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OF THE REPUBLIC OF SOUTH AFRICA

REPORT ON STATE-OWNED ENTERPRISES FOR THE STANDING COMMITTEE ON FINANCE

March 2015

Parliamentary Budget Office

The Parliamentary Budget Office (PBO) has been established in terms of the Money Bills Amendment Procedure and Related Matters Act, 2009 (Act no. 9 of 2009). The main objective of the PBO is to provide independent, objective and professional advice and analysis to Parliament on matters related to the Budget and other money Bills. The PBO supports the implementation of the Act by undertaking research and analysis for the finance and appropriations committees.

This report has been compiled in response to a request sent from the Chairperson of the Standing Committee on Finance in Parliament. The Committee asked the PBO to analyse the financing of state-owned enterprises, and the disposal of state assets, in light of proposals in the 2014 Medium-Term Budget Policy Statement.

Please note that this document is a shortened overview of the full report. For a more detailed analysis including references, please refer to the full report.

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EXECUTIVE SUMMARY

State-owned enterprises (SOEs) are legal entities created by government to undertake commercial activities on its behalf. As in other countries, SOEs play a critical role in the South African economy and their financial status is an important component of public finance oversight.

There has been some confusion in terminology, partly caused by the two main pieces of legislation in this area: the Companies Act and the Public Finance Management Act (PFMA). State-owned *entities* are public entities as defined in the PFMA and include a wide variety of organisational forms and objectives. Within this are state-owned *enterprises* under Schedule 2 of the PFMA – also referred to as 'government business enterprises' and 'major public entities'. The term 'state-owned company' (SOCs) refers to SOEs that are also governed by the Companies Act. For reasons discussed below, the current report is primarily concerned with SOCs, but we will use the more common acronym 'SOE' – in line with current usage. The analysis excludes development finance institutions.

Introduction

State ownership of enterprises occurs for a variety of broad reasons that are common across many countries. An SOE may resolve a 'market failure'; where the private sector does not undertake investment or production in a certain area despite it yielding a net benefit to society. Another reason is 'natural monopoly', where government owns an enterprise to limit the negative consequences of monopoly power that arises from a sector's structure. Enterprises that are relevant to national security, or securing supply of a critical resource, are often referred to as 'strategic' and placed under state ownership. Another important role of SOEs has been ensuring equity in citizens' access to critical services or infrastructure.

Since 1994, SOE policy has passed through two main phases: privatisation and restructuring. More recently, a third phase of 'rationalisation' has begun that attempts to align SOEs explicitly with the broader notion of a developmental state.

According to the National Treasury, in 2013/14 state-owned companies in South Africa: generated R260 billion in revenue, compared to the R810 billion raised by government; had R467 billion in interest-bearing debt, compared to R1 400 billion for government; and spent R110 billion on infrastructure, compared to government's R104 billion. These figures reflect particularly large roles in the transport (Transnet, ACSA, PRASA, SANRAL, SAA and SA Express), energy (Eskom), communications and telecommunications (Post Office, Sentech, Broadband Infraco), and defence (Armscor and Denel) sectors.

The current report arises from the financing and policy proposals relating to SOEs in the recent 2014 Medium-Term Budget Policy Statement (MTBPS). With at least two SOEs – Eskom and South African Airways (SAA) – facing financial difficulties in a context of falling economic growth and government revenue collection, this raises important questions regarding short- and long-term approaches to SOE financing. The three specific proposals, or policy statements, in the MTBPS were:

1. "[developing] a new framework for funding state-owned companies that will distinguish purely commercial activities from the costs of exercising their developmental mandates"
2. "state-owned companies should operate on the strength of their balance sheets"
3. "capitalisation will only be funded by the sale of non-strategic state assets, and will not be drawn from tax revenue or added to the debt of national government".

These form the basis for the current report prepared by the Parliamentary Budget Office (PBO) – as per its mandate under the Money Bills Amendment Procedure and Related Matters Act (2009), to support the finance and appropriations committees of Parliament in exercising oversight over public finances.

The analysis is based on a review of relevant literature, policy documents and publicly available information. Additional information, or clarity, was obtained from National Treasury on various issues, but detailed information on state assets and SOE balance sheets was not forthcoming. The analysis gives detailed consideration to the research and recommendations of the Presidential Review Committee on State-Owned Entities (PRC), which was established in 2010 and completed its work in 2012. The PRC examined all state-owned entities, whereas the current report focuses on state-owned *enterprises*. A database of entities was developed for the PRC, but has not been updated since 2012 and the PBO could not access it through the HSRC where it is currently housed.

At an institutional level, the PRC has recommended that a 'transitional SOE reforms committee' be established along with an 'SOE Council of Ministers'. These two structures could then take forward the PRC's recommendations.

On the legislative front, the PRC has recommended that, "Government should enact a single overarching law ('State-owned Entities Act') governing all SOEs" based on the General Shareholder Management (GSM) Bill. This Bill was drafted by the Department of Public Enterprises in 2008, but has not yet been tabled in Parliament. The GSM Bill is intended to provide an overarching legislative framework for the governance and management of SOEs. That would resolve inconsistencies or omissions across the PFMA, the Companies Act and various corporation-specific Acts.

Issues of governance, or performance monitoring and evaluation, are not part of the current report. (An exception is the issue of shareholder compacts discussed further below). Nevertheless, governance is fundamental for financial and operational performance, as well as ensuring consistency between SOE behaviour and the state's policy objectives. Measures to address financial performance must be coupled with measures to address any associated governance failures.

Every aspect of SOE policy, whether relating to finance or anything else, should be considered with reference to the primary purpose of that enterprise's existence. A challenge in the South African context is that the original reason for an SOE's establishment may be different from an appropriate role for it in the *current* economic and policy environment. For this and other reasons, the PRC suggested that government should, "periodically review and balance the social, political and economic priorities of SOEs". The analysis of non-commercial mandates and financing below supports that conclusion.

Parliamentary oversight of SOEs, including finances, has typically involved the Standing Committee on Public Accounts (SCOPA) and the Portfolio Committee on State-owned Enterprises. There may, however, be a greater role for the Standing Committee on Finance in the current context, given its oversight responsibilities relating to National Treasury and the fiscal framework.

Key issues

- It is important to clarify terminology. 'State-owned entity' is an overarching term that includes state-owned enterprises (SOEs). The Presidential Review Committee considered all forms of state-owned entity, whereas the current report focuses on SOEs.
- The current 'rationalisation' phase of SOE policy requires assessing whether SOEs are serving a worthwhile purpose in the context of a developmental state.
- The PRC has suggested establishing a 'transitional SOE reforms committee' and an 'SOE Council of Ministers' to consider and implement its recommendations.
- In relation to SOE governance, which is largely outside the scope of the current report, the PRC has endorsed the development of a uniform governance framework based on the draft Government Shareholder Management Bill.

- A database on state-owned entity finances was developed for the PRC's work, which was supposed to be updated annually and made publicly available. However, the database – currently housed at the HSRC – has not been updated since 2012 and is not available for use.
- The Standing Committee on Finance could play a greater role in oversight over SOE finances given its oversight of National Treasury and the fiscal framework.

State-owned enterprises and the developmental state

In the last decade, South Africa has pursued economic growth and development through policies inspired by the model of a 'developmental state'. Developmental states play an *active* role in pursuit of a particular vision for economic development. This is in contrast to 'regulatory states' where governments prefer to regulate economic activity rather than engaging in it themselves, or driving it in a particular direction.

Successful developmental states have been characterised as those that plan, coordinate and implement steps to achieve a vision for economic development. Doing this requires technical capacity and competence, an ability to establish social compacts, and avoiding capture by partisan interests.

SOEs present developmental states with an important mechanism to direct and influence the process of economic development. As noted above, since 1994 South Africa has taken different approaches to the role of its numerous SOEs in the pursuit of growth and development. Arguably the most important recent initiative was the establishment of the PRC. Its mandate was to assess whether state-owned entities, including SOEs, are playing an appropriate role in the context of a developmental state.

