

## **ECONOMIC DEVELOPMENT AND STATE-OWNED ENTERPRISES (SOEs)\***

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### **INTRODUCTION**

During the first semester of 2013, the Peruvian government showed interest in acquiring through its state-owned hydrocarbons enterprise PETROPERU<sup>1</sup>, the Pampilla Refinery, property of Repsol, a company with Spanish holdings. Originally this refinery was a state-owned company, but in 1996, after a privatization process, it became privately owned by Spanish hands. Today the company's refinery and sales capacity represent more than 50% of the local energy consumption, representing a strategic asset in the hydrocarbon sector. Nevertheless, after weeks of protests headed by the private sector, the Peruvian state-owned company withdrew its buying interest.

This desire of the Peruvian President Ollanta Humala's Administration to participate in this business activity was seen as an interest in becoming part of the South American race of recent years of "nationalizing" private sector enterprises<sup>2</sup>, through mixed companies or

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<sup>1</sup> Petróleos del Perú S.A.

<sup>2</sup> See (Article published on May 28, 2013); *El Nacimiento de la Empresa Estatal* [www.otramirada.pe](http://www.otramirada.pe) *Gobierno Peruano apuesta por Nacionalización de Actividades Económicas* [www.forosperu.net](http://www.forosperu.net) *El Nacimiento de la Empresa Estatal* [www.otramirada.pe](http://www.otramirada.pe) (Debate on April 28, 2013). Finally, "the government

companies entirely owned by the state (both known in Spanish as *Empresas de Propiedad Estatal* “EPEs”, or in English State-Owned Enterprises “SOEs”), led by Hugo Chavez in Venezuela and followed by Bolivia and Ecuador.

However, Peru has not only taken interest in the creation and strengthening of national state-owned enterprises, it has also been interested in foreign state-owned enterprises acting as investors in private business activities. In April 2014, the most important transaction in Peruvian history took place.<sup>3</sup> A consortium of Chinese companies headed by Minerals and Metals Group (MMG), a company of the Chinese state-owned China Minmetals, bought the most important mining project in the country: Las Bambas, located in Apurímac. In 2013, the most important acquisition was the sale of assets in Peru from Petrobras, a Brazilian state-owned hydrocarbon company, to the Chinese state-owned company PetroChina.

Even though the initiative of governments to participate in these business activities has been associated in our continent as the landmark from which a “democratic” government transforms into a “nationalistic or authoritarian” one, economically it is not too far off from the rest of the world.

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found a sensible and logical way in view of the extreme positions on the state-owned oil company” (La República, December 18, 2013, quoting President of the Peruvian Republic, Ollanta Humala). On December 17, 2013 the Law that declares of national interest the Talara Refinery (Piura, Peru) modernization and privatization of Petroperu was passed. According to this Law 49% of Petroperu shares will be sold to private shareholders, while 5% will directly go to citizens through placements in the Stock Market. The idea is to raise funds to invest in modernizing the Talara Refinery (Piura, Peru). This means that we are witnessing the privatization of the state-owned oil company and the sale to citizens would be what some has called “a true partial nationalization of the company that today has been simply governmental.” (Sergio Sarmiento, “*Real Privatización*,” December 19, 2013).

<sup>3</sup> The purchase operation amounted to US\$ 5.850 billion, which is close to the total amount of all mergers and acquisitions in Peru in 2013 (US\$ 6.767 billion, approximately). Besides its financial transcendence, this mining project is considered the most important in the country, requiring an investment of US\$ 5.9 billion. “There have not been mining investments as large as that of Las Bambas” says Marita Chappuis, blogger at *Semana Económica*. See SEMANA ECONÓMICA, digital edition of April 13, 2014. *Venta de Las Bambas: El deal más grande de la historia del Perú*.

History has shown us that in the past, as well as in the present, SOEs are part of an imminent and contagious global economic phenomenon, and not precisely a tendency of South American “antidemocratic” governments. Why are governments trusted and will keep being trusted to incur in business activities? Extensive literature discusses how inefficient it results to have governments controlling enterprises as well as their poor ability to take upon business activities, and there is also literature discussing how to prevent governments to incur in this type of inefficiencies. The present paper does not aim to elaborate in these issues, but seeks to analyze what Law can offer in order to live with state-owned companies neither stopping the country’s economic development nor discouraging the direct or foreign investment promotion, even over the criticism of state business management.

Part I of this paper comments the story which has generated the birth and resurgence of the SOEs worldwide in different economic cycles in the world. Part II discusses the conflict of interests originated by the SOEs, as a result of having the government acting as a shareholder and as a regulating entity in the market, which is known as the SOEs’ “*agency problem*”, and the consequences that may arise from this conflict, like investment protection and the development of an adequate legal mechanism for regulating the control and ownership of enterprises. Part III discusses the response to conflicts generated by the dual role of the government as manager and regulator: obtaining an approach in balance of public and private interests in regards to company ownership. Our proposal is to regulate Corporate Governance practices for SOEs, based on the model proposed by the

Organization of Economic Co-operation and Development “OECD”<sup>4</sup>, incorporated by the World Bank. Finally, Part IV analyzes SOEs in Latin America and the implementation of Corporate Governance practices.<sup>5</sup>

## **I. SOES AS A GLOBAL ECONOMIC PHENOMENON**

SOEs have survived the privatization processes in emerging and developing economies and they have continued expanding and growing all over the world. The first privatization wave, between the mid-1980s and 2000, was predominantly European. The privatization pace accelerated after 1991, when Eastern Europe started offering thousands of rusty state-owned companies for sale. The second privatization wave came in the mid-2000s, as European economies sought to cash in on buoyant markets.<sup>6</sup>

In Western Europe, privatization became a socially accepted policy element after the vigorous implementation of the United Kingdom’s privatization program in the mid-1980s.

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<sup>4</sup> OECD was officially born on September 30, 1961, when the OECD Convention entered into force. After the World War II, the Organization for European Economic Cooperation (OEEC) was established in 1948 to run the US-financed Marshall Plan for reconstruction of a continent ravaged by war. OEEC paved the way for a new era of cooperation that was to change the face of Europe by making individual governments recognize the interdependence of their economies. Later its work fostered a global stage, when Canada and US joined OEEC members in signing the new OECD Convention on December 14, 1960. Other countries joined in, starting with Japan in 1964. Today OECD has 34 member countries worldwide, which work to identify problems, discuss and analyze them, and promote policies to solve them. Many countries have either joined the OECD or adopted its standards and principles. Russia is negotiating to become a member of the OECD, and there are close relations with Brazil, China, India, Indonesia and South Africa through an “enhanced engagement” program. Members together with all of these others engaged bring around countries that account for 80% of world trade and investment. For Latin American countries members of OECD, see Part IV of this paper. See OECD.org (last seen April 2014).

<sup>5</sup> We will not include state entities or governmental agencies within SOEs. Nevertheless, some of them are organized as corporations.

<sup>6</sup> *Briefing State-Owned Assets*. THE ECONOMIST, January 11, 2014.

In Latin America, where state entrepreneurship has a long tradition, privatization was introduced as part of fiscal adjustments to the debt crisis in the early 1980s. After the collapse of communist regimes in Central and Eastern Europe and the former Soviet Union, the SOE reforms and privatization became central elements of a comprehensive transformation process to create market economies based on private property rights. These world-wide trends in privatization imply a massive transfer of ownership and control rights to the private sector over the ten-year period from 1984 to 1994.

However, as the financial crisis of 2008 began, the wholesale privatization growth reversed. Bail-outs of failing banks and companies have contributed to a dramatic increase in government purchases of corporate equity since 2008, as featured by the expansion of state capitalism carried out by China and other emerging countries. According to recent studies<sup>7</sup>, privatization is alive and well due to states selling SOEs' minority stakes, mostly in developing countries.

There is no methodic updated data on size, composition, ownership structure and economic value of SOEs.<sup>8</sup> However, there is sufficient evidence to support their growth, especially following the 2008 financial crisis. By that time, several SOEs in the Middle East and Asia were publicly exposed to controversy when they sought to invest in ports, oil companies, and other sensitive sectors in the United States and Europe, mainly due to the fact that

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<sup>7</sup> MEGGINSON, William. University of Oklahoma. Michael Price College of Business.

<sup>8</sup> The document that analyzed the latest data on SOEs in developing countries is a World Bank publication "*Bureaucrats in Business: The Economics and Politics of Government Ownership*" (New York: Oxford University Press, 1995), with no subsequent follow-up thereafter. The dataset was compiled for 40 countries, for 1971 through 1991. Although the report is aimed at examining the economic problems that arise when governments own and operate enterprises that could be managed by the private sector, it draws on a rich dataset and detailed country case studies of reform of SOEs.

opponents of these transactions argued that they would go against the national security of investment of the receiving countries.

