

## CORPORATE GOVERNANCE IN STATE - OWNED ENTERPRISES – RELEVANT EUROPEAN STANDARDS

### *Abstract*

*Corporate governance standards are confirmed in corporate world, slightly modified applied in state-owned entities in developed European countries (OECD countries). Corporate scandals, among other issues, have led to introduction of corporate governance standards in capital market companies. Numerous abuses and inefficiencies in public enterprises management and other state-owned entities have urged for application of adequate principles as a guarantee of a higher level of accountability and efficiency. New rules for establishment of structures and processes in open joint-stock companies primarily aims at provision of long-term stockholders' interests (investors), as well as other company related stakeholders. This paper is focused on the analysis of those international standards and good governance practices for that kind of enterprise and possibilities for applying rules providing for transparency, independence and accountability, professionalism and efficiency, as well as a conflict of interests resolution in our legal system.*

**Key words:** *corporate governance, state owned enterprises*

### **1. Importance of state – owned enterprises**

Contrary to profit-oriented private enterprises, public enterprises follow an additional, public duty. i.e. general public interest to be performed and protected in an optimal way. Public good must be cheap and yet be produced at an adequate quality - corresponding to strategic objectives of the enterprise. This balancing act is often associated with implementation difficulties.

Private owned enterprises are the skeleton of market economy. However, the state should no way be neglected as a participant in economic

<sup>1</sup> Associate Professor, Belgrade Banking Academy, mail: predrag.dedeic@bba.edu.rs

<sup>2</sup> Senior Research Fellow, Institute of Comparative Law, Belgrade, mail: gordana.gasmi@gmail.com

life, but on the contrary. Looking from the state side and widest social interest viewpoint, such an entity requires special attention, whether it appears as a public enterprise founder or investor in a company.

This implies that a state-owned enterprise, or with a large stake of the state ownership in the market is *sui generis* entity in economy of any country. Introduction of corporate governance structures and processes in any of those enterprises poses a special problem and challenge. OECD countries experiences and existing standards are definitely precious for Serbia when trying to deal with the issue. Example of a good approach can be seen in India where state owned enterprises in manufacturing sector have doubled its rate of profitability during the last decade<sup>3</sup>.

A huge importance of enterprises with a high percentage of state ownership, which are as a rule to be found in energy sector, infrastructure and telecommunication in all economies around the world, underlines the need of management grounded on principles of efficiency, transparency and accountability. Interest to establish (or fail to) such a system comprises a wide range of entities (at national and international levels). It is an extremely challenging task to try and make these enterprises successful in their businesses, and at the same time keep equal legal position as other participants in the market have, and , at the same time, expose them to the market mechanisms effects (free competition, solvency, take over).

Excessive political interference is a key obstacle (including a direct lobbying by numerous groups), leading to politicisation and lack of professionalism in management, hence consequently to inefficiency and unaccountability. A way out of this currently unfavourable situation lies in application of corporate governance standards taking all specific characteristics of these entities into consideration. OECD Guidelines on Corporate Governance of State-Owned Enterprises 2005<sup>4</sup> provide important directions for resolving a number of above mentioned problem related issues. Those standards are the supplement to 'OECD Principles of Corporate Governance 2004'<sup>5</sup>. Results, nonetheless, depend on synergy of a number of factors that should contribute to establishment of a new corporate culture in state-owned enterprises (this primarily refers to enterprises where the state has a significant stake in or even more than that). Academic institutions, NGO sector, corporate sector and state bodies need to act as one aiming at overall economic interest.

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<sup>3</sup> A.S.Khanna, „State Owned Enterprises in India: Restructuring and Growth“, *The Copenhagen Journal of Asian Studies* 30 (20) 2012., 26.

