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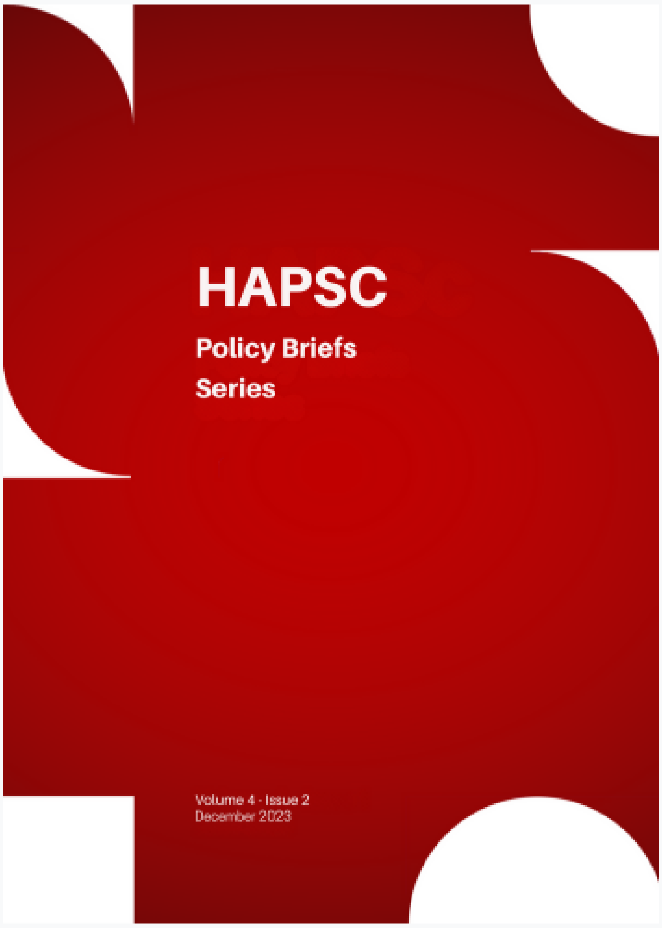

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Reforming State-Owned Enterprises (SOES) to Facilitate the Economic Recovery of Sri Lanka[1]

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Abstract

The economic downturn and escalating debt levels prompted Sri Lanka to seek assistance from the International Monetary Fund (IMF), resulting in the formulation of the 17th IMF program. This program, aimed at fiscal consolidation and restructuring, designates SOEs as a pivotal element in the nation's economic recovery strategy. This policy brief addresses the imperative need for reforming State-Owned Enterprises (SOEs) in Sri Lanka. A historical overview reveals the evolution of Sri Lanka's SOEs, from their establishment during World War II to a surge in numbers in the 1980s. Despite their vital role in the economy, SOEs have faced operational inefficiencies, financial struggles, and governance issues, leading to a privatization policy in 1988. The document explores international experiences in SOE reform, drawing insights from successful models in Singapore, China, and India. Current policy measures in Sri Lanka encompass various reform strategies, such as corporatization, restructuring, and commercialization, focusing on enhancing financial transparency and accountability. The establishment of the State-Owned Enterprise Restructuring Unit (SRU) reflects a commitment to effective implementation, with international support from entities like the International Finance Corporation (IFC). In conclusion, the path to economic recovery in Sri Lanka hinges on the successful transformation of SOEs, ensuring financial viability, transparency, and sustainable growth.

Keywords: State-Owned Enterprises (SOEs), Reforming SOEs, Economic Recovery of Sri Lanka, IMF Bailout program, Corporate Governance.

Introduction

Before the COVID-19 outbreak, Sri Lanka's economy was already beginning to exhibit signs of decline. Growth and the fight against poverty had stalled in the previous five years. External imbalances had been exacerbated by a controlled exchange rate, a weak investment environment, years of loose monetary policy, and a restrictive trade regime. Tax cuts in 2019 and ongoing fiscal inequalities, mostly caused by inadequate revenue collections, have all contributed to huge fiscal deficits, significant gross financing requirements, and a quick increase in unsustainable debt.

