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**Morning Session: The Importance of Good Corporate Governance for SOE's**  
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## The Importance of Good Corporate Governance for State-Owned Enterprises

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### Introduction

The OECD may be best known as an economic policy organization that advocates liberal market policies for industrialized market democracies. Its policy advice was supportive of OECD countries' efforts to undertake extensive privatisation programmes in the 1980s and 1990s. Much of its work, including its advocacy of the OECD Principles of Corporate Governance, has been aimed at further strengthening private sector-led economic growth. So you might wonder, why has the OECD decided to develop guidelines on corporate governance for state-owned enterprises? Does this represent a shift towards advocacy of a state-owned sector, or some other shift in OECD thinking?

I would say first that the OECD is not shifting the overall direction of its thinking, but its thinking has gotten more sophisticated. Work that the OECD carried out in the late 1990s on state-owned enterprises, privatisation and corporate governance concluded that, despite extensive privatisation activity, state-owned enterprises are likely to remain important in many OECD countries, and that their corporate governance will be a critical element in ensuring their positive contribution to the overall economic efficiency and competitiveness of the economies concerned. More recent experience summarised in the OECD publication, "Privatising State-Owned Enterprise, An Overview of Policies and Practices in OECD Countries," concluded that for privatisation to be effective in terms of economic performance, adequate corporate governance practices and an appropriate institutional framework must be put in place.

In a nutshell, good corporate governance of state-owned enterprises is important because state-owned enterprises are an important part of the economy, and because good corporate governance will contribute to their efficiency and the achievement of their overall objectives. Thus, work to develop new Guidelines on Corporate Governance of State-Owned Assets is not intended to take a position on whether existing state-owned enterprises should be privatised, or, considering the Vietnam context, perhaps I should say that the Guidelines do not take a position on whether SOEs should be **equitised**. Rather, the point is, that good corporate governance is beneficial for a number of reasons, whether for private companies, banks, or state-owned enterprises.

I wanted to start by introducing you to this overall OECD thinking about SOEs, to put it in context for the main part of my presentation. In the main part of my remarks, I plan to address four topics:

- First, the significant scale and scope of state-owned enterprises in OECD countries and also in some developing countries with whom the OECD has been working;
- Second, why the OECD considers corporate governance of SOEs important;
- Third, what are some of the key challenges with regards to current corporate governance practice;
- Lastly, I will talk about new draft OECD Guidelines on Corporate Governance of State-Owned Assets, including the consultation and decision-making process that the OECD is following to develop these guidelines.

## **The Scale and Scope of SOEs: a Comparative Look**

In Vietnam, SOEs remain the backbone of the economy. I understand that estimates of exact numbers differ, but one estimate provided to us indicated that Vietnam has 5,000 SOEs that produce 38% of GDP and, through earnings and taxes, contribute 22% of total government revenue. This is quite high compared to OECD countries and other countries in Asia, attesting to the importance that good corporate governance of SOEs can have on the Vietnamese economy.

Looking at the global picture, it is important to realize that despite considerable privatisation activity in the 1980's and 1990's, the state remains a large domestic owner of commercial enterprises in both OECD and non-OECD countries. While the size and scope of SOEs varies quite a bit across the OECD, and their importance has declined significantly in some OECD countries, SOEs may still represent up to 20% of GDP, around 10% of the employment, and as much as 40% of market capitalisation in a few countries. State ownership includes businesses from various sectors, notably utilities and infrastructure, with energy, transport and telecommunication usually being the most important industries.

