



# Pakistan Policy Note 4

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## Reforming State-owned Enterprises

*State-owned enterprises are a sizable element in Pakistan's economic landscape—more than 100 of them operate in a wide range of economic sectors, contributing around 10 percent of GDP and representing about a third of stock market capitalization. But many are marred by weak corporate governance, cost-ineffective service delivery, and considerable financial losses. This note highlights the negative implications of large state-owned enterprises and suggests that they are a burden to already strained fiscal resources, deliver poor services, and create market distortions—all of which hold back economic growth and private sector development. Emphasizing the urgency of state-owned enterprise reforms, the note's policy recommendations propose measures (including commercializing state enterprise) to curtail fiscal costs, professionalize the role of the government as owner, and improve corporate governance and accountability in state enterprises.*

*State-owned enterprises (SOEs) play an important economic role globally.* Their weight may vary from country to country but they remain prominent in energy and network industries such as air and rail transport, electricity, gas and water supply, and natural resource extraction. SOEs are also predominant in the financial sector—particularly banking and insurance—and a considerable and increasing number are also listed on national stock exchanges. They represent a significant part of total stock market capitalization—from around a fifth in Singapore, a fourth in India and Thailand, a third in Indonesia and Pakistan, half in Malaysia, and three-fifths in China (OECD 2010).

*Pakistan has substantial investment in its SOEs.* They contribute about 10 percent of GDP, and the State Bank of Pakistan estimates that the country has about 100 SOEs at the federal and provincial levels (Speakman 2012). These enterprises provide infrastructure services (power, transport, logistics), economic development services (oil and gas, mining), financial services (banks, insurance). And they are spread throughout manufacturing.

*Over the past several decades, Pakistan's governments have followed various approaches to manage SOEs.* An Experts Advisory Cell was set up under the Ministry of Industries to monitor and support industrial SOEs in the 1980s, and in the early 1990s a privatization program was launched with a series of strategic sales in the industrial, energy, and banking sectors (including one power plant, two gas distribution companies, and one bank.<sup>1</sup> In the early 2000s, the program conducted a series of capital market transactions that helped mobilize domestic savings and strengthen the domestic capital markets. These transactions included international market listings in the form of global depositary receipts for United Bank Limited (\$650.2 million) and Oil and Gas Development Company Limited (\$772.4 million), which allowed the government to tap international institutional investors. Thus far, 167 privatization transactions have been concluded, realizing about \$9 billion (Government of Pakistan 2011).

*A few SOEs incur substantial losses and have a major negative fiscal impact on public finances.* This is due mainly to poor labor and capital productivity, obsolete management practices, and inadequate regulatory arrangements for utility tariffs. SOEs can also constrain private sector growth because of poor service provision. They can crowd out private provision in product and factor markets. And they may generate a strong negative image of the public service. The estimated losses of some key SOEs during 2011 were PRs 28 billion for Pakistan International Airlines Corporation, PRs 36 billion for Pakistan Railways, PRs 22 billion for Pakistan Steel, and PRs 300 billion for the power sector.

*Heavy fiscal deficits in recent years have generated a large public debt.* With little funds from external sources, financing has shifted toward domestic sources. Much higher fiscal deficits than in the recent past amplify the other challenges facing the government, including slow economic growth, recurring and devastating floods, severe energy shortages, high inflation, and a weak security situation.

*The SOEs are a significant drain on the state's limited resources.* The State Bank of Pakistan in its Annual Report 2011–2012 stated that the fiscal deficit reached 8.5 percent of GDP in 2011/12, or PRs 1,761 billion, deviating from the provisional estimates of 6.4 percent of GDP. This considerable slippage was exacerbated by shortfalls in tax revenues, nonrealization of some nontax revenues, and overruns in expenditures on account of the energy sector's "circular debt" and SOE losses.<sup>2</sup> The fiscal deficit also included one-off payments of PRs 391 billion (1.9 percent of GDP) for settling SOE debts (State Bank of Pakistan 2012). Apart from these direct subsidies, contingent liabilities represent an onerous fiscal impact: guarantees issued to SOEs affect the state's capacity to borrow and thus negatively affect the state in the medium term. These explicit and implicit guarantees include unfunded losses of state-owned entities such as Pakistan Steel Mills, Pakistan International Airlines Corporation, Water and Power Development Authority, Pakistan Electric Power Company

