



PRIVATE OR PUBLIC? WHAT KIND OF BUSINESS DOES EUROPE PREFER?

Case Study: State-owned enterprises in Lithuania, Estonia, Poland,
Bulgaria and Slovakia from 2007 to 2016

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Executive Summary

Over the last decade, there has been a tendency for states to engage in economic activity. According to the Organisation for Economic Co-operation and Development (OECD), the ultimate purpose of state ownership of enterprises should be to maximise value for society through an efficient allocation of resources. Nevertheless, it also stresses that each state is responsible for explaining the rationale for the establishment and functioning of state-owned enterprises (SOEs).

A comparison of private and public businesses based on twelve criteria shows that private capital markets promote efficiency and innovation, increase labour productivity, improve capital investment, expand entrepreneurship and competition, increase transparency, ensure efficient pricing, enhance customer services, remove politics from decision-making, attract foreign investment, boost export, deepen and broaden equity markets, and benefit the state budget. This leads to the conclusion that private capital-based economies have an advantage over those dominated by SOEs. Therefore, states should primarily focus on the promotion of private capital markets and should have substantial reasons for establishing SOEs.

In addition, OECD enumerates the following five most common rationales for state-ownership:

1) to support national economic and strategic interest; 2) to ensure continued national ownership of enterprises; 3) to supply specific public goods or services that are unavailable on the market; 4) to perform business operations in a natural “monopoly” situation; and 5) to create a state monopoly (or oligopoly) when market regulation is inefficient or not feasible. Having analysed the implications behind these rationales, the present paper delineates the below principles and recommendations that should be followed to avoid unjustified establishment of SOEs and negative implications of state economic activity.

- First, there is a need to verify the validity of the problem to be addressed by establishing an SOE. For example, if goods or services that are unavailable on the market are necessary for a consumer and if the consumer could not find a substitute for them.

- If there is a need to address a well-founded problem, it should be established if the problem does not stem from government regulation. If so, regulatory obstacles should be eliminated, providing sufficient time for the market to solve the problem.

- Even if the problem does not stem from regulatory practices, all possible alternatives should be considered. The best alternative should be selected based on a cost-benefit analysis and the assessment of alternative costs and risks.

- The rationales for state ownership should be kept under a continuous review to reflect market changes and examine the possibilities of privatisation.

Having regard to the advantages of private capital markets and risks associated with SOEs, the establishment of SOEs should be justified and based on a rigorous risk assessment and the above recommendations.

The present paper also analyses the development of the SOE sector throughout the last decade in Bulgaria, Estonia, Lithuania, Poland and Slovakia. Four of the countries do not have the rationales for state ownership established by law; consequently, decisions to expand or reduce state participation in the economy or implement best practices are not consistent, depend on political will and usually change together with the government.

The establishment and management of SOEs depend on the government. Governments struggle to align their interests as owners, market regulators, competitors and elected repre-

sentatives. Simply put, being a competitor with infinite financial resources and a market regulator with the power to set its own rules of the game, the state undermines the business and competitive environment for private enterprise. As a result, states face difficulty in ensuring free competition.

Introduction

State-owned enterprises (SOEs) operate in the majority of European countries. The advantages and disadvantages of their market operation has always been a debatable issue. States shape different policies and adopt contrastive decisions on their engagement into economic activity.

In the present paper, a state-owned enterprise is defined as a legal entity directly or indirectly controlled by the state in which the state owns 50 percent or more of the voting shares. For the purposes of this paper, municipality-owned enterprises do not fall within the definition of state-owned enterprises.

The Guidelines on Corporate Governance of State-Owned Enterprises by OECD provides that the state should define the rationales for owning an individual SOE. However, specific criteria that could be followed by policy-makers is not provided, stating that the ultimate purpose of state ownership of enterprises should be to maximise value for society, through an efficient allocation of resources.

At present, it is unclear if different states follow specific criteria in establishing whether the state may operate on the market. If no criteria exist, is the decision taken on a case-by-case basis? In addition, the market share of SOEs in different countries remains unclear.

Therefore, the present paper provides a review of the rationales behind state ownership and the decisions to establish SOEs as well as delineates specific implications of these policies. In addition, the paper provides a review of policies and decisions, relating to the corporate management of SOEs in Bulgaria, Estonia, Lithuania, Poland and Slovakia, focusing on the scope of state participation in economic activity throughout the last decade.

Based on twelve criteria, the first part of the paper provides a comparison of public and private businesses. The second part focuses on the rationales behind state participation in commercial activity and their implications. The third part provides reviews of corporate governance of state-owned enterprises in Bulgaria, Estonia, Lithuania, Poland and Slovakia from 2007 to 2018.

Part 1 A comparison of public and private businesses

Both in Europe and globally the question of the reasonableness of state participation in the economy is constantly raised. The problem lies in finding the answer when and why the operation of SOEs is beneficial or detrimental. Recently, this issue has become particularly relevant as an estimated 22 percent of the world's largest firms are now effectively under state control. This is the highest percentage in decades¹, indicating that both local and international markets are increasingly dominated by SOEs.

The number of SOEs varies significantly across countries. So do the sectors in which they operate and the rationales behind their establishment. As markets develop, states occasionally decide to privatise enterprises. In 2016, Chris Edwards analysed cases of privatisation in Europe and the United States and provided a comparison of public and private businesses based on the following twelve criteria.²

Efficiency and innovation

Businesses are profit-oriented. Profit reflects the added value created by them. To avoid bankruptcy, businesses have to adequately respond to any failure to generate profit or achieve positive results and implement necessary changes. On the contrary, state-owned enterprises do not have to follow this rule as excessive expenditure or a failure to meet the needs of society are generally subsidised by government funding. Shareholders and managers

of SOEs rarely risk their position due to poor performance of SOEs and therefore do not feel the pressure to create value and generate profit.

Changes of labour productivity

Poor incentives to keep expenditure under control and lacking budgetary constraints result in excessive employment in SOEs. In many cases SOEs turn into the means of job creation or the instrument of political patronage. Privatisation usually leads to efficiency, higher wages and an overall economic growth.

Capital investment improvement

Private businesses are motivated to keep their means of production well maintained and make investments to meet the increasing needs of consumers. This is achieved by reinvestment of profit and financing from debt and equity markets. On the other hand, SOEs frequently have outmoded and poorly maintained infrastructure due to the lack and inadequate distribution of investment capital.

Expansion of entrepreneurship and competition

Governments that own enterprises producing goods and services tend to engage in an unfair competition by granting monopoly rights to their companies or indirectly hindering the activities of other market players that are unwilling to compete with state-subsidised producers. Moreover, SOEs are quite reluctant to change and innovation, most of which come from innovative market entrants. Therefore, economic progress depend on open markets and fair competition.

¹ OECD, "State-Owned Enterprises as Global Competitors", 8 December 2016, retrieved from: <http://www.oecd.org/corporate/State-owned-enterprises-as-global-competitors-9789264262096-en.htm>

² Edwards, Ch., "Privatization", 12 July 2016, retrieved from <https://www.downsizinggovernment.org/privatization>

Transparency

Though indirectly financing the activities of SOEs, citizens have no control over them. The aims and finances of SOEs are frequently opaque and difficult to understand. On the other hand, private enterprises have clear aims such as profit and increased sales and their activities are supervised by auditors, shareholders and creditors. Moreover, they tend to be transparent and their success may be measured in terms of consumer choice.

Assurance of efficient pricing

The theory of economics suggests that the general well-being is at a maximum when the prices of goods and services are based on the supply and demand in competitive markets. SOEs tend to set prices based on political factors rather than the supply and demand, resulting in inefficient allocation of resources and reducing the well-being of society.

Enhancement of customer service

The quality of goods and services provided by state-owned enterprises usually cannot match the quality offered by private entities. This results from the fact that some SOEs are not profit-oriented while others have a solid customer base ensured by the state. In such cases, SOEs do not have to ensure the highest possible quality, because the consumer has no choice. To compare, private entities compete in terms of the best price-quality ratio to attract more customers.

Influence of politicians

The decisions of state-owned enterprises frequently reflect political interests rather than economic logic. As a result, their costs are exaggerated while income is too low. This undermines the results and efficiency of SOEs.

Foreign investment attraction

One of the reasons for the initiation of privatisation is the need to attract foreign investment. By means of privatisation, states are able to attract foreign capital for economic development. Privatisation revenue in the majority of OECD countries comes from foreign investors.

In a broad sense, foreign capital is followed by technological advancement and the implementation of innovative management methods.

Exports boosting

Usually state-owned enterprises do not export their goods and services as there are no incentives to do so; therefore, their activities are focused on domestic markets. As a result, economic growth is protracted. To compare, private enterprises focus on both domestic and foreign markets and generate more revenue, thus accelerating growth faster than SOEs.

Depth and width of equity markets

In many states one of the drivers of privatisation was the development of strong equity markets. Many of the biggest publicly traded companies were SOEs. The privatisation of such companies accelerated economies and allowed households to invest, thus opening up new saving opportunities. Investors usually gain from the privatisation of share issues.

Benefits to the government budget

Privatisation of SOEs increases budgetary revenue not only due to the income from the transaction, but also because of an increase in tax revenue from that particular company. This is the result of an increased efficiency and revenue which is frequently the result of privatisation. Budgetary revenue may also increase as privatised companies no longer enjoy tax exemptions. Finally, the budget saves money that would have been spent in the form of subsidies

Side effects of state-owned enterprises

Prior to taking a decision to solve an issue by establishing a state-owned enterprise, states should consider the side effects of SOEs. Compared to private entities, state businesses are less efficient, produce lower quality goods and services at a higher price, are reluctant to implement innovative practices and fall behind their competitors, if there are any³⁴. To keep SOEs on the market, their inefficiency is usually compensated by additional budgetary allocations.

