State-Owned Enterprise Reform and the Role of the Government

By Sirimal Abeyratne, University of Colombo

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I. INTRODUCTION

Does ownership matter? Answers to this question may be different under different circumstances or in the context of different political and economic ideologies and vested interests of stakeholders. There are, however, fundamental differences between private-owned enterprises (POEs) and public-owned enterprises (SOEs) in terms of enterprising objectives, principal-agent relations, and the environment in which they operate. All these factors can result in significant differences in performance and efficiency between the POEs and the SOEs. Sub-standard performance and inefficiencies of the SOEs all around the world have been a well-known issue which has led to far-reaching reforms in both developed and developing economies alike.

Although privatization of the SOEs received priority in the early years of trade liberalization reforms, it has not been a panacea. The global policy thrust and public sympathy towards privatization has changed in the recent past. Nevertheless, the fundamental problems of the SOEs continued to remain a policy issue resulting in a wider SOE reform process aimed at improving corporate governance of the SOEs in both developed and developing countries. According to OECD which focused much on the issue in its member countries, good corporate governance of the SOEs is an important prerequisite even for effective privatization, since it improves the bargaining power of the seller and makes the SOEs more attractive to prospective buyers (OECD, 2005, p. 9). Even if it is not for privatization, improvement of the corporate governance of the SOEs is critical, as the sub-standard performance and inefficiencies of the SOEs have resulted in a massive cost to the nation in different forms. The losses of the SOEs entail a fiscal cost that is often passed down to a third party. The distortionary cost resulting from bad corporate governance leads to a misallocation of resources and unfair treatment among different types of stakeholders and, thereby paralyzing the business environment. There is also a developmental cost to the nation in terms of forgone development of the enterprise and the industry at micro level, and of the overall economy at macro level.

Apart from the internal issues, a new challenge of the SOEs has emanated from the dynamisms of the external environment. While integration of economies through trade and investment flows has challenged the domestic market-oriented SOEs, they continue to be left behind the globalizing SOEs from some other countries that undertake SOE reforms.

The whole issue of SOEs in Sri Lanka melts down into lack of reforms of a wide range of SOEs for decades. The focus of the Sri Lankan SOEs on domestic market has hardly changed, overlooking the challenges and opportunities in the context of global integration. Thus the issue of SOEs in Sri Lanka is not limited to the forgone efficiency benefits emanating from the domestic market, but also to those emanating from the dynamic global market.

In spite of having more than a 35-year old liberalized economy, SOE reforms in Sri Lanka did not take place in a consistent manner as an essential component of the market-oriented reform process. Under different forms of legal entities a wide range of SOEs continued to be in operation in Sri Lanka, while some of the large SOEs operating far below the standards of normal corporate governance continued to burden the fiscal operations in particular, and the economy in general. Even the pre-1948 colonial SOE
models as well as the pre-1977 closed economy SOE models continued to remain to-date as they were at the time of establishment, indicating the severity of forgone SOE reforms.

Under the current post-2005 economic model, there has been a complete turn-around in SOE strategy, including the government initiatives to extend its hand into private enterprising and to bring back private economic activities under the direct or indirect control of the government. Although there was much concern at policy and political circles about the continuing issues of the SOEs, there has been little effort aimed at enhancing corporate governance of the SOEs. Even if privatization is not an alternative policy option in the context of the current political-economic environment, all evidence from the SOE sector in Sri Lanka calls for for a bold and broad reform process in order to make them commercially viable economic activities lessening their fiscal burden, contributing to economic development, and entering competitively into the global markets.

The purpose of the study is to examine the present status of the SOEs in Sri Lanka and to draw guidelines for a bold and broad reform process ensuring its continuity and effectiveness. In the light of theoretical premises and global environment of the SOEs, the study is aimed at (a) providing an account of the problems of sustaining the SOEs in their present form, (b) the importance of SOE reforms and their continuity for the country’s fiscal and development needs in international context, (c) a recognition of the political-economic justification as well as vested interests and their sensitive nature, and (d) drawing out pragmatic policy recommendations that would be acceptable within the existing political setup and policy framework.

Reform is not a choice but a mandate irrespective of the ownership, and is not conclusive, but continuous. Management needs to spend more time for reforms (based on research and development) than for running the current business operations. It is more important for SOEs than for POEs, because of the nationwide costs and benefits of the former compared to those of the latter.

By drawing upon the theoretical groundwork and the international experience, the study is intended to outline a set of strategies based on broad-based ownership, power delegation, and improved accountability. The guidelines for corporate governance of the SOEs formulated by the OECD provide valuable insights, but an effort is taken to represent the local requirements through the policy recommendation.

The rest of the paper is organized as follows: Section II presents a brief discussion on theoretical issues of the SOE problem in the world, and the international experience of SOE reforms. The SOE problem in Sri Lanka is analyzed in Section III, focusing on its major issues and dimensions. Section IV provides guidelines for SOE strategy for Sri Lanka, while the Section V presents the conclusions of the study.

II. NEVER-ENDING SOE REFORMS

The reforms that different countries have undertaken in order to face the challenges of the SOEs have never come to an end, as the global experience with SOE reforms suggest. As a result, however, the SOEs have been undergoing substantial changes in order to be in line with domestic requirements and
global dynamics. The state ownership that expanded over a vast area of businesses during the post-war period in both developed and developing countries started to shrink with market-oriented policy reforms since the late 1970s. Although privatization received priority in the early years of policy reforms, the initial enthusiasm for privatization has depleted globally. Nevertheless, SOE reforms continue to exist to date to improve their corporate governance and to bring about different forms of private partnerships.

