prices for many of its core products.

Permit Bankruptcy. In the tradable sector, there is no sound economic reason why a state owned corporation should not be subject to bankruptcy. Protection from creditors removes from corporation managers one of the strongest incentives for efficiency and profitability. The absence of a threat of bankruptcy has kept alive most of the failing SOEs in reform. The Polish case study of Ksiaz Porcelain Factory, however, demonstrates that bankruptcy does not always result in a complete loss. There, the process resulted in a liquidation and restructuring exercise which in turn led to a rejuvenation of the firm and an opportunity for regeneration. Thus a significant, but often overlooked, advantage of bringing bankruptcy to bear on SOEs is that part of the reconstruction of a firm after its bankruptcy often involves constructing arrangements for motivating new and surviving managers and employees.

Develop and Enforce Independent Auditing Standards. One of the features that has frustrated attempts to improve the efficiency of SOEs is an absence of reliable financial information on the performance of the company. This type of information is important from a

number of perspectives. First, accounts that are audited by an independent, professional firm up to internationally accepted standards will provide the owners and the Board of Directors with a reliable data base to supplement management accounts and on which the strategy for the enterprise can be developed and monitored. Second, this independent data will be a necessary pre-condition for entering into significant joint venture partners—particularly with non-nationals—or for preparing the company for partial divestiture. Countries as varied as France, New Zealand, Norway and, more recently, Indonesia have recognized that this type of information is necessary for increasing the performance of their respective enterprises in both domestic and international markets. Finally, governments are better able to design and to implement taxation and customs regimes which both satisfy revenue generating requirements and, at the same time, broaden the tax base in such a way that principles of equity are more efficiently achieve.

Table 3-1. International Experience with SOE Reform

WHAT HAS WORKED:	WHAT HAS NOT WORKED:
I. Governance	**I. Governance**
Separate commercial from social objectives	Create multiple and conflicting objectives
Clarify principal/agent relationships	Permit ad hoc political interference in running of the company
Pay private sector level salaries and provide similar labor incentive packages to managers	Link SOE managerial salaries to civil service pay scales
Appoint private sector and union representatives on Boards	Staff Boards with politicians and civil servants
Appoint strong, independent private sector oriented CEOs	Appoint CEOs responsive primarily to political agendas
Minimize bureaucracy in the organization of the firm(s)	Create large Holding Company Structures

WHAT HAS WORKED:	WHAT HAS NOT WORKED:
II. External Incentives	**II. External Incentives**
Encourage competition between SOEs and with the private sector, foreign and domestic and open trade and investment channels	Prohibit competition in product markets; create a monopoly
Apply hard budget constraints	Allow SOEs to accrue arrears with banks unchallenged or avoid taxes, customs duties
Allow shares of SOEs to be sold to the private sector	Prohibit the sale of shares to the private sector
Allow labor markets in the public and private sector to operate freely	Restrict the operation of labor markets
Encourage the development of external, independent auditors	Rely on internal auditors
Avoid complex external performance monitoring schemes	Establish complex, ambiguous performance contracts
Establish internationally accepted Company and Security Laws	Rely on ad hoc rulings on legal issues impacting SOE performance

C. SUMMARY: INTERNATIONAL LESSONS OF EXPERIENCE

The broader international experience, the cross-sectional data and the case studies examining SOE reform suggest a number of broad conclusions. These are summarized in the table above. The main lessons are:

(a) SOE performance can be improved measurably through reforms such that the enterprise, government and consumers *all* benefit from efficiency gains, even in the absence of divestiture;

(b) Improvements in internal corporate governance are a necessary but not sufficient condition for enhanced SOE performance. Equally, the external environment and policy framework must be allowed to operate effectively and to impact, in full, the performance of the SOE sector; ***but***

(c) International experience shows that these reforms may be politically and technically difficult for governments to implement;

(d) The whole package of reforms must be implemented—partial reforms are seldom sufficient—and they must be sustained over time;

(e) This is a challenging agenda for most governments and there are few examples of real success stories; ***and***

(f) Even where there are successes with SOE reform, governments have increasingly recognized that to sustain these reforms, there is a compelling case for increasing the role of the private sector in terms of financing, management and, most importantly, as equity shareholders.

APPENDIX A

SUMMARY OF INTERNATIONAL DIVESTITURE EXPERIENCE

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Global Trends in Divestiture

The divestiture process began in Chile, the UK and a limited number of other countries in the 1970s and early 1980s but it was not until the mid-1980s that SOE equity sales began to accelerate internationally. More than 8,500 SOEs in over 80 countries have been sold over the past fifteen years. The former socialist countries of Eastern Europe and the FSU—most notably the Czech Republic, Russia, Kazakhstan, Poland and Hungary—have all embarked on ambitious divestiture programs. But this activity has not been confined to economies in transition—developed, middle-income and, to a lesser extent, poorer countries have also sought economic and social benefits through divestiture initiatives. To illustrate:

- In *France*—historically a country with the strongest SOE sectors in the EU—the Government decided in late 1993 to sell all or part of 21 public sector groups. These recent equity sales in 1993 and 1994 have included very large enterprises such as the giant oil group Elf Aquitaine, Rhone-Poulenc the chemicals conglomerate, a large Bank, BNP, and the insurance group, UAP. The remaining 17 firms slated for divestiture range from loss makers such as Air France and Aerospatiale to currently profitable firms such as Usinor Sacilor and the tobacco firm, Selta.

- In *Italy*, a number of the IRI subsidiaries and companies such as Alitalia, Agip and the telephone company, STET, are being offered for full or partial sale. The Government hopes to raise as much as $15 billion from these sales.

- In *Germany*, a decision was recently taken by the Government to divest shares in two of its largest companies—Lufthansa and Deutsche Telecoms. It will take some time to prepare the telecoms company for divestiture given the regulatory and competition issues involved but it is anticipated that the sale will take place in 1996.

- In *Indonesia*, the Government—initially wary of divestiture—has already floated shares of the cement company Semen Gresik and Indosat, the telecom satellite enterprise. It has recently announced plans to float shares of the telecoms and electricity companies on the Jakarta and international stock exchanges as well as divesting shares of a major toll road company.

- In *Pakistan*, the Government has sold 22 companies since October 1993 when Benhazir Bhutto took power, adding to the sixty companies previously divested

during the period 1991-93. In 1994, shares of Pakistan Telecoms were sold along with power plants and gas companies.

- In *Argentina*, as recently as January 1995, the Government announced its intention to embark on another round of divestitures aimed at selling several hydroelectric plants, three nuclear power stations and a large petrochemical plant. The Government intends to consolidate Argentina's public debt and to build up a budget surplus.

- In the *Philippines*, a series of Governments have implemented a comprehensive divestiture program which began in 1985 and which has generated over US$4.5 billion in sales revenues. During the course of 1995 major companies targeted for divestiture include the National Steel Corporation, the Manila Electric Company and the National Power Corporation.

- In *Kenya*, the Government has recently signed a Letter of Intent with the IMF in which it has agreed to sell—or, as appropriate, liquidate—all of the non-strategic parastatals over the next three years. In addition, the Government is committed to contracting out the services of parts of the Ports Authority and preparing the Telecoms company for divestiture.

- In *Ghana*, divestiture has already begun with the sale of a number of the larger SOEs. For example, Ashanti Gold Mines shares were floated on the Ghana and London Stock Exchanges in 1994 coupled with the earlier involvement of strategic private sector investors. By the end of 1996, the Government plans to divest a further 50 SOEs including the telecoms company and Ghana Airways.

Pre-Conditions for Effective Divestiture Programs

One of the main international lessons of experience that can be gleaned from divestiture programs has been the importance of planning and structuring the implementation process carefully. The main messages are highlighted below as follows:

- The more market-friendly a country's policy framework, including the capacity to regulate, the less difficulty it will have in privatizing and the higher the likelihood that the sale will yield positive results. Countries in this category include Chile, the UK, New Zealand and France;

- An appropriate regulatory framework must be in place before privatizing monopolies (e.g., British Telecoms, Chile Telecom). Failure to regulate private monopolies or oligopolies properly can not only impact consumer welfare and efficiency levels adversely but also reduce popular support for privatization;

- Low income countries with a limited regulatory and institutional capacity, should consider increasing the role of the private sector through management contracts, contracting out, leases or concessions (e.g., Côte d'Ivoire Water) as a first step towards ownership change;

- Some restructuring of SOEs may be necessary before divestiture but these should be restricted to legal changes, managerial reorganization (British Airways), labor shedding (steel and railways in Argentina), financial engineering and organizational changes. The State should avoid large capital investments in new projects prior to divestiture;

- Emphasis should be placed on developing comprehensive and sustained public relations campaigns (e.g., Russia and the UK Gas divestiture program) aimed at educating consumers, labor, the general public, civil servants and the politicians on the economic and welfare benefits of divestiture;

- Transparency in transactions is essential if the process and the results are to be deemed fair from the perspective of potential investors and the general public. Public offerings, although more complex and time-consuming than trade sales, are normally the most transparent form of transaction;

- Governments must consider the establishment of appropriate social safety nets (e.g., UK, Italy, Argentina, Tunisia) in anticipation of the short-term impact of possible down-sizing and the need for re-training of the labor force. Many countries in Eastern Europe and Central Asia are developing social safety nets to address these issues; and

- Most successful divestiture programs have benefited from a "champion" of the process from the outset of the program. Margaret Thatcher in the UK, Valcav Klaus in the Czech Republic and President Menen in Argentina are good examples of individuals who have fulfilled this leadership role.

Divestiture Process: Implementation Options

At the heart of any divestiture program lies the need to weigh the advantages and disadvantages of different divestiture processes. Table A-1 below outlines the main divestiture options that have been utilized internationally in the full or partial sale of SOEs. The table provides a broad framework for analyzing trade-offs in divestiture objectives.

Table A-1. SOEs: Divestiture Options

	Pre-Conditions	Advantages	Disadvantages
Initial Public Offering: Domestic	• track-record of profitability • national audit requirements • often minimum size	• transparency • wider share • ownership promotes capital market development	• takes time • preparation complex needs effective secondary market • absorptive capacity may be limited
Initial Public Offering: International	• international listing requirements • Minimum Size	• introduce forex • management and marketing skills	• often difficult to meet listing standards
Trade Sale	• must fit with buyer's strategy • company performance data available	• speed • management, marketing and technical skills • sales revenue maximization	• less transparent than IPOs • more concentrated ownership
Liquidation	• poor financial performance • future prospects • poor	• reduce losses • release some productive assets	• risk of redundancies
Employee Shares	• financing must be available	• gain employee commitment to privatization • spreads ownership	• majority employee shares can lead to asset stripping
Mass Divestiture Programs	• strong political and popular support of divestiture • infrastructure required to disseminate vouchers and hold auctions	• speed once system established • promotes broad domestic ownership • promotes capital market development	• on its own does not introduce additional capital and/or technology • may provide inadequate corporate governance
Combination of Methods	• good performing enterprise	• flexible method to promote share sales	• takes time to prepare • complex negotiations

Benefits of divestiture

Transferring ownership from state to private hands has a number of immediate consequences. First, the political influence on the management of state enterprises, a major cause of efficiency loss, is reduced. Second, it transfers the residual risk of the company to the private owners thus providing powerful incentives for efficiency gains. Third, under private management and ownership, enterprises are forced to face hard budget constraints because they are unable to borrow "soft money" with implicit or explicit subsidies and guarantees. Finally, privately owned firms are more likely to face closure or liquidation than SOEs and thus have a strong incentive to operate efficiently.

While there are a limited, but growing, number of empirical studies examining post-divestiture performance, the evidence available strongly supports the contention that ownership matters in terms of enterprise efficiency gains and positive welfare consequences. Selected examples of post-divestiture changes in enterprise behavior are summarized below.

- *Enhanced productivity and improved services to customers.* During the 1980s, the British government sold a number of SOEs; most notable among the enterprises sold were British Airways, British Telecom, and British Gas. In a short period of time following divestiture, these enterprises were transformed from being loss-makers to high profit-makers. A recent study by the Center for Study of Regulated Industries in the UK[1] found that since divestiture, the average productivity in British Telecom, for example, increased by 7.2 percent annually between 1989-94. Moreover, this increase in productivity has been delivered at lower prices to consumers largely due to increased competition. In Bangladesh, the sale of a loss-making chemical company led to a 30 percent increase in production and a 50 percent increase in sales. Worker productivity increased five-fold and the cost of production was significantly reduced by lowering procurement costs of raw materials and labor. Although some workers became redundant when the enterprise was sold, the increase in production and sales is expected to result in an expansion of the enterprise and, subsequently, to a growth in employment. A study undertaken by the World Bank and Boston University (see Galal, Jones, Tandon and Vogelsang, 1992) which examined the experience of 12 divestitures in four countries concluded that, in all but one case, divestiture yielded positive gains for the economy as a whole in terms of the efficiency of the enterprise, subsequent investment and consumer welfare. The Chilean telephone company doubled its capacity in four years after sale while the Mexican telephone company reduced its per-unit labor costs sharply.

- *Rationalizing the labor force.* One of the main causes of poor SOE performance has been the rigidities inherent in the labor markets of these state-owned firms. Divestiture will allow market-oriented solutions to facilitate the more efficient use

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[1] "Privatization and Recession," Centre for the Study of Regulated Industries, March 1995.

of both labor and capital inputs. However, fear of immediate redundancies is one of the most common and difficult obstacles faced while implementing divestiture and there is evidence from the Eastern Europe divestiture experience of heavy unemployment costs. However, a recent study of the divestiture of 61 companies in 18 countries has shown that performance of state enterprises can improve significantly with relatively low layoffs (see Megginson, Nash, Randenborgh, 1993). Another study[2] found that 41 firms divested through public offerings—including Chile, Jamaica, Mexico and Singapore—also expanded their workforce by small margins while increasing returns on sales. A study of the Chilean privatization programs[3] indicated that privatized firms increased employment levels significantly faster than SOEs once the boom of the late 1970s started. The study concludes that while divestiture will tend to increase employment to its optimum level per unit of output, instead of maintaining the excess levels of employment associated with SOEs, this does not imply that divestiture will increase overall unemployment in the economy.

- *Fiscal gains.* Although net revenues from divestiture may be limited due to large transactions cost and/or settlement of outstanding debts and taxes, in some countries (especially in Latin America) revenues earned from the sale of enterprise equity has been significant (Table A-2). In some cases, proceeds from divestiture may even be negative, but over the long run, the reduction in transfers of resources from state to enterprise and an increase in tax revenue as the enterprise becomes profitable, is likely to offset the transaction cost for divestiture. In Argentina, the telecommunications company paid US$100 million more in taxes within the first year of its divestiture. Divested public enterprises in the UK now pay close to US$4 billion in taxes to the government. In Mexico, transfers to state enterprises were reduced by US$4 billion between 1982 and 1988 due to an overall stabilization program, the imposition of hard budget constraints on SOEs and divestiture.

Table A-2. Revenues from divestiture of SOEs, 1988-93 (US$ billions)

EAP	ECA	LAC	MNA	SAS	SSA	Total	OECD	Total all countries
16.1	17.9	55.2	0.7	3.6	3.4	95.9	174.0	270.0

Source: World Debt Tables 1994, World Bank

[2] Attiat F. Ott and Keith Hartley, eds, *Privatization and Economic Efficiency: A Comparative Analysis of Developed and Developing Countries*, Brookfield, VT: Edward Edgar, 1991.

[3] Dominique Hachette and Rolf Luders, *Privatization in Chile: An Economic Appraisal*, ICS Press, San Francisco, 1993.

- *Capital market development.* Divestiture of SOEs has led to the creation or revival of long-moribund capital markets. Stock exchanges have opened or re-opened all over Eastern Europe to facilitate trading by new shareholders. The ability to exercise ownership rights through equity markets imposes discipline and prudential management on enterprises. Daily published prices of enterprise shares serve as a public barometer to measure a company's performance, and managers of companies quickly become alert and sensitive to this reality. This has been the experience with partial minority sales of equity as well as majority sales. At the same time, equity prices allow managers to see the perception of their company's performance, thus enabling them to make well-informed decisions. In addition to providing corporate governance, equity markets are a significant source of much-needed capital for enterprises and in a number of cases rights issues, leading to a dilution of Government's ownership share, have been designed to fund new capital-intensive projects (e.g., Semen Gresik in Indonesia).

- *Foreign investment.* Divestitures have also proved successful in attracting foreign investment—both long-term flows in the form of direct investment in enterprises and portfolio flows. Between 1988 and 1993, of the nearly US$100 billion received in privatization revenues by developing countries, roughly one-third was from foreign investors. (Table A-3.)

Table A-3. Foreign exchange flows in divestiture transactions, 1988-93 (US$ billions)

EAP	ECA	LAC	MNA	SAS	SSA	Total
5.0	10.2	16.8	0.03	0.007	0.07	95.9

Source: World Debt Tables 1994, World Bank

Dangers of poorly conceived divestitures

The potential benefits associated with divestiture can only be realized when transactions are carried out under a suitable regulatory framework in a transparent manner and within the context of a social safety net program. As indicated in Section I above, lack of transparency and the replacement of a public monopoly by a private one will lead quickly to disillusionment among the general public and may not lead any improvements in enterprise performance, if the incentives it faces remain the same as before. Some of the problems associated with divestiture programs are outlined below.

- *Lack of Transparency.* Poorly designed and implemented divestitures have resulted in allegations of corruption and selling state assets to privileged individuals. For example, in Guinea, information regarding divestiture was not distributed widely among investors and, in some cases, the government received less than two offers per enterprise. Moreover, the price of enterprise equity was not based on valuation of enterprises assets but on financial offers made by

investors. There were no sales via public tender and excessive sweeteners (in the form of long payment terms and various tax breaks) were given to new owners resulting in reduced competition and efficiency. The early examples of "spontaneous privatization" in Hungary and Russia also resulted from poorly designed divestiture programs which gave managers and employees an opportunity for asset stripping and less than transparent joint-ventures with foreign investors.

- *Lack of Political Will to Divest.* Lack of commitment to divest by politicians, civil servants in Line Ministries and some SOE managers often leads to disinterest among potential investors and a rapid deterioration of SOEs performance and poor governance as they get caught in the hiatus between the decision to divest and the conclusion of the transaction. In Cameroon, the state-owned sugar company CAMSUCO was offered for divestiture in 1992 after overcoming a four-year long opposition from enterprise managers. The performance of the company, which was to weak to begin with, only worsened during the four-year period. As a result when it was finally offered for public tender, investor interest was low and only one bid was received. The bidder not only offered a heavily discounted price, but demanded additional benefits such as ten-year payment plan, 30 percent increase in the price of sugar, and strict protection from imports. While the government waited to receive more offers, the enterprise's technical and financial situation deteriorated precipitously and in 1994—two years after the company was offered for sale—it ceased production due to mounting losses.

Conclusions

International experience across the board provides evidence that the sale of equity to outsiders is an effective way of providing governance and improving performance of state enterprises. It is not enough, however, simply to divest. Experience has also shown that without the proper regulatory, institutional, and strategic framework, divestiture may compound the existing problems of SOEs and create perceptions of unfairness. Implementing and managing divestiture should, therefore, be done with well-defined institutional responsibilities and through clear and competitive procedures.

APPENDIX B

ANGLO-AMERICAN MODEL OF CORPORATE GOVERNANCE

ANGLO-AMERICAN MODEL OF CORPORATE GOVERNANCE

Introduction

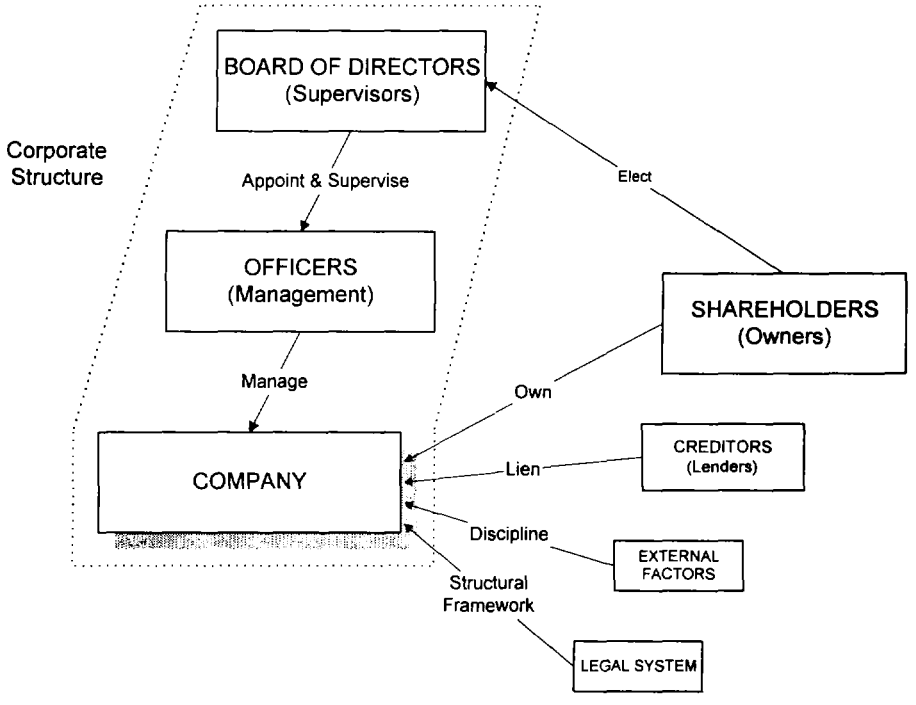
The modern Anglo-American corporation has evolved from peculiar English forms of doing business which in turn evolved from earlier Church and Roman concepts of juristic personality. The English model of the joint stock company emerged in the seventeenth century to finance trading voyages and engage in commercial activities. By 1700, shares were freely transferable, management of the corporation was seen as distinct from its shareholders, shareholder liability was legally recognized as limited to their capital contribution, and the corporation was recognized as having a distinct and permanent life through the granting of a charter by the state. The American model was inherited from English practice and although the two have many differences in details, primarily concerning share issuance and trading, the two have virtually identical governance structures.

The primary participants in the modern Anglo-American model of corporate governance are the shareholders, the board of directors and the officers (see Figure B-1 below). The shareholders own the corporation; the Board of Directors, elected by the shareholders, supervise the affairs of the corporation; and the officers, elected by the Board, manage the day-to-day activities of the corporation. The Anglo-American corporate model seeks to balance the rights and duties of each of these three participants to achieve the most efficient results for the corporation, and ultimately, for its shareholders.

Legal System

Governmental laws and regulations provide a framework within which corporations must operate. The United Kingdom has a national Companies Law. The United States has no national companies law but rather each of the 50 states has its own corporation law, though the differences are not extreme. The United States has national laws regulating the public trading of shares, the stock market and its participants. In addition, in both the US and the UK, laws in general provide objective boundaries for corporate activities but do not permit the government to proactively interfere with a corporation's affairs. Such governmental laws and regulations include tax laws, labor laws, environmental laws, antitrust laws and fair trade laws.

Figure B-1. Anglo-American Model of Corporate Governance



Incorporating

"Articles of Incorporation" and "Bylaws." The articles of incorporation and the bylaws are the corporation's governing documents. The articles of incorporation, also referred to as the "corporate charter," address important public issues regarding the corporation, evidenced by the requirement that the articles of incorporation be publicly filed with the state. By contrast, the bylaws of the corporation address less important issues primarily concerning the internal governance of the corporation and accordingly are not required to be filed with the state.

The articles of incorporation declare:

- corporate name;
- nature of the corporation's business;
- amount of stock authorized for issuance;
- the corporation's term of existence (usually perpetual);
- limited liability of the shareholders;
- express powers of the board of directors;
- power to amend the articles of incorporation;
- director's and officer's indemnification;
- shareholder action by consent and without a meeting; and
- super-majority voting on important issues to protect minority shareholders.

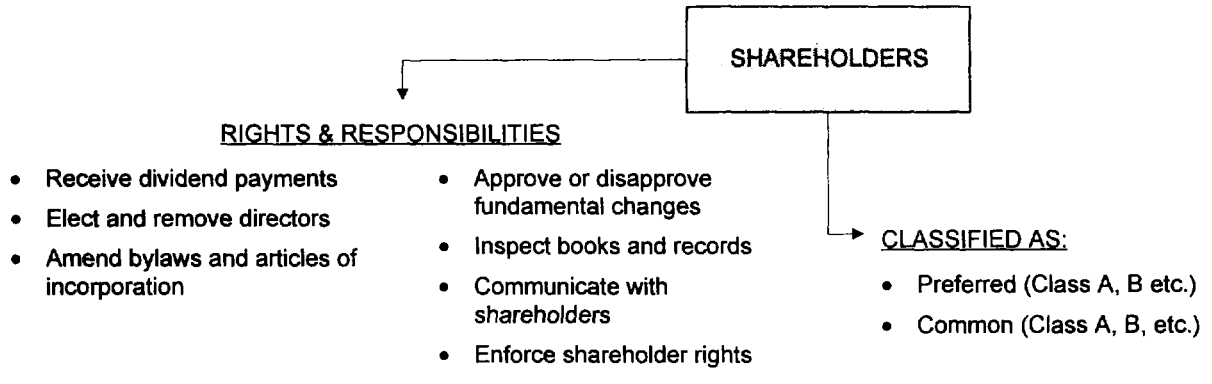
The bylaws provide:

- date, time and place for the General Shareholders Assembly (GSA);
- number of directors comprising the board;
- whether cumulative voting will be utilized in director elections;
- "officer" positions and accompanying duties (e.g., president, vice-president, secretary and treasurer); and
- quorum number for a board of directors' meeting.

Shareholders

The shareholders own the corporation. An investor becomes a shareholder or owner of the corporation by subscribing for or purchasing one or more shares in a corporation. (See Figure B-2 below.)

Figure B-2. Shareholders



Classification of Shares. Corporations often designate their stock, and therefore their shareholders, into several different classes, such as preferred stock or common stock. Each class of stock differs on issues of voting power per share, the amount of dividends that each share commands, and the preference status to the corporate assets per share in the case of liquidation or dissolution.

Shareholder's Rights. Although the shareholders have delegated the use rights of the corporation's property to the directors and the officers, the shareholders retain several important rights including:

(a) the right to receive periodic dividend payments per share;
(b) the power to elect and remove the board of directors through the voting process;
(c) the right to amend the articles of incorporation and the bylaws of the corporation;
(d) the right to approve or disapprove fundamental changes concerning the corporation through the voting process;
(e) the right to inspect the corporation's books and records;

(f) the right to communicate with other shareholders; and
(g) the right to enforce shareholder rights against the corporation.

These rights, discussed more fully below, are typically exercised in an General Shareholders Assembly (GSA) as provided in the corporation's articles.

Stock ownership and dividends. Most fundamentally, the owner of a share has a right to the residual in the case of liquidation and to profits on a periodic basis. The right to residuals may be altered by the classification of the share.

Election and removal of the board of directors. The shareholders elect the members of the board of directors at the AGM. The most common election model is the "annual board" whereby each director, and thus the full board of directors, normally serves a one-year term with the potential to be re-elected the following year. Many corporations have adopted alternative election models referred to as a "staggered board" and a "classified board."[1]

Amending the articles of incorporation and bylaws. The shareholders are authorized to amend the articles of incorporation through the voting process; for example, increasing the corporation's capital or expanding the nature of the corporation's business. The shareholders also are authorized to amend the bylaws of the corporation; for example, increasing the number of directors comprising the board.

Fundamental changes. The shareholders, because they are the owners of the corporation, retain the authority to approve or disapprove fundamental changes regarding the corporation (non-ordinary uses of the corporation's property). Recall that the shareholders are not permitted to manage the day-to-day uses of the corporation's property because they would rarely agree on a single use. Therefore, permitting the shareholders to control fundamental changes, while allowing the directors and officers to control daily affairs, both protects the shareholder's ownership interest and maintains the managerial flexibility required to operate a business successfully. A "fundamental change" includes:

- corporate merger;
- sale of all or substantially all of the corporation's assets;
- incurrence of substantial or collateralized debt;
- corporate dissolution;

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[1] A *staggered board* of directors is apportioned into several groups. Each group serves a term greater than one year and the groups stagger their election years. A staggered board increases continuity in the board of directors because one or several groups remain on the board for the following year. A staggered board also removes the potential for a dramatic change in the composition of the board through only one election (such as in the case of a hostile takeover where an "annual" board could potentially be replaced in one election by a new, controlling shareholder).

A *classified board* of directors is elected by each class of shareholders. For example, in the election for a twelve-member board, the preferred class of shareholders may elect a specified number of directors and the common class of shareholders may elect the rest.

- share exchanges with another corporation; and
- share repurchases.

Inspection rights. Shareholder's possess the right to inspect the corporation's books and records in order to protect their ownership interests.[2] For certain materials, the shareholder possesses an automatic right of inspection. However, for more sensitive materials, where the risk to the corporation is great if the materials are used for an improper purpose, the shareholders are subject to a higher burden prior to inspecting. An automatic right of inspection applies to the following corporate materials:

- articles of incorporation and bylaws of the corporation;
- board resolutions;
- minutes from recent shareholder meetings;
- names and addresses of current officers and directors;
- written communication to shareholders; and
- the most recent annual report.

The higher burden applicable to sensitive materials basically requires that the shareholder specify in sufficient detail the proper purpose for the inspection and that the requested records are directly related to the shareholder's stated purpose. Examples of a proper purpose include the desire to evaluate one's investment and a desire to deal with other shareholders as investors. Examples of an improper purpose include the pursuit of personal goals unrelated to stock ownership, such as the stealing of trade secrets, and the desire to pursue social or political goals. The proper purpose standard applies to the inspection of:

- minutes of the board of director's meeting;
- accounting records; and
- shareholder lists.

Shareholder communication. Shareholders are authorized to communicate with each other to protect and maximize their interests. The shareholders have the choice of (i) bearing the expense personally for the communication or (ii) having the corporation bear the expense of the shareholder's communication by including the communication in the corporation's annual proxy materials. The shareholder's right to communicate at the expense of the corporation is limited by securities laws in order to protect the corporation from the cost of frivolous communications.

Enforcing shareholder rights. In both the UK and the US, the law provides significant protection to shareholders. Shareholders may enforce their legal rights against the board of directors or officers of the corporation; often for a breach of a fiduciary duty owed to the shareholders by the directors or officers. In the US, shareholders may bring (i) a direct action, where the shareholders sue the corporation in their capacity as shareholders or (ii) a derivative action, where the shareholders sue the corporation not in their capacity as shareholders, but on

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[2] In the US, several states require that a shareholder, in order to inspect the corporation's books and records, holds a minimum amount of stock in the corporation for a minimum period of time. See N.Y. Bus. Corp. L. § 624.

behalf of the corporation. In the UK, legislation such as the Insolvency Act of 1986 protects shareholders from abuse by directors and officers.