A number of non-OECD countries also have very significant state sectors and in some cases these are a dominant feature of the economy. These countries are in many cases reforming the way they organise and manage their state owned enterprises and are often looking towards the OECD experience to help guide their own reforms. SOEs produce approximately 8% of GDP in Asia, 6% in Latin America, while in many Central and Eastern European countries the state sector still accounts for 20% to 40% of output. It has been estimated that globally SOEs still account for 20% of investment and 5% of employment. A few specific examples in Asia may be of particular interest:

- In China, central government is responsible for 17,000 SOEs, local governments for over 150,000. The 1200 SOEs listed on the Shanghai and Shenzhen stock exchanges along with the SOEs listed on the Hong Kong Stock Exchange produce 18% of China's GDP.
- In India there are 240 SOEs outside the financial sector. These enterprises produce 95% of India's coal, 66% of its refined oil, 83% of its natural gas, and about one-third of its finished steel and aluminum.. Indian Railways alone employs 1.6 million people, making it the world's largest state-owned commercial employer.
- The Indonesian Ministry of State Owned Enterprises controls 161 SOEs. With \$86 billion in assets and an estimated 1.4 million employees, over 70% of these SOEs operate in competitive sectors, including pharmaceuticals; agriculture, fisheries and forestry; printing and publishing and over 20 other industries.

## **Why the OECD Considers Corporate Governance of SOEs Important**

The mere size of state ownership in commercial enterprises makes efficient governance of these enterprises an important determinant for overall economic performance. In addition, the globalisation of markets within most industries, technological changes and liberalisation of monopolistic markets in many infrastructure sectors have made readjustment and/or restructuring of the state-owned sector often necessary to remain competitive in the global economy.

For the SOEs themselves, good corporate governance practices open the way to strong efficiency gains, better performance and ability to compete with private competitors. It also enhances valuation of their assets. At a more macro level, improvements in the governance of SOEs are intended to promote growth through improved economic performance and increased productivity. It should lead to a more

transparent allocation of resources and enhance investment and job creation as it will facilitate access to capital (both debt and equity). It may also contribute to fiscal sustainability through a decrease in the budgetary burden and in the level of public debt. Finally, better corporate governance of state-owned assets will promote competition and improve overall public governance through a better valuation of state-owned assets and improved transparency.

There is also an argument to be made that if the state's record in applying good corporate governance practices to SOEs is not good, it may undermine its credibility and effectiveness as a regulator and supervisor of corporate governance of private sector listed companies.

In order to carry out its ownership functions, the state can benefit from using tools that are applicable to the private sector, including the OECD Principles of Corporate Governance. This is especially true for listed SOEs, where the OECD Principles of Corporate Governance offer guiding principles.

### **Distinct Governance Challenges for SOEs**

However, SOEs face a specific set of governance challenges that are distinct from those faced by private corporations. SOEs tend to suffer both from passive ownership by the state, or to the contrary from undue political interference.

SOEs are often protected from two major threats that are essential for policing management in private sector corporations, i.e. takeover and bankruptcy. More fundamentally, corporate governance difficulties derive from the fact that there is a complex chain of agents, without clearly and easily identifiable, or remote, principals. SOEs have multiple principals, involving Ministries, the Parliament, local authorities, the population or interest groups, and the SOE itself. To structure this complex chain of accountability in order to encourage SOE management to make efficient decisions is a real challenge.

### **The Draft OECD Guidelines on Corporate Governance of State-Owned Assets**

Considering the range of specific governance challenges related to SOEs, the OECD Steering Group on Corporate Governance has mandated its Working Group to develop complementary Guidelines on Corporate Governance of State-Owned Assets. The Guidelines refer to assets rather than enterprises because they also cover situations in which the state is a minority shareholder. Nevertheless, my remarks refer to State-Owned Enterprises, or SOEs, because that is the predominant case that we are dealing with. These Guidelines differ from the OECD Principles of Corporate Governance, in that they consider corporate governance from the perspective of the state as an owner. They look at the main characteristics and components of the state's policy as an owner. The Guidelines also cover the way in which the ownership function should be organised within the state administration. It should be understood that the Guidelines only seek to amplify or add specificity to the Principles in certain areas, and do not supersede nor conflict with them. The Guidelines should thus be seen as complementary to the Principles.