Based on current policy, South Africa's SOEs have been accorded a number of important responsibilities. Besides the typical tasks of providing public goods, basic rights and infrastructure, SOEs have been tasked with: enhancing the competitiveness of the economy; investing in economic infrastructure; stimulating growth; and fulfilling a range of industrial policy goals. The PRC report has indicated that any rationalisation of SOEs should take into account the importance of particular economic sectors. And the National Development Plan (NDP) suggests the introduction of private competition, where applicable, to improve SOE performance.

The PRC and the NDP have emphasised the need for SOEs to be financially sustainable, and to fulfil their roles in an equitable and cost effective manner. Both documents, along with many other analyses, also highlight the importance of state capacity for effective developmental states – a point that applies equally to SOE capacity and governance.

Key issues

- Developmental states are characterised by a more interventionist role in the economy and SOEs are a potential mechanism for directing economic development.
- Among the expectations of SOEs that may go beyond their more traditional roles are: investment in economic infrastructure; promotion of industrial policy; and increasing the competitiveness of South Africa's economy.
- As emphasised by the NDP and PRC, achieving such objectives – whether in SOEs or elsewhere in the developmental state – requires adequate capacity and good governance.

Non-commercial mandates

Government is proposing a new framework for funding state-owned companies that will distinguish purely commercial activities from the costs of exercising their developmental mandates (National Treasury, MTBPS)

The arms-length relationship created between government, as shareholder, and SOEs requires explicit communication of government's expectations of an enterprise. In the literature, these expectations are often divided into 'commercial' and 'non-commercial' mandates. A non-commercial mandate could be anything that a state-owned enterprise does, or is expected to do, that would not typically be required of a private company that maximises profit or financial returns to shareholders. Such expectations include: *expanding access* to services (such as electricity, water and telecommunications); providing *affordable services*, even for the poorest citizens; *investing in infrastructure* that has wider social and economic benefits; and providing, or generating, *employment*. Among the expectations one could add in the South African context are skills development, preferential procurement and small business development.

In principle non-commercial mandates, which include developmental mandates, should follow directly from the rationale for state ownership. Non-commercial mandates unrelated to the primary reason for an SOE's existence could arise where there is poor governance and vested interests.

In recent experience with SOEs in South Africa, inadequately funded non-commercial mandates have been blamed for the poor financial and operational performance of a number of enterprises. In the context of immediate measures needed to stabilise the balance sheets of institutions like Eskom and SAA, determining appropriate interventions is challenging in the absence of consistent separation of mandates.

Among the non-commercial mandates that have been claimed to negatively affect Eskom are: delayed maintenance and use of diesel turbines to minimise loadshedding; non-collection of municipal debt; inadequate tariff increases, to protect consumers and businesses; and empowerment requirements in the coal supply chain. In the SAA case, international routes that were deemed 'strategic' for South Africa are blamed for annual losses of over a billion Rand. Determining the accuracy of these claims is outside the scope of the current report. For immediate interventions the basic point is that such mandates must be factored into any diagnoses of, and solutions to, SOE financial and operational problems.

For long-term efforts to improve SOE management, the above examples suggest that a more transparent and systematic approach is required for non-commercial mandates in South Africa. There is increasing consensus in the local and international literature that non-commercial mandates should be stated and funded explicitly. Non-commercial mandates are sometimes funded implicitly by: reducing earnings expectations; allowing higher tariffs for an SOE's goods or services; cross-subsidisation within an SOE; cash transfers ('bailouts'); or, some combination of these. However, implicit financing makes it significantly harder to monitor an SOE's financial and operational performance or provide incentives for better performance. Furthermore, bailouts may take place where public finances are already constrained and therefore result in higher total public finance costs than the explicit funding of mandates.

Implicit funding also hinders prioritisation of mandates and prevents direct assessments of their financial feasibility. It is possible that relatively low priority mandates could compromise more important non-commercial mandates, or even the primary role of an SOE, due to their high cost. For these and other reasons, the NDP, PRC, the Organisation for Economic Cooperation and Development's SOE guidelines for the Southern African Development Community, and recent reports by international financial institutions, all endorse the clear separation and funding of mandates. It is important to note, however, that separation does not resolve financing problems so much as make them explicit.

Separating mandates has many practical implications and challenges. The main components of an explicit approach to funding non-commercial mandates are: identification of possible non-commercial mandates; development of clear operational versions of these mandates; costing of mandates; assessment of the fiscal and economic feasibility of the costs; prioritisation of mandates based on importance and cost; and, finally, formalisation of the operational and financial arrangements in an appropriate agreement with the SOE. In some countries the process involves 'commercialising' non-commercial mandates, by requiring SOEs to bid for contracts against private competitors – whether this is appropriate in South Africa is unclear. The structural reforms to SOE governance proposed by the PRC, including a single 'SOE Act', could be used to improve the way non-commercial mandates are currently determined, financed and monitored.

In the current legal framework within which South African SOEs operate, it appears most appropriate for non-commercial mandates and associated funding arrangements to be contained in SOE 'shareholder compacts'. These compacts, signed by an SOE and its shareholder ministry, are intended to serve as comprehensive performance agreements between the state and an SOE. The NDP has stated that these compacts should be made public. At present they do not appear to have been made available to Parliament, even though it is responsible for critical aspects of SOE oversight.

Key issues

- To what extent have non-commercial mandates, as opposed to inefficiencies or external factors, contributed to current SOE financing requirements?
- In the absence of a clear framework for funding non-commercial mandates, do new and existing SOE financing initiatives take into account the consequences of past and present approaches to funding non-commercial mandates?
- Are there instances in which the implicit financing of mandates is undermining the state's broader developmental objectives?
- Do the existing guidelines for shareholder compacts make adequate provision for mandate separation and funding?
- Given the critical role of shareholder compacts, and the recommendations of the NDP and PRC in this regard, what progress is being made in providing these to Parliament for oversight?
- What role, if any, can the draft Government Shareholder Management Bill play in addressing the separation and financing of non-commercial mandates?
- Are there instances in which commercial and non-commercial mandates are irreconcilable, and if so what might be the alternatives to separation in such cases?

Financing of SOEs

Though the state establishes SOEs this does not necessarily imply that they should receive state funding. As commercial enterprises, SOEs earn revenue and can borrow from financial markets – subject to PFMA regulations. There are three main reasons for government to finance an SOE: to ensure the enterprise has adequate capital to implement its mandate; to compensate for costs incurred from non-commercial mandates; and, to reduce SOEs' (and therefore total public) financing costs.

There are various mechanisms within the control or influence of the state that affect SOE finances. These can be broadly classified as either direct or indirect forms of financing. Direct funding, such as cash transfers and loans, receives a great deal of attention. However, where an SOE's funding is drawn primarily from commercial activities, indirect financing is usually more important. Since 2008, slower economic growth, lower revenue collection and growing government debt levels have led to a renewed emphasis on SOEs funding themselves with minimal direct state support. In this regard, the PRC report argued that SOEs may have been unnecessarily discouraged from taking-on debt. However, the National Treasury has since emphasised the precarious situation of some SOE's balance sheets. It is therefore not clear how much further SOE self-financing can be extended.

Successful SOE financing requires a balance between commercial financing and various forms of direct and indirect state financing. If any one source of financing is inadequate it may place a greater burden on other sources. Alternatively, if financing from one source is excessive, it will limit the efficacy of any conditions attached to other sources. Furthermore, different mechanisms and processes are likely to be required for financing related to infrastructure/investment programmes as opposed to financing of operational activities.

The two most important forms of *indirect financing* are guarantees (either for debt or public-private partnership contracts) and tariff regulation. In South Africa, the National Treasury is the final arbiter of guarantees, while responsibility for tariff regulation is typically assigned to independent economic regulators. In both cases oversight by the legislature has been limited.