While such deals thrust SOEs into the public spotlight, the growth of sovereign investments by emerging markets reflects deeper trends in the global economy. First, the dramatic rise in global significance of the emerging economies themselves. The BRICS (Brazil, Russia, India, China and South Africa) have grown significantly as a share of the world economy, rising from a combined fifteen percent in 1992 to twenty-six percent in 2010, becoming some of the world's largest economies.<sup>9</sup> Second, the rapid growth of the world economy in the years leading up to the financial crisis, and the still rapid though lower growth since 2009, has caused a persisting rise in primary commodity prices and agricultural products. The result has been soaring profits of the natural-resource economies, and soaring budget revenues for the host countries (especially Brazil, Russia and the Middle East oil states). These large earnings in turn have fueled the investment plans of SOEs. In the Middle East and North Africa (MENA), the state has traditionally been significant, mainly due to ideology and rents originating from natural resources such as oil, which have made it an important tool for political patronage. Until the twenty first century, topics as privatization were almost taboo in most MENA countries.<sup>10</sup> Third, more liberalized international investment regimes opened the way for SOEs to become involved as diversified investors in high-income economies. Albeit the fact that the initial push for global capital market

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<sup>9</sup> In 2010, Chinese companies took three of the top ten spots on the Fortune 500 list, compared with none in 1980. Emerging markets, led by China, currently encourage their SOEs' global growth and expansion as Multi-National Enterprises (MNEs). Ian Bremmer, *The End of the Free Market: Who Wins the War Between State and Corporations?* (New York: Portfolio, 2010) pp. 85-145.

<sup>10</sup> CELASUN, Merih (editor) *STATE OWNED ENTERPRISES IN THE MIDDLE EAST AND NORTH AFRICA: PRIVATIZATION, PERFORMANCE AND REFORM*. Routledge Studies in Development Economics. (2001)

liberalization came from the high-income countries, who aimed to invest in each other and in the developing economies, the reality has been different. The 2008 financial crisis brought about deep geopolitical changes that expanded the SOE trend as opposed to privatization and, moreover, thrust corporate control outside SOE investors.<sup>11</sup> Moreover, studies show that governments remain shareholders of one-third of “privatized” firms.<sup>12</sup>

## II. THE “AGENCY PROBLEM” OF SOES

Before elaborating the agency problem inherent to SOEs, it is useful to state some major theoretical and empirical findings relating to SOEs.

First, there is no clear theoretical case either for or against SOEs. Pervasive information asymmetries require “hierarchical arrangements” (firms) rather than “contractual arrangements” (markets).<sup>13</sup> The Sappington-Stiglitz Fundamental Privatization Theorem describes that SOEs’ performance is superior to that of private-sector firms only under stringent and often unrealistic conditions.<sup>14</sup>

Second, the problems faced by large SOEs and large private firms are frequently very similar. Because of multiple and overlapping layers of hierarchy within large and complex organizations, they both suffer from complex “agency problems” or “principal-agent

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<sup>11</sup> Karl P. Sauvant, Lisa E. Sachs, and Wouter P.F. Schmit Jongbloed, *Sovereign Investment. Concerns and Policy Reactions*. (Oxford University Press, 2012)

<sup>12</sup> BORTOLOTTI, Bernardo & Mara FACCIO, *Government Control of Privatized Firms*, 22 REV. FIN. STUD. (2009).

<sup>13</sup> SIMON, Herbert. REASON IN HUMAN AFFAIRS. Oxford: Basil Blackwell. 1983.

<sup>14</sup> SAPPINGTON, David and Joseph STIGLITZ. *Privatization, Information and Incentives*. JOURNAL OF POLICY ANALYSIS AND MANAGEMENT, 6 (4). 1987.

*problems*”. Regarding private-sector firms, there is an assumption that they are perfectly controlled by their owners, assuming no agency problems. However, if we compare idealized private-sector firms with real-life SOEs, it is not surprising that the former come out on top.<sup>15</sup>

Third, theoretical findings about SOEs can be ambiguous; hence, it is important to take note of real-world outcomes. Certainly, there are many inefficient SOEs, but there is no clear systematic evidence that SOEs are *per se* burdens on the economy.<sup>16</sup> Moreover, the more literature talking about the poorly performed SOEs, the bigger wrong impression of the prevalence of poor SOE performance. Despite popular perception, SOEs can be efficient and well-run. This is very important to address given the depth of prejudice against SOEs. Many countries achieved economic success on the basis of a large SOE sector and with little privatization. Throughout most of the second half of the 20<sup>th</sup> century, European countries like Austria, France, Norway, and West Germany had large SOE sectors and performed well, especially in France where SOEs were at the forefront of industrial modernization.<sup>17</sup> Conversely, many unsuccessful economies have small SOE sectors. Argentina and the Philippines are commonly touted as economies that failed because of

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CHANG, Ha-Joon. *State-Owned Enterprise Reform*. NATIONAL DEVELOPMENT STRATEGIES, POLICY NOTES. United Nations, Department for Economic and Social Affairs (UNDESA), 2007.

<sup>16</sup> CHANG, Ha-Joon and A. SINGH. *Public Enterprise in Developing Countries and Economic Efficiency*. UNCTAD REVIEW, 1993, No. 4.

<sup>17</sup> Chang gives examples of successful SOEs: Singapore Airlines, often voted the best airline world-wide, is a SOE with 57% owned by the government holding company Temasek Holdings, whose sole shareholder is the Singapore Ministry of Finance. World-class companies like the Brazilian regional jet manufacturer EMBRAER, the French carmaker Renault, and the Korean steel-maker POSCO all initially succeeded as SOEs, with the state still exercising critical influence in the case of EMBRAER and Renault. The “economic miracle” is attributed to Taiwan (Province of China). The miracle years were the 1960s and 1970s, when the SOE sector occupied the “commanding heights” of the economy, controlling the banking sector and the key upstream inputs industries, such as steel and petrochemicals. Taiwan started privatizing in a serious way only in 1996, relinquishing majority shares in SOEs in banking, insurance, petrochemicals, transportation, and a few other industries. However, Taiwan’s privatization has been a very controlled one, as the government still has a controlling stake (35.5% in average). See CHANG, Ha-Joon. *State-Owned Enterprise Reform*. *Supra* note.



large public sectors; despite the fact that their SOE sector represented less than a 1/5 of the 40-developing-country average (10.7% of the GDP), featured in a World Bank study between 1978 and 1991.<sup>18</sup>

In addition to the above real life examples, there are respectable theoretical justifications for the existence of SOEs.<sup>19</sup> The most frequently cited is the case of *natural monopoly*, where technological conditions dictate that there can be only one supplier. The monopoly supplier may produce at less than socially optimal level and appropriate monopoly rents; thus, there is a strong case for an SOE to be set up and regulated to prevent abuse of such natural monopoly. Another justification for SOEs is *capital market failure*, where private sector investors refuse to invest in industries that have high risk or a long gestation period and the government “has” to set up and run SOEs itself. *Externalities* (or the “social return”) are higher than the “private” return when businesses with risk of abuse of a monopoly position are run by an SOE. The most important class of externalities, for the purpose of economic development, is the “learning externality” – the knowledge spill-over from new industries to traditional sectors.<sup>20</sup> Finally, SOEs may be set up to address *equity concerns*. SOEs are an easy way to ensure universal access to essential services for all citizens. Profit-seeking firms in industries that provide basic goods and services may refuse to serve less profitable customers, such as poor people or people living in remote non-commercial areas.

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<sup>18</sup> WORLD BANK. BUREAUCRATS IN BUSINESS: THE ECONOMICS AND POLITICS OF GOVERNMENT OWNERSHIP” (New York: Oxford University Press, 1995) See Table A.1

<sup>19</sup> CHANG, Ha-Joon. *State-Owned Enterprise Reform*. See note 15.

<sup>20</sup> GREENWALD, Bruce and Joseph STIGLITZ. *Helping infant economies grow: Foundations of trade policies for developing countries*, AMERICAN ECONOMIC REVIEW, 96 (2).

All of the above justifications for SOEs, in theory, can be addressed by private sector enterprises operating under an appropriate regulatory regime and tax-and-subsidy scheme, which equates private and social costs/benefits.<sup>21</sup> Therefore, SOEs may appear to be unnecessary. However, those regulations suppose high “transaction costs” of negotiating all possible contingencies in a contract. Choosing SOEs, instead, represents saving transaction costs that still have to be set against the “organizational costs” of SOEs. Even considering the latter, it is often much less costly to set up an SOE and deal with some unexpected contingencies through internal government directives than to set up a contract-based regime (regulation or tax/subsidies).

Albeit the theoretical justifications in favor of SOEs and the many examples of SOEs running well, many SOEs do not perform well. Why? Due to the *agency problem*.

By definition, an SOE is run by managers who do not own the firm, and no SOE manager would run the firm as efficiently as an owner would. This is based on the assumption of self-seeking nature of humans. This problem would not exist if the SOEs’ owners (principals) could *perfectly* monitor the SOEs’ managers (agents). But, it is inherently difficult for principals to verify if poor firm’s performance is due to managers or circumstances beyond their control. Thus, principal monitoring will remain *imperfect* and, consequently, it will result in an inefficient management. This is known as the *agency problem* or the *principal-agent problem*.

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<sup>21</sup> For example, the government may subsidize private-sector firms that are engaged in activities with high externalities, or the government may license private-sector firms to operate “essential services” (e.g., post, rail, water) on the condition that they provide universal access. Notwithstanding, regulation involve contractual agreements that are costly to manage. Costs associated with regulating all contingencies, known as “transactional costs”.

Not only do SOEs show the principal-agent monitoring conflict, but address the tension between the state's interests as a shareholder and its role as a regulator. The financial or profit-maximizing interests of states as shareholders influence their willingness to charter potential competitors, regulate competitive and open access to sectoral regimes and create and reduce tax benefits.

