State Owned Enterprises: Fiscal Costs, Risks and Good Governance

LITHUANIA GOVERNANCE COORDINATION CENTRE

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Natalie Manuilova
Senior Economist
Fiscal Affairs Department

Why Worry about SOEs Fiscal Impact

SOEs are significant economic players accounting for a large share of public sector activity

- Globally, SOEs account for 40% of output, 20% of investment, and 5% of employment
- SOEs deliver key critical services in important economic sectors
- SOEs account for a significant proportion of a country's net wealth
- Many SOEs rank amongst the world's largest companies

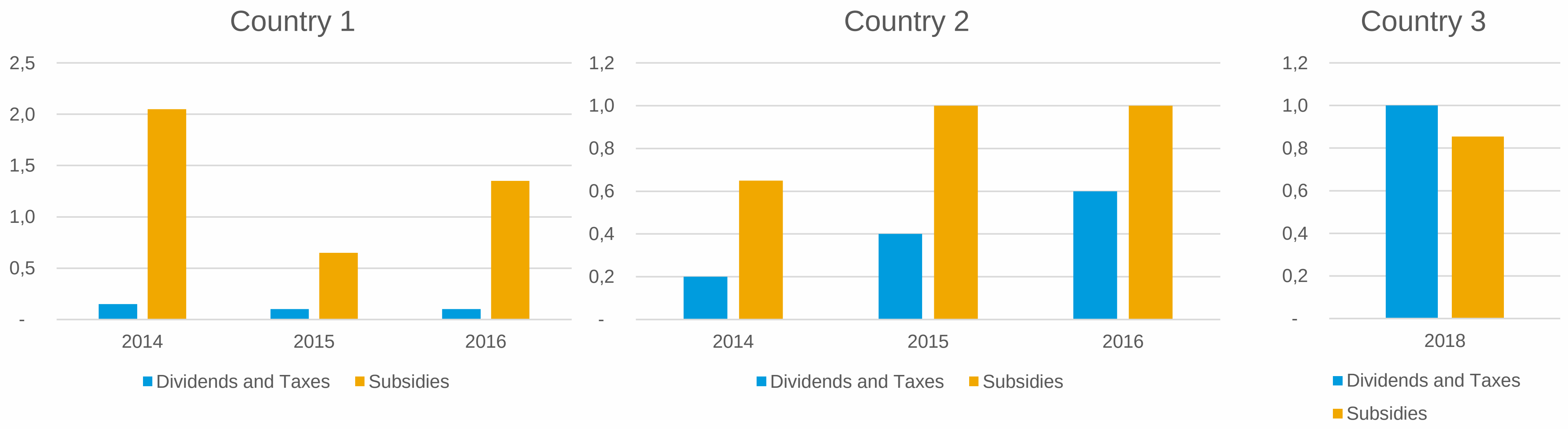
Underperforming SOEs have high social and economic costs

- Troubled SOEs impose large fiscal costs on the budget
- Poor performance by SOEs erodes a country's accumulated wealth
- Shortages of key infrastructure, often provided by SOEs, is a major constraint on growth
- SOEs weaken the financial system through preferred access to credit, underpriced risks and crowding out of the private sector

Why Worry about SOEs Fiscal Costs

- Relationship between SOEs and the budget are not fully assessed/ disclosed
- Quasi-fiscal activities may not be fully quantified and/ or funded
- Fiscal costs from SOEs' operations rarely assessed on a wholistic level

