Foregone opportunities: how state owned companies burden public budgets
- Lessons learned from Romania -

Summary: Despite 25 years of reforms towards a market economy, the Romanian public sector companies remain a major fiscal and economic burden. When poorly governed, such companies distort the competition in various markets. They may purchase overpriced supplies or sell goods and services at below market prices, in contracts concluded non-competitively with preferential partners. By such deals, by being allowed to operate inefficiently on subsidies and by defaulting on payments to the budget or to their commercial partners, SOEs burden heavily the public finances and other market players. Thus, in 2013 alone, SOEs built arrears amounting to 2% of GDP, while also foregoing profits that could have become dividends to the consolidated budget. These inefficiencies are caused by poor, incomplete implementation of governance rules and of structural conditionality imposed by the IMF.

Romanian SOEs: slow and painful post-communist transition

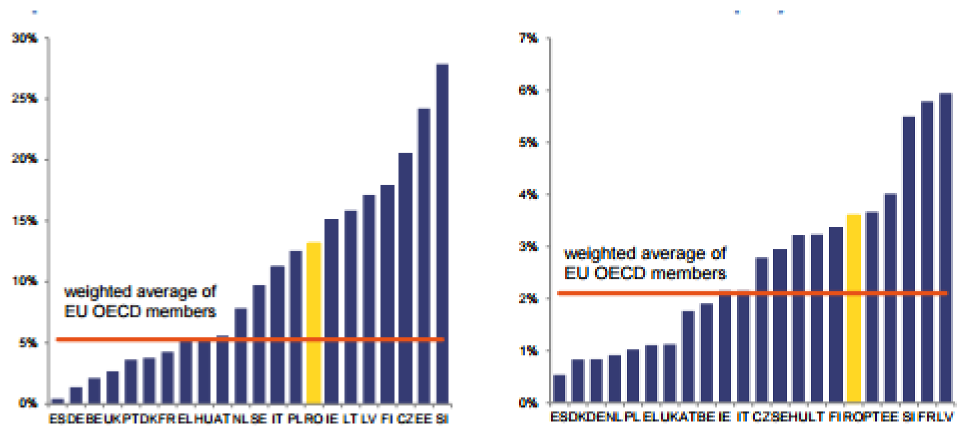
The share of SOEs has declined slightly in the past decade both in terms of turnover and employment following several privatizations (mainly in the energy sector). However, they continue to play a major role in the Romanian economy. As of end-2014, SOEs contributed 8% of the total turnover of the non-financial sector and some 300,000 employees (or 4% of the total employment). Subsidies and transfers to SOEs represent almost 2% of consolidated budget expenditures[1]. The share of the SOE sector in the total economy is somewhat above OECD average, though not out of line with other EU member states. At present, in Romania there are over 1400 SOEs, of which about 250 under the central government, whereas the rest are under local governments[2].

Romanian SOEs are very different in terms of business model, financing source, type of service provision and size. Some have less than 5 employees and low turnover, whereas the largest (Posta Romana - the Romanian Postal Services) employs over 20,000 people at a turnover of 260 mil EUR. The largest 25 companies generate over two thirds of the total SOE output and each employ over 2,000 people. In terms of institutional setup, not all SOEs are fully commercialized. Some (particularly local SOEs) are still operating as "regie autonoma", an intermediate entity between state agency and commercial company - a legacy of the incomplete commercialization and regulatory reforms of the post-communist public service provision. However, the number and share of such entities has declined in recent years and they represent today 10% of all SOEs, operating

[1] ECFIN, 2015. " The role of state-owned enterprises in Romania", Helena Marrez http://ec.europa.eu/economy_finance/publications/country_focus/2015/pdf/cf_vol12_issue1_en.pdf
[2] IMF, 2015, IMF Country Report No. 15/80. http://www.imf.org/external/pubs/ft/scr/2015/cr1580.pdf

mostly at local level for local service provision (e.g., public transport, transport and distribution of centralized heating).

Figure 1-2: Equity of SOEs relative to GDP (left) and employment in SOEs compared to total employment

