Utilising a Crisis to Reform State-Owned Enterprises

By Imesha Dissanayake, Senior Research Associate at the Economics Intelligence Unit of the Ceylon Chamber of Commerce

Introduction

State-Owned Enterprises (SOEs) in Sri Lanka are mostly governed by the 'Administer Part II' of the Finance Act No. 38 of 1971, and recently several have been established under the Companies Act No. 07 of 2007[1]. There are 52 strategic SOEs monitored by the Ministry of Finance (MoF) and 87 SOEs with strong commercial aspect monitored by the Department of Public Enterprises[2]. SOEs in Sri Lanka are present in strategic sectors such as energy, water, ports, banking, insurance, transportation, aviation and construction, and hence play a pivotal role in the economy.

The MoF identifies that during 2021, the 52 SOEs recorded a significant net loss of LKR 86 billion. On closer analysis, it comes into light that 97% of SOE losses were contributed by 3 SOEs and 88% of SOE profits were contributed by 6 SOBEs (refer figure 1 and 2). This relays that not only is the profitability eroded by loss making entities but that there is only a handful of SOEs making significant profits.

The pricing policy adopted by SOEs is one of the causal factors that compromises the balance sheet of both the SOEs and state banks, and as a result have benefited the non-poor while putting state banks in a precarious situation. The credit provided by the banking sector to the SOEs stood at Rs. 1,188 billion as at end 2021[3]. The budgetary transfers by the MoF for capital and recurrent expenditure was at Rs. 274 billion and Rs. 93 billion, respectively in 2021[4]. These further increase the indebtedness of the government.

Owing to SOEs being inherited with financial distress, lower productivity, overstaffing, sub-optimal performance and maintaining monopolies, which dilute scarce resources have led to an accumulation of debt over 10.9% of GDP in 2021[5].

Therefore, inculcating a performance oriented culture whilst ensuring transparency and accountability are crucial areas for SOEs in Sri Lanka. Hence, SOE reforms are certainly warranted at this difficult juncture of the economic turmoil.

Figure 1: Top Contributors for SOE Profits

---

[1] According to the Department of Public enterprise and as given in the Central bank of Sri Lanka Annual report of 2021
[2] https://www.youtube.com/watch?v=-fbK1taTBwc
[3] According to statistics given in the Central bank Annual report (2021) - https://www.cbsl.gov.lk/en/publications/economic-and-financial-reports/annual-reports/annual-report-2021
[4] According to statistics given in the Ministry of Finance Annual Report (2021) - https://www.treasury.gov.lk/api/file/a7a35d1a-556f-49b2-81e0-20294eb5a519
According to statistics given in the Ministry of Finance Annual Report (2021) - https://www.treasury.gov.lk/api/file/a7a35d1a-556f-49b2-81e0-20294eb5a519
[5] Ministry of Finance Annual Report (2021) - https://www.treasury.gov.lk/api/file/a7a35d1a-556f-49b2-81e0-20294eb5a519

