



THE WORLD BANK

Improving the Corporate Governance of State-Owned Enterprises: The Approach of the World Bank

Despite extensive privatization over the past 20 years, state-owned enterprises (SOEs) remain important in many developing countries. SOEs—also referred to as government corporations, government-linked companies, parastatals, public enterprises, or public sector enterprises—are especially prominent in such sectors as transportation, electricity, gas and water supply, broadcasting, natural resource extraction, telecommunications, and banking and insurance. Many large listed companies still have significant state ownership, or are held indirectly by state pension funds or other government-controlled companies. Globally SOEs account for 20 percent of investment, 5 percent of employment, and up to 40 percent of output in some countries.

Unlike the past, SOEs today face much higher pressure to increase operational and financial performance. A number of forces have led to a more demanding environment, including greater competition, financial sector liberalization, restructuring and privatization of state-owned banks, technological changes, international agreements, and budgetary reforms. In response to these pressures, many developing countries are now embarking on wide-ranging corporate governance reforms of their state-owned sector. By improving the governance of SOEs, the state aims to better protect its assets and enhance performance.

Corporate Governance Challenges

SOEs face significant corporate governance challenges, driven by a wide separation of ownership (by the state on behalf of the citizens of a country) from control (by the directors and managers that run the company). Many government bodies influence SOEs (one or more ministries, cabinet, an ownership entity specifically created to oversee SOEs, the Parliament), and each may potentially use the companies to achieve short-term political goals, undermining their efficiency and opening the door to corruption.²

SOEs and their owners typically face five corporate governance challenges:

Unclear ownership objectives. Although there is general acceptance of “shareholder value” as the goal for privately held companies, SOEs have been given a wide range of goals and objectives. SOEs may face price controls, output targets, requirements for comprehensive service (e.g., rail, telephony, mail), employment goals, community development targets, pressures to correct past social injustices, requirements to provide social services, and financial targets such as returns on capital. Some of these objectives may be explicit; others may be implicit but no less important in practice.

When SOE objectives are ambiguous or conflicting, managers have substantial discretion to effectively run the firm in their own interest. Governments may also abuse this discretion and meddle in company affairs for political gain, under the cover of their various policy mandates.

Explicitly defining and limiting SOE objectives can help reduce political interference, clarify management goals, improve performance monitoring, and reduce opportunities for corruption.

Weak owners. In a private company, owners play a key role in corporate governance. An ideal owner elects or appoints the best people it can find to the board of directors, sets clear goals, monitors company performance, makes changes in the board as necessary, and provides capital to fund expansion plans. By contrast, in many or most countries the state exercises its ownership role through weak institutions, sets inconsistent goals, does not monitor company performance, is unable to make changes to correct poor performance, and cannot supply capital.

Increasing the professionalism and capability of the state's ownership function is a major corporate governance challenge. Some countries are building a single government body (such as a ministry or holding company) to assume responsibility for the government's stake in all SOEs on the grounds that such a body is better able to develop specialized capabilities and ensure accountability for performance.

On the other hand, countries with large and more complex state sectors fear that a single ownership entity with too much bureaucratic power would waste resources and act as a magnet for corruption. Many are thus pursuing a more decentralized model, in which enterprises are overseen by different ministries or other parts of the government. Still others are adopting a dual approach where ownership functions are decentralized while a single body plays a coordinating role.

Choosing the right approach is bound to vary from one country to the next, based on the administrative and political culture as well as the size and complexity of the state sector.

Low levels of transparency and disclosure. Although "publicly owned," many SOEs lack transparency. They tend to have no public reporting requirements, and their accounts and other information may be treated as a state secret. Opacity undermines performance monitoring, limits accountability at all levels, conceals debt that can damage the financial system, and creates conditions under which corruption can flourish.

To improve transparency, SOEs are increasingly made to comply with high standards of accounting and auditing. Many governments are also developing an aggregate report to present an accurate picture of its SOE portfolio.

Unprofessional boards of directors. SOE boards rarely play a true corporate governance role. Boards tend to act as a "parliament" representing various stakeholders. SOE boards in many countries include elected officials, civil servants, and employee representatives, all of whom may have agendas that conflict with the interest of the company as a whole. Unsurprisingly, SOE boards are weak, and decision-making is heavily influenced by the government.

Improving SOE boards requires many of the same steps as in private companies, including increased authority, autonomy, and professionalism.