In simple terms, a debt guarantee constitutes a promise by government to pay an SOE's debts, or interest costs, if it is unable to do so itself. Guarantees have two notable advantages. First, they reduce the burden on main government finances by increasing SOEs' own ability to borrow. Second, if government has better information about an SOE's prospects than financial markets it can reduce SOE borrowing costs to better reflect actual risk. However, guarantees also have limitations. They lead to *contingent liabilities* for the state: the risk that payments may be required in future if the SOE cannot meet its obligations. Those liabilities are now routinely factored into the debt sustainability analyses conducted by the International Monetary Fund (IMF) and credit ratings agencies. Shifting financial obligations in this way may therefore not have any positive effect on external assessments of South Africa's public finances. By helping to defer financial difficulties guarantees can also encourage inefficiencies and reduce oversight over public finances.

South Africa's net liability levels, including debt guarantees, are currently planned to stabilise at approximately 58% of GDP by 2017/18. This is more than Treasury's preferred maximum of 50%, but below SADC and IMF guidelines that state a 60% maximum. Debt guarantees utilised by SOEs total R224.9 billion in 2014/15; that is 5.8% of GDP from a lowest level of 2.6% of GDP in 2008/9. However, total guarantees issued by the National Treasury are R461.1 billion (11.9% of GDP). Closer monitoring of the risk to the fiscal framework posed by contingent liabilities may be advisable.

Tariffs for SOE goods and services are a second critical indirect financing mechanism, since they form the basis for an enterprise's commercial operations. The appropriate level for tariffs depends on an SOE's mandate. Whereas a private company may set tariffs to maximise profits, an SOE may want lower tariffs to ensure equitable access or higher tariffs to cross-subsidise other goods or services.

The PRC report notes that in practice *economic regulation* in South Africa appears to have had an unwarranted negative effect on SOE financial performance, by preventing tariff increases needed to finance large infrastructure programmes. Examples are Eskom's infrastructure programme and the Airport Company of South Africa's construction of King Shaka International Airport. In other cases, such as Transnet's reported use of revenues from port tariffs to cross-subsidise other operations, some studies argue that excessive tariffs have compromised industrial policy. Whatever the specifics, poor tariff-setting decisions mean that SOE finances may not accurately reflect an SOE's performance.

In the context of constrained public finances, the idea of obtaining greater SOE financing through tariffs is appealing. However, there are two reasons to be cautious in doing this. First, tariff increases may have negative distributional consequences, affecting the poorest the most. Second, to the extent that tariff increases discourage economic activity they may compound an underlying problem (declines in economic growth and revenue collection). Such 'administered price' increases contribute to inflation and may lead to the Reserve Bank increasing interest rates – with possibly negative consequences for economic growth.

Regulatory failures to date have partly been due to problems with regulators themselves. To a significant extent they have also arisen from unclear policy in relation to funding of infrastructure programmes, and the expectation that SOEs perform unfunded non-commercial mandates.

The guidance provided by the modern international literature on SOE financing is increasingly focused on the notion of '*competitive neutrality*': the idea that state support to SOEs should not benefit those enterprises relative to actual or potential private sector competitors. Although there is no overarching policy, South Africa has incrementally adopted a number of policies that effectively implement competitive neutrality principles. One example is the Treasury charging debt guarantee fees to SOEs. The PRC has also endorsed the role of economic regulators in applying principles of competitive neutrality. However, an unresolved concern is whether competitive neutrality is compatible with the developmental state orientation inherent in other policies.

The *PRC has recommended* that government "should address the issue of non-financially viable commercial SOEs…by considering some of the following options:

- Rationalisation of SOEs based on certain criteria; or
- Limit State involvement where technology disrupts natural monopolies; or
- Retaining and adequately funding them as non-commercial entities; or
- Injecting private sector practices and therefore gradually phasing them into commercial entities with a mix of public and private equity ownership; or
- Completely disposing of them as State entities; or
- Absorbing them into the line function department where there is a case for running them less costly as a Government line function.
- The final determination should be done in concurrence with the SOE Council of Ministers."

An important question that must be addressed prior to implementing such recommendations is how to assess 'financial viability' of SOEs. Simple assessments are likely to be compromised by problems and inconsistencies relating to non-commercial mandates, regulatory decisions and other forms of state funding. SOE balance sheets may therefore not be an accurate reflection of *potential* viability. The example of Independent Power Producers (IPPs) illustrates the possible dilemmas: IPPs have been proposed by some experts as a solution to Eskom's electricity supply limitations. At the same time, IPPs are reported to require higher tariffs than Eskom has been allowed. Setting appropriate tariff levels should arguably precede, or at least inform, any restructuring.

In the current context, with limited room for manoeuvrability in public finances and apparently large cash reserves being held by private sector firms, the *involvement of private capital* appears appealing. Restructuring of SOEs to facilitate this may be an important component of a new, comprehensive policy – as suggested by the PRC. Nevertheless, private equity financing – through selling a stake in an SOE – would have to be reconciled with the broader mandate of the relevant enterprise.

Difficulties in financing large infrastructure programmes have caused some of the current problems with South African SOEs' balance sheets. Private capital can potentially assist with financing there too, through public-private partnerships (PPPs). These come in various forms, but have two main purposes: to alleviate the immediate financing burden on the SOE and/or state; and, to utilise private sector technical expertise and capacity. It is important to note that PPPs typically smooth the total demand on government finances over a longer period, rather than actually reducing it. In the case of the Gautrain, for example, the state contributed 87% of the capital required and in 2013/14 still paid out an annual 'patronage guarantee' of R1.4 billion to the private operator. The case of E-tolls has also illustrated the complexity and risk of large PPPs. In short: if PPPs are used, this must be done carefully to ensure that they do not expose the state to excessive future financial, operational and political risks.

In considering the above approaches to resolving current SOE financing problems, the adequacy of the existing financing framework itself must first be determined. It is also necessary for the state to assess the extent to which current financial difficulties experienced by SOEs can be alleviated through improved governance and operational efficiencies. If such issues are neglected, restructuring or other innovative solutions may not deal with undesirable financial and operational performance of SOEs in way that best advances the public interest.

Key issues

- SOE financial performance is the result of different financing mechanisms. Where does the responsibility lie within government for ensuring that an appropriate balance is found?
- To what extent can existing financial challenges experienced by SOEs be alleviated through better management or a reorientation of operations and investment?
- The PRC makes a number of recommendations as to how the state can deal with 'non-financially viable' commercial SOEs, but assessing viability requires accounting for the relationship between *existing* financial performance and weaknesses in funding and policy frameworks.
- Economic regulation of SOE tariffs has been problematic, particularly in the context of large infrastructure programmes.
- The PRC envisages a uniform framework for economic regulation being implemented between 2020 and 2025; this may be a realistic timeframe, but what should happen with tariff-based financing until then?
- The relationship between developmental state economic policy and the principle of competitive neutrality must be adequately reconciled for consistency in SOE policy and regulation.
- What is National Treasury's plan to manage contingent liabilities over the MTEF, and how can Parliament improve its oversight of any associated risk to public finances?
- Can the use of private capital to reduce the burden on public finances be reconciled with the reason for state ownership of enterprises?
- PPPs may assist with spreading-out the burden of infrastructure financing, but can also expose the state to significant risk and could also be subject to greater Parliamentary oversight.
- For accountability and equity it is important to ensure that the financial burden and financial risk of SOE funding is distributed equitably over generations.