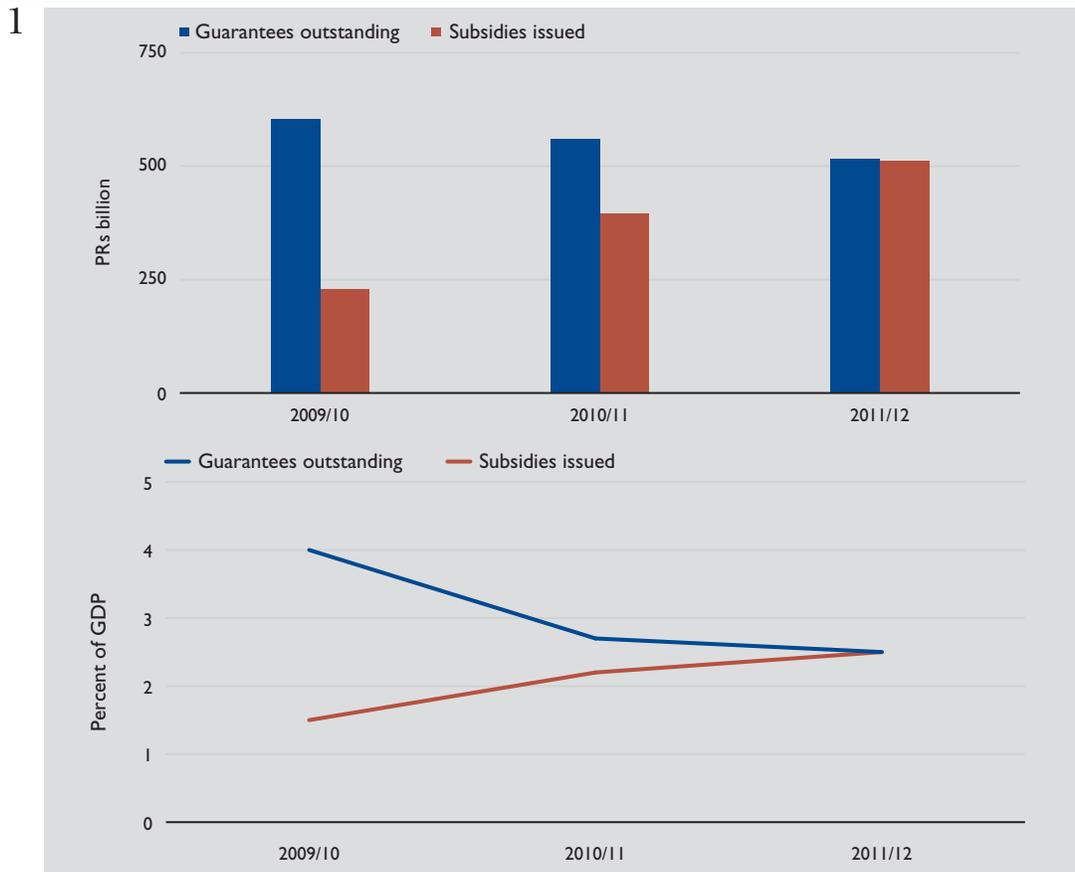
(PEPCO), and Pakistan Railways. In 2011/12, the government issued guarantees aggregating to PRs 203 billion (1 percent of GDP). The outstanding contingent liabilities as of June 30, 2012, stood at PRs 517 billion (2.6 percent of GDP), which includes the stock of explicit debt guarantees in domestic (55 percent) and foreign (45 percent) currencies that appear in SOE's books of account (Ministry of Finance 2013).

