**The Pathfinder Economic Alert**

# Taming the "Monsters".

## Preamble

State ownership of public utilities dates back to the colonial period. The early post-Independent years saw the state establish public enterprises that were involved in the production and distribution of key goods and services. The share of state ownership in the economy expanded steadily and gathered momentum in the 1970s when government policy, in the name of socialist or progressive reforms, sought to gain control of the "commanding heights of the economy". State involvement in production and distribution was rolled back to a certain extent, during the period 1977 – 2005, as successive governments privatized a number of state enterprises. The privatization process has been halted since 2005. The state - owned enterprises sector still accounts for a significant share of the economy (see below). Despite improvements in their performance, these enterprises continue to provide a very low or negative return on investment for the people of Sri Lanka.

## Loss Making SOEs, Burdening People (mostly poor).

Senior policy-makers have spoken of a number of "monsters" which undermine Sri Lanka's development prospects. These are the State-Owned Enterprises (SOEs) which incur large losses that eventually have to be borne by the people of this country through higher direct or indirect taxes. The losses of SOE's, such as the Sri Lanka Transport Board (SLTB), Ceylon Petroleum Corporation (CPC), Ceylon Electricity Board (CEB) and Sri Lankan Airlines/Mihin Air are due to both non cost-reflective pricing policies pursued to achieve social objectives and under-performance. In this respect, the Performance Report (2010) of the Department of Public Enterprises, Ministry of Finance and Planning, identifies a number of factors that contribute to the large losses incurred by the SOE sector. "Loss making SOE's continue to incur losses due to lack of good governance, low productive use of employees, weak financial management, lack of internal controls and structural deficiencies. It is noted that Boards of Management of some key SOEs, which have often made decisions that were neither socially nor economically viable, violating government policies and regulations, contributed significantly to the losses incurred by SOEs."

The losses of SOEs undermine the development prospects of the country and impose burdens on the people, particularly the poor by way of higher prices/taxes and lower wages through three transmission channels:

- The budget deficit
- The costs and quality of the services delivered
- Lower wages as a result of lower productivity.

Now that Sri Lanka has attained lower-middle-income country status and is exposed to the "tyranny" of capital markets and rating agencies through its increased external commercial borrowings, it has become even more essential to address effectively the problems of unsustainable subsidies, operational inefficiencies and poor governance of SOEs. Failure to do so will have a significant negative impact on growth, inflation and employment. In this connection, the recent adjustment of key administered prices to make them more cost- reflective is timely and necessary.

**Role and Burden of SOEs on the Economy**

There are 81 SOEs and the government is also a partial owner of several entities established under the Companies Act (2007). The total turnover of SOEs amounted to Rs. 954 billion in 2010. The five largest SOEs [CEB, CPC, Sri Lanka Ports Authority (SLPA), Bank of Ceylon (BoC), Peoples Bank (PB)], exceeded the turnover of all 245 companies listed in the Colombo Stock Exchange. In addition, SOEs accounted for 17.2% of GDP and employed 160,000 people (2010). The size of the SOE sector, as well as the breadth of its activities across the economy, makes it a crucial determinant of the overall productivity of the economy and therefore, the level of wages that can be sustained without fueling inflation. The difficulties experienced in accommodating international prices of key imports, like fuel, without unduly burdening the people through its impact on the cost of living may be attributed to the low productivity/low wage syndrome in the economy. The underperformance of SOEs is a major part of this narrative.

All SOEs are expected to contribute 30% of their profits or 15% of their equity, whichever is higher, to the Consolidated Fund. Such levies and dividends from SOEs amounted to Rs. 31 billion in 2010. However, the CPC, CEB, SLPA and National Water Supply and Drainage Board (NWS&DB) alone made combined losses of Rs. 48 billion in that year. Furthermore, the CPC and CEB on their own made a loss of Rs. 130 billion in 2011 (this amount is sufficient to build 130 high class schools or 65 300-bed hospitals). While Sri Lankan Airlines/Mihin Air recorded losses of Rs 13 Bn. These figures do not include the accumulated losses of SOEs or the government guarantees issued to them. As Sri Lanka becomes more exposed to capital markets and rating agencies, the financial health of the SOE sector and its direct and indirect impact on the Government budget will become more important as a determinant of the country's creditworthiness.

**Crowding out of the Private Sector**

With the mere existence or expansion of state intervention in the economy, the government, intentionally or unintentionally, reduces the space occupied by the private sector and crowds out activities that could be undertaken with higher efficiency. With regard to areas where there is a government monopoly [such as CEB & Ceylon Government Railways (CGR)], and sectors where the government is legally empowered to impose restrictions to entry (such as petroleum refining and distribution & gas), the role of the local private sector is virtually non-existent or limited. This constrains economic growth as expansion activity is held back by inadequate government financing; and efficiency gains are curtailed through lack of competition.

**Government Policy – Lets be Pragmatic not Dogmatic.**

The Government has established a clear policy of non-privatisation of SOEs in 2005. Its objective has been to orient them towards a dividend-paying entrepreneurial culture through adopting innovative management reforms so that they become commercially efficient and reduce their reliance on government assistance. In this connection, a number of measures have been introduced to strengthen the performance of SOEs. The Ministry of State Resources and Enterprise Development has been tasked with restructuring 23 SOEs; Boards of strategic SOEs have been infused with private sector managers; the regulatory functions have been built up through institutions such as the Public Utilities Commission; and the monitoring and supervisory function of the Department of Public Enterprises of the Treasury has been strengthened. These measures have led to improvements in performance. However, there remain continuing challenges as demonstrated by the recent report of the Committee of Public Enterprises (COPE). As well as the Ministry of Finance document sited above.