Crowding out effect is yet another issue. By engaging in economic activity, SOEs reduce the possibilities of private enterprise to enter the market. This diminishes the position of private capital in goods, services and labour markets; therefore, economies dominated by SOEs are less attractive for investors.

The abovementioned side effects result from the nature of capital. Enterprises have fewer incentives to save public money and therefore are less responsible in spending it. The owner of a private enterprise risks his own investment while the state does not. Therefore, businesspersons make well-informed decisions and seek efficiency and profit. State businesses are financed by taxpayers', but they have virtually no control over SOEs, especially given the prevailing lack of transparency in their operations.

The present comparison of private and public business suggests that private capital-based economies have a competitive advantage over those dominated by state-owned enterprises. Therefore, states should promote private capital markets and should consider the side effects of the state participation in the economy prior to establishing SOEs.

3 Caplan, B., Course: "Industrial organization", Week 13: "Problems with Government Ownership", George Mason university, retrieved from <http://econfaculty.gmu.edu/bcaplan/e370/I010.htm>

4 Rothbard, M. F., *For a new liberty, The Libertarian Manifesto*, (2006), Ludwig von Mises Institute

Part 2 Rationale behind state-owned enterprises and possible implications

The Organisation for Economic Development and Co-operation (OECD) stresses the importance of defining the rationales for owning individual SOEs,⁵ stating that the ultimate purpose of state ownership of enterprises should be to maximise value for society through an efficient allocation of resources. The OECD report *State-Owned Enterprise Governance: A Stocktaking of Government Rationales for Enterprise Ownership*⁶ outlines five rationales for state ownership. The present chapter will focus on possible implications of those rationales.

SOEs support national economic and strategic interests

If the government sees a failure of private capital-based markets in ensuring economic and strategic interests of the state, a decision to use public funds for the establishment of an SOE follows. This rationale depends on how the state identifies and defines its economic and strategic interests and whether this is based on a sound methodology established by law. In the absence of the definition of the national economic and strategic interests, it is of major importance to

eliminate the threat of populism and the risk of politically motivated interests spreading to politically sensitive areas at a given time.

SOEs ensure continued national ownership of enterprises

As through their SOEs governments gain control over certain sectors, they strive to ensure a continued national ownership of them. This is one of the explanations of the tendency to ignore the primary goals of SOEs and search for new arguments in favour of maintaining state ownership. A continued operation of state-owned enterprises should not be seen as a value in itself and maintained at the expense of the public budget. The situation under which an SOE has been established may change over time; therefore, at some point that SOE may become redundant. The business continuity of every state-owned entity should be kept under a constant review, taking into account the reasons for its establishment and their relevance. Moreover, there is a need to carefully assess the alternatives, including privatisation, reorganisation and even liquidation.

SOEs supply specific goods and services that are unavailable on the market

Prior to the establishment of SOEs, there is a need to carry out a careful assessment of why specific goods and services are unavailable on the market. Such an assessment should take into account the following aspects:

- One of the reasons why specific goods and services are unavailable on the market is

⁵ OECD, „Guidelines on Corporate Governance of State-Owned Enterprises”, 2015, retrieved from

<http://www.oecd.org/corporate/guidelines-corporate-governance-SOEs.htm>

⁶ OECD, *State-Owned Enterprise Governance: A Stocktaking of Government Rationales for Enterprise Ownership*, 2015, retrieved from http://www.keepeek.com/Digital-Asset-Management/oecd/governance/state-owned-enterprise-governance_9789264239944-en#.WcqdHTt97Dc

regulation (e.g., excessive costs, burdensome licensing, unstable rules of the game, etc.) Regulatory burden makes the provision of certain goods and services unattractive to private businesses. In such cases, it would be enough to reduce the regulatory barriers, thus allowing the market to offer those goods and services.

- Apart from regulatory reasons, there might be other explanations why specific goods and services are unavailable on the market. First, there may be no consumer demand for specific goods or services that would allow the establishment of a competitive market. Second, high market entry barriers may discourage potential businesses. Third, the provision of certain goods and services may not be economically viable as market players will not be able to offer goods and services at a marketable price. Usually SOEs are not as efficient as private businesses, meaning that they could not offer a better price without state subsidies. Any artificial reduction of prices to make goods and services attractive to consumers will probably have to be backed by public funding. In other words, consumers will be forced to indirectly pay a higher price that they would have wanted to. This will not reflect the actual consumer choice and distort the market, hindering its development.

- It cannot be excluded that consumers already meet their needs by choosing other goods and services according to their purchasing power. This is confirmed by the New Theory of Consumption⁷, stating that consumers need specific qualities rather than goods and services. Different goods have different qualities that may be combined in different ways; therefore, consumers can make an individual choice to meet their needs best.

- Even if specific goods and services are necessary and cannot be replaced by other products, all possible alternatives should be

considered prior to establishing an SOE. For example, by improving business environment and promoting growth which will result in higher purchasing power and allow consumers to purchase necessary goods and services. In addition, specific goods and services may be purchased by announcing a public tender, thus ensuring competition and allowing private entities to participate in the process.

SOEs perform business operations in a natural monopoly situation

A natural monopoly situation may be defined as a situation when a single market player is more efficient because of economies of scale. Technical and legal prerequisites for competition exist in a natural monopoly situation, but under such competitive environment, the price of goods and services will be significantly higher⁸. Therefore, the following aspects should be considered in case of a natural monopoly situation:

- Potential benefits may come from replacing a wide range of goods and services with a single or several goods and services; however, it does not necessarily imply a reduction in the number of producers.

- Sometimes businesses are wrongly regarded as natural monopolies or monopoly rights are unduly granted to specific entities (e.g., a utility company), because a specific activity does not display the characteristics of a natural monopoly. Statistics⁹ show that competition exists in such markets and goods and services are provided at competitive prices.

⁷ Lancaster, K. T., *A New Approach to Consumer Theory*, *Journal of Political Economy*, April, 1966 m; *perspausdintas Modern Consumer Theory* (Brookfield, Vt. and Aldershot, England: Edward Elgar, 1991).

⁸ A dictionary of economic terms, retrieved from <http://zodynas.vz.lt/Naturalioji-monopolija>

⁹ Thomas J. DiLorenzo, *The Myth of Natural Monopoly*, *The Review of Austrian Economics*, Vol. 9, No. 2 (1996), Ludwig von Mises Institute

- The role of consumer should not be underestimated. Even a single producer is affected by the purchasing power of consumer. Moreover, government's understanding that specific goods or services are necessary and actions taken for those goods and services to be available on the market imply that consumer choices would be different in the absence of such actions. Consumers will find better ways to meet their needs, thus forcing the monopoly owner to improve or leave the market¹⁰.

- Sometimes states adopt a decision to nationalise natural monopolies; however, SOEs tend to be inefficient and therefore a private natural monopoly operating under state regulation is a better alternative. This is practiced by many countries as well as regulated by EU directives and recommendations as it helps both to avoid the risks associated with state-owned enterprises and to exploit the benefits of private capital markets.

SOEs create a state-owned monopoly (or oligopoly) where market regulation is infeasible or inefficient

The establishment of a state monopoly is probably the most detrimental form of market intervention, completely eliminating private capital from the market. Therefore, cases when a state monopoly is acceptable must be clearly defined on the basis of a solid methodology and sound arguments. These might include cases when a state monopoly is necessary to ensure the independence and protect the sovereignty of the state as well as to protect the strategic interests of the state; however, the benefit of such a monopoly must nevertheless be worth the price of restricting the freedom of competition.

To generalise, in order to avoid unjustified state participation in commercial activity and its implications, the following aspects should be taken into consideration prior to the establishment of state-owned enterprises:

- First, there is a need to verify the validity of the problem to be addressed by establishing an SOE. For example, if goods or services that are unavailable on the market are necessary for a consumer and if the consumer could not find a substitute for them.

- If there is a need to address a well-founded problem, it should be established if the problem does not stem from government regulation. If so, regulatory obstacles should be eliminated, providing sufficient time for the market to solve the problem.

- Even if the problem does not stem from regulatory practices, all possible alternatives should be considered. The best alternative should be selected based on a cost-benefit analysis and the assessment of alternative costs and risks.

- The rationales for state ownership should be kept under a continuous review to reflect market changes and examine the possibilities of privatisation.

Therefore, the advantages of private capital and the risks associated with the activities of state-owned enterprises suggest that the establishment of SOEs should be well-justified, follow a careful assessment of possible implications and take into account the abovementioned recommendations.

¹⁰ Lithuanian Free Market Institute, *Competition, monopoly and cartels*, (2010), retrieved from <https://www.llri.lt/wp-content/uploads/2013/07/konkurencija-monopolija-ir-karteliai.pdf>

Part 3 Management of state-owned enterprises in Lithuania, Estonia, Poland, Bulgaria and Slovakia from 2007 to 2016

Throughout the last decade Bulgaria, Estonia, Lithuania, Poland and Slovakia have adopted a number of decisions as regards the management of state-owned enterprises

Different procedures for the establishment of SOEs. For example, in Estonia SOEs are established according to the State Property Act¹¹. Lithuania also has a single legal act for the establishment of both state- and municipality-owned enterprises¹², stating that state-owned enterprises shall be established by the government. In Slovakia SOEs are established as any other commercial limited liability company. Poland regulates¹³ the establishment of municipality-, not state-owned enterprises. Bulgaria has no specific document and no specific procedure for the establishment of SOEs as decisions are taken on an ad-hoc basis.

Four of the countries do not have the rationales for state ownership established by law. Estonia is the only state where the rationale for the establishment of SOEs is clearly stated by law, stipulating that SOEs may be established in case of a market failure.