*Other than the publically guaranteed debt of SOEs, the government issues counterguarantees against the commodity financing operations of Trading Corporation of Pakistan, Pakistan Agricultural Storage and Services Corporation, and provincial governments.* The Fiscal Responsibility and Debt Limitation Act 2005 stipulates that the issuance of guarantees, including those for rupee lending, bonds, rates of return, output purchase agreements, and all other claims and commitments that may be prescribed from time to time, as well as renewal of existing guarantees, should not exceed 2 percent of estimated GDP in any financial year. Figure 1 illustrates the total guarantees outstanding and subsidies issued over the last three years.

*The fiscal support to SOEs in general and to the eight SOEs on the radar of the Cabinet Committee on Restructuring in particular is heavy (Figures 2 and 3).* During 2011/12, the government issued PRs 203 billion in guarantees. That year, the total outstanding stock of guarantees declined by PRs 42 billion, implying that PRs 245 billion in guarantees either expired or were retired through government resources.

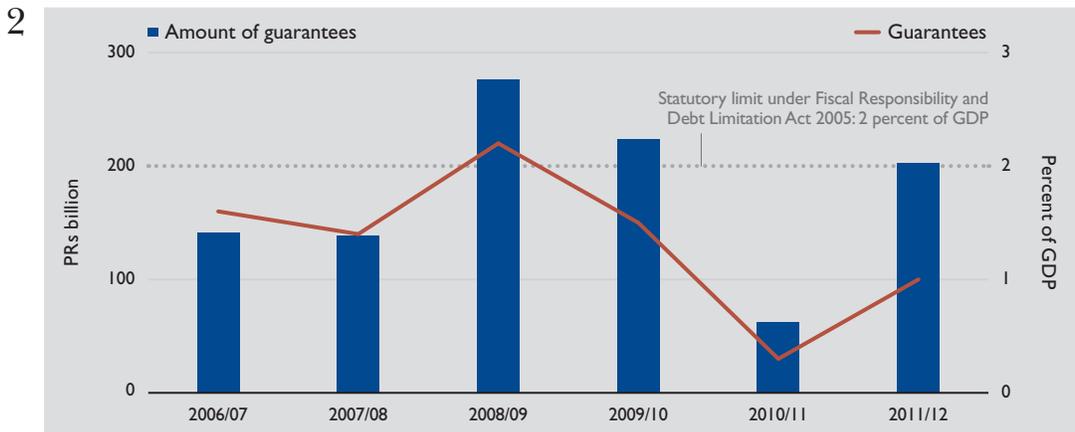
*Subsidies remain a major drain on the government's financial resources.* In 2011/12, PRs 512 billion (2.5 percent of GDP) was spent on subsidies, out of which PRs 464 billion (2.2 percent of GDP) was for power. (In 2010/11, the equivalent figures were 2.2 percent and 1.9 percent of GDP; Government of Pakistan 2010.) It is important to eliminate the price differential in electricity tariffs that generate circular debt in order to create fiscal space for development expenditure. In 2011/12, 21 percent of the government's fiscal resources were consumed in power subsidies, a sharp jump from 6 percent

**Figure 1 Guarantees outstanding and subsidies issued to state-owned enterprises, 2009/10–2011/12**



Source: Government of Pakistan 2012b; Ministry of Finance *Debt Policy Statement* various years; Ministry of Finance *Fiscal Policy Statement* various years.