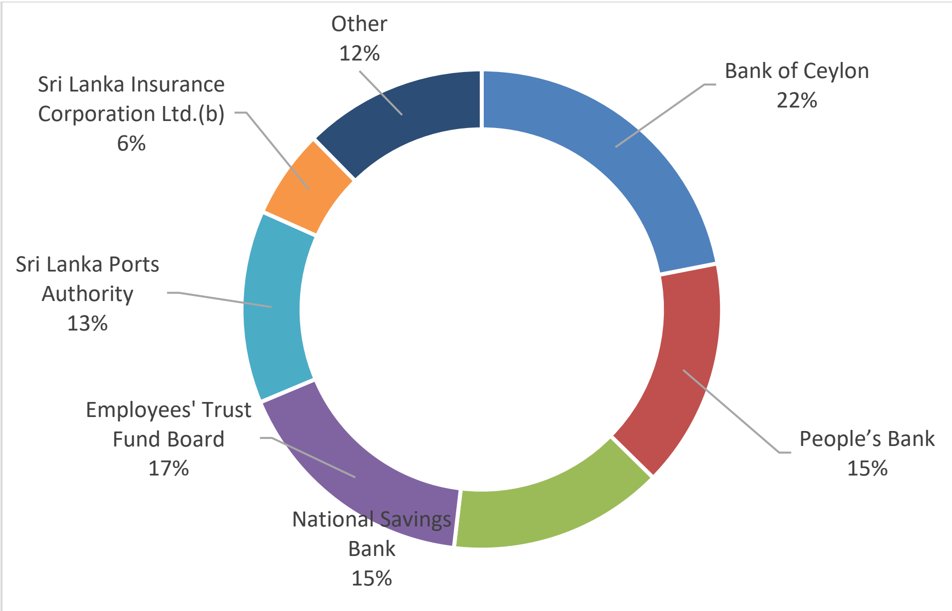
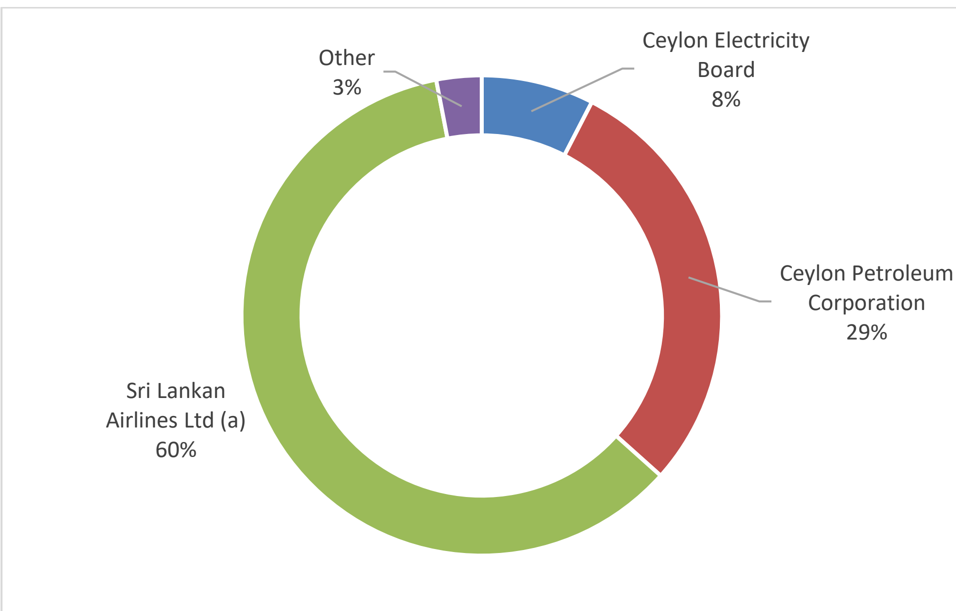


Figure 2: Top Contributors for SOE Losses



Source: Ministry of Finance, Sri Lanka

Benchmarking Models from the Global Experience

Countries such as Singapore and Malaysia have in place a super-holding company model for their SOEs (also known as Government-linked Companies) and as a result have demonstrated a good growth for their SOEs. Since this mechanism allows the government to adopt an arms-length approach to SOEs' operational decision-making, government is relieved of its direct responsibility of overseeing all the SOEs dispersed across various industries. Instead the government could use their energy and budget elsewhere.

Temasek in Singapore was established in 1974 under the Singapore Companies Act. This agency was created to facilitate SOEs to contribute to Singapore's economic growth by nurturing them into world-class companies through effective stewardship and strategic commercial investments. Today, it operates in 9 countries and its portfolio value amounted to SGD 381 billion (around USD 283 billion) as at the end of March 2021[6].

Khazanah in Malaysia was established in 1993 under the Companies Act in Malaysia and was revamped in 2004. This fund fulfills the dual objectives required by the Malaysian economy with two separate funds, namely; Commercial Fund (CF) and the Strategic Fund (SF). The SF undertakes investments to deliver impactful economic and societal returns for Malaysia. While CF focuses on investing responsibly and commercially, to grow the long-term value of assets[7]. The two funds were valued RM 106 billion (around USD 25 billion) and RM 28 billion (around USD 7 billion) for CF and SF, respectively at the end of 2021[8].

One of main reasons as to why the Temasek and Khazanah models were successful was because both Temasek and Khazanah are registered under the Companies Act of the relevant countries, subjecting the holding companies to the same requirements as a private sector business. Unlike most SOEs in Sri Lanka, which are governed by the 'Administer Part II' of the Finance Act No. 38 of 1971.

Another parallel that can be drawn is the economic crisis Sri Lanka is currently facing. Both Singapore and Malaysia, faced a crisis period that enabled the formation of Temasek and revamping of Khazanah. The severe economic conditions coupled with a challenging political environment in Singapore during the late 1950s to the early 1970s was a major factor in the development and governance of SOEs. As it played a key role in nurturing good political governance in Singapore, which was then transposed to the SOEs.