The consistency of SOE management policies over the last decade. The Polish government has not been consistent in implementing policies relating to SOEs. The privatisation programme in Poland lasted until a change in the government and turned back towards state-ownership again. There have also been some developments in Slovakia, namely the dissolution of the National Assets Fund and an increased use of SOEs for specific purposes. In Bulgaria SOEs have mostly been used for partisan and populist goals so the policies did not change much. Lithuania's policies have remained relatively stable as the government did not show any willingness to reform and simply followed OECD recommendations.

The number of state-owned enterprises. Statistics¹⁴ show that Bulgaria had the biggest number of SOEs in 2014 while Estonia had the lowest. In addition, Poland had the lowest number of SOEs per one million inhabitants (see Table 1). However, neither of these numbers help in the assessment of whether or not the states followed justified, consistent and sustainable policies.

In the countries under analysis, the establishment and management of SOEs depend on governments that struggle to align their interests as owners, market regulators, competitors and elected representatives. Simply put, being a

11 Riigivaraseadus, retrieved from <https://www.riigiteataja.ee/akt/RVS>

12 The Law on State and Municipal Companies of the Republic of Lithuania, retrieved from <https://www.e-tar.lt/portal/lt/legalAct/TAR.29FB2C8807FE/YnqaFNDDJx>

13 The Law on State and Municipal Companies of the Republic of Lithuania, retrieved from <https://www.e-tar.lt/portal/lt/legalAct/TAR.29FB2C8807FE/YnqaFNDDJx>

14 A comparison of four countries is provided. 2015 data for Bulgaria is unavailable.

competitor with infinite financial resources and a market regulator with the power to set its own rules of the game, the state undermines the business and competitive environment for private enterprise. As a result, states face difficulty in ensuring free competition.

Table 1. The number of majority-owned SOEs and the number of SOEs per million inhabitants, 2015

2015	No of SOEs	No of employees in SOEs	Value (USD, in billions)	No of SOEs per million inhabitants
Bulgaria [*]	782	169,089 [*]	<i>no data</i>	108,25
Estonia	66	26,026	4,2	50,21
Lithuania	128	40,711	5,7	44,31
Poland ^{**}	126	128,016	15,7	3,32
Slovak Republic	113	60,471	<i>no data</i>	20,83

Source: OECD, except for the data for Bulgaria.

* The data for Bulgaria comes from 2014. There were 237 SOEs in 2016.

** Poland preserved minority shareholder rights in 346 enterprises.

Part 4 Reviews of corporate governance of state-owned enterprises in Bulgaria, Estonia, Lithuania, Poland and Slovakia from 2007 to 2016

BULGARIA

A wrap-up of recent developments

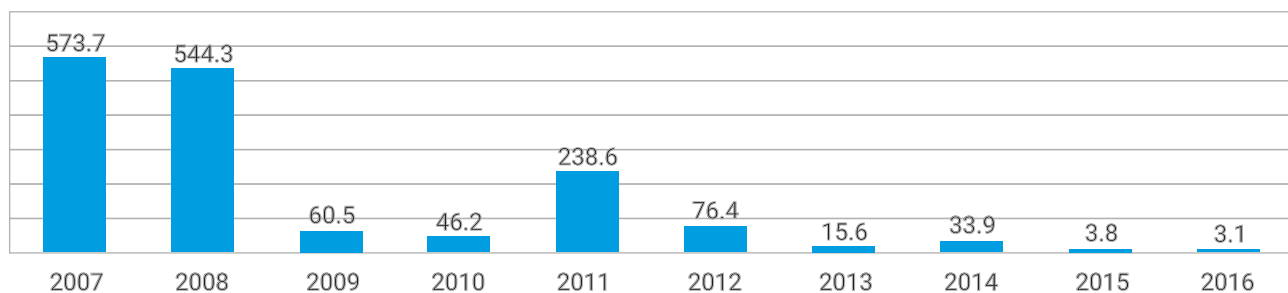
Official policies regarding SOEs in Bulgaria since 2007 can be summarized as inconsistent and driven by short-term considerations, which in turn can be often traced to partisan or private interests. Privatisation has gradually stalled, while liberalization of the SOE-dominated energy sector has hardly moved forward, despite Bulgaria's commitments as a member of the European Union. In fact, there have even been cases of re-

nationalisation of formerly privatized state-owned companies in a bid to keep them at bay and avoid their insolvency. The main developments regarding SOEs in the 2007-2016 period can be summarized as follows:

A gradual suspension of privatization

The privatization process has slowed down after 2008 to a virtual halt in the past two years (see Graph 1).

Graph 1. Budgetary revenue from privatisation, net, BGN million (1 EUR=1.95583 BGN), 2007-2016



Source: The Ministry of Finance of Bulgaria

The prevailing view in the government is that there is not much left for privatization. This view has found its way into a draft bill for the suspension of all kinds of privatization, submitted in May 2017 by the new minister of economy (ironically, the same person used to be a long-time director of the privatization agency). Under this bill, privatization procedures can only be launched in exceptional cases, with the prior approval of the Parliament.

The view that there is hardly anything left for privatisation is quite arguable. According to the latest official data of the Ministry of Finance of Bulgaria, the government is the majority shareholder in 237 enterprises. There is no official statistics on all state and municipal companies and their ownership, but according to the Activ accounting company, their number is close to 800. A list of 237 state-owned companies by the Ministry of Finance shows that almost a third of these are hospitals and medical care units and about 10 percent are local water and sewerage enterprises. In addition, there are several energy companies (mostly for generation and transmission), several seaports, river ports and airports, regional forest management companies, several scientific and research institutes and a number of industrial and economic zones.

Even if one assumes that the abovementioned companies are of strategic interest and should therefore remain state-owned, there is a considerable number of companies in which state participation may not be reasonably justified (see Table 2). For instance, the state owns a big dairy

company, a rail cargo company, mines, construction and engineering companies, foreign trade companies, weapon producers and traders, resort management companies, a bank, an IT company, sports companies, a lottery, a textile company, a printing house, a movie studio, a music recording company, etc. In all of the above sectors, state-owned entities compete with private enterprises. Regrettably, SOEs often have an unfair advantage in public procurement, not to mention the risks of corruption, misuse, and waste of public funds that these enterprises are exposed to. For example, the information on the export of armaments is not public, fuelling scandals about illegal export of weapons to conflict-ridden countries and authoritarian regimes.

The use of SOEs for partisan interests and populism

A possible explanation of the falling interest in privatisation in recent years can be sought in two directions. Firstly, in the crisis and recovery years after 2008, the government resorted to a hefty fiscal reserve (accumulated during the economic boom) to finance its budget deficits. Hence, it was not forced to privatise amid a difficult market. More recently, budget execution has been quite strong (with significant surpluses till late year), which has also swiped the need to finance the budgetary deficit.

Secondly, SOEs have proven to be a convenient instrument for political assignments, drainage of their funds to service private interests, and

Table 2. The number of Bulgarian SOEs operating in different sectors, 2016

Sector	No of SOES	Sector	No of SOEs	Sector	No of SOEs
Primary sectors	3	Telecoms	1	Other utilities	31
Manufacturing	6	Electricity and gas	4	Real estate	6
Finance	7	Transportation	16	Other activities	163
				Total	237

Source: The Ministry of Finance of Bulgaria and IME's estimates

populist policies. For instance, the national electricity company (Natsionalna Elektricheska Kompania - NEK) has been traditionally used as a "buffer" for under-pricing of electricity bills for households. The most blatant example of the use of NEK for populism was the sharp reduction of electricity prices for households in three steps over 2013 (in March, August and December, respectively), which resulted in increased losses and rising debts of the electricity company. Only short-term liabilities of NEK rose by over BGN 1 billion (€500 million) between end-2011 and Sep 2013¹⁵.

Similarly, the passenger railway company and the post company are also kept afloat with regular subsidies and capital transfers for their "social" role. Usually, transfers to these companies remain relatively stable even if less and less customers use their services, while inefficiency is blatant. For example, only some 30 percent of the revenue of BDZ-Passenger Transport is generated from fares; the remaining 70 percent come as a state subsidy.

Another illustration of the inefficiency of the state railways is the growing amount of state transfers per transported passenger. The number of passengers has been on a stable downward trend from 50 million people in 2000 they fell more than twice to 24.5 million people in 2014. Thus, the total state transfer to the company increased from BGN 6 (approx. €3.1) per passenger in 2010 (no earlier data is available) to BGN 8.2 (approx. €4.2) in 2014, or by more than 1/3¹⁶.

Overall, annual budget transfers to the three SOEs in the railway sector already approach BGN 500 million (approx. €250 million), with about half of these due to the passenger transport company. Those transfers are equal approx. 0.5 percent of GDP and approx. 2-2.5 percent of the state budget (see Table 3). Put in perspective, this means that the state allocation for the railway companies is more or less equal to the funding for the judiciary and exceeds the state subsidy to higher education establishments.

Table 3. Budgetary transfers to railway SOEs, million EUR, 2007-2016

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
BDZ-Passenger Transport,	11	12	12	103	108	108	107	112	98	116
Railway Infrastructure National Company	72	89	101	111	111	111	112	123	123	123
Holding BDZ	63	77	91	0	0	0	0	1	20	0
Total for the three companies	146	178	203	214	219	219	219	236	241	239
% of GDP for the three companies	0,45	0,48	0,55	0,57	0,54	0,52	0,52	0,55	0,55	0,53
% of the state budget for the three companies	1,97	2,14	2,38	2,59	2,49	2,46	2,37	2,39	2,36	2,18

Source: The Ministry of Finance of Bulgaria and IME's calculations

15 IME, *Pricing Policy in the Energy Sector in 2013 in Contradiction to the Normative Base and Common sense* (2014), retrieved from http://ime.bg/var//images/Cenova_politika_2013_IME_Final.pdf

16 BDZs annual reports. For details see the websites of the Ministry of Finance (www.minfin.bg) and BDZ (www.bdz.bg)

The use of creative accounting to channel privatization proceeds to the budgetary revenue side

According to the law on the establishment of a so-called silver fund¹⁷ (meant to support financially the PAYG pension system), all privatization proceeds should be directed to this fund. Yet, in 2009, the then-government bypassed this law by establishing a new state-owned holding company, the State Consolidation Company (SCC). The purpose of its establishment was to find a legal way to channel privatization proceeds to the budgetary revenue side, rather than to account them below the bottom line, as budget deficit financing. After that, stakes at SOEs earmarked for privatisation have been contributed to the capital of SCC. As a result, once these were privatised, the revenue was accounted as profit for SCC. After yearend, 80 percent of the profit of SCC (in fact privatisation proceeds) has been paid to the state budget as non-tax revenue. There is no public statistics on the dividend paid by the SCC, so one can only guess how much proceeds have bypassed the Silver Fund that way.