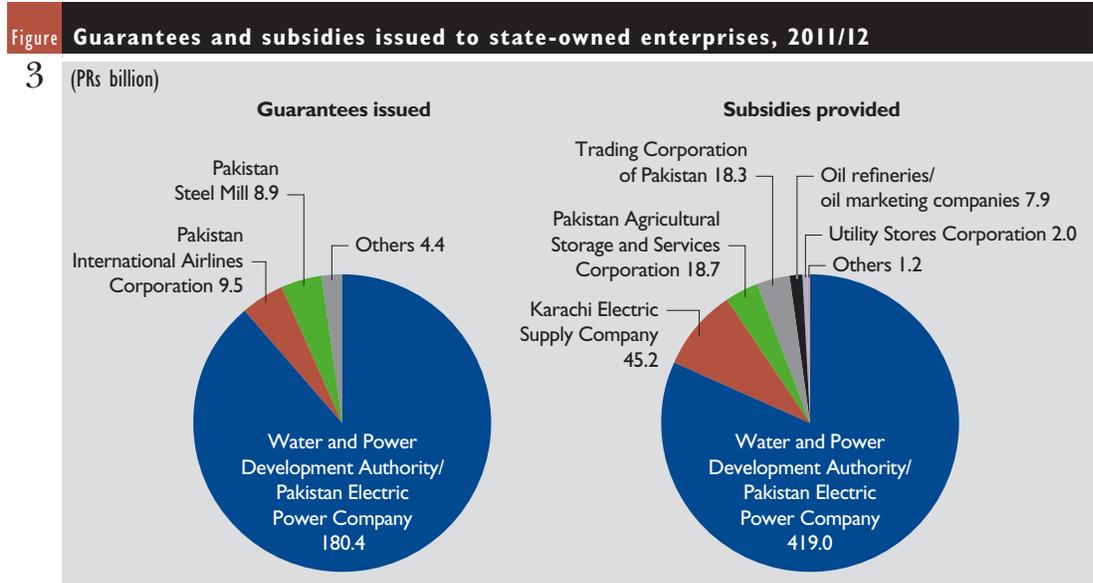
**Figure 2 Annual fiscal support to state-owned enterprises—new guarantees issued, 2006/07–2011/12**



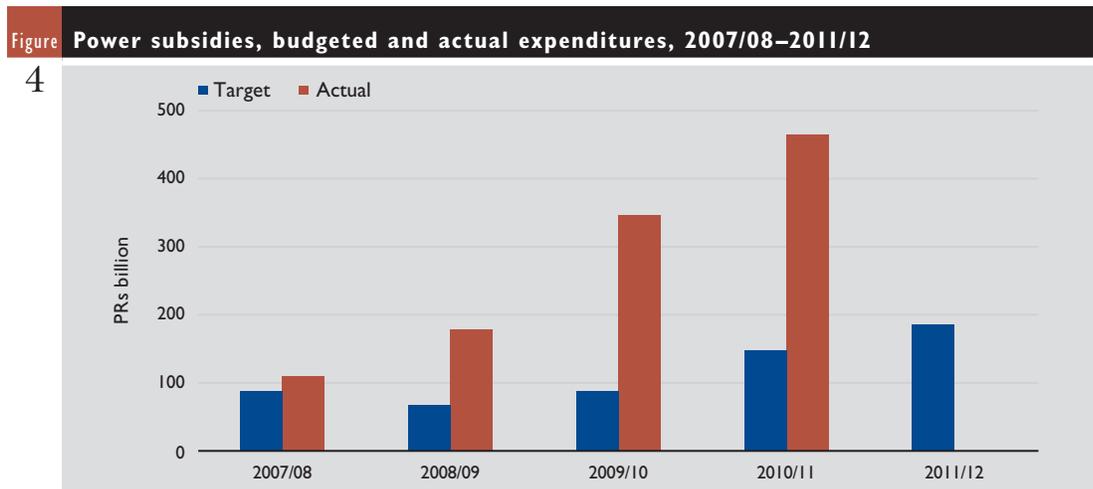
Source: Government of Pakistan 2012b; Ministry of Finance *Debt Policy Statement* various years.

of total fiscal resources in 2005/06 (Government of Pakistan 2012b; Ministry of Finance *Fiscal Policy Statement* various years). Moreover, actual expenditure on subsidies has been much higher than budget estimates consistently for

the last four years, particularly due to increasing power subsidies. In 2010/11 and 2011/12, actual power subsidies were three and two times the budgeted amounts (Figure 4; Government of Pakistan 2010).



Source: Government of Pakistan 2012a; Ministry of Finance 2013.



Source: ADB 2012.