Closely held corporations distinguished. The shareholder rights described above apply when examining widely-held or publicly traded corporations but differ significantly when examining closely-held corporations (usually involving no more than thirty shareholders). In addition to the small number of shareholders, a closely-held corporation differs from a widely-held corporation in that the shareholders are more active in the management of the corporation, the shareholders often look to the corporation for employment and the shareholder's investment interest is not easily transferable, since it is not registered for public sale.

In closely-held corporations, the small number of owners also participate in the management and the supervision of the corporation. To account for this unconventional overlap in duties by the shareholders, a number of control devices usually are implemented through a "shareholder's agreement." Such control devices include super-majority voting provisions, vote-pooling agreements, voting trusts, share classifications and irrevocable proxies. The net effect in the closely-held corporation is that the owners also act as the managers but are still monitored for abuse in their managerial position.[3]

The role of institutional shareholders. Institutional investors—mainly pension funds, mutual funds and insurance companies—often possess a substantial or controlling interest in corporations. Because the institutional investors control such a large percentage of the shareholder vote, they are able to be more active and effective in guiding the corporation's activities. Accordingly, institutional investors often act as a strong check on the directors and officers of the corporation.

Board of Directors

Composition. The Board of Directors is responsible for supervising the affairs of the corporation and therefore, oversees the actions of the officers of the corporation. In a widely-held corporation, the Board of Directors is usually composed of a combination of inside directors, quasi-inside directors and outside directors. Inside directors concurrently occupy a position in the corporation as an officer or employee of the corporation. Quasi-inside directors have a significant non-director relationship with the corporation, such as acting as the corporation's outside council or investment banker. Outside directors have no other ties to the corporation. In both the UK and the US, the percentage of outside directors (called non-executive directors in the UK) serving on a Board is increasing with the goal of preserving partiality. (See Figure B-3 below.)

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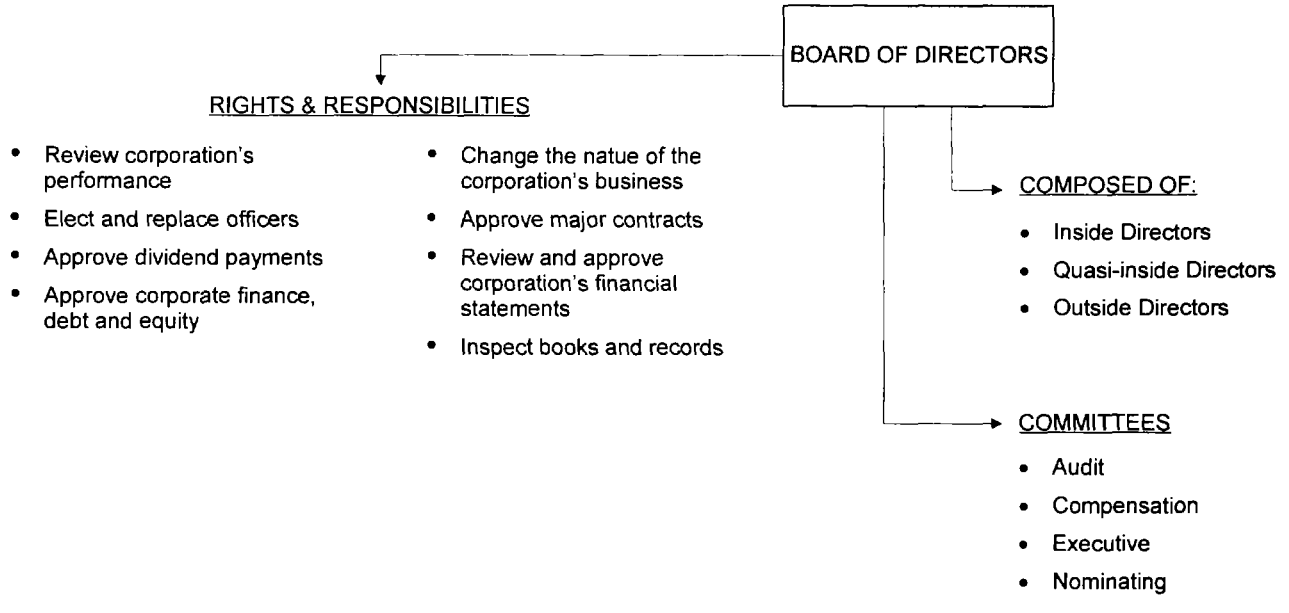
[3] The discussion below focuses primarily on the corporate governance structure of the widely-held corporation and where appropriate, refers to the structure differences displayed by the closely-held corporation.

Selection of the board of directors. Regardless of whether the shareholders elect an annual Board, a staggered Board or a classified Board, they must follow one of two voting methods in selecting the directors—straight voting or cumulative voting. Straight voting allows shareholders with a majority of the votes to exclude the wishes of shareholders with a minority of the votes 100 percent of the time.[4] Cumulative voting, on the other hand, allows shareholders with a minority of the votes to elect a representative number of directors on the Board (correlating roughly to the minority's representation as a shareholder) and thus, not be excluded by the majority shareholders 100 percent of the time.[5]

Figure B-3. Board of Directors



Rights and responsibilities. The Board of Directors, as supervisor over the corporation (particularly its officers) typically has the following rights and duties as provided in the articles of incorporation:

(a) review the corporation's overall performance;

(b) elect, replace and determine the compensation packages the officers;

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4 Under straight voting, each shareholder gets one vote per share for each director position up for election. The shareholder must the place the vote or votes on the director of his or her choice for each director position. In other words, a shareholder may not group all of his or her votes (for all of the director positions) and place them on one director position.

5 Cumulative voting, similar to straight voting, assigns each shareholder one vote per share for each director position. The difference, however, is that a shareholder may group all of his or her votes (assigned for all of the director positions) and vote them on one director. This method differs from straight voting where the votes had to be spread out over all of the director positions. Therefore, cumulative voting allows a twenty-percent minority shareholder to elect close to twenty-percent of the board.

(c) declare dividend payments;
(d) raise capital via the issuance of new securities or the incurrence of new debt;
(e) change the nature the corporation's business;
(f) approve major contracts;
(g) review and approve the corporation's financial statements; and
(h) inspect the corporation's books and records.

For most of these functions, the Board of Directors will act on the recommendation of the senior officers of the corporation. Often, therefore, the Board will act as a "rubber-stamp" for the officer's actions. The director's rights and duties will be discussed below.

(a) *Review the corporation's performance*. The general duty of the Board of Directors is to review the corporation's performance, and when the corporation is performing poorly, institute changes.

(b) *Election and replacement of officers*. The Board is responsible for electing and replacing the officers of the corporation, including, for example, the CEO or president, vice president, secretary and treasurer. The board must also determine the compensation packages for each of these officers.

(c) *Declaration of dividends*. The Board is responsible for declaring dividend payments for the shareholders of the corporation. Statutory law requires that certain minimal financial standards be met prior to the payment of dividends in order to protect the creditor's rights. The minimum standard protects creditors from a financially unsound corporation transferring its remaining capital to the shareholders (as dividends) prior to declaring insolvency or dissolving, thereby leaving nothing for creditors who have priority to the corporation's assets in such a case.

(d) *Raising capital*. The Board is responsible for approving the corporation's plans for raising capital either through the issuance of new securities or the incurrence of new debt.

(e) *Changes in the business of the corporation*. The Board of Directors is responsible for approving any changes in the business of the corporation (which is specified in the articles of incorporation), usually subject to approval by a majority of the shareholders. Requiring Board approval protects against sending unsound proposals to a costly shareholder vote.

(f) *Approving major contracts*. The Board is responsible for approving major contracts into which the corporation is entering. For example, the Board would be required to approve a long-term lease negotiated by the officers due to the substantial commitment it imposes on the corporation.

(g) *Reviewing and approving the corporation's financial statements.* The Board, especially the outside directors, is required to review and approve the corporation's financial statements. Independent review and approval by outside directors protects the corporation from fraud and misrepresentation by the officers of the corporation. The officers have an incentive to cheat because their compensation packages and employment security is tied to the corporation's financial performance.

(h) *Inspection of the corporation's books and records.* A director has a virtually absolute right to inspect the corporation's books and records; subject only to the limitation that the director is not acting with manifestly improper motives. The rationale for this broad right as compared to the cautious right granted to shareholders is twofold: first, the directors are few in number and therefore are easy to monitor; and second, the directors require uninhibited access to the corporation's books and records in order to properly supervise the affairs of the corporation.

In sum, the role of the Board of Directors is to supervise the affairs of the corporation in order to protect the shareholder's interest. In fulfilling this role, the Board will refrain from managing the day-to-day affairs of the corporation (because that is the role of the officers) but will become involved where the corporate action is large in scope or involves the potential for self-dealing by the officers.

Committees. To better fulfill their duties, the Board of Directors often will create committees consisting typically of three or more directors. Each committee will review a particular area of the corporation's affairs and issue reports and recommendations to the full Board. Two primary rationales support the creation of committees. First, in light of the complexity of the business and the infrequency in which the Board meets, a smaller, specialized committee will be better able to keep itself, and therefore the whole Board, well informed of the corporation's business. Second, some board action is best handled by a committee consisting only of outside directors because of the potential for self-dealing by inside and quasi-inside directors ("interested directors").

Almost every widely-held corporation has an audit committee. The audit committee is responsible for reviewing the corporation's financial statements and the accounting firm's audit process in order to make a well-informed recommendation to the full Board regarding the approval or denial of the corporation's financial statements. The audit committee usually consists of a majority of outside directors. The rationale for this is to ensure a disinterested review of the audit process due to the relationship between a corporation's financial performance and an officer's (inside director's) remuneration. In addition to the audit committee, widely-held

corporations will sometimes have a compensation committee, an executive committee, and a nominating committee.[6]

Officers

The officers are the high level employees of the corporation responsible for managing the corporation's day-to-day affairs. Officers are distinguished from other employees because they formulate policy and are appointed by the Board of Directors. (See Figure B-4 below.)

The officer positions, as well as the powers and duties that accompany them, are detailed in the bylaws of the corporation. The positions generally include CEO, president, chairman of the Board, vice president, secretary and treasurer. The officers are organized in a pyramid structure, usually with the CEO presiding and the other officers falling in below.

The officer's actions are governed by "agency law" principles which are enforced through the strong legal systems of the US and UK. Under agency law, the officers possess the authority to act for and bind the corporation (so long as the particular officer's position specifies that authority), and the corporation is subject to liability for the officer's actions (so long as the actions are within the officer's scope of employment).

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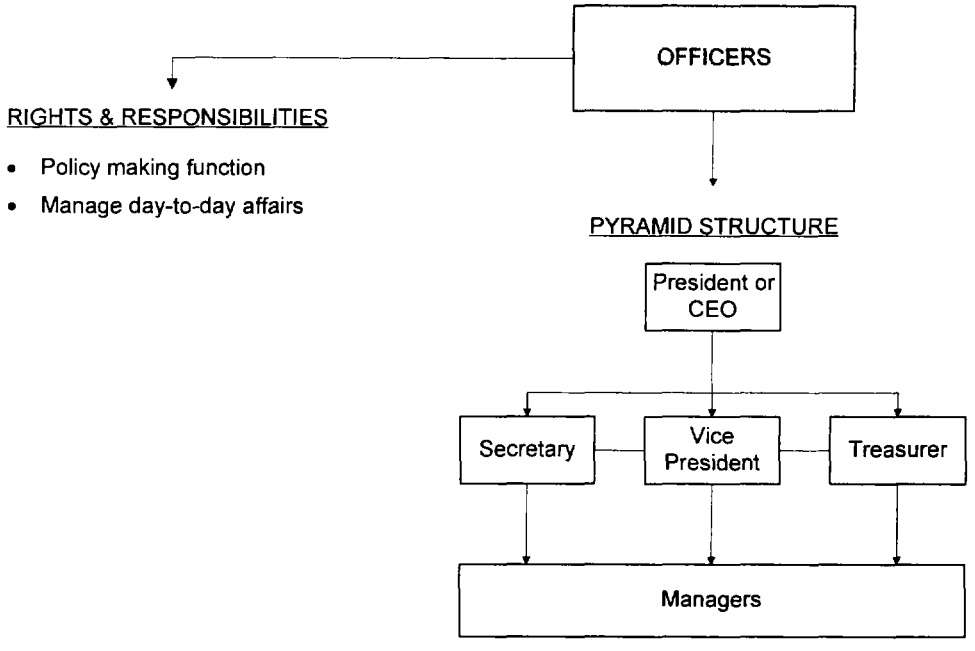
[6] A *compensation committee* is responsible for setting the compensation packages for the senior officers of the corporation. This committee is composed primarily, if not exclusively, of outside directors because this committee determines the compensation of the inside directors.

An *executive committee*, composed primarily of inside directors, is responsible for performing the Board's functions between Board meetings. The executive committee is primarily composed of inside directors because the committee members must be available to meet on short notice and be familiar with the day-to-day affairs of the corporation.

A *nominating committee* is responsible for nominating candidates to fill vacancies on the Board of Directors, which are then presented to the shareholders for a vote.

Figure B-4. Officers



Duty of Care and Duty of Loyalty

The directors and officers owe fiduciary duties to the shareholders, referred to as the duty of care and the duty of loyalty, which requires the directors and officers to manage the corporation in the best interest of the shareholders. These duties offer adequate protection to the shareholders for their investment while also affording the directors and officers a sufficient degree of discretion in the management of the corporation. The obvious rationale behind holding the directors and officers accountable for careless or disloyal actions is to protect the shareholder's interests. The rationale behind management discretion is to encourage the directors and officers to take risks which ultimately may benefit the corporation.

Duty of care. The duty of care applies to "disinterested" directors and officers (those with no self- interests in the decision) and requires that when making a decision on behalf of the corporation, the director or officer act in good faith, with ordinary care, and in a manner that he or she rationally believes to be in the best interest of the corporation.

The duty of care is balanced by a principle which states that business decisions made by disinterested directors and officers, even if unprofitable for the corporation, are accorded deference and protected from judicial scrutiny so long as the decision was made in good faith, without self-interest and with adequate information. US courts have termed this principle the "business judgment rule." So long as the directors and officers acted within the scope of the business judgment rule when making the business decision, they will not be held liable.

Courts generally will hold directors and officers liable for breach of the duty of care only if the director or officer acted with gross negligence or recklessness when making a corporate decision. Several examples of gross negligence or recklessness include: failing to attend meetings, failing to learn the business of the corporation, failing to read the reports of the corporation, failing to obtain outside counsel when the business is in jeopardy or generally neglecting to act diligently. The officers, and in particular the directors, usually will be permitted to rely on the reports and testimony of others (for example, experts or committees) in making their decisions.

Duty of loyalty. The duty of loyalty applies to the actions of "interested" directors and officers which primarily include "self-dealing" transactions. Self-dealing transactions are those in which the director or officer stands to make a personal gain, such as in the award of a corporate contract to the director's or officer's personal business. The actions by interested directors and officers are not per se illegal because they may ultimately provide an economic benefit to the corporation.

To protect the shareholders from abuse by an interested director or officer, the business decision is subjected to a higher standard of review (versus the lower, more deferential standard applied under the duty of care) to determine whether the decision should be upheld. That higher standard of review, referred to as the "full fairness" test, requires that the terms of the decision be substantively fair and in the best interest of the corporation and that all material facts relating to the decision be fully disclosed.

External Participants

Creditors. The creditors to the corporation are the persons or institutions that loan capital to the corporation, and thus hold a debt security in the corporation (compare this with the shareholders who pay capital to the corporation and thus hold an equity interest). The debt security represents the contractual obligation of the corporation to repay the principal plus interest on the loan. As with equity financing, where the shareholders are grouped in separate classes based an variations of their respective rights (for example, preferred stockholders and common stockholders), so too are creditors in debt financing (for example, senior lenders and subordinated lenders).[7]

The two methods of corporate finance, debt financing and equity financing may be contrasted based on the different rights that the person or institution providing the capital receives. Generally, debt and equity financing may be contrasted based on the type of corporate control each group receives, the preference status of each group in the case of liquidation or dissolution and the type of return on the capital received by each group. (See Figure B-5 below.)

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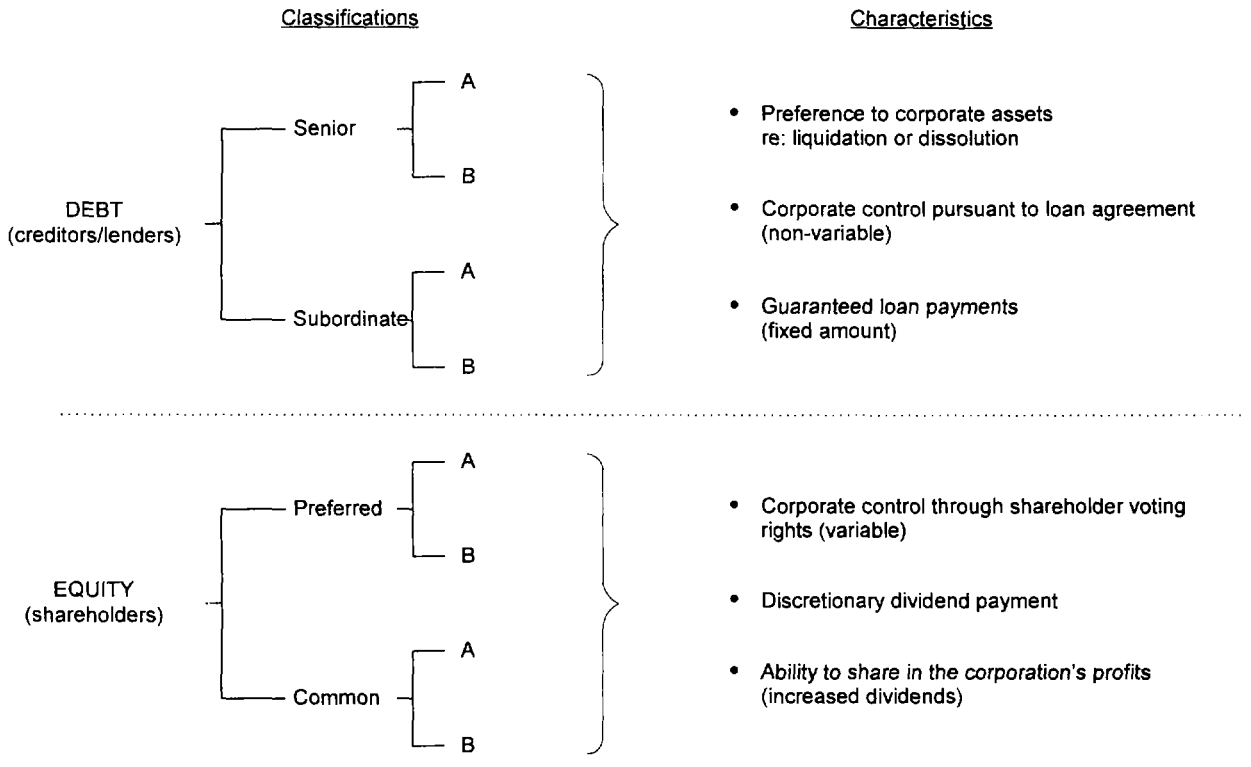
[7] Each of these subclasses often are subdivided further into class A, B, C, etc. For example, class A and class B of preferred stock; class A and class B of common stock; class A and class B of senior debt; and class A and class B of subordinated debt.

Figure B-5. Corporate Finance: "Anglo-American Model"



First, equity financing offers a greater degree of variable control (for example, through voting rights) over the corporation's affairs than debt financing. Variable control entitles the shareholders to exercise their authority in the manner they see fit as each situation arises. The creditors alternatively, obtain a fixed type of control over the corporation which is determined in the loan agreement at the beginning of the loan period. For example, the creditors may include provisions in the loan agreement that: prevent the corporation from acquiring additional debt obligations; changing the nature and scope of the corporation's business; or entering into any mergers or joint ventures or require the corporation to maintain certain debt/equity ratios; maintain a minimum amount of working capital; or maintain specific bank accounts for its revenue. It is often stated that the creditors play a crucial role in the corporate governance structure by keeping the directors and officers in check.

Second, debt financing offers a higher preference status to the corporation's assets in the case of liquidation or dissolution than equity financing. Therefore, the creditors' investment in the corporation is more secure than the shareholders' investment.

Third, equity financing offers an unlimited, but discretionary return to the shareholder in the form of a dividend which is usually paid only if the corporation has sufficient cash. Debt financing, on the other hand, offers a non-discretionary, but fixed loan repayment to the creditor. In other words, the creditor is guaranteed to receive a payment and the shareholder is not.

However, if the corporation makes a tremendous profit in one year, the shareholder is able to receive a portion of those profits while the creditor is limited to its agreed upon payment.

When examining characteristics of debt holders and equity holders (and each of their respective subclasses), it is important to place all of these categories on a continuum. Placing the categories on a continuum underscores the premise that characteristics strongly associated with one class and its subclasses are not exclusive to that class and its subclasses. Those highly correlative characteristics may nonetheless be present, although less so, in the other class and its subclasses. For example, the characteristic of high corporate control associated primarily with equity holders may be seen with some creditors,[8] and the characteristic of high preference status associated with creditors may be seen to a limited extent with some equity holders.[9]

Stakeholders. The stakeholders of the corporation are those groups or concerns, other than the shareholders, that hold an interest in the corporation. In the Anglo-American model, as compared to the German or Japanese model, these groups play a relatively moderate role. Generally, stakeholders include labor, suppliers, customers, community concerns (education and arts) and environmental concerns.

Courts historically permitted the officers and the directors only to consider the shareholder's interests when making a corporate decision. Some of these decisions made in the best interest of the shareholders often produced grave results for stakeholders such as labor. The recent trend by the courts is to permit the officers and directors of the corporation to consider these stakeholder interests when making a corporate decision so long as the decision does not <u>significantly</u> disfavor the shareholder's interests. One rationale for considering stakeholder interests is that the goodwill to the stakeholders results in an indirect benefit to the corporation. For example, when corporations provide educational grants to the community, it improves the community which indirectly benefits the corporation through the increased quality and demeanor of its work force. The position of stakeholder interests in corporate decision making is currently unresolved.

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[8] The creditor may have control over certain aspects of the corporation through the contract (debt instrument). For example, the creditor may possess the authority to approve future debt obligations of the corporation (during the creditor's loan period) or the creditor may possess the authority to prevent the corporation from selling certain assets.

[9] For example, preferred shareholders have preference over common shareholders to the corporation's assets in the case of liquidation or dissolution. Although the preference characteristic may be associated within subclasses of equity holders, equity holders generally will never have preference over creditors in the case of liquidation or dissolution.

APPENDIX C

GERMAN MODEL OF CORPORATE GOVERNANCE

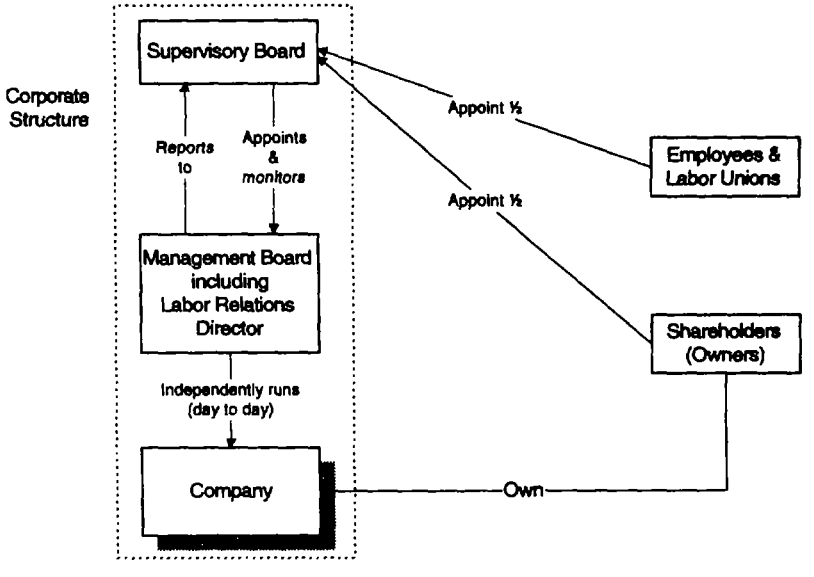
GERMAN MODEL OF CORPORATE GOVERNANCE

Introduction

Two forms of corporations are most widely used in Germany, one designed for a few shareholders with management closely monitored by those shareholders and the other designed for a widespread shareholding. The first is commonly referred to as the limited liability company (GmbH), and the second is referred to as the share company or stock corporation (AG). In both firms, shareholders liabilities are limited to their share contribution. GmbH corporations do not ordinarily issue shares. State Owned Enterprises have the AG structure.

The corporate governance structure varies slightly in both AG and GmbH companies, depending on the number of employees in the corporation, the amount of capital and the type of industry. For GmbH companies with less than 500 employees the corporate structure consists primarily of the shareholders and a managing director. In GmbH companies with more than 500 employees and in all AG companies there is a two tier board structure comprised of a Board of Management and a Supervisory Board. The Supervisory Board is usually elected in equal part by the shareholders and the employees of the corporation through a system of *codetermination* (see Table C-1.). The Supervisory Board is responsible for the election of the Board of Management, who oversee the running of the corporation. A person may not be on both Boards of one corporation at the same time, although they may be on the Boards of up to ten different corporations. (See Figure C-1 below.)

Figure C-1. German Model of Corporate Governance (Share Company)



German corporate governance is often referred to as an "insider" model in which a few large stakeholders supervise the firm. This in turn encourages not only competition between companies but also cooperation through a complex institutional system of ownership and governance. "Outside" governance, through takeover markets as a means of management control, play a minor role.

Legal System

The German form of corporate governance is defined for AG corporations by the Stock Corporation Act of September 6, 1965 and for GmbH corporations by the Law Concerning Companies with Limited Liabilities of April 20, 1892, as amended July 4, 1980. The relationship between owners and managers is determined by the statutes of the corporation.

Shareholders

Companies, banks and governments own a large percentage of the shares in German corporations: widespread individual share ownership (direct or through mutual funds) is not as common as in the United States. The Bundesbank in June 1991 gave the following figures for 1990 showing that shares in German corporations were held as follows:

Private Individuals	16%	
Companies	41%	
Insurance Companies	11%	
Banks	10%	
The Federal and Länder governments		6%
External	17%	

These numbers affect the composition of the Supervisory Board which usually reflects the composition of the shareholders.[1]

A General Shareholders Assembly (GSA), held at least once a year, is compulsory for an AG and optional for a GmbH corporation. Most of the GSA's powers are concerned with the general organization of the corporation. A resolution is passed at the GSA in most cases by a simple majority of votes cast. Decisions taken by the GSA must be carried out by the Board of Management.

Powers of the GSA:

- appointment of their representatives to the Supervisory Board
- appropriation of profits
- allocation of profit

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[1] E. Gerum, H. Steinmann and W. Fees, Der mitbestimmte Aufsichrat: Eine Empirische Untersuchung, Stuttgart, 1988.

- discharge from obligation of the members of the Supervisory Board and the Board of Management
- appointment of the auditors
- alteration of the statutes of the corporation
- liquidation of the corporation
- ratify certain management decisions, but only insofar as requested by the Board of Management

Banks

Acting as owners or on behalf of owners in addition to their traditional role as creditors, banks frequently play a role in influencing management through participation on the Supervisory Board. A typical large German corporation may have 3 or 4 banks with a combined voting block of shares equaling 30 percent or more of all votes. Bank voting power comes from directly owned stock, from investment corporations controlled by banks, and from voting shares on behalf of their clients. Concerning the latter, banks offer custodial service for shares; including administering (e.g., cash in dividends) and voting in place of the client at shareholders meetings. There is no legal limit on a bank's voting rights.

Supervisory Board (Aufsichtsrat)

Composition. The composition of the Supervisory Board varies according to the amount of stock capital, the number of employees and the type of industry (see Table C-1). In corporations with over 2,000 employees half of the Board is elected by the shareholders and the other half by the employees, or representatives of the employees. Board members are elected for a limited time, usually for four years.

Table C-1. Composition of Supervisory Board

(1)	Amount of Stock Capital		
	– stock capital up to DM3 million:	0	
	– stock capital more than DM3 million:	15	
	– stock capital more than DM20 million:	21	
(2)	Number of Employees		
	– less than 2,000 employees:	1/3 elected by employees	
	– more than 2,000 employees:	1/2 elected by delegates chosen by employees	
		delegation of employees	delegation of shareholders
	– not more than 10,000:	6	6
	– not more than 10,000, less than 20,000:	8	8
	– more than 20,000:	10	10

The shareholders elect their representatives to the Supervisory Board at the GSA. The representatives of the employees are elected either indirectly by delegates or directly through different groups of laborers and employees. In the election of employee representatives there are four special qualifications which must be observed: (i) only part of the employee's representatives may be union officials; (ii) only employees of the corporation may be elected; (iii) the employees must come from all levels of employees; and (iv) if more than half of the employees are women, at least one of the Board members must be a woman.

Duties of the Supervisory Board:

- elect and dismiss members of the Board of Management
- monitor the Board of Management—with respect to legality and economical effectiveness
- give advice to management
- grant consent to the Board of Management for certain major transactions
- act on behalf of the corporation in a suit against the Board of Management
- approve the balance sheets, annual reports and dividend
- fix the salaries of the Board of Management

The Supervisory Board generally meet three or four times a year.

The Supervisory Board is legally responsible for their actions and members may be held jointly and severally liable for damage caused to the corporation. If the Board is negligent in the performance of their duties they may be held jointly and severally liable. These duties and other possible violations for which the Supervisory Board are responsible are set out in the Stock Corporation Act. (They are the same duties as set out for the Board of Management.)

President (or chairman) of the Supervisory Board. The shareholders elect the President of the Supervisory Board as one of their representatives on the Board. This decision affects the operation of the corporation as the president may vote twice if a stalemate in the votes of the Board occurs. This permits the shareholders to have one more vote than the workers in certain situations. This may have great impact in the decisions for positions on the Board of Management.

Duties of the President of the Supervisory Board:

- prepare meetings of the Board
- propose the agenda
- stay in steady contact with the management
- ensure that he/she is be briefed by management on all important occasions
- cast the deciding vote if there is a stalemate in a vote on a codeterminated Board

Arbeitsdirektor. Under the Codetermination Law of May 21, 1951, corporations engaged in mining, iron or steel producing must have a director on the Supervisory Board who is specially responsible for the employees interests—the Arbeitsdirektor. The Arbeitsdirektor is appointed by the Supervisory Board with the approval of those members who represent the employees. The

employees' representatives on the Board have the same rights and duties and carry the same responsibility as the other members of the Supervisory Board. The Arbeitsdirektor is concerned particularly with welfare matters, such as agreeing to the social plan for closure of pits following rationalization.