Disposal of state assets

Over the next two years, capital injections for Eskom and funding for other state-owned companies will be raised in a way that has no effect on the budget deficit. In some instances, government will dispose of non-strategic assets to raise resources for financial support. Such assets could include property, direct and indirect shareholdings in listed firms, non-strategic government shareholdings in state-owned companies and surplus cash balances in public entities. (National Treasury, MTBPS)

The 2014 MTBPS has indicated an intention to sell non-strategic state assets in order to fund interventions to strengthen the finances of some state-owned enterprises. The term 'non-strategic' has not been defined, though some examples have been provided in the MTBPS – as quoted above. The work of the PRC and other literature suggest some possible definitions, but ultimately it is for the executive to determine what SOEs and assets are unnecessary for attaining its social and economic objectives. The PBO was unable to obtain detailed information on categorisation of South Africa's state assets, or their value, from National Treasury.

Parliament has little direct oversight over asset sales. With that in mind, there are at least three components to Parliament's role in the process. First, the legislature must determine whether additional financing for SOEs should be obtained through asset sales rather than alternative mechanisms. If so, it must then consider whether the assets selected by the Executive are appropriate and whether the sale of these will have a net social benefit. Finally, Parliament needs to satisfy itself that the process of sale is designed to achieve, and does achieve, the stated objectives.

The merits of different financing mechanisms were discussed above. Whether it is appropriate to sell a particular state asset will first depend on the extent to which the asset is required to implement government policy. The Treasury's statement appears to imply a commitment that no asset required for implementing important policies will be sold.

Since the stated purpose of the disposal is to raise revenue, any proposal should be assessed by this standard. Two particular factors to consider regarding the design and implementation of the process are accurate valuation and choice of a revenue-maximising sale mechanism. Nevertheless, revenue maximisation should not compromise other government policies – as would happen if a stake in a natural monopoly was sold at a high price because buyers expect to earn monopoly profits.

The process should also be maximally transparent, except where there are convincing reasons to make an exception. In keeping with the principle of maximising social benefit through revenue maximisation, the process must also avoid rent-seeking – where private interests benefit from the asset being sold at below its market value.

It is not clear, as yet, how surplus cash balances of public entities might be used to provide direct funding to SOEs. In such cases Parliament would need to satisfy itself that a given surplus is genuinely unnecessary or is better utilised for SOE funding.

As noted by the Irish government's Review Group on State Assets and Liabilities: whatever the short-term objective of asset disposal, the process **"**should be assessed from the standpoint of its contribution to long-term economic recovery".

Key issues

- The National Treasury's decision to sell state assets to provide additional funding to SOEs implies that other funding mechanisms (tariffs, debt guarantees and so on) are inadequate for this purpose.
- Whether asset sales are appropriate, depends on whether the additional financing is justified and whether the requirement is best met through assets sales rather than one of the sources of SOE finance described in the previous section.
- Parliament has relatively little direct oversight over the disposal of state assets.
- As with other countries, there does not appear to be a comprehensive database of state assets with valuations that reflect likely market value – the database that does exist has not been provided to the Parliamentary Budget Office.
- Given the stated motivation for Treasury's proposal, the process of selecting and selling assets should prioritise the maximisation of revenue, without contradicting other government policy relating to economic growth and development.
- The commitment to only provide balance sheet support after receiving funds from asset sales could compromise revenue maximisation or SOE credit ratings, particularly with assets that cannot be sold quickly.
- The notion of a 'non-strategic' asset is not well-defined: it is either too narrow and fails to recognise the implications of a developmental state orientation, or is too broad to be useful.
- The sale of stakes in state-owned entities, or assets held by those entities, should ideally be consistent with broader policy decisions that emerge from the process proposed by the PRC report.
- Determining whether and how an asset should be sold must also involve considering the effects of a change in ownership – such as where the disposal of a state asset increases a private firm's market power.
- International and local best practice is to develop a clear and transparent process for disposal of state assets; in some instances exceptions may be necessary, but these are likely to further limit Parliamentary oversight.
- It is not clear, as yet, how surplus cash balances of public entities might be used to provide direct funding to SOEs.

1 INTRODUCTION AND OVERVIEW

State-owned enterprises (SOEs) are legal entities created by government to undertake commercial activities on its behalf. As they do in many other countries, SOEs play a critical role in the South African economy and their financial status is an important component of public finance oversight.

There has been some confusion in terminology, partly caused by the two main pieces of legislation in this area: the Companies Act and the Public Finance Management Act (PFMA). State-owned *entities* are public entities as defined in the PFMA and include a wide variety of organisational forms and objectives. Within this are state-owned enterprises, of which state-owned companies (SOCs) are a particular form denoted in the Companies Act. For reasons discussed below, the current report is primarily concerned with SOCs, but we will use the more common acronym 'SOE' – in line with current usage.

State-owned enterprises play a critical role in the South African economy, albeit to a lesser extent than in the pre-democracy era. A major challenge since 1994 has been the determination of appropriate roles for SOEs, along with relevant policy and governance frameworks, given successive governments' broader economic and social objectives and priorities.

Despite early expectations that the new state's political priority may be to expand the number and size of SOEs, in practice SOE policy has passed through two main phases to date: privatisation and restructuring (ANC, 2012). More recently a third phase of 'rationalisation' has begun that attempts to align SOEs explicitly with the broader notion of a developmental state.

However, the current macroeconomic and fiscal context compounds existing challenges and presents a number of additional dilemmas. The current report arises from the financing and policy proposals relating to SOEs in the recent 2014 Medium-Term Budget Policy Statement (MTBPS). Those proposals have been necessitated by a combination of severe challenges relating to SOE performance and finances, along with declines in economic growth and forecast revenue collection.

The National Treasury has proposed expenditure and debt ceilings in order to protect the fiscus, but these provide little room for increasing recurrent SOE financing or large once-off transfers. As we discuss later, there also appears to be some concern about the extent of government's guarantee exposure to SOEs and a desire to contain net public liabilities below a particular 'prudency threshold'.

With two large SOEs – Eskom and South African Airways (SAA) – facing financial difficulties, this has raised important questions regarding immediate funding interventions and the approach to SOE financing in general.

The three specific proposals, or policy statements, in the MTBPS were:

4. "a new framework for funding state-owned companies that will distinguish purely commercial activities from the costs of exercising their developmental mandates";
5. "policy remains that state-owned companies should operate on the strength of their balance sheets";
6. "capitalisation will only be funded by the sale of non-strategic state assets, and will not be drawn from tax revenue or added to the debt of national government".

These form the basis for the current report prepared by the Parliamentary Budget Office, as per its mandate under the Money Bills Amendment Procedure and Related Matters Act (2009) to support the finance and appropriations committees of Parliament in exercising oversight over public finances.

The report is based mostly on the existing local and international literature, policy documents, secondary data and – in relation to very recent developments – press statements and newspaper articles.

The analysis that follows builds to a significant extent on the research, recommendations and final report of the Presidential Review Committee on State-Owned Entities. The Committee was established in 2010 and completed its work in 2012. A high-level categorisation and summary of the PRC's recommendations is provided in Table A1 of the Appendix.

As the PRC report notes, it is important to be clear about terminology and distinguish between analysis of different kinds of state-owned entities. The PRC was tasked with examining *all* state-owned *entities* and uses the acronym 'SOE' in that way. It proposed a categorisation of entities into: commercial; DFIs; statutory corporations; non-commercial state-owned entities. The present report is concerned primarily with state-owned *enterprises*, of which state-owned companies are one sub-type, which would be considered 'commercial' entities under the PRC's definition. Figure 1, taken from the PRC report and based on prior work by the National Treasury and Department of Public Service and Administration, provides a valuable taxonomy of state-owned entities.

