REFORMING STATE-OWNED ENTERPRISES: WHAT ARE THE KEY REFORM PRINCIPLES?

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Within a week, Eskom announced that the company would make an R11 billion loss in 2018, adding to a debt burden of over R400 billion, and that the country would face serious load-shedding in December. While clearly terrible, headlines like these are hardly surprising, given the constant barrage of crisis-stories at numerous state owned enterprises. The story of SOEs increasingly seems to be one blighted by bailouts and budget support, State Capture, and blistering criticism from investors. Reform is clearly needed, but the path forward is riddled with complexity. Many of the SOEs are too big to fail, both in the absolute scale of their enterprises, and in the underlying role that they play in the economy. Reform will be a long, difficult process that, if not carefully managed, could well make things worse. For this reason, reform will need to be guided by a set of underlying principles. This piece suggests three such principles that could help guide effective reform of the SOEs.

Principle 1: Distinguish commercial and public good functions

The most important principle for reform is that state owned enterprises must start distinguishing between their public good and commercial functions. Most SOEs have a blend of these two functions. Eskom, for example, sells energy to a wide range of consumers in South Africa. But it also plays a number of public good roles, such as extending electricity connections to underserved communities, providing low-cost energy to vulnerable energy-intensive industries, and procuring locally to support domestic industry.

These public good functions are an inevitable part of SOEs in South Africa, in which pressing social needs makes it difficult for state companies to act in the same way as purely commercial interests. If used correctly, these social good activities can be incredibly beneficial to the country, and can be sustainably implemented by offsetting their cost against the income earned by the enterprise.

The problem is that social good functions are frequently used as cover for many of the core problems faced by SOEs. State enterprises such as SAA and Eskom have blamed their failure to operate properly on their need to meet their social good mandate. When SOEs do this, they frequently use their social good work to call for subsidies or bailouts from government, which creates a relationship of dependence on state funds that undermines any pressure to operate efficiently. The mix of commercial and social good functions also makes it difficult to build internal structures that are devoted to a set of coherent objectives. The all-out profit focus of commercial firms is diluted by the need to consider social good, while the social good objectives are diluted by the need to constantly considered costs and profitability.

These problems are not inherent to the dual mandate of SOEs, but rather result from enterprises that are not designed to distinguish between the enterprise's two objectives. SAA claims they make losses on certain routes because they're important for the country, but the company does not distinguish between commercial and public good routes. The South African Bureau of Standards claims certain laboratories are for the public good, but cannot distinguish these from its commercial labs. Eskom claims it needs higher tariffs because of all its public good work, but it cannot account for the share of this work in the tariffs they receive. Across the board, procurement officers target a blend of social and commercial objectives, but frequently lack clear rules on how to make these weigh-ups, and do not comprehensively report on their decisions and how the balance plays out in practise.

State owned enterprises must start distinguishing between their social good and commercial objectives. This must be a key part of the organisation's planning and reporting. Creating the distinction between these two sides is the only way that government support to SOEs can be managed in a way that is fair, sustainable, and offers value for taxpayers money. In response to the dual system, government must commit to offering strategic subsidies and other support to SOEs social good role. But at the same time, they must commit equally to staying out of the business of the commercial operations, expect in time of absolute crisis. Public reporting on the two functions must be open, transparent and rigorous - and must consistently return to question why commercial operations should receive public support.

In the long-term, the objective should not simply be to distinguish these two parts, but to make them work for each other. In particular, the ability to focus in on commercial operations, and to improve the efficiency of these operations, should open up the potential for cross-subsidisation between the commercial and social good functions, and ultimately allow SOEs to do more good with less public resources.

Principle 2: Reinforce multiple points of accountability

Accountability is clearly a major problem among state owned enterprises. SOEs have become notoriously riddled with corruption and state capture. There is extensive evidence of questionable deals done by SOEs - including multiple incidents among a network of the most famous culprits of Eskom, Transnet, Tegeta, Regiments, Mckinsey, KPMG, and many others. And yet despite all this evidence, no major legal findings have been made against any of the culprits. Where punishment has been meted out, it had mostly been voluntarily, by companies like Mckinsey or KPMG, in order to salvage their reputation from widespread public condemnation.

While ad hoc committees like the State Capture Commission may reveal and act on specific incidents, they don't offer the type of ongoing checks and balances that a functioning system of accountability would seem to demand. Accountability, in this sense, should not simply mean procedural justice, in which a crime is met with a punishment. Rather, it should be seen as a system that quickly and effectively identifies and neutralises incidents of corruption or bad management - before they can do lasting damage to SOEs.

Without this type of system, the country could easily find multiple versions of the Eskom problem: where even after the guilty parties are pushed out of the organisation, the structural problems that they created remain.

The difficulty with building accountable SOEs is that many of the problems of corruption and capture occurred under what is already a sophisticated system of accountability. SOEs have at least three points of accountability: their boards, the Minister of Public Enterprises, and their regulators (such as Nersa for Eskom). In addition, financial management is overseen by the National Treasury, specific sectoral policy is determined by other departments (such as the Department of Energy for Eskom), and overarching oversight is vested with the National Assembly.