Poor relationships with other shareholders and stakeholders. SOEs face powerful stakeholders, including consumers or communities, state-owned creditors and employees. SOE employees may have a greater say in governance than employees in the private sector do. Many SOEs also have minority shareholders. As with other controlling shareholders, the state may abuse minority rights. This can include transactions that benefit management or other SOEs at the expense of outside shareholders.

Minority shareholders in state-controlled companies should have the same legal rights as shareholders in other companies and should be treated equally. The state must avoid using its power to abuse minority shareholders and should exercise policy objectives in a way that preserves their legal rights.

Our approach

The World Bank Group addresses the problems faced by SOEs both at the company level and at the ownership level.

Diagnosis. The Corporate Governance Department of the World Bank Group has developed a new diagnostic report to identify the strengths and weaknesses of the SOE corporate governance framework. It complements the World Bank Corporate Governance ROSC program, which assesses the corporate governance of listed companies, as well as our other diagnostic programs that review corporate governance practices in various financial sectors.

The diagnostic report is based on the 2005 *OECD Guidelines for the Governance of State Owned Enterprises*, and thus addresses six main areas:

- ensuring an effective legal and regulatory framework for SOEs;
- the state acting as an owner;
- the equitable treatment of shareholders;
- relations with stakeholders;
- disclosure and transparency; and
- the responsibilities of the board.

Our methodology analyzes the current SOE portfolio and the accompanying governance framework, highlights both the positive features and the inefficiencies of the prevailing system, and includes a series of policy recommendations.

Diagnostic reviews are conducted in five main phases:

- **Phase 1: Setting clear project goals and objectives.** An initial scoping mission is carried out by corporate governance experts from the World Bank Group. The project team meets with senior civil servants of the Ministries and regulators with responsibility for SOEs; chief executive officers, chairmen and other board members of selected SOEs; the primary public sector auditor and external auditors; and other stakeholders. At the conclusion of the scoping mission, a clear set of goals and objectives is established for the review.
- **Phase 2: Data Collection.** Experts from the Ministry or other body that acts as the oversight entity (working closely and as needed with the World Bank team) collect a set of standardized information about SOEs and their owners. This is either carried out in partnership with the “ownership entity” in each country, by a corporate governance NGO / institute working closely with our counterparts, or by a consultant engaged by the project team. Information to be completed includes: [\[Need to specify this here\]](#)
- **Phase 3: Assessment and Report Writing.** The World Bank team working in conjunction with government experts collates the survey and questionnaire information, and then drafts the review. A draft of the review is submitted to our counterparts for their review and comments.
- **Phase 4: Dissemination of study results.** The dissemination is conducted in conjunction with other projects and institutions that are working to improve SOE governance.
- **Phase 5: Development of an action plan.** Following an in-depth discussion of the strengths and weaknesses present in the corporate governance framework, the project team works with the owners and stakeholders to develop an integrated action plan to improve corporate governance.

Follow-up and implementation. In many countries the diagnosis is only the starting point in improving governance. The World Bank Group (including the IFC and the Global Corporate Governance Forum) is the world's largest provider of technical assistance and policy advice to reform corporate governance. Implementing the recommendations of the action plan can require substantial technical assistance and capacity-building efforts. Areas that could require significant technical assistance include:

- Capacity building and training of the ownership entity
- The development of an ownership policy
- The development of a performance monitoring system
- The development of an aggregate reporting framework
- Work at the company level with a specific enterprise, to create a “champion” of SOE governance reform.

SOE Corporate Governance Improvement Programs

The World Bank Group can also work with specific sectors or enterprises to implement corporate governance, and create “champions” of SOE governance reform. The World Bank can draw on the International Finance Corporation's work with client companies from more than 80 countries on board practices, shareholder rights, the internal control environment, and transparency and disclosure. The IFC Corporate Governance Methodology employs specialized assessment tools tailored to the different governance priorities of state-owned enterprises. This methodology can be used to assist project teams and client companies to improve governance practices, or as an input into risk analyses and investment decision processes.

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¹ These ideas are further developed in *The Visible Hand: the Challenge of SOE Corporate Governance for Emerging Markets*, which is available here.

² Many observers interviewed as part of the World Bank's Corporate Governance ROSC program have also commented that while corporate governance in the private sector is a major concern, SOE governance is a larger problem. Please visit http://www.worldbank.org/ifa/rosc_cg.html for more information about the Corporate Governance ROSC program.