Board of Management (Vorstand)

Composition. In accordance with the Stock Corporation Act of 1965, this Board, consisting of one or more members, is elected by the members of the Supervisory Board. Nominations for the Vorstand usually originate from the Vorstand itself, rather than the Supervisory Board. There are no requisite qualifications in order to be a member of the Board. Members are selected for a period of five years and may be removed by the Supervisory Board, before the end of this period, for good cause, such as gross violation of duties or incapacity. Removal may also occur if a majority of shareholders have withdrawn their confidence from the Board member. The members of the Vorstand may choose a President or Chairman among themselves, however, this is not mandatory.

Most large AGs have at least nine different departments of management represented on the Vorstand: coordination (chairman), planning, materials, finance, research, production, sales, personnel and law.

Duties:

- control the day-to-day administration of the corporation
- pursue the interest of the corporation
- inform the Supervisory Board about important questions of management policy through regular reports
- call shareholders meeting in cases of losses amounting to more than half of the stock capital and to inform the shareholders about the situation
- represent the corporation in and out of court. The Board's must observe the restrictions on the scope of their authority set out in the articles of the corporation
- monitor the individual competence of its own members

The Vorstand usually meets once a week.

Labor Relations Director

In corporations with more than 2,000 employees a Labor Relations Director (Arbeitsdirecktor) must be elected as a Supervisory Board member of equal status. The labor relations director must be chosen by a qualified majority of votes (2/3) to ensure that the influence of the employees on the Supervisory Board is taken into account.

Works Council

The Works Constitution Act of 15 January, 1972 legally establishes the rights of the Works Council, the body representing workers' interests at plant level in limited liability corporations. The Act covers virtually all German businesses except very small enterprises.

Composition. Members are chosen for a period of four years by election from the workforce. The Council meets quarterly. The size of the Council is relative to the size of the corporation.

Duties:

- consider all matters appertaining to conditions of employment (hours, flexible working, overtime, payment, leave, safety at work, incentives, suggestion schemes)
- negotiate with employers, or use the conciliation procedure[2] if the negotiation fails.
- ensure the employees right of codetermination in issues of dismissals, employees' vocational training, and grievances.
- require measures to be taken to ensure security of employment.

Employee representatives on the Supervisory Board have a flow of information to and from the Works Council. This forms the background for participation at Board levels.

Economic Committee. Larger corporations (more than 100 employees) are required by law to have an Economic Committee. This committee does not have rights of codetermination but does have rights to information on:

- the economic and financial situation of the corporation
- the production and sales situation
- the investment program
- rationalization projects and closures
- organizational changes, including mergers
- proposed changes in method

The Works Council Compared to the Unions. Unions have sole bargaining rights on basic pay and conditions, backed by the right to strike. Works Councils do not have this right to strike and must go to conciliation procedures to resolve the conflict. The more heavily unionized a corporation is, the more likely that union officials will be elected to the Works Council.

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[2] The conciliation procedure entails a meeting with a committee with a neutral chairman which can make a binding settlement.

APPENDIX D

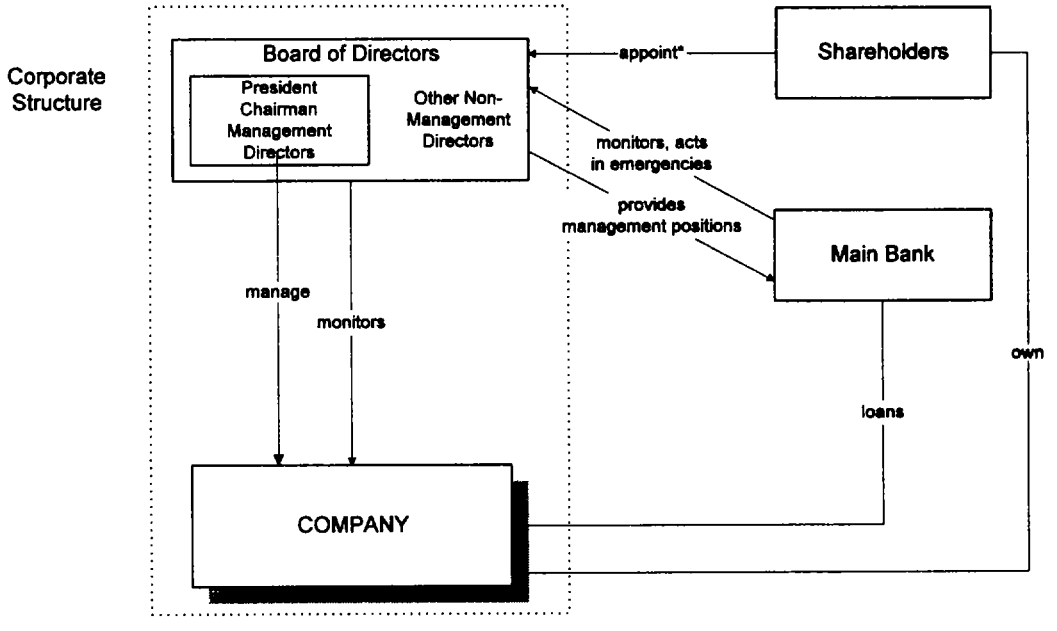
JAPANESE MODEL OF CORPORATE GOVERNANCE

JAPANESE MODEL OF CORPORATE GOVERNANCE

Introduction

Japanese corporate governance promotes the long term preservation and prosperity of the corporation, with less emphasis on shareholders' short term interests. The primary means of monitoring management, outside the internal arrangements for governance, is through a financial intermediary, with comparatively less emphasis on monitoring by the capital market. While the Anglo-American system (and to a lesser degree the German system) also relies on clear legal and regulatory monitoring, the Japanese system provides for a somewhat less transparent, but generally effective, administrative monitoring of management through the Ministry of Finance (MoF) and the Ministry of International Trade and Industry (MITI). Figure D-1 summarizes the main corporate governance relationships in the Japanese model.

Figure D-1. Japanese Model of Corporate Governance



* This appointment is most often a ratification of nominees for the Board chosen from within the company

Legal System

The Commercial Code (1899, revised 1974) in Japan governs the formulation, structure and conduct of companies in Japan. It sets out the rights of the shareholders, the appointment mechanism for the Board of Directors and the powers and duties of the members of the Board and of the Auditors.

Shareholders

Under the Commercial Code, residual control of the Japanese corporation lies with its owners, the shareholders, who exercise their power through a General Shareholders Assembly (GSA). Financial institutions compose a large part of shareholders, owning about 50 percent of the outstanding shares of stock exchange listed companies.[1] Non-financial firms own approximately 25 percent of all the outstanding equity of stock exchange listed corporations.[2] Shareholders owning at least three percent of the capital of the company may request a court to force the resignation of an errant director.

In general, the formal mechanisms of Japanese corporate governance afford only modest opportunity for shareholders to influence day to day corporate operations. The primary opportunity for shareholders to be involved in the corporation is at the GSA, which is held at least once a year in accordance with the Commercial Code.

Powers of the GSA:

- to elect members to the Board of Directors.
- to remove a director from office.
- to approve the dividends.

The election of members to the Board is generally perceived as a ratification of choices of members which were previously made within the corporation.

Rights of shareholders:

- Right to information.
- Right to vote and to contest Board resolutions as invalid.
- Right to participate in profits.
- Right to participate in assets in a winding-up.
- Right to take up the new issued shares.
- Right to withdrawal.

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1 Public Enterprise Governance Reform Study, Asian Development Bank, Technical Assistance Project 1924, Peoples republic of China, p. 20.

2 ibid.

Cross-shareholdings: Cross-shareholdings, where corporations join into a corporate group, arose in Japan after the prohibition through legislation of the holding company structure which had been prevalent before World War II. Originally, cross-shareholdings were formed as a means of protection from hostile mergers and acquisitions. In Japan, members of an enterprise group often have significant ownership cross-holdings. In total, non-financial institutions own about 25 percent of all the outstanding equity of stock exchange listed companies. Corporate cross-holdings and supplier/distributor ownership reinforces good monitoring of management and also informal contract enforcement.[3]

Main Bank

Banks have a combined role of shareholder, trustee and business partner in Japanese corporations. As shareholders banks can own up to five percent of equity in the corporation. In Japan, banks in aggregate hold about twenty percent of enterprise equity and are represented on the Board of Directors.[4] Typically the main bank owns five percent and other financial institutions (including insurance companies, pension funds, etc.) in the enterprise group own another twenty percent. In aggregate, financial institutions own about 50 percent of the outstanding shares of stock exchange listed companies. Because of their vast lending and business experience, banks are well positioned to take a lead in enterprise governance.

Most companies have one bank with whom they have a very strong affiliation–the main bank. This bank often has a long term lending policy with the corporation, has the largest loan share of the corporation, and holds the largest amount of bank stock (up to 5 percent) in the corporation. (See Figure D-2 below.)

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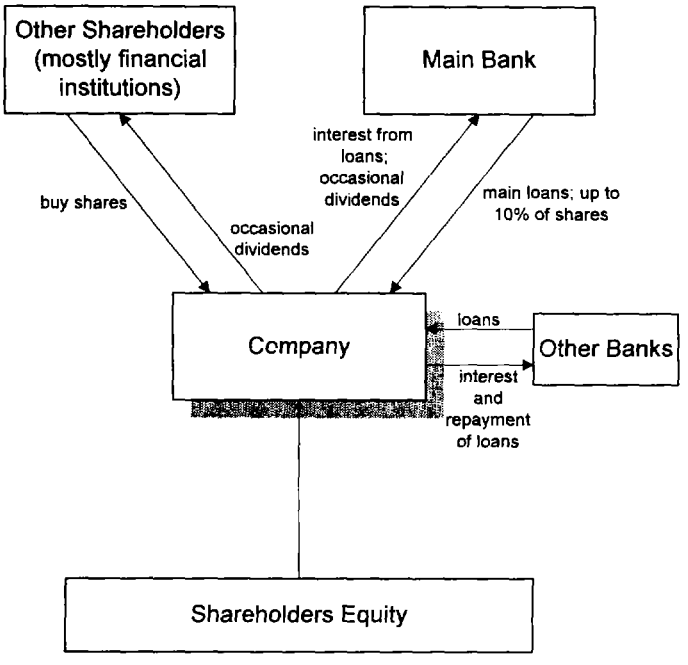
3 Public Enterprise Governance Reform Study, p. 20.

4 ibid.

Figure D-2. Financial Flows



* The majority of the finance entering a Japanese company is through loans not shares. This is slowly changing.

Functions of the main bank:

- *to rescue or liquidate an unstable corporation.* The role of the bank in its relationship with the corporation often depends upon the financial stability of the corporation. The more financially independent the corporation is, the less involvement there will be from the bank. The main bank will generally be very involved in companies that are unstable. Under such circumstances the bank may come in and replace management or add management, merge the corporation, or do whatever is necessary to save the corporation. If the corporation does not appear to be viable, the main banks would take the initiative to liquidate them.

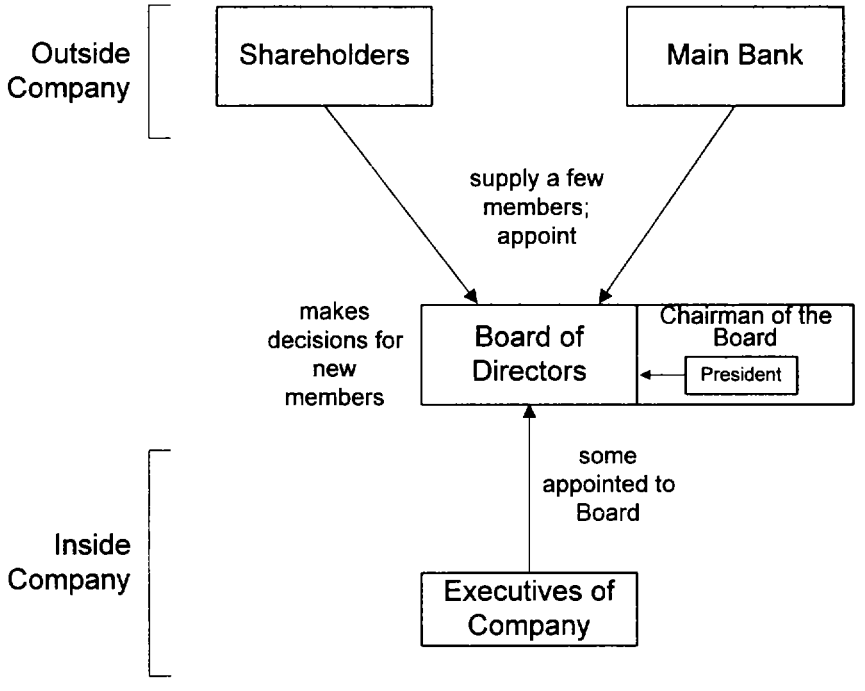
- *to elect members to the Board of Directors.* There are often representatives from the bank on the Board of Directors of the Corporation. Executives of the main bank will often be offered a position, in mid-career, to work for the corporation.

- *to monitor the corporation.* By supplying ex-employees to sit on the Board of Directors or to work in management, the main bank is able to monitor the corporation. This allows the main bank to be aware of any financial difficulties which the corporation may encounter.

Board of Directors

Composition. The Board is comprised of a president, sometimes a chairman, senior executive directors and other executive directors. The Boards are generally larger in number than those in the United States of America. The president, upon nomination by the current members of the Board and other colleagues, chooses the new members of the Board of Directors. (See Figure D-3) This election is rubber-stamped first by the Board and then ratified by the GSA.

Figure D-3. Composition of Board of Directors



The Directors are usually people who have reached high management positions within the corporation. The newly appointed members often continue their role as management at the same time as representing the rights of the shareholders through the Board. The Board is composed primarily of insiders (lifetime employees of the corporation) and a few outsiders (former lifetime employees of other organizations who entered the Board late in their careers). The head of the labor union is occasionally appointed to the Board upon retirement. Members are elected to the Board for a period of two years, which is often renewed repeatedly until retirement.

Duties:

- to represent the interests of the shareholders.
- to call the GSA as provided for by the Code.
- to decide the policy of the corporation concerning the administration.
- one or more of the Directors is empowered to sign documents on the corporation's behalf.

President

The positions of president and chairman are combined in many companies. In companies which have both positions, the current president will often become the future chairman. The candidate for president is selected from within the corporation, often in practice by the previous president of the corporation. The Board of Directors then legally elect the new president. A president, as a member of the Board, is elected for a period of two years which is often renewed until his retirement.

Duties of the President:

- to ensure that the machine runs well.
- to ensure that top personnel matters are properly handled.

The president is the principal voice in the determination of strategy. However, a collegial approach to management decisions, which are consensual between the president and the top management, is common in Japan.

Board of Directors

The Board often functions as a de facto substructure of top executive management. The fact that many of the members of the Board come from management, after working their way up through the corporation for thirty years, makes it more likely that their loyalty will lie with the employees rather than the shareholders. Furthermore, many of the newly elected Board members continue in their positions as high level management making it extremely difficult for the Board to effectively monitor the management.

If a decision concerns a matter which is sufficiently important to warrant formal Board approval, the decision will generally first be subject to wide consultation with all the relevant parts of the corporation. This process is very thorough and also very time consuming. In small companies the Board of Directors is often the decision-making body for both policy and day-to-day management issues. In bigger firms, a top management team will generally manage the corporation—this usually is comprised of several members from the Board of Directors. The top management generally meet once a week. Their duties are to discuss key policy matters and to handle broad administration functions of general management.

Incentives for management. The structure of the governance system, although important, does not reflect, on its face, the manner in which the system functions. The incentives for Japanese management teams to work well appear to be more subtle than incentives for profit or to not be fired. The position on a management Board is a position of honor and power. It is a demonstration that one has reached the highest level in the corporation.

Statutory Auditors

According to the Commercial Code, auditors are to be appointed by the shareholders of the corporation. For large companies or those who are registered on the stock market, the auditors must be certified public accountants. Their function is to audit the director's activities to ensure that business is conducted in accordance with applicable laws and with the corporation's regulations and in the best interest of the shareholders. For small companies the auditors may be selected from within the corporation and the role of the auditors is merely a formality without substance. However, all auditors must make reports at the GSA concerning the activities of the Board of Directors.

APPENDIX E

SUMMARY OF THE CASE STUDY SAMPLES

SUMMARY OF THE CASE STUDY SAMPLES

All of the companies chosen for the case studies are large enterprises operating in the manufacturing tradable sectors in a cross-section of developed and developing countries. It is acknowledged that this sample of SOEs errs significantly in favor of the more efficient SOEs but, this reinforces some of the lessons of experience. These companies were selected for this review primarily because of their relative importance in the State sector and their significance at the national level in terms of financial and economic impact. Infrastructure companies, often referred to as "natural monopolies,"[1] were excluded from the sample since these enterprises raise a number of quite specific issues concerning the regulatory framework which are of particular importance to firms in these non-tradable sectors.

The companies covered in the cases are described briefly below:

(a) ***Semen Gresik***: This Indonesian SOE was established as a legal entity in 1953 and is engaged in the cement industry. Semen Gresik is one of the top three cement producers in Indonesia, an industry which is comprised of nine companies, four of which are in the private sector and five from the public sector. In 1991, Semen Gresik became the first Indonesian SOE to issue shares on the Jakarta Stock Exchange. The public offering comprised 40 million shares or 27 percent of total share capital generating about US$ 140 million.

(b) ***Usinor Sacilor***: One of the largest SOE manufacturing operations in France, the company was created in 1986 as the result of a merger of two companies taken over from the private sector by the State. The tonnage of liquid steel produced by Usinor-Sacilor is the third largest in the world after Nippon Steel (Japan) and Posco (Korea). The company is set up as a holding company with four main subsidiary operations with a significant degree of autonomy from the owners (Government) in the running of the companies. The company is subject to rules covering competition from the European Union and does face stiff challenges from both SOEs and private companies in all of its market sectors. In addition, the French Government has imposed a "hard budget" constraint on the company thus imposing strict commercial criteria on the company's dealings with commercial banks. Following the restructuring of the company and the return to

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[1] This validity of the concept of "natural monopolies" as a rationale for state ownership has been challenged in recent years, particularly with the privatization of utilities and the break-up of larger utility companies into smaller competing entities. In addition, questions of economic efficiency have often been addressed by establishing regulatory systems to monitor potential abuses of concentrated power. Important as they are, the issues of infrastructure enterprise reform and divestiture are not dealt with directly in this paper given the special features of the non-tradable sectors.

net profits of Ffr1.5bn (US$282.2m) in 1994, the company is now being prepared for privatization.

(c) ***Statoil***: The largest company in Norway measured in terms of revenues, Statoil occupies a dominant position in the economy. The company was established as a SOE in 1972 to engage in the exploration, production, transportation, refining and marketing of petroleum and derived products. The company operates in a truly international market for its downstream products and has had to operate on primarily sound commercial principles, receiving no direct or indirect subsidies from the Government. It is a technologically innovative firm and has, over the years, entered into a number of joint ventures and cooperation agreements with other European companies in the sector to secure and expand its share of international markets.

(d) ***Coalcorp***: As the major producer of both thermal and coking coal in New Zealand, Coalcorp operates twelve mines and accounts for 50 percent of the domestic market. The remaining market share is supplied by in excess of forty privately-owned mines. Coalcorp is one of the nineteen enterprises which were corporatized under the New Zealand Government's initiative to enhance SOE efficiency. In 1987 the company was transferred from the auspices of a Government Ministry and established in a corporate form with a Board of Directors with dominant private sector participation. The company is expected to operate along purely commercial lines and its financial performance since corporatization has been markedly improved.

(e) ***IRI***: In Italy, SOEs have played a significant role in the economy and in the early 1990's accounted for 20 percent of value added and 25 percent of fixed investment. Many of these enterprises have been organized as private joint-stock or limited liability corporations in which the government held a controlling interest through principal State-owned Holding Companies (SHCs). The largest of these SHCs is the Instituto per la Ricostruzione Industriale (IRI), a multi-sector holding company with involvement in: steel, advanced technology manufacturing, food processing and distribution, shipbuilding, civil and industrial plant engineering, telecommunications, sea and air transport as well as banking and finance. The total number of Group employees in 1991 reached more than 408,000. Most recently, the 1992-93 crisis of public finances across the state sector in Italy has precipitated moves towards the privatization of many of the firms in the IRI Group.

(f) ***Sumer Holding***: The manufacturing arm of what used to be Sumerbank Holding, Sumer Holding employs over 25,000 in 28 manufacturing units, 435 retail and distributing outlets, primarily in the textile sector. By the early 1980s almost all of its operations were in financial difficulty and lagging behind the growing private sector in production. Following reforms in the 1980s, the banking unit split off (and has since been privatized and made profitable) and most non-textile

production was also split off in separate enterprises, some of which have now been privatized. Today, Sumer Holdings' remaining operations are all losing money. Market share and productivity have declined in favor of private sector companies. Early reform efforts have been disappointing. Although Sumer Holding is in the form of a corporation under the peculiarities of Turkish law, the majority of state-owned corporations, are not subject to the same commercial laws as are privately owned corporations. Their debts are guaranteed by the Treasury; their assets could not be seized for non-payment of debts. Yet their management does not report to the Treasury but rather to a Minister whose objectives are primarily largely non-commercial (regional development and local empowerment). Sumer Holding's senior managers are civil servants and pressures form public sector unions make it hard to release or reshuffle them. Sumer Holding is currently undergoing a consolidation of its potentially viable assets in preparation for divestiture.

(g) ***Hindustan Machine Tools (India)*:** Established with the collaboration and equity participation of Oerlikon of Switzerland to produce machine tools in 1953, HMT became a fully owned undertaking of the Government of India in 1957. One of India's largest producers of machine tools, HMT has diversified its businesses and now produces a broad range of industrial and consumer goods (machine tools, tractors, printers, bearing, watch, lamp, etc.). HMT has a workforce of more than 27,000 and its turn-over in 1992-1993 was about Rs. 8 billion (US$240 million). Though HMT has grown rapidly since its creation through the 1980s in terms of sale and production, its profitability has remained low and declined since the mid-1980s, except its tractor unit. Due to protectionist measures, HMT has not been motivated or able to take advantage of "state of the art" technology that might otherwise have been imported. HMT's performance is monitored through targets stipulated in a Memorandum of Understanding (MoU) signed with Government each year. The MoU sets production and sales targets, however, the MoU takes into account Industrial Policy and employment targets and a growth pattern, based in part, on regional development.

(h) ***Ksiaz Porcelain Factory (Poland)*:** Built in the 1970s with production commencing only in 1980s, KPF, with over 1,400 employees in 1990, never reached full production of its line of tableware and other consumer products. Its situation deteriorated significantly in 1991 when loses totaled almost 50 percent of sales. Exports accounted for 72 percent of sales in 1990. In the same year, KPF had significant overstaffing with only 70 percent of labor in direct production. Product quality was very poor with the domestic markets taking the worst production. Exposure to competition in 1990-91 resulted in liquidation. KPF went into liquidation in June 1991. Management was replaced by a liquidator appointed by the local government. The liquidator sought a restructuring business plan which resulted in the creation of a limited liability company "Ksiaz Porcelain Factor, Ltd." (KPFL) in October 1991, with state owned enterprises (primarily a commercial bank which was KPF's main creditor)

as shareholders. The Executive Board is supervised by a 9-member Supervisory Board representing shareholders. Production at KPFL recommenced in June 1992. By 1994 it was marginally profitable due to improvements in quality and direct foreign marketing.

APPENDIX F

SEMEN GRESIK (INDONESIA)

SEMEN GRESIK (INDONESIA)
Case Study In Corporate Governance

Company Information

Background and Legal Status. Semen Gresik is a state-owned enterprise (SOE) engaged in the cement industry and based in Gresik, East Java.[1] The company was established as a legal entity in 1953 by the Bank Industry Negara acting on behalf of the Government of Indonesia following the discovery of sizable limestone deposits in the area. In 1969 the company was established as a "Persero" under Government Regulations number 9/1969. A "Persero" is a limited liability company with at least 51 percent Government ownership. Private sector limited liability companies operate under similar commercial legislation, although separate regulations apply to management and operations of SOEs.

Operations. Semen Gresik operates in East Java about 16 km from Indonesia's second largest city, Surabaya, on a 750 hectare site comprising a physical plant of 15 hectares and adjacent limestone and clay deposits. The company owns an additional 200 hectare limestone deposit on the nearby island of Madura. Production began in 1957 with an initial installed capacity of 250,000 tons per year (tpy) using a wet process system. Subsequent expansions of productive capacity were undertaken in three phases over the period 1961 to 1976 and involved investment in the dry process system resulting in installed capacity of 1.5 million tpy. Cement production capacity was further expanded to 4.1 million tpy in 1994 following a major investment program financed by an initial public share offering (IPO) in 1991. The additional capacity is located in Tuban, some 100 km from Gresik. A further capacity addition of 2.3 million tpy has been decided at Tuban and is expected to come on stream in 1997.

Almost 90 percent of the company's output is accounted for by Portland Type I cement although it also produces Types II, III and V as well as Portland pozzolanic cement. These products have applications in general construction purposes such as house and building construction, roads and bridges; dams, piers and heavy footing construction; modern construction techniques such as products that set and harden rapidly; applications that require high sulfate

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[1] Gresik also has equity participations in seven cement-related businesses: (i) Eternit Gresik (23 percent SG participation): producer of construction components from asbestos; (ii) Panesge (65 percent SG): management consulting and data processing services; (iii)Kawasan Industri Gresik (65 percent SG): industrial estate development; (iv) Varia Usaha (25 percent SG): cement transportation and distribution; (v) Swadaya Graha (25 percent SG): real estate, contracting and engineering; (vi) Industri Kemasan Semen Gresik (60 percent SG): paper sacks for cement, flour, and animal and shrimp feed; (vii)United Tractors Semen Gresik (55 percent SG): joint venture with Astra International's listed heavy equipment subsidiary United Tractors.

resistance; sea water construction and mass concrete applications. The following table provides selected operational data for Semen Gresik for 1989-1994.

Table F-1. Semen Gresik: Selected Operational Indicators, 1989 - 1994

	1989	1990	1991	1992	1993	1994
Design capacity ('000 tons)						
cement	1,500	1,500	1,500	1,500	1,800	4,100[1/]
Actual production ('000 tons)						
cement	1,278	1,346	1,406	1,462	1,732	2,139
Capacity utilization (%)						
cement	85%	90%	94%	97%	96%	97%[2/]
Energy efficiency						
Fuel (Kcal/kg clinker)	1,359	1,276	1,319	1,313	1,119[3/]	1,095
Electricity (Kwh/ton cement)	170	171	165	156	143	133

1/ October 1994 when 2.3 million tpy addition of Tuban capacity came on stream

2/ January - September 1994

3/ Improvement in energy efficiency due to plant optimization project

Cement industry and competition environment. Total cement industry capacity in 1994 was about 21 million tons and is expected to increase through capacity expansions and new projects to 37 million tons by 1999. The industry is comprised of 10 companies, of which 5 are in the public sector. Semen Gresik is one of the top three cement producers in Indonesia and is the dominant supplier to one of Indonesia's fastest growing regions—East Java. It represented 12 percent of total domestic capacity in 1993, which increased to 18 percent in 1994 following its capacity expansion. The largest Indonesian producer—Indocement—accounts for about 50 percent of domestic capacity and has a dominant market position in West Java. It is majority privately owned, with a minority Government participation of 27 percent. The five state-owned cement producers together account for 30 - 40 percent of total domestic capacity in 1993. The three other companies—Semen Cibinong, Semen Andalas, and Semen Nusantara—are fully privately owned, and account for about 20 percent of the market. Semen Andalas and Semen Nusantara have been acquired by Indocement and Semen Cibinong respectively. A new company, PT Semen Kodeco is expected to come on stream in 1997 with a capacity of 2.3 million tpy.

The Indonesian Government intervenes in the domestic cement market by setting regional benchmark prices, and by allocating regional markets based on proximity ("defined natural markets"), installed capacity and projected cement demand. Export of cement also needs to be authorized after domestic cement needs have been met. This market control is realized by the Ministries of Industry and Trade in consultation with the Association of Cement Producers which includes all the private cement companies and SOEs. These arrangements have tended to restrict competition in the domestic cement market and may have contributed to periodic price fluctuations. Government is actively considering deregulation of cement pricing and marketing arrangements as an incentive for investment promotion in the sector to avoid future supply bottlenecks.

Human Resources. Semen Gresik employs approximately 1,800 permanent employees. Labor turnover has been low. The company operates a series of regular training programs for staff including courses on management training, total quality control, and safety. In addition to basic salaries, employees receive food allowances and other benefits such as a pension program, employee accident insurance, and other medical and health facilities. The company also owns and operates a number of "social assets" for the benefit of its employees and their families, including employee housing, educational facilities (kindergarten through senior high school, and a technical high school), recreational facilities, and transport facilities to carry employees to and from work.

Financial Performance. As shown above, Semen Gresik has operated at relatively high capacity level. It has also displayed a strong financial performance. Operating with its relatively old plants in Gresik, it has shown good profitability, posting high rates of return on sales, assets and equity, a high dividend payout ratio, and a favorable debt/equity structure. The high returns on assets and equity in 1990-91 are due to non-operating income from the sale of Semen Gresik's holdings in PT Cibinong, as well as financial income on the process of the sale and of the IPO in 1991. Financial performance in 1994 is expected to be less favorable due to commissioning of the new Tuban plant, but is expected to improve in 1995 as the new plant would reach capacity and realize efficiency gains. The following table highlights key indicators of Semen Gresik's financial performance during 1989-1994.

Table F-2. Semen Gresik: Selected Financial Indicators, 1989 - 1990

	1989[1/]	1990[1/]	1991[1/]	1992[1/]	1993[1/]	1994[2/]
Total assets (Rp bln)	161	382	661	892	969	994
Sales revenue (Rp bln)	104	128	156	166	218	172
Oper. income as % of sales[3/]	12%	21%	17%	13%	18%	15%
Return on assets (%)[3/]	8%	43%	13%	9%	5%	3%
Return on equity (%)[3/]	8%	55%	13%	12%	7%	4%
Dividend payout ratio (%)	N.A.	10%	50%	50%	50%	50%
Current ratio (times)	4.1	3.8	31.9	13.8	2.4	3.8
LT Debt to equity ratio	1:99	0:100	0:100	24:76	28:72	21:79

1/ Audited

2/ As of September 30, 1994, unaudited

3/ The very high return on assets and equity in 1990 was a result of gain on sale of SG's holding in PT Cibinong.