The SOE problem is a global one which has led to far-reaching reforms sweeping across the world in both developed and developing countries. This is because in general their corporate performance is different from the POEs. By implication, thus, the sub-standard performance of the SOEs and the accumulation of financial losses lead to an abuse of public funds, a misallocation of resources, and impediments to development process. Apart from that, globalization processes pose new challenges to SOEs, gradually undermining their current position. Thus, SOE reforms occupy a critical aspect of policy formulation and good governance in both developing and developed countries.

2.1 What is the problem?

The rationale for state-ownership of commercial enterprises comprises a mix of social, economic, and strategic interests. The presence of natural monopolies, the existence of vast externalities, strategic importance of some sectors, and weak private participation mainly due to high sunk costs are some of the underlying factors used to justify state-ownership of enterprises. For the same reasoning, it is common to observe that key industrial and service sectors such as utilities, energy, infrastructure, and public transport are in the hands of the state-ownership, although private investment in these areas have been expanding in the past few decades. State-ownership, however, does not limit to these key areas. Depending on the differences in political-economic ideologies of governance and vested interests, state-ownership in some of the countries has extended to cover a wide range of economic activities.

Under the private ownership, the objective function of enterprising is simple and straightforward; it is profit maximization, which may not be compromised even if there are other objectives. For this reason, the enterprises under private ownership respond to market incentives and challenges. If a state-owned enterprise adopts management and economic principles as a private enterprise does, then apparently the SOE must be as efficient as the POE so that the ownership does not matter. It may not be difficult to observe many SOEs from different countries stand as individual examples in confirming this idea.

The issue of the SOEs is, however, different and complex. Given the assumption that a government seeks to maximize economic welfare of the country, it is easy to set the objective function of a SOE as to perform for the benefit or the interest of public instead of profit maximization. For this reason, state involvement in many of the strategically important sectors such as infrastructure, utilities, energy, and transport appears to be common, although the state in individual countries tend to extend its hand well beyond those sectors. Defining ‘public interest’ itself is a problematic exercise. The distinction between short-term and long-term is also a point of debate, because the decisions for the benefit of public interest in the short-run might be contradictory to long-run benefits.
There are multiple monitoring bodies for the SOEs such as the general public, elected politicians, non-elected bureaucracy, and the management, but ultimately the questions melts down into who is accountable for what. Whatever the complexity associated with the SOEs in terms of the ‘principal-agent’ problem, the burden of inefficiencies and underperformance could be transferred to a third party – the tax payers. The government has multiple objectives which can influence or undermine the enterprising objectives of the SOEs. The environment in which the SOEs operate the objective of public interest could be displaced by the interests of the influential stakeholders, whose ‘vested interests’ can guide decision-making.

2.2 SOE Reforms: International Experience

In general, SOEs face distinct challenges of corporate governance as reflected by the evidence from all around the world (OECD, 2005, p. 10): First, they suffer from undue hands-on and politically motivated ownership interference as well as from totally passive or distant ownership by the state. Second, SOEs are often protected from two major business threats which are essential for policing management in private enterprises – take over and bankruptcy. Thirdly, the difficulty of corporate governance of the SOEs emanates from a complex chain of agents – management, board, ownership entities, ministries, and the government, without clearly identifiable principals. Consequently, the accountability is diluted, and the corporate governance is a challenge.

The common problems of the SOEs have been identified as follows: operational inefficiency and poor financial performance, dependence on government transfers, indebtedness and circular debt issue, supply shortages and poor product quality, inability to expand investment and capacity, over-staffing and employment-related issues.

Privatization – sale of SOEs to private agents, received much emphasis in addressing the SOE problem, and swept across both developing and developed countries since its inception in UK in the early 1980s. In the face of increasing use of markets as a global phenomenon to allocate resources, privatization was considered as the legitimate and core tool of governments over 100 countries in the world to deal with the issue of SOEs (Megginson and Netter, 2001). However, privatization slowed down and its public support declined in the recent past, while there were even reversals of the governments’ policy stance on privatization against the adverse effects of global financial crisis in 2008-2009. According to World Bank database on privatization in developing countries, there were more than 8300 privatization transactions during the period 1988-1999, but the number has declined to only 1,858 during the period 2000-2008. Despite recent evidence of declining privatization trends, from a different perspective on sectoral analysis the evidence shows resounding success of privatization in competitive sectors (Kikeri and Kolo, 2005). According to this analysis, even though privatization declines in terms of number or volume, its sectoral focus continues to perform successfully.

Even if privatization has slowed down, SOE reforms continue to exist as an essential area of policy reforms. Along with that private sector participation in the areas where SOEs dominated previously has increased, while the governments have shown enthusiasm to rely on partnerships with the private sector in managing the SOEs. The OECD countries have began to carry out indepth studies on the SOE
problem and to provide guidelines to improve corporate governance of the SOEs, and to monitor the progress of SOE reforms in individual member countries (OECD, 2005, 2011a, 2011b).

SOEs in the world have faced with an external challenge of globalization too, demanding for continuity in reforms. The benefits of integration with the global economy through trade and investment have been limited by the efficiency of the SOEs operating in certain key areas which are strategically important to the competitiveness of the rest of the economy. As OECD argues, this issue has been at the forefront of internationalization in OECD as well as non-OECD countries (OECD, 2010). The international competitiveness of the economy is at a disadvantage due to inefficiencies of the sectors under the SOEs such as utilities and energy. In addition, some of the sectors operating in international markets such as airlines, shipping lines, aviation services, and port services which are sometimes operating under state-ownership naturally face international competition.

A new development of SOE operations is their increased expansion into international market, although they were traditionally considered to be domestic market-oriented enterprises. The SOEs from developed countries as well as from emerging economies have entered into export businesses as export-oriented SOEs and off-shore operations as state-owned trans-national corporations (TNCs) by competing successfully with private firms. In fact, the state ownership of the global economy has been growing, while emerging economies have been performing better; as of 2010-2011, out of the world’s 2000 largest listed firms 204 were identified as SOEs, originating mainly from China, India, Russia, UAE, and Malaysia (Kowalski et.al., 2013, p.20).