### Key Policy Issues

#### Absence of a legal and regulatory framework for state-owned enterprises

The government has taken some initial steps to improve the performance of key SOEs. In January 2010, the prime minister constituted a Cabinet Committee on Restructuring of public sector enterprises to tackle institutions’ financial losses. The Committee identified eight SOEs for restructuring with the objective of improving overall corporate governance of these entities, curtailing financial hemorrhaging, improving service delivery, and reducing the fiscal burden on the exchequer.<sup>3</sup>

To improve SOE governance standards, the Ministry of Finance constituted a task force of public and private sector representatives to finalize the corporate governance rules for SOEs, drafted by the Securities and Exchange Commission of Pakistan (SECP). These rules are for SOEs with a corporate structure and are based on the best principles of corporate governance of the Organisation for Economic Co-operation and Development (OECD). The task force completed its work and the draft Public Sector Companies (Corporate Governance) Rules were notified by the SECP for public consultation in March 2012 and were placed on the SECP’s website. To seek stakeholders’ views, a thorough consultative process was then followed and conferences

held in various cities. These rules were formally approved by the government on March 8, 2013, and will be effective after 90 days of the issuance of the notification.

*Broader SOE reforms are being carried out as part of Pakistan's development agenda and framework for economic growth.* Some of the government's other SOE reforms are in Box 1 (Economic Reforms Unit 2012).

*The government has started a program for granting stock options to SOE employees under the Benazir Employees Stock Option Scheme.* The Scheme was announced in August 2009 and offers 12 percent stock options from the 80 public organizations to the employees of their respective organization.<sup>4</sup> Around half a million employees are expected to benefit.

*Going forward, it is important to focus on SOE corporate governance reforms as this will help improve management and thus in delivery of better and more cost effective distribution of goods and services to the public at large.* Currently, there is no diagnostic assessment of the sector and hence no roadmap or action plan formulated to move forward in a coherent manner.

*There is no SOE Act or equivalent law in the country that would lay down the foundation for good corporate governance.* Most jurisdictions have a SOE law that provides the framework for how the state, as owner and policy maker, governs its SOEs. Others have developed an SOE ownership policy, laying down the parameters of state ownership, its role in the corporate governance of SOEs, and how the government will implement its ownership policy. However, both the SOE law and ownership policy are missing in Pakistan.

### Lack of clear ownership role

*A fundamental tenet of SOE reform is the need to separate the government's role as owner from its role as policy maker, coordinator, subsidy deliverer (typically handled by the line ministry), and regulator (typically handled by an independent regulator).* In some cases, the line ministry's role is further reduced by moving the subsidy-financing role elsewhere. Lack of clearly defined, explicit, and consistent ownership policy has resulted in vaguely defined roles and responsibilities for the government, leading to conflicts of interests at the government level, ineffective monitoring and evaluation of SOE performance,

#### Box Some initiatives for state-owned enterprise reform

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- The Economic Reforms Unit set up in the Ministry of Finance was designated as the secretariat to the Cabinet Committee on Restructuring.
- The government has expedited implementation of the Power Sector Reform Plan 2010, which was upgraded under the Power Sector Recovery Plan 2011. Dissolution of Pakistan Electric Power Company is under way and will be completed by the end of September 2013 with transfer of operational functions to National Transmission and Dispatch Company and Central Power Purchase Authority. The Authority is already operating, and boards of directors for the nine distribution companies and Generation Holding Company have been reconstituted.
- The board of directors of Pakistan Steel Mills has been strengthened and implementation of a business plan for revitalizing the company, approved by the cabinet, has started.
- A restructuring framework for Pakistan Railways has been brought into operation. An asset management company is being set up for optimum use of the entity's assets. Priorities are to repair locomotives—commercial borrowing has been obtained to repair 96 locomotives—and to rationalize routes and freight operations. Reconstituting the board of directors and senior management has also been part of the overall restructuring process since early 2012.
- A restructuring plan for Pakistan International Airlines Corporation has been finalized, and addresses corporate governance, human resource rationalization, financial and operational restructuring, engineering improvements, procurement and logistics, airport services, and dispatch reliability.
- Initial restructuring plans for Trading Corporation of Pakistan, Pakistan Agricultural Storage and Services Corporation, and Utility Stores Corporation have been framed.
- General reforms such as implementation of rules for regulating public procurement of goods, services, and works by the Public Procurement Regulatory Authority have been introduced.
- The role of the Competition Commission of Pakistan in providing a level playing field has been strengthened through a separate Act.

and weak corporate governance practices at the SOE level.