The *agency problem* assumes that the costs that an individual owner incurs in monitoring SOE managers are solely his or hers, while the benefits of improved management accrue to all owners. Therefore, an individual principal has a low (or inexistent) incentive to monitor the SOE managers. As a result, no one monitors agents. This is called the free-rider problem of the agency problem.

This agency problem and free-rider problem explains poor performance in firms with dispersed ownership. It may be easier, though, to monitor SOEs than to monitor private sector firms with dispersed ownership. At least theoretically, taxpayers have a greater incentive to discipline errant SOEs, whose contributions will be squandered if their performance is poor. Likewise, the centralized governance structure within which SOEs operate, with identifiable supervisory agencies<sup>22</sup>, makes it easier to monitor them, while dispersed shareholders of private sector firms cannot take concerted actions unless they are large enough shareholders able to unilaterally monitor them.

However, the fact that many companies with dispersed ownership, either private or state-owned, are well managed suggests that there is more to good management than giving owners the right material incentives. This is because individual self-interest is not what

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<sup>22</sup> Other forms of centralized governance are: ministries, public holding companies, government audit board.

drives human beings, moral values do. When it comes to SOEs, there may be additional motives that need to be taken into account, like nationalism, dedication to public service and, concern for social justice, among others.<sup>23</sup>

The presence of SOEs in the economic model might represent threats, such as affecting the economic development of the country to a great extent, due to their main role in the national economy, or as a government intervention against minority private shareholder interest in SOEs. However, investment figures in the equity market show an interest among investors for buying listed SOE shares. What can we do to mitigate these threats, beyond relying on SOE profitability statistics?

The solution often recommended by today's economy orthodoxy is full-scale privatization; still, this is only one possible way to deal with the problems of SOEs. The state may sell a significant portion of shares of an SOE, but retain a majority share or at least a controlling stake in it. SOEs' performance can be improved not only by selling shares, but through an organizational reform, an increase in competition, and political-administrative reforms.<sup>24</sup> An organizational reform demands that SOEs have clear goals in order to improve the quality of information regarding their performance (although it is also argued that disclosure is unlikely to provide an adequate remedy, since enactment of legal reforms rely ultimately on the state) and the ability of the supervisory agency to process it and establish

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<sup>23</sup> People working in a firm are motivated not simply by selfish things like salaries and power, but also loyalty to the firm, sense of obligation to co-workers, honesty, dignity, work ethic. If everything could be specified in a contract, "working-to-rule" could never be a method of industrial action as workers would be doing exactly what they should be doing. Firms run well because people put in efforts beyond their contractual obligations. Laureate Herbert Simon, 1978 Nobel Economics, remarked if humans were as selfish, it would be impossible to run any company. In such a world, companies would collapse under the burden of monitoring and bargaining transactions costs. Non-selfish motives matter and good managers are those who can induce his/her workers to do extra through mechanisms that cannot be contractually specified.

<sup>24</sup> See CHANG, Ha-Joon. *State-Owned Enterprise Reform*. Note 15.

a competent agency dedicated to SOE supervision within an appropriate ownership structure.

There are two main categories of possible institutional arrangements to mitigate the influence of the government as a shareholder: ownership and legal strategies.<sup>25</sup> Ownership strategies mitigate the impact of the government's role as shareholder by choosing among different corporate ownership structures. In turn, legal strategies mitigate the impact of the government's role as regulator by differentiating the corporate legal regime applicable to private firms and SOEs or by assigning regulatory authority to a foreign or non-state organization to design and enforce corporate and securities regulations.

| <b>Ownership Strategies</b>           | <b>Legal Strategies</b>   |
|---------------------------------------|---|
| Wholesale Privatization               | Dual Regulatory Regimes   |
| Whole Ownership by the State*         | Dual Regulatory Authorities within the same State               |
| Minority Shareholdings by the State** | Federalism  |
|                                       | Private and Public Regulatory Authorities within the same State |
|                                       | Dualism across Jurisdictions                                    |

\* as opposed to mixed ownership

\*\* as opposed to controlling shareholdings

Corporate Governance practices can address many of these institutional and organizational reforms, as it will be argued in Part III.

<sup>25</sup> PARGENDLER, Mariana. *State Ownership and Corporate Governance*. 80 FORDHAM L. REV. (2012),

### **III. THE BALANCE BETWEEN PUBLIC AND PRIVATE INTEREST: APPLYING CORPORATE GOVERNANCE PRACTICES TO SOES**

#### *1. Corporate Governance*

Corporate Governance is the set of practices that rule the relationships among those participating in a corporation with the right allocation of power and responsibilities among the board of directors, management and shareholders or owners. These practices seek to strengthen direction and control organs (shareholders meeting, investors or owners, board of directors and management, internal control structure), while at the same time they define clear rules of the game among players and increase the transparency level vis-à-vis interest groups. Consequently, organizational competition and soundness are strengthened and maintained, preparing organizations for crisis situations, improving their credibility and performance and adding value.<sup>26</sup>

The two main Corporate Governance systems in the world are those based on principles and those based on norms. The one based on principles, exemplified by the United Kingdom and the European Union, is the model SOEs prefer. It is also known as the “comply or explain”<sup>27</sup> corporate government system.

Companies voluntarily adopt Corporate Government Code or a set of principles, but they are obliged to give a detailed explanation each time a non-compliant act is undertaken in

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<sup>26</sup> Deloitte Touche Tohmatsu Limited, Work Document. Corporate Governance Workshop. February 2014.

<sup>27</sup> This system makes sense for state-owned companies because, since it is flexible and customized, it promotes a Corporate Governance well adapted to the company's mission and purpose, but it implies considerable responsibility for the board of directors and management: justifying when principles are exceptionally breached. The European Commission has been critical concerning adequacy of explanations given by companies under the system; however, corporate governance based upon principles is still the dominant approach in the world.

the company's best interest.<sup>28</sup> The system based on norms is led by the United States. Corporate Governance in U.S. companies has been established and applied through federal legislation (such as the *Sarbanes-Oxley* Law and the *Dodd-Frank* Laws) and the rules adopted by the Securities Exchange Commission (SEC), the stock exchange and other regulatory organs. A Corporate Governance system based upon rules might be inflexible for SOE dynamics, at least in Latin America.<sup>29</sup>

Globalization has contributed to value the need for improving Corporate Governance norms and principles in many countries. Thus, these principles have become a global standard that governments, regulatory organizations and stock exchanges have adopted almost all over the world, including developed and developing countries. Global institutions such as OECD, the World Bank, the International Financial Corporation (IFC), the United Nations Principles for Responsible Investment (UNPRI), the International Corporate Governance Network (ICGN), the *Círculo de Empresas de América Latina* (Latin America Corporation Circle) and many other groups partake in a global network that supports and confirms its commitment with the Corporate Governance principles.

In 1999, the OECD issued the first declaration of principles of Corporate Governance, underpinned on the progress made by economic theory on agency and information of asymmetry problems. In 2004, these principles were reviewed, as it was understood that they have an evolutionary nature and that they have to be reviewed to fulfill new demands from societies.

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<sup>28</sup>BERNAL, Andrés y Andrés ONETO. *Gobierno Corporativo en América Latina. Importancia para las Empresas de Propiedad Estatal*. CAF - SERIE POLÍTICAS PÚBLICAS Y TRANSFORMACIÓN PRODUCTIVA N° 6 /2012.

<sup>29</sup> See note above.

In 2005, *Corporación Andina de Fomento* (CAF)<sup>30</sup> published the Guidelines for an Andean Corporate Governance Code, including fifty-one recommendations that make up the foundations of Corporate Governance for different kinds of companies. As the document so states, it has a dynamic character and can be enriched following its implementation.<sup>31</sup>

The Bank for International Settlements (BIS)<sup>32</sup> published in 2006 a document containing eight principles for improving Corporate Governance, which in 2010 – following the 2008 international financial crisis – were reviewed and amended through the publication of “Principles for Enhancing Corporate Governance.”<sup>33</sup>

The global financial crisis showed many corporate governance failures and conflicts of interest in financial institutions and large private corporations, including weaknesses in exercising property responsibilities by shareholders. In 2010, the Financial Reporting Council of the United Kingdom published a “Code for the effective performance of Corporate Governance responsibilities” by institutional investors who act as owners.<sup>34</sup>

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30CAF is Latin America’s Development Bank with the mission of stimulating sustainable development and regional integration, is one of the main sources of multilateral financing and an important generator of knowledge for the region. It was founded in 1970 and has 18 member countries from Latin America, the Caribbean and Europe.

31This document has taken into account international experiences within the framework of the European Union and the action plan for corporate law that started from the Winter Group Report, the British Combined Code, the Spanish Aldama Commission Report, the “Principles and framework for the preparation of a corporate governance code” prepared by CONFECAMARAS-CIPE in Colombia in August 2002, and the “Governance Principles for Peruvian Corporations” published by CONASEV on July 2002 besides other reports, codes and laws adopted in other countries, such as the American Sarbanes-Oxley Act of 2002. See CAF.com (last visit on April 2014).

32The Bank for International Settlements is the central bank of 60 central banks and monetary authorities headquartered in Basel (Switzerland). As an international organization, it encourages international financial and monetary cooperation and is the bank of central banks without being accountable before any government. It was founded following the 1930 The Hague Agreement.

33 Principles for the Enhancement of Corporate Governance (October 2010).

34Financial Reporting Council. *The UK Code on Corporate Governance*. FRC, 2010. This Code is currently a model to develop similar property guidelines in many other countries.