Therefore, the privatisation of state-owned enterprises has been used as an instrument to generate more budgetary revenue, rather than a traditional source of deficit financing. That way, the revenue side was boosted, so that it can fund an expansionary policy course, while financing the resulting deficit from fiscal reserves or new debts.

The use of SOEs to service partisan or private interests

The case of LB Bulgaricum – a state-owned dairy producer that holds exclusive rights to the license for Bulgarian yogurt – is a recent textbook example of the usage of SOEs for private interest. The company was first earmarked for privatization as the state's shareholdings were transferred to SCC. Reportedly, a local media mogul who also runs a

business in the dairy sector eyed the company and stood behind the sudden haste for its privatization. Later, however, the privatization process was suspended but rumour had it that the same businessman has found a way to use the company by influencing the nomination of one of its managing board members. Reportedly, the businessman currently used the production base and the technology of LB Bulgaricum to produce his own dairy brands. In brief, the company is de facto privatized, without being de jure so¹⁸.

Renationalization and establishment of new state-owned companies

In addition to the gradual suspension of privatization, in recent years there have even been cases of renationalization and creation of new state-owned enterprises. In May 2016, the formerly privatized Avionams (military aircraft maintenance and repair works) was acquired by the State Consolidation Company¹⁹. The deal became possible after Avionams was declared insolvent and its assets were put up for sale. At that time, the Prime Minister Boyko Borissov argued in favour of²⁰ renationalization with the company's importance to the Bulgarian military.

Similarly, the past few years saw the emergence of several new state companies. In 2008, the then-government established a holding company for all its shareholdings in the energy sector, the Bulgarian Energy Holding (BEH). The holding company was established with the primary aim to attract financing for ailing state companies in the energy sector, including in local and foreign markets. As its balance sheet combines both

17 Закон за държавния фонд за гарантиране устойчивост на държавната пенсионна система, retrieved from <http://www.lex.bg/bg/laws/ldoc/2135605211>

18 Закваската на Пеевски. Как работи схемата за превземане отвътре на държавно дружество, 3 апр 2015, retrieved from http://www.capital.bg/biznes/kompanii/2015/04/03/2505954_zakvaskata_na_peekvski/

19 Военният завод "Авионамс" официално стана държавна собственост, 16 май 2017, retrieved from http://www.dnevnik.bg/bulgaria/2017/05/16/2971898_voen_niiat_zavod_avionams_oficialno_stana_durjavna/
20 news.bg "Държавата вече е собственик на военния завод „Авионамс“ (2016)

profit-making and loss-making/heavily indebted companies, it can attract loan and place bonds at much better terms than some of its subsidiaries. The financing thus raised is then lent to daughter companies at preferential terms. Thus, energy sector SOEs in dire financial state, that have no access to financing at market terms, continue to receive funding (through the BEH by-pass), and are kept at bay for years despite their huge losses and mounting debts.

In addition to BEH, in 2009 the government established the SCC, mentioned above this time with the sole aim to bypass the Silver Fund law. A couple of years ago, the state-owned Tech Park, meant to become a hi-tech R&D hub, has also started operations. The Tech Park was financed entirely with EU funds, but so far, its office premises are almost entirely vacant.

SOEs as a contingent liability on the state

SOE have accumulated significant debts, which come up to 12 percent of GDP as of end-2015, according to the latest data of the National Statistical Institute. Most of the debts are concentrated in the energy and railway sectors. Most of these debts are state-guaranteed and state guarantees have already been triggered in the past, as soon as SOEs find themselves unable to service their debts. In comparative terms, debts of state-owned companies are equal to almost half of the entire public debt. Loss-making companies owe more than 50 percent of all debts.

Conclusions

To summarise, the last few governments had gradually slowed down privatization of SOEs until it was brought up to a virtual halt in 2015-2016. On top of that, a formerly privatized company has been re-nationalized on populist grounds and two SOEs have been established. The latter were set up for purely financial and budget-related considerations. The first one was established as a creative accounting tool to channel privatization proceeds to the budgetary revenue side rather than accounting the proceeds as deficit financing. The second one, in turn, is a hollow holding company that is able to place state-guaranteed debt at market terms and then use the loans to

finance its subsidiaries in dire straits that have no access to the markets. Moreover, SOEs have been traditionally exploited for partisan purposes, political assignments and populism, including the promotion of social policies via them. Last but not least, SOEs have been acting as a channel for state capture as some of these assets are reportedly being used at no expense by private companies, to service their (private) needs.

Considering the fact that that the senior coalition partner in the new government (that took office in May 2017) has been in office twice since 2009, the likelihood that privatization of SOEs will be resumed is close to zero. The same holds true for all the above-mentioned practices with regard to the management and exploitation of SOEs, including the lack of transparency, populism and the use of SOEs as a part of the state capture governance model of Bulgaria.

ESTONIA

Some of the state-owned enterprises have been privatized in Estonia while others remain in the hands of the state due to their strategic importance. To achieve high competitiveness, the state has to engage with business, but its direct participation in the market is much more an ideological issue. The proprietary attitude is mostly a historical relic from the times when property used to denote national pride. However, the important issue is how and to what extent the state is represented in the managing bodies of its companies. Are the documents used to govern the state, such as legal acts, programmes, decisions, coalition agreements, etc., reflected in the activities of SOEs? This raises a major dilemma: are state companies run like private ones, or like social companies that are occasionally forced to make economically irrational decisions?

Changes in the number of SOEs and their employees between 2007 and 2017

The number of SOEs has remained relatively stable in the recent years. From 2007 to 2017, the total number of SOEs has merely decreased from 37 to 32. Transportation and environment were the main sectors that the government operated in. Probably the biggest development was the buyback of the shares of the Estonian railway company in 2007 due to political reasons as the government saw things differently than the private owner, who wanted to minimize the cost and reduce quality.

Over the period between 2007 and 2016, the number of employees in state-owned enterprises has decreased by 33 percent, from 20,062 to 13,532. In principle, this is the result of increasing the efficiency of two major companies Eesti Energia AS and AS Eesti Post. The number of employees in Eesti Energia AS decreased from 8,456 to 5,696 due to technological advancement and the number of employees in AS Eesti Post was reduced from 4,017 to 2,244 by closing post offices.

Corporate governance of SOEs in 2008-2017

The will of the state regarding its companies is rather marginal and the state seldom interferes with their activities. With no established plan to follow, the state expresses its will in a rather sporadic manner. Over the course of time, the functioning of state-owned companies has changed. It used to be more acceptable for a company to behave like a social enterprise and to serve the general interests of the state, all the while working at a loss. Now such economically irrational behaviour is no longer tolerated. State-owned enterprises function like private capital enterprises, with the aim of making profit.

In 2008 the fundamental change was that the government decided to establish five road maintenance companies, including AS Pärnumaa Teed, AS Tartumaa Teed, AS Virumaa Teed, AS Saaremaa Teed ja AS Võrumaa Teed. After some years, they have been consolidated into one big company. This is one of the companies that some politicians are willing to sell, because it competes with private companies and, is not able to offer competitive prices.

In 2009 the government decided to get rid of its telecommunications company AS Eesti Telekom. The company is still very successful in the private sector today. It had 2,341 employees in 2008.

In 2010 the State Property Act was adopted, stipulating that the goals of SOEs should be linked to the national development plans. In addition, the composition, appointment and fees of supervisory boards were regulated, providing more independence for their members. In Estonia, the debate about state-owned enterprises develops around their management and supervisory boards and there are ideas that all SOEs should be under the management of a single public company.

From 2011 to 2013 the market was relatively stable with no major changes. Adopted back in 2010, the State Property Act started producing results in 2014. The majority of SOEs get separate document of owner's expectations and explanation why all SOEs are necessary to the government, except for eight company's (AS Eesti Post, AS Eesti Teed, AS Estonian Air, AS Teede Tehnokeskus, AS Rocca al Mare Suurhall, OÜ Pro-tooted AS Eesti Metsataim, AS Andmevara). SOE management (board of directors, supervisory board, and company manager) must follow that. These documents are updated and reviewed periodically. In addition, most SOEs get new strategy papers also.

The last major development as regards the Estonian SOEs was the bankruptcy of Estonian Air when the government was forced to establish two new companies in order to ensure the country is accessible via air transport. In 2015 the Nordic Aviation Group (brand and flights operator) and OÜ Transpordi Varahaldus (an investment company) were founded. Both companies are 100 percent owned by the state of Estonia.

The slowdown in economic growth and low energy prices in the last couple of years has been adversely affecting profits, which has significantly reduced the income of the country's largest company Eesti Energia. The share of equity has steadily declined, indicating that more and more loan funds are being used and the use of state resources is thereby more efficient. The plan to solve the situation is to sell some parts from four company AS Tallinna Sadam, Enefit Taastuenergia OÜ, AS Eesti Teed and AS EVR Cargo in near future and maybe list them on the stock exchange.