Sri Lanka struggled through the biggest economic crisis in history and faced a substantial economic downturn in 2022 due to the issues that emerged in the fiscal, monetary, and external sectors. The

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real GDP of Sri Lanka was predicted to decline by 9.2 percent in 2022 and by a further 4.2 percent in 2023 (World Bank, 2022). Sri Lanka requested assistance from the IMF for the 17th time as the crisis worsened. In September 2022, the IMF and the government signed a staff-level agreement on a 48-month Extended Fund Facility program worth approximately US$2.9 billion (IMF, 2022).

Six goals are outlined in the 17th IMF program. The primary goal is to advance revenue-based fiscal consolidation and restructure social safety nets, financial institutions, and state-owned enterprises. Second, it aims to re-establish the viability of the public debt. The program also aims to restore price stability by rebuilding external buffers. Additionally, the initiative aims to protect against corruption and provide public financial stability. Another broader goal of the program is to raise sustainable economic growth. Among these goals, reforming state-owned enterprises has obtained national and international attention for several reasons. At the national level, state-owned enterprises have secured a significant public interest, while at the international level, several international investors are focusing their keen attention on these institutes to capture some investment opportunities. Thus, this policy brief attempts to critically analyze the necessity of reforming SOEs, given the need for economic recovery.

Development of SOEs in Sri Lanka

Enterprises in which the state exercises substantial control through full, majority, or significant minority ownership are identified as State-owned enterprises (SOEs) (Kim & Ali, 2017). SOEs have been significant in the socioeconomic development of world economies for a long time. Well-performing SOEs are vital in employment creation, poverty alleviation, and fiscal stability. Furthermore, State-owned enterprises (SOEs) often comprise the country's mega infrastructure projects and remain a critical source of employment and economic growth in developing Asian countries (Robinett, 2006).

Sri Lanka's public sector enterprises were established during the Second World War (CBSL, 2021). However, in the mid-1950s, the Sri Lankan government favored socialistic policies; thus, central planning was considered the key development path. During this period, several SOEs were established, including those related to cement, paper, ceramics, leather, and footwear. In 1959, the Sri Lankan government introduced a Ten-Year Plan which favored the Import Substitution Industrialization (ISI) policy (CBSL, 2021). The main intention of adopting the ISI policy was to address the balance of payments deficits by producing imported items domestically. Therefore, the government initiated SOEs in cement, steel, paper, tires, mineral sands, salt, flour milling, plywood, petroleum refining and fertilizer.

With the government's favoritisms to import substitution economic policy, the number of SOEs rose rapidly from 14 in 1962 to over 280 public enterprises by the mid-1980s (CBSL, 2021). However, several complications could be observed with SOEs in the 1980s. These obstacles included operational inefficiencies, poor financial performance, low quality of products and services, supply shortages, political interferences in recruitments for SOEs, inefficient allocation and mobility of resources among SOEs, and heavy reliance on the government budget. Because of these reasons, the Sri Lankan government initiated the privatization policy for SOEs in 1988. The initiation of the privatization policy for SOEs was facilitated by the IMF structural policy adjustment program in 1989, and it was identified as the second wave of liberalization in Sri Lanka (Kelegama & Dunham, 1995).

The recent performance of SOEs in Sri Lanka

Companies Act No. 07 of 2007 and "Administer Part II" of the Finance Act No. 38 of 1971 control SOEs in Sri Lanka (MoF, 2018). At present, the Ministry of Finance (MoF) oversees 52 strategic State-Owned Business Enterprises (SOBEs), the Department of Public Enterprises oversees 87 SOEs with a strong commercial aspect, and the National Budget Department oversees 117 SOEs with noncommercial aspects (SOE Reforms; the Impetus for Post Pandemic Economic Revival, 2021). Due to their prevalence in vital industries like banking, insurance, energy, water, ports, transportation, aviation, and construction, state-owned enterprises (SOEs) constitute a significant portion of the Sri Lankan economy. The 52 key SOEs employed over 10% of all public sector workers in 2019, and their asset base grew by 16.6% year over year (YoY) in 2020 (MOF, 2020). The subpar financial performance of State-Owned Enterprises (SOEs) has resulted in a substantial fiscal burden and noteworthy macroeconomic ramifications, notwithstanding their crucial role in the economy across vital sectors. In addition to crowding out profitable investments, SOEs' heavy reliance on the banking system to cover their losses has made the financial system susceptible to their poor financial performance. Figures 1, 2 and 3 project the profits/losses and the outstanding credit from the banking sector of the Ceylon Electricity Board, Ceylon Petroleum Corporation, and Sri Lanka Airlines.