<sup>4</sup> OECD Guidelines on Corporate Governance of State-Owned Enterprises 2005 OECD, available in November 25, 2014, <http://www.oecd.org/daf/ca/41814777.pdf>

<sup>5</sup> OECD Principles of Corporate Governance available in November 25, 2014 at: <http://www.oecd.org/daf/ca/corporategovernanceprinciples/34625094.pdf>

## 2. Relevant issues of state ownership

There is a significant competitive advantage of public enterprises over private enterprises. Many opportunities for crosssubsidization exist in public enterprises, because the surplus of profitable and often monopolized business units can be re-routed to loss-generating. Public enterprises have advantages in raising capital due to the reduced bankruptcy risk, which results from protective coverage guaranteed by the state and conveys a rating advantage. Furthermore, public enterprises can often make use of an information advantage over their private competitors, which stems from close connections to political leaders<sup>6</sup>.

Public enterprises, as entities in the market one always first thinks of when talking about state ownership in business entities, have been of huge importance in Serbia. These enterprises employ a great number of people, performing activities of public importance, bear big potential when it comes to its share in the GDP and have a significant impact on the market game. In Germany in banking sector state ownership is extremely important<sup>7</sup>. However, it has to be underlined that other business entities have been equally important. State investments become even more relevant at crisis when it aims at saving certain companies - ‘too big to fail’. Nationalisation mechanism is to be activated then (state capital subsidy), contrary to equally relevant process of privatisation (topical sale to a strategic partner here).

The public has undoubtedly had a negative attitude towards public enterprises and the states as a commercial entity. They have been a synonym of inefficiency, political interference and unprofessional management. Public believes their management boards are designed to be home to party cadres. Transparency Serbia (NGO) survey at a sample of 25 enterprises shows that this view is well grounded in a large number of cases.

State bodies entrusted to manage the state property act as state property owner agent, its representative, a person working on behalf and for the principal<sup>8</sup>. Principal is an owner of the state property, composed of citizens of the respective state. Owner in corporate governance system always has her/his clearly defined goal. He/she has policy in place and resources to implement it. Owner’s primary goal is to maintain and enlarge ownership in the long run. He/she cannot do it on his/her own,

<sup>6</sup> T.Lenk, O.Rottmann, F.F.Woitek, *Public Corporate Governance in Public Enterprises – Transparency in the Face of Divergent Positions of Interest*, Faculty of Economics and Business Administration, University of Leipzig, 2009, 6.

<sup>7</sup> J.A.Kregel, „Corporate Governance of Banks: Germany“, *BNL Quarterly Review*, Special Issue, March 1997., 78.

<sup>8</sup> Law on Public Enterprises of Serbia-*Official Journal of Serbia*, No. 119/2012, 116/2013 – authentic legal interpretation

since people are needed with special skills and experiences; the owner is forced to hire such cadre, i.e. professionals.

Should we translate this principle into the state enterprises language, it is logical that their property is managed by professionals, and not political party members. This implies that depolitisation and professionalization are the first prerequisite. In the same time it is important to understand that state and state owned subject have interests of their own<sup>9</sup>. Should we make a step further in the analysis, we will be able to see that even professionals, despite being well-educated, experienced and capable of protecting interests of an enterprise and state ownership in it as a rule, may have a destructive impact on the state interest. This is a problem, theoretically known as „principal-agent problem”, stemming from potential for conflict of interest between owner and manager. The citizen as a customer of public services still expects high quality for an adequate price. Following the postulate of maximizing welfare, the citizen thus endows the politician with a mandate to fulfill this public intent. This multilevel “principal agent problem”, is therefore based not only on conflicts of interest but also on information asymmetries. The uniqueness of public enterprises stems mainly from their relationship to the reference systems of market and politics, i.e. the business focus has to be fixed a priori. This describes the framework for these enterprises to be profitable or to follow the postulate of providing SGI. Since public enterprises sometimes have to decide between public duty and the financial result, the main goal of the public enterprise needs to be clarified precisely.