The international crisis allowed the identification of deficiencies in the document prepared by BIS in 2006: insufficient supervision of management by board of directors, inadequate risk management and corporate and organizational structure complexity and lack of transparency. The result was the publication of “Principles for Enhancing Corporate Governance”, which contained fourteen principles grouped in six large subjects: the role of the board, the qualifications and composition of the board, the importance of an independent risk management function, the importance of monitoring risks on an ongoing firm-wide and individual entity basis, the board’s oversight of the compensation systems and the board and senior management’s understanding of the corporate’s operational structure and risks. The principles also emphasize the importance of supervisors regularly evaluating the corporate governance policies and practices.<sup>35</sup> In comparison to the document prepared by OECD in 2004, the BIS Basel Committee does not develop principles emphasizing shareholder issues, but corporate structure (board of directors and management) issues and risk management and internal supervision.

In 2013, CAF reviewed and updated the guidelines it published in 2005 and brought out the “Guidelines for the 2013 Latin American Corporate Governance Code.” These guidelines comprised fifty-seven guides focused in acknowledging shareholder rights, equitable treatment and concrete ways to exercise them; risk management as a tool towards secure and reliable companies; board of directors as a neuralgic governance center of the corporation with clear functions, appropriate dynamics, without getting into co-management and invading management competences; and information disclosure not as a shareholder right but as a corporate duty. These guidelines are based upon a governance

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<sup>35</sup>BIS.org (Last seen on April 2014)

model in which Corporate Governance strikes a balance among the three groups that participate in the SOE: Directors, Management and Shareholders/Owners. This is what is known as a Corporate Governance Triangle.<sup>36</sup> An SOE has the same aim as a private company: to produce goods and/or services, to get economic and/or corporate benefits and to attain sustainability. Achievement of these objectives requires balance in the Corporate Governance Triangle dynamics.

Considering these international standards, each country is expected to create its own Corporate Governance practices code for companies, in general and for specific corporate modalities, such as SOEs.

Corporate Governance itself does not guarantee success for SOEs. Institutional reforms, sound legal and judiciary system performance, clearly defined and applied ownership structures and efficient control and supervision policies are strongly required. Why does an SOE need Corporate Governance practices?

## *2. Application of Corporate Governance Practices to SOEs*

SOEs are important companies at social and economic level in strategic sectors, which means they have to maximize their leadership position. Corporate Governance practices are geared towards fulfilling this objective and towards increasing and improving access of companies to capitals, both locally and globally, reducing costs and improving their

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<sup>36</sup>The Corporate Governance Triangle was originally designed to illustrate Corporate Governance dynamics in terms listed in the stock market as dispersed shareholding companies. Nevertheless, the participant layout is essentially the same for state-owned enterprises.

conditions. As for SOEs with a mix of shareholding, Corporate Governance practices improve relationships with minority shareholders who feel their interests are protected and they receive the same treatment as all other shareholders. Since these are global standards, their adoption exemplifies the best practices of the state itself, giving it credibility, while at the same time they establish integrity standards for all companies in the country.

The process of incorporating Corporate Governance practices has been key in emerging markets. Since the 1990s, Brazil and India have carried out important political and economic reforms that reshaped their local SOE Corporate Governance model. As a result, their SOEs are more competitive and have even been more attractive for foreign investors. Brazil has shown significant development in respect to implementing Corporate Governance rules and positively promoting them within SOEs.<sup>37</sup> In India, privatization and deregulation have promoted the adoption of Corporate Governance practices. As a result, private investment in SOEs has increased.<sup>38</sup>

Corporate Governance rules are also successfully being applied in non-democratic political models, such as China's. Its economic and political reforms have contributed to SOE regime ones including governance practices. Two of the most important governance practices implemented have been clear ownership structures between SOEs and the state, as well as separate state shareholder and regulatory roles.<sup>39</sup>

The World Bank Corporate Governance Group points out that, as opposed to the past, SOEs today face greater pressure to increase their operational and economic yield. Several

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<sup>37</sup> See Part IV regarding the Latin American experience.

<sup>38</sup> OECD: *State Owned Enterprises in India: Reviewing the Evidence* (2009).

<sup>39</sup> OECD: *State Owned Enterprises in China: Reviewing the Evidence* (2009).

forces have led to a much more demanding environment, with more competition, liberalization of the financial sector, restructuring and privatization of state-owned banks, international agreements and budgetary reforms.

In response to these pressures, many developing countries are betting on large corporate governance reforms in the SOE sector. Enhancement of SOE Governance allows governments to better protect their SOE investments and improve their yield. The World Bank Corporate Governance Group is based upon good international practices, such as those reflected in the *OECD Guidelines on Corporate Governance of State-Owned Enterprises*, which are considered an international reference that facilitates assessment of Corporate Governance policies and practices in SOEs. Among these we have equitable treatment among shareholders (public and private), relationships among shareholders, transparency and information disclosure, the responsibility of decision making organisms and the role of government as share owner.

The OECD Guidelines on Corporate Governance of State-Owned Enterprises highlight some of the main challenges SOEs face:<sup>40</sup>

1. *Competition between SOEs and Private Enterprises*

An important challenge of SOEs is maintaining a level playing field between private sector companies and SOEs and ensuring that governments do not distort competition using their regulatory or supervisory powers. No entity competing in the market place should have undue advantages – or disadvantages – due to its ownership. This principle of competitive

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40 BLUME, Daniel. OWNERSHIP OVERSIGHT AND BOARD PRACTICES FOR LATIN AMERICAN STATE-OWNED ENTERPRISES, report prepared for the 2012 meeting of the OECD/CAF Latin American Network on Corporate Governance of State-owned Enterprises. Its findings do not necessarily reflect the views of the OECD or its member countries.

neutrality does not cover all public sector business activities and it is far from clear as to how to obtain it in practice.<sup>41</sup>

SOEs compete directly with private, profit-maximizing enterprises in many important markets. For example, postal offices, hospitals and educational institutions compete directly with private suppliers of similar services.<sup>42</sup> Unlike Europe, Australia, New Zealand, or even Canada, the United States has never embraced government ownership of enterprise. Railroads, telephone companies, banks, airlines and electric utilities were routinely owned and operated by the state in Europe and much of the world.<sup>43</sup> Other than during wartime, the U.S. government generally has refrained from nationalizing and from directly managing private industries. Times have changed and the United States now feels the growing influence of the European Commission (EC) and the various enforcement agencies around the world.

Production by SOEs can be particularly widespread in developing countries and, consequently, represent a significant portion of the gross domestic product (GDP). During

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41 BLUME, Daniel. COMPETITIVE NEUTRALITY: MAINTAINING A LEVEL PLAYING FIELD BETWEEN PUBLIC AND PRIVATE BUSINESS, report prepared for the 2012 meeting of the OECD/CAF Latin American Network on Corporate Governance of State Owned Enterprises. Its findings do not necessarily reflect the views of the OECD or its member countries. Blume states that there are many ways in which competitive neutrality can be achieved in practice; however, it is not yet clear whether these practices are useful, or even relevant, to the rest of the world. Hence, OECD has commenced a process of consultation. Likewise, OECD work has focused on competitive neutrality in the national context, but has also been discussed in an international context, for example, as part of negotiations currently under way on a Trans Pacific Partnership agreement involving countries such as Chile, Mexico, Peru, the United States, Canada and some Asian countries.

<sup>42</sup> David E.M. Sappington and J. Gregory Sidak. *Competition Law for State-Owned Enterprises*. 71 ANTITRUST LAW JOURNAL N°2 (2003).

<sup>43</sup> John Vickers and George Yarrow. *PRIVATIZATION: AN ECONOMIC ANALYSIS* (1988).

the 1980s, for example, SOEs accounted for approximately 14% of GDP in African nations, and approximately 11% in developing countries, as a whole.<sup>44</sup>

SOEs are typically instructed to pursue goals other than profit maximization. Therefore, one might suspect that SOEs would act less aggressively toward their competitors than would private, profit-maximizing firms. But, the opposite is often the case. Even though they may be less concerned with generating profit, SOEs may have stronger incentives than profit-maximizing firms to pursue activities that put competitors in a disadvantage.<sup>45</sup> Incentives to act aggressively toward competitors can be created by governmental policy objectives that induce SOEs to value an enlarged operating scale. SOEs can be instructed to increase local employment, to ensure access to services or to provide affordable service to low-income families. Such goals introduce a system where the success of the SOEs' manager is measured more by the scale and scope of his operations than by the revenues his operations generate. Thus, an SOE may have a greater incentive to charge below-cost prices than would a private firm.

Opposite to private firms, SOEs may have greater ability to act in an anticompetitive way. This ability arises in part from the power and special privileges that are often attributed to SOEs. Policy makers are increasingly recognizing that this greater ability, coupled with a corresponding greater incentive of SOEs to put rivals in a disadvantage, deserves the

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<sup>44</sup> World Bank, *BUREAUCRATS IN BUSINESS: THE ECONOMICS AND POLITICS OF GOVERNMENT OWNERSHIP* 30 (1995). The statistics are consistent with earlier findings of this report that, on average, SOEs accounted for 8.6% of GDP and 27% of capital formation in the late 1970s.