The importance of penetration into global market by SOEs from emerging economies is two-fold: On the one hand, it shows that given the right corporate governance, the SOEs can perform as equally as private firms to enter into export markets and off-shore businesses. On the other hand, it poses an emerging new threat to SOEs in other countries which adopt a lukewarm policy on SOE reforms because they are likely to be left behind. Thus, the inefficiencies of the SOEs should be understood not only as an internal problem of not performing well but also as a problem of falling against progressive SOEs operating in international markets.

The theory and evidence on the operations of SOEs clearly suggest that the SOE problem is global phenomenon, while the continuous reform process has addressed the issue at source. Even if privatization in individual countries exhibited mix results, more importantly the overall SOE reform process in many countries has been continuing. As an important outcome of the reform process, a set of SOEs which were traditionally considered to be domestic market-oriented have penetrated into international markets competing with private companies.

III. THE SRI LANKAN ISSUE

Sri Lankan government owns a large number of SOEs ranging from large to small in size, and operating in a wide range of economic activities from strategically important sectors such as energy, utilities, and transport to the activities related to manufacture of salt, sugar, cashew, paper, cement, milk and
palmirah. They are also organized under many different legal ownership structures such as statutory bodies, public funds, limited liability companies – both private and public, and even government departments. Thus, the SOE issue in Sri Lanka is a complex one.

3.1 How many SOEs?

How many enterprises are there in Sri Lanka under state ownership? This is a difficult question to answer due to the difficulty of defining ‘enterprise’ as well as ‘state ownership’ so that even the policy documents and reports of the government record different figures. Even if the purpose of operating a SOE is guided by multiple objectives other than the profit motive, the presence of commercial nature of an organized economic activity makes it an enterprise. The state ownership can also be a source of controversy due to the legal structure of the enterprise and the state control over it. As a result it is not difficult to observe some of the statutory bodies in which the commercial nature is trivial are reported under the SOEs, while some other SOEs in which the commercial nature is overwhelming remain outside the SOE classifications.

Evidence from various sources suggests that there are about 300 SOEs in Sri Lanka, while the number has increased in the recent past due to policy changes during the post-2005 regime. While the government declared its non-privatization policy, it also took steps to acquire a number of former SOEs which were under private ownership, and to expand its hand into private enterprises.

A list of SOEs prepared by the Ministry of Finance and Planning in 2014 presents 115 SOEs, although the Ministry’s Annual Reports from different years record different figures. Out of these SOEs, 55 are classified as ‘business enterprises’ that are operating in the areas of banking and finance, insurance, energy, ports, water, aviation, transport, construction, livestock, plantations, minerals, lotteries, health, media, and marketing and distribution. In addition, there are 21 ‘restructuring’ commercial units which are engaged in manufacturing and distribution activities. The rest of the SOEs are classified under regulatory agencies, promotional institutions, educational institutions, and other.

The Annual Report 2008 of the Ministry of Finance and Planning mentions about a revision of the categorization of 285 public enterprises to ensure proper monitoring and supervision (MFP, 2008, p. 141). The Committee on Public Enterprises has examined 244 Public Enterprises as recorded in its Second Report (COPE, 2013). They are classified under six headings as regulatory bodies, promotional agencies, state-owned enterprises, educational agencies, development agencies, and research institutions. The Report of the COPE (2013, p.6) also discloses a number of non-operational public enterprises which continue to exist without being liquidated, and some other public enterprises which are in operations without a viable commercial activity needed for their existence. While the SOE subsidiaries do not appear to be recorded in the list of SOEs, the Report of the COPE (2013, p. 7) points out that these subsidiaries are not accountable to the Parliament either.

Apart from above, there are some other SOEs which are not considered to be recorded as SOEs even if their commercial purpose is overwhelming. The government departments, which are engaged in

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commercial activities such as railway, postal service, and government factory, are not considered to be SOEs so that the departmental enterprises are not reported in the lists of SOEs.

3.2 Sri Lankan Focus on SOEs: Past and Present

The post-1977 policy reform process, though dramatic in terms of trade liberalization, was incomplete and inconsistent as it did not make a substantial influence on the public sector and the SOEs, among other things. Being one of the most-regulated economies in the 1970s, during which state intervention penetrated into production, distribution, and management in almost all sectors, Sri Lanka had much to do with SOE reforms during the post-1977 market-oriented policy regime. Yet privatization, which was still a new phenomenon in the policy reform waves in the world, did not come into effect. Instead, the government took initiatives to end its monopoly in many sectors opening them for private investment, and continued to work with the private sector under different partnership models. Privatization programme, which finally came into effect only after the second wave of policy reforms in 1989, recorded a massive increase in the 1990s, but short-lived. As the World Bank database on privatization records, Sri Lanka has privatized 98 SOEs during 1990-1999, and only 4 SOEs during 2000-2004.

At the beginning of the post-2005 new policy regime, government declared its withdrawal of the privatization strategy, and stated its objective of restructuring the SOEs to improve their performance. Generally, it was also welcomed by the employees of the SOEs whose job security and privileges were under threat by the privatization move as well as the general public who have seen many failure cases of privatization and associated corruptions. In fact, the privatization programme of Sri Lanka which produced only mix results, was also come under severe criticisms due to its alleged corruption and underselling practices (Ameresekera, 2011a, 2011b).