A glimpse into the future

In the past, there have been ideas and even attempts to privatize state-owned enterprises but no common policy was followed. With Estonia's new government in power since 23 November 2016, the debate about privatization seems to be going on again. However, despite debates about the intention to privatize some SOEs, including EVR Cargo, Eesti Teede, Tallinna Sadama, Eesti

Energia and Levira, no progress has been made yet. The main purpose for this would be to get rid of redundant companies and get the low-performing Tallinn Stock Exchange up and running.

Conclusions

The state should define its strategic interests more clearly for all the companies in which it is a shareholder. If the necessity of owning a particular company cannot be justified, privatization should be considered. While the State Assets Act stipulates that one of the reasons for state participation in business is to provide services that the private sector is unwilling to provide for economical or some other reason, the state should give more thought as to whether it makes sense to establish a separate company for a particular purpose, or whether the relevant service could be provided through a ministry or its units.

LITHUANIA

State policies from 2007 to 2016

Over the last decade, Lithuania has paid special attention to state-owned enterprises with the objective of reforming their corporate governance framework for increased asset performance and operating efficiency. Set in 2010, today these objectives remain far from being achieved; therefore, a review of state policies and significant developments should focus on key documents unfolding how and on what basis Lithuania pursued the goals set for reforming state-owned enterprises.

The Concept on Improvement of the Efficiency of State-Owned Enterprises.

To implement the principles for the management of state-owned enterprises set out in the OECD Guidelines on Corporate Governance of State-Owned Enterprises, in 2010 the Lithuanian government adopted the Concept on Improvement of the Efficiency of State-Owned Enterprises²¹ (hereinafter referred to as 'the Concept'). The Concept outlined four main targets in reforming state-owned enterprises: 1) clear objectives of SOEs; 2) a separation between commercial and non-commercial functions of SOEs and the assessment of the costs of performing non-commercial functions; 3) a separation between SOE ownership and regulatory functions; and 4) higher transparency concerning the activity of SOEs.

Transparency and Ownership Guidelines. In 2010 Lithuania adopted the Transparency Guidelines²², setting out transparency and accountability standards for SOEs and in 2015 passed the Ownership Guidelines²³, laying down the principles of setting strategic and financial targets of SOEs, the rules for the appointment of board members, and the separation of ownership and regulatory functions, etc.

OECD recommendations for Lithuania. In 2015 the Organisation for Economic Co-operation and Development assessed the Lithuanian SOE sector as regards its compliance with the requirements of the recast of the Guidelines on Corporate Governance of State-Owned Enterprises²⁴. In its recommendations for Lithuania, OECD called for the following actions: 1) strengthening the state's ownership function by enhancing the existing co-ordination within state administration in cases when centralised exercise of the ownership function is not possible, i.e. ensuring the independence and adequate resourcing of the Governance Coordination Centre as well as the due implementation of the decisions adopted by the Government; 2) strengthening the independence of boards, including an increase in the number of independent board members; 3) reviewing the legal forms under which SOEs operate, including the corporatisation of statutory SOEs while optimising the sectors in which many SOEs engage in similar activities, i.e. 42 forestry enterprises and 11 road maintenance enterprises; and 4) introducing mandatory disclosure requirements at least for large SOEs.

21 Government decision no 1731 of 1 December 2010 "On the Approval of the Concept on Improvement of the Efficiency of State-Owned Enterprises", retrieved from http://www.gmu.lt/lr_vyriausybes_nutarimai/nid.2288/

22 Government decision no 1052 of 14 July 2010 "On the Approval of Transparency Guidelines for State-Owned Enterprises", retrieved from <https://www.e-tar.lt/portal/lt/legalact/tar.f4ab9539e95e/nisrcfpoew>

23 Government decision no 665 of 6 June 2012 "On the Approval of Ownership Guidelines for State-Owned Enterprises", retrieved from <https://www.e-tar.lt/portal/lt/legalact/tar.6af226769db2>

24 OECD, "Guidelines on Corporate Governance of State-Owned Enterprises" (2015), retrieved from http://www.oecd-ilibrary.org/governance/oecd-guidelines-on-corporate-governance-of-state-owned-enterprises-2015_9789264244160-en

The implementation plan for OECD recommendations. To implement the abovementioned recommendations, in 2016 the Lithuanian Government adopted the Implementation Plan for the Recommendations Expressed in OECD Review of the Corporate Governance of State-Owned Enterprises in Lithuania²⁵ (hereinafter referred to as 'the Government's action plan'), including 11 measures (14 as per the classification of the National Audit Office of Lithuania). These measures may be classified under the following four categories that are in line with OECD recommendations: 1) measures strengthening the state's ownership function; 2) measures strengthening the role of management and supervisory boards; 3) measures aimed at reviewing the legal forms under which SOEs operate; and 4) measures aimed at enshrining mandatory disclosure requirements for SOEs.

What have been the results of these actions? The Rate of Return of State-Owned Enterprises²⁶, a 2017 report by the National Audit Office of Lithuania shows the progress made in achieving the aforementioned objectives. According to the National Audit Office, six out of nine measures outlined in the Government's action plan have been achieved while three appear to be falling behind. To add, two of the former have been implemented without aiming at higher governance and transparency standards. The report also states that the SOE ownership policy review mechanism does not work in practice, transparency issues persist and the objectives of some SOEs are not clear. Therefore, it is likely that these and other deficiencies in corporate governance

result in ineffectiveness of the majority of SOEs and a failure to meet their financial targets. Table 4 below provides the chronology of OECD recommendations, government's actions and the assessment of the National Audit Office.

A summary of the discussed documents provided in Table 4 above shows that every subsequent government plan or OECD recommendation outline similar measures. According to the National Audit Office, previously selected measures were not implemented properly therefore suggesting that the government has failed to achieve its objectives concerning state-owned enterprises set back in 2010.

A review of state-owned enterprises

The number of SOEs. According to the data of the Ministry of Economy and the Governance Coordination Centre (see Graph 2), in 2016 there were 118 SOEs in Lithuania, 44 (or 27 percent) less than in 2009. In 2015 there were one majority owned listed entity, 48 majority owned non-listed enterprises and 79 statutory corporations and quasi-corporations. It should be noted that since 2014 Lithuania is no longer engaged in the management of the activities of minority-owned entities. In 2013 there were two such entities, AB Lietuvos dujos and AB Amber Grid.

Though in seven years the SOE sector in Lithuania has decreased by 44 SOEs or 27.2 percent, this change may not be significant as it is unrelated to consistent government policies and decisions aimed at increasing the effectiveness or otherwise reforming SOEs.

25 "The Implementation Plan for the Recommendations Expressed in OECD Review of the Corporate Governance of State-Owned Enterprises in Lithuania", retrieved from https://ukmin.lrv.lt/uploads/ukmin/documents/files/imported/lt/Valstybes%20valdomos%20imones/EBPO_rekomend_igyvendin_planas_LRV_2016-04-04.pdf

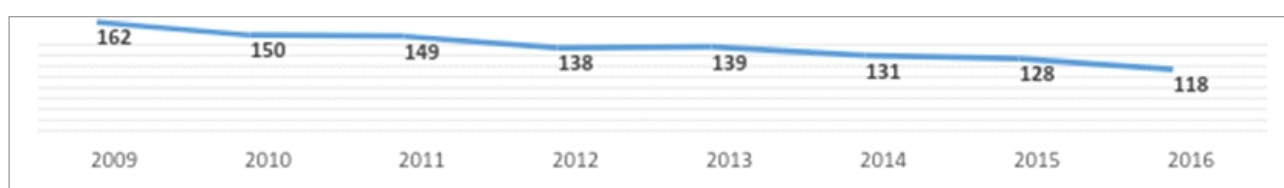
26 The National Audit Office of Lithuania, A Report of State Audit of 25 April 2017 no VA-2017-P-20-3-10 "The Rate of Return of State-Owned Enterprises".

Table 4. The chronology of OECD recommendations, government's actions and the assessment of the National Audit Office (2010-2017)

Document (year)	Objectives: plans and results			
The Concept on Improvement of the Efficiency of State-Owned Enterprises based on 2005 OECD standards (2010)	Clear objectives of SOEs	A separation between commercial and non-commercial functions of SOEs and the assessment of the costs of performing non-commercial functions	A separation between SOE ownership and regulatory functions	Higher transparency concerning the activity of SOEs
Legal acts (2010-2015)	Ownership Guidelines		Transparency Guidelines	
OECD recommendations for Lithuania (2015)	Strengthening the state's ownership function	Reviewing the legal forms under which SOEs operate, including the corporatisation of statutory SOEs while optimising the sectors in which many SOEs engage in similar activities	Strengthening the independence of boards, including an increase in the number of independent board members	Introducing mandatory disclosure requirements at least for large SOEs
The Government's action plan for the implementation of OECD recommendations for Lithuania (2016)	Strengthening the state's ownership function	Reviewing the legal forms under which SOEs operate	Strengthening the role of management and supervisory boards	Enshrining mandatory disclosure requirements for SOEs
The report of the National Audit Office of Lithuania (2017)	The objectives of some SOEs are not clear	There are no comprehensive criteria for the selection of legal form	The majority of board members are public servants; the Governance Coordination Centre does not ensure the independence of their functions	The transparency of the activities of SOE is not ensured

Source: compiled by LFMI based on the documents indicated in the first column.

Graph 2. The number of SOEs from 2009 to 2016.