<sup>45</sup> David E.M. Sappington and J. Gregory Sidak. *Incentives for Anticompetitive Behavior by Public Enterprises*. 22 REV. INDUS. ORG. 183 (2003).

heightened scrutiny of the competition authorities.<sup>46</sup> According to Sappington, there are at least five sources of this enhanced ability:

- a. *SOEs legal framework*: it may impose upon the SOE the duty or the prerogative to pursue objectives other than profit maximization. This duty or prerogative may endow an SOE with greater ability to sustain prices below costs for extended periods of time. The decision of the government to create an SOE suggests the attempt by the government to rectify a perceived market failure or to advance towards a desired social objective.
- b. *SOEs may not need to recoup losses*: unlike private competitors, SOEs may not need to recoup the costs of an anticompetitive behavior by subsequently raising prices in markets where it has a statutory monopoly, or via direct expenditures from the public treasury.<sup>47</sup> An SOE may have substantial ability to carry forward losses into future periods of the ratemaking process. This has also to do with the *soft budget constraint* that SOEs are typically subject to and will be explained under Government Bail-Out below.

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<sup>46</sup> See, e.g., OECD Committee on Competition Law and Policy, PROMOTING COMPETITION IN POSTAL SERVICES (Best Practices Roundtables on Competition Policy No. 24, DAF/CLP (99) 22, Oct. 1, 1999)

<sup>47</sup> Sappington refers to this feature of public ownership in direct contrast to scholarship on predatory pricing by private firms, which has emphasized that, after the exit of competitors or the prevention of entry, the dominant firm will seek to raise the price sufficiently above the competitive level for a sufficient time to, at a minimum, recoup the earlier profit sacrifice. The OECD has drawn the distinction that, in the case of a public enterprise, predatory pricing is a temporary form of “distortionary” pricing which does not necessarily require conventional recoupment of losses. See David E.M. Sappington and J. Gregory Sidak. *Competition Law for State-Owned Enterprises*. *supra* note 42, at 515.

c. *SOEs may enjoy privileges and immunities* (apart from explicit state subsidies) that facilitate recoupment of losses or make them irrelevant. In addition, an SOE may be exempt from taxation, which in effect reduces its operating costs.<sup>48</sup>

d. *SOEs may be subject to less binding price regulation* than is a typical private firm because the agency overseeing the SOE, unlike those overseeing private firms, lacks key regulatory instruments.<sup>49</sup> Hence, the SOE may have greater opportunity to engage in anticompetitive behavior, including below-cost pricing.

## 2. *Finance Discipline*

Private investors refuse to finance projects that have high returns in the long run, but carry high risks in the short term. This is because capital markets do not like risky large-scale projects with long gestation periods. A solution to capital market failure is for the government to set up a development bank that finances risky long-term ventures, rather than to set up and run SOEs itself. However, even with a development bank, most developing countries have a shortage of entrepreneurial talent in the private sector and the necessary venture may not be easy to set up.

Apart from a small number of state-owned enterprises listed on national stock markets, most SOEs also lack the scrutiny of capital markets and shareholders, which may reduce pressures for financial discipline and efficiency. Easy access of entities to financial resources and “easy” political support leads to economic waste.

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<sup>48</sup> Sappington uses the example of the U.S. Postal Service. The U.S. Postal Service has no obligation to compensate its investors and is exempt from taxation. See David E.M. Sappington and J. Gregory Sidak, *Competition Law for State-Owned Enterprises*, *supra* note, at 516.

<sup>49</sup> For example, the U.S. Postal Rate Commission lacks subpoena power and has limited powers to set maximum prices for postal services.



### 3. *Government Bail-Out*

This affects accountability, which under other circumstances the company's management would have to assume. SOEs are often protected from two major threats - takeover and bankruptcy - diluting accountability and undermining SOE financial discipline, as losses may be absorbed by the state.<sup>50</sup> Accountability can be further diluted by the complex chain of government ownership, which can be exercised through many different governmental entities with differing priorities (such as the President's office, Congress committees, sectoral ministries and state agencies).

Due to their status as public enterprises, SOEs are subject to *soft budget constraint*.<sup>51</sup> The argument is that SOEs are able to secure additional finances if they encounter losses and get rescued by public money if they are threatened with bankruptcy. Then, SOEs can act as if the limits to their budgets are "soft". Politically generated or sustained soft budget constraints encourage lax management. However, the existence of soft budget constraint does not infer the existence of poor managers, because managers are more interested in their personal welfare and not whether the company survives thanks to government bail-out. Therefore, its adverse impact on SOE efficiency will be reduced as SOE managers are held accountable for SOE management.

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<sup>50</sup> See BLUME, Daniel. OWNERSHIP OVERSIGHT AND BOARD PRACTICES FOR LATIN AMERICAN STATE-OWNED ENTERPRISES. *supra* Note 40

<sup>51</sup> The term "soft budget constraint" was introduced by the Hungarian economist, Janos Kornai, to explain the behavior of socialist enterprises under central planning, but it can be applied to SOEs in capitalist economies too. The existence of "sick enterprises" in India that never go bankrupt is the most frequently cited example of the soft budget constraint of SOEs.

#### 4. *Political Periods*

The composition of SOE government organs and management can exclusively depend on political dynamics. Government changes produce changes in entity objectives, which generate little predictability in SOE conduction. SOEs usually face the criticism that political changes oblige them to focus on short-term or on non-commercial objectives in exchange for objectives based upon a new political environment.

In turn, state interference leads SOEs to have limited autonomy. Most importantly, the lower degree of transparency of the firm-type arrangement compared to more contractual arrangements with private sector firms may make the former (SOEs) more susceptible to political influence and, worse, corruption.<sup>52</sup> A control structure under these conditions will hardly be able to mitigate the risk of corruption.

The OECD Guidelines on Corporate Governance of State-Owned Enterprises (“OECD Guidelines”) offer an international benchmark to help governments overcome these challenges. The OECD Guidelines suggest that the state’s ownership rights of an SOE should be clearly identified. The OECD Survey of Corporate Governance of SOEs characterized governments as having three main types of ownership models for SOEs: (i) the Decentralized or Sector Model, (ii) the Dual Model, and (iii) the Centralized Model. Although the trend among OECD members is to move towards more centralized ownership models, the OECD suggests the centralization of the ownership function and accepts that each country will adapt its SOE ownership model to meet its specific political and

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<sup>52</sup> The fact that SOEs have often been the worst offenders in terms of safety and environmental standards in many countries is due at least partly to this reason. Therefore, it is important to subject SOEs to the same clearly specified regulatory standards as private-sector firms. See CHANG, Ha-Joon. *State-Owned Enterprise Reform*. *supra* Note 15.

economic context, sometimes tied to historical context, like trends of privatization or financial crises. Moreover, the OECD has created a broad set of guidelines designed to help facilitate good governance, regardless of the country's chosen model.

In the ***Decentralized or Sector Model*** (the traditional model for SOE governance), SOE oversight is dispersed among a large number of ministries with only limited coordination at the center. This model allows the most sector expertise, as SOEs are assigned to a ministry based on its sector of operation, and demands a coordinating entity to play a role in advising on overall government ownership policies and corporate governance measures. The challenges of this model include less clear separation between the ownership and the regulatory role, when regulation is handled by the same ministry exercising ownership and the higher risk of government interference in everyday operations.

In the ***Dual Model***, responsibility is shared between the sector Ministry and a “central” Ministry or entity (usually the Finance Ministry). The advantage of this model is that the government's two roles of owner and regulator are divided into two constituencies, as it also facilitates simultaneous technical and fiscal oversight. However, the model exposes potential blurring of responsibilities between ministries and the possibility of having the SOE regarding this as double oversight, which may infringe on management and operational productivity.

The ***Centralized Model's*** advantages include a clear line of accountability, from the SOE to the government, close fiscal supervision, conditions for a coherent SOE policy and efficient allocation of limited human resources among civil servants. The challenge of this model is to ensure sufficient sectoral expertise that would normally come from a sectoral ministry.

The regulatory framework and the market structure under which an SOE operates are key to defining corporate governance strategies. OECD Guideline II.A “The State Acting as an Owner” states that the government should issue an ownership policy that defines the overall objectives of state ownership of SOEs and the State’s role in SOE governance. Thus, governments must communicate their state-ownership objectives in relation to SOEs and the State’s role in SOE governance. Because these objectives are not always clear, it may be helpful to use specific economic, social and political indicators to better clarify the role of each SOE. SOEs may be classified according to the degree or type of market competition that exists within its particular sector or by their individual objectives (SOEs generally have public policy goals, which may range from offering services to the public to generating revenue for the state, and often include both).

The CAF has set out possible considerations for classifying SOEs:<sup>53</sup>

- \* SOEs created for the purpose of achieving public policy objectives.
- \* SOEs responsible for producing public services.
- \* SOEs that exclusively produce goods or services required by the state (for example, military suppliers)
- \* SOEs responsible for producing revenue for the state and competing with private sector standards (profit maximizing).