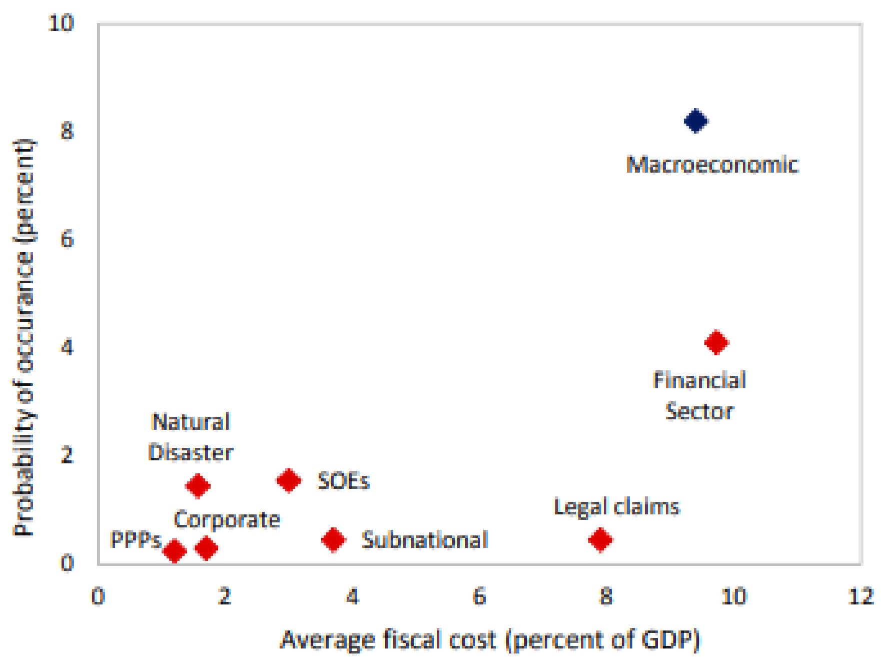
Illustration of the transfers between SOEs and the Budget in IMF CD countries (% of GDP)



Why Worry about SOEs Fiscal Risks

- Fiscal risks from SOEs can be substantial - tend to be large, correlated, occur surprisingly often
- Average cost of bailouts about 3% of GDP (historic data)
- In some cases, bailouts amounted to 10-15% of GDP

Historical Occurrence and Fiscal Costs of Contingent Liabilities per Source
(% of GDP)



Contingent Liability	Number of Events	Events with Costs	Fiscal Cost (% of GDP)	
			Average	Maximum
Financial Sector	91	82	9.7	56.8
Legal	9	9	7.9	15.3
Subnational	13	9	3.7	12.0
SOEs	32	31	3.0	15.1
Natural Disaster	65	29	1.6	6.0
Corporate	7	6	1.7	4.5
PPPs	8	5	1.2	2.0
Other	5	3	1.4	2.5
Total	**230**	**174**	**6.1**	**56.8**

Source: Analyzing and Managing Fiscal Risks – Best Practices (IMF, 2016)

Why Worry about SOEs Fiscal Risks

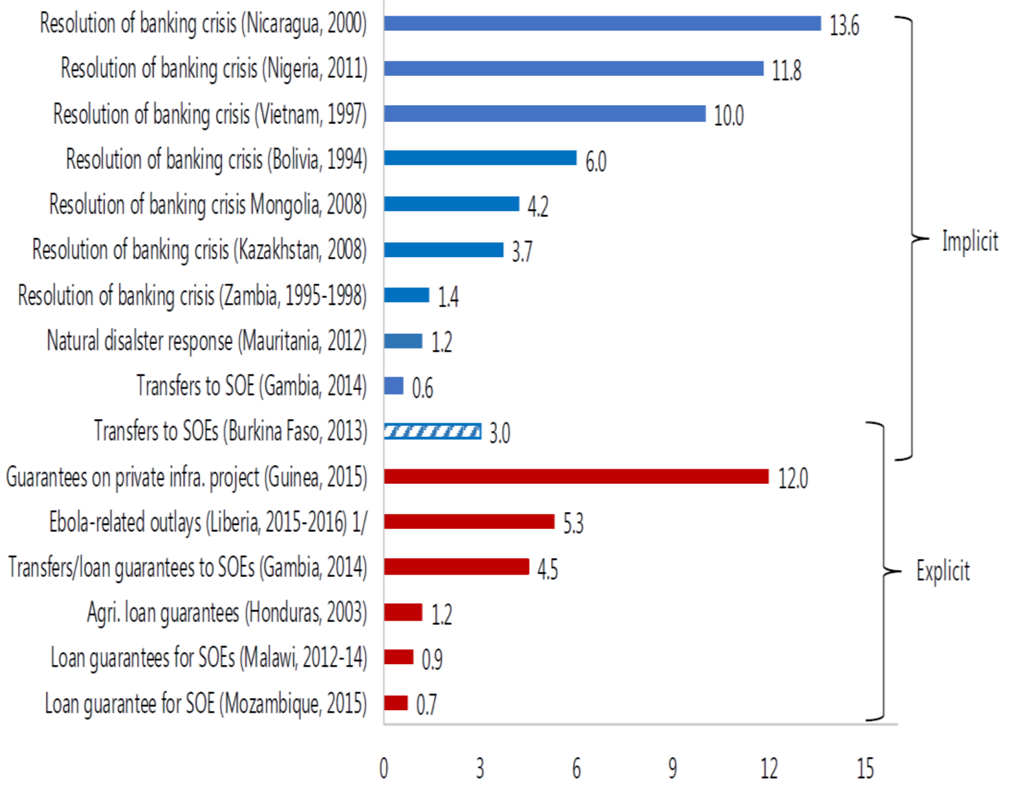
- Implicit versus Explicit Fiscal Risks: quantification approach varies, probability of materialization differ