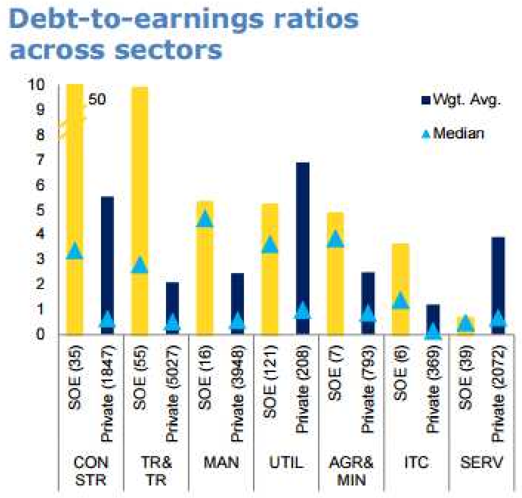


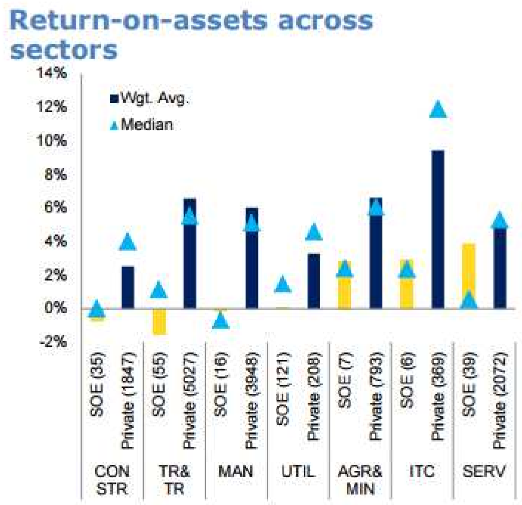
Source: ECFIN, based on OECD data, 2015

Burden on the economy or motor for growth?

Following incomplete commercialization reforms, the absence of a clear definition and proper financing of services of general economic interest, and because of "soft budget constraints", SOEs have been since the '90s one of the sources of Romania's macroeconomic imbalances. This is why the improvement of SOE management, commercialization and governance reforms have become part of the fiscal conditionality whenever the country asked for external assistance from international donors. During the economic crisis of 2009, as the Romanian public deficit spiralled out of control at 7.2% of GDP, the country requested international financial assistance from IMF, EC and the World Bank. Since the first agreement of 2009, but also in the subsequent two (2011, 2013), the donors identified SOEs as a **source of hidden deficits and arrears**, as well as potential, yet untapped additional revenues to the public budget. At the same time, SOEs in critical sectors such as energy and transport were viewed as **potential motors for sustainable growth**, attracting private investments or enhancing the infrastructure needed for the production or mobility of goods and services. However, before the potential for SOEs could be untapped, the following structural issues had to be solved:

- SOEs are heavily indebted compared to private companies and are less profitable and overstaffed (graphs below). SOEs arrears to the budget reached 5% of GDP in 2010 (gradually declined to 3.4% in 2013 as result of IMF pressures); more than 2% of GDP are arrears of just 10 large SOEs. Even today, SOEs continue to represent about half of the total tax arrears to the consolidated budget. SOEs also generate distortions in the private sector, as SOEs represented 17% of overdue payments to private suppliers (e.g., railways to electricity suppliers).





Source: ECFIN, 2015 http://ec.europa.eu/economy_finance/publications/country_focus/2015/pdf/cf_vol12_issue1_en.pdf

- unlike private companies, SOEs often operate under "soft budget constraints". For example, they are allowed to default on payments to the budget or, because of flaws in the legal or regulatory framework, even to private companies. The most prominent example in recent years was in the railways sector: electricity suppliers continued to supply power to railways despite non-payments because of "traffic safety" regulatory restrictions that made disconnections difficult. SOEs can also be supported through various means of transfers and subsidies, though the scope of such support has been limited after Romania's accession in the EU in 2007 by the European state aid rules. Despite the restrictions on direct subsidies under EU rules, the Government could obtain derogations (e.g., for hard coal, subsidies are still allowed by 2018); approvals of certain support schemes (e.g., a support scheme for cogeneration that in fact also allowed the continued operation of inefficient state-owned power plants[3]); or it could violate EU rules without risks of following up with penalties (e.g., smaller state aid not investigated or deemed acceptable by DG Competition[4]).
- Romanian SOEs raise additional corporate governance concerns compared to private companies, because their management is further removed from the final owner (the taxpayer) than is the case in a private company and the chain of accountability is not as clear. In particular, the international donors were concerned about risks such as:
  - overstated procurement, at above-market prices, which may distort competition among the markets of SOE suppliers
  - understated sales, at below-market prices, which may distort markets of the SOEs clients
  - politicization of the management, i.e., appointments of key staff based on clientelistic criteria instead of competence

[3] http://candole.com/files/Raport_carbune_en.pdf. The cogeneration bonus scheme is an operational subsidy allowing the provision of district heating in cogeneration to units above a rather low threshold of efficiency.

[4] One example is Government Decision 138/2013, by which two coal-fired power plants obtained preferential access to the market. The Decision constitutes state aid, though it was not formally submitted to EC for approval, nor investigated by DG Competition as illegal state aid.

- soft budget constraints, e.g., support for loss-making SOEs from hidden or cross-subsidies.