Public share offering. The Indonesian Government has been increasingly reluctant to increase its capital participation in SOEs and has encouraged the companies to seek long-term investment financing from the capital market. In line with this policy, Semen Gresik in July 1991 became the first Indonesian SOE to issue shares on the Jakarta stock exchange to finance its

capacity expansion project at Tuban.[2] The public share offering comprised 40 million new shares, or 27 percent of total share capital, and generated about Rp. 280 billion ($140 million equivalent). Shares have a nominal value of Rp 1,000 ($0.50) and were sold initially at Rp 7,000 per share with a price/ earning ratio of 16. The share price dropped to Rp.2,900 during the period of tight money policy announced by the Government later in the year in line with a general drop in the Jakarta Stock Exchange index. Semen Gresik's share price recovered, and in November 1994, traded at Rp. 7,600. Of the new shares sold, some 34 million (85 percent of total) are now held by foreigners, mostly institutional investors.[3]

Corporate oversight and management

Before public offering

The corporate governance and asset management system for Indonesian SOEs is set out in Law No. 3/1983[4] and Government Regulation No. 55/1990.[5] Since 1969, Semen Gresik has been organized as a limited liability company (Persero) with the shareholder, i.e., the State, being represented by the Minister of Finance. The technical minister i.e., Minister of Industry or Director General in related ministry chairs the periodic (bi-annual) shareholder meetings which review company results and approve the annual budget. As other Indonesian SOEs, Semen Gresik is managed by a Board of Directors which is appointed by the Minister of Finance based on the recommendation from the technical minister. Supervision is carried out by the Board of Commissioners whose membership typically includes representatives from the technical ministry, the Ministry of Finance as well as the military. The Board of Commissioners typically met once a month. Corporate accounts were audited annually by the Government Auditor (BPKP) which submitted its audit opinion to the Minister of Finance. In the case of Semen Gresik, the Board of Commissioners was made up of 4 representatives from the Ministry of Industry, and a representative from the Ministry of Finance.

The second half of the 1980s saw renewed Government efforts to improve efficiency and productivity of Indonesia SOEs. Based on a Presidential Decree in 1988, an assessment was made of the financial soundness of each SOE and a program developed for restructuring in each case. The proposed measures varied from changes to a more commercial legal status, mergers,

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2 IPO timing was actually delayed from 1990 to 1991 due to late processing of a Government regulation which set up guidelines for management of "going public" state-owned enterprises. See footnote 3.

3 Semen Gresik listed a total of 70 million shares (of which 40 million new shares) which allowed foreigners to buy some 35 million shares. Foreigners are allowed to hold only 49 percent of listed company shares in Indonesia.

4 Law on Procedures for Promoting and Supervising Departmental Agency (Perjan), Public Corporations (Perum), and Limited Liability State Corporation (Persero).

5 Regulation on State Trading Companies (Persero) Going Public Through the Capital Market.

management contracts, joint ventures, public share issues, to liquidations. Semen Gresik's IPO took place as part of this program. In 1989, the Government also introduced a system to monitor financial performance of each SOE on an annual basis, following an evaluation on the firm's profitability (profits before tax/operating assets at book value), liquidity (current assets/current liabilities) and solvency (total assets/total liabilities). To reflect technical differences among subsectors, additional non-financial performance indicators were introduced in 1993. Financial performance indicators now account for 70 percent of enterprise evaluation and technical indicators tailored to each subsector or enterprise make up the balance.[6] Upon evaluation, the scheme classifies SOEs each year into four groups: very healthy, healthy, not so healthy, and not healthy. Remuneration of SOE management is linked to the level of healthiness of the company. Semen Gresik has been clarified as very healthy under the scheme.

All Indonesian SOEs are required to submit a long-term corporate plan (usually five-year plan) to the Minister of Finance to be endorsed and validated. The plan, which includes objectives and targets to be achieved during the five-year period, is further translated into annual workplans and budgets. Annual plans consist of targets and objectives to be realized during the current year and are the operating guidelines for the Board of Directors and a monitoring tool for the Board of Commissioners. They are also used to measure management's performance.

While the reforms have led to a more modern system of oversight and management of Indonesian SOEs, their implementation and impact have fallen short of expectations. The main corporate oversight and management issues which impede the further commercialization of SOEs are as follows: (i) inclusion of non-commercial objectives in SOEs mission; (ii) conflict of interest between the dual roles of technical ministries in supervising sector SOEs and regulating all enterprise activity in their sectors; (iii) the requirement to follow onerous government procedures which delays decision making especially with regard to financing, procurement, and labor reduction;[7] (iv) remaining inadequacies in performance evaluation and management compensation system; (v) inadequate financial transparency.

Impact of public share offering

Following the successful public listing in 1991, Semen Gresik was accorded special SOE status as set out in Government Regulation 55/1990. This brings the status of Semen Gresik more in line with that of private sector firms. Given the minority share of private holdings in the company, however, Semen Gresik is still considered a state-owned enterprise. As stipulated in Regulation 55/1990, therefore, the Minister of Finance maintains veto power with regard to: (i) a change in the company's share capital; (ii) capital participation or relinquishment of capital

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6 In the scheme, SOE's profitability is weighted 52.5 percent of total evaluation, liquidity and solvency each contributes 8.75 percent, and each of three additional technical indicators specific to each subsector provides 10 percent of the evaluation weight.

7 Regulation 55/1990 gives considerably more freedom to SOEs which have been approved for listing in the stock exchange.

participation not conducted through the Stock Exchange; (iii) establishment of a subsidiary company; (iv) relinquishment of part or all of the company's share; (v) liquidation, merger, or reorganization of the company; (vi) amendment to or change of articles of association; (vii) profit distribution; and (viii) Board of Directors' compensation, and Board of Commissioners' honoraria.

Company management and oversight have been affected in significant ways, however, following the public share offering. Regulation 55 allows SOEs that have publicly sold shares to be exempted from the cumbersome regulations on Government supervision and monitoring, and onerous Government procurement regulations, while enjoying greater flexibility in sourcing of funds. This brings the status of Semen Gresik more closely in line with that of private sector firms, and allows it greater flexibility. Supervision of the company is now delegated to the Board of Commissioners, which decides on all matters of investment, funding, budgets and procurement. Regular SOEs need to refer to Government on these issues. A shareholders meeting takes place once a year chaired by the President of the Board, rather than two such meetings chaired by Ministry officials for regular SOEs. Semen Gresik's Board continues to be made up of Government officials, but is felt to be more professional than for other SOEs. Private sector representation on the Board is under consideration. The new status has also permitted to extend greater incentives (both salaries and bonuses) to company management and personnel in order to bring remuneration more in line with the private sector. In 1993, bonuses have equaled 5 months of salaries. There is also greater freedom in moving staff around to realize efficiency gains. This is important as the new investments allow to improve labor productivity considerably.

A very significant impact of the IPO is the much greater scrutiny of performance by the private shareholders. Public reporting now takes place once every three months, while company finances are audited by a reputed international audit firm in line with international accounting and audit standards. Company performance is also scrutinized by external financial analysts which publish regular recommendations on the attractiveness of Semen Gresik's shares for current and potential shareholders. The much closer scrutiny has led to greater transparency of Semen Gresik's performance and has created a greater sense of accountability by company management for efficiency improvement. While Semen Gresik's performance has been good, further efficiency improvements are expected as a result of the new investments coming on stream. Together with the closure of the remaining outdated wet-process facilities in the coming year, this will allow considerable savings in production costs as energy efficiency would increase further and labor productivity would improve.

In a recent development, Semen Gresik is expected to expand further through the acquisition of two other cement SOEs through a rights issue. The consolidation is expected to provide the company with additional critical mass to provide a countervailing balance to the large private sector cement companies and allow greater synergy in operations and marketing. While increasing the scale of Semen Gresik's operations, it would also spread the above discussed benefits of IPO status to the two SOEs that would be consolidated.

APPENDIX G

USINOR SACILOR (FRANCE)

USINOR SACILOR (FRANCE)
Case Study In Corporate Governance

Brief History of the Company

Background Information. The oil crisis of 1974 had a negative impact on the European steel industry and French industry in particular. The French State, responded to the decline of the industry by giving grants and lending money at a subsidized rate to the remaining steel companies. In 1984, after further declines, the State acquired two companies from the private sector—Usinor and Sacilor. In 1986 the two companies were merged to form a single state-owned enterprise—Usinor Sacilor, today Europe's largest steel company. From 1986 to 1995, the company embarked on a major restructuring effort resulting in significant increases in productivity and a profitable balance sheet in 1994.

Ownership of the Company. Until the July 1995 privatization, the French state held a direct 80% ownership interest. As in the case of all French SOEs, a state owned bank also holds equity, in this case, Credit Lyonnais. Although ownership is vested in the Treasury and although it may be required to fund the company, the Treasury has no independent power to exercise its ownership rights. Rather the exercise of state ownership rights is with the Prime Minister.

Table G-1. Ownership in 1993[1]

	No. of Shares	Value	%
French State	149,235,516	5,969,420,640	80
Credit Lyonnais	37,308,879	1,492,355,160	20
Total	186,544,395	7,461,775,800	100

Objectives of the government. The initial objectives of the French government, as owners of Usinor Sacilor, were to halt the rapid deterioration of the steel industry and address the accompanying social problems, particularly declining employment in politically sensitive areas. By the early 1990s, as the industry stabilized and reliance on the government decreased, the objectives of the government changed to the following: (i) financial independence; and (ii) employment maintenance and growth through globalization in regions with unemployment problems.

Legal Status. Usinor Sacilor is organized under French corporate law and must comply with it on the same basis as any privately owned company. A State Owned Enterprise law defines the relationship between the SOE and the owner—the government.

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1 Usinor Sacilor, Annual Report 1993.

Company Information

Product Lines. Usinor Sacilor is divided into three subsidiary product groups—flat products (Sollac), long products (Ascometal & Unimetal) and stainless steel (Ugine). These groups are then further subdivided. Of the steel produced in 1993, 66.6 percent was used for flat products, 25.6 percent for long products and 7 percent for stainless steel and alloy. The remainder is distributed for diverse metallurgy activities.[2] Flat Products represent two thirds of the steel produced. Eighty-eight percent of the steel produced by Usinor Sacilor is produced in France, 9.5 percent in Germany and 2 percent in the United States, this balanced by wholly or partially owned interests in including Belgium, Canada, Germany, Great Britain, Italy, the Netherlands, Spain and the United States.[3]

Productivity. Productivity ratios at Usinor Sacilor are considered at or above the level of international standards and are the best ratios in Europe.

Employment. Since Usinor Sacilor's foundation in 1986, its workforce has been decreased from approximately 250,000 to 61,500 employees in December 1994 (79 percent in France, 11 percent in Germany and 5 percent in the United States).

The termination of employees in 1993 affected 3,356 people in France and 1, 265 people overseas.[5] This year the number of redundancies is expected to decrease to 1,800. Usinor is expected to achieve the reduction without need for dismissals. Most jobs will be lost through retirements and reconversions. Compensation for redundant workers is provided according to the social laws in France and the accords in force in each country. The group also has a number of partnerships with regional authorities to place former steelworkers in new jobs.

Table G-2. No. of Employees at Sacilor in 1993[4]

Activities	France	Germany	Rest of World	Total
Flat Products	22,723	6,264	2,158	31,145
Long Products	10,190	798	417	11,405
Stainless Steel	9,787	286	2,781	12,854
Other Industrial Activities	10,486	39	622	11,147
Business/ Sales	453	323	657	1,433
Group Total	53,639	7,710	6,635	67,984

Technology. In 1993, the research budget was increased to FF1.1 billion and research for the corporate group was centralized. At the beginning of 1993, a wholly owned subsidiary—Usinor Consultants—was created to respond to the growing demand for technical assistance

2 Annual Report 1993, p. 3.

3 ibid.

4 Annual Report 1993.

5 Annual Report 1993.

directed to the group. Usinor Consultants undertakes contacts and seeks offers for technology contracts on the behalf of Usinor Sacilor. Among the contracts already negotiated are (i) a technical assistance project to build a blast furnace in Piombino, Italy, and (ii) a project to commence galvanization installation at Galmed, Spain.

Significant Changes over the Last Five Years. The most significant change in the last five years has been the July 10 sale of equity to the public and the earlier partial divestiture of some of the subsidiaries. Last year the stainless steel sector had 49 percent of its stocks floated on the stock market.

Financial Performance. Since nationalization, certain activities of Usinor Sacilor have been very profitable while others have sustained a loss. Unimetal from the long sector has constantly run a deficit and has been cross-subsidized from the other subsidiaries. The strongest sectors are the Flat Products and Stainless Steel. The last year has shown an improvement in financial performance as demonstrated in the chart below.

Table G-3. Key Financial Data[6]

(in millions of francs)	1989	1990	1991	1992	1993	1994
Consolidated turnover	97,0	96,1	97,2	87,0	75,3	79,5
Cash Flow	14,9	8,7	3,1	1,3	-1,2	5,6
Industrial Investments	4,2	6,1	6,0	5,0	3,4	2,8
External growth	1,9	7,1	2,0	2,4	1,5	-
Net profit	6,8	3,2	-3,0	-2,4	-5,7	1,0
Shareholder's Equity	25,7	28,9	27,2	23,7	20,0	22,1
Debt	22,0	28,9	30,0	29,5	24,4	17,4
Net finance Charges	2,1	2,8	3,1	3,2	2,2	-

Market Share and Competition. Usinor Sacilor competes freely for the French and European market against other European SOEs and various private sector companies.[7] Private

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6 Annual Report 1993.

7 There are no barriers to entry in France for companies based in countries who are members of the European Union. The European market, however, is protected against imports from non-EU countries, in particular to Eastern European countries which have large production capacities. The main producers of steel in Eastern Europe are Poland, the Czech Republic, and Slovakia. The two most important trade measures adopted to date have been Voluntary Restraint Agreements and anti-dumping duties. It has not been uncommon for the EU steel industry to use anti-dumping proceedings which may impose punitive duties, payable on importation, on imports from third countries.

A tariff protection system was set up in Europe after the creation of the European Coal and Steel Community. During the crisis period from 1980 until 1986, tariffs were used to protect the European

companies, such as those from Germany and British Steel, are able to compete for the French market which has reduced the market share of Usinor Sacilor, in France, to 50% despite the fact that the company is responsible for 85 percent of steel production in France.

There is also very stiff competition in the steel industry from mini-mills which produce long products such as bars and beams.

The market price for steel in France is regulated by the EU. Usinor Sacilor must ensure that its prices are in line with the European market. Market regulation mechanisms are used under the European Coal and Steel Community Treaty (ECSC) in order to protect, encourage, and stabilize the community steel industry.[8] From 1980 until 1986, the EU used the ECSC to regulate the market through fixing prices. The prices were based on data gathered by Eurofare, an association of large steel producers. The data collecting procedures are still functioning which enables companies with this data to adapt output to short-term evolution of the market.

Under the ECSC treaty the EU has the option to fix prices at any time. This treaty is due to expire in 2002, from which date it is likely that the coal and steel industry will be governed solely by the provisions of the EU treaty.

Corporate Structure

Members of the Board and their qualifications. The Board of Directors of Usinor Sacilor is comprised of representatives from the government, the private sector and the employees. The Prime Minster is responsible for the selection of the Board members. A short list is proposed by the different government ministries and the business community, and the Prime Minister makes the final decision. These selections are then ratified by the Parliament. The CEO of Usinor Sacilor is the chairman of the Board. For nine years, that person has been Mr. Francis Mer, reconfirmed as Chairman in June, 1995.

The boards of each of the subsidiaries are composed of the CEO of the subsidiary, representatives of the employees of the subsidiary, the CEO of the Holding Company, other members from within the company, and some members of the community with experience. The members are selected by the CEO of Usinor Sacilor and put to the General Assembly of the Subsidiary. The General Assembly is composed of the owners of the subsidiary company and are primarily representatives of the government. The Boards are considered to play a role of "puppet boards," with their actions primarily controlled by the Holding Company. This will change in the stainless steel sector where the company is no longer wholly owned by the government.

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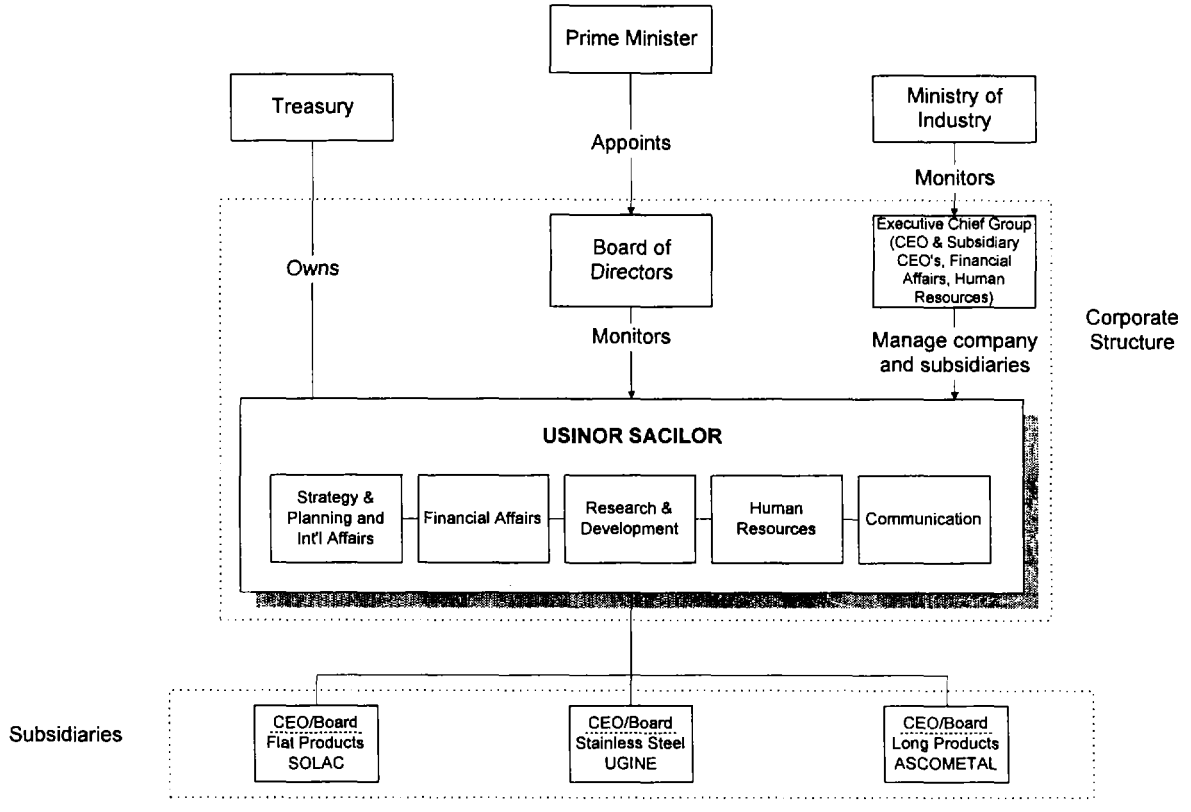
producers from international competitors, in particular Brazil and South Korea. Since 1986, tariff protection has not been used.

8 Jean Francois Bellis, The Changing EC Trade Regulatory Environment, Steel World pp. 13-16.

Figure G-1. Usinor Sacilor



Duties & Outputs of the Board. The function of the Board is to assist the CEO. The Board is an informational channel for the government, enabling monitoring of the company to be more efficient. The Board has no executive power in the running of the company. Responsibility is usually delegated from the Prime Minister to the CEO rather than the Board. Subjects which are discussed at Board meetings do concern matters of extreme importance, however, in general the Board does not make decisions on these matters.

However, board meetings are an ideal time for Ministries or others dissatisfied with the running of the company to put their complaints on the table. The Board of Usinor Sacilor meets biannually as do the Boards of the subsidiaries. It appears that the CEO's objectives for the company, rather the government's objectives take precedence at the board meetings. The CEO of Usinor Sacilor uses the Board meetings to explain the strategies of the company and the developments which have occurred in the previous months. There is generally a preparatory meeting to arrange the agenda for the Board meeting. Board representatives of the employees are not invited to the preparatory meeting.

Remuneration of the Board members. A position on the Board of Directors of the holding company is primarily an honorary position which entails only token remuneration. There is no remuneration for the members of the Boards of the subsidiaries.

Limits on management's ability to operate. The management of the company, which is primarily controlled by the CEO, is independent from the Board concerning day-to-day matters. The management team is not responsible to the Board although the board members are free to complain at board meetings concerning the actions of the management. The management's ability to operate is rarely inhibited unless the Prime Minister is involved.

The agency responsible for monitoring the chief executive group is the Ministry of Industry. The Ministry of Industry is responsible under law for monitoring all state owned enterprises. It periodically contacts the company concerning recent activities, however, there is no strict monitoring procedure. The Ministry of Industry represents the French steel industry in international affairs—including discussions and negotiations on behalf of the government and the industry. This representation provides an incentive for the Ministry of Industry to monitor the company.

Compensation, Bonus Systems and/or Sanctions for Management Performance. Members of the Corporate management are paid full time salaries, which correspond to the salaries of management in the French private sector. There is no bonus system for management of the Holding Company. The companies each have their own bonus systems. In Ugine, for example, there is a profit sharing scheme. At the end of the year, 20 percent of the profits are spread among the employees according to their salaries. Since part of Ugine's shares have been sold, now shares are being used as a bonus award for employees. There is a limit on the amount of shares which can be sold, since the state desires to retain 51%.

How the Chief Executive Officer is chosen, by whom, and how he/she is replaced. The CEO of the company is elected for a three year term by the Prime Minister of France. This term may be renewed at the end of the three years at the Prime Minister's discretion. The Prime Minister also has the power to replace the CEO during the term. The process of selecting a president is as follows: The Prime Minister is provided with a number of names. These names are provided by several groups; from within the company, a few from the steel sector, and a few from outside sources (usually political choices). The Prime Minister then chooses a candidate from the list. This choice is ratified by the General Assembly of the Holding Company—which is comprised of government officials representing the owner of the company. The selection is then discussed and approved by the parliament.

There are two important informal criteria in choosing the CEO. The first is political and the second is educational. The political aspect usually ensures that the new CEO will support the political party represented through the Prime Minister. The education requirement ensures that the CEO went to one of the Grandes Ecoles. If there are no candidates who attended one of these schools there will be pressure, both from the schools themselves and from within the government, so that an alumni from the Grandes Ecoles be added to the list.

In 1988, the current CEO, Francis Mer, was elected. His term has been renewed twice and his present term of office ends in 1998.

Autonomy of the CEO in the Management of Usinor Sacilor. The CEO has a great deal of autonomy in the management of Usinor Sacilor. For example, in 1992, the European steel industry suffered a recession. The effects were felt by Usinor Sacilor. Instead of asking the Treasury for money, Francis Mer explained the reasons for the loss to the government, how he could finance the loss and demonstrated that he didn't need financial support from the Treasury. The CEO's autonomy in managing the company allowed the French government to play a minimal role in acquiring funds for the company when the SOE was having financial difficulties.

The autonomy of the CEO has conflicted with government objectives in decisions concerning employment targets. The government agreed in 1993 to the decrease the number of employees of Usinor Sacilor by 10 percent over the next three years. Usinor Sacilor, with the approval of the government planned to close a large plant in Lauren, an area with high levels of unemployment, meant the loss of about 3,000 jobs. Mr. Mer hoped to partially rectify the situation by building a small plant in the area which would employ 700 of the redundant workers. The Ministry of Industry was discontent with this decision and wanted a medium-size plant, creating twice the number of jobs to be built instead, thereby decreasing the loss of employment. Mr. Mer resisted these requests of the Ministry of Industry and the issue went to the Prime Minister. Only under orders of the Prime Minister was decision made for the medium-size plant to be constructed.

Corporate Finance

How the Budget is Set. Each subsidiary is required to prepare a document outlining financial requests for the following year. A meeting is then held between the CEO and the management team of the subsidiary at which the proposal is presented. The CEO will then approve or deny the request. If the request is approved, it will then pass to the Ministry of Finance for review and final approval.

How the Company is financed. Usinor Sacilor was recapitalized by the Treasury, in both 1984 and 1986. In 1987, the Treasury stated that it would no longer supply financial assistance to Usinor Sacilor. Today, the major source of financing for Usinor Sacilor is through borrowing money from both state owned and private banks. Credit Lyonnais was formerly the primary creditor for Usinor Sacilor. Now, Credit Lyonnais, in the process of being privatized, is no longer providing loans to Usinor Sacilor.

Despite Usinor Sacilor's status as a SOE, which implies that the government will pay for defaults on loans, banks do not provide loans easily. A risk exists that, unless there is assurance of repayment, in writing, by the Treasury, that the State Owned Enterprise will not repay the loan.

There are no special conditions granted to Usinor Sacilor, such as receiving loans without delay or receiving longer terms of repayment. Any special treatment granted to the company is due to the fact that Usinor Sacilor is a large enterprise with which a bank would like to do business—not because it is a state owned enterprise. Nevertheless, the assurance of repayment (through the Treasury) by a government-backed enterprise probably plays a role in the granting

of some loans. Risks of bankruptcy and liquidation are less and the company obtains a better investment rating.

Usinor Sacilor is free to go to whomever it pleases to request loans. In 1992 and 1993, the Holding Company had commercial papers issued in the United States. Usinor Sacilor can also obtain loans from commercial banks on security or collateral. Equipment has been mortgaged in the past for this purpose.

Other mechanisms to help with financing are used. For example, in 1994 the floatation of 49 percent of the stocks of Ugine—the stainless steel industry—helped to accelerate the process of freeing Usinor Sacilor from debt. The debt/equity ratio of Usinor Sacilor was 75/25 according to the 1994 annual report.

Finance of the Subsidiaries. The debt level of Usinor Sacilor was controlled until 1992 through the Holding Company. In 1992, the subsidiary companies were granted the right to go out on their own in search of financial support. The reasoning behind this was that the Holding Company had reached the ceiling limit on loans with most of the banks in France. Now, if one of the subsidiary companies wishes to borrow money from a bank they have automatic approval, up to a certain level, from the Holding Company. Unimetal, the weakest subsidiary, has 90 percent of its debt with the Holding Company as it does not have the financial stability to obtain loans easily from the banks.

There are also limits on the power of the management of the subsidiaries, which restrict buying and selling powers of the subsidiaries without approval. These limits are included in the regulations of the company. The main limitations are imposed on the subsidiaries by the CEO of the Holding Company.

Financial surpluses from the subsidiaries flow upwards to the Holding Company. This may result in the demoralization of the management of the subsidiaries as they watch the profits they achieved cross subsidize other sectors of the company. The sectors of the company which are operating at a loss continue to be granted funds from the Holding Company.

The CEOs of the profitable subsidiaries are complaining because they do not want to supply any more money to the profit losing companies. Lately, there has been a push by the CEOs of the individual subsidiaries for privatization of the industry by product line. The problem then arises that in order to do this, the weaker subsidiaries would need to be liquidated. The government refuses to do this. This cross subsidization has held back advances in stronger sectors of the company.

Subsidies from the State. The French government is restricted in the subsidies which it may grant to Usinor Sacilor under the EU agreement. The permitted subsidies include those for research and development, and investments to comply with environmental policy. The cofinancing of research and development projects provided by the government amounts to approximately 5 percent of the total amount of the project. In 1993, the government's

contribution for environmental protection constituted 8 percent of the amount that Usinor Sacilor spent in this area.

The government pays partial compensation to the redundant employees. The amount to be paid by the government is negotiated with the Steel worker's Union. The government pays about 50 percent of the redundancy fees. In addition to what the company provides, the government provides services are services such as compensation and retraining. This is a typical part of the social safety net.

Dividends. By law profits of the corporation must revert to the owner of a company—the Treasury. In the years that Usinor Sacilor has operated at a profit they have paid dividends to the Treasury. The amount of the dividends is negotiable and the amount paid in the past has been 5 percent of the net profits. This action sends a message to the company that there is an owner. Usinor Sacilor did not distribute any dividends in 1991 or 1992 due to the difficult financial times. The dividends are set by the General Assembly, attended by representatives of all of the shareholders, under proposition of the Board of Directors.

Assessment of Performance to date

Effectiveness of the company in carrying out the government's objectives. In general, Usinor Sacilor has been carrying out the government's primary objectives, in that it has been financing itself without the support of the government and improving efficiency. The second objective of the government, is to help the unemployment conditions in certain regions. This social objective has been resisted by the company's management but has been achieved in certain regions.

Early in February 1995 Ministry of Economics announced that it was looking for banks to advise the government on the sale of Usinor Sacilor. The decision to privatize Usinor Sacilor is thought to be based on the groups fast return to the black and the government's ambitious targets for privatization income.[9] It is estimated that there could be a total of Ffr 12bn-20bn in equity on the sale.[10] The state will probably unburden itself of the majority of Usinor shares, retaining approximately 10 percent.[11]

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9 "Usinor Sheds Jobs as Privatization Looms." Metal Bulletin, 12 January, 1995, p. 19.

10 "Usinor Privatization" p. 32.

11 "Usinor Sacilor fait le forcing pour être privatisé avant l'été." les Echos, 12-13 May, 1995, p. 8.

APPENDIX H

STATOIL (NORWAY)

STATOIL (NORWAY)
Case Study In Corporate Governance

Company Information

Legal Status. Founded on June 2, 1972, as a 100 percent state-owned company, Statoil (*Den norske stats oljeselskap a.s*) is, "either on its own or through participation in or together with other companies, to engage in exploration for and production, transportation, refining and marketing of petroleum and derived products, as well as other activities." The company is 100 percent state-owned, and operates on a commercial basis. The basis for establishing Statoil was the prospect of the State's direct participation in developing and benefiting financially from the potentially large oil and gas resources in the Norwegian sector of the North Sea. Statoil operates several Norwegian oil and gas fields, the most important being the giant Statfjord field. In 1996 the Statoil operated gas field Troll will be on stream. Troll is the centerpiece of Norwegian future gas deliveries to Europe.

Activities. Statoil is a fully integrated oil company whose activities include:

- *Exploration and Production* – including development and operation of offshore installations.

- *Oil Trading and Shipping* – the sale of crude oil supplies, including the Norwegian government's crude oil, sale of refined products and natural gas liquids, and maritime transport.