- Explicit may include but not limited to:
  - Direct subsidies, transfers, including to cover public service obligations of SOEs
  - Contracts (incl. PPPs) with guarantee clauses, e.g., securing loan repayments
  - Sovereign guarantees for SOE debt
  - On-lent loans to SOEs…

- Implicit may include but not limited to:
  - Arrears owed to the State
  - Inter-enterprise arrears
  - Default on unguaranteed SOE debt (bailouts, capital injections)
  - Cleanup of SOE liabilities, arrears

- Implicit risks are some of the largest – but least easily identifiable and quantifiable

Example implicit and explicit fiscal risks
(% of GDP)



Source: IMF, 2016

Main Impact Factors

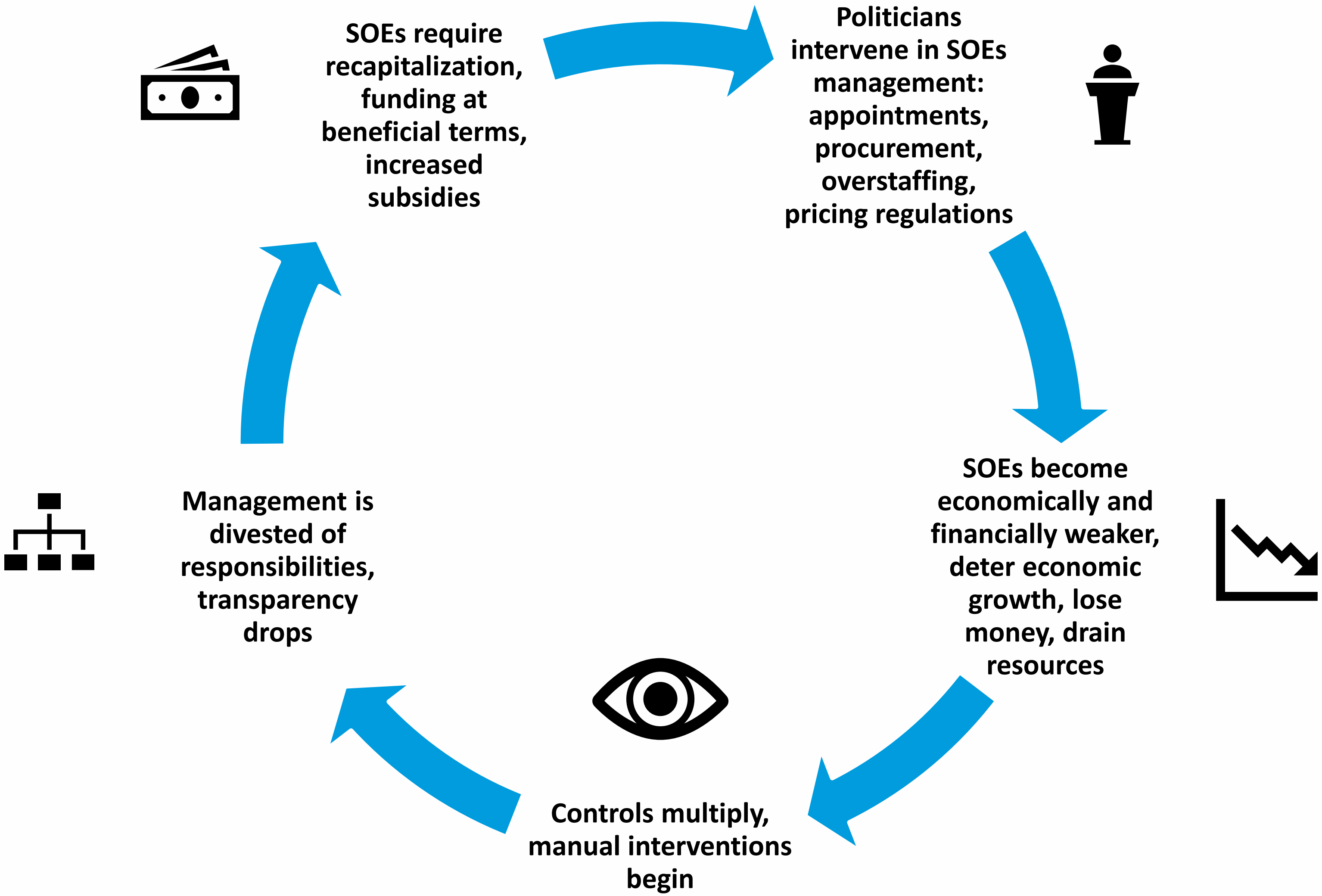
- Exogenous shocks that affect SOEs finances: macroeconomic variables or market-specific factors
- Correlated factors: slowdown in the economy, rises in interest rates, movements in exchange rates
- SOEs as mechanism for circumventing traditional fiscal controls
- Unclear or uncompensated public policy mandates, social obligations
- Excessive dividend (or tax) extraction
- SOEs use in crisis situations: COVID-19

One of the major impact factors – SOEs weak corporate governance

- Institutional and governance weaknesses compound the above risks
- Broken accountability lines lead to wrong incentives
- SOEs boards lack the necessary independence due to political interference, ineffective systems of board selection and appointment
- SOEs management lack management decision power, lag behind on necessary skills mix
- Inadequate oversight leads to higher risk taking and weaker budget discipline - incentives for less efficiency and higher risks

Vicious Cycle

Interconnectivity of SOEs Governance and Fiscal Measures



- SOEs do not carry positive or negative impact per se
- Their impact hinges crucially upon the country's institutions:
  - good institutions instill financial discipline while providing decision making independence
  - weak institutions retain manual control, use of SOEs to circumvent budget controls and offer wrong incentives
- Well-governed, transparent, and efficient SOEs that compete on a level playing field support economic growth, better use public resources and contribute to public net worth

Source: (1) K. Szarzec, Á. Dombi, P. Matuszak "State-owned enterprises and economic growth: Evidence from the post-Lehman period", Economic Modelling, Volume 99, 2021; (2) IMF (2020), Fiscal Monitor, April 2020, Chapter 3: State-Owned Enterprises: the Other Government