**SOE/Government Budget Nexus.**

SOE losses are often not directly reflected in the government budget. Instead they are found on the balance sheets of the BoC and PB. This not only undermines the financial integrity of these institutions but ultimately the government balance sheet as well. First, these losses increase the provisioning that has to be made by the state banks, thereby raising interest rates through enhanced spreads. As the BoC and PB account for a large segment of the market, this also provides a “free ride” for other banks to enjoy higher margins. The upshot is higher interest rates which constrain investment, growth and employment.

Secondly, these losses are also a call on the Consolidated Fund. From time to time the Treasury is compelled to recapitalize the state banks (including through the issuing of bonds). In addition, the substantial guarantees, which have been issued to SOEs, are contingency liabilities which impact on the government’s overall creditworthiness and therefore, on the assessments made by rating agencies which are becoming an increasingly important determinant of the country's prospects.

It is also important to recognize that by increasing the effective size of the budget deficit, SOE operations serve to fuel inflation by raising aggregate demand in the economy. This exerts pressure on interest rates and the exchange rate. The underperformance of SOEs, therefore, serves to undermine macroeconomic stability, with adverse consequences for the overall performance of the economy.

**Nexus between SOE Productivity and Wages.**

As mentioned above, given the size of the SOE sector its productivity influences the level of wages that can be sustained in the economy without generating inflationary pressures. Improved productivity can create better jobs and higher incomes that increase the resilience of the people in the face of both internally and externally induced price shocks. However, it must also be conceded that higher productivity in SOEs is likely to be achieved through a reduction in over-staffing and therefore, a loss in jobs. It can be argued that this can trigger a positive process that benefits the economy as a whole through a shift in labour to more productive sectors. This argument is based on the fact that a number of more productive sectors (eg: apparels) are currently confronted with labour shortages.

**Re-thinking the Current Model.**

Historically, governments have sought to subsidise basic needs, such as fuel, energy, transport and water and sanitation. Generalized subsidies were more justifiable when Sri Lanka was a low-income country and a higher proportion of the population lived below the poverty line. It was also more affordable when Sri Lanka received large amounts of grants and concessional loans. However, Sri Lanka is now a $2,800 per capita income country and the poverty level is 8.9%. As a lower-middle-income country it is no longer eligible for concessional assistance. Furthermore, it has been argued above that the underperformance of SOEs undermines the macroeconomic stability needed to access the financing required from international capital markets for the country's development programmes. This new environment attaches even higher priority to addressing the underperformance of SOEs. As mentioned above, the losses of SOEs are due to non cost-reflective pricing policies, operational inefficiencies and poor governance; and the recent move to more cost-reflective administered prices is a welcome development. However, it should be accompanied by a concerted and accelerated campaign to strengthen the ongoing efforts to improve the performance of SOEs.

As Sri Lanka's exposure to international capital markets increases, policy-making will have to be characterized by greater discipline, flexibility and speed of response to a rapidly changing global landscape. International capital markets are not sensitive to concerns regarding the sovereignty of national economic policy-making. They impose their own brutal discipline. The political challenges associated with a shift to this new paradigm can be met more effectively, if there is a well designed and better targeted social safety-net. It would be more affordable if it is administered on the basis of need rather than political patronage (unlike the current Samurdhi programme). It should cover the poor and vulnerable as well as those who are temporarily affected by the transitional costs of adjustment policies.

**The Way Forward**

The Performance Report 2010 of the Department of Public Enterprises calls for the following measures to improve the performance of SOEs: improvement in corporate governance; appointment of competent CEOs; recruitment of qualified professionals for procurement, finance, human resource management and other key managerial positions; adoption of realistic pricing and investment strategies; institutionalizing performance audit and financial management controls; and strict adherence to the annual budgets and commitment controls in expenditure management. Private participation in the SOE sector can assist in achieving these objectives. Private sector infusion, while retaining Government control, can range from handing over management or selling a minority stake to the Government retaining a golden share. Another option is to list 10-15% of the value of commercial SOEs (eg banks) on the stock exchange. The disclosure requirements associated with this will introduce greater discipline in the operations of the whole enterprise. The State Bank of India has benefited greatly from such a course of action.

It is also important to recognize that the track record of successive Sri Lankan Governments in managing SOEs has been extremely poor. It has been driven by political patronage rather than commercial principles. In Singapore, SOEs are very professionally managed with any politics being conducted out of dividends rather directly on the balance sheet. Sri Lanka has not had a political culture with the discipline to operate in this way. The experience with the telecommunications sector clearly demonstrates the benefits that can be gained from privatization and deregulation. The competitive industrial structure has provided consumers with lower tariffs and a better quality of service.

Another consideration is that the ineligibility for concessional assistance and the reduction in the head-room for commercial borrowing mean that the momentum of the Government's much-needed infrastructure development programme can only be maintained through public/private partnerships (PPPs). A pragmatic approach that assesses the relative merits of all options is necessary for the country to achieve a higher trajectory of growth. Dogma in either direction (statism or market fundamentalism) is counter-productive.

In the past, the negative effects of the poor performance of SOEs have been cushioned by access to large amounts of concessional assistance. As the Pathfinder Foundation has repeatedly emphasized Sri Lanka is no longer eligible for such assistance and is more exposed to the brutal discipline of international capital markets. The country can no longer afford to overlook the negative effects of underperforming SOEs. Failure to take effective action can have severe adverse consequences for ordinary people if markets lose confidence in Sri Lanka's creditworthiness.

***This is the Twenty – Sixth in the series of Economic Alert articles published by the Pathfinder Foundation. Readers' comments are welcome at pm@pathfinderfoundation.org***