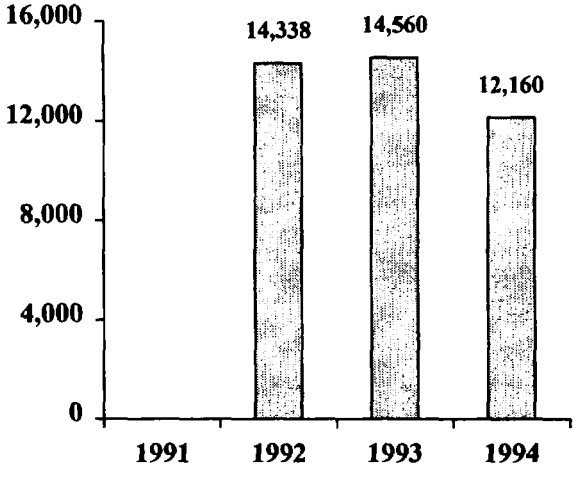
- *Refining and Marketing* – the operation of refineries in Sweden, Denmark and Norway and the marketing of products

- *Petrochemicals and Plastics* – the operation of petrochemical plants in Norway (polyethylene and other plastics) development, production and marketing for olefins, polyolefins, specialty products and finished plastic components were combined in 1994 with Neste (a Finnish company) which merged the bulk of its petrochemical business with that of Statoil into a new company Borealis with its headquarters being in Copenhagen. The new company is owned 50-50 by Statoil and Neste.

- *Natural Gas – the export of gas.* In 1986, the Gas Negotiating Committee was established to negotiate gas sales abroad. Statoil chairs the Committee, which also includes two other Norwegian oil companies—Norsk Hydro (51 percent state) and Saga Petroleum (100 percent private).

Employment. Statoil is the biggest company in Norway, by revenues and profits and the second largest by employment. At the end of 1993 Statoil employed 14,560 people. On January 1, 1994, some 2,400 employees from Statoil's petrochemical business were transferred to the new company Borealis. Statoil's employees are located in 13 countries.

Figure H-1. Employment



Technology. Extensive restructuring and reshaping of work processes were implemented by the Exploration & Production division of Statoil during 1993 in order to reduce costs and strengthen the acquisition of expertise. This process permitted the company to undertake new operator commitments without any significant expansion in new recruitment.

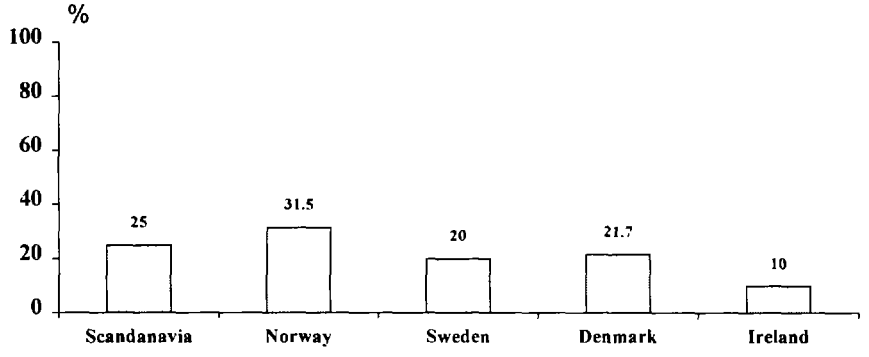
Statoil, in cooperation with Norwegian engineering company MCG, developed a new storage-free submerged turret loading (STL) system which attracted considerable international interest. A separate company, Advanced Production and Loading (APL), was established by Statoil and MCG to market technology, equipment and technical services. In 1993 Statoil Norge became the first oil company in Norway to introduce a new unleaded and environment-friendlier petrol aimed at cars unable to use conventional unleaded grades.

Market Share and Competition. About 25 oil companies are active on the Norwegian continental shelf, including many of the major internationals and the three Norwegian companies—Statoil, Norsk Hydro, and Saga Petroleum. Statoil is also exposed to fierce international competition in both refining and marketing activities.

Statoil is the largest trader of North Sea oil, selling 1.4 million barrels of crude per day in 1993. This represents more than a half of Norway's production of crude oil and natural gas liquids (NGLs) which was at 2.4 million barrels/day in 1993. In 1994, Statoil moved into third position among the world's largest oil exporters. The acquisition of BP's 240 Swedish service stations network in 1993 made Statoil the leading petrol retailer in Scandinavia, with an overall

market share of about 25 percent. In addition, Statoil acquired 160 service stations in Ireland and opened service stations in Germany, Poland, Latvia and Russia during 1993. At the end of 1993, Statoil operated some 1,900 stations in nine countries. Statoil's share of total oil product sales was roughly 23 percent in 1993.

Figure H-2. Overall Market Share



1993

Northern Europe remains Statoil's principal market for crude oil. However, increased exports to the USA and Canada have helped to strengthen the competitiveness of and market differentials for Statoil's various crude oil grades in relation to other crudes on the market. Statoil's markets for oil products include European countries and USA, and recently Mediterranean and Far East. Statoil is pursuing gradual expansion in new markets around the Baltic.

Technical Procedures. Parliament decides on the opening of new exploration areas and the Government allocates, by license, exploration acreage to companies in yearly or bi-yearly concession rounds. Concessions are given to oil companies on the basis of proposed activity programs (plans for wells, seismic coverage, etc.) and competence. Statoil as well as the other Norwegian companies have been given preferential treatment compared to international companies. Concessions have been given to consortias of about 3 to 8 companies, with mixed ownership, but generally, cumulatively more than 50 percent Norwegian. Allocation of fields is decided on by the Ministry of Industry and Energy through the competitive bidding process with usually 20-25 companies participating.

Strategic Alliances. Several years ago BP and Statoil entered into a strategic alliance, with participation distributed as follows: BP - 60 percent, and Statoil - 40 percent. The objective: to work together internationally on oil (primarily) and gas development, alternating operatorship per project. Capital expenditures for this effort remain modest.

Financial Performance. ROI for Statoil was between 10 and 11 percent in 1994 on the after tax basis, compared to a long-term level of around 12 percent for the major international companies.

Table H-1. STATOIL - Consolidated Financial Results

Key figures (NOK million)

	1993	1992	1991
Operating Revenues	81,057	74,526	74,558
Operating Profit	12,429	12,575	13,238
Profit before Taxation	11,980	9,884	13,191
Net Profit	3,394	2,300	4,254
Interest-bearing Debt	25,742	24,606	20,610
Shareholder's Equity	26,507	24,205	23,210
Investments & Acquisitions	13,427	10,609	10,425
Cash Flow	12,590	12,911	11,385
Before-tax Return on Capital Employed	28.3%	28.0%	34.3%
After-tax Return on Capital Employed	7.8%	6.7%	11.0%
Return on Equity	13.4%	9.7%	19.5%
Equity Ratio	29.6%	28.3%	28.9%

Capital Employed = Total assets less non-interest-bearing debt
Equity Ratio = Shareholder's equity as a percentage of total balance less SDFI-related accounts payable

Exchange Rates: NOK/USD

December 1991 5.9615
December 1992 6.8685
December 1993 7.387
December 1994 6.882

Figure H-3. End December Exchange Rate

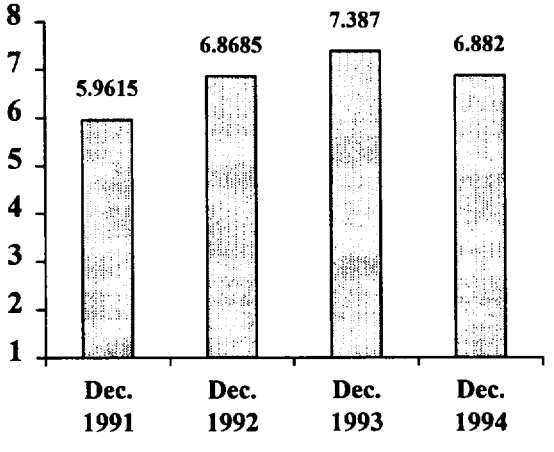


Figure H-4. Return on Capital Employed

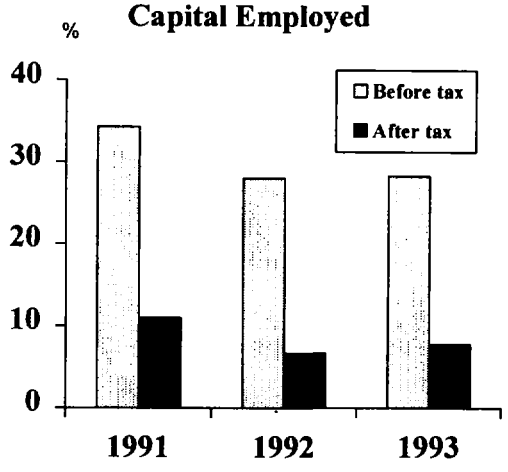
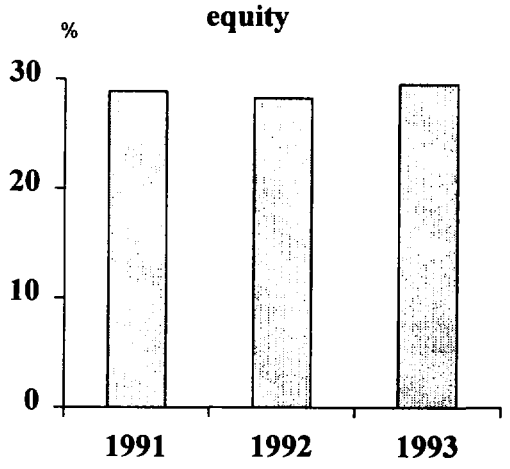


Figure H-5. Shareholder's equity



Asset Management Model

State Participation. The development of Norwegian oil and gas policies since the early 1970s have emphasized national management and control, buildup of a Norwegian petroleum industry and State participation at the upper levels. The Norwegian Parliament (the Storting), and a dedicated Ministry along with the Norwegian Petroleum Directorate, are in charge of management and control.

Relations with the government. Until the mid-1980s, Statoil was virtually independent in its decisions and policy from the government. Statoil's management was guided by commercial objectives.

Box H-1. Features of Statoil conducive to its efficiency

* Separation of government ownership from day-to-day management
* Commodity product, highly competitive
* Statoil operates for export, not for domestic market
* Non-corrupt management
* Hard budget constraint
* Active private sector Board members, including Chairman
* Remuneration/incentives for management comparable to private sector

Observed negatives

* Early social/employment objectives led to sub-optimal location of on-shore activities
* Borrowing has implicit government guarantee and may put Statoil at advantage over private sector companies but also put state finances at risk if market prices fall

In December 1984, the Storting adopted a resolution to divide Statoil's financial participation in most of the production licenses between the State and Statoil. Statoil's participating interest is divided into two economic shares: one is the company's own financial involvement in the various licenses,

and the other is the State's Direct Financial Interest (SDFI). Thus, a part of Statoil's gross revenues from its production activities in the various fields is automatically transferred to the State, and a corresponding part of Statoil's expenditures (investments, operating costs, etc.) associated with the individual fields is covered by the State through the SDFI. The split between the direct financial interest of the State and Statoil's own financial interest, is decided on the basis of the individual circumstances of each case. The operational involvement of the State in the petroleum industry is, however, still handled entirely through Statoil.

Role of the Ministry of Industry and Energy. The Ministry of Industry and Energy (MIE) plays two roles: owner/regulator for natural resources and representative of the owner of Statoil. For its first function, MIE has the overall responsibility for ensuring that administrative and financial controls are exercised with respect to exploration for and production of petroleum on the Norwegian Continental Shelf. In this respect, the MIE acts for the State as owner of the resources, not as owner of Statoil. Furthermore, the Ministry ensures that control is exercised with respect to exploration for and production of petroleum so that these activities are carried out in accordance with the energy policy of the Storting. The responsibility for petroleum activities rests with the Oil and Gas Department. The Oil and Gas Department has the following functions: (i) preparation and implementation of exploration policies, such as opening of new areas and awards of new licenses; (ii) development and operation of gas and oil fields; (iii) making economic analyses of the petroleum sector, including estimates to form part of the National Budget, the Governmental Budget and long-term programs; and (iv) follow-up of the State's financial interests in the petroleum sector, including the owner's administration of Statoil's and the State's Direct Financial Interest (SDFI). MIE's role as representative of the owner in the corporate governance of Statoil is discussed below.

Non-Economic Objectives. In the 1970s, location of on-shore organizations for operating oil fields was heavily influenced by the MIE, leading to the organizations being spread out along the Norwegian North Sea coast to cover different regions and create jobs evenly. After the mid-1980s the situation changed drastically, especially after 1986 when oil prices took another deep dip, the government involvement thinned out and Statoil management was governed only by the commercial objectives in its operational activities.

Ownership Function of the State. The State uses two methods to maintain its role in important decisions: the state-run shareholders' meeting—the General Meeting, and state appointment of the members of the Board of Directors. The State can play a role in major strategic and financial decisions, but rarely intervenes in day-to-day operations. State/ MIE approval is required for such issues as company's strategy, acquisitions/divestments, and major projects. As for the issues concerning debt/financing, domestic pricing, resource allocation among activities, and operations, they are all resolved by Statoil autonomously from the State.

Board of Directors. The Board of Directors of Statoil is composed of a maximum of nine directors. Six directors including Chairman and Vice-chairman are elected by the General Meeting, i.e., in essence are appointed by the State through the MIE. Three directors are elected by the employees in accordance with regulations made under provisions of the Norwegian

Companies Act concerning the right of employees to be represented on the Board of Directors and in the Corporate Assembly of companies limited by shares. The Board usually consists of the following individuals:

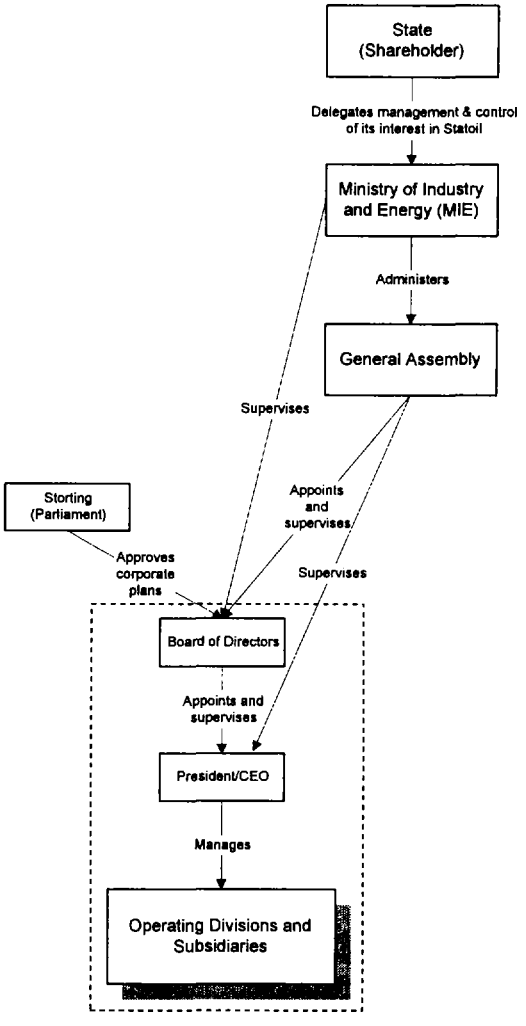
- president of labor unions
- presidents of private companies
- civil servants

Usually 2/3 of the members come from the industry, i.e., private sector; Chairman is generally chosen from the industry or academia; there are representatives from the labor unions, and also workers of the company (usually two employees). The members of the Board are chosen for a term of two years, and could be replaced. The Board of Directors functions in general as Western private company boards.

Remuneration. The remuneration of the Board of Directors' members follows the norms in the industry in Norway. Being a member of the Board is not a full-time job, the Board meets with intervals of one to few months.

Corporate Management. The President of the company is appointed by the Board of Directors at the recommendation of the MIE (similarly to the Chairman of the Board of Directors). But the President is not a member of the Board. The President of the company, independently of the Board of Directors, chooses his management team. The management remuneration system is exactly the same as in the private sector. The President's salary is stipulated by the Board. Statoil is considered to be among the best run companies in Norway and the one where politics are separate from commercial objectives. Although Statoil's financial results have been below industry norms for some years, in 1994 Statoil had the largest profits in history (nearly 1 billion US dollars before tax). This was due to huge efficiency increases.

Figure H-6. Statoil Corporate Governance Structure



Corporate Finance

How the Company Is Financed. Statoil was originally financed by the fund transfers from the Treasury. Later, the Government imposed a hard budget constraint on Statoil's capital requirements and subsequent expansions have been financed by the cash flow and through the borrowing on international and domestic markets. Borrowing is in the form of issuance of bonds and obtaining lines of credits from the commercial banks. All these transactions are reflected on the balance sheet of the company. There is no formal Treasury guarantee securing the borrowing activities, however, for the lenders Statoil's status as a secure borrower may be implicit through government's ownership.

APPENDIX I

COALCORP (NEW ZEALAND)

COALCORP (NEW ZEALAND)
Case Study in Enterprise Reform

Company Information

Background Information. New Zealand is a parliamentary democracy which has a mixed economy with both private and state owned enterprises. Since 1984, New Zealand has implemented major economic reforms with the primary goal of enhancing economic efficiency. As part of those reforms, the government transferred commercial operations from conventional government agencies to nineteen state owned enterprises (SOEs).[1]

Before this transfer, the New Zealand government had tried to achieve a mixture of commercial and social objectives through the activities of departmental (i.e., enterprise) commercial operations; for example, promoting employment and keeping prices low for consumers. This led to a confused and conflicting set of objectives for the department itself, the inability of the government to monitor its performance, and the lack of accountability on the part of departmental managers. The end result was often a failure to achieve either the social or the commercial objectives.

In order to rectify this situation the government set up a new institutional structure in the State Owned Enterprise Act which was implemented in 1986. Section 4(1) stated that the principal objective of every state owned enterprise shall be to operate as an effective business and to this end be:

(a) as profitable and efficient as comparable businesses that are not owned by the Crown;

(b) be a good employer; and

(c) an organization that exhibits a sense of social responsibility by having regard for the interests of the community in which it operates and by endeavoring to accommodate or encourage these when able to do so.

In order to encourage this goal there were three key features of the operating environment which were established by the government:

(a) the separation of commercial objectives from broader social objectives;

(b) a competitive market in which the SOE would sell its product; and

(c) effective control and monitoring by the state.

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[1] Robert Anderson, The Establishment and Control of State Owned Enterprises: the New Zealand Experience, 1990.

The regulations, for the establishment and the functioning of the SOEs, are codified in the State Owned Enterprises Act of 1986. Under this act, SOEs are conferred the legal status of a limited liability corporation and, as such, are governed by the general laws applicable to all corporations. This was an explicit attempt to develop a legal structure for SOEs in order to mimic the best features of private sector companies. The SOE Act also refers to the relationship between the company and the owner, and to the monitoring procedure.

In 1987 the State Coal Mines, which had been under the auspices of a ministry of the New Zealand government, was transformed into a SOE and renamed CoalCorp.

Productive Capacity. CoalCorp is responsible for the operation of 12 coal mines and has two major businesses: (i) a domestic business based on Huntley Coal, and (ii) an export business based in the South Island. The enterprise holds licenses for over 120 million tones of bituminous and sub-bituminous coal amounting to 15 percent of total New Zealand reserves.

Products. CoalCorp has both opencast and underground mines which produce both thermal and coking coal. New Zealand coal is used to produce coke, activated carbon, cement, steel, briquettes, chemicals, and electricity.

Human Resources, Employee Welfare, and Social Assets. The number of employees at CoalCorp has greatly diminished, since incorporation in 1987, allowing for greater efficiency in the organization. There were 530 employees in 1994, down from 1,861 in 1987. Prior to corporatization all employees were covered by the Public Service Association for salaried workers or were part of the United Mine Workers Union. Presently, twenty percent of the staff are employed on an individual contract basis outside of union coverage.

Several small New Zealand towns, situated near mining operations, are inextricably linked to CoalCorp's future. These communities receive additional, although limited, support from the company in addition to the direct impact of job creation. For example, CoalCorp provided a car for the Huntly community constable.

Market Share. CoalCorp's annual output accounts for 50 percent of the New Zealand domestic market. CoalCorp is responsible for 65 percent of total coal production in New Zealand. The remainder is produced by forty to fifty privately owned firms. (1992 Figures)

Coalcorp competes in the commercial heating market with other coal producers. Since the establishment of the SOE there have been general adverse conditions in New Zealand, particularly due to the recession. The demand for New Zealand Coal has been greatly depressed and opportunities for Coalcorp in the electricity generating sector have been eliminated. However, Coalcorp feels that their position is sound in the bulk thermal market, and there is significant potential for long term growth.

With the depression of sales to the domestic market, CoalCorp has been looking more and more to foreign markets. In 1992, CoalCorp made a decision to greatly expand their existing

export market. As a consequence of a concerted marketing drive, export income for the 1993-94 year amounted to NZ $68.70 million, an increase of 49 percent over the previous year.

Financial Performance. Figures I-1 through I-6 below set out the summary financial data for the period 1987-1994. From its incorporation in 1987 until 1994, CoalCorp has achieved marked improvement in its performance despite generally adverse market conditions. This excludes a setback in 1992-93, due in part to a fire and explosion in the Huntley mines and the cost of restructuring. The encouraging statistics for 1993-94 demonstrate that CoalCorp has resumed its upward growth trend in terms of output, productivity and overall financial performance.

Figure I-1. Tonnes sold/employee

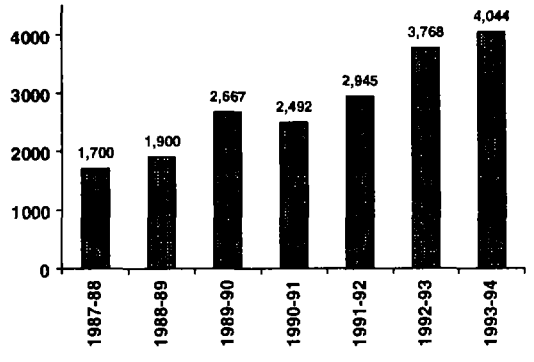


Figure I-2. Return on Shareholders Funds (Percent)

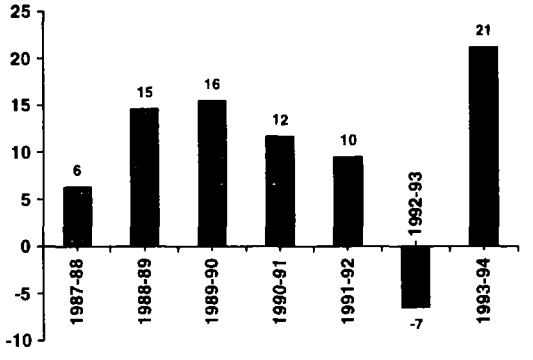


Figure I-3. Sales (000 tonnes)

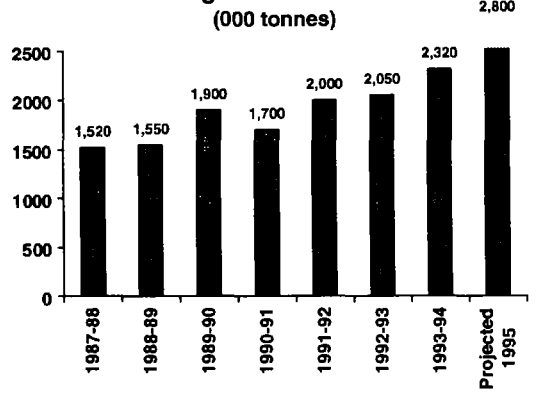
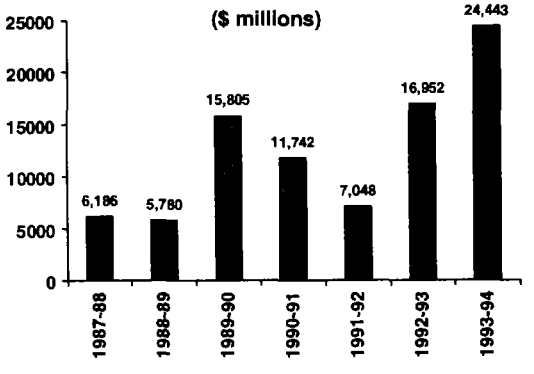
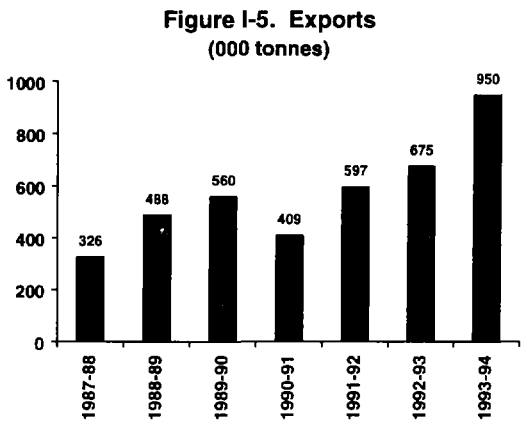
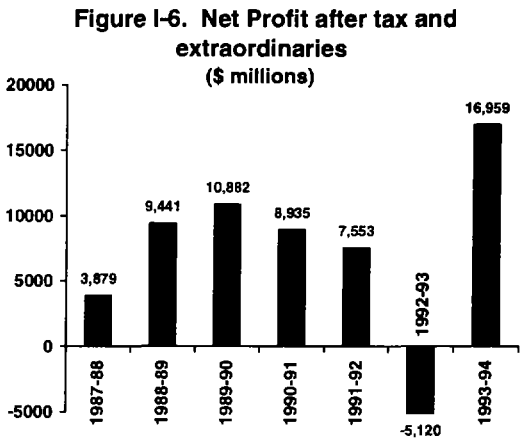


Figure I-4. Profit before tax and extraordinaries ($ millions)







However, this year New Zealand has been forced to enter into a joint venture in order to develop its west coast coal because the New Zealand Government will not put up the money. The joint venture partner chosen for CoalCorp's west coast project is Australian Pancontinental Mining Group which would pay $NZ48 million to CoalCorp to acquire a 60 percent interest and operational control of CoalCorp's west coast coal resources. The funds would be used by CoalCorp to meet its 40 percent share of expected capital costs of the proposed expansion. The joint venture is likely to be established on July 1, 1995.

Asset Management Model

Formal Representation of Government Ownership. The shares of each SOE in New Zealand are held by two government Ministers on behalf of the Crown. These Ministers are the Minister of Finance and the Minster of State Owned Enterprises.

The duties of the shareholders are primarily to monitor and control the commercial performance of the SOE through a board of directors. The shareholders are not expected to pursue broader social objectives through the company. Other Ministers of the government are responsible for ensuring the achievement of social objectives; indeed, the SOEs are not responsible for social objectives that reduce profitability unless compensated in full by a payment from the state.

Board of Directors. CoalCorp is monitored by a board composed of five to seven directors from the private sector. Board members are appointed and removed by the shareholding ministers, often after recommendation by the Crown Company Monitoring Unit or the Treasury. Ministers and government officials do not usually sit on the board, nor are managers of the company appointed to the board. The appointment of private business men and women to the board has gone a long way to ensuring the availability of sound commercial and business experience necessary to monitor and to provide strategic guidance to the managers of the SOE. This further avoids the problem of pursuing social objectives which may arise if ministers, or government officials, are appointed to the board. Of the thirty people in Coalcorp's

Corporate office, only two were associated in the past with the State Coal Mines and only a small proportion of the employees are ex-ministry of Energy or public service staff.

Membership on the board is part time employment and is remunerated as such. Board meetings take place monthly.

The relationship between the board and the state is regulated by the State Owned Enterprise Act. However, the relationship between the board and the company is determined by normal commercial practice. The board of directors:

(a) sets overall strategic targets and direction for the SOE;

(b) ratifies major decisions of the Board of Directors;

(c) ensures that the Statement of Corporate Intent (SCI), discussed below, is consistent with the objectives and criteria set out in the SOE act;

(d) is accountable to the shareholding ministers, whose appropriate channel of communication with the company is through the board rather than the CEO.

(e) manages the SOE in the best interests of the owner;

(f) appoints the full-time managers of the SOE; and

(g) determines compensation standards and incentive schemes for the senior management.

The principal duty of the board is to manage the SOE in the best interest of the State. The board has broad authority over the operations of the SOE. No constraints are placed on the SOE that do not apply equally to private industries. For example the board may hire and fire employees, set prices, and invest in new plant and equipment.[2] However, based on best practices in the private sector, the board does not usually make day to day operational decisions but determines broad strategy and ratifies major decision of the management. The board is responsible for the appointment of the executives, including the CEO.

Statement of Corporate Intent (SCI). Each year the SOEs must prepare a public statement of corporate intent in a style approved by the shareholding ministers. The key elements of the SCI are set out in the SOE Act and include:

(a) the nature and scope of the business activities of the SOE;
(b) performance targets for the next three years;
(c) level of the dividend to be paid;
(d) information to be provided to shareholding Ministers during the year;

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2 ibid p. 15.

(e) procedures to be followed when the SOE invests in any other company or organization; and

(f) any compensation that the SOE expects to receive from the government for pursuing non-commercial objectives.

The shareholding ministers, who may find it difficult to monitor the company through annual reports, rely on the performance targets put forward by the managers to assess the abilities of the management. If the company does not achieve its projected targets, the management may be fired by the Board. The preparation of the SCI involves the submission of a draft of the SCI, by the company, to the Ministers. The Ministers will then provide comments on the draft. A meeting is usually held between the board and the Ministers to discuss past performance and future targets. There are often differences between objectives of the shareholding ministers and the Board of the SOE in preparing the SCI. These involve:

(a) Financial targets: Shareholding ministers want these increased to create a greater incentive for the Board and management to improve efficiency. The board and management's performance are measured against these targets so they argue it is not practical to achieve such high targets;

(b) Dividends - both levels and frequency of payment; and

(c) Diversification and expansion: the government may wish to reduce its involvement in commercial activities while the well managed company may wish to expand.

The SOE submits financial reports and an audited annual report each year, to both the Board of Directors and the shareholding Ministers. If the figures in the reports are not compatible with those in the SCI, the company is asked to explain the differences. The state enterprise's statutory statements and reports, which are delivered to the shareholding ministers, must be put before the House of Representatives.

Other Factors Influencing Corporate Governance. Government policy since 1984 has been to remove most statutory barriers to competition and to assure that SOEs are not given competitive advantages compared to private enterprises. SOEs must pay the same taxes as private enterprises and must borrow from private financial institutions without state guarantees.

The assets of the former government departments were "sold" to the SOE at a price that approximated their market value as if offered for sale to other buyers. This assured that the SOE does not have a competitive advantage compared to other enterprises. The state provided a mixture of equity and debt capital for the SOE to purchase these assets. The interest rate on the debt was set at the normal commercial levels, and the debt principal was to be repaid in two to three years. Presently, the SOE is responsible for arranging debt financing from private institutions without government guarantees.