All these indicators help to build up an SOE classification to determine how an SOEs’ governance may be structured to best serve the state’s goals. A company may be state-

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<sup>53</sup> CAF Latin American Development Bank (2012) WHITE PAPER ON THE IMPORTANCE OF CORPORATE GOVERNANCE IN STATE-OWNED ENTERPRISES.

owned for any of these reasons, although frequently they overlap. However, understanding the state's motivation with SOEs, serves to clearly disclose SOE objectives and create the basis for active, value-creating ownership.<sup>54</sup>

Some countries have created their own SOE categorizations based on ownership objectives.<sup>55</sup> Norway<sup>56</sup>, for example, has divided SOEs into two main categories: those sector policy objectives and those with commercial objectives. Within the latter, there are companies with commercial objectives where the state holds a dominant influence over the company, companies with commercial objectives that must maintain headquarters in Norway and companies with commercial objectives as well as other specific objectives. Likewise, some Latin American countries use a classification system to differentiate SOEs. In Mexico, for-profit SOEs are categorized into three groups: non-equity, majority-owned and public trust funds. PEMEX<sup>57</sup>, a non-equity SOE is focused on developing priority sectors and public services. Majority-owned SOEs, like development banks, focus on facilitating market development and are governed by technical committees. Certain types of SOEs may be subject to differing legislation based on which classification they fall into, and consequently, the corporate governance framework is complex. Most aspects are covered by a mix of regulation: its own individual regulatory framework, the public

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<sup>54</sup> ONETO LA FAYE, Andrés. *Gobierno Corporativo en América Latina: Importancia para las Empresas Estatales*. CAF – Dirección de Políticas Públicas y Competitividad. Vicepresidencia de Estrategias de Desarrollo y Políticas Públicas. October 2012.

<sup>55</sup> See BLUME, Daniel. OWNERSHIP OVERSIGHT AND BOARD PRACTICES FOR LATIN AMERICAN STATE-OWNED ENTERPRISES. *supra* Note 40

<sup>56</sup> Norway is member of OECD since 1961, when the original Organization for European Economic Cooperation (OEEC) was reformed into OECD and membership was extended to non-Europeans states.

<sup>57</sup> PEMEX stands for Petroleos Mexicanos (Mexican Petroleum), the Mexican state-owned oil company created in 1938 and is the world's second largest non-publicly listed company by total market value, and Latin American's second largest enterprise by annual revenue as of 2009. (Financial Times 14 December 2006. "FT Non-Public 150 - the full list"

administration, SOE general laws and, finally, the Commercial Company Laws.<sup>58</sup> In Peru, SOEs are divided into commercial and non-commercial enterprises, but in both categories they are involved in commercial-oriented production of goods and services and this division does not imply different standards or requirements for the SOEs in different categories.<sup>59</sup>

Within country ownership structures, some SOEs' structures are prevalent by sectors. Generally, SOEs are prevalent in sectors where performance is important to a large part of the population and other parts of the business sector, like banking and financial institutions. An Inter-American Development Bank (IDB) study investigates the role of government intervention in the form of state ownership in banking (which may be newer or less advanced in developing countries)<sup>60</sup>. The study concludes that direct state-ownership of banks may be justified in developing countries as a way to safeguard credit allocation and contribute to consumer confidence. In times of financial instability, public banks may be seen as a safer investment rather than private investments. In Latin America, Costa Rica has the most state-owned banks, while Ecuador, Chile and Peru have the most privatized financial sectors. Mexico's banks change from private to public ownership, following political trends.

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<sup>58</sup> Information provided by the Vice Ministry of Finance and Public Credit in Mexico, Mr. Dario Luna, for the 2011 OECD Meeting of the Latin American Network on Corporate Governance of State-Owned Enterprises.

<sup>59</sup> FONAFE (National Funding for the Financing of the Peruvian State's Business Activities), the central entity to oversee Peru's SOEs, is currently considering moving to a sectoral-based classification system that would divide SOEs based on their particular undertakings, such as energy, financial, sanitation, transportation, infrastructure. See BLUME, Daniel. OWNERSHIP OVERSIGHT AND BOARD PRACTICES FOR LATIN AMERICAN STATE-OWNED ENTERPRISES. *supra* Note 40

<sup>60</sup> Yeyati, Eduardo, Alejandro Micco and Ugo Panizza. SHOULD THE GOVERNMENT BE IN THE BANKING BUSINESS? THE ROLE OF STATE-OWNED AND DEVELOPMENT BANKS. IDB, BID. (2004).

Public policy objectives can often justify SOEs to follow particular ownership and management strategies. The World Bank authored a working paper entitled “National Oil Companies and Value Creation”<sup>61</sup>, which investigates the Corporate Governance practices best suited to national oil companies. The study examined twenty companies worldwide, including PEMEX (Mexico)<sup>62</sup>, ECOPETROL (Colombia)<sup>63</sup> and PETROBRAS (Brazil)<sup>64</sup>. The analysis found that national oil companies with the largest oil reserves have lower incentive to produce efficiently and create value for the government. Countries with the highest dependence on national oil company revenues tended to exercise SOE ownership rights directly or indirectly through a central authority; hence, a centralized ownership structure, where the state maintains most or all of the voting rights and direct control over board nomination, is preferred to be adopted. Those countries were also more likely to grant special privileges to the SOEs (exclusive rights) and to adopt more flexible decision-making methods.

Notwithstanding, another World Bank study<sup>65</sup> concludes that those sectors that have experienced rapid technical change or that have high investment risk benefit particularly from partial private participation from decentralized ownership. Oil, gas, coal and mining are very capital-intensive industries, with high geological and market risks (it takes several years to develop a mine or well). For this reason, it may be a more successful strategy to share public and private ownership rather than 100% state-ownership, as this allows for risk

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<sup>61</sup> World Bank, NATIONAL OIL COMPANIES AND VALUE CREATION. Working Paper No. 18. (2010).

<sup>62</sup> See note 58.

<sup>63</sup> ECOPETROL, formerly known as *Empresa Colombiana de Petroleos S.A.* (Colombian Petroleum Co.), is the largest and primary petroleum company in Colombia. It is one of the 25 largest petroleum companies worldwide, and it is one of the four principal petroleum companies in Latin America. (Ecopetrol Information Page accessed January 2014).

<sup>64</sup> See reference to Petrobras in Part IV.

<sup>65</sup> World Bank, *Overview of State Ownership on the Global Minerals Industry*. EXTRACTIVE INDUSTRIES FOR DEVELOPMENT SERIES No. 20. (2011).

sharing. As suggested for listed SOEs, SOEs for this sector are also advised that internal corporate governance should be paid attention to.

Governance of boards and company management has a tendency to be overlooked more often than ownership structures. Overall, there appears to have been more reform activity in Latin America around ownership structures than in relation to board nomination and practices. The Government as owner is accountable for ensuring that sound Corporate Governance practices are advocated in its SOEs' ownership policy, but it is also important to ensure that the boards of directors are able to carry out their responsibility of strategic guidance and management monitoring. However, board nomination processes and other practices aimed at achieving SOE board effectiveness are not the purpose of this paper.

#### IV. CORPORATE GOVERNANCE AND SOES IN LATIN AMERICA

Corporate Governance in Latin American SOEs is varying from an ideological debate to a pragmatic issue, where SOEs are fundamental players for local economies.<sup>66</sup>

Many of the SOEs have adopted a corporate form<sup>67</sup> and are governed by the same legal regime applicable to private business corporations<sup>68</sup>, where some others have special fiscal treatment and privileges. The board of directors is mainly made up of public officials. This

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<sup>66</sup> ONETO LA FAYE, Andrés. *Gobierno Corporativo en América Latina: Importancia para las Empresas Estatales*. See note 28.

<sup>67</sup> That is, by taking a corporate form, SOEs have limited liability, are ruled by corporate law and have corporate formalities (such as General Shareholders Meeting, Board of Directors, etc.)

<sup>68</sup> Pargendler says that despite this form is recommended by the growing literature supporting improvement of corporate governance practices in SOEs, "*it pays no attention to how SOEs affect the efficiency of corporate and securities laws as they apply to private firms*". See PARGENDLER, Mariana *The Unintended Consequences of State Ownership: The Brazilian Experience*. Vol. 13 p. 505.



means that independent directors are not a common practice yet. As for managers, their selection takes place, in many cases, through discretionary political appointments. Financial information transparency and information disclosure are evermore significant among SOEs, which even use external auditors to certify their financial statements.<sup>69</sup>

To improve SOEs' corporate condition, the concept of Corporate Governance needs to prevent political bias and implementation processes have to be carried out. It should be understood that implementing these practices does not entail a SOE "privatization". On the contrary, the idea is to achieve SOE corporate structure heterogeneity by adjusting regulatory frameworks so that SOEs can be on the same foot to act in competitive corporate environments and so that governments develop a clear property policy on them. Building strong institutional capacities for the organ that exercises property rights as active and responsible shareholders is a necessary condition for good governance. As we concluded at the beginning of this section, only if SOEs clearly define their objectives will they be able to establish adequate property structures and the necessary Corporate Governance model for each SOE.

Many Latin American countries have adapted their SOE Corporate Governance Model to the OECD Guidelines, although they are not all members of the OECD. As of today, only Mexico (since May 1994) and Chile (since May 2010) are members of the OECD. In 2011, President Juan Manuel Santos of Colombia expressed the country's willingness to join the organization during a speech at the OECD headquarters.<sup>70</sup> In 2013, the OECD decided to

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<sup>69</sup> GUASCH, Andrés L. y LÓPEZ AZUMENDI, S. *Governance in State-Owned Enterprises Revisited: The Cases of Water and Electricity in Latin America and the Caribbean*. Policy Research Working Paper 5747, World Bank. 2011.