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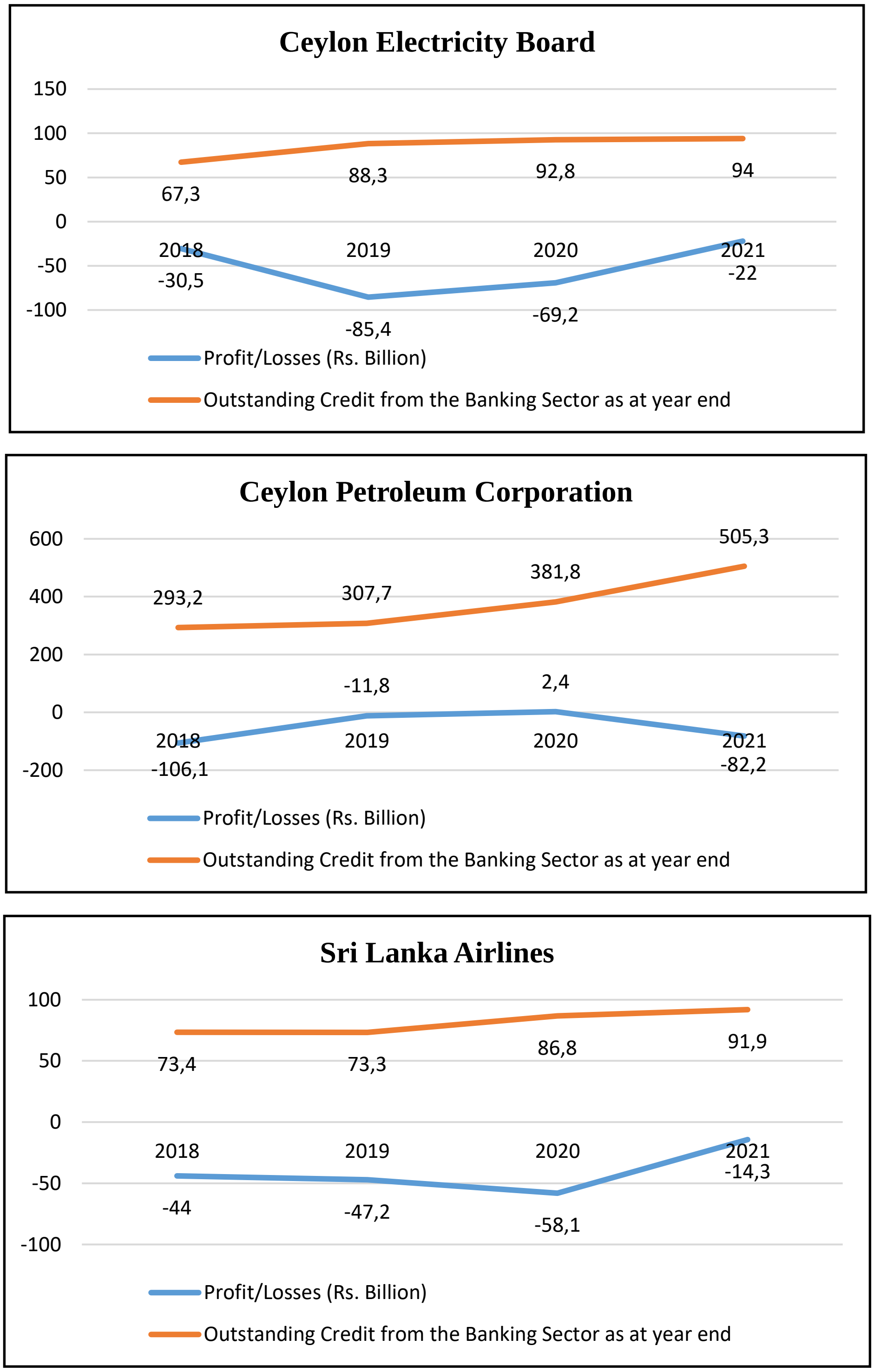
Figure 1: Comparison of Profits/ Losses and Credit Obtained from the Banking Sector for Selected SOEs – (Rs. Billions)