The enterprise now relies largely on its base business for profit. For the first two years after corporatization the profits of the company were significantly affected by aid from the Crown: (i) the revenue from coal stockpiles and stores was transferred to the corporation at no cost on 1 April, 1988, and (ii) the commission for surplus properties and other assets sold as agent for the Crown. These short term gains no longer have a major effect on the functioning or profits of CoalCorp.

CoalCorp is responsible for paying dividends to its owner - the government. The dividend payments for the proceeding year are set out in the SCI. If the company is not able to provide these dividends, the management is responsible for explaining the reason for this shortfall in its targets.

Box I-1: Factors Encouraging Positive Commercial Performance At Coalcorp

Internal

I. Separation of Owner, Board, and Management.

Shareholders

- CoalCorp is 100 percent owned by the New Zealand government.
- There are two shareholding ministries--Minister of State Owned Enterprises, and Minister of Finance--who formally represent government ownership.

Board of Directors

- The shareholders monitor the company through the board of directors.
- The members of the board of directors are chosen from the private sector.
- The board deals with strategic targets and directions for the company.

Management

- Elected and dismissed by the board of directors.
- Manage day to day affairs.
- Compile a Statement of Corporate Intent (SCI) which must be ratified by the board of directors and the Ministers.
- Must comply with the SCI.

II. Separation of Social from Commercial Objectives

- The shareholding ministers are only responsible for commercial objectives.
- Separate ministers have the duty to find options for social objectives.
- The Company will not be required to accomplish social objectives unless duly compensated, as in the private sector.

III. Competitive Rates of Pay and Incentives

- The Board establishes the competitive wages for the managers.
- The Board determines incentive schemes for senior management.

External

IV. Competition

- CoalCorp's annual output accounts for 50 percent of the New Zealand domestic market.
- Laws and regulations protecting State Owned Enterprises from competition have been abolished.
- CoalCorp has an expanding market overseas subjecting the company to competition from other state owned and private companies.

V. Finance

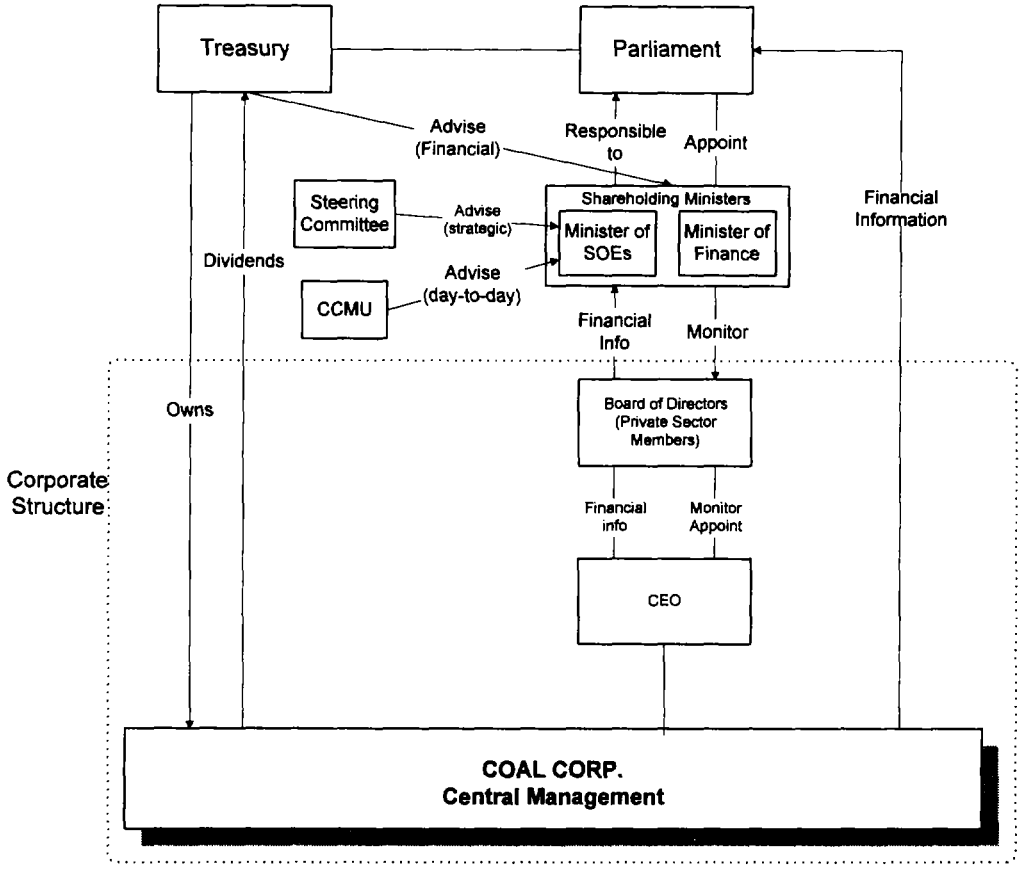
- CoalCorp pays the same taxes as private corporations.
- The government does not guarantee loans or debts for the company.
- CoalCorp is expected to earn a rate of profit and pay dividends to the State comparable to private companies.

Additional Monitoring. A State Owned Enterprises Steering Committee and Crown Company Monitoring Unit also monitor the performance of all of the SOEs. The committee is composed of individuals from the private sector who advise the Minister on strategic issues. The

Monitoring Unit, also composed of private sector individuals, advises only the Minister of State Owned Enterprises. The members of the Unit determine whether day to day actions by the management are in the best interest of the company. The monitoring unit advises the Minister on whether the Statement of Corporate Intent of each state owned enterprise is reasonable. For example, if the members of the unit believe that the Statement of Corporate Intent has underestimated the company's capacity to function profitably, they will advise the Minister to return the statement to the management for further review. The Government Audit Office is also required by law to audit the state enterprises financial reports.

Figure I-7 summarizes the corporate structure.

Figure I-7. CoalCorp (New Zealand)



Privatization. In 1988, the New Zealand government stated its intention to sell shares in CoalCorp to the public. The process was stalled in 1989 when the an injunction was granted to the Tainui Maori Trust Board, pending a decision relating to the Maori interests in land owned by CoalCorp. However, in late 1994 a negotiated agreement was being discussed which would allow the government to implement its policy of privatizing the company. This is a particularly significant decision since it reflects the government's recognition that the best way to lock in the hard-won efficiency gains from a "corporatized" company like Coalcorp is to move from mimicking the market to full exposure to market forces through private ownership.

APPENDIX J

IRI (ITALY)

IRI (ITALY)
Case Study In Corporate Governance

Company Information

Legal Status. IRI (*Istituto per la ricostruzione industriale)* is a State-Owned Holding Company (SHC), an ndependent Autonomous Management Agency which, until mid-1992, was neither a joint stock company nor part of the civil service. Until 1992 it had been under the control of a Ministry of State Holdings (*Ministero delle partecipazioni statali* or MPS), two cabinet committees, and the parliament. Through this holding the state has a controlling interest (*imprese a partecipazione statale)* in sectoral subholdings and operating companies which are private joint-stock companies, not nationalized ones, often with a substantial participation of private investors. Thus, the only "non private" entity is IRI itself.

Even though it was "non private" from a strictly juridical point of view, IRI always acted as a private holding group. This was the basic innovation introduced by the founders of IRI, who chose not to follow the model of nationalized companies, a model already widespread in other parts of Europe and in Italy. They preferred the framework of joint-stock companies, which they considered to be better attuned to a market economy, and therefore easier to be privatized.

Evolution of IRI. IRI was set up in 1933, as part of the rescue for the Italian banking system following the banking crisis of 1929. The role of IRI as a shareholder was initially conceived as a temporary one: industrial companies and banks had to be turned around and then sold back to the market, or liquidated. From its inception, IRI was quite free to privatize its portfolio (and in fact it did privatize many of the companies in the first three years), and to allow private capital to be invested in its companies. It was able to behave exactly as any other private industrial and financial holding.

Box J-1. Rationale for IRI's existence in Italy

– **1933** - IRI was established as a rescue operation for the Italian banking system and some of the major Italian manufacturing companies.

– **1945** - Allied Authorities concluded that the IRI Group presence could be positive for the Italian economy. IRI began to play a major role in the reconstruction of Italy.

– **1960s and the 1970s** - the Government gave IRI a somewhat different and wider role by entrusting (and burdening) it with two additional tasks:
- to contribute to the development of the Mezzogiorno (the economically underdeveloped regions of Southern Italy);
- to rescue lame-duck private companies which had suffered the 1973 and 1978 oil shocks.

– **last ten years** - the main effort of IRI was directed at the restructuring of its companies and ensuring the development of their international competitiveness.

From 1933 to 1960 IRI never received, or expected to receive, cash support or any other special privilege from the Government. IRI companies were managed with all the constraints of a (relatively) free market economy.

From 1945 onwards, IRI played a major role in the reconstruction of Italy, always following a free and open market philosophy, and without any special support from the Italian Government. Government's assistance came in the form of endowment funds. IRI was somehow expected to support and foster industrial employment all over the country.

The enormous tasks the government expected IRI to undertake in the 1960s and the 70s clearly could not be pursued by IRI without additional financial resources. Resources were needed both to maintain a reasonable investment/equity ratio and to face the huge risk factors typical of the areas abandoned by private enterprise. Indeed, some investment choices were mainly motivated by social issues, such as the preservation of jobs or the creation of new ones in less developed areas. At times, this also meant accepting a much delayed return on investments. Even then, public funds counted for only a relatively small share of IRI's total financial needs. For example, between 1970 and 1985, Government outlay accounted for between 7 and 12 percent of the IRI Group's capital requirements. The remaining 90 percent was financed by IRI (through profits and depreciation), or by private shareholders and/or banks, both Italian and international.

During the 1970s IRI incurred substantial losses. Its recovery in the form of comprehensive physical and financial restructuring began in 1980 with the sale of assets of certain loss-making activities, i.e., privatization of ALFA ROMEO, the raising of new capital on the stock exchange for the more profitable enterprises in the group,[1] a sharp reduction in the labor costs through retrenchment, and a reorientation of certain large strategic sectors, in particular, the subholdings FINMECCANICA, for engineering products and ILVA, for steel. The heavy losses in the 1980s were largely attributed to the high debt leverage of the companies coupled with a long period of very high interest rates.

IRI's recovery plan in the steel sector was particularly significant, involving the winding-up of a steel subholding FINSIDER, the transfer of strategic steel activities to a single operating steel company ILVA and finally, the elimination of non-strategic businesses.

In mid-1992, IRI underwent a drastic change in its statutes. With the appointment of a new Italian government in July of 1992, a decision was taken to convert IRI into a joint-stock company under private company law with the Treasury as the owner, with a view to eventual sale, i.e., privatization of its subholdings and operating companies.

Products. IRI is a multi-sector holding company with both industrial and service activities. IRI's subsectors as of December 31, 1992 included the following (see Figure J-1. below):

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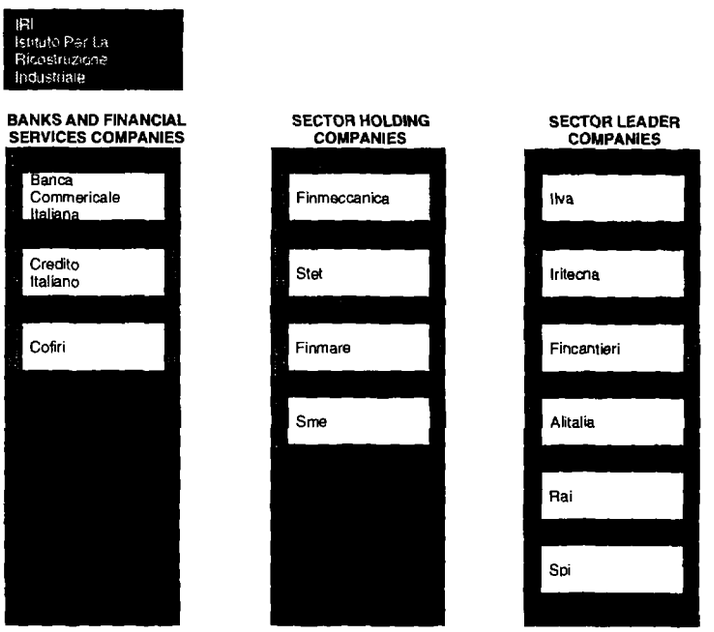
[1] The capital market approach followed a bottom-up strategy, beginning with the sale of stock in operating companies. In some instances (i.e., STET and FINMECCANICA) portions of IRI's holding in sector holding companies were sold through public offerings as well.

Figure J-1. Structure of IRI and Its Subholdings, December 1992

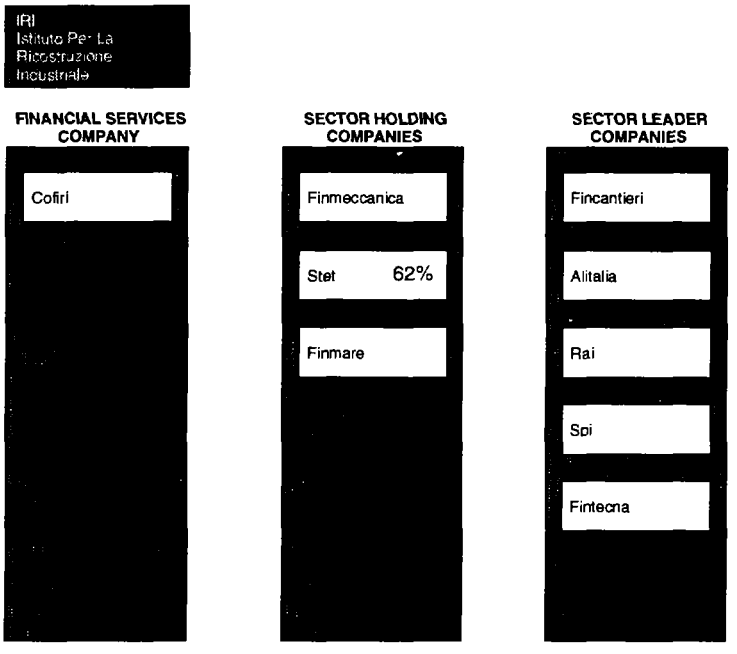


After 1992, IRI underwent significant changes: in 1994 it released control of two commercial banks (the so-called banks of national interest, in which it held 60-85 percent of total shares) left in its portfolio—BCI and Credito Italiano—through public offerings; SME was privatized; the civil and industrial plant engineering business was restructured and a new entity was formed—Fintecna (Iritecna is being liquidated); and the steel company, Ilva, was sold to the Italian Riva group in March, 1995 after substantial restructuring. The new subsectors structure is shown in the Figure J-2 below.

Box J-2. IRI Facts in 1991:

- majority shares in 540 companies
- minority shares in around 300 companies
- over 400,000 stockholders, who held shares equal to 44 percent of total consolidated net worth (35 percent for banks)

Figure J-2. Structure of IRI and Its Subholdings, May 1995



Employment. The number of persons employed in IRI fell from over 500,000 in 1984 to about 385,000 in 1992—a drop of nearly 25 percent.

Technology. The IRI Group spent about US$ 1,256 million in 1991 in R&D and employs over 12,500 technicians (full-time equivalents), 7,700 of whom are researchers. The group structure evolved continuously and it had recently expanded into high-technology areas where it could have an advantage in bearing the necessary heavy research costs such as biotechnology, communication networks and advanced production technology (Fintecna, Spi, Finsiel). Traditional manufacturing activities, in areas such as cement (Cementir) or food processing, began to be shed from the early 1990s.

Market Share.[2] In the domestic steel market, as of 1991 before major spin-offs were initiated, IRI's share was about 50 percent for steel alloys and special steel laminates, with cast iron and flat hot-worked products nearing 90 percent. In terms of EC production, IRI accounted for 8 percent of steel, 11 percent of cast iron, 14 percent of special steel laminates and 12 percent of flat hot-rolled products. The volume of its activities in the plant engineering sector places IRI in second position in Europe and tenth among other leading international groups. In the energy sector, IRI controls 70 percent of the Italian market for generating facilities and about 10 percent at EC level.

IRI plays an important role in the automation of continuous processes, as well as in the commuter aircraft segment of the aeronautic sector; its share in these markets in 1991 was respectively

2 *IRI Gruppo 1992-93 Yearbook*, pp. 22-24.

10 and 25-30 percent of total production. IRI accounted for 60 percent in Italy and 12 percent in EC of production in electrified railway transportation sector; for shipbuilding these figures were 70 and 10 percent respectively. In food processing IRI accounted for 24 percent of ice cream and frozen foods, and 15 percent of milk production. In sea transport IRI's share was 20 percent domestically and 3 percent at EC level, and in mass distribution - 5.5 percent. IRI is Italy's leading software manufacturer and the second in Europe. IRI's share in Italian banking in 1991 was relatively low: 8 percent for total domestic deposits and 11 percent for total domestic lending.

Financial Performance. IRI found it difficult to maintain consistent and acceptable levels of profitability. In 1990, the group made profits of around US$735 million but in 1991 total losses amounted to some US$200 million, and escalated to US$2.7 billion in 1992, and US$6.5 billion in 1993. However, net financial debt has continued to drop since 1993. At the end of March 1995, IRI reported a debt of L23,125bn which was L926bn lower than at the end of 1994.

Table J-1. Consolidated Financial Highlights of IRI Group (1990-93)
(US$ million)

	1990	1991	1992	1993
Value of production	48,632	52,835	54,873	47,483
of which foreign sales	7,502	8,250	10,253	11,908
Net income (loss)	733	(206)	(2,683)	(6,065)
Employment at year end (No.)	419,565	408,066	385,580	327,266
R&D costs	1,208	1,256	1,311	N/A
Net financial debt	36,587	41,876	47,986	41,850
Invested capital	55,947	62,959	67,072	55,992

[a/] The 1993 data was translated at the prevailing exchange rate on December 1993, i.e., 1US$ = 1,680.31 Italian lire.
[b/] Source: IRI Gruppo, 1993.

The Group's capital investment in the industrial sector was about US$ 11,774 million in 1991, representing 6 percent of the country's overall investment. Investment largely focuses on services, mainly telecommunications, as a further indication of the Group's interest in rapidly growing, high-technology areas.

Export revenues were approximately US$ 8,250 million in 1991. Around 76 percent came from manufacturing and plant engineering and 24 percent from the service sectors (air transportation, shipping and telecommunications). These figures represent 4 percent of Italian goods exports and 6 percent of service exports.

Non-economic objectives. Non-economic objectives are mainly defined as creating/preserving jobs and promoting investment in lesser developed areas. These objectives, imposed by the Government on IRI Group, adversely affected the financial performance and commercial objectives of its sub-holdings and operating companies. One such example was the regional development programs

in southern Italy (the *mezzogiorno*). SOEs have been required by law since 1959 to ensure that at least 40 percent of total and 60 percent of incremental investment directed towards new projects is located in these regions. In practice, this requirement has not been followed. Over 1987 to 1990, less than a third of total investment from IRI was directed towards the *mezzogiorno*.

Competition. Despite disappointing overall financial performance, some of the sectoral sub-holdings and operating companies of the IRI Group are nevertheless profitable. However, one can argue that government protection has created quasi-monopolistic position in some sectors. This may explain the high levels of profitability in such sectors as steel and telecommunications. The telecommunications[3] sector has been dominated by the telecommunication company SHCs and has long enjoyed significant tariff protections. In 1992, STET brought in the largest part of revenues (1,539 billion lire), or 20 percent of total revenues of the IRI Group (of 7,685 billion lire). In general, a large part of IRI's revenues comes from the service sectors. Price regulation by the state in these sectors results in prices of services in Italy being higher than in the rest of Europe. Some price controls for public services exist at both the national and the local levels, regulated (at the national level) by an Interministerial Committee.

IRI faces a prospect for increased competition, partly as a result of new European Union rules. Subsidiaries of IRI have enjoyed monopoly concessions in the past. In 1989 IRI had a 72 percent market share in telecommunications. This included the entire urban telecommunications network and half of the domestic inter-city long distance lines.[4] In telecommunications IRI has almost a complete monopoly, with the recent creation of TELECOM ITALIA.

Once the market is opened up, and foreign companies enter the market, it is anticipated that competition will increase. The 1990 law on competition policy and concentration of enterprises established a new antitrust agency, empowered to report directly to the parliament.

Asset Management Model

State Ownership and Interest. State ownership of the company is exercised in the form of a holding companies structure. At the level of the holding company itself the Board of Directors is the primary asset management tool.

Up to the 1990s IRI has been a holding company organized under administrative law and acting for the state as a shareholder in each of many enterprises organized under private company law. Since 1992 (following its transformation into a joint-stock company) IRI is itself a corporation under private law. Subsidiary holdings and enterprises were incorporated as joint-stock companies under the private law and are expected to follow 'criteria of economic viability'. IRI exercises stockholder rights according to the provisions of ordinary company law. Figure J-3 illustrates the corporate governance structure of IRI.

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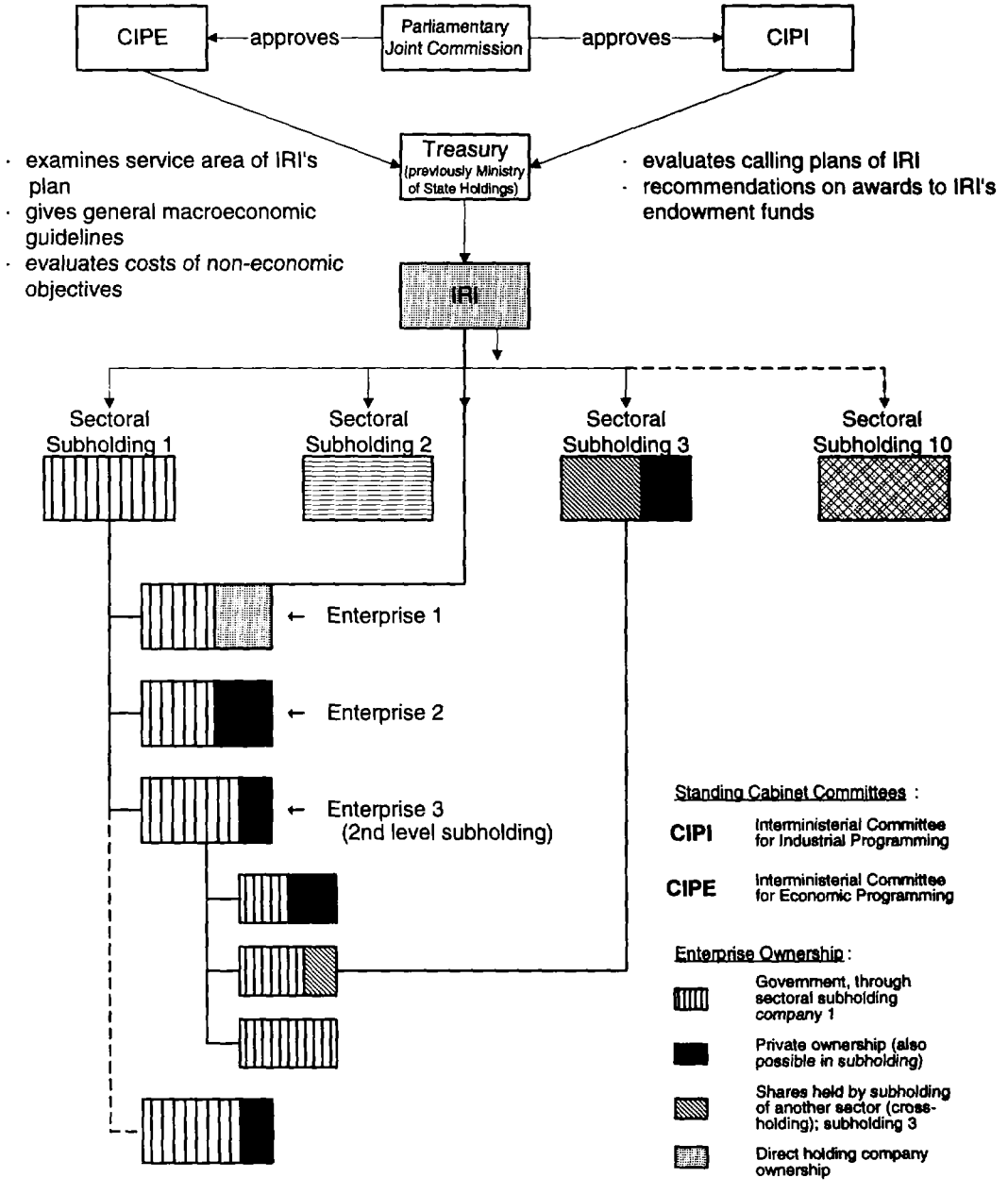
3 As in the case of broadcasting—RAI company.

4 Anjali Kumar, p.67.

Figure J-3. IRI: Ownership and Vertical Structure



The Purpose of the Holding Company, its Duties and Outputs. According to IRI statutes, IRI is an institution which 'manages the holdings and other assets held by it'. At the end of 1992 IRI holding had 563 employees, including persons on loan from group subholdings. Its principal roles are: (i) to manage the strategic planning of the group's activities; (ii) to review their financial implications and requirements.

The Council of Ministers is responsible for laying down the general guidelines to be followed by IRI in the public interest. IRI represents its subholdings and operating companies in discussions and formal relationships to the government. On questions of new projects, IRI conveys an overall proposal of subholding/operating company to the government, spelling out in particular its financial implications, in terms of the need for government support (shareholder's role of providing investment capital). The proposal goes to the two Standing Cabinet Committees - CIPI - Interministerial Committee for Industrial Programming, whose functions are to evaluate calling plans of IRI and to make recommendations on awards to IRI's endowment funds; and/or CIPE - Interministerial Committee for Economic Programming which examines service area of IRI's plan. IRI also keeps its enterprises appraised of relevant government policy guidelines and objectives, of general macroeconomic guidelines given by CIPE. In addition, IRI used to ensure the cost estimates of implementation of non-economic objectives with a help of CIPE which evaluated these costs, but this practice became rather lax by the beginning of the 1990s.

IRI's Board of Directors. The Board composition varied from 8-10 to 3 people. Currently the Board consists of 6 persons (civil servants and technical experts). Civil servants are usually part-time, non-executive senior civil servants from different ministries (indeed, most of them are at the level of Director General), and technical experts are full-time with no limits on renewing appointments,[5] but in essence, political appointees. The Chairman of the IRI Board and the CEO (or Director General) in some cases were the same person, but with privatization these two functions are separated, so that the Chairman who is politically appointed will have less influence on operational and privatization decisions. Thus, the CEO is member of the Board only when he is Chairman of the Board. The Board is appointed for the term of five years, with the Chairman and Vice-Chairman being appointed for three year term, renewable not more than twice.

In practice, since IRI was not a joint-stock company until July 1992; its Board was nominal only. The Board's members reflected "de facto" consent by more than affiliation to political parties in the Government.

Choosing the Board Members. The appointment of the Chairman and other Board and Committee members of IRI has been strongly influenced by political parties. The Chairman of IRI is appointed by the Prime Minister of Italy, and members of the Board of IRI are appointed by the Council of Ministers after recommendation and consultation with the Head of Treasury (Minister of State Holdings) and selected from among the party of the ruling coalition. This can pose problems for IRI's operation since the Government of Italy is often a coalition of several parties, and IRI's Board reflects a compromise reached by the coalition. Traditionally the Chairman is associated with the Christian Democrat party.

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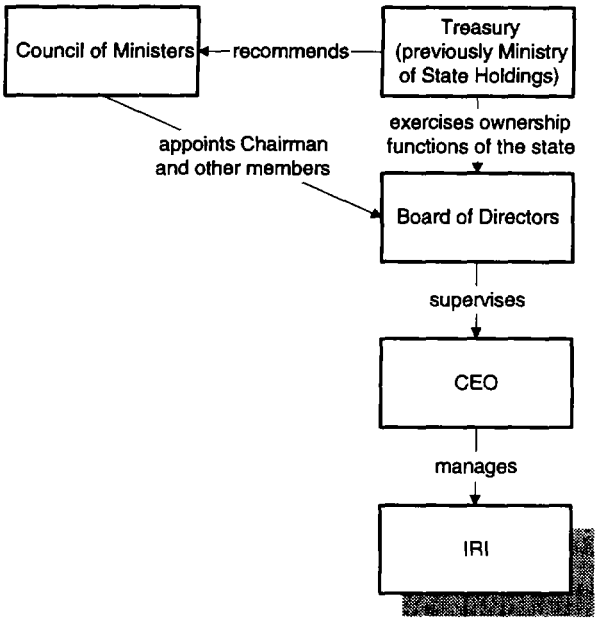
5 Anjali Kumar, p.74.

Figure J-4. IRI's Board and Management Structure



Private Sector Participation. In the present Board there are business appointees from the private and academic sectors. The influence from the private sector is very important.

Boards of Directors at the level of Subholdings and Operating Companies (Lower Levels). IRI's chairman, in consultation with its Board, appoints the chairman, vice-president, general manager and other Board members of subholdings in proportion to the shares it holds. Appointments are delegated to top executives of the subholding; in practice, there would be a consultation or negotiation with IRI. Board members are drawn from public and business life, including, at the subholding level, IRI's department heads. At the level of operating company, senior officers for the Board are drawn from the subholding, IRI itself and the top management of the same operation. There are no limits on renewal of appointments in subholdings and operating companies. The remuneration offered to the members of the Boards of subholdings and operating companies is standardized on the size of the company.

Shareholding Structure. Under IRI, a structure of subholdings (*finanziaria*) and operating companies (*azienda*), is grouped broadly by sectoral area of activity. Table 6 illustrates this structure. The structure is flexible and variable which is largely the outcome of evolutionary development and current requirements, rather than the result of an application of a specific formula. Not all first-level subholdings are financial subholdings in the IRI sense; some of them are large operating enterprises which are placed directly under IRI. Some holdings have further holdings below them. Cross-holdings occur quite often when IRI directly holds shares in lower level operating companies. The organizational concept, i.e., the three level structure, often generates significant inefficiencies: in some

cases it shows results in duplication of tasks/ responsibilities and "power" struggles that cause delay in decision making and lead to higher overheads. Some critics have argued that, in order to achieve greater efficiency, IRI should be a lean organization, probably 1/5th its present size.

Private Sector Ownership. An important feature of IRI is the fact that most of its subholdings and operating companies below them are partially owned by the shareholders from the private sector. Usually their stake is limited to no more than 49 percent (i.e., minority stake). In 1992, IRI's shareholding in its subsidiaries varied from 100 percent (ILVA, SPI) to a little over 50 percent for STET (telecommunications) and around 70 percent for SME (food). Other, minority shareholders are private Italian or foreign nationals/companies. Investors can purchase shares in IRI Group companies through the stock exchange, since some of the subholdings and operating companies are listed there. In cases when IRI has minority shares in the companies (in 1991 it had minority shares in around 300 companies), the majority ownership of the companies could as well be private Italian and/or foreign. IRI actually concluded technological/marketing alliances and partnerships with foreign companies which in some cases turned into shareholding agreements. One such example was in 1991 when FINMECCANICA's operating company ALENIA purchased a 49 percent stake in an American company, Space System Loral (ex-Ford Aerospace).