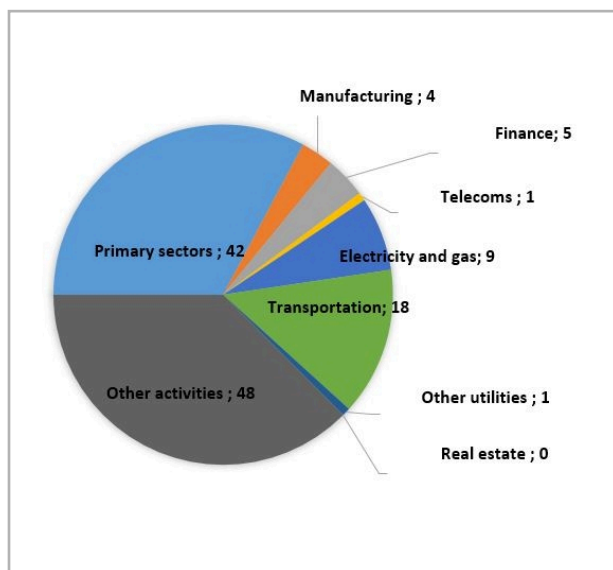
Source: the Ministry of Economy and the Governance Coordination Centre

The number of employees. In 2016 SOEs had 38.9 thousand employees, 9.5 percent less than in 2012. In 2015 42 thousand employees of SOEs accounted for roughly 3.2 percent of the employed in the country. With such a high ratio, Lithuania runs second in terms of the highest number of people employed by state-owned enterprises in OECD and Partner Countries²⁷. Therefore, SOEs have a larger influence on the labour market, the economy and the country's competitiveness in Lithuania as compared to other countries.

According to OECD classification²⁸, in 2015 the majority (37.5 percent) of SOEs operated in other sectors (see Graph 3). Other sectors that do not fall within the scope of the nine-sector

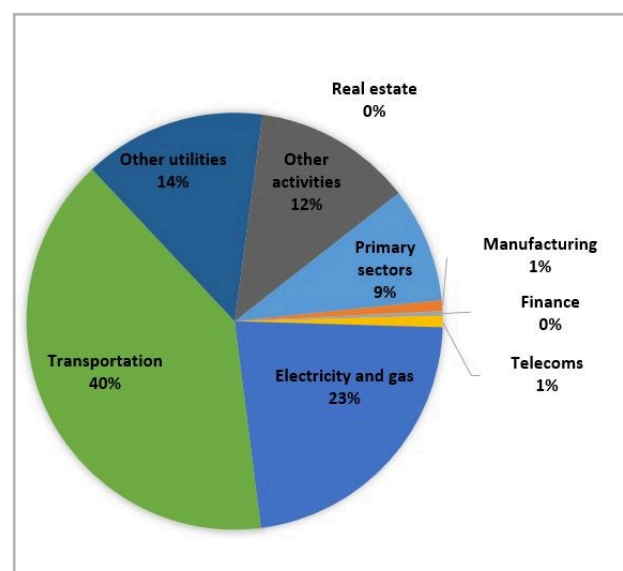
classification include pharmacies, publishing houses, bookstores, training centres, mints, assay offices, the armaments industry, the centre of registers, deposit and investment insurance, agriculture-related and similar activities²⁹. Such a large array of activities performed by state-owned enterprises show that SOEs operate beyond the boundaries established by OECD. The distribution of employees across different sectors is different from the distribution of enterprises (see Graph 4), reflecting significant differences in the size of SOEs.

Graph 3. The number of SOEs in different sectors, 2015



Source: compiled by LFMI.

Graph 4. People employed by SOEs in different sectors, %, 2015



The value of enterprises and return on equity. In 2015 the total value of SOEs in Lithuania was \$5,223 million, 23.5 percent lower than in 2013. The decrease in the total value was mainly due to a 43.4 percent (\$1,836 million) decrease in the value of the electricity and gas sector, resulting from asset valuation and designation at fair value.

27 OECD, Lithuania Policy Brief: Corporate Governance. The Reform of State-Owned Enterprises (2016), retrieved from https://www.oecd.org/policy-briefs/lithuania-reforming-state-owned-enterprises-sector_LT.pdf

28 The OECD classification distinguishes the following sectors: primary sectors, manufacturing, finance, telecoms, electricity and gas, transportation, other utilities, real estate, and other activities.

29 A list of state-owned enterprises (2016), retrieved from http://vk.turtas.lt/static/uploads/VV_sraas_2016Q2.pdf

According to the National Audit Office, in 2015 the overall return on equity³⁰ in SOEs was 2.1 percent while the normalised return on equity reached 4.4 percent (see Graph 5). The normalised return on equity grew due to the results of the electricity and gas sector in which the return on equity grew by 5.5 percent, from 2.9 percent in 2014 to 8.4 percent in 2015. The National Audit Office also concluded that the energy sector has made the most significant improvement in terms of good governance.

In 2015 the return on equity in private Lithuanian enterprises reached 9.2 percent and was four times as high as in state-owned enterprises, suggesting ineffectiveness of the latter.

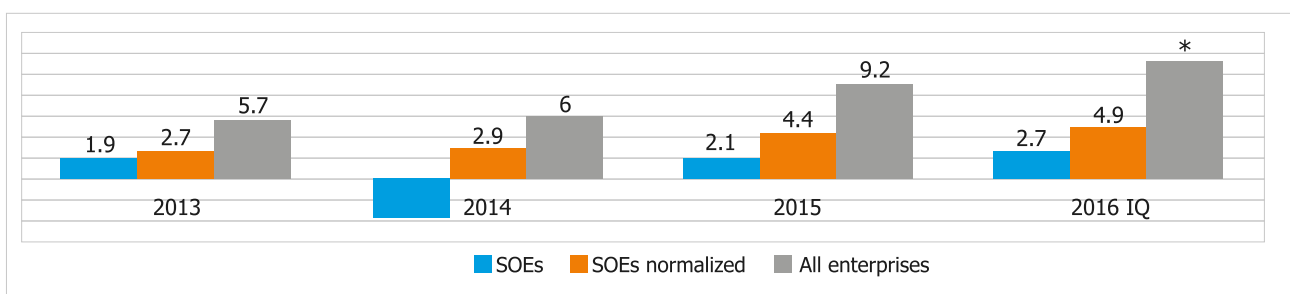
A peak and a decline of private capital participation of private capital in major SOEs arguably reached its peak in 2008 with the creation of LEO.LT with a merger of privately owned energy companies and SOEs in energy sector. This point is symbolic for two reasons. First, this is the last time in recent history when private capital was deemed politically acceptable to participate in strategic undertakings in Lithuania. Second, after dissolution of LEO.LT private capital was (and is) steadily being pushed out of the energy sector. No major privatisation of SOEs was undertaken after LEO.LT, even more, the government has pushed out private investors from major energy infrastructure companies.

Currently the political climate is not overwhelmingly hostile to privatisation of small mismanaged companies that are deemed of having no strategic importance. Yet even reorganisation of these SOEs has been stalling for the past decade. In case of strategic SOEs, it is hard to envision any plans for reducing government-owned stake. Moreover, some of these companies are actually expanding into other sectors that previously were off-limits to SOEs, e.g. energy production, IT, or even electronic payment systems.

Conclusions

Lithuania struggles to implement its policy framework in state-owned enterprises and fails to achieve most of its objectives. Given the results of the recent audit by the National Audit Office, it appears that the government may not yet have political will to implement its policies in a fair and transparent manner. In general, this review shows that instead of making policies on its own initiative, the government simply follows OECD recommendations. Due to a lack of political will to reform SOEs, the decisions on privatisation, nationalisation and reorganisation of SOEs adopted throughout the last decade are mostly triggered by parliamentary elections rather than consistent policies.

Graph 5. Return on equity in Lithuanian SOEs and private enterprises (2013-Q1 2016), percentage



*Provisional data for 2016, Statistics Lithuania
Source: the National Audit Office and Statistics Lithuania

30 A financial indicator of the effectiveness of investment that shows the amount of net income returned as a percentage of shareholders equity, calculated by dividing net profits by the total equity.

POLAND

In 1989 most of output in Poland was produced by state-owned enterprises. In the following years due to both privatization and rapid growth of private sector, the role of SOE declined. In 2000 SOEs generated 13 percent of the value added in Poland and by 2015 their share declined further to 5 percent. Notwithstanding these numbers, SOEs still play an important role in the Polish economy as state ownership is concentrated in crucial sectors like finance and energy. It could hardly be argued that further privatization will boost the Polish economy; however, throughout the last decade governments were reluctant to give up the control of the biggest companies, as they used them in pursuing political goals.

SOEs controlled by the central government

Until 31 III 2017 SOEs were managed by the Ministry of Treasury (MoT) (with some exceptions like railway companies managed by the Ministry of Infrastructure), but the new government dismantled the Ministry and now companies are either under a direct responsibility of the Prime Minister or under the control of relevant ministers. This is a part of a wider policy change after the elections won by the Law and Justice party (PiS) in 2015. The new government has publicly announced the end of privatization and questioned several privatizations made under the previous governments of the Civic Platform (PO) and the Polish People Party (PSL) that were in power from 2007 to 2015. Therefore, the two periods (from 2007 to 2015 and from 2015 to 2017) should be analysed separately.

The period from 2007 to 2015

Privatization attempts by the ruling coalition (PO-PSL) were half-hearted. On the one hand, out of 56 companies controlled by MoT with assets above PLN 1 billion (\$266 million) only three companies were fully privatized. On the other hand, MoF successfully privatized 735 smaller companies and the Ministry of Infrastructure successfully

restructured and initiated the privatization of railway companies.

Despite huge amounts of stocks sold by MoT in the largest companies, transactions were structured in such a way that MoT was able to retain control. Between 2008 and 2015 MoT received PLN 48.2 billion (\$12.9 billion)³¹ from the sale of shares in 56 biggest companies, but only in three of them MoT gave control to private investors. To put it into perspective, the total revenue from privatization can be disaggregated into:

- PLN 31.57 (\$8.41 billion) from transactions in which MoT sold shares but remained the largest(controlling) shareholder;
- PLN 9.16 billion (\$2.44 billion) from transactions in which SOEs bought shares of other SOEs;
- PLN 5.56 billion (\$1.47 billion) disinvestment from companies in which MoT did not have control;
- PLN 1.91 billion (\$0.51 billion) from genuine privatization (Ciech SA, Zespół Eletrowni Pątnów Adamów Konin SA, Polski Holding Farmaceutyczny SA).