An illustration of the fiscal and market-distortion effects of poor SOE corporate governance is illustrated in the Annex on Hidroelectrica.

Towards an adequate corporate governance framework

The clarification of the corporate governance framework to enhance managerial accountability is critical in solving the above-mentioned issues. In Romania, the major governance concern derives from the fact that the broad state ownership policy is not clear and ownership and managerial responsibilities are not properly assigned.

Thus, for proper managerial accountability of SOEs, it is critical to understand **why these companies are owned by the state**, as SOEs are expected to behave differently than private companies[5]. SOEs can operate as commercial, fully competitive companies whose end-consumers pay in full for the services or goods (e.g., pharmaceuticals, chemicals, postal services etc.). Others can be entities financed from the budget to perform certain public service obligations, particularly in the case of natural monopolies (e.g., construction of infrastructure). Most SOEs fall in between these extremes, providing services paid partly by consumers and partly by the budget (e.g., railway transport for passengers). In the particular case of Romania, as illustrated also in Hidroelectrica's case above, one major governance issue is the **poor definition of public service obligations and services of general economic interest**; and the poor financial arrangement for the performance of such obligations.

Several issues concerning corporate governance of SOEs were addressed following the IMF /WB/EC program, which pushed for a reform along the OECD guidelines and focused monitoring of implementation specifically on several large companies in the energy and transport sectors[6]. The main principles in the programs were the **separation between government's ownership and policy-making functions; managerial transparency; separation of public service obligations from competitive operations and avoiding cross-subsidization, and professional boards**. Indeed, in autumn 2011 the Government approved a decree (109/2011) that introduced competitive appointments of management and boards for large SOEs, higher operational transparency and set up a monitoring unit in the Ministry of Finance. In addition, the IMF required listings and majority privatizations in several companies that were commercially viable, mostly to ensure that these companies are forced at least to meet the minimum corporate governance requirements of the Stock Exchange. What was not achieved in terms of legislation, despite efforts since 2011, was to shield off the SOEs from undue interferences from the line ministries in their day-to-day management or to clarify public service obligations and ensure they are financed from the budget and not from the commercial operations of the SOE.

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[5] OECD, 2015. "Balancing Commercial and Non-Commercial Priorities of State-Owned Enterprises", Hans Christiansen. http://www.oecd.org/daf/ca/OECDCorporateGovernanceWorkingPaper6.pdf

[6] http://www.oecd.org/corporate/ca/corporategovernanceofstate-ownedenterprises/34803211.pdf

The implementation of the decree and of the other measures concerning SOEs left much to be desired three years later (see graph below). However, while the reforms basically stalled in 2014 and was even partially reversed, the changes in governance practices still had positive effects on the overall performance of several large SOEs during 2012–13[7]. Two large loss-making companies (hard coal mining and a very inefficient power producer) were liquidated. Some arrears were restructured and rescheduled. IPOs were successful for several companies in the energy sector (power distribution Electrica, gas producer Romgaz), while listings or privatizations of other companies (power producers Hidroelectrica and Oltenia, majority privatization of the freight rail transport CFR Marfa) were delayed. Some 33 SOEs implemented Ordinance 109, though not in all the selection was indeed competitive, and in some the professional managers were fired unduly.

To conclude, the partial implementation of reforms in the SOE sector meant partial results on the overall SOE arrears, dividends to the budget, and enhanced market operations in certain sectors dominated by several large SOEs. Pressures from international donors are critical for the reform of SOEs: as long as the IMF indeed had leverage (before 2014), it was easier to enforce conditionality. The Government was actually reluctant to implement reforms in SOEs because SOEs represented a large source of rents and clientelistic employment.

Table: Partial implementation of reforms started in 2011, 3 years later

Company	Listing Status²	Independent Board²	Professional Management²
Hidroelectrica	X	NA	NA
Romgaz	✓	✓	✓
Electrica Distributie Muntenia Nord	X	?	?
CN Aeroporturi Bucuresti	X	X	X
Nuclearelectrica	✓	?	✓
Electrica Distributie Transilvania Nord	X	?	?
Electrica Distributie Transilvania Sud	X	?	?
Conpet	✓	✓	?
Complexul Energetic Oltenia	X	?	?
Societatea Nationala a Sarii Salrom	X	X	X
Electrica Furnizare	X	?	?
CN Administratia Porturilor Maritime	X	✓	✓
Posta Romana	X	X	X
Romaero	✓	X	X
CN Administratia Canalelor Navigabile[3]	X	✓	?
A.I. Timisoara – Traian Vuia	X	X	X
Oil Terminal	✓	?	?
Plafar	X	X	X
AI M. Kogalniceanu – Constanta	X	?	?
CN Administratia Porturilor Dunarii Fluviale[3]	X	?	?
CN Administratia Porturilor Dunarii Maritime	X	?	?

