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Government ownership: Why this time it should work

There are good reasons to believe that government intervention today will be far less damaging than past experience would indicate.

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This is a Conversation Starter, one in a series of invited opinions on topical issues. In this essay, independent adviser and law professor Simon Wong lays out five reasons why recent government investments in private companies might avoid the hazards experienced by state-owned enterprises in the past. Read the essay, and then share your thoughts by writing a letter to the editor.

Taxpayers are anxious. In Germany, Ireland, the United Kingdom, the United States, and elsewhere, governments have acquired substantial stakes in—and in some cases full ownership of—a number of private firms in efforts to revive economies that were teetering on the edge of collapse. Yet historically, government ownership of private companies has been notorious for lowering productivity, wasting resources, and distorting competition—often as a result of unclear objectives, political interference, lack of discipline, and poor transparency.[1]

In Italy, for example, persistent political interference in state-owned companies—including railways, postal service, and public transport, among others—has significantly hampered their productivity, efficiency, and profitability. One government-owned US rail operator relies on government support in excess of $1 billion a year to cover its costs, in part because of government-mandated obligations to serve unprofitable routes. Similarly, the World Bank has concluded that, in emerging markets, a banking sector dominated by state-owned firms poses a threat to economic development and stability—as preferential lending and patronage creates market distortions and chases away private competitors.

But there are good reasons to believe that taxpayers may be spared these governance failures this time. A scan of the predicaments in which governments currently find themselves reveals five structural characteristics—shaped both by circumstances and by design—that should reassure the public that government intervention today will be far less damaging than past experience would indicate. Furthermore, if government leaders can share best practices for putting certain safeguards in place, they could instill the public with greater confidence that they are acting not only to insulate government-held firms from inappropriate political influence but also with the companies' best commercial interests in mind.

First, Western governments have been *forced* into equity ownership. In the past, owning commercial enterprises was an integral part of the governing philosophy in many liberal democracies; today, most Western governments maintain a strong aversion to such stakes. In the United Kingdom and the United States, government officials have repeatedly proclaimed that they are "reluctant" shareholders and pledged to manage their ownership stakes in a commercial manner.

Second, the UK and US governments insist that they will seek to sell their holdings as soon as possible. In the United Kingdom, the Treasury has also pledged to "maximize sustainable value for the taxpayer." The desire and necessity to sell their stakes to private investors at a profit (or minimal loss) means that the government must pay close attention to its interventions. Politically driven actions—such as pursuing politically popular projects or interceding on plant constructions and closures—could reduce the value of government holdings.

[1]For a fuller discussion of the role these issues play in the poor performance of state-owned enterprises, see Simon C. Y. Wong, "Improving corporate governance at SOEs: An integrated approach," *Corporate Governance International,* 2004, Volume 7, Number 2, June 2004.

Third, a limited number of capital injections—rather than budgetary and operational support distributed over years and decades—makes it is easier for the public to measure the value created or lost and to hold governments accountable for their performance.

Fourth, with record budget deficits looming, governments can ill afford to engage in wasteful spending at bailed-out firms. Standard & Poor's has already served notice to the British government that spiraling debt levels are endangering its AAA credit rating. The United States, notwithstanding the dollar's status as a reserve currency, may meet a similar fate—particularly as foreign governments grow reluctant to continue financing US deficits.

Finally, as a signal of their discomfort, many governments have kept a portion of companies' ownership in private hands by holding preference shares or nonvoting common stock. Retaining a public float enables these firms to maintain their stock exchange listings, which carry mandatory reporting requirements that both preserve high levels of transparency and compel governments to consider the impact of their actions on other shareholders. Furthermore, as the owners of smaller but continuing stakes in these enterprises, shareholders themselves still have an incentive to hold governments accountable for company performance.

Despite this relatively favorable starting point, governments will have to resist the temptation to interfere politically, particularly as elections approach and regarding bailed-out companies that must be held for longer periods of time. But on that score, governments can learn from a number of countries, such as Sweden and the United Kingdom, on what safeguards should be put in place to enhance their ability to oversee these enterprises at arm's length.

As the first step to success, governments must establish a baseline for evaluating their own performance as owners. They should clearly state the objectives for their holdings. The UK Treasury, for instance, has laid out three overall aims for its financial sector interests: maximize sustainable value for the taxpayer, maintain financial stability, and promote competition.

Furthermore, governments should define and announce their "rules of engagement," including the areas in which they will intervene and which government entities are empowered to do so. The UK government, for example, has created UK Financial Investments (UKFI) to manage its financial-sector investments. Described as an arm's length, government-owned company ultimately accountable to Parliament, its specific responsibilities are to develop and execute an exit strategy for the government, work with bank boards to strengthen their membership, develop financial incentives for bank management based on maximizing long-term value, and exercise all ordinary rights and responsibilities of a shareholder.

Equally important, the UK government expressly forbids the UKFI from intervening in the day-to-day management of these enterprises. As a distinct intermediary body, the UKFI helps to differentiate the government's shareholder role from its regulatory role and other functions. The UKFI also provides a layer of insulation from political meddling, which in turn reduces the likelihood that politicians will be blamed for controversial decisions such as layoffs or plant closures. Moreover, this structure allows the government to extricate itself from its equity holdings as smoothly as possible.

While establishing the UKFI and spelling out its remit were good first steps, Parliament, the Treasury, and other UK government agencies must also define the limits of authority for each

government body. To reduce the prospect of investee companies receiving conflicting guidance or demands, the UKFI must also coordinate its activities with other regulatory bodies and establish proper protocols for what agencies are responsible for what tasks.

Experience in various countries has shown that a critical factor in successfully avoiding undue political interference is strong, unequivocal, and sustained support at the apex of government. Political leaders at the highest levels must regularly reiterate support for managing government-owned firms on a commercial basis and at arm's length.

In the United States, the fragmented financial regulatory structure and ambiguity over the limits of each agency's authority has caused confusion as to which government agency is ultimately responsible for nursing bailed-out firms back to health. Making matters worse, regulators have allegedly clashed on such matters as whether the senior leadership of Citigroup should be replaced and what financial health rating it should be assigned.

Moreover, from the outside, the governance arrangements in place to manage the US government's stakes look problematic because they appear to separate voting power (which is entrusted to independent trustees) from strategic influence (which resides in the Treasury and the regulatory agencies). As a matter of good corporate governance—as well as to ensure coherent decision making—voting rights and strategic influence should go hand in hand. The UKFI, for example, can legitimately influence the strategy and board composition at government-controlled banks precisely because it possesses the authority to vote the UK government's shares in these institutions. For these reasons, the US government should establish an equivalent intermediary body.

Where governments pursue public-policy objectives, they should be separately funded or underpinned by commercial principles. In New Zealand, the government must obtain separate appropriations from Parliament to subsidize the development of local programming at state broadcaster TVNZ. In return for government financial assistance, Royal Bank of Scotland (RBS) agreed to maintain lending to home owners and small businesses at 2007 levels for three years. This condition, however, is based on the premise that RBS can price its loans competitively.

Another way in which governments can show their commitment to a high level of transparency is to formally announce a timetable on exiting its investments. Though no government has done this, yet, announcing even a preliminary timetable would help ensure that work is carried out with focus and discipline. Thereafter, governments should publish regular updates, at least twice a year, on their progress.

While these safeguards cannot guarantee the elimination of unwarranted political intrusions, they could reduce the likelihood and severity of such issues. Of course, the true test of how durable these safeguards will be is highly predictable—stay tuned as elections approach. Q

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