Privatization activities during the period of first five years (1990-1994) seem to have been carried out in an ad hoc manner under a special division of the Ministry of Finance. With the establishment of the Public Enterprises Reform Commission (PERC) in 1996 as an independent statutory body the privatization programme of Sri Lanka was streamlined. The PERC had the mandate of advising the government on reforms of the SOEs, guided by a set of given criteria. The Strategic Enterprises Management Agency (SEMA) was established in 2004 with the purpose of providing expertise guidance for strategic SOEs to improve their efficiency and effectiveness and to sustain as autonomous and commercially viable enterprises.

As privatization programme was ceased, the PERC was closed down in 2007. The strategic enterprises that came under the purview of SEMA were organized into five clusters as financial, utilities, plantation assets, transport and logistics, and special projects. Whatever the institutional arrangements may have been in effect, they all appear to be failures as they all fell short of executing improvements in the SOE sector. If not for that matter, the Report of the COPE (2013) would have been presented to the Parliament with a different message.

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The bottom line on SOE performance that has been presented in the Annual Report 2005 of the Ministry of Finance and Planning at the beginning of the post-2005 policy regime was that the public enterprises continued to strain the budget. As the report highlights, the common weaknesses of many of the SOEs includes uneconomical transactions, absence of realistic pricing strategies, lack of corporate strategies and managerial skills, lack of business focus, exceptionally high overhead cost, and inefficiencies (MFP, 2005, p. 28). Interestingly, the Annual Reports of the Ministry of Finance and Planning, published during the subsequent years did not have to report any change in above weaknesses, but did analyze the gravity of the issue in spite of concern of the government and subsequent the institutional arrangements executed to address the issue.

The Annual Report 2008 of the Ministry of Finance and Planning (MFP, 2008, p. 140) analyzed four major continuing issues of the SOEs as follows:

1. Heavy reliance on the government budget for recurrent expenditures of several loss-making and non-functional public enterprises
2. Non-payment of dividends to the government by most of the minority share-holding companies
3. Heavy public enterprise debts which have impact on bank performance
4. Unusual accumulation of inter-public enterprise debts (circular debts)

It is interesting to note that there are not only loss-making SOEs, but also defunct SOEs draining recurrent expenditure from the government budget. As we have already seen, the point was also noted by the Report of the COPE (2013) implying that these defunct and non-liquidated SOEs continued to exist. Plausibly, at least financially it might be less costly for some of the SOEs to remain defunct rather than in operations, if liquidation was not an option for the government for reasons not explained in the relevant study reports. Out of 92 limited liability companies, including 49 plantation and other companies in which the government has less than 50 percent holding, only 46 companies have paid dividends to the government at least once over the period from 2000 – 2008 (MFP, 2008, p. 142).

The debt problem of the SOEs is two-fold as bank debts and circular debts. The normal practices of corporate governance are undermined in bank lending to the loss-making SOEs as government guarantees are available for these enterprises to borrow from banks on the one hand, and the banks which lend to them are also part of the SOEs on the other hand. The circular debt problem arises as SOEs continued to remain indebted to each other not only due to their practice of borrowing from other SOEs but also due to the non-payment of outstanding bills of the other SOEs. Apart from borrowings, the government continued to assist the loss-making SOEs with numerous subsidies, grants and contributions from the government budget. According to the Annual Report 2012 of the Ministry of Finance and Planning,

SOBEs [state-owned business enterprises] were supported through budgetary provisions inclusive of grants and loans amounting to Rs. 32.2 billion [in 2012], an increase of 16 percent over 2011 and government guarantees to selected enterprises such as CEB, CPC and Sri Lankan Airlines totaled to Rs. 321.2 billion enabling SOBEs to have access to funding from bank sources” (MFP, 2012, p. 434).
In spite of repeated calls at policy level, thus, the SOE performance throughout the post-2005 regime continued to lag behind contributing to the macroeconomic and development challenges of Sri Lanka. While the government has been attempting to restructure the various SOEs facing challenges, and to expropriate non-performing or underperforming privatized business, the fiscal and economic burden of the SOEs appears to have been worsening.

<table>
<thead>
<tr>
<th>Turnover (LKR billion)</th>
<th>Enterprise</th>
<th>Share of turnover (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Over 100</td>
<td>Ceylon Petroleum Corporation, Ceylon Electricity Board, Sri Lankan Airlines Ltd</td>
<td>79.8</td>
</tr>
</tbody>
</table>

Note: Table presents only 40 non-financial SOEs as reported in the data source, whereas the MFP (2014) reports 47 non-financial state-owned business enterprises.
Source: MFP (2012)

### 3.3 Current Profile of the SOEs

Out of 40 non-financial state-owned business enterprises, as reported in the Annual Report 2012 of the Ministry of Finance and Planning (MFP, 2012), the top ten enterprises according to the size of the annual turnover, account for over 93 percent of the total turnover. The top three enterprises with turnover exceeding Rs. 100 billion a year include Ceylon Petroleum Corporation (CPC), Ceylon Electricity Board (CEB), and Sri Lankan Airlines Ltd which alone accounts for nearly 80 percent of the total annual turnover. The second category of state-owned business enterprises classified according to the size includes seven enterprises with annual turnover between Rs. 10 – 100 billion, accounting for 13.6 percent of the total turnover of the non-financial state-owned enterprises.

The biggest SOEs are the biggest losers too. The operational losses of CPC, CEB, and Sri Lankan Airlines together account for over Rs. 180 billion in 2012. They have a long history making losses under the state ownership, but it seems they have been experiencing increasing losses in the past few years reaching
their historical high levels in 2012. The next biggest losers include Sri Lanka Transport Board, Mihin Lanka Ltd, and National Water Supply and Drainage Board. The total amount of operational losses of all these top six loss-making SOEs in 2012 (Rs. 190 billion) is greater than what is spent as current expenditure on both health and education together in the same year (Rs. 189 billion).