In Malaysia, though Khazanah was established in 1993, it did not play an active role until the Asian financial crisis. The aftermath of the crisis, led to the transformation of Khazanah together with major corporate restructurings and institutional reforms to SOEs. Since, the inefficiencies and suboptimal performance of SOEs were exposed and felt deeply by the Malaysian economy during this time.

Way Forward

The presence of SOEs in strategic sectors of Sri Lanka is proof of the substantial value creation SOEs can generate through trickle-down effects. The societal returns too are greater as it links to day-to-day activities of all Sri Lankans such as drinking water, electricity and even transportation. Therefore, it is important that SOEs perform effectively and deliver favourable socioeconomic outcomes without financially burdening the state.

The transformation of existing SOEs from fiscal burdens and into value creators, through reforms, is vital in order to emerge as an impetus for Sri Lanka's growth and development, rather than serving as stumbling blocks.

The economic crisis Sri Lanka is facing presents a perfect opportunity for Sri Lanka to reform its SOEs to be efficient and facilitators of growth. A crisis reveals vulnerabilities of a country, and now more than ever Sri Lanka needs to improve its revenue generation and cut down on unnecessary expenditure. As

---

[6] Temasek Investment Portfolio - https://www.temasek.com.sg/en/our-investments/our-portfolio

[7] Khazanah Investment Portfolio - https://www.khazanah.com.my/our-performance/our-portfolio/

[8] Khazanah Investment Portfolio - https://www.khazanah.com.my/our-performance/our-portfolio/

explained above, countries such as Singapore and Malaysia have had a bad economic period that triggered reforms into SOEs with good governance practices. Therefore, this will be an opportune time for Sri Lanka to reforms its SOEs, and place Sri Lanka on a path towards growth and development.

In a bid to capitalise on the success of holding company models seen in Singapore and Malaysia, Sri Lanka too can implement a super holding company to manage its SOEs. The Public Enterprise Reform Commission (PERC), which is the agency that carried out one of the most successful divestment (Sri Lanka Telecom in 1997) in Sri Lankan history is testimony to the effectiveness of a holding company model and can serve as artifacts to support the implementation of the holding company model.

The holding company can be registered under the Companies Act No. 07 of 2007 subjecting the company to the same requirements as a private sector business. It can play a monitoring and facilitating role to the SOEs in Sri Lanka and have an arms-length approach with the government operational activities and policy making.

The holding company can carry out feasibility studies for each SOE and take timely action for reforms in these SOEs. Divestment of minority stake in strategic assets and major shares in non-strategic assets is a methodology that can be followed by the holding company to bring in accountability and transparency to SOEs. This can open new avenues of Foreign Direct Investment (FDI) to come into the country and can also improve the pricing policy of these SOEs and thereby improve the balance sheets.

The Government must recognise that even though that these reforms may require certain unpopular policy initiatives at the onset, these can pave the way for the creation of SOEs that are financially viable and economically beneficial. The SOE reforms that were carried out a decade ago under the umbrella term of peoplisation where state employees were provided with company shares as are means on gaining public buy-in for divestment of SOEs without much resistance is an example of tackling unpopular reforms.

The holding company can ensure performance management tools are in place to ensure that required goals are achieved in an effective and efficient manner through periodic monitoring and evaluation. An inherent challenge SOEs face is that they have both commercial and social objectives to achieve. The social goals often times carry financial costs, making it difficult to evaluate the financial performance, thus creating a tradeoff. Therefore, a sound performance monitoring framework addressing these challenges should be developed by the holding company.

The holding can ensure that SOEs build effective boards by setting out guidelines on the appropriate composition of the board, tenure of the directors, their size, and appointment process. A board bears the ultimate responsibility for stewardship and performance of SOEs, hence, its composition and functioning have a significant impact on the SOE’s operational and financial performance. Therefore, the board should be of the right size, comprise the right mix and should comprise of competent individuals through a robust selection process. Maintaining continuity of boards is also imperative so that the boards' objectives and goals would not change time-to-time from complete changes in board composition.

Finally, the holding company should have the right talent and leadership to carry out these major restructurings and the reform process should be powered by political will in order it to be successful. Countries such as Singapore, which have no natural resources, have been successful in building their reserves and national savings through the reforms that took place. Therefore, a country such as Sri Lanka that has been endowed with natural resources should make the best use of it and build fiscal strength to overcome crises such as the present economic crisis.

Disclaimer: *The opinions and analysis presented here are the author's alone and by no means reflect the views of the institutions that the author is affiliated with.*