IRI's CEO used to be appointed by the Minister of State Holdings (now that the company is under the Treasury, this function is carried out by the Head of Treasury) from a short list proposed by the Chairman of the Board. Until late 1980s there has been a high degree of stability in the chief executives over time, with only 6 chairmen and six CEOs in forty years. There were instances where the CEO was the Chairman of the Board.

Corporate Management Compensation. All senior executive jobs were salaried, with high salaries which did not follow the civil service pay scale. Salaries of top positions in the principal holdings and operating companies were negotiated, in view of objectives and responsibilities, and paid directly by IRI. The mobility of personnel between the various branch holdings was high, and movements to and from the private sector also occurred.

Minimum wages at other levels were determined through a national system of collective bargaining, by sector. Different elements of the contract were negotiated at national, sectoral and enterprise levels. Although there are two separate employers' organizations for the private and public sector, there is no major difference between the nature or level of their wage agreements. The two organizations are *Intersind* for the public sector and *Confindustria* for the private sector. Both contracts are under private law, unlike the contracts of public departmental undertakings.

Bonus System. Performance linked bonuses were offered to the senior management of subholdings and operating companies. They were up to 20 percent of the basic wage, based on the Hay point system, which was introduced in the mid 1980s.[6]

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6 Anjali Kumar, p.75.

Corporate Finance

Equity Financing. Financial structure of the IRI Group is two-fold—equity and borrowing. Original capitalization of IRI came in the form of the Ministry of State Holdings' transfers of equity, i.e., endowment funds (*fondo di dotazione*). Thus, equity is provided to IRI by the government. IRI in turn makes equity contributions and extends equity loans to subholdings. Subholdings in their turn, give equity and corporate guarantees to the operating companies.

Endowment funds became the principal channel of government transfers of funds to IRI, intended to be used for recapitalization, restructuring or for new investments. (See Table J-2. for government assistance to IRI.) In practice, net transfers of endowment funds to IRI were heavy in the early 1980s and were used essentially to relieve its accumulated debt burden, permitting it also to extend the maturity of its debt and convert foreign debt to domestic debt.

Government's contributions through the endowment fund allocation depend upon a process of negotiations. There have been often delays and non-implementation of financial contributions. The form of compensation used is a direct Treasury subsidy, forwarded through IRI to the relevant subsidiaries. This is in accordance with EC directives.

IRI was reimbursed by the government for implementing non-economic objectives. For example, IRI's investment proposals presented to the government included details on incremental employment created in four designated 'crisis areas': Naples, Taranto, Genova and Terni, together with the estimated cost of this additional employment creation. Until the beginning of 1980s Interministerial Committee CIPE paid close attention to calculations of costs of non-economic investments which were taken into account when payments from the endowment fund were made. Now this does not hold anymore, although special cases may be negotiated, as in the case of the steel sector.

When Government transfers declined in the mid 1980s, IRI began partial privatizations of its larger enterprises, initially through the issue of convertible bonds and warrants, later through the placement of new listings and through the sales of existing shares. Government transfers through the endowment fund mechanism stopped completely in 1987.

IRI also received funds from the government for the purchase of stock in private companies on the verge of bankruptcy—through the GEPI (*Gestioni e partecipazioni industriali*) fund, which is an independent legal entity with its capital held equally between the three major state holdings. Total capital losses per entity on account of GEPI by December 31, 1989 amounted to US$250 million. After 1990 the government revoked funds which it had granted earlier and delayed reimbursements, in essence imposed a hard budget constraint on IRI, since it could no longer afford transfers and its subsidies were greatly criticized by EC with regards to its recent competition policy directives.

Borrowing. Government guaranteed borrowing was effected along two lines—(i) loans to IRI from the European Investment Bank (EIB); and (ii) large bond issues of the IRI Group, where the holding company makes payments to the bondholder. In both cases the Treasury undertakes to reimburse the holding company for the repayment of the principal and interest. But the Government was not always servicing the debt on behalf of IRI, more often it reimbursed the interest expenses only

(these bonds were a substitute for equity). Bond issues by IRI (guaranteed by the Government) played an important role - they were alternative means of procuring the necessary funding not otherwise provided by the shareholder.

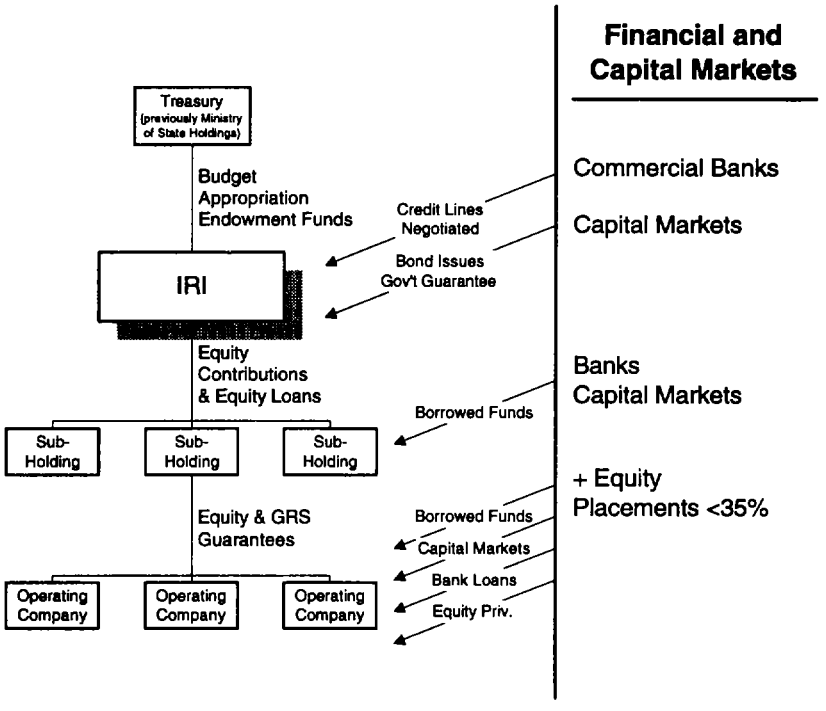
Table J-2. Government Assistance to IRI Group (1984-1989)
(US$ million)

	1984	1985	1986	1987	1988	1989
Endowment Funds (excluding GEPI)	2,129	1,124	584	14	–	–
Capital and Interest Repayment on EIB loans	–	30	48	76	81	142
New EIB loans	307	95	741	648	783	572
Bond Issues	–	612	783	386	–	–
Assistance	2,437	1,989	1,789	773	641	558
Profits/Losses	–	1,279	-684	-53	-1,325	-798

In commercial banking borrowing, the financing structure of IRI has been targeted towards maximizing leverage. In essence, the same implicit government guarantee allowed the Group to effect borrowing at three levels - at the IRI level itself, at the level of subholdings, and at the level of operating companies. IRI has extensively used this mechanism, especially after 1984 when there was a rapid decline in government transfers. IRI did not have an explicit guarantee from the Ministry of State Holdings; instead, IRI was considered to some extent a "sovereign" credit by virtue of a perception, as it benefited from an informal umbrella guarantee from the Government. This became very clear in 1991 when a sister organization of IRI in the state holding system (EFIM) asked to reschedule its debt service and the Government did not take over its indebtedness. EFIM was liquidated much later and in the meantime the Government helped by all possible means in order to avoid default, which would have negatively affected the overall Italian credit rating, but the principle of an umbrella guarantee was denied.

As to IRI, with the transformation into a joint-stock company fully (100 percent) owned by the Treasury, such a guarantee indeed came into existence because the Italian Commercial Code states that the sole shareholder is jointly and severally liable for the controlled company's obligations. As to subholdings and operating companies (second and third tiers), this principle holds to the extent there is an explicit guarantee by IRI itself on their indebtedness. This is not at all current practice because: first, some subholdings have long since developed independent access (and credit rating) to financial markets (both domestic and international) based on their own balance sheet, like for example, STET and FINMECCANICA; second, particularly in periods of financial rationing, the banks' perception of the credit risks declines as the borrower is placed closer to the productive assets: this happened in the IRI Group when additional lines of credit were more available to operating companies than to subholdings. The terms at which the financial community was extending loans to IRI's companies were not different from those of the other private companies. Furthermore, there was a "negative covenant" in the former IRI's banks operational directives, concerning exposure limits to IRI's industrial sector.

Figure J-5. IRI's Financial Structure



Political Impact on Finances. Although the subholdings and operating companies of IRI did not receive any preferential treatment from the banks and other players in the financial community, there are reasons to believe that sometimes this was the case before IRI became a joint-stock company in 1992. First of all, the mere size of these enterprises made them a powerful and big client, which would be preferable to deal with over that of the private sector. Secondly, the implicit government guarantee, i.e., a "de facto" strong patronage, made IRI companies secure borrowers, and positioned them favorably on the customer priority lists of the banks. These seemingly harmless factors have a great implication for the private sector development in the country, i.e., the latter was negatively affected. Since the financial markets have only finite amounts of capital to lend, and the distribution is limited to identifying the most powerful borrowers, and if they are the ones from the public sector, that means that the private sector development will suffer.

Bond issues by IRI Group represent the same type of problems. Government guarantees had an influence on the credit ratings of these companies, boosting them up, thus, the ratings picture could have been distorted. Again, from the point of view of investors, their money resources are limited and they make their decisions based on the ratings, thus, if public sector dominates the scene, one would expect the private sector to be crowded out and having more difficulties in financing its expansion and new investments. A second point, which is even more important, is that often money raised by the IRI Group through the commercial paper turned out to be used inefficiently, i.e., the money was invested into inefficient companies often to cover their debts or debt payments.

Existing political patronage of IRI has been sub-optimal for the company from the commercial point of view. More often than not it didn't take into account the profitability of the company. IRI Group has become embroiled in the patronage and corruption of Italian politics (consider the number of senior executives implicated in the scandals of the last few years).

Dividends Policy. The formula on the division of profits or the distribution of dividends is not complex. At the level of operating enterprises, there was a requirement to transfer 5 percent of profits to legal reserves. This is however required under the Commercial Code and it applies to all companies. In one company AUTOSTRADE, a limit of 8 percent on the distribution of dividends had been adopted, but this was a special case, based on the concession system regulating its activity. In practice, any such restriction has been circumvented by the issuing of new rights shares. Dividends were not necessarily distributed if profits were made; the past record of profits and losses, as well as proposals for new investments, were taken into account. At the IRI level, the issue of remitting of dividends to the government, even when IRI did show profits, has not arisen. So far transfers have been exclusively in the opposite direction. The government did not make any explicit claims that it wants/expects a dividend payment for its equity contributions to IRI.

APPENDIX K

SUMER HOLDING (TURKEY)

SUMER HOLDING (TURKEY)
Case Study in Corporate Governance

Introduction

Sumerbank was established as a state organization in 1933 as part of the Government's program to promote industrialization. Sumerbank commenced its operations in the textile and banking industries with capital of TL20 million, 5,000 employees, and four factories.

During the 1980s, Turkey embarked on a program of economic liberalization which exposed many of the weaknesses of Turkey's State-Owned Enterprise (SOE) sector. Despite the efforts of the Government, SOEs continued to operate inefficiently and produce large losses. By 1990, all loss-making SOEs accounted for TL5 trillion (1.9 percent of GNP) of losses.

The Government's renewed answer to the problem of SOE losses was to transform the SOEs into enterprises that more closely resembled private commercial enterprises. Accordingly, the Government in 1984 adopted Decree Law 233 which afforded the SOE's greater operational autonomy through the introduction of a corporate governance structure similar to that of a commercial enterprise. The Government in 1986 also passed Law 3291 which outlined the decision making process and procedures for corporatization and privatization.

By 1992, the Government's privatization program had accelerated with the privatization of relatively large cement companies, several agro-industry firms, and the continued sale of minority shareholdings. In July 1993, the Government received a Parliamentary vote of confidence for reform which earned privatization a central role in accomplishing the economic tasks of improving efficiency and reducing the fiscal deficit.

In mid-1993, the banking division of Sumerbank was split from its industrial divisions and the resulting companies were called Sumerbank and Sumer Holding, respectively. To date neither Sumer Holding nor Sumerbank has been privatized.

Products and Industries

Since its formation, Sumerbank developed production facilities in the steel, pulp and paper, food, soil, and chemical industries. Its major interests, however, remained in the textile, garment, and shoe manufacturing industries. Over the past several years Sumerbank has divested itself of many of its non-textile enterprises such as Karabuk Iron-Steel Enterprise, Sivas Cement Factories, Bozuyuk Ceramics, Kutahya Ceramics, Konya Crome, Bolu Laminated and Fibered Panel Factory, and Ordu Soybean San.

Sumerbank's, and now Sumer Holding's textile operations utilize 28 enterprises and 7 affiliated companies, produce cotton and woolen yarn, textile items, ready-made articles, hand-

made and machine-made carpets, leather articles (shoes, garments), viscon, valex, tiles, porcelain and textile dyes. Sumer Holding distributes its products throughout Turkey using its 17 regional sales directorates, 435 retail stores, and 62 distribution agencies; all of them affiliated with a marketing enterprise headquarters in Istanbul.

Move Toward Privatization

Historically, SOEs such as Sumerbank have not been managed as commercial enterprises; rather they have been managed as governmental departments. Persistent political interference has deprived the SOEs of the flexibility required to adjust to changing market conditions. Furthermore, non-commercial objectives that conflict with financial considerations have been required by the government; including inflation abatement, employment generation, regional development, support for the agricultural sector, income redistribution and industrial and infrastructure development.

In 1986, Turkey adopted its privatization law 3291 to remove State interference from industries such as Sumerbank and to raise revenue. Under the decree, Sumerbank was placed under the control of the Public Participation Administration (PPA) and slated for privatization. The PPA has been converted into the Privatization Administration (PA) and both Sumer Holdings and Sumerbank continue to come under the PA's administration.

Presently, Sumer Holding is active in textile production, related chemical industries, and small pipe manufacturing. Sumer Holding comprises approximately 35 plants, 433 retail outlets and several distribution and marketing agencies, and employs 27,000 staff and employees. Sumer Holding's domestic market share is modest with 8.9% in cotton, 16.6% in cotton weaving, 4.2% in woolen yarn, 8.4% in woolen weaving, and 3% in hand-made and machine carpets.

Sumer Holdings was to be privatized by Spring 1994. The goal is now for privatization by late 1995; however, the same issues which hindered its earlier privatization still exist. Thirty textile plants are to be privatized via separate tenders between May and August. The PA has sent financial information to 1,200 potential foreign and domestic investors. Reorganization and consolidation in some plants has begun, although the process remains somewhat inefficient. 300 retail outlets have been privatized, primarily through sale to their employees.

Analysis of Performance

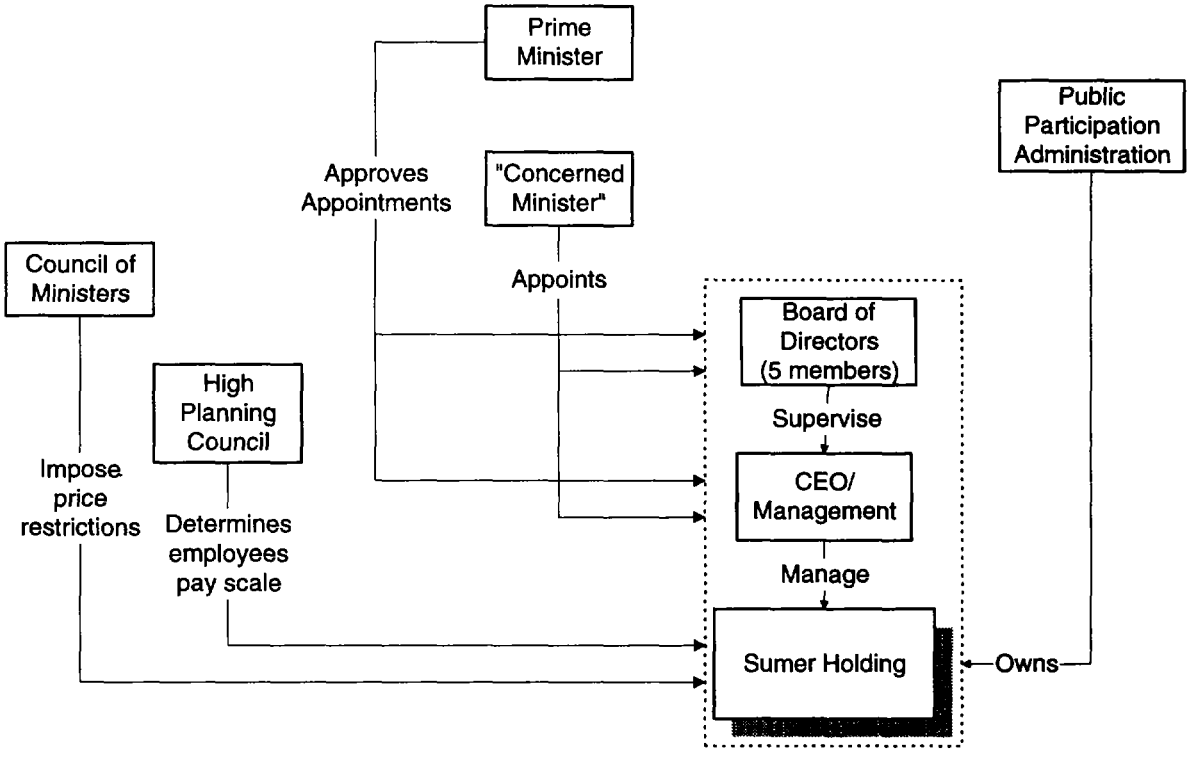
In 1992, Sumerbank (prior to the split) accounted for less than 8% of the major textile production in Turkey. Sumer's exports of $50 million, accounted for less than 1% of Turkey's textile exports of $5.4 billion. Sumerbank posted net losses in 1992 of $960 million. The level of losses in recent years, if anything, has increased. Most losses are due to rolling over debts.

Financial performance remains low as Sumer Holdings continues to be susceptible to problems generated by political interference, such as the setting of non-economic goals and a surplus of employees.

Governance

Decree Law 233, adopted in 1984, describes the governance structure in which most SOEs, including Sumer Holding, must operate. (See figure K-1. below.)

Figure K-1. Sumer Holding Corporate Governance



Concerned Minister. Under the Decree, SOEs are supervised by a specific minister refereed to as the "Concerned Minister." The Concerned Minister is either the existing line minister (for example the Minister of Agriculture or Transportation) or as in the case of Sumer Holding, a newly created Minister of State under the office of the Prime Minister.

Board of Directors/Management. Each SOE has a Board of Directors consisting of six members. The Chairman of the Board is also the CEO (Director General) of the SOE. Of the other five board members, two are selected from the upper-level management of the SOE. Therefore, three of the six board members (including the Chairman/CEO) are part of the SOEs management team.

The Board of Directors is responsible for supervising the SOE by:

(a) establishing the SOEs' operating principles and policies;
(b) ratifying the annual programs and reports of the SOE, its subsidiaries and affiliates;

(b) ratifying the annual programs and reports of the SOE, its subsidiaries and affiliates;
(c) appointing the SOEs' assistant directors general and other management, as well as the Boards of Management of the SOEs' subsidiaries and affiliates, all nominated by the Chairman of the Board/CEO;
(d) monitor the activities of the CEO; and
(e) establish rules for the use/purchase of vehicles by the SOE.

The Chairman of the Board, as well as four other board directors are appointed by the Concerned Minister. The one remaining board member is appointed by the Treasury. All six of the appointed directors must be approved by "joint decree" which entails the signed approval of the President, the Prime Minister and the Concerned Minister.

Each Director serves a three-year term with the option for renewal. A director of one SOE may not serve on the board of any other SOE. The board is required by the Decree to meet at least two times per month. The frequent meeting schedule as well as the high number of board members who are from the SOEs' management team has been criticized for encouraging the board to manage the affairs of the SOE versus supervising its activities.

Subsidiaries. The subsidiaries of a SOE are formed by a board of director resolution of the parent company. Each subsidiary is managed by a Board of Managers. The board of managers consists of a Chairman, who is also the CEO of the subsidiary, and four members from the subsidiary's upper-level management.

Government Role. The Government has a role in the overall activities of the SOE. The High Planning Council (HPC) consists of nine members including the Prime Minister, seven ministers and the undersecretary of the State Planning Organization. The HPC is responsible for general economic policy, development plans, the affairs of the SOEs and since 1986, the privatization of SOEs. One responsibility for the HPC is to determine the pay scale for employees. The HPC has been criticized in performing this task because by approving low, non-competitive salaries it has prevented SOEs from attracting high-level employees.

The Council of Ministers also affects the SOEs through its role of imposing price restrictions and other types of duties on the SOEs.

APPENDIX L

HINDUSTAN MACHINE TOOL (INDIA)

HINDUSTAN MACHINE TOOL (INDIA)
Case Study in Corporate Governance

Company Information

Background Information. State Owned Enterprises (SOEs) have played an important role in the Indian economy since 1956, when the Industrial Policy Resolution gave the public sector a strategic role in the economy. The resolution reserved 17 industries, considered to be of strategic importance, for the public sector and empowered the government to regulate all industries through licensing. Massive investments have been made by the Indian government over the past four decades to strengthen the public enterprise sector. State Owned Enterprises manage 55 percent of the economy's (excluding households') capital stock and account for one-fourth of non-agricultural GDP.

Established with the collaboration and equity participation of Oerlikon of Switzerland to produce machine tools in 1953, Hindustan Machine Tools (HMT) became a fully owned undertaking of the Government of India in 1957. For many years HMT was the Indian example of how companies can be profitable and innovative in the public sector. In recent years, however, HMT has for the first time been experiencing losses.

Activities and Productive Capacity. One of India's largest producers of machine tools, HMT has a diversified business and produces a broad range of industrial and consumer goods (machine tools, tractors, printers, bearings, watches, lamps, etc.). HMT has two wholly owned subsidiaries, HMT International Limited and HMT Bearings Limited, as well as one partly owned subsidiary, Praga Tools Limited. HMT has 16 manufacturing units spread throughout ten states with its headquarters based in Bangalore.

Human Resources. A major problem facing HMT is that of extreme overmanning caused by government's use of the company for job creation. HMT has a work-force of more than 28,000. In October 1992, HMT chairman P.C. Neogy implemented a voluntary retirement scheme in order to address the problem. By 1995-96 HMT's workforce should be reduced by twenty-five percent. This should increase value addition per employee from Rs. 1.5 lakh per person to Rs. 4 lakh by 1996-97.

Technology. The 1990-1991 HMT annual report recognized the importance of research and development (R&D) to HMT's future business and stated that in the past the company has made significant progress in the development of its products through its R&D efforts. However, a recent article contends that much of the technology being worked on by HMT's R&D

department has been available for some time in many countries.[1] In order for HMT to compete domestically and become a global player they must have state-of-the-art technology.

Market Share. The HMT machine tools group had 40 per cent of the market share in 1991. The percentage has diminished as sales have dropped in recent years. In the tractor division HMT has 10 to 12 percent of the market share. In terms of global ranking HMT's machine tool industry is number eighteen.

Financial Performance. Until 1991 HMT grew rapidly in terms of sale and production, although profitability remained low and has been declining since the mid 1980s (except in tractor unit). For numerous years HMT has been indulging in practices such as overselling, dumping products at low prices at high credits, and booking sales for the following year in advance.[2] Since 1991, the decline of investment in the economy together with a sharp reduction in capital goods tariffs affected numerous Indian companies. In 1992-93, HMT, finding it difficult to cope with external and domestic competition, recorded a net loss for the first time in its history. The turn-over in 1992-93 was about Rs. 8 billion (approx. US$248 million) slipping 22 percent from the previous year. HMT was one of 24 state owned enterprises to sell a portion of its equity to public sector financial institutions in 1991 and 1992. Just over 5% of HMT's equity has been sold to date.

Significant Changes Over the Last Five Years. In July 1991 the central government of India announced a three-pronged strategy to improve SOE finances consisting of: (i) eliminating SOEs privileges such as entry barriers, protection from external competition, and preferential access to budget and bank resources; (ii) restructuring potentially viable SOEs, liquidating others, and establishing a safety net program to cushion the social cost of this process; and (iii) providing SOEs more autonomy and the mandate to become profit oriented. This approach has had limited success. The profits of profit-making SOEs have not improved, and the losses of loss-making SOEs have not declined.[3]

In 1991, the Department of Heavy Industries (DHI), in conjunction with HMT, arranged for a team financed by the Japan International Cooperation Agency (JICA) to assess changes needed to enhance the competitiveness of HMT. In May 1992, JICA submitted a recommendation to the Government for a comprehensive restructuring program of HMT including:

(i) organizational restructuring;
(ii) $330 million investment for the modernization of production facilities;

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1 Stuart E. Wicks, Hindustan Machine Tools, July 1994, p. 25.

2 Meera Shenoy and Devaprasad Purokayastha, "HMT: Learning to Dance," Business India, February 28-March 13, 1994, p. 67.

3 India: Recent Economic Developments and Prospects, Report No. 12940-IN World Bank: Washington, D.C., 1994, p. 55.

(iii) promotion of productivity improvement activities;
(iv) promotion of mechatronics (technology combining mechanics with electronics); and
(v) intensification of export promotion and expansion of international operations.

The study recommended that HMT should be reorganized into three main business groups, focusing on the most profitable lines of business: machine tools, tractors, and industrial machines. The project is to occur in two phases. During Phase I, HMT would be restructured into five main business divisions, including the three listed above plus engineering and consumer goods. Phase II would involve consolidation of the three main groups under the ownership of a holding company. The other groups would become separate companies able to form joint ventures with multinationals and HMT would withdraw from production areas where major and risky developments are required in order to compete with private companies. During Phase II joint venture companies are to be formed with foreign private strategic investment partners and government shares are to be disinvested through public sale.

Based on the recommendations of the JICA study, HMT in coordination with DHI elaborated a detailed restructuring program for government approval in May 1993. In January 1994 the Government approved the HMT restructuring program and authorized HMT to engage a professional agency to identify suitable joint-venture partners. By March 1994, HMT Chairman P.C. Neogy had taken the first steps and separated the company into the five divisions as suggested in Phase I.

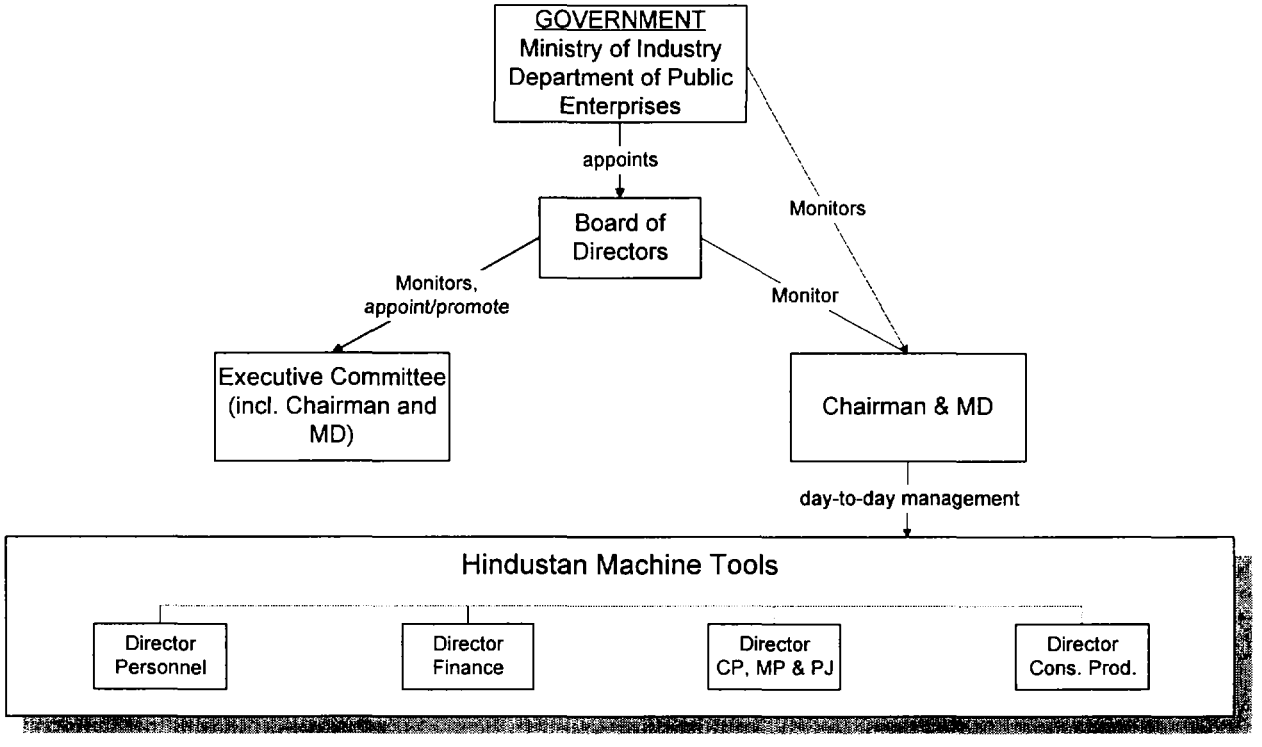
In August 1994, the government decided to privatize the machine tools and tractor divisions. Three private sector companies, Mahindra & Mahindra, Escorts and TAFE showed interest in becoming joint sector partners of the tractor division of HMT. As to date no joint ventures have been entered with these companies. However, the Indian government approved the proposal of HMT and Sudmo Scheicher of Germany to float a joint venture company for process engineering and marketing of automated food processing lines.

Asset Management Model

Government's Ownership of the Company. The formal representation of the government in HMT is through a Board of Directors. (See Figure L-1.) The Prime Minister, through the supervisory ministries, acts on the behalf of the government to monitor the company through the Board.

Supervisory Ministries. The supervisory ministry responsible for overseeing the functions of SOEs, including HMT, is the Ministry of Industry. The Ministry of Industry comprises the Department of Industrial Development, the Department of Small Scale Industries and Agro and Rural Industries, the Department of Public Enterprises, and the Department of Heavy Industry. The most important to HMT is the Department of Public Enterprises.