Table 2: Biggest Losers among the SOEs

<table>
<thead>
<tr>
<th>SOE</th>
<th>Turnover 2012</th>
<th>Losses 2012</th>
<th>Profits/Losses 2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ceylon Petroleum Corporation</td>
<td>515,704</td>
<td>-89,658</td>
<td>-3,748</td>
</tr>
<tr>
<td>Ceylon Electricity Board</td>
<td>170,652</td>
<td>-61,163</td>
<td>17,800</td>
</tr>
<tr>
<td>Sri Lankan Airlines Ltda</td>
<td>117,186</td>
<td>-29,973</td>
<td>-15,754</td>
</tr>
<tr>
<td>Sri Lanka Transport Boardb</td>
<td>20,165</td>
<td>-9,972</td>
<td>-9,064</td>
</tr>
<tr>
<td>Mihin Lanka Ltda</td>
<td>7,452</td>
<td>-2,866</td>
<td>-675</td>
</tr>
<tr>
<td>National Water Supply &amp; Drainage Board</td>
<td>16,294</td>
<td>-579</td>
<td>389</td>
</tr>
</tbody>
</table>

a: For the financial year 2012/13  
b: Data source reports losses after recurrent subsidy as LKR 4,653 million in 2012, and LKR 4,178 million in Jan-Sep 2013.  
Source: MFP (2012), MFP (2014)

Table: Outstanding Debts and Dues of the SOEs reporting Major Losses in 2012

<table>
<thead>
<tr>
<th>SOE</th>
<th>Debts to banks 2012</th>
<th>Other debts and dues 2012</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Sep-13</td>
<td></td>
</tr>
<tr>
<td>Ceylon Petroleum Corporation</td>
<td>211,163</td>
<td>203,719</td>
</tr>
<tr>
<td>Ceylon Electricity Board</td>
<td>43,839</td>
<td>51,698</td>
</tr>
<tr>
<td>Sri Lankan Airlines Ltda</td>
<td>27,684</td>
<td>26,926</td>
</tr>
<tr>
<td>Sri Lanka Transport Board</td>
<td>627</td>
<td>660</td>
</tr>
<tr>
<td>Mihin Lanka Ltda</td>
<td>3</td>
<td>317</td>
</tr>
<tr>
<td>National Water Supply &amp; Drainage Board</td>
<td>-</td>
<td>36,300</td>
</tr>
</tbody>
</table>

a: For the financial year 2012/13  
b: Other debts and dues are reported in the data source as government debts and statutory dues. The figures do not include capital contributions to Sri Lankan Airlines Ltd (LKR 12,600 millions in 2012) and Mihin Lanka Ltd (LKR 1,894 millions in 2012), and Treasury subsidies to Sri Lanka Transport Board (LKR 5,894 million in 2012).  
na: Not available  
Source: MFP (2014)

The debt accumulation of the loss-making SOEs is alarming. The outstanding bank debts of the top three SOEs—CPC, CEB, and Sri Lankan Airlines, amount to Rs. 494 billion in 2012. While there are other types of outstanding government debts and dues too, the government used to provide different forms of subsidies and capital transfers.
Even though Sri Lanka Railway should have been classified as a constant big loss-maker, for being a government department it continued to escape from being listed under the loss-making SOEs. In 2012, the operational expenditure of Sri Lanka Railway amounts to Rs. 10.6 billion, of which its income could cover only Rs. 5.4 billion, leaving an operational loss of Rs. 5.2 billion (CBSL, 2013, p. 87). While Agriculture and Agrarian Insurance Board and Hotel Developers Lanka PLC have also made considerable operational losses in 2012, amounting to Rs. 3.7 billion and Rs. 1 billion respectively. Ceylon Fisheries Corporation, Ceylon Fishery Habour Corporation, Sri Jayawardenapura General Hospital, Sri Lanka Broadcasting Corporation, Sri Lanka State Plantations Corporation, and Janatha Estates Development Board were among other loss-making SOEs in 2012.

There are many SOEs which recorded profits in 2012, but it does not necessarily mean that they are operating efficiently and effectively in responding to market incentives and challenges, and that they are free from facing the common problems of the SOEs. As long as they operate within the same management framework of the SOEs, their commercial viability remains at a risk even though they make profits for some specific reasons.

Along with an increase in government revenue, budgetary transfers to public corporations and institutions have also increased remarkably. During the past 10 years, the government transfers to public corporations and institutions increased 3-times from Rs. 15 billion in 2003 to Rs. 45 billion in 2013, while government revenue has increased nearly 4-times. The increase in transfers to public corporations and institutions could be attributed to the increase in the size of the public corporations and institutions as well as their rising expenses and losses.

There is an improvement in performance of the SOEs during the period of January-September 2013, as reported in the Fiscal Management Report 2014 of the Ministry of Finance and Planning (MFP, 2014). The net loss of 47 non-financial SOEs amounting to Rs. 155 billion in 2012, improved and turned to be a net profit of Rs. 34 billion (MFP, 2014, p. 67). Outstanding bank debts of 28 non-financial SOEs, amounting to Rs. 322 billion in 2012 also declined to Rs. 307.5 billion (MFP, 2014, p. 66).

The improvement is attributed by the the Fiscal Management Report 2014 to a number of factors as ‘...the revision of prices towards achieving cost effective prices, positive impact of the weather, expansion of physical infrastructure, and gradual improvement in business strategies, management and governance’ (MFP, 2014, p. 65). Even though the first three factors are noticeable and measurable, it is not easy to assess the robustness of the ‘improvement in business strategies, management and governance’, and the short-run reform process that led to it. Price adjustments do not necessarily mean that the SOEs are now operating efficiently and competitively, because the prevalent regulatory mechanisms and the state monopoly affecting the operations of the SOE continue to remain the same.