This system appears, on paper, to be relatively robust. And yet it consistently failed for two key reasons. First, is that all points of accountability are vulnerable to influence from the Executive branch of government. The Presidency appoints Ministers, who in turn appoint board members and, frequently, oversee regulatory bodies. While this system makes it hard for smaller incidents of corruption to infect the whole system, it makes the entire system vulnerable to intervention from the executive. Second, few of the oversight bodies have either ongoing monitoring systems or proven tools to enact change. Board members generally rely on reports provided by the executives of SOEs, with only limited oversight provided by independent auditors (many of whom were complicit in past failings of accountability). If board members suspect a problem and want to enact change, their only real power is to change the executive, which can destabilise institutions and doesn't target the type of structural problems that underpin many systems of corruption.

Regulators are the most insulated from both of these problems, but are limited by the powers they have. Nersa, for example, can limit Eskom's ability to raise tariffs - but they can't impact the underlying costs involved in Eskom's energy generation business. The result is that often the regulator has no realistic choice but to accept the demands of the SOE, because the underlying structural problems demand a set response from the regulator.

There is no easy solution to fixing accountability, but as a key principle, every layer of accountability needs to be reinforced with greater independence and deeper powers to intervene as needed. Independence could be improved by measures such as increasing tenure terms for regulatory decision-making boards, rotating portions of SOE boards on a regular basis, and adding permanent oversight roles to Ministries at the civil service level. Intervention powers could be helped by adding tools such as the ability of boards to carry out special audits (including into the lifestyle of senior executives) and adding 'morality' clauses to procurement contracts, that punish companies that are found guilty of ethical violations.

None of these answers are perfect, since ultimately accountability will have to remain a function of the political system, and therefore will remain vulnerable to political machinations. But having a broad system of accountability that is at least difficult to capture, will allow for the best possible oversight of SOEs.

Principle 3: Create sustainable competition

Perhaps the core reform question in many people's mind will be whether SOEs should remain under the control of the state, or whether they should be offloaded to the private sector. Those who support privatization argue that the problems at SOEs are inherent to the structure of state ownership, and that limited competition, an assumed promise of a bailout from the state, and meddling in boards and oversight will regularly result in inefficient and costly SOEs, which the private sector could run better.

While this is a legitimate debate to have, there is a clear logic to keeping SOEs under state control. These reasons should become clear when (as specified by Principle 1), SOEs begin separating their social benefit role from their commercial role. Privatising SOEs effectively means that social benefit role disappears. At times, this might still be worthy of debate. For example, SAA's maintenance of underperforming routes creates broader social benefits, but those mainly accrue to the upper-middle class, and might not be a priority. On the other hand, cases like Eskom seem to demand some role for government, to assure that energy generation doesn't serve the narrow interests of those who can afford expensive tariffs, but also reaches the most vulnerable. While some of these benefits can be replicated through other policies (such as paying for the electricity the poor purchase from a private utility), it should not be assumed that privatization is the best option, when in many cases it can disempower the state and commercialise crucial services that need to meet the standard of both commercial viability and economic justice.

The argument for introducing competition to SOEs is, however, far stronger. One of the core reasons that dysfunction at Eskom and Transnet has been so damaging is because they are the only supplier of their particular services in the country. Competition means that there are more options, which lessens the blow if one of those options fails. This is most obvious in the case of the crisis at the Post Office, the impact of which has been softened by the offer of increasingly competitive services from the like of Postnet and courier companies. In that example, the Post Office is clearly still important to providing services to individuals who cannot afford expensive private providers, but their presence prevented a problem from paralysing the entire South African postal network.

Many will also claim that competition improves efficiency at SOEs. And while evidence on this is mixed (SAA's struggles, for example, come despite robust competition from private airlines), efforts to bring commercial operations in line with the private sector could well be aided by competition with local firms, particularly through the natural process of staff movement and ideas sharing that occurs in competitive industries.

The key to adding competition will be to do so in a way that brings the commercial side of SOEs into competition with the private sector, while protecting the interests of SOEs public good role. This may mean that, as competition increases pressure on the commercial side of operations, government subsidies may need to increase for public good work. This may seem counterintuitive, but efficiency in a competitive market can mean SOEs earns less than an inefficiency monopoly, and thus have less capacity to subsidise their non-commercial work. This is yet another reason that Principle 1 is so essential - because separating out planning for the two mandates will allow for an assessment of commercial efficiency separately from the requirements of meeting social goods.

Conclusion

None of these principles fix the core problems at the heart of many South African SOEs. Eskom will continue to be burdened by a huge debt burden and unfulfilled coal contracts, Transnet will continue to be a sprawl of enterprises that are virtually unmanageable, and SAA will still have to compete with a questionable asset ownership model. These specific problems will require specific interventions, which will consume government work for years to come. But changes to the underlying principles informing SOEs are essential to prevent these problems from occurring in the future. Building these safeguards now will mean that, when the problems dogging SOEs are eventually addressed, the enterprises are on a far more stable footing for long term sustainability.