*The government has made little progress in separating these roles as in most cases they are with the line ministries, which vary in capacity but do not act as informed and active owners.* Little effort is made by line ministries to ensure that SOE governance is carried out transparently, accountably, professionally, and effectively. No formal monitoring mechanism is in place to gauge SOE performance. There are no regular checks on managerial performance as the boards set neither targets nor performance indicators for management. And there is also no clearly defined board nominations policy that ensures that the best possible directors are nominated independently and transparently to serve on SOE boards.

*Pakistan has examples of institutional governance working well—and not so well.* The country can be proud of institutions like the State Bank of Pakistan, but PEPCO—a company set up for two years to facilitate corporatization of power sector entities—outlived its useful life and continued operations for more than 14 years, and with limited effect. PEPCO failed because of a lack of political will in government, policies incentivizing high-cost production, insufficient autonomy, dependency on legacy staff to implement reforms, and lack of accountability and clear lines of authority, among others (USAID and World Bank 2012).

### **Weak corporate governance standards**

*The corporate governance Report on Observance of Standards and Codes 2005 found that corporate governance was making progress, despite generally low awareness of its importance.*<sup>5</sup> This was exacerbated by a preponderance of family-owned private companies that tended to avoid modern corporate governance practices. Such a finding is not unusual in emerging markets and typically requires enforcement interventions (regulatory capacity, legislative protection, and disclosure requirements) as well as capability building among directors themselves. For SOEs there was no distinction between the ownership role (referred to above) and the role of directors,

yet this is fundamental to effective corporate governance, particularly when minority shareholdings or multiple shareholding interests are at stake (World Bank 2005).

*Good corporate governance begins with appointing and empowering an independent board of directors.* It is inadvisable to include current civil servants or ministers on the board, which is common practice in Pakistan. The directors are generally not aware of their fiduciary responsibilities, and the board structures are underdeveloped, with limited effectiveness of board committees and processes. Finding competent independent directors can also be quite challenging (World Bank 2005). The Corporate Governance Rules approved by the government in March 2013 are a good first step, but the real test lies in their implementation. Further, the SOEs listed on stock exchanges are already mandated to abide by the 2012 Code of Corporate Governance for listed companies.<sup>6</sup>

*Of particular importance in Pakistan is the appointment and role of the CEO.* Identifying and selecting a professional CEO of an SOE, independent of government interference, is a challenging but critical factor for any SOE reform. Measures or protection are needed to ensure that only qualified and nonconflicted directors and CEOs are appointed. Moreover, CEOs should be appointed by the board rather than by the government. Such measures could be part of the implementation mechanism for the new Corporate Governance Rules.

*Weak disclosure practices and poor control frameworks are two significant corporate governance weaknesses.* The disclosure refers to both financial and nonfinancial practices while the poor control mechanism relates to risk management, internal controls and internal audit frameworks.

### **Policy Recommendations**

*Efforts to reform SOEs have stalled in Pakistan for almost five years—contributing to steep fiscal losses and to worsening and cost-ineffective services.* Urgent policy measures are needed to improve the efficiency and effectiveness of SOEs, now discussed under three areas.

## Enhance financial discipline and strengthen legal framework

*The government has to identify enterprises that need to be privatized and ensure completion of the privatization process within the assigned timeframe.* Corporate governance reforms are no substitute for privatization but do improve the prospects of the entity to be privatized. To build public confidence, privatization needs to be transparent.

*To bring down fiscal costs, it is important to continue the reform process initiated by the government through restructuring boards and managing key SOEs.* This step should be followed by corporatization where the SOEs are not already in a corporate structure. The SOEs should be required to prepare business plans. Restructuring will reduce fiscal costs if the newly appointed boards and management are effective and if corporatization brings the entities under the same law (the Companies Ordinance) and under one regulator (the SECP), thus ensuring a level playing field for the private sector. These measures are in line with OECD guidelines recommending that governments simplify and streamline the operational practices and legal form under which SOEs operate.