CEB, which made a massive loss of Rs. 61 billion in 2012, has been able to make a profit of Rs. 17.8 billion during the first nine months of 2013. Although this performance has been supported by upward price revisions, electricity tariffs in Sri Lanka are already high by international standards; according to a study of International Energy Consultants (IEC, 2012), the average retail electricity tariff in Sri Lanka (including the government’s subsidy component) is estimated to be USD 25 cents per kwh, which is
higher than that of 42 countries selected from Europe, Australia, East Asia, and Southeast Asia as well as Canada and South Africa. Upward revisions in tariffs or improved weather conditions, therefore, do make CEB an efficient enterprise. Apart from that, being a domestic market oriented enterprise, CEB and many other SOEs do not have to anticipate competitive pressure in an international market.

**Chart 1: Government Transfers to Public Corporations and Institutions**

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**3.4 Diagnosing the SOE Problem**

The Report of COPE (2013) points out that the SOEs are making losses as a result of serving the national interest by foregoing correct pricing:

> The greatest challenge faced by the public enterprises with a commercial basis is that they are required to compromise on catering to the national interest of the country while being engaged in a highly competitive dynamic business environment. The severe losses of the Ceylon Electricity Board [CEB], Mihin Lanka Ltd. Etc. had been due to the under-selling of their services for not being able to pass the burden to the general public. (COPE, 2013, p. 4)

The diagnosis made by COPE seems debatable. The requirement of the SOEs to cater to the ‘national interest’ through lower pricing also seems ungrounded as the losses are eventually passed on to the general public through budgetary transfers. A micro level analysis of each SOE would reveal the sources of internal inefficiencies, in addition to the common issues faced by the SOEs. In fact, apart from improper financial planning, the COPE highlights a series of issues of the SOEs that contribute to their substandard business performance. Some of these issues include inadequate public sector salary scales, overstaffing and dearth of qualified staff, sustaining redundant SOEs, lack of cost accounting systems, adverse influence of trade unions, and unsatisfactory debt management.
The IMF pointed out that Sri Lanka’s fiscal position is weak and debt burden is high, so that large losses of the SOEs such as CPC and CEB are unsustainable:

> These companies’ [CPC and CEB] large losses are unsustainable. At the same time, electricity prices are high by regional standards. A comprehensive approach is required, including better management, lowering electricity generation costs, raising efficiency, and moving toward cost-recovery pricing, followed by adoption of an automatic price adjustment mechanism. (IMF, 2013, p. 12)

Mixing the multiple objectives of the government with the objectives of the SOE has been a fundamental issue of the SOEs. The attempt of the government to achieve its social, political, and developmental objectives through the SOEs is not a commendable strategy as it achieves neither of them in the long-run, but only drives the SOEs as well as the overall policy environment into disarray.

It seems that the regulatory mechanism and the market structure within which SOEs operate are the two basic issues underlying most of the problems highlighted by the COPE. As a result the decision-making process of SOEs to a great extent remains beyond the purview of the SOE. As the SOEs are protected by the regulatory mechanisms, the hands of the government, and the domestic market monopoly power all enable them to stand without being competitive and accountable. Implicitly or explicitly, the SOEs are protected against not only the difficulties but also the bankruptcies.

Lack of information and statistics, enterprise profiles, and historical performance do not permit to undertake analyses of the SOE performance. SOEs hardly disclose their data and information on their employment structures, cost structures, research and development, annual performance, and historical performance. In fact, there are no research and development divisions within SOEs. Even the websites maintained by many SOEs look empty without substantial information to present other than the vision and the mission. Many SOEs have exhibited their inability even to provide their Annual Reports; only 18 SOEs (including 10 operating in the banking and financial sector) out of 55 have submitted their Annual Reports in 2011 to the Department of Public Enterprises (MFP, 2012, p. 514).

The centralized decision-making process in the Sri Lankan SOEs makes their operations inefficient and uncompetitive on the one hand, and prevents their different branches and activities to stand as separate individual business centres. The centralized decision-making system that did not undergo a substantial reform process continued to remain in the SOEs as well as many other public sector institutes. The lack of power delegation constrains decision-making at lower strata. When this weakness exists in the SOEs, the different branches and activities of an enterprise or an institute do not have the capacity to function as a separate activity and to exhibit its own performance.

International businesses are still a new field for the Sri Lankan SOEs, even at a time that SOEs from even developing countries have been entering into international bidding process and undertaking international projects. As we have already discussed, the SOEs from many countries have been transforming into state-owned transnational corporations (TNCs) and expanding their businesses globally. Most of the Sri Lankan SOEs are operating in a protected domestic market, although by nature of the business a few enterprises such as the airlines have to do business in an international
environment. They are protected by their monopolistic nature of the activity within the domestic market or the government’s regulatory mechanism that governs the operations of the SOEs under different legal structures.

Fear for reforms is an overwhelming feature of the Sri Lankan economy and the polity. Even at policy-making levels, *ad hoc* measures to deal with petty issues at superficial levels appear to take precedence over the need for reforms aimed at source of the fundamental issues. It could well be a result of the lack of coordination and trust among the stakeholders of the SOEs. Although the past experience provides evidence on penalizing at least one party of the stakeholders in the case of SOE reforms, it is not a justifiable reason to abandon the reform process. Even at experimental stages, the reform process needs to continue.

### 3.5 Camouflaged State: Creeping into Private Business

It is a new phenomenon in the post-2005 regime that the government creeps into private business. Even if this initiative was adopted on altruist sense in the current regime, and perhaps was justified by the positive developments, it is necessary to look into it cautiously; it has serious long-term economic and political implications in weakening private investment and retarding economic growth, among other social and political issues.