More specifically, the Guidelines divide the corporate governance issues into six areas that parallel the chapters of the OECD Principles:

- Ensuring an effective legal and regulatory framework for SOEs;
- The State acting as an owner;
- Equitable treatment of shareholders;

- Relations with stakeholders;
- Transparency and disclosure;
- The responsibilities of SOE boards.

### **Key challenges**

Rather than go into detail on each of the chapters, I would like to highlight three of the key challenges for corporate governance of SOEs that have emerged from this work:

- First, the state needs to better identify how it will organise the **exercise of its ownership rights**, what we refer to as the ownership function within the state administration;
- Second, improvement is needed in the **transparency of SOEs' objectives and performance**;
- Third, it is important to **strengthen and empower SOE boards**.

### **The First Challenge: Exercising the Ownership Function**

The draft OECD Guidelines call upon the state to act as an informed, accountable and active owner, and to establish a clear and consistent ownership policy that ensures that the governance of SOEs is carried out in an autonomous and accountable manner, with the necessary degree of professionalism and effectiveness. This includes developing and issuing an ownership policy that defines the overall objectives of state ownership, the government's role in the corporate governance of SOEs, and how it will implement its ownership policy. The state as represented by the government should let SOE boards carry out their responsibilities and limit its own participation in these boards. The government should not be involved in the day-to-day management of SOEs, and allow them full operational autonomy to realise their defined objectives.

OECD countries are quite split on how they exercise this function. Essentially there are three models of organisation: the decentralised model, the dual model, and the centralised model. Just as in other areas of public sector governance, there are arguments for decentralising management, as long as clear overall objectives are set by the state, or centralising, to try to enforce a more consistent policy of state ownership across the government.

However, within the OECD, there appears to be more of a trend for countries to move toward a centralised model for exercising the ownership function (Belgium, Denmark, the Netherlands, Spain, Poland, Norway, Sweden and France). Advocates of centralisation see it as a means to develop a more unified and consistent ownership policy, and to clearly separate the ownership function from other functions such as industrial policy or regulation. Centralisation also facilitates consistency of aggregate reporting on the SOEs' results. Last but not least, centralisation allows for organising "pools" of experts in relevant matters, such as financial reporting or board nomination.

On the other hand, some countries have cautioned against a centralised approach, particularly a number of large non-OECD countries, who have argued that centralised exercise of ownership rights, if handled poorly, can have negative consequences for the individual SOEs. The traditional model of oversight by sectoral ministries has the advantage of allowing development of sector expertise and the capacity to implement a more active industrial policy. The main drawbacks or dangers resulting from such an organisation are greater difficulty in clearly separating the ownership function from other state

functions, particularly its regulatory role and industrial policy. The public may also perceive that Ministries are running the SOE, rather than the board, and interfering in the day-to-day management of SOEs, irrespective of the real degree of such interference.

Some countries have a dual ministry model, where two ministries may have the right to appoint members to the board, such as the sectoral Ministry and Ministry of Finance. In Korea, there are often three ministries systematically involved in exercising ownership rights, including a sector Ministry, Ministry of Finance and Ministry of Planning and Budget.

### **The Second Challenge: Strengthening Transparent Reporting of Objectives**

The draft OECD Guidelines call upon SOEs to observe high standards of transparency in accordance with the OECD Principles of Corporate Governance. But the draft Guidelines also go further: they particularly emphasise the importance of clearly stating the company objectives, and reporting on fulfilment of these objectives.

There are well known difficulties in defining objectives and measuring performance in any kind of company. These difficulties are even greater in the case of SOEs, as they typically have a more complex set of objectives since they are often being called upon to implement government policy. Moreover, the relative importance of these multiple objectives is not always clearly specified. Some countries, such as Australia, New Zealand, France and Greece, have set up management contracts between the SOE and state authorities, and these are usually submitted to Parliaments, to establish and monitor performance objectives. These contracts or statements of objectives need to be complemented by public reports on the actual SOE performance against the established objectives.