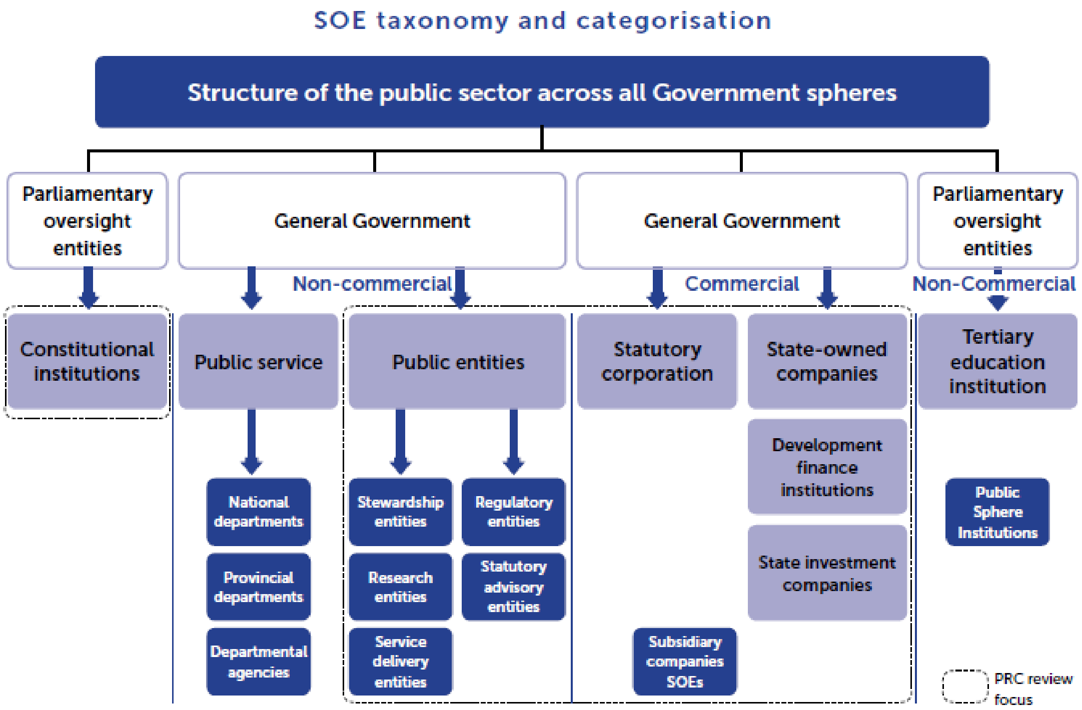

Figure 1 Presidential Review Commission categorisation of state-owned entities (source: PRC Report)

Although South Africa has a mixed economy dominated by the private sector, the scale of state-owned enterprise (SOE in the remainder of the report) operations is striking. According to the National Treasury, as of 2013/14 state-owned companies: generated R260billion in revenue compared to the R810billion raised by government; had R467billion in interest-bearing debt compared to R1,400billion for government; and, spent R110billion on infrastructure compared to government's R104billion (National Treasury, 2014). These figures reflect particularly large roles in the transport (Transnet, ACSA, PRASA, SANRAL, SAA and SA Express), energy (Eskom), communications and telecommunications (Post Office, Sentech, Broadbank Infraco) and defence (Armscor and Denel) sectors.

Recommendations by the PRC report that relate to the mandates and financing of SOEs are discussed further in sections below. At an institutional level, the PRC recommended that a ‘transitional SOE reforms committee’ be established with members appointed by the President, ‘central authorities’ (such as the National Treasury and Department of Public Enterprises) and other relevant government stakeholders. The President should also establish an ‘SOE Council of Ministers’. These two structures could then take forward the PRC recommendations.

An important legislative issue emphasised by the PRC is the General Shareholder Management (GSM) Bill, first drafted by the Department of Public Enterprises in 2008 but not yet tabled in Parliament. The purpose of the Bill is to provide an overarching, consistent legislative framework for the governance and management of SOEs. The Public Finance Management Act (PFMA) is currently the main piece of legislation governing SOEs, but there are others – such as the Companies Act and various corporation-specific Acts – with which it overlaps or differs. The PRC has recommended that, “Government should enact a single overarching law (‘State-owned Entities Act’) governing all SOEs” (PRC, 2012, p. 97) based on the GSM Bill.

The analysis that follows does not deal in much detail with issues of governance or performance monitoring and evaluation, as they are outside the scope of the current reports. Nevertheless, both sets of issues are fundamental for financial and operational performance, as well as ensuring consistency between SOE behaviour and the state’s policy objectives. One exception to this – discussed in section 3 – is the issue of shareholder compacts, since these play an important role in the definition, agreement and funding of non-commercial mandates.

In considering any specific aspect of SOE policy, whether relating to financing or anything else, it is critical to do so with reference to the primary purpose of that enterprise’s existence. (Implicit in this is the assumption that private ownership is the default form of economic activity). The PRC provides a number of generic reasons why state-owned entities and enterprises may exist, some of which are shown in Table 1 along with other explanations that appear in the literature.

A generic point that arises from the analysis below is the potentially damaging consequences of uncertainty; whether this is in relation to governance arrangements, SOE mandates or financing frameworks. This can hamper SOE performance, increase financing costs, and reduce the likelihood that restructuring efforts will succeed.

In the South African context, it is important to note that the original reason for an SOE’s establishment may be very different from the appropriate role for it in the current economic and policy environment (Presidential Review Committee on State-owned Entities, 2012; ANC, 2012). Furthermore, while SOEs may have one core mandate they are typically expected to implement many other government policies as part of their normal operations. The PRC suggested that government should “periodically review and balance the social, political and economic priorities of SOEs” (Presidential Review Committee on State-owned Entities, 2012, p. 14).

Parliamentary oversight of SOEs, including finances, has typically involved the Standing Committee on Public Accounts (SCOPA) and the Portfolio Committee on State-owned Enterprises. There may, however, be a greater role for the Standing Committee on Finance in the current context, given its oversight responsibilities relating to National Treasury and the fiscal framework.

The analysis of the remainder of the report is structured as follows. Section 1 provides a conceptual background to the *role of SOEs in a developmental state*. Section 2 examines the arguments for, and challenges in, *separating commercial and non-commercial mandates*. Section 3 discusses appropriate *policies and mechanisms for SOE financing*. Finally, Section 4 provides a *conceptual analysis of the proposal to sell state assets* in order to finance balance sheet support for SOEs.[1]

[1] The full terms of reference is provided in the Appendix.

Key issues

- It is important to clarify terminology. ‘State-owned entity’ is an overarching term that includes state-owned enterprises (SOEs). The Presidential Review Committee considered all forms of state-owned entity, whereas the current report focuses on SOEs.
- The current ‘rationalisation’ phase of SOE policy requires assessing whether SOEs are serving a worthwhile purpose in the context of a developmental state.
- The PRC has suggested establishing a ‘transitional SOE reforms committee’ and an ‘SOE Council of Ministers’ to consider and implement its recommendations.
- In relation to SOE governance, which is largely outside the scope of the current report, the PRC has endorsed the development of a uniform governance framework based on the draft Government Shareholder Management Bill.
- A database on state-owned entity finances was developed for the PRC’s work, which was supposed to be updated annually and made publicly available. However, the database – currently housed at the HSRC – has not been updated since 2012 and is not available for use.
- The Standing Committee on Finance could play a greater role in oversight over SOE finances given its oversight of National Treasury and the fiscal framework.