More progress was made in case of smaller companies. A total of 573 companies were sold for PLN 8.35 billion (\$2.2 billion) and 162 companies were transferred to local governments.

In addition, the Ministry of Infrastructure followed the privatization agenda as regards railway companies. During the period between 2012 and 2015, state-owned Polish Railways (PKP) sold noncore businesses (cable railway, energy, telecommunication and real estate) for PLN 1.9 billion (\$0.51 billion). Also, a cargo company went through an initial public offering (IPO) and although PKP remained the main shareholder, the process brought more transparency into the

³¹ Exchange rate: USD 1.00 = PLN 3.75

company and generated a revenue of PLN 2 billion (\$0.53 billion) for the parent company. Revenues from privatization were used by PKP to deleverage. Overall, PO-PSL privatized many small companies and brought transparency into some larger companies that, regrettably, remain under a strong influence of politicians.

However, the new government (PiS) has openly declared that no further privatization will be made and dismantled MoT, making relevant ministers responsible for controlling and developing SOEs in various sectors. Such a significant change induced infighting between ministers for most valuable companies and highly paid positions they offer, so it is too early to indicate how the new structure of governance will look like.³² Although PiS has publicly criticized privatization efforts of the previous government, until now no court confirmed the accusations of mismanagement by PO-PSL. The PiS government continues a dangerous policy of increasing public ownership in the banking sector. For example, backed by the government, PZU has become the major shareholder in Pekao, the second largest bank in Poland.

The biggest SOEs controlled by the central government

The role that SOEs play in the Polish economy is much larger than it would stem from their share in employment (5.6 percent of workforce) as state ownership is concentrated in the biggest companies. In 2016, out of the 50 biggest companies in Poland 18 were controlled by government. Table 5 provides an overview of WIG-20 companies (Warsaw Stock Exchange Index of the biggest companies). Twelve out of twenty companies in the index are controlled by the government, either directly or through another state-owned entities. It should also be noted that some SOEs control investment and pension funds that hold shares in other SOEs.

³² *The most spectacular fight was between the Minister of Development and the Minister of Justice over the controls of PZU the biggest Polish insurance company; in order to quell the fights within the ruling party, the Prime Minister had to take control over the company.*

Policy issues

State control among the biggest companies in Poland result in serious policy issues. An extensive involvement of SOEs in upstream sectors affects the efficiency of the Polish economy. Research by Bouis and Duval (2011)³³ shows that in OECD countries less competitive upstream markets (more regulation and state ownership) negatively affect productivity. With particularly rigid markets (as measured by PMR indicator), Poland is among the countries that can reap the biggest gains from privatization and liberalization. Bouis and Duval (2011)³⁴ estimate that privatization could increase the Polish GDP by 15 percent within a decade.

Besides more nuanced impact that state ownership has on productivity (as measured by Total Factor Productivity, TFP), more direct results of political interference into management are observed. Currently, the best example is the involvement of state-owned energy companies in supporting coal mining enterprises. In Poland coal mines were restructured in the 90s, but remained state-owned. Pressure from labour unions and a lack of proper corporate governance during the period of high coal prices after 2000 wages went up and investment outlays were neglected. With high wages and low efficiency, companies were caught unprepared by the fall of coal prices after 2011. In order to keep trade unions satisfied, politicians kept subsidizing inefficient companies at the expense of more productive ones. As coal companies run out of money, they pressed the state-controlled energy companies to "invest" into mining.

The increasing government's involvement in the banking sector is a serious concern. Although the biggest Polish bank (PKO BP) has never been privatized and remains state-owned, until recently it had to operate in competitive environment of private, mainly foreign banks. Recently, however, the state controlled PZU has taken over Alior and Pekao (the second largest bank), increasing the

³³ Bouis, R., Douval, R., „Potential growth after the crisis”, OECD, 2011.

³⁴ *Ibid.*

market share of state-controlled banks from 24 percent to 38 percent (of total banking assets). The government argued that more involvement of domestic capital in the banking sector is needed as during the crisis credit from foreign banks contracted due to problems of their mother companies, while credit from domestic banks proved to be much more stable (Adams-Kane et al. 2017³⁵, Temesvary and Banai 2016). Although such an argument is true, it should also be noted that public ownership in the banking sector is also a source of serious risks (see World Bank 2001 for a general overview and De Marco i Macchiavelli, 2016³⁷, Englmaier and Stowasser 2016³⁸, Jackiewicz et al. 2013³⁹, Claessens, Feijen and Laeven 2008⁴⁰, Damijan, 2012⁴¹ for more recent research) as state-controlled listed banks tend to have considerably lower capitalization to book value ratio compared to their private counterparts.

Conclusions

During the last 10 years privatization in Poland was in retreat. Although PO-PSL coalition (in power from 2007 to 2015) privatized 735 smaller companies, it has retained or even increased its control over the biggest companies, inducing state owned company to buy one of the largest private banks (Alior). The new government formed by PiS (in power since 2015) openly declared the end of privatization and with the purchase of Pekao (second biggest bank in Poland) further increased state ownership. State ownership remains a serious issue as the state controls 12 out of 20 companies in WIG-20 (the stock index of the biggest companies) with negative consequences for productivity and growth prospects of the Polish economy.

35 Adams-Kane, J., Caballero, J. A. and Lim, J. J., „Foreign Bank Behaviour during Financial Crises”. *Journal of Money, Credit and Banking*, 49: 351-392. doi:10.1111/jmcb.12382, 2017.

36 World Bank, „Finance for Growth policy choices in a volatile world”, World Bank and Oxford University Press, 2001.

37 De Marco, F., Macchiavelli, M., „The Political Origin of Home Bias: the case of Europe”, *Finance and Economics Discussion Series 2016-060*, Washington: Board of Governors of the Federal Reserve System, 2016.

Retrieved from <http://dx.doi.org/10.17016/FEDS.2016.060>

38 Englmaier, F., Stowasser, T., „Electoral Cycles in Savings Bank Lending”, *Journal of the European Economic Association*, 2016.

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https://www.eeassoc.org/doc/paper/20160613_215703_ENGLMAIER_STOWASSER.PDF

39 Jackowicz K., Kowalewski O., Kozłowski Ł., „The influence of political factors on commercial banks in Central European countries” *Journal of Financial Stability*, Elsevier, vol. 9(4), str. 759-777, 2013; Temesvary J, A. Banai, „The Drivers of Foreign Bank Lending in Central and Eastern Europe”: The Roles of Parent, Subsidiary and Host Market Traits, 2016.

40 Claessens, S., Feijen, E., Laeven, L., „Political connections and preferential access to finance: The role of campaign contributions”, *Journal of Financial Economics* 88(3):554-580, 2008.

41 Damijan, J., „What Went Wrong in Slovenia?”, *OpEd in Die Presse*, September 8th., 2012.

Table 5. WIG-20 companies in Poland in 2017

SOE	Capitalization (July, 2017) Billion EUR	Book value, billion EUR	Sector	Share owned by the government /SOE	Share owned by investment/ pension funds controlled by SOE
PKNORLEN	12,9	7,7	Primary sector	32 %	6 %
PKOBP	11,5	8,9	Finance	29 %	5 %
PZU	10,2	3,7	Finance	34%	2%
PGNIG	9,9	8,9	Electricity and gas	72%	2%
BZWBK	9,3	5,4	Finance		
PEKAO	8,8	6,2	Finance	33%	2%
PGE	6,0	11,6	Electricity and gas	57%	6%
KGHM	5,9	4,4	Primary sectors	32%	6%
MBANK	5,2	3,5	Finance		
CYFRPLSAT	4,2	3,1	Other activities (Telecom)		
LPP	3,4	0,5	Other activities (Retail)		
LOTOS	2,6	2,5	Primary sectors	53%	8%
CCC	2,5	0,2	Other activities (Retail)		
JSW	2,3	1,3	Primary sectors	55%	3%
ALIOR	2,1	1,7	Finance	31%	14%
ORANGEPL	1,8	2,7	Other activities (Telecom)		
TAURONPE	1,6	4,6	Electricity and gas	40%	4%
EUROCASH	1,2	0,3	Other activities (Retail)		
ENERGA	1,1	2,4	Electricity and gas	52%	3%
ASSECOPOL	1,1	1,5	Other activities (IT)		

Source: FOR's calculation based on <https://stooq.pl>

SLOVAKIA

Like all ex-communist countries, Slovakia has entered the post-89 period with companies solely in the hands of the state. These enterprises were privatized in two large waves

The golden era of privatisation⁴²

The first wave. The majority of SOEs had been privatized between 1990 and 1995, either by direct sale, or via voucher system. Direct sale of the smaller enterprises (hairdressers and pubs) often involved employees, while the big companies were usually sold to persons with strong ties to the government. The voucher system offered a “coupon book” to all adult citizens (for a symbolic price) that could be allocated to the selected companies (through auctions) thus making one a shareholder. In almost all cases the ownership was completely transferred. What remained was a handful of big utility companies, rail and bus companies, the mail service and several dozen of smaller companies, usually with some specific function (airports, hospitals, testing facilities, etc.) The majority of new owners came from Slovak nationals, with some exceptions (VW investment into the Bratislava car factory BAS).