*Graduating to the next stage—commercialization—will take more time and a substantial commitment of resources.* Commercialization, after the conversion of an enterprise to a company, typically includes identifying noncommercial activities, separating them from the enterprise, and financing them separately; cleaning up the balance sheet and establishing appropriate staff levels through financial and operational restructuring; establishing modern systems of professional management (information, human resources); upgrading human resources; and changing the culture. Commercialization will probably lead to a rethinking of efficiency and profitability at these SOEs, highlighting the question of retrenchment. The government needs to ensure that the right mechanisms are in place to manage, retrain, or compensate staff.

*It is important to move forward coherently.* The first step could be to undertake a diagnostic

assessment of the sector, including fiscal issues, legal/regulatory framework, current corporate governance practices, key issues, menu of reform options, and preliminary recommendations. Based on this assessment, a road map/action plan can be prepared by the government for SOE reform.

*It is crucial to have a legal and regulatory framework for SOEs.* The new Corporate Governance Rules are the right step, but an SOE Act or equivalent law is needed to provide the framework for how the state, as owner, governs its SOEs. Typically such an Act requires SOEs to be commercially oriented; SOEs to be forbidden to expand or contract the scope of their activities without government approval;<sup>7</sup> SOE obligations to provide timely financial and management information; guidance on dividends; clarity on which activities of government should be turned over to SOEs and those that should not; clear delineation of the roles and responsibilities of the government, boards, and management; and processes for appointing boards of directors. The legislation may also include hard budget constraints that incentivize the SOEs to run profitably. In parallel, the government takes on the obligation to compensate in a timely manner the SOE when it contractually agrees on services from the SOE—nothing breaks down SOE reform discipline faster than nonpayment of debts owed by other government agencies.<sup>8</sup> A core question for Pakistan's authorities is whether they need the equivalent of an SOE Act. A lesser option would be to issue an ownership policy that defines the overall objectives of state ownership, the state's role in the corporate governance of SOEs, and how it will implement its ownership policy.

## Professionalize the role of government as owner

*It is imperative to separate the government's role as owner from its role as policy maker, coordinator, and regulator.* The government should refrain from getting involved in day-to-day management and should allow SOEs full operational autonomy to achieve their objectives by professionalizing SOE boards and holding them accountable through the development of a

proper performance monitoring and evaluation system. The government should replicate past models that succeeded but were unfortunately discontinued.<sup>9</sup>

*Appointing and monitoring the boards is integral to monitoring ownership.* As the owner, the government is accountable to Parliament, and it needs to appoint directors capable of meeting the owner's expectations, following a skills-based appointment process. Anything less—such as patronage or representation—diminishes the skills on the board. There should be a well-structured and transparent board-nomination process. The boards, once appointed, should be allowed to exercise their responsibilities independently. Centralized reporting systems should be put in place to allow regular monitoring and assessment of SOE performance.

*The ownership function of SOEs in Pakistan lies with the concerned line ministry.* Several countries have moved toward creating a centralized ownership entity charged with SOE oversight. Ownership models can be grouped in three broad types (World Bank 2012):

- The decentralized model, where ownership responsibilities are dispersed among different line ministries.
- The dual/hybrid model, where, in addition to line ministries, a second ministry, such as the Ministry of Finance, may also have certain responsibilities like approving annual budgets, subsidies, and transactions and monitoring financial performance.
- The centralized model, where ownership responsibilities are consolidated in an entity that is independent or under the authority of one ministry.

There is no one-size-fits-all solution for ownership models. But Pakistan can shift from the current decentralized model to either a dual/hybrid model or a centralized model. A centralized model can take various forms like an advisory/coordinating body (India, New Zealand, Norway, South Africa, Sweden), ownership agencies (China, France, Indonesia), or holding/investment companies (Gulf countries, Hungary, Malaysia, Singapore). Determining which model is most feasible in Pakistan needs to be based on a more detailed assessment

of the legal framework and the institutional context.