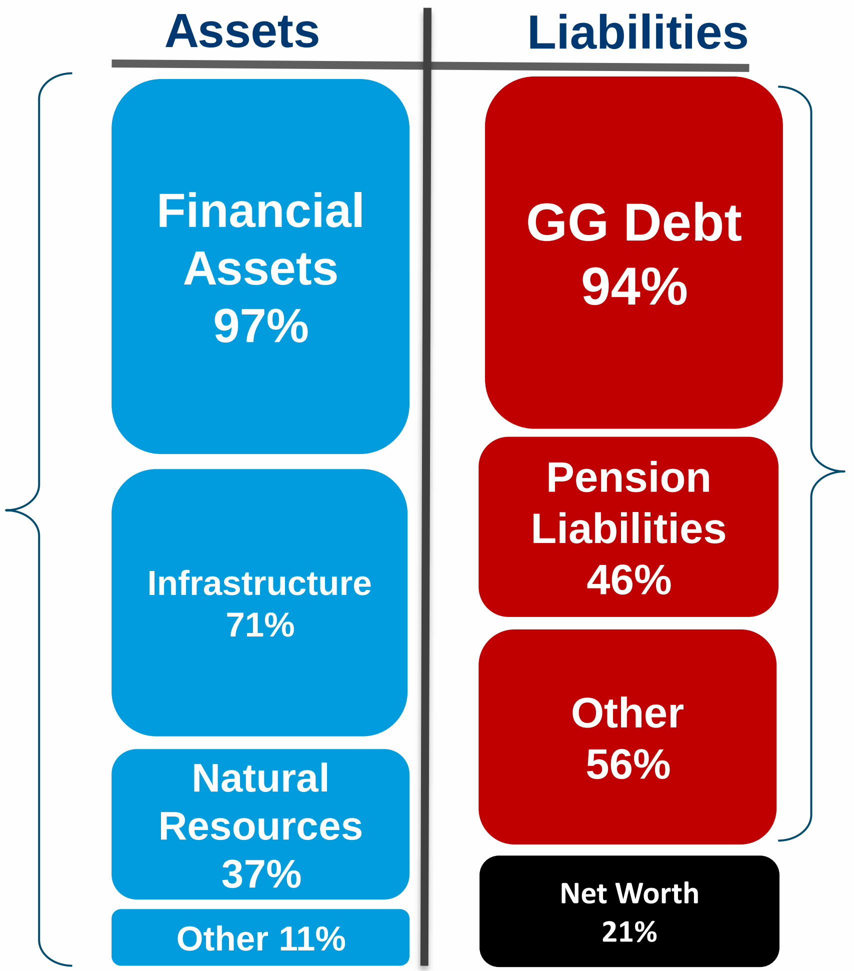
Lithuania Practice: At the Forefront of SOE Reforms

- Strong and coordinated reform effort amid OECD accession
- Political support for improved corporate governance at central-level SOEs
- Transparent and regular reporting on SOE portfolio (IFRS based)
- Improved (and improving) SOE profitability and accountability
- SOE governance scorecards and social responsibility
- Reporting on public service obligations
- Cascading the reforms to sub-national level SOEs

Good Practice! Keep Leading

Broader look: public sector balance sheets

Aggregate Public Sector Balance Sheet
(in percent of GDP)