There have been a number of initiatives in the recent past enabling the government to interfere in private businesses and to expand the SOE sector. The government has stepped into this initiative through direct acquisition of private businesses and assets as well as through the use of private savings and pension funds to procure a stake in private businesses.

The second initiative came through the post-war necessity of occupying the military forces in productive activities. Apart from the areas of security, the military also has the skills and legitimacy to get involved in security-related economic activities. At least as a temporary initiative the country can also benefit by diverting the skills and resources of the military in the areas where the role of the government is overwhelming. However, its attempt to move beyond these boundaries into any economic activity needs cautious consideration, as such moves would put the emerging and expanding private sector in a competitive disadvantage. It is not a commendable achievement to observe that in the long-term the country has a shrinking private sector in the context of state expansion in economic activity, which is unsustainable economically and politically, but irreversible.

Even if the ownership does not matter as long as the businesses operate on their economic and management principles, there are dangerous long-term repercussions of the government’s *ad hoc* move into private sector economic activities. After all it is not the government, but the private sector that plays the major role in long-term economic development for which the government is expected to play a facilitating role. The initiatives by the government are should not undermine the emerging post-war business environment.

The main weakness of the post-2005 policy regime on SOEs is the lack of a Code of Conduct to guide its SOE policy. The government emphasized its non-privatization policy, but did not clarify its alternative
programme of reforms. The government expressed its enthusiasm to ‘restructure’ SOEs, but there was no clarified set of guidelines for restructuring. Without a Code of Conduct for SOEs and a policy framework for managing the SOEs, the \textit{ad hoc} measures of interference left the SOEs in disarray. For this reason, on the part of the government there is no guarantee that SOEs in Sri Lanka would continue to perform better than they did in the past.

IV. GUIDELINES FOR REFORMS

Although ownership matters in business performance, given the political will for reforms the link between the two can be changed for bringing the SOEs under good corporate governance. In fact, reforms are not a choice but a mandate regardless of the ownership. If there is political will to ensure better performance of the SOEs and to upgrade them to be competitive in the global market, it requires a reform process. Reforms are not a set of changes once and for all, but a continuous process guided by research.

4.1 Broad-based Ownership

The ownership of the SOEs needs to be based on a multiple-ownership structure which should consist of (i) government, (ii) other private share-holders, (iii) employees of the enterprise and, (iv) public. The change towards a multiple-ownership system requires reforms in the legal structures of the SOEs, which currently exists in many different types varying from statutory bodies to governmental departments. The change is based on the argument that SOEs should move into public limited liability companies, even if the government continues to remain the controlling share-holder. Privatization is, though not excluded, not considered here as an option, while it is simply a reduction of the controlling stake of the government.

If the government remains as the controlling share-holder, the government should have a clear state-ownership policy, separating the SOE objectives from the government’s other objectives, defining its ownership boundaries, and ensuring a level-playing field for the SOE in both local and international context. A policy of transferring part of the ownership to the employees has been practiced in the past SOE reform endeavours in Sri Lanka. The ownership granted to the employees could be traded in the Stock Exchange. The broad-based ownership is important for the share-holders to act on specific SOE objectives in a market-based approach without mixing them with the government’s other objectives.

4.2 Regulatory Framework

The broad-based ownership structure of the SOEs is not completed and effective unless the regulatory framework is established in consistent with the ownership structure. The decision-making process of the SOE needs to be an internal matter free from the direct or indirect Ministerial and Departmental control, influence, and interference.

The government should establish a Code of Conduct regarding its policy on SOEs, ensuring the operational autonomy of the SOEs, accountability of the Director Board, the management, and the
employees, and transparency of the role of the government. The regulatory framework should have self-imposed limitations on the role of the government ensuring the entrepreneurial autonomy of the SOE and establishing the competitive conditions for SOEs as for the private enterprises including its withdrawal from recruitments, procurements, pricing, and other areas of management. The SOEs should operate purely on competitive conditions and not under the state patronage, and should not be exempted from the application of the country’s laws and regulations. Finally, the regulatory framework should guarantee fair treatment to different stakeholders, while transferring internal inefficiencies to consumers and financial burdens to third parties should be dealt with effectively.

4.3 Transparency and Disclosure

The SOEs should be responsible for establishing a greater degree of transparency in their operations and disclosure of information than any other type of enterprise. Although the regulatory framework can establish the clauses of requirements for transparency of operations and disclosure of information, this area is important not only for stakeholders, but also for research studies and policy-making. As a policy measure, the SOEs should maintain their detailed statistical databases and information for annual and historical data on output and sales, cost structures, employment structures and other information for access to public. They should also be responsible for publishing their audit reports and annual reports.

The SOEs should be subject to standard accounting and auditing practices. The business operations and employee recruitments should be internal matters handled by the management with transparency and disclosure of information. Under its SOE policy, the government should also adhere to the policy of selecting and nominating its board members from among competent persons in a transparent manner, and granting them the necessary responsibilities and powers to carry out their functions. The government should refrain from influencing the internal decision-making by the SOEs or ruling out the internal decisions of the SOEs.

4.4 Internal Reforms

Internal reforms are an internal matter – an area which is primarily left for the Board of Directors to take decisions, and the management to carry out in achieving the SOE objectives. If the Board of Directors have the autonomy and competency to carry out its responsibilities subject to a greater degree of accountability, internal reforms should be an essential component of the internal operations of the SOEs. However, if the government continues to remain an influential partner, and if some of the SOEs remain as strategically important enterprises, it is necessary to highlight a few additional areas of concern other than those related directly to its operations.