Source: Annual Report 2021, Central Bank of Sri Lanka

Considering the continuous losses of most of the SOEs in Sri Lanka, a huge public discussion emerged, empathizing with the necessity of reforming SOEs. Furthermore, the Auditor General's and the Committee on Public Enterprise (COPE)'s reports have detailed numerous examples of carelessness, corruption, fraud, and poor management (Advocate, 2019). The problems were deeper, systemic flaws rather than isolated instances of people acting opportunistically or infrequently losing control. As a result of that, when the Sri Lankan government requested assistance from the International Monetary Fund for the 17th bailout package, reforming SOEs became a major policy objective. The 17th IMF assistance program is expected to address the debt overhangs of SOEs and improve their governance.

Reforming SOEs: International Experiences

In Singapore, the investment holding company Temasek has experienced significant success. It was founded in 1974 to own and manage investments and assets the Singaporean government previously owned. Due to a dearth of unprocessed natural resources, Singapore launched a vigorous industrialization and economic development program after gaining independence in 1965. Temasek was created to relieve relevant ministries of the commercial management of these businesses in which the government held a majority stake, as the government launched startups in several important industries. The government's reluctance to get involved in investment decisions has likely contributed to Temasek's success in enhancing the corporate governance of its invested companies rather than imposing stringent legislative requirements (Chen, 2016).

From the 1970s, market-oriented economic reforms that sought to open the Chinese economy to foreign trade have led to several reforms affecting China's state-owned enterprises (SOEs). To finance and oversee SOEs, the State-owned Assets Supervision and Administration Commission (SASAC) was founded in 2003. China started concentrating on large-scale SOE mergers and expanding mixed ownership programs in 2013. China's SOE reform program aims to make SOEs "stronger, better, and bigger" (Guluzade, 2020). SOE reforms have supported China's economic growth in two ways: First, the shift to SOEs has allowed for the birth and flourishing of private firms and enterprises with alternative ownership structures by creating the required space and conditions. Second, the SOEs' efficiency and competitiveness have increased due to this shift, contributing to a notable increase in their output. This has allowed SOEs—especially the larger ones—to keep a sizable portion of the economy (Ligang, 2018).

In response to the problem of inefficient SOEs, India has adopted a disinvestment strategy in recent years. This has required transferring management control and selling a sizeable chunk of the government's stake in businesses. According to Fortune Global 500, India has the second-highest state-owned enterprises (SOEs) after China. The Privatization of Air India, with the government of India getting roughly US$360 million in equity and a private company taking over US$2 billion in debt, is a recent step in its reform plan (Kim & Panchanatham, 2019). Concerning infrastructure and human capital, where the government has a clear role to play, India's recently announced privatization strategy could help shift the balance sheet composition of the public sector toward high-return public sector investments, freeing up commercially viable companies for the private sector. (Agarwal, 2022).

Ongoing policy measures to reform Sri Lanka's SOEs

Several types of SOE reform can be utilized for the Sri Lankan context, considering the potential benefits they can generate. Corporatization, Corporate restructuring, Commercialization, Public-private partnership, and Privatization are those possible ways (Athukorala et al., 2017). Corporatization makes a conscious effort to keep political and economic factors apart. Corporate restructuring is known as reorganizing an entity's ownership, legal, operational, or other structures to improve its current state of organization or increase profitability. Commercialization aims to restructure the SOE into a profitable business enterprise without government funding. In order to increase the SOE's financial viability, financial restructuring goes hand in hand with it. A public-private partnership is a long-term agreement wherein a private company and a government organization work together to provide a public good or service.

The Sri Lankan government aims to adopt these types of reforms where necessary. According to the Central Bank of Sri Lanka, four identified major SOE reforms include introducing cost-reflective pricing policies, improving strategic direction, enhancing financial transparency and accountability, and strengthening corporate governance (CBSL, Anual Report, 2021). After requesting assistance from the IMF for the 17th bailout program, the Sri Lankan government agreed to implement specific reforming measures to mitigate fiscal risks arising from the energy SOEs and implement structural reforms to make SOEs financially viable (IMF, 2023).