However, World Bank studies reviewing the experience with performance contracts in developing countries have suggested that their impact on SOE efficiency has been disappointing, with no pattern of improvement in trend productivity or profitability apparent. The poor results are explained by three reasons: first, the SOE managers have an information advantage in negotiating targets; second, there are often insufficient incentives provided to motivate managers; and third, the government's commitment to achieving the contract targets may lack credibility. In negotiating these contracts, too often governments have pledged politically unrealistic achievements or have underestimated the associated political costs. The conclusion drawn by the World Bank on its extensive experience with such performance contracts is that they have to be part of a broader package of SOE reforms.

For OECD countries, the effectiveness of objective setting and performance monitoring systems have varied, and have depended on three main aspects:

- First, the quality of the preparation and negotiation of the contracts;
- Second, the quality of the performance indicators; and
- Third, the effective independence of SOE management and their capacity to protect themselves from political interference.

Overall, however, they have contributed to the clarification of objectives and independence of management, and in some cases have improved co-ordination between different governmental bodies with interests in SOEs' strategies.

### **The third Challenge: Empowering Boards**

The third challenge I wish to highlight is the importance of empowering SOE boards. The draft Guidelines suggest that SOE boards should have adequate authority, the necessary competencies and sufficient objectivity to carry out their function of strategic guidance and monitoring of management. They should have sole responsibility for SOE performance and be fully accountable to the owners and the company itself.

Experience in most OECD countries reveals difficulties in meeting this standard. Political influence in the nomination process is strong in a number of OECD countries, but the process often degenerates into a situation characterised as political interference. This can involve the nomination process itself, featuring complex political negotiations, or direct nomination of political appointees. This is often identified as a main weakness of SOE governance, with too many state representatives lacking a business perspective and often independence. In a number of OECD countries, SOE boards also tend to be too large (in France SOE boards may comprise up to 30 members). The presence of employee representatives may in cases transform SOE boards into a political negotiation arena, especially as the state sector labour force tends to be the most organised.

However, an increasing number of OECD countries have undertaken important reforms to professionalise and empower SOE boards. To this end, they seek to limit political interference and have increased the independence and competence of SOE boards through structured and skill-based nomination processes. They have restored their responsibility in critical areas such as monitoring of management and strategic orientation, and are developing more systematic evaluation processes.

### **The Process and the Road Ahead**

I would like to conclude by telling you about the process that the OECD is undertaking to further develop Corporate Governance Guidelines for SOEs, including how you can be involved in that process. The OECD Working Group on Privatisation and Corporate Governance of State-Owned Assets initiated work on the Guidelines in 2003 by issuing a questionnaire on practices in OECD countries. Responses have been used to develop a draft comparative report on corporate governance of SOEs in OECD countries. In the mean time, the OECD began work earlier this year on a complementary report on non-OECD countries. Work on development of the Guidelines began more intensively earlier this year, following the adoption of the revised OECD Principles of Corporate Governance.

A consultation process has also been launched, involving representatives of SOEs, agencies that oversee SOEs, and representatives of more than 20 non-member countries who gathered with members of the OECD Working Group on Privatisation and Corporate Governance of State-Owned Assets in October to consider a draft of the Guidelines. A new draft taking into account comments from these consultations will be published on the OECD's Web site at <http://www.oecd.org/daf/corporate-affairs> in late December and January for public comment. We would be very pleased to have your involvement in reviewing the next draft of the Guidelines to help ensure that it is relevant to your experience in Vietnam, and would encourage you to consult the draft when it becomes public in late December.

Following these consultations, OECD members will convene to consider a final draft of the Guidelines in the spring of next year. Formal adoption of the OECD Guidelines will require the consensus of all 30 member governments, but they have been developed as broad, objectives-based guidelines that take into account differing approaches in different OECD countries.

Finally, I would say that the Guidelines are just a tool in the larger effort to improve corporate governance of state-owned assets. The OECD also works intensively to review and share experience in

OECD as well as non-OECD countries, and would be pleased to work with Vietnam in the future on this important issue.