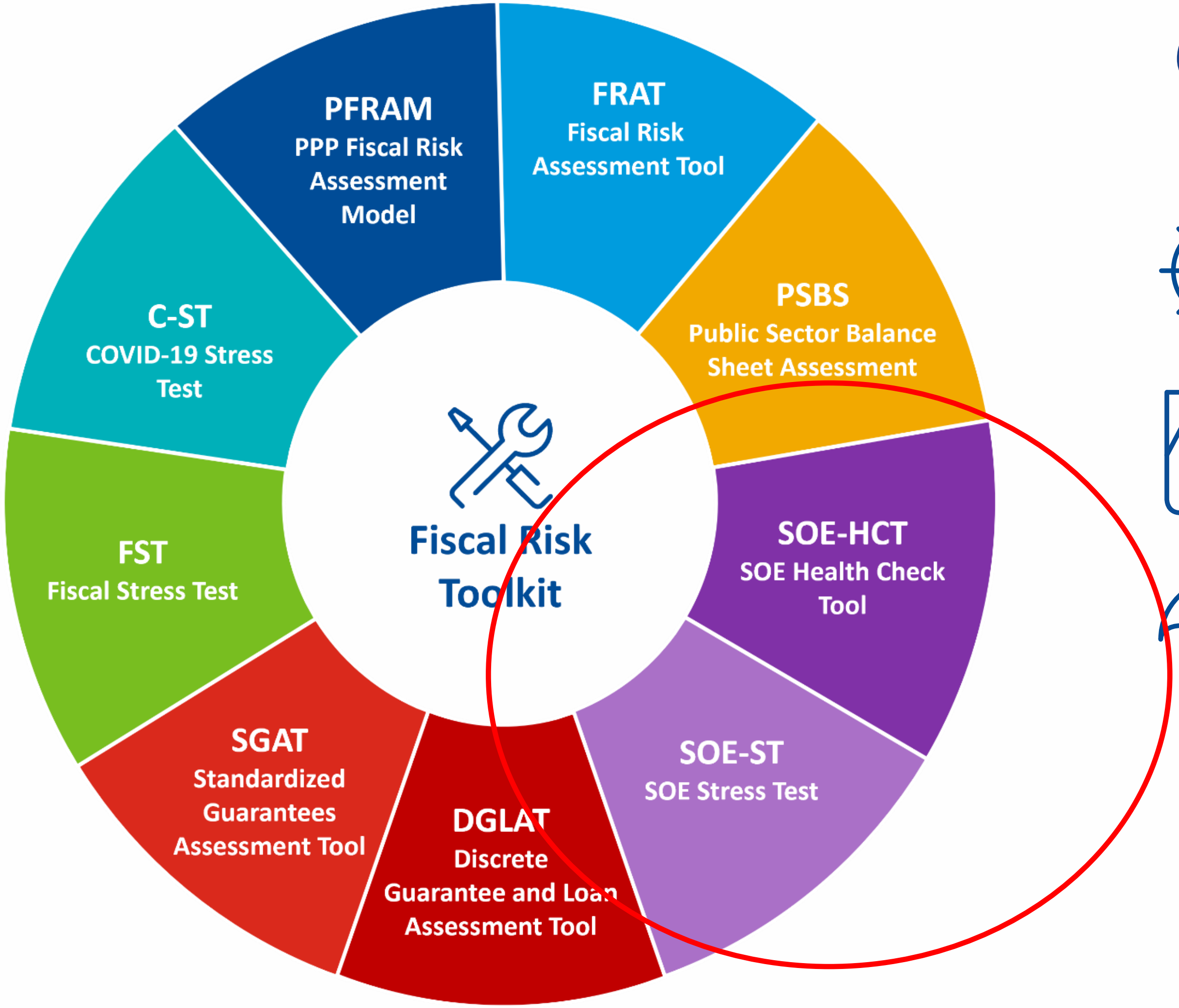
US$103 Trillion or 216% of GDP*

195% of GDP

*This includes 120% of GDP in public corporation assets.

Source: IMF Public Sector Balance Sheet Database

The IMF’s Fiscal Risk Toolkit



Better understand risk exposures

Improve management of fiscal risks

More transparent reporting of risks

More resilient public finances

IMF SOE Health Check Tool

What does the tool do?