Retail fuel prices were hiked several times in early 2022 to reach cost-recovery levels, passing on to customers the sharp increase in fuel prices worldwide and the significant depreciation of the rupee. Furthermore, the Cabinet authorized the inclusion of further private sector firms in the downstream petroleum industry in June 2022. Three businesses received retail gasoline permits from the Ministry of Power and Energy due to this decision: Sinopec, a Chinese company; United Petroleum, an Australian company; and RM Parks, an American company that partners with Shell (Newswire, 2023). This action was made to increase competition in the petrol market and enhance the fuel supply because Sri Lanka needed to set the price of fuel using an established formula regularly. Consequently, on November 21, 2022, the government approved the fuel pricing formula that was introduced in 2018. Furthermore, audited financial statements of several major SOEs for 2021 were published, including CPC (IMF, 2023).

Sri Lanka expects to introduce legislative reforms, making the Minister of Power and Energy responsible for implementing cost-recovery-based fuel and electricity price adjustments by 2024. Along with energy pricing reforms in Sri Lanka, SOE reforms intended by the IMF assistance program are expected to achieve the following:

(i) Cabinet approved a comprehensive strategy to restructure the CPC, CEB, the Road Development Authority, and Sri Lankan Airlines balance sheets by June 2023.

(ii) Prompt publication of audited financial statements for all 52 major SOEs.

(iii) Prohibition of new foreign exchange borrowing by nonfinancial SOEs with limited foreign exchange revenues. In addition, the authorities should commit to further strengthening SOE governance by clarifying key SOE mandates through Statements of Corporate Intent and reviewing the framework for selecting SOE board members (IMF, 2023).

Moreover, The State-Owned Enterprise Restructuring Unit (SRU), a division of the Ministry of Finance, Economic Stabilization and National Policies (MoF), was established by GOSL to carry out SOE reforms. The March 13, 2023, Cabinet resolution requires the SRU to divest a certain SOE group. The SRU looks to designate reputable, competent, and experienced firms to offer transaction consulting services to help with such divestments. The International Finance Corporation (IFC) has been appointed Transaction Advisors for The Lanka Hospitals Corporation PLC, Sri Lankan Air Lines Ltd, and Sri Lanka Telecom PLC (MOF, 2023).

Conclusion

In conclusion, the economic challenges faced by Sri Lanka, exacerbated by the COVID-19 pandemic, have underscored the urgent need for comprehensive reforms in State-Owned Enterprises (SOEs). The country's economic downturn, marked by a sharp decline in GDP and unsustainable debt levels, prompted a request for assistance from the International Monetary Fund (IMF). The 17th IMF program, focusing on fiscal consolidation and restructuring, identified SOEs as a key element in the economic recovery strategy.

The historical context of SOEs in Sri Lanka reveals a pattern of inefficiencies, operational challenges, and financial burdens, necessitating a shift in policy. International experiences, such as those in Singapore, China, and India, offer valuable insights into successful SOE reforms. These examples demonstrate the importance of corporate governance, disinvestment strategies, and public-private partnerships in enhancing SOE performance.

Current policy measures in Sri Lanka emphasize reforms such as corporatization, restructuring, commercialization, and public-private partnerships. The government aims to address cost-effective pricing policies, strategic direction, financial transparency, and corporate governance issues. The recent hikes in fuel prices and the inclusion of private sector firms in the petroleum industry are steps toward creating a competitive market.

As Sri Lanka moves forward, implementing the proposed reforms, as outlined in the IMF assistance program, will be crucial. Timely publication of audited financial statements, comprehensive restructuring of major SOEs, and governance enhancements are expected outcomes. The establishment of the State-Owned Enterprise Restructuring Unit (SRU) reflects a commitment to effective implementation, with international support from entities like the International Finance Corporation (IFC). In conclusion, the path to economic recovery in Sri Lanka hinges on the successful transformation of SOEs, ensuring financial viability, transparency, and sustainable growth.

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