Table 1 Possible reasons for state-owned enterprises

Reasons for an SOE	**Brief explanation**	**Examples**
Natural monopoly	State ownership of a monopoly, that arises due to the structure of a sector, to prevent negative impact on the economy.	Airport infrastructure
Market failure	The state-owned enterprise engages in long-term investment, or provides important goods or services, that would not be done if left to 'market forces'.	Development financing
Externalities	State ownership of enterprises that have greater benefits to society than accrue to themselves, so that these produce more than they would under private ownership.	Research and development
Social equity	State ownership ensures universal access to critical services that would otherwise not be provided by private operators (typically due to low returns).	Postal services
Security of supply	State ownership ensures the supply of nationally critical goods or services.	Water storage and distribution infrastructure
National security	State ownership of enterprise whose activities are important for national security.	Weapons production
Competitive advantage	"Leveraging the country's resources" where this is not adequately done by the private sector.	Minerals beneficiation
Investment returns	A by-product of developmental financing or/and the retention of profitable SOEs as a means of socialising the gains from growth in key sectors.	Any profitable government enterprise

Source: PBO and Presidential Review Committee Report (Presidential Review Committee on State-owned Entities, 2012, pp. 51-54)

2 STATE-OWNED ENTERPRISES AND THE DEVELOPMENTAL STATE

Following the first decade of democracy, economic policy shifted from the more Keynesian emphasis in the Reconstruction and Development Programme (RDP), to the Growth, Employment and Redistribution (GEAR) strategy that emphasised the creation of an 'enabling environment' for the private sector. More recently, the ruling party has committed itself to pursuing growth and development through building a developmental state. This shift has occurred from the ANC's National General Council in 2005 (ANC, 2005) to, most recently, its 2014 election manifesto (ANC, 2014).

The intention to operate as a developmental state has resulted in a range of policies and initiatives including the National Industrial Policy Framework and its subsequent Action Plans (IPAPs), and the National Development Plan (NDP). Given the significant number of SOEs in South Africa and their potential to promote development, the role of SOEs in South Africa's developmental state has received particular attention. The above policies identify different roles for SOEs in the process of economic development. More recently, the Presidential Review Committee on State Owned Entities (PRC) was established to address the question of whether SOEs are serving their purpose within this broader policy framework. As part of its mandate, the PRC was also tasked with making recommendations on the place of SOEs in the developmental state.

2.1 The role of the state in economic development

Most, if not all, countries pursue economic development, simply defined as improving the quality of the lives of its citizens. A country's level of development has traditionally been measured in terms of its Gross Domestic Product (GDP). However, in recent decades the measurement of development has been broadened to include a range of human development indicators such as life expectancy, infant mortality, access to health care, nutrition, and levels of education attainment (Todaro & Smith, 2004).

The means through which countries (should) pursue development, or simply develop, is a subject of considerable difference among policy makers, development practitioners, political leaders and academics. The concept of the developmental state is located within the debate on how a country should pursue development.

With the fall of the Berlin Wall and the collapse of the USSR, free market capitalism was considered and promoted as the ideal approach for economic growth and development. The 1980s and 1990s saw the wide adoption of policy packages among most developing countries which called for a minimal role for the state in the economy. Promoted by the International Monetary Fund (IMF) and the World Bank, policy packages collectively known under the rubric of the "Washington Consensus" called for: deregulation of markets; liberalisation of trade policy; balanced budget or surpluses through lower public expenditure; and privatisation of SOEs. It was believed that market forces left to their own devices would unlock a country's economic potential and allow for development and prosperity. It was held that the private sector could provide certain goods and services more efficiently than the state and therefore the role of the provision of goods and services should be transferred to the private sector (Stiglitz, 2008). This necessitated the privatisation of SOEs. The role of the state was to be limited to maintain law and order, and the provision of basic public goods and infrastructure that the private sector would not provide (Chang, 1999).

However, two decades after the broad adoption of "Washington Consensus" policies, many developing countries were still in a state of low development. The failure of Washington Consensus policies to create sustained and significant growth and development raised questions about the suitability of these policies. In contrast, several countries such as Japan, the East-Asian "Tiger economies", China, India, Brazil and the Scandinavian states all experienced sustained and widespread growth and development. However, their respective governments played an important role in directing and supporting their economies. This served to widen the debate on the role of the state in economic development (Amsden, 2008; Stiglitz, 2008; Chang, 1999).

2.2 Defining the developmental state

It is the experience of one these countries, namely Japan, which led to the term *developmental state* being coined in 1982 by Chalmers Johnson (Johnson, 1982). In the post WW2 period Japan experienced very high and sustained levels of economic growth, with the Japanese state playing a strong interventionist role. The developmental state can be broadly defined as a state wherein the government plays a central and active role in the process of economic development. This is in contrast to a *regulatory state* in which government focuses its resources and regulating private sector activity. The type and nature of the role played by the government in the economy may differ according to country, time and political climate.

Despite the heterogeneity among countries classified as successful developmental states, there are some important shared characteristics (Presidential Review Committee on State-owned Entities, 2012; Kuye & Ajam, 2012):

- The government has a *particular vision for the level and nature of economic development* it aspires towards. This is in contrast to the case where government is agnostic, allowing market forces to fully shape the development trajectory of the country.
- With a particular vision and set of objectives to realise this vision, a developmental state *plans, coordinates, and implements* steps to develop in a *deliberate manner and direction*. The degree to which non-state actors, such as the private sector and civil society, are included in the planning and implementation varies between states.
- The bureaucracy, responsible for planning and crafting the development vision and associated interventions, has the *technical expertise* and is empowered with mandate to effect the necessary change. The state apparatus, responsible for implementation of policies through the executive or SOEs, needs to be *highly competent* with an intimate understanding of the different sectors of the economy, and spheres of society.
- As the developmental state requires coordination across government and the different spheres of society (labour, capital and civil society) the ability of the state to *wield influence and forge social compacts* while remaining insulated from partisan interests is crucial.

2.3 The role of SOEs in the developmental state

With developmental states playing a direct and active role in their economies, seeking a particular vision of development, it is intuitive that SOEs, given state control, have been accorded key roles. Many countries, including South Africa, have attempted to align their SOEs with their development and growth priorities. This has been necessary in light of the challenges brought about by globalisation such as, increasing trade and competition, mobile and volatile capital, coupled with persistent social problems of unemployment and inequality. (Presidential Review Committee on State-owned Entities, 2012).

The traditional textbook role for SOEs is premised on a limited role for the state in the development process and includes (Cuerv-Cazurra, et al., 2014):

- The provision of key social and public goods that the private sector is not willing to provide, or whose provision is inadequate in level or price. This constitutes the *market-failure* basis for state provision of goods and services. This includes goods such as transport infrastructure, defence, healthcare, sanitation and scientific research.
- Ensuring socially optimal outcomes in the context of a natural monopoly. In the case of a *natural monopoly*, wherein market or natural factors determine that only one such supplier may exist, private ownership may result in supply or prices that are not socially optimal. As such, state ownership is desired. This is particularly the case with natural monopolies providing basic rights/public goods, where the potential of social exclusion exists.
- Countries have also maintained SOEs on the basis that they provide 'strategic value'. The conception of 'strategic' value added by SOEs varies between countries and has been justified on various grounds such as national security (defence, water and energy) and 'national pride' (national airlines).

However, in the context of a developmental state, SOEs play a broader role in the development process as observed in the development experience of the East Asian Tiger Economies, and more recently with Brazil and Norway. Unlike the case of privately-owned enterprises, where shareholders are primarily interested in profit maximisation, the owners of SOEs in the context of a developmental state are interested in promoting development. Empowered through its role as the shareholder, the state is able to direct the mandate, activities and operations of its SOE, coordinated with other SOEs, and in cooperation with other parts of government, labour unions and the private sector. As the shareholder of SOEs, the state may be willing to forgo higher financial returns for the sake of broader development outcomes, as well as providing additional financial support to SOEs.

The PRC notes that many countries have expanded the role and mandate of SOEs beyond the provision of public goods. This has entailed the creation of coordinated policies and oversight mechanisms to ensure that SOEs activities dovetail with national development and growth strategies (Presidential Review Committee on State-owned Entities, 2012).

SOEs may play a number of roles in a developmental state. SOE investment in infrastructure enables governments to deliver on pro-poor policies (e.g. solar water geysers for low-income households). The operation and maintenance of social infrastructure by SOEs can allow governments to fulfil their social mandates (e.g. provision of free-basic electricity to households).

Public investment in economic infrastructure is an important instrument for economic development. It increases the competitiveness of an economy, stimulates economic activity and may attract additional investment. Investment in economic infrastructure is generally undertaken by SOEs on the behalf of the government (e.g. expanding rail infrastructure and electricity generation capacity).