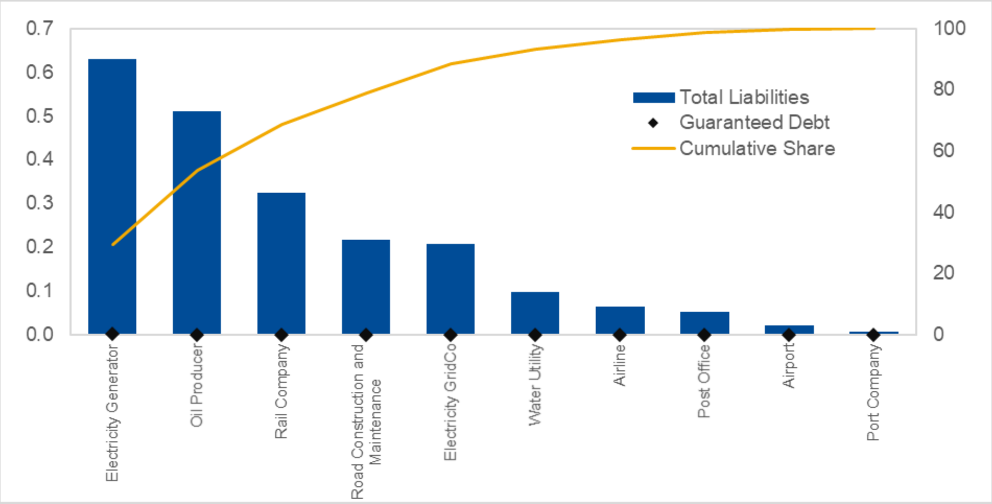
- Assesses the financial vulnerability of non-financial SOEs
- Computes a set of financial vulnerability indicators based on income and balance sheet information
- Assigns an overall risk rating to each SOE
- Provides ratios, charts, and risk matrix to enable analysis of individual SOEs
- Produces summary outputs of the financial soundness of the SOE sector.
- Supports compilation of aggregate liabilities and balance sheet for the SOE sector as a whole

Sample outputs

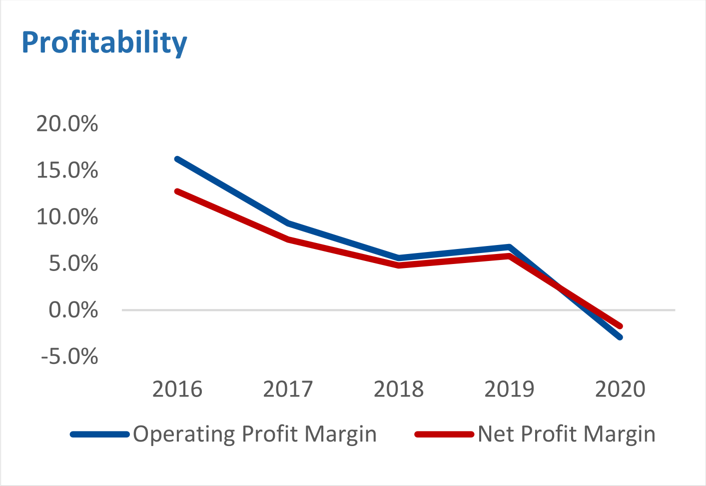
SOE Risk Ratings (2020)

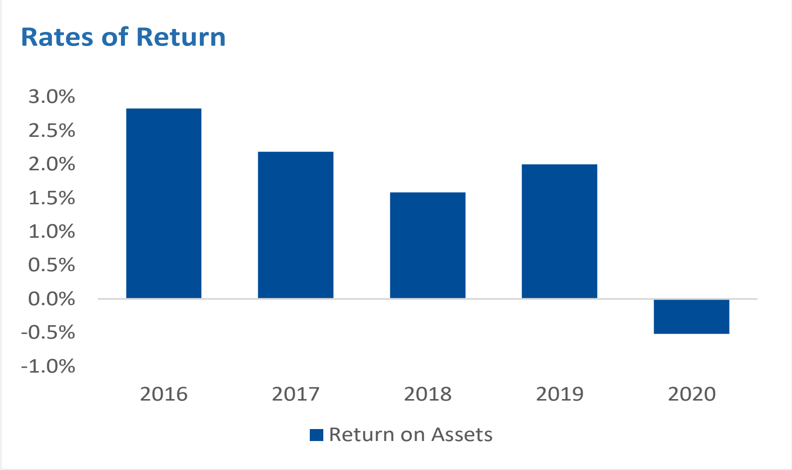
	Profitability		Liquidity		Solvency		Overall Risk Rating
	Return on Assets	Cost Recovery	Current Ratio	Creditor Turnover Days	Debt to EBITDA	Interest Coverage	
Electricity Generator	Category 1	Category 1	Category 4	Category 5	Category 2	Category 1	Category 2
Oil Producer	Category 1	Category 3	Category 2		Category 3	Category 1	Category 2
Rail Company	Category 4	Category 3	Category 5	Category 4	Category 5	Category 5	Category 4
Road Construction and Maintenance	Category 4	Category 5	Category 5		Category 5	Category 5	Category 5
Electricity GridCo	Category 4	Category 3	Category 5	Category 3	Category 5	Category 5	Category 4
Water Utility	Category 5	Category 5	Category 2	Category 5	Category 5	Category 5	Category 4
Airline	Category 5	Category 4	Category 5	Category 5	Category 5	Category 5	Category 5
Post Office	Category 3	Category 4	Category 4	Category 2	Category 5	Category 5	Category 4
Airport	Category 3	Category 2	Category 2		Category 4	Category 5	Category 3
Port Company	Category 4	Category 4	Category 1	Category 1	Category 5	Category 5	Category 4