While the government should specify its boundaries of assistance and interference under the SOE policy, the SOEs should also have their own guidelines not to transfer the burden of internal inefficiencies and wrong practices to a third party (through the government budget or government guaranteed borrowings), not to violate the principle of fair treatment to all stakeholders, and not to compromise enterprising objective for national interests. While achieving and maintaining global competitiveness and standards should be reflected in the corporate vision and mission, instead of the current practice of
setting goals and agenda in the context of an isolated local environment, this needs to be tested and testified. In fact, in the medium to long term, they should be able to conduct their off-shore operations competitively. It is, therefore, important to set foundation for research and development activities within each of the SOE as well.

4.5 Reforms in Specific Sectors

Once the government’s overall SOE policy framework is in place, it is necessary to customize the reform programme identifying different sets of SOEs, established under different legal structures and regulatory mechanisms, operating in different types of markets, and performing differently. The near monopoly or duopoly status set by regulatory mechanisms, or sunk fixed costs, or natural market conditions needs to be eliminated. More competitors can be brought into the market, while the different activities and branches of the SOEs can be split into separate activity or profit centres. The SLTB that co-exist with a system of private bus operators, and the Sri Lanka Railway that still remains as a government department need substantial reforms at source of the issues and the adoption of corporate strategies to improve their service performance.

The objectives of some of the SOEs need to be reformulated stressing their commercial nature and the need for cost-recovery pricing. The centralized decision-making systems should be abandoned in general, while even the different activities with a commercial nature run by the government departments can be treated as separate and autonomous activity or profit centres. In principle, the SOEs which have to be operated purely on commercial purpose do not have to be in the hands of the government.

4.6 Current Economic and Financial Issues

The SOEs have to deal with their current economic and financial issues, while it is understandable that they do not have the capacity to do so. The issues are numerous and complex so that the government’s SOE policy and the regulatory mechanism should be designed in such a way that the government assistance within a given time framework is available to the Director Boards and Management to act upon the current issues. High debts of the SOEs can be transformed into equity. The government can set the time frameworks for budgetary transfers, specially the salaries and operational costs, as the SOEs are due to meet the operational costs internally. Internal time frameworks and working plans can be set for improving efficiency and effectiveness, reaching financial targets to cover operational costs, and meeting the global competitive standards.

As the SOE reform process is directed at setting a level playing field for the SOEs to become efficient and competitive, apparently there may be a list of SOEs which cannot meet these goals. It is worthwhile to reconsider how important it is to sustain these institutes in serving for national interest.

4.7 Reforms and Reforms

The SOE reform process should not be considered as one-time adjustment in setting a new era for the SOEs, but a continuous process without ending. Continuity in reforms is important in order to learn from
trial and error and making the process itself more effective, and to take the contemporary global challenges and dynamics in the operation of SOEs into account.

The lessons from past experience and from other countries provide valuable guidelines to initiate the reform process. Sri Lanka itself has a long history of running SOEs, restructuring experience, privatization experience, and partnership experience to provide rich lessons for the SOE reform process. The SOE reforms in developing countries and of OECD countries have been continuing to-date. While there are failures and success cases everywhere to learn, some of the SOEs have transformed into state-owned TNCs conducting off-shore operations and business, and competing with private TNCs. The world experience on SOE reforms provide valuable lessons to learn in executing an effective reform process in Sri Lanka.

V. CONCLUDING REMARKS

The study was aimed at taking an account of and analyzing the present status of the SOEs of Sri Lanka, and to draw out policy guidelines for reforms. The ownership does not matter as long as the SOEs operate as private enterprises, but the world experience suggests that ownership matters. Thus, sub-standard performance and inefficiencies of the SOEs is common issue in the world, prompting SOE reforms and their continuity. While the reform process itself has opened up avenues for the world to learn the lessons, the SOE reforms in many countries – both developing and developed, have enabled them to improve SOE performance and, to enter into global business facing international competition. In fact, global integration through trade and investment has brought about new challenges to face and new opportunities to exploit by the SOE sector in the countries adopting liberalization reforms. In this context, it is not surprising that the countries which adopt lukewarm strategies on SOE reforms continue to lag behind.

The problem of the SOE operations in Sri Lanka is a complex issue, and has been worsening in the recent past. The SOEs exist under different legal structures; including some of them continue to remain even as government departments. The economic and financial issues of the Sri Lankan SOEs have been worsening in the recent past, while the temporary improvements do not appear to be sustainable in the absence of reforms. In fact, it is the lack of reforms that appear to be the major factor underlying the worsening performance of the SOEs. Under the post-2005 policy regime, there has been an expansion of the SOE sector as well as an increase in state involvement in private enterprising in setting the parameters for future risks and uncertainty.

The economic and financial issues of the SOE sector results in a fiscal burden transferred to a third party, market distortions and misallocation of resources, and a long-term development cost. Thus, Sri Lanka is at a crossroad calling for a bold and broad SOE reform process that has been belated throughout the post-1977 liberalized policy regime.

The study draws policy guidelines to set the Sri Lankan SOE sector on a reform path identifying the significance and urgency of a reform process, recognizing the sensitive nature of reforms to stakeholders
of the sector. However, it is noteworthy that the reform process is not a choice but a mandate, and not conclusive but continuous in order to improve the economic and financial sustainability of the Sri Lankan SOEs and to allow them to grow as internationally competitive enterprises carrying out off-shore businesses.

The guidelines are formulated under seven headings: (a) adopting a broad-based ownership structure by incorporating the employees and other shareholders with the aim of listing as public companies; (b) setting up a regulatory framework enabling the SOE to operate on a level playing field as the private enterprises, (c) transparency of decision-making and disclosure of information to public, (d) autonomy and competency enabling the SOEs to carry out internal reforms, (e) reforms in the specific sectors, and in different divisions, (f) dealing with current economic and financial issues, and (g) continuity in reforms as a process.

Works Cited