Many countries have also utilised their SOEs as part of their industrial policy strategies. This has included:

- Requiring SOEs to charge certain domestic customers below market-price to support and develop the domestic economy (developmental pricing).
- Requiring SOEs to procure from local suppliers with the intention of developing local capabilities.
- Requiring SOEs to make investments that the private sector would not consider, on the basis that the investment would catalyse further investment from the private sector, with benefits accruing to the state in terms of higher employment and tax revenue.

The high financial returns earned by the state -as the shareholder- from profitable SOEs (e.g. state oil company) can be used to fund other national development priorities. Ad in certain countries SOEs are expected to contribute more directly to growth and development, through creating decent and secure employment opportunities.

2.4 Envisaged role for SOEs in South Africa

SOEs have always played a central role in the economic development of South Africa. Prior to 1994, with the state oriented towards the promotion of the interests of the white minority, apartheid industrial policy saw SOEs utilised to promote "Afrikaner Capital" and stave-off the effects of anti-apartheid sanctions. In this period SOEs were used to uplift white South Africans through providing secure employment, developing local capabilities, and allowing for South African "self-sufficiency". In this period SOEs such as SASOL, ISCOR, DENEL and ARMSCOR were established.

With the transformation to democracy in 1994, the new government had inherited a highly unequal country, with large under-provision of social and economic infrastructure and services. In addition, existing infrastructure was poorly managed and maintained, while SOEs were often bloated and inefficient. In this period, South Africa increased the roll-out of social and economic infrastructure through its SOEs, and concurrently embarked upon a policy of privatisation of SOEs. The privatisation of SOEs was intended to raise revenue and create black owners of capital (Presidential Review Committee on State-owned Entities, 2012). For example, SASOL and several SABC radio stations were privatised, while part of Telkom (30%), South African Airways (20%) and Airport Company South Africa (25%) were privatised.

Since the early 2000's, with economic policies directed to creating a developmental state, government's approach to SOEs shifted away from privatisation and towards greater use of SOEs for development and social objectives (ANC, 2012). The envisaged role for SOEs in South Africa's developmental state can be summarised as follows.

The basic role envisaged for SOEs entails the provision of *public goods, basic rights and infrastructure* (NPC, 2013). This role is not unique to a developmental state as the majority of countries have SOEs that provide these goods and infrastructure.

With the objective of enhancing the competitiveness of the economy and attracting investment, South Africa's SOEs have been mandated to increase *investment in economic infrastructure*. This includes telecommunications, roads, ports and rail.

The investment in infrastructure is also intended to directly *support growth and stimulate the economy*. Investment in infrastructure, driven by SOEs, has in recent years compensated for decrease in private investment in infrastructure.

As South Africa develops and implements its industrial policy as part of the larger developmental state agenda, its SOEs have been called upon to promote industrial policy goals. These include; industrialising and diversifying the economy; increasing black participation in the economy; developing domestic capabilities; and increasing investment. Key instruments identified to realise these objectives include procurement (e.g. DTI designation for local content requirement) and industrial financing.

Coupled with the above envisaged role for SOEs in the developmental state, is an underlying emphasis on improving outcomes of SOEs in terms of availability, quality of service and price. The NDP as well as the PRC report emphasise the need for SOEs to be financially sustainable and to fulfil their roles in an equitable and cost effective manner.

Acknowledging that the various mandates of SOEs may affect the performance of SOES, the NDP and the PRC report note the need for clarity over the mandates of SOEs, the public goods they provide, and how this serves the public interest. The NDP notes that certain SOEs and development finance institutions were established under considerably different economic, social and political conditions. Given this, it asks if certain SOEs are still required.

For SOEs to better realise their developmental goals, there is an acknowledgement of the role of the private sector. The NDP notes that introduction of private players to compete with SOEs, in certain sectors, can allow for more efficient SOEs.

The PRC notes that while certain SOEs fulfil “strategic” roles (e.g. Denel in defence) this is largely a function of historical developments rather than an overarching “strategic approach” for state ownership. The PRC notes the same issue applies where SOEs are intended to further the state’s regional development objectives (Presidential Review Committee on State-owned Entities, 2012).

A final, cross-cutting issue, concerns capacity in SOEs themselves, as well as shareholder departments and other relevant institutions of government. All authors appear to agree that state capacity is fundamental to a successful developmental state. Chang notes that, “South Africa has…a wide range of organisations that are ingredients of a developmental state” and “has enough capable people to ‘do’ a developmental state”, but success depends on how those institutions are managed and the relevant human resource capacity employed (Chang, 2010, pp. 91, 93). Mkandawire argues for “the utilisation, retooling and reinvigorating of existing capacities” (Mkandawire, 2010, p. 67) and Butler, more pessimistically, argues that developmental state initiatives should first focus on reforming the civil service (Butler, 2010).

2.5 Summary

Like other developmental states, South Africa has formulated a range of policies and initiatives to direct and affect the process and trajectory of its economic development. In addition to the basic role of providing public goods, basic rights and infrastructure, South Africa’s SOEs have been accorded key roles as part of the developmental state agenda.

Nevertheless, as Chang (2010) notes, every developmental state is different and must be adapted to the relevant context. With a mixed economy dominated by private sector activity, this also means combining and reconciling the more interventionist orientation of a developmental state with the more guiding role of a regulatory state.

SOEs are required to enhance competitiveness of the economy, invest in economic infrastructure, stimulate growth, and fulfil a range of industrial policy goals. In fulfilling these key roles, there is an acknowledgement of the need to improve SOE performance through ensuring financial sustainability in operations, private competition, and clarity over SOE mandates.

Key issues

- Developmental states are characterised by a more interventionist role in the economy and SOEs are a potential mechanism for directing economic development.
- Among the expectations of SOEs that may go beyond their more traditional roles are: investment in economic infrastructure; promotion of industrial policy; and increasing the competitiveness of South Africa’s economy.
- As emphasised by the NDP and PRC, achieving such objectives – whether in SOEs or elsewhere in the developmental state – requires adequate capacity and good governance

3 SEPARATING COMMERCIAL AND NON-COMMERCIAL MANDATES

"Government is proposing a new framework for funding state-owned companies that will distinguish purely commercial activities from the costs of exercising their developmental mandates. It will include closer monitoring to ensure efficient delivery on government priorities, while simultaneously promoting improved commercial performance. Government has also introduced more stringent financial reporting requirements for public entities." (National Treasury, 2014, p. 26)

"In cases where the State requires [commercial SOEs] to undertake non-commercial mandates, then the State should contract and fund them for these mandates." (Presidential Review Committee on State-owned Entities, 2012, p. 11)

The introduction discussed the many different reasons for the existence of SOEs, ranging from addressing market failures to strategic and developmental objectives. In this section the focus is on the financial implications of non-commercial mandates that SOEs are expected to fulfil. Although the Medium Term Budget Policy Statement refers only to 'developmental mandates', strictly speaking developmental mandates are only a subset of non-commercial mandates, which all pose funding challenges. At present, most South African SOEs are operating in an environment where they have, or have had, significant non-commercial mandates that are not explicitly funded.

Most of the literature on this subject views the problem through the `principle-agent' model of economics, in which the state is the *principle* seeking to achieve certain societal objectives through its SOEs and the SOEs are the *agents* that may wish to pursue a variety of objectives besides those of the state. This perspective has particular significance in the case where SOEs have been 'corporatised' and therefore have an arms-length relationship with the state.

Given this it is also unsurprising, as the subsequent analysis makes apparent, that there is a strong link between proper management of commercial and non-commercial mandates and SOE governance. Non-commercial mandates are often developed and enforced by stakeholders other than those responsible for ensuring the enterprise's financial health. Furthermore, in some cases the mere existence of certain non-commercial mandates reflects governance failures. Nevertheless, while governance structures are therefore key for SOE performance, a detailed analysis falls outside the scope of the current report. Instead this section focuses on three issues: reasons for separating mandates; practical issues relating to the separation of mandates (including financing); and, relevance to the recent South African experience with SOEs and the national Budget.