Instruments ensuring motivation of these people to work in interest of those who appointed them have been extremely important in such a situation, providing adequate supervision and disciplinary measures. Such a situation underlines importance of transparent appointment of managers (necessity of a public advertisement) and motivation mechanisms that would help he/she should become efficient and loyal. Supervision of their work is an important step as well, i.e. appointment of supervisory board members and their responsibilities.

Merging business transactions control of all state owned entities is especially important for the overall success. Having this in mind, it is necessary to appoint a body-entity that would be in charge of monitoring business transactions and results of state owned enterprises. This entity would have to act in line with the policy passed by the Government and ratified by the Parliament, being directly accountable to the Parliaments itself.

<sup>9</sup> C.Rentsch, M.Finger, „Yes, No, Maybe: The Ambiguous Relationships Between State-Owned Enterprises and States“, Working Paper n. 2014-05. *Milan European Economy Workshops*, 1.

### 3. Corporate governance standards

Corporate governance is a system improving business efficiency and brings about a higher level of trust of investment public. It, by the definition, should provide for operational efficiency and access to external financing<sup>10</sup>. Better efficiency is to be achieved through clearly defined policies, set objectives and professional governance.

Corporate governance rules have been largely incorporated in our legal system, pertaining to the corporate sector, public enterprises in the first place (open joint-stock companies). Changes have been triggered by OECD activities and passing the Principles of Corporate Governance. Numerous items of the standards are to be found in the Company Law of Serbia, Serbian Law on capital market, Serbian Law on Takeovers of Joint Stock Companies and other general and special laws (e.g. Law on banks), Corporate governance Code of the Serbian Chamber of Commerce, Belgrade stock exchange Code, etc.

Public enterprises and other entities owned by the state fail to follow this path despite the fact that OECD has passed special Corporate governance guidelines for state owned enterprises, annexed to previously adopted standards and adjusted to specific characteristics of this type of enterprises.

Guidelines comprise a number of important issues. They start from the observation that good and solid legal and regulatory framework is a base for building a different approach aiming at establishment of modern corporate governance in state-owned enterprises, or in those the state has larger share. Such a framework should help free market game and prevent disturbances and destructive actions of some factors, in particular confusion of economic functions with other state run functions (e.g. social). Should we wish to have a state owned enterprise in the market, it is logical to expect it to meet its commitments and be exposed to mechanisms the market applies to discipline the unsuccessful ones. Need to provide for equality among entities in the market requires in the first place an even access to banks and other sources of external financing. Specific characteristics of public enterprises impose the need for transparency as an extremely important one, meaning that every public service commitments should be made public.

One of more significant issues within the corporate governance system is a way to turn the owner, 'lazybones king', into an active keeper of self-interest. Concretely speaking, this implies that the state, as an owner of a share in any entity has to use its full governing capacity it has as an

<sup>10</sup> International Financial Corporation, *Korporativno upravljanje*, Beograd. 2011, 6.

owner. This is underpinned by adequate ownership policy incorporating goals and resting on pillars such as information, transparency and accountability.

Interference of controlling owner in a company's management is one of identified issues with corporate governance in Serbia and corporate sector. This undoubtedly does harm to the company's efficiency and has other negative repercussions (harmful for minor shareholders). Once we translate this issue into state owned enterprises related problems, we face with administrative boards independence issue. It is thus essential one should ensure a good quality personnel, adequately divide competencies and make responsibilities precise, provide adequate resources, motivation mechanisms and independence in boards daily businesses. Independence should not exclude supervision. Supervision of all state owned business entities should be differentiated from interference in running the company.

The state should protect its own interests of a stakeholder, aiming at drawing other investors as well. However, it should adequately show respect for interest of all those who invested any resources (smaller stakeholders), or are related in any other interest or risk with this very enterprise. This is a main principle. Corporate governance standards are based upon, pertaining to protection of all stakeholders right and their equality, as well as all stakeholders rights protection. This approach rests on a high level transparency in business transactions, easy and timely access to information, and adequate reporting. Synergy between internal and external audit is definitely the base for setting up such a regime.