<sup>70</sup> "Demanda de Santos para que Colombia entre a OCDE fue bien recibida" ("Santos' request to join OCDE was well received") *El País* (in Spanish) January 25, 2011.

open membership talks with Colombia, likewise with Costa Rica in 2015.<sup>71</sup> Another Latin American country that has expressed interest in an OECD membership is Peru<sup>72</sup>.

Peru and Chile are the main examples of the OECD definition of a centralized model. Most SOEs in these two countries are overseen by a singular agency: SEP in Chile<sup>73</sup> and FONAFE in Peru<sup>74</sup>. Brazil and Ecuador also feature strong coordination mechanisms, fitting more closely with a dual model involving both sectoral ministry representation on the board of directors and shared central coordination. In Brazil, like Chile and Peru, the government entity DEST is specifically responsible for SOE ownership, but SOEs are also overseen by two ministries: the Ministry of Finance and the sectoral Ministry. The Inter-Ministerial Corporate Governance and Federal Government Management of Participation Commission (CGPAR) of Brazil provide an additional coordinating mechanism to decide

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<sup>71</sup> OECD Press Release, May 30, 2013

<sup>72</sup> Andina.com.pe November 15, 2012

<sup>73</sup> SEP is the Public Enterprise System, the main ownership, monitoring and reporting entity of the government accountable for overseeing 22 of the country's 33 SOEs. The 11 exceptions have their own supervisory structures but are still responsible to a separate government agency (for example: Codelco, the world's largest copper producer, to the Ministry of Energy and Mining). All 33 SOEs are accountable to the Congress, the President and the General Comptroller Office. All SOEs are subject to an external independent audit with resulting information made publicly available. The creation of SEP has brought several measures to ensure the separation of owner and regulator within SOE governance. In accordance with OECD Guidelines on Corporate Governance of State-Owned Enterprises, the Chilean government has developed a written ownership policy regarding all SOEs under SEP, outlining its role and objectives in SOE governance. SEP issued its non-mandatory People Management Guide in 2012, which main priority is to ensure external competitiveness, or private sector comparability, and to achieve higher results in profitability and client satisfaction, following the OECD. (OECD Questionnaire for the 2011 OECD Network Meeting). See BLUME, Daniel. OWNERSHIP OVERSIGHT AND BOARD PRACTICES FOR LATIN AMERICAN STATE-OWNED ENTERPRISES. *supra* note 40.

<sup>74</sup> FONAFE is the National Funding for the Financing of the Peruvian State's Business Activities, established in 1999 as a centralized entity to oversee Peru's SOEs. Its main functions are to exercise ownership rights of the state, approve the consolidated budget and management procedures, and appoint its representatives to the Annual General Shareholders Meeting, for the SOEs in which the state is a majority shareholder. FONAFE's mission is to align its own interests with those of the SOEs and the state, and to present them in a homogenous way to facilitate transparency. It maintains the ability to establish corporate governance best practices as a minimum requirement for the SOEs under its control; specifically, FONAFE has implemented framework guidelines as will be discussed in Part IV.

and control the execution of proposed guidelines for managing SOEs.<sup>75</sup> In fact, the Brazilian institutional arrangements could be drawn as both counterintuitive and contrary to influential OECD Guidelines on SOEs.<sup>76</sup> Ecuador has a unique tripartite structure of ownership oversight with a strong coordinating role played by SENPLADES.<sup>77</sup>

Argentina, Colombia and Mexico have developed SOE ownership strategies aligned with the OECD's definition of a "decentralized model", with somewhat more limited central coordination and sectoral ministries playing a strong role.<sup>78</sup> In Argentina, SOEs' corporate governance is achieved through three separate entities that fall under the executive branch: an audit committee (AGN) that exercises external control, a monitoring committee, and the General Trustee of the Nation (SIGEN), that exercises internal and SOE performance control.<sup>79</sup> SOEs in Colombia are split into two categories: SOEs that are 100% state-owned

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<sup>75</sup> DEST is the Department of Co-ordination and Corporate Governance of State Enterprises, within the Ministry of Planning, Budget and Management. DEST is responsible for establishing corporate governance guidelines, approving the allocation of income, fixing board member remuneration, appointing one board member and approving bylaws and capital increases. In turn, the Ministry of Finance approves financial statements, represents the state at shareholder meetings and authorizes issues of debt and securities, while the sector Ministry appoints the majority of non-executive board members and sets out the strategy of the board of directors and for investment. Members of the CGPAR include the Minister of Planning, Budget and Management, Minister of Finance, Chief of the Presidential Staff Office, and other ministers of state. See Murilo Barella, *Government Companies in Brazil*. MODELS OF THE STATE OWNERSHIP FUNCTION ORGANIZATION, PUBLIC ENTERPRISE, Vol. 18, Nº 1-4.

<sup>76</sup> See PARGENDLER, Mariana. *State Ownership and Corporate Governance* (see note 25) and *The Unintended Consequences of State Ownership: The Brazilian Experience* (see note 85).

<sup>77</sup> SENPLADES is the National Secretary for Planning and Development. It appoints one board member to each SOE and is responsible for issuing the government's national development plan "*Plan Nacional del Buen Vivir*", which serves as a basis for the government's overall ownership objectives along with the Constitution. The other two SOEs' board members are appointed by the President of the Republic and by the responsible sectoral ministry. See BLUME, Daniel. OWNERSHIP OVERSIGHT AND BOARD PRACTICES FOR LATIN AMERICAN STATE-OWNED ENTERPRISES. *supra* note 40.

<sup>78</sup> See BLUME, Daniel. OWNERSHIP OVERSIGHT AND BOARD PRACTICES FOR LATIN AMERICAN STATE-OWNED ENTERPRISES. *supra* note 40.

<sup>79</sup> According to Argentina's questionnaire response in BLUME, Daniel. OWNERSHIP OVERSIGHT AND BOARD PRACTICES FOR LATIN AMERICAN STATE-OWNED ENTERPRISES. *supra* note 10, the most pressing corporate governance challenges facing SOEs in Argentina are mandating a director nomination process, defining criteria for reporting financial statements and audit reports, and avoiding interference with the day-to-day operation of SOEs.

and those that have both public and private capital.<sup>80</sup> The Ministry of Finance and Public Credit oversees SOEs in the financial sector and those SOEs owned by the Ministry of Mines and Energy, as well as other public services, while other sectoral ministries maintain ownership responsibilities for SOEs within their sectors.<sup>81</sup> Colombia's SOE's framework distinguishes types of SOEs and special laws may apply to them, as well as some sectors are subject to special laws. Commercial and industrial SOEs are regulated, considering that these companies must follow the same requirements as other private companies, without any advantages. Likewise, listed SOEs with mixed ownership shall meet the same requirements as other publicly listed companies to address minority shareholders rights. In Mexico, each SOE is overseen by the ministry corresponding to its sector of operation, which is responsible for dictating company policies and appointing its minister as chairman of the board. Each ministry is accountable to the President and Parliament. SOEs fully owned by the state can be attributed state subsidies.

State-owned enterprises in Latin America are generally not listed in a stock exchange.

Brazilian and Colombian SOEs are the two most visible exceptions.<sup>82</sup> State-owned

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<sup>80</sup> SOEs with state-ownership greater than 90% technically also fit in the category of SOEs with 100% state ownership (information provided by the Superintendent of Corporations in Colombia, Mr. Luis Guillermo, for the 2011 OECD Meeting of the Latin American Network on Corporate Governance of State-Owned Enterprises). The other group of enterprises is called "*sociedades de economía mixta*", corporate structure that has been used by Venezuela during the process of nationalization of the oil sector since 2006 by the name "*empresa mixta*". In Colombia, the *sociedades de economía mixta* are supervised by another government agency: the *Superintendencia de Sociedades*.

<sup>81</sup> While the Ministry of Finance and Public Credit is also responsible for monitoring the financial position of companies to mitigate financial risks, the Superior Counsel for Fiscal Policy - CONFIS (*Consejo Superior de Política Fiscal*) sets out policies regarding dividends, debt and equity structuring, and defines investment plans. One challenge emerging from Colombia's SOE structure, in addition to the impact of political influence, is the tendency to manage SOEs on budgetary grounds as opposed to strategic grounds, for the strong role of the Ministry of Finance to oversee SOEs. See BLUME, Daniel. OWNERSHIP OVERSIGHT AND BOARD PRACTICES FOR LATIN AMERICAN STATE-OWNED ENTERPRISES. *supra* note 40.