Note: SOEs are ordered by size of liabilities from largest to smallest.



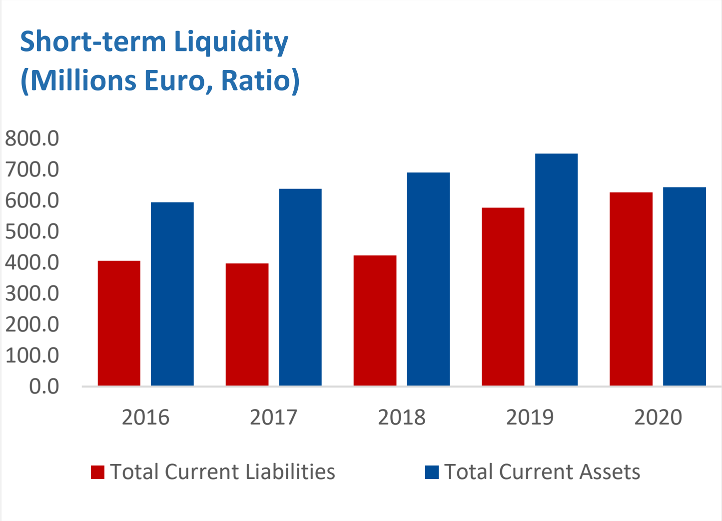
IMF SOE Health Check Tool

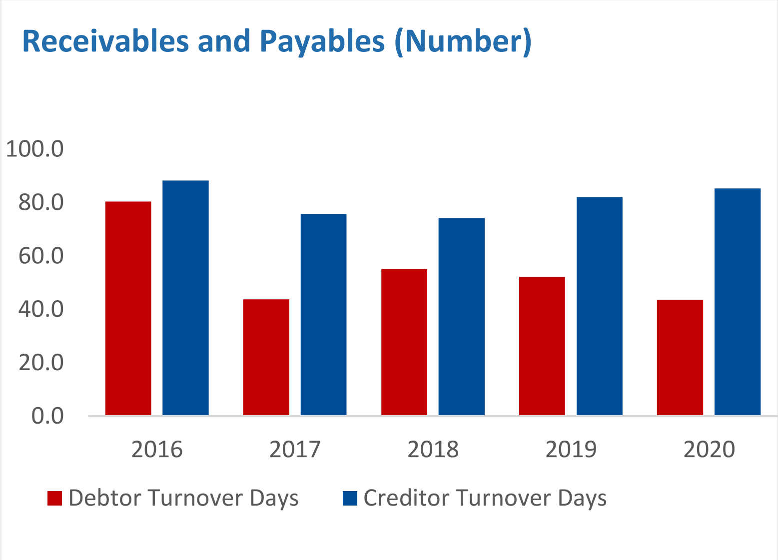




Steep reduction in profitability and ROA

Worsen Liquidity





Improvement in collecting but not in paying

What about off-balance sheet pension obligations?

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