OECD guidelines for corporate governance in state owned enterprises stipulate the need for communicating company's objectives with the general public and ways of their realisation; financial assistance by any foreign country, transaction with related persons, all relevant risks for the company's success, as well as ownership structure and electoral ballots distribution. Having said this, one may easily spot the complexity of the issue<sup>11</sup> and the reason the assessment from the first part was based upon: introduction of corporate governance standards in state owned enterprises is a huge challenge.

#### 4. Concluding remarks

The balance between political influence, the management's executive power and economic success forms the pillars in the discussion about purposeful governance of public enterprises<sup>12</sup>. Corporate Governance standards for the public sector generate positive effects through

<sup>11</sup> A.K.Kim, R.J.Nofsinger, *Corporate Governance*, Pearson Prentice Hall, New Jersey. 2007, 37.

<sup>12</sup> T.Lenk, O.Rottmann, F.F.Woitek, 5.

increasing transparency and comprehensive reporting. Implementation of governance regulations for state/owned i.e. public enterprises is only possible, if all parties take part on all levels in this improvement. The question is to what extent the citizen has the opportunity to follow the procedure of public production of goods and services, especially in the light of diverging interests and the high number of participants in the decision-making process in the public sector. Public enterprises have been an obvious example of how the state behaves as an owner of a business entity. Should we start from the fact that a country is seriously indebted, poorly positioned for investments, with a chronic deposit, its capacity to manage its property efficiently has been logically questioned. As the country's property is actually property of all its citizens, managing any role the state has had with any business entity is of the widest social importance.

Positive effects of corporate governance standards in state - owned companies are the following:

- Increased flexibility and adaptability for future developments,
- Greater executive power because of more operational freedom,
- Extended applications to approaches regulated by law,
- Supporting orientation, capacities for communication and organization,
- Reduction of task duplication by a transferable fundamental framework,
- Functions of regulatory policy.

Application of the corporate governance standards is essential for reaching those objectives. New structures and processes within this type of business entities should make them more independent and free them from the burden of serving to other interests, as is the case now, as well as to make their boards more efficient, depoliticized, professional and accountable.

**Prof. Predrag Dedeić, Ph.D**

vanredni profesor, Beogradska Bankarska Akademija

**Prof. Gordana Gasmi, Ph.D**

viši naučni saradnik, Institut za uporedno pravo, Beograd

## **KORPORATIVNO UPRAVLJANJE U JAVNIM PREDUZEĆIMA -RELEVANTNI EVROPSKI STANDARDI**

### Rezime

Standardi korporativnog upravljanja su potvrđeni u korporativnom svetu, malo izmenjeni su primenjeni u kompanijama u državnom vlasništvu u razvijenim evropskim zemljama (zemljama OECD). Korporativni skandali su, uz druge faktore, bili podsticaj uvođenju standarda korporativnog upravljanja u kompanije koje se nalaze na tržištu kapitala. Nova pravila su bila osnov izgradnje struktura i procesa u javnim preduzećima sa primarnim ciljem da dugoročno obezbede interese akcionara i drugih nosilaca rizika. Brojne zloupotrebe i neefikasnosti upravljanja javnim preduzećima i drugim subjektima sa državnim vlasništvom uslovili su nužnost uvođenja adekvatnih standarda koji bi trebalo da garantuju viši nivo odgovornosti i uspešnosti.

Ovaj rad usmeren je ka analizi međunarodnih standarda i dobroj praksi upravljanja tom vrstom preduzeća i mogućnostima njihove primene u našem pravnom i privrednom životu, u smislu obezbeđenja transparentnosti, nezavisnosti i odgovornosti, profesionalizma, efikasnosti, brižljivosti, kao i uspešnog rešavanja situacija konflikta interesa.

**Ključne reči:** korporativno upravljanje, preduzeća u državnom vlasništvu