The second wave of privatization came with the two reform governments at the beginning of the millennium. In the years 2002-2004, part of the stakes in the utilities were sold to foreign investors. The state kept 51 percent of shares (with the exception of the power generator Slovenske Elektrarne, where only 34 percent was retained by the state and Telecom with 49 percent stake). However, the state surrendered its

managerial control to the investors. The privatisation process of seventeen regional bus companies started in mid-nineties and finished a decade later. Water utilities have been transfer to municipalities and consequently sublet to private operators. A handful of new SOEs were established at the end of the period, serving as entities established for a specific reason, mainly for development (industrial parks, highways, etc.)

The first wave of privatisation is considered to be very controversial, especially because big industrial companies were quickly drained of any valuable assets by their new owners and many of them collapsed. Meanwhile, smaller shareholders were usually squeezed out by big players thanks to the poor rule of law in financial, accounting and holding matters.

The second wave proved to be much more successful, largely due to different political environment in the country. Some of the privatized companies turned into well-known, high-performing and respected international players (Enel, GDF Suez, Deutsche Telecom, etc.) though some concerns were raised about their selling price which was considered too low or influenced by corruption.

The change of attitude towards SOEs after 2006

The attitude towards privatisation changed with the new government coming into power in 2006. Besides intensive rhetorical condemning of the previous privatisation, the ongoing privatisation process of the Bratislava Airport and CARGO (rail freight transport) was abandoned. The core of the government has remained unchanged until today, so had its official attitude towards privatisation of state-owned enterprises. In 2009, after a major employer in central Slovakia filed for bankruptcy,

42 Bačišin, V., Dejiny slovenskej privatizácie (2012),
retrieved from
<http://www.senicanahlas.estranky.sk/clanky/slovensko/dejiny-slovenskej-privatizacie.html>

the government adopted a law⁴³ on "strategic companies". this controversial law gave the government the right of the first buyer for "strategic companies"⁴⁴ in case of bankruptcy. however, it has never been used prior to its major revision a year later⁴⁵. the topic of "strategic companies" surfaced again with the new government in 2016. the law would ban the privatisation of such companies, but has not turned into reality yet.

Yet, despite the rhetoric, there were some opportunistic moments. The government, for example, tendered a collection of new electronic road tolls to a private company.

However, the financial crisis revealed chronic economic problems of some SOEs. The best example is the CARGO due to a massive decline in revenue, the company had to be rescued by a substantial state subsidy shortly after the privatisation offer was declined. To keep the company afloat, it had to be segmented, selling its key assets (all freight cars) to investors. But the only major privatisation since 2006 was the sale of the remaining 49 percent of Telecom shares to the majority holder in 2015. In the opposite direction, the government recovered 49 percent of the SPP parent company of the Slovak gas holding in 2014. However, when (and if) this step will materialize is uncertain. In the last years, the relationship between the owner (ENEL) and the government substantially deteriorated, which culminated in a one-sided revocation of a 30-year lease contract on the biggest hydro power plant (which was not included in the original privatisation deal) by the government in 2015.

Therefore, it is safe to conclude that in the period between 2007 and 2016 the position of state ownership in Slovakia's economy has changed rather marginally. The total number of SOEs fluctuated, but it was mainly the result of formal mergers of some SOEs.

Formal management of shares in SOEs

The majority of SOEs were formally registered as "state companies", a special legal form in the 90s. This legal form was associated with some restrictions on the management (limited ability to transform assets being one of the foremost), so those companies were gradually changed into standard legal entities. Only 27 percent of SOEs are registered as "state companies" today. The majority of these operate in agriculture and forestry sectors, with some exceptions. For example, the Slovak Railway company has a special legal form and is governed by a separate law.

The majority of the companies to be privatized were then transferred to a special state equity fund "Fond národného majetku" (National Assets Fund), which was responsible for the formal side of management and privatisation. SOEs not intended for privatisation have been formally held under the ownership of respective ministries (the Ministry of Economy for utilities, the Ministry of Transport for rail companies or post, etc.) Ministries are also the responsible shareholders in the companies, where private investors hold managerial control, despite having minority share. There are five companies where the state acts as a minority shareholder, the biggest one being the Slovenske elektrarne. These also include two airports co-owned by the regions, the natural resources storage company (private investors) and the joint venture of state and the city of Bratislava for the development of public transportation.

43 Law 409/2009 (Strategic companies Law: 2009-2010 version), retrieved from <https://www.slov-lex.sk/pravne-predpisy/SK/ZZ/2009/493/20091201.html>

44 The law defined a strategic company as one having 500+ employees, or supplying considerable amount of gas or electricity, or operating a dam, a sewage system or water treatment utilities

45 The existing law focuses on setting tax and duty rules on some categories of companies under destructuralisation and has not much in common with the first version of the law

The fund was finally disbanded in 2016. The remaining SOEs in its portfolio were transferred under ministries and unsettled liabilities and obligations were transferred to a new joint-stock company. The existence of the fund helped to facilitate the second wave of privatisation, but it had to bear multiple accusations of succumbing to strong political influence during the process. The fund did not avoid the biggest political scandal of the decade as well

Recently, an idea to create an "energy holding" emerged within the government. The holding would concentrate all stakes in energy utilities, which are the most valuable SOEs in market value terms. However, the realisation of this idea is uncertain due to a potential clash with the unbundling rules of the EU (the holding would pool the national grid operator, distributors and power generators).

There has been no coherent general strategy for SOEs, with each ministry pursuing its own goals.

A lack of long-term strategic management, the pressure to retain employment (4 out of 10 biggest employers in Slovakia are SOEs with a public share of 100 percent and a combined workforce of 40,000), political nominations to the top managerial position and low transparency of decision-making turned many SOEs into chronic economic underperformers.

Topology of Slovak SOEs in 2015⁴⁶

In 2015, eleven ministries and two governmental agencies were shareholders or owners of 65 SOEs. The state held the majority in 59 companies (though four companies were managed by the minority shareholders) with over 95 percent of shares in 56 of them. The total book value of equity was €19.4 billion and equity weighted by share was €16 billion.

The majority of equity is concentrated under the Ministry of Transport (€6.6 billion in weighted equity) and the Ministry of Economy (€5.3 billion in weighted equity). The biggest holdings are the National Motorway Company (100 percent, €3.5 billion), SPP - Slovak Gas Industry (100 percent, €2.6 billion⁴⁷) and the Railways of the Slovak Republic (100 percent, €1.6 billion).

In Slovakia SOEs have over 60,000 employees (some of the smaller companies do not publish official numbers). The three rail companies and the Slovak Post employ around 40,000 of them. Major employers also include the state health insurer (2,000 employees), the National Highway Company (1,500 employees) and the co-owned power generation and electricity distribution companies (over 5,000 employees across four companies)

There were thirteen SOEs in the transportation sector, nine in primary sector, seven in gas and electricity, five in finance, two in manufacturing, two in other utilities and some in other sectors.

None of the SOEs are listed on the stock exchange. This is due to the extremely small size of the Bratislava Stock Exchange. The privatisation of the Slovak Post via IPO has recently been suggested as a way to revive the stagnating stock exchange, but with no progress to this date.

No long-term concept for SOEs

While many SOEs have been privatized, the influence of the state remains strong in some sectors, especially in rail transport and energy. There is no clear economic strategy or concept for SOEs. The management lacks transparency as important positions are often filled with political supporters and suppliers have ties to political stakeholders. Some SOEs are notorious for providing low quality services and inability to compete with private providers on the market and it was only recently that some attempts to introduce standard goal-oriented management processes emerged.

⁴⁶ The list of SOEs is taken from Annex 3 of the Public Budget Law, retrieved from

<http://www.finance.gov.sk/Default.aspx?CatID=11224>
Financial data acquired via Finstat.sk.

⁴⁷ SPP is a holding with 51 percent stake in a number of energy companies across Slovakia. The remaining 49 percent in its subsidiaries is held by private investors, holding managerial control.

Conclusions

1. There are ample economic reasons for privatizing SOEs, yet quite often due to non-economic rationale and arguments privatization is not undertaken.

2. SOEs should be treated as a measure of last resort, yet often they are seen as the "default" option by politicians.

3. Existing and newly created SOEs pose tangible threats to competition, regulation and economic efficiency. In order to minimize these threats, a comprehensive impact assessment should be undertaken prior to establishing SOEs. This assessment should at least cover the following points:

- First, there is a need to verify the validity of the problem to be addressed by establishing an SOE. For example, if goods or services that are unavailable on the market are necessary for a consumer and if the consumer could not find a substitute for them.
- If there is a need to address a well-founded problem, it should be established if the problem does not stem from government regulation. If so, regulatory obstacles should be eliminated, providing sufficient time for the market to solve the problem.
- Even if the problem does not stem from regulatory practices, all possible alternatives should be considered. The best alternative should be selected based on a cost-benefit analysis and the assessment of alternative costs and risks.

- The rationales for state ownership should be kept under a continuous review to reflect market changes and examine the possibilities of privatisation.

4. The countries under analysis have a different regulation of the establishment of SOEs. Lithuania and Estonia have separate legal acts on the establishment of SOEs, in Slovakia SOEs are established as ordinary commercial companies and Bulgaria and Poland do not regulate the establishment of SOEs separately. Yet, the latter has a law on the establishment of local SOEs. The absence of clear legal framework for establishing new SOEs allows politicians to create new government businesses without proper impact assessment, cost-benefit analysis, or estimates how new SOEs affect competition, what burden they create for taxpayers.

5. In most countries, decisions to expand or reduce the market share of the state and to follow or disregard OECD recommendations depend on political will and usually change together with the government. Therefore, their policies are inconsistent and unsustainable. Estonia is probably the only country that has improved its SOE management throughout the last decade.

6. The establishment and management of SOEs depend on governments that struggle to align their interests as owners, market regulators, competitors and elected representatives. Simply put, being a competitor with infinite financial resources and a market regulator with the power to set its own rules of the game, the state undermines the business and competitive environment for private enterprise. As a result, states face difficulty in ensuring free competition.



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