Figure L-1. Hindustan Machine Tools



The Department of Public Enterprises originated in 1965 in response to a need for a centralized coordinating unit which could make continuous appraisal of the performance of state owned enterprises. The Department of Public Enterprises acts as a central agency for all SOEs and assists in policy formulation pertaining to the role of SOEs in the economy in addition to formulating policy guidelines on performance improvement and evaluation, financial accounting and personnel management. The Department collects, evaluates and maintains information on several of the SOEs and provides an interface between the SOEs and other ministries.

In order to accomplish these duties more effectively the Department is divided into five sections: the financial policy division, the management policy division, the MOU division, the administration and coordination division and the permanent machinery of arbitration.

The Department of Heavy Industry administers 48 public sector undertakings, including HMT. The department assists the SOEs in their efforts to improve capacity utilization, increase profitability, generate resources, and establish linkages with the user sections.

The Department of Industrial Development is responsible for formulation and implementation of promotional and regulatory measures for balanced and rapid growth of the industrial sector, taking into account national priorities and socio-economic objectives.

The Board of Industrial and Financial Restructuring is in charge of restructuring or liquidating chronically loss-making enterprises.

Duties of the Supervisory Ministry.

- setting Board guidelines
- issuing government guidelines/directives
- creating 5 year capital outlay plans
- making foreign investments
- making foreign technology agreements
- creating privatization policies
- managing share holding, joint venture, or joint working arrangements
- Dealing with matters relating to the Memoranda of Understanding
- assisting interface of the company with Parliament or other departments of government
- declaring dividends
- restructuring

Board of Directors. The Prime Minister is responsible for appointing the members of the Board of Directors. The Board of Directors is composed of government officials from the Department of Public Enterprises and the Department of Heavy Industry as well as outsiders such as from the Stock Holding Corporation. A number of directors are also elected from within the company. In 1991 there were twelve Board members up from 6 in 1988.

Duties of the Board of Directors.

- rolling 5 year corporate plans
- annual operating plans
- research and development, technology, products development plans
- financial plans
- appointment/promotion of executive directors
- manpower plans
- revision of wages/salaries/benefits in accordance with guidelines issued by the Government.
- revision of annual bonus/incentives
- pricing approval
- borrowing
- investments
- delegation of managerial power

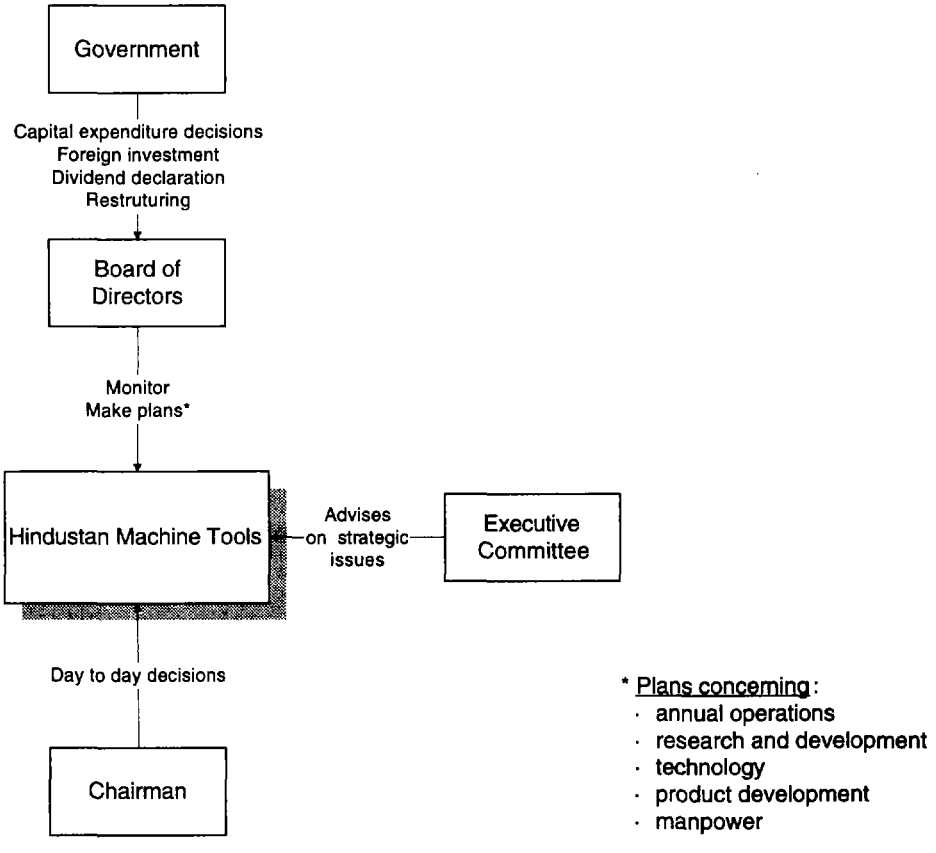
Executive Committee. The executive committee is comprised of some members of the Board of Directors, including the Chairman and Managing Director, and the executive directors of the various sectors of the company. These members are appointed by the Board of Directors. The Executive Group is responsible for advising the company on strategic issues.

Chairman and Managerial Director. The Chairman of the Board of Directors is appointed by the Government. At HMT the Chairman and the Managerial Director roles have been combined. The present chairman and managing director of HMT is C.P. Neogy. Decisions made by the chairman are ratified by the government through the Ministry of Industry.

Management. To date, SOE managers have been given a mandate to run SOEs as profit-oriented commercial concerns, but have not been given the authority to introduce necessary restructuring measures, such as large scale retrenchment, corporate reorganization, closure or selling of units, and joint ventures with private investors. All such measures have required the approval at Cabinet or Parliament level through a time-consuming and often inconclusive process.[4]

The management together with the Board of Directors is responsible for investments. Pricing is decided by individual Business Group Executive Directors and implemented with Corporate approval. (See Figure L-2 below.)

Figure L-2. Management Relationships



4 India: Recent Economic Developments and Prospects, p. 55.

Reporting and Monitoring. Reports issued on a regular basis help the Indian government to monitor HMT. Each section of the corporate structure is responsible for issuing reports on the activities of the company. The Executive Committee compiles a monthly review. The Board of Directors receives quarterly reports from the company management. An annual report, including plans for the future, is produced by the Ministry of Industry in Coordination with the Board of Directors. Furthermore, half yearly results of the companies financial data are published by the press and the stock exchange.

The company is also monitored by statutory audits conducted by the Comptroller and Auditor General.

Memoranda of Understanding (MOUs). MOUs, which have been used at HMT since the late 1980s, are an annual agreement between the government and the SOE. They are drawn up by the Department of Public Enterprises. The SOE management are to endeavor to comply with the stipulations set forth in the MOU. MOUs provide SOE managers with a clear mandate to focus on financial results.

Other Factors Influencing Corporate Governance. Since the elimination of formal barriers to entry in 1991, SOEs in India have faced competition from new entrants in the various sectors. Liberalized markets in India pose major challenges to HMT:

- Competition from foreign producers has eroded market share and profitability in HMT's major products;
- HMT has not kept pace with developments in production methods and production design; and
- Inability to generate internal capital surplus and fiscal constraints facing the Government have placed severe limitations on HMT's ability to finance investment for improvements in product design, productivity and marketing which HMT needs to maintain its position as market leader.

The inability of HMT to keep abreast with private companies in the area of production and technological development has lead to the relative decline of HMT's influence in the field of tractors.

- *Tractor Business.* The tractor business unit is the most profitable among HMT's various business units. However, its market share has declined from the second largest producers in 1985-86 to the fifth in 1990-91. While HMT cannot increase its market share, due to its production capacity and technology development, its main competitors have expanded their production capacity and improved their technology with the help of foreign partners. One of the reasons why HMT's tractor business unit could not expand its production capacity is that it has been obliged to allocate its surplus to other non-profitable business units such as the lamp business unit. HMT tractor unit's market share has eroded due to lack of investment and technological up-grading.

Each individual section of HMT is dependent on the headquarters for direction and generally reluctant to take initiatives.[5] This encourages the management of the individual sections not to take full responsibility for their actions and achievements, with the ability to hide behind the headquarters as an excuse for not performing well.

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5 Stuart E. Wicks, p. 2.

APPENDIX M

KSIAZ PORCELAIN FACTORY -KPF (POLAND)

KSIAZ PORCELAIN FACTORY - KPF (POLAND)
Case Study In Corporate Governance

KPF - History

Legal Status. The Ksiaz Porcelain Factory (KPF) is a State-Owned Enterprise (SOE) which was founded in the 1970s in Walbrzych (Poland) by the local government - Wojewoda of Walbrzych, representing State Treasury. It was a so-called "central investment", planned and financed by the government.

Products. The factory took fifteen years to build, which is quite typical for centrally-planned investment projects. There were a lot of interruptions in the construction caused by temporary lack of resources. Production began in 1980s but KPF never in its short history operated at full capacity. KPF manufactured decorative and non-decorative tableware, plates, mugs, tea/coffee sets, dinner sets and other china. Output was sold in sets or by pieces.

Production Capacity. KPF consisted of four divisions, all situated under the same roof. The production process was continuous, going through the following phases:

Div. 1: Modeling, paste and glaze productions (preparing materials, paste and glaze)

Div. 2: Throwing division (surface molding, recipients molding, casting, forms production section)

Div. 3: Furnace division (furnace, glazing, sorting)

Div. 4: Ornaments division (decalcomania, mechanical ornament, painting)

In accordance with initial plans part of the production of Division 1 was to be sold to other porcelain factories in the region. However, it turned out that these factories were not interested and continued to prepare their own paste. Divisions 3 and 4 both produced finished goods: decorative products and white porcelain respectively. Division 3 was a technical bottleneck for the manufacturing of finished porcelain goods: maximum capacity of the furnace was approximately 10,000 tons annually.

The structure of KPF's assets was favorable. Machines represented 68% of total productive assets and they were relatively modern. The composition of total assets was as follows:

(i) Productive Assets (71%) – machines and equipment were silo and mills (Division 1, Hungarian and German production, in operation since 1986), 30 lines for production plates and cups (Division 2, in operation since 1985-88), biscuit ovens and glaze fire ovens (Division 3, Polish production, in operation in 1985-87) and

and the UK lines for making ornaments. The KPF had also its own cardboard box production line.

(ii) Non-core Assets (22%) – means of transportation, a railway siding, different equipment of mechanical division, etc.

(iii) Non-productive Assets (7%) – social infrastructure - workers' hotels, canteen, housing and factory clinic.

Employment. In 1990 the enterprise had 1,400 employees. The total employment in March 1991 was 1,345, including 744 male and 601 female workers. The employment structure was as follows:

58% Production-Related Workers
20% Support Workers
15% Administration and Service Personnel
6% Managers (Productive and Non-Productive Divisions)
1% Senior Management

Quality of the labor force was low. Most of the workers were young, insufficiently trained and lacked motivation. Worker loyalty was virtually non-existent. Given the low level of wages, the workforce turnover was, not surprisingly, high. There was no work ethic; the management had frequent problems with alcohol consumption during working hours and small scale thefts. There were no positive work incentives; In 1991 management tried to introduce negative, pro-quality incentives.

There was drastic overemployment in production related sections. In the Production department only 70% of workers were directly related to production. The other were administration and support workers.

The lack of good organization, discipline and poor quality of labor had an adverse impact on the quality of production. KPF was recording a 31% rate of defective production, compared to 25% for its competitors. In 1990 56% of final products were of the III category of quality (i.e., the worst).

Markets and Competition. KPF sold its output both on domestic and international markets. The domestic market for KPF products consisted of two segments: institutional buyers – army, hotels, motels and dormitories – were buying 11% of production in 1990; the remaining 89% went to approximately 2,000 buyers, including wholesalers, retailers and individual buyers. The biggest customer bought 5.3% in 1989 and 3.3% in 1990. Wholesalers constituted approximately 50% of all domestic sales. Their share, however, decreased following the liquidation or restructuring into smaller units of big state-owned and cooperative wholesalers. Private wholesalers appeared but preferred to trade in small quantities.

In 1990-91 the domestic market collapsed due to various factors including: (i) low demand – porcelain was regarded as a luxury item rather than a daily necessity; (ii) financial problems of institutional buyers; and (iii) disappearance of the old wholesalers network.

Competition in the domestic market was intense. There were 9 major producers of porcelain in Poland (including KPF), two of which together accounted for almost 50% of the total volume sold. The share of KPF was approximately 9%.

Exports in 1989 accounted for 7% of sales; 45% was exported to Yugoslavia, 30% to the US, 10% to Holland and 15% to other countries. With the collapse of the domestic market exports rose to 45 in 1990 and 60 in the first quarter of 1991. In 1990 and 1991 the German market became the most important absorbing 27% and 55% of KPF's exports, followed by Italy, France and Sweden.

The increase in exports was a typical phenomenon for other Polish porcelain producers as well. The export share in total production rose from 27% in 1989 to 41% in 1990. For some companies this figure reached even 70%. This was a potential strength: the Polish porcelain industry did not need reorientation to foreign markets, because in 1990 already 72% of production was exported with the largest share being sold to developed countries.

The increasing role of export benefited KPF in terms of higher prices for its products and a lower turnover tax. The export prices for the same pieces or sets were from 30% to 140% higher than domestic prices. Initially, the 98% of export was sold through the state-owned foreign trade company Minex. In 1990 and 1991 this percentage fell to 61 and 30 respectively. Minex's share was taken over by private intermediaries.

Financial Performance. In 1990 KPF's sales were 60 bn. zl. ($6.3 million). Most of KPF's sales (80%) came from decorative porcelain sold both domestically and abroad. The key problem for KPF was that throughout its product range it was making losses (even on export sales) due to very high costs of production. The table below shows returns on sales of different product groups:

Table M-1. Return on Sales

Share in Sales		Returns On Sales (%)	
Product Groups	(%)	Domestic	Export
DECORATIVE			
pieces	36	-43	-30
dinner sets	20	-15	5
other sets	15	-25	-6
tea/coffee (sets)	8	-22	-3
NON-DECORATIVE			
pieces	14	-56	-45
dinner sets	6	-20	0
other sets	0.8	-40	-2.5
tea/coffee sets	0.2	-27	-8

The losses were due to underutilized productive capacities, poor quality of production, high rates of waste, inappropriate pricing, increasing production costs in relation to prices of finished goods.

The state of KPF's finances is shown in the balance sheets and income statements for years 1989-1991 (see annex). The situation was dramatic with the liabilities almost twice as high as the current assets. Interest payments and depreciation were the major loss drivers in 1990 and the beginning of 1991. In 1990 the interest payments amounted to almost 30% of sales. The economic reform of 1990 revealed the financial and organizational weaknesses of KPF. Collapse of the domestic market caused a 40% reduction in sales volume. Operational costs grew and the enterprise ended the year with the loss of 28.5 bn. zl., compared to 1.8 bn. of profit in 1989. The loss was equal to almost 50% of 1990 sales. This situation deteriorated further in 1991.

At that point the adverse impact of the macroeconomic stabilization program on the financial position of the enterprise became very obvious. Interest rates as of March 1991 were:

investment credit	95%
short-term credit	95%
special short term credit	100%
credit overdue	150%

The local Bank Zachodni was KPF's major creditor and as the financial situation grew worse it applied a very restrictive policy. Total liabilities to the bank were 31.5 bn. zl of which 2.3 bn. consisted of overdue credit. Liabilities to the bank constituted 52% of total liabilities.

Corporate Management. General Director was also the CEO. The most important departments were: Technical and Production, Trade, Accounting, and Economic. There were also Personnel and Training, Quality Control, and Development and Investment departments.

The management of KPF was not prepared to deal with crisis situations. Modern management techniques (MIS) were not applied. There was no cost control system, no pricing system, no stocks and distribution management and no proper quality control. Production planning was poor. For example, in 1990 in a situation of falling demand, KPF did not cut production which led to a tripling of the inventory. Another bad decision resulting from the lack of modern MIS was to use a mixture of domestic (low quality) and imported raw materials. This lowered the direct costs of raw materials (whose share in total costs did not exceed 5%) but increased significantly other costs such as storage, transportation costs, labor, energy, waste, etc. In addition, the expected "savings" resulted in the fact that the porcelain produced from this mixture was of poor quality and unattractive; it could be sold only at low prices. Personnel management and work organization in KPF were poor.

KPF Transformed into KPFL

Liquidation. The decision to liquidate KPF was made by the Office of the Wojewoda on the 19th of June, 1991. Since that day the management of the enterprise has been taken over by a Liquidator appointed by the Wojewoda. He was obliged to prepare and submit to the Wojewoda for his approval "A Program of Liquidation" that would include:

- an assessment of all of the enterprise's assets;
- a program for the disposal of assets;
- a program for layoffs;
- securing of the documentation; and
- a financial program of liquidation.

The Law on State-Owned Enterprises provides a legal base for liquidation allowing it for state-owned enterprises that have ceased to pay debts or dividend taxes. The law establishes two liquidation options: (1) selling-off enterprise's assets and using proceeds to cover liabilities; or (2) selling enterprise as a going concern, i.e. the whole enterprise – assets and liabilities, as provided by the Polish Civil Code. Assets are to be sold at a public auction. There is a certain time-table for liquidation: if the Liquidator is unable to complete the process and repay the debts within this time, he is obliged to file for bankruptcy. When the court declares bankruptcy it nominates a commissioner ("Syndyk") to conduct the process. The Polish courts are extremely slow in dealing with business cases, so the bankruptcy process may last many months and often in the end only proceedings costs are covered.

Usually the second option in liquidation is preferred. It does not eliminate the enterprise physically and retains the workforce. But this option is not easy to implement. Most of the liquidated enterprises have high liabilities-to-assets ratio, i.e. high liabilities the potential buyer would have to acquire. This does not provide incentives. The investor who would like to buy such a factory would rather wait for its bankruptcy which would enable him to buy it cheaply from a court-nominated commissioner.

The sale of an enterprise by pieces is usually not an easy option either. First of all, machines or equipment if sold separately, i.e. not as a part of production lines, are worth close to nothing. On the other hand, the Liquidator is usually afraid to sell too cheaply, because he could be accused of misdemeanor. Secondly, it may be simply impossible (or totally cost-inefficient) to dismantle the factory's machines. Thirdly, the property rights to land and buildings are very often not defined. Finally, it may prove impossible to find a buyer for the enterprise property whose buildings cannot easily be adapted to suit an alternative function.

The Liquidator of KPF decided from the outset that he would take the second option i.e., sale of the enterprise as a whole. He proposed that the selling price should be equal to the value of KPF's liabilities plus the liquidation costs. The public offer was prepared and published in the press.

Negotiations. In March 1991, British consulting company - Central Europe Trust (CET) submitted to the Industrial Development Agency (IDA) an offer to prepare a solution and restructuring plan for KPF. The offer was accepted and results of this initial work presented to the IDA's executive board and Wojewoda of Walbrzych. The most important conclusion of the study prepared by CET was that KPF may constitute an attractive investment opportunity, provided it received certain support and its operations were restructured. This notion was based on the following assumptions about KPF's strengths: (i) attractive designs and products which are sought after by export markets; (ii) intrinsic profitability with quality adjustment at low cost, reduced financing burdens, and higher output/capacity utilization; (iii) low cost workforce; (iv) access to the domestic market, when it recovers; (v) big potential for mass production; (vi) relatively modern equipment.

The study also showed the requirements for a successful KPF's turnaround: (i) equity financing to solve KPF's short-term debt financing problems; (ii) strategic management – definition of product ranges, definition of targeted market segments, and development of export distribution links; (iii) production – management of inventory, prevention of bottlenecks, and production driven by orders; (iv) cost and pricing management; (v) internal reorganization; (vi) marketing and distribution.

In accordance with the findings of this study IDA decided to organize a consortium for restructuring of KPF. In June 1991, IDA signed a contract with CET to conduct negotiations with potential partners in the consortium and to prepare a business plan for the restructured enterprise. The idea of a consortium assumed that it would be organized in the form of a limited liability company that would buy the KPF from the Liquidator and then restructure its operations.

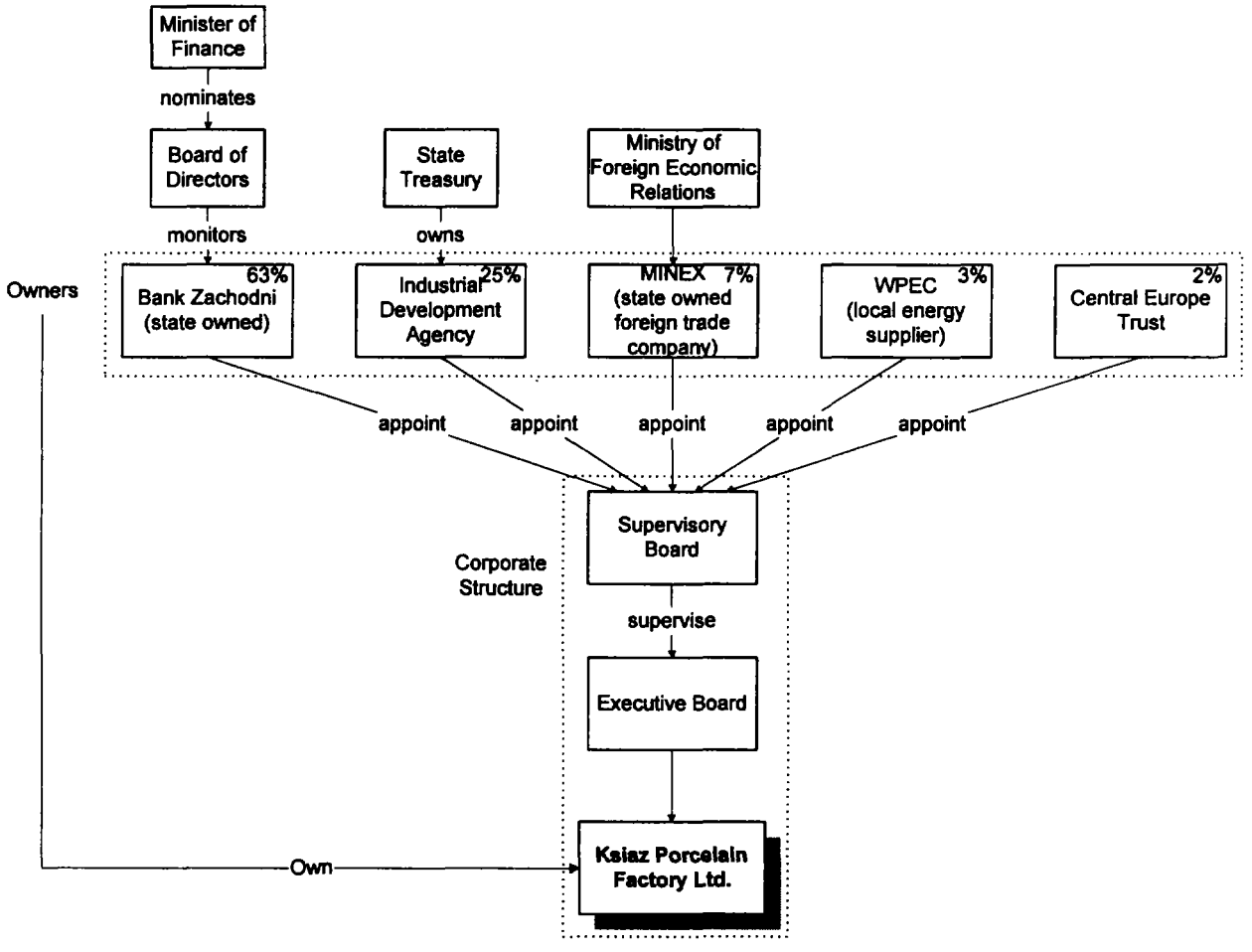
The negotiations were long and difficult. CET approached several potential investors, including foreign companies active in porcelain business. Unfortunately, the conditions demanded by potential foreign partners could not be accepted. Among Polish institutions approached, there were banks and foreign trade companies. Simultaneously, CET negotiated with the Liquidator, Wojewoda and tax authorities over the conditions of a KPF takeover. The position of tax authorities was especially important. The potential consortium members (Bank Zachodni and IDA) decided that they would be unable to make a transaction unless part of the tax liabilities of KPF were written off.

Finally, the limited liability company "Ksiaz Porcelain Factory Ltd." (KPFL) was established in October 1991. It had the following shareholders:

- 63% Bank Zachodni S.A., Wroclaw (state-owned commercial bank, major KPF's creditor)
- 25% Industrial Development Agency
- 7% MINEX (state-owned foreign trade company, KPF's trade partner)
- 3% WPEC (local energy supplier)
- 2% Central Europe Trust (consulting company)

Figure M-1. illustrates these relationships

Figure M-1. Ksiaz Porcelain Factory Ltd.



The shareholders' contributions to the newly established company were as follows:

Bank Zachodni:	KPF's liabilities and cash
IDA:	cash
MINEX:	KPF's liabilities
WPEC:	KPF's liabilities
CET:	in-kind contribution (restructuring program, business plan)

The executive board of KPFL started to cooperate with the Liquidator of KPF, negotiating with creditors debt relief and installment payments. They also negotiated the final terms of transaction for buying KPF from the State Treasury represented by the Wojewoda. The contract was signed in April, 1992, and the factory in Ksiaz became the property of KPFL. The long delay of this transaction was caused by the difficulties in achieving consensus among all parties involved. This delay was also the source of additional costs that had to be incurred after the factory had been bought up.

Is it appropriate to call this transaction "privatization"? Unlikely. KPF was bought by the company in which state-owned institutions hold 98% of shares. Bank Zachodni is a profit-oriented commercial bank, but its board is nominated by the Minister of Finance. The Minister of Industry and Trade represents State Treasury as the owner of IDA. The "owners" of MINEX and WPEC are the Ministry of Foreign Economic Relations and the Walbrzych Wojewoda respectively. Out of these institutions, Bank Zachodni and MINEX are currently close to a "real" privatization. When that happens, it would automatically make KPFL a private company.

Even though the transaction was not a true privatization, it was a precondition for successful restructuring. The institutions - shareholders of KPFL treat this company as a purely commercial unit and the evaluation of performance of its management is based on this attitude.

Restructuring. The negotiated price of the transaction was 173,499 mln. zl. This was precisely the level of former KPF's liabilities on March 30, 1992. To repay these liabilities, KPFL signed agreements with all its creditors. As a result, out of the total amount of 173, 499 mln.:

69,936	were liabilities of KPFL's shareholders
38,900	repaid in cash
31,975	was written off
32,688	was agreed to be repaid in installments

The drawn-out negotiations led to the new management taking over a company which was no longer producing. There were only a few employees remaining to maintain the machinery and equipment. Even worse, due to the ceasing of production and the lack of heating in winter 1991-92, the technical state of equipment and machinery was bad. Some installations were damaged and needed repair. Due to these factors the period of re-starting the production was delayed and costs proved to be higher than expected.

Company Information

Products. Taking over the non-producing factory caused certain adverse effects. All installations, equipment and machinery had to be reviewed and necessary repairs made. In doing so, the management simultaneously implemented some technological changes and improvements. Actual production restarted in June 1992. As a result, the new mixture for paste was developed and the quality of porcelain produced have been constantly improving since July.

The Executive Board of KPFL decided in May 1992 to start two different investment programs with the view to: (i) start a new production line (sanitary ceramics); and (ii) improve the quality of glazing. Both investment projects were financed partly by a loan obtained at the Bank Zachodni and in part from company's own resources. When implemented, they should increase both the market potential of KPFL (new products) and the quality of its products.

Employment. There are less employees in KPFL than in the former KPF: 1,030 compared to 1,345. What is important, the quality of employees seems to be higher. Due to high

unemployment in the Walbryzch region and the fact that the Liquidator laid off all former employees, new management was very careful in hiring new people. About 20% of employees have been trained in special ceramic vocational schools.

Markets and Competition. KPF ceased production in April 1991. This was in fact equal to the loss of all markets that the company used to sell to. In the initial period of KPFL's operations the marketing division was not working and the company did not have reliable information concerning the demand for porcelain, both domestically and abroad. The rebuilding of sales channels has became the most urgent task.

In the domestic market the management decided to adopt an aggressive tactic selling porcelain at 10-20% discount on prices offered by other producers. KPFL offered also special discounts to wholesalers and favorable terms of payment. The company promoted its production participating in the International Poznan Fare and inviting to the factory more than 60 wholesalers dealing with porcelain in Poland. This strategy proved to be effective and the company reentered the domestic markets relatively quickly.

The same process proved more difficult and gradual in relation to foreign markets. Only by the end of 1992 had serious links with foreign clients been reestablished. Currently, the company sells to such markets as: Germany, Greece, USA, Scandinavia, UK, Belgium, and Italy. In the course of 1992 KPFL used its promotional pricing strategy in its foreign markets as well.

Financial Performance. A year after restarting production, KPFL was not yet profitable. The costs of restarting, interest payments on investment loans and slower than expected increases in sales meant that losses could not be avoided.

Asset Management Model

The KPFL is managed by a 5-member Executive Board and supervised by a 9-member Supervisory Board representing shareholders. The company was completely reorganized and executives were among the first employees. After several changes, an organizational structure was adopted in which the General Director and 4 other directors - Technology Director, Marketing and Trade Director, Economic Director, and Financial Director - as members of the Executive Board manage 5 broad corresponding divisions.

Major changes in comparison with the former KPF structure are: greater responsibility for others apart from the General Director and members of the Executive Board, fewer levels of management and larger marketing and trade division.

Crucial factor contributing to the success of restructuring is to provide the enterprise with the true owner executing its ownership rights. Enterprises possessing a strong and skilled management group (playing the role of "owner") – and KPFL is such an example – tend to deal much better with restructuring than others. This suggests that privatization remains the most certain way of bringing the necessary changes at the firm level.

Box M-1. Restructuring Benefits

Restructuring is a continuous process and it is too early to assess whether the case of KPF has been a complete success. Nevertheless, it has proven a successful case of government-sponsored restructuring.

This restructuring process was possible due to the following several factors:

(i) The object of restructuring (KPF) was a viable company, which had a good product with export potential and relatively modern machinery;

(ii) The structure of incentives was already in place – the parties involved had a direct interest in restructuring:

The Wojewoda of Walbrzych was interested in saving jobs;
The Liquidator was interested in quick, successful liquidation;
Bank Zachodni and MINEX wanted their old loans to be repaid;
IDA, by definition, was interested in successful restructuring in the Walbryzch region;
CET (the consultant) was interested in selling its services and the implementation of its findings.

(iii) Financial resources were available (there is no restructuring without new investment).

(iv) Good analysis and business planning prepared by CET were available.

If these factors were not in place it is doubtful that KPF restructuring would have ever taken place. One other important factor is time. The new owners of KPFL lost a substantial amount of resources because the negotiations preceding the takeover lasted too long. The time in restructuring processes seems equally important as the money involved.

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