<sup>82</sup> In Brazil, SOEs currently account for 24.8% of Brazil's stock exchange, BM&F BOVESPA (Petrobras - *Petroleo Brasileiro S.A.*, the Brazilian state-owned oil company - accounts for 16.6% of market capitalization. Of the 25 SOEs listed on BM&F BOVESPA, 17 are controlled by states and 8 by the federal government. See

enterprises have ruled Brazil's capital markets for the most part of the twentieth century. In 2011, listed SOEs accounted for thirty-five percent of the market capitalization of Sao Paulo's BM&F BOVESPA, the world's ninth largest stock exchange.<sup>83</sup> Globally speaking, state-owned enterprises accounted for twenty percent of global stock market value in 2010, which is more than two times the level observed one decade earlier.<sup>84</sup> The rationale behind public listings of SOEs is that they can promote efficient management and boost firm performance.<sup>85</sup>

### Latin America SOEs - Country Report

| Country          | Nº of SOEs | Commercial SOEs | Fully Ow ned | Majority Ow ned | Minority Ow ned | Listed SOEs | Revenue s GDP | % of Employment |
|------------------|------------|-----------------|--------------|-----------------|-----------------|-------------|---------------|-----------------|
| <b>Argentina</b> | 112        | 40              | 23           | N/A *           | N/A             | 17          | N/A           | N/A             |
| <b>Brazil</b>    | 147        | 119             | 38           | N/A             | N/A             | 8           | 5.65%         | 0.7             |
| <b>Chile</b>     | 33         | 33              | 30           | 3               | 0               | N/A         | 13%           | 0.7             |
| <b>Colombia</b>  | 105        | 105             | 18           | 51              | 36              | 3           | 16.70%        | 0.12            |
| <b>Ecuador</b>   | 24         | N/A             | 21           | N/A             | N/A             | 0           | 29%           | 1               |
| <b>Mexico</b>    | 110        | 90              | N/A          | N/A             | N/A             | 0           | N/A           | N/A             |
| <b>Peru</b>      | 31         | N/A             | N/A          | N/A             | N/A             | 9           | 2.99%         | 0.15            |

Source: Information from OECD Report on Ownership Oversight and Board Practices for Latin American State-Owned Enterprises (2012)

\* SOEs that are wholly or majority-owned by the State are about half of all companies with government involvement.

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Ana Paula Higa (2009) THE ROLE OF SOES IN THE BRAZILIAN ECONOMY. Unpublished report prepared by the OECD consultant. In Colombia, only 3 of Colombia's 105 SOEs are listed. These three constitute 52% of market capitalization. See Colombia OECD questionnaire response in BLUME, Daniel. OWNERSHIP OVERSIGHT AND BOARD PRACTICES FOR LATIN AMERICAN STATE-OWNED ENTERPRISES. *supra* note 40.

<sup>83</sup> *The Company that Ruled the Wave*, THE ECONOMIST, Dec. 17, 2010. See PARGENDLER, Mariana. *The Unintended Consequences of State Ownership: The Brazilian Experience*.

<sup>84</sup> Chinese Acquisitions: China Buys Up the World, THE ECONOMIST, Nov. 11, 2010. See PARGENDLER, Mariana. *The Unintended Consequences of State Ownership: The Brazilian Experience*.

<sup>85</sup> PARGENDLER, Mariana. *The Unintended Consequences of State Ownership: The Brazilian Experience*. Pargendler states that SOEs should welcome private investors preferably by trading their shares on public securities markets. In *State Ownership and Corporate Governance*, 80 FORDHAM L. REV. (2012), Pargendler compares the choice of private block sales in Brazil and the adoption of share offerings in Italy and Germany. While the former weaken minority shareholder rights upon control sales, the latter prompted their governments to improve minority rights and the governance environment of privatized firms in order to maximize privatization proceeds.

Other Latin American countries, like Argentina, Chile and Peru, have SOEs listed, while Ecuador and Mexico have chosen not to list any SOEs. There is no preferred ownership structure for them, according to the OECD. However, it should not be disregarded from a reform policy-making agenda, since this group of SOEs often includes companies of major importance in their national economy. In the case of Brazil, the largest increase in the adoption of Corporate Governance practices has taken place in those publicly traded in Sao Paulo's BM&F (BOVESPA). Petrobras, the largest publicly traded company in Brazil, is a perfect example. In 2010, Petrobras migrated from being a purely state-owned enterprise to a mixed company. When the Brazilian state was Petrobras sole shareholder, there were no organizational entities supervising the company's decisions. This evidently exposed Petrobras to potential risks associated with decision making groups within the company.<sup>86</sup>

In Peru, SOEs Corporate Governance regulation is relatively recent. A committee of eight public and private sector entities was formed in 2002. It was chaired by the Peruvian Securities Regulatory Agency (formerly CONASEV, today SMV),<sup>87</sup> and aimed at establishing Corporate Governance Principles applicable to Peruvian companies. The committee issued the document on "Principles of Governance for Peruvian Corporations," which was based on the document "Principles for Corporation Governance" issued by OECD, but considering the specificity of Peruvian corporations' legal frameworks. This document became a reference of good practices for Peruvian corporations and CONASEV, the regulatory agency, required corporations whose securities were publicly traded to

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<sup>86</sup> BERNAL, Andrés. *Gobierno Corporativo en América Latina*. Importancia para las Empresas de Propiedad Estatal *Supra* note 28.

<sup>87</sup> CONASEV is the Spanish acronym for *Comisión Nacional Supervisora de Empresas y Valores* (National Corporation and Securities Commission), and SMV is the Spanish acronym for *Superintendencia del Mercado de Valores* (Securities Superintendence).

disclose how much they adhered to corporate governance principles in their annual reports and brochures.

Ten years after, in February 2012, a committee was appointed to update the document “Principles of Governance for Peruvian Corporations,” considering legal regime changes in the Peruvian securities market, the weaknesses evidenced in the 2008 international crisis concerning information transparency and internal corporate control, as well as progress made on corporate governance by CAF and OECD. This time, the committee was made up by fourteen institutions and associations representing the Peruvian securities market and corporate sector, under the chair of SMV, the regulatory agency and thanks to the financial support of CAF.<sup>88</sup> The result was the recently published “Code of Corporate Governance for Peruvian Corporations.”<sup>89</sup>

The “Code of Governance for Peruvian Corporations” includes two annexes of complementary principles: one for state-owned enterprises (SOEs) and another for family corporations. With this inclusion, SMV shows that their relevance is acknowledged in the country’s economic activities, particularly taking into account that some of them are publicly traded.<sup>90</sup> These annexes have to be read jointly with the “Code of Corporate Governance for Peruvian Corporations,” that applies to all Peruvian corporations (either controlled by the state or by private investors), in such a way that the annexes are

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88 The Committee was made up by fourteen institutions and corporate associations, chaired by the Security Market Superintendence (SMV). Its other members were the Association of Companies that Promote the Capital market (PROCAPITALES), the Ministry of Economy and Finance (MEF), the banking, Insurance and Private Pension Fund Administrator (SBS), the national Fund for Financing the State’s Corporate Activity (FONAFE), the Lima Stock Exchange (BVL), the Security Clearance and Settlement Institution (CAVALI), Peru’s Association of Stock Exchange Brokerage Firms, the Bank Association (ASBANC), the Private Pension Fund Administrators Association (AAFP), the National Confederation of Private Corporate Institutions (CONFIEP), the Peruvian Institute of Independent Auditors (IPAI) and Capital Markets, Investments and Finance Consulting S.A. (MC&F).

89 This document was published on November 08 2013.

90 See [smv.gob.pe](http://smv.gob.pe) (last visit: March 2014)

additional considerations due to the specific characteristics and conditions of state-owned and family-owned companies. In spite of the fact that the adoption of this Code is voluntary, the corporation has to show its adoption of the Code through corporate documents, as well as its effective application in line with the internationally acknowledged principle “comply or explain.” Corporations that assume the Code will improve their appraisal before investors, will reflect a clear self-regulatory capacity, and will contribute to their positioning in the country’s and foreign capital market.<sup>91</sup>

Annex A of the “Code of Corporate Governance for Peruvian Corporations”, on complementary principles for SOEs, emphasizes issues on (i) board of directors, (ii) information transparency and (iii) equitable treatment of shareholders.

According to the latter, a Peruvian SOE should give equal treatment to public and private shareholders. This does not prevent them from having different share classes (in which case, equal treatment refers to the fact that same class shareholders keep the same conditions) neither providing privileged information to a group of shareholders in prejudice of the remaining shareholders. In no case should there be share classes without a right to vote.

It is important to distinguish among different shareholder classes because not all have the same interests: there are institutional shareholders who are mere investors; others who are more interested in daily corporate administration and management and in participating in the shareholders’ meeting; and minority shareholders who are less interested in attending

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<sup>91</sup> Statistically, companies in the corporate government index have approximately a 20 to 25% market premium (Source: Lima Stock Exchange)



the shareholders' meeting and voting. Despite the different interests, the company should promote participation of all its shareholders in the shareholders' meeting. It is necessary to grant minority shareholders rights such as: requesting a meeting, to state the content of the call and documents to be annexed, to access complete text of agreement proposals, to request the inclusion of items in the shareholders' meeting agenda, to count on a procedure for exercising the vote remotely, to use technology to cast the remote vote, to disclose voting policies, among others.

## **CONCLUSION**

The need for countries to apply Corporate Governance practices transcends their political ideologies, as well as economic development and presents itself as an important challenge to all. Corporate Governance is an important tool used to strengthen management and control of enterprises and serves to guarantee transparency and an efficient allocation of the state's interests in SOEs.

Governance principles can serve to mitigate the conflicts of interest inherent to SOEs. Such a conflict exists due to the dual player and referee role of the state, which worsens when it is a controlling shareholder, adversely impacting the minority shareholders' rights as a regulatory agent.

The Corporate Governance practices encourage SOE corporate forms where the state ownership control is clearly separate from the supervising and regulatory role. These

corporate forms demand a dual regulatory regime for SOEs instead of applying general corporate rules, as if the latter were efficient enough to control the state shareholder interest.

Latin America is in the process of implementing the Corporate Governance practices by means of principles or rules and will have to face the inherent challenges of SOEs, among others: the state acting as a controlling shareholder, publicly traded shareholder interests, board member designation and supervising compliance with Corporate Governance practices. All these challenges have to be re assessed as the governance models evolve.