Source: Fondul Proprietatea, 2014.

[7] http://www.imf.org/external/pubs/ft/scr/2015/cr1580.pdf

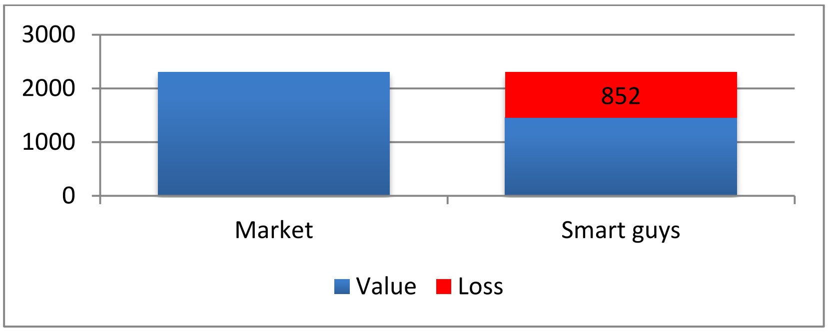
Annex: Hidroelectrica's governance failures

State owned power producer Hidroelectrica is a typical case study on SOEs captured by vested interests. It became famous mainly in the Romanian media for the so-called "contracts with the smart guys", which were sales of electricity to preferred partners, selected in non-competitive terms, at well-below market prices. DG Competition investigated since 2011 several such contracts amounting to 1 billion EUR - the rationale being that such discounts represent a form of subsidy channelled through a public company, being illegal state aid[8]. In 2012, drained of profits through such contracts and following a particularly bad year, the company filed for insolvency. The judicial administrator published a report on the causes of insolvency (Judicial Administrator's Report, 2012):

- overstated procurement. Hidroelectrica's judicial administrator managed to renegotiate maintenance contracts with existing suppliers achieving a 30% savings.

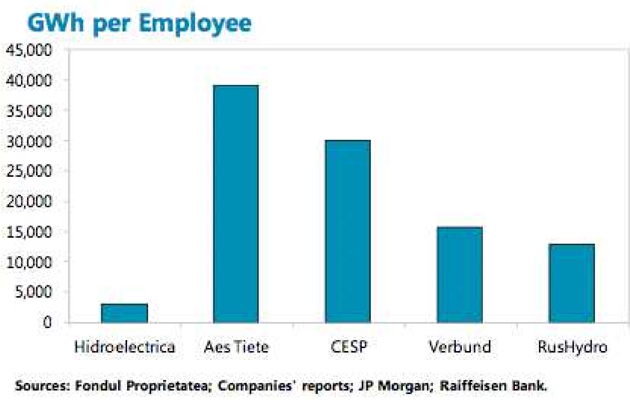
- understated sales. For example, Hidroelectrica sold 12 TWh in 2011 at a price of 121 RON/MWh; while the average market price in 2006-2011 was 192 RON/MWh. In other words, this meant foregone revenue 852 mn RON (about 200 mn EUR).

Foregone revenues in 2011, Hidroelectrica



Source: OPCOM, own calculations

- clientelistic employment. Hidroelectrica's staff comprised a large number of non-producing / administrative employees.



[8] http://europa.eu/rapid/press-release_IP-12-397_en.htm

- soft budget constraints in the energy sector: Hidroelectrica actually purchased expensive electricity from coal-fired generators owned by other SOEs and resold the energy at lower prices.

With a more profit-oriented management, Hidroelectrica became profitable, with annual profits in 2014 above 250 million EUR.

Hidroelectrica's experience suggests that also other SOEs could operate much better in a different corporate governance environment. Before 2012, Hidroelectrica's management was not independent from the line ministry and accountability for managerial decisions was shared among several layers of political decision, diluting individual responsibility. Also, the company could hide the excessively low profits under the pretext of having to also provide public service obligations that were cross-subsidized from the company's commercial operations. Thus, managers claimed publicly that Hidroelectrica could not maximize its profits because it had other objectives, such as proper water management in cases of drought or floods.

It must be noted also that Hidroelectrica's non-commercial behaviour had broader effects on the Romanian economy than just unrealized profits and revenues to the budget. The company produces one third of Romania's electricity, and by its non-competitive sales it was seriously distorting the wholesale electricity market and average prices, as certain traders and large consumers benefited cheaper energy than all other players in the market and thus has a competitive edge. By its direct contracting of supplies at above market prices, Hidroelectrica affected also the competition among such suppliers. It also allowed the survival of other inefficient power companies (coal-fired) by purchasing electricity from them and reselling in the market at lower prices.

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