*Irrespective of the option selected, regular monitoring of financial and managerial performance is extremely important and needs to be prioritized.* The government should ensure that each SOE has a strategy, clarifying commercial and noncommercial strategic objectives. Also there should be a set of clearly defined key performance indicators in a memorandum of understanding that is tracked regularly by the government. To introduce more transparency into the SOE portfolio, the government should start an annual SOE publication, which highlights financial performance and information such as key performance indicators and board composition.

#### **Improve corporate governance and accountability**

*Effective corporate governance of SOEs can have a positive impact on an economy, especially for a country with many SOEs.* The benefits of better governance include improved SOE financial performance, better service delivery, and greater access to capital markets. The Republic of Korea and Singapore are two notable success stories of strong corporate governance and well-run SOEs. In Pakistan, most of the SOEs listed on the Karachi Stock Exchange and that follow the exchange's corporate governance requirements are profitable. But listing on the Exchange does not mean that SOEs will be free of political influence and continue to be commercially viable.<sup>10</sup> For corporate governance framework to succeed for SOEs in Pakistan, the government must not interfere in the enterprise's operations. The SOEs should have an autonomous board of directors accountable to the government for results and performance. The CEO should be appointed transparently by the board.

*The approval of the Corporate Governance Rules for SOEs is a good first step, but the real test lies in effective implementation.* Also important will be workshops and training sessions to build awareness and understanding of the Rules. Developing an implementation plan that clearly lays down the roles and responsibilities of the line

ministries, Ministry of Finance, and SECP is important. The government should also extend the requirements of the Rules to SOEs that are not in corporate structure until all SOEs are corporatized.

*Internal and external accountability mechanisms are a function of formal relationships and disclosure.*

Accountability and disclosure to the Parliament through an annual report on SOEs that includes financial and operational reporting for each enterprise can be a start. The Annual Report of the State Ownership Steering Department in the Prime Minister's Office of Finland is a benchmark of accountability to the National Assembly (Government of Finland 2011). The financial statements of SOEs should follow international financial reporting standards and should be placed on the SOEs' websites. The performance of the senior management on the targets (for example, key performance indicators) should be evaluated by the board and should be linked to remuneration. A transparent mechanism should be put in place to evaluate the performance of the Board.

### Notes

1. Kot Addu Power Company Limited was privatized in 1993 and Muslim Commercial Bank in 1991. Sui Southern Gas Company and Sui Northern Gas Pipelines Limited were corporatized in 1990s and shares sold on the stock market.
2. Circular debt in the energy sector of Pakistan refers to the increasing receivables in the power supply chain among refineries, marketing companies, power producers, distribution companies, and end users. Overall circular debt was estimated at PRs 382.5 billion in July 2012 (State Bank of Pakistan 2012).
3. These were the National Highway Authority and Pakistan Railways—established under the relevant enactments; Pakistan International Airlines Corporation—a listed company under section 503 of the Companies Ordinance 1984 (the section applies to listed companies governed by special enactment); Pakistan Steel Mills, Trading Corporation of Pakistan, PEPCO,

and Utility Stores Corporation—private companies; and Pakistan Agricultural Storage and Services Corporation—a public company.

4. For more information, see Government of Pakistan (2011).
5. World Bank 2005. This report is based on the OECD principles of good governance.
6. The 2002 Code of Corporate Governance was revamped and brought in line with international practices. The 2012 Code was implemented in April 2012.
7. While the memorandum of association somewhat limits the scope of activity of a corporatized SOE, this issue is rarely monitored.
8. This is often referred to as circular debt.
9. Policy, regulatory powers, and ownership of assets were separated in the Ministry of Petroleum and Natural Resources, until 2008 when it was reversed.
10. The two relatively well-performing companies (Sui Southern Gas Company and Sui Northern Gas Pipelines) listed on the Karachi Stock Exchange for quite some time are now overstuffed and face serious liquidity and recovery problems with unaccounted for gas losses hitting double digits, up from 3–4 percent previously.

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