3.1 The rationale for separation of mandates

Many SOEs currently require a massive injection of capital and finance policies require close re-examination. Funding models for social and economic development mandates of SOEs are blurred and confusing, leading in some instances to undercapitalisation, which impedes the SOE's ability to contribute to meeting national challenges. (Presidential Review Committee on State-owned Entities, 2012, p. 8)

As noted by the final report of the Presidential Review Committee, conflation and inadequate financing of mandates can lead to problems with SOE balance sheets which in turn negatively impacts on their ability to perform their core functions.[2] This position is consistent with the NDP, which states that: "major SOEs need clear public-interest mandates and straightforward governance structures that enable them to balance and reconcile their economic and social objectives" (NPC,

[2] Similarly, the ANC's discussion paper on SOEs and DFIs (ANC, 2012) notes that a "crucial element [of viable and effective SOEs] is funding adequacy as well as the owners' readiness to support further socio-economic objectives, as is necessitated by the developmental state agenda" (ANC, 2012, p. 23).

2012, p. 410) It is also in line with recent work by multilateral organisations, such as the Organisation for Economic Cooperation and Development (OECD), World Bank and International Monetary Fund (IMF), which notes the importance of clearly identifying and funding non-commercial mandates.

A non-commercial mandate could be anything that an entity does, or is expected to do, that would not be expected of a private company in the same industry or situation. Leaving aside long-term strategic ownership by government, which may involve a fairly passive role for the state, non-commercial mandates should in principle follow directly from the objectives of SOE ownership. It is important to note, however, that in practice there may also be implicit mandates that result from pressures imposed by vested interests that are not compatible with public interest objectives.

There are various channels through which non-commercial mandates can have a negative effect on SOEs financial status, through increasing operational and investment spending or decreasing capacity for revenue collection or generation. Furthermore, besides direct financing issues the failure to separate mandates can compromise regulatory oversight (Steyn, 2011, pp. 33-34).

The two extreme situations that can result are: i. large-scale waste of state resources on a poorly performing enterprise; ii. enterprise failure, or forced privatisation, of a strategically or developmentally important enterprise. The costs incurred in the first scenario may outweigh any social or economic benefits derived from state ownership. In that case the state may be forced to divest itself of the SOE if it cannot remedy the situation. The second scenario will impose more of the costs on society and participants in the economy directly, through a decline in the quantity or quality of services.

To the extent that it reduces the prospects of such dire outcomes, the case for separating mandates is a strong one. It enables clear prioritisation of the government's and enterprise's objectives; ensures greater financial stability; and, through these, enables more accurate monitoring of enterprise performance which should lead to greater efficiency. The recommendation in the OECD's SOE guidelines for Southern Africa, is that: "Any obligations and responsibilities that a SOE is required to undertake beyond its normal commercial functions should be clearly mandated, disclosed to the public and their costs covered in a transparent manner." (OECD, 2014, p. 5).[3]

Implementing such separation in practice, however, comes with a number of challenges and costs, which we now discuss.

3.2 Separating and financing mandates in practice

There are two broad challenges to consider regarding separation of mandates. The first is clearly delineating commercial and non-commercial mandates. The second is determining adequate financing for non-commercial mandates, including appropriate financing mechanisms.[4]

Related to this, the PRC report (PRC, 2012, p. 62) notes the importance of reducing the complexity of the SOE environment, both for the state and the SOEs themselves. Clarification of mandates may assist in this process but will also require significant capacity to disentangle existing arrangements and establish new, stable institutional policies and procedures.

[3] This is similar to the recommendation in the main OECD guidelines which states that: "Any obligations and responsibilities that an SOE is required to undertake in terms of public services beyond the generally accepted norm should be clearly mandated by laws or regulations. Such obligations and responsibilities should also be disclosed to the general public and related costs should be covered in a transparent manner." (Christiansen, 2013, p. 8)

[4] A third issue is ensuring adequate delivery or performance, but this performance monitoring and evaluation issue applies whether mandates are separated or not and we will not consider such issues in the current report.

Identifying different kinds of mandates

There are many generic forms of non-commercial mandates, along with some that may be sector-, or country-, specific.

One of the most common forms of non-commercial mandates are so-called `universal service and access obligations' (USAOs), under which SOEs are required to provide *access* to services or networks for all citizens and/or a basic level of services. The earliest examples often related to postal or telephone services, but most developing country governments have similar objectives for water and electricity. Although much of the literature has only been concerned about the funding of such mandates in the context of liberalisation and privatisation, there are strong arguments for being explicit about non-commercial mandates even for enterprises that will remain public monopolies.

South Africa's national electrification programme provides a useful illustration. This programme's primary objective is universal access to electricity and Eskom, under Schedule 2 of the PFMA, receives direct annual transfers from the Department of Energy for expansion of its electricity transmission infrastructure. Another example of a clear non-commercial mandate for a public entity is the expectation that urban commuter rail services be provided at fares below the level required to cover costs. In South Africa, the Passenger Rail Agency of South Africa (PRASA), which falls under Schedule 3b of the PFMA, currently receives a transfer of funds in part to cover the financial shortfall from provision of such services.

A less clear case of a non-commercial mandate, internationally, is that of 'corporate social responsibility programmes'. Some experts are of the view that since these are often part of normal corporate practice that they constitute a commercial mandate. Some have gone so far as to argue that if SOEs do *not* have such programmes they will be unfairly advantaged compared to their corporate counterparts (OECD, 2012). There has been less consideration of whether these programmes are an efficient use of funds that could be returned to the state shareholder as dividends.

Arguably a more pertinent factor in the South African context is that a number of additional transformation and skills development objectives are incorporated into SOE strategic plans; these typically go beyond the activities of standard private sector operators.

A specific example in the South African case is preferential procurement. The policy intention is that this is in the long-term interests of the country because it promotes racial transformation of the economy and small business development. In the short-run, however, it may increase SOE expenses since procurement cost is given a lower weight than other factors in choosing suppliers. Nevertheless, at present there appears to be no intention to fund such activities as non-commercial mandates. In the absence of such funding, it is unclear whether one can directly compare SOE performance to private sector competitors. This in turn may make performance assessment harder and accountability more difficult to achieve.

This example can be included in a broad category of non-commercial mandates that concern 'externalities': benefits to the rest of the economy, or society, from an SOE activity that do not accrue directly to the SOE itself. An important example relates to industrial development. Requiring an SOE to charge lower prices for key industrial inputs to domestic firms may have economic benefits by encouraging industrial development, but it means that an enterprise collects less revenue.

Based on the available literature, most non-commercial mandates can be placed in one of the categories outlined in Table 2.

Table 2 A categorisation of non-commercial mandates

Type of mandate	**Traditional examples**
Universal access obligations	Access to postal services
Universal service obligations	Affordable pricing of electricity for all citizens
Positive economic externalities	Investment in research and development, or training and skills development
Positive social externalities	Infrastructure investment, such as railway stations, that promotes social inclusion through local economic development
Employment and remuneration	Creation or maintenance of employment, or remuneration, levels beyond equivalent private sector operators
Corporate social responsibility	Engaging in community or other outreach or social support programmes

Funding of mandates

Having identified a non-commercial mandate, the obvious question is what this will cost the SOE, where that funding will be obtained and what financing mechanism(s) will be used.

Any large non-commercial mandates must somehow be funded in order to avoid a negative impact on the finances and sustainability of SOEs that would compromise their operations and future existence. If the extent of funding, as determined through an impartial process, is considered excessive then the mandate ought to be reconsidered. In some instances this may imply reconsideration of the broader role of the SOE itself, depending on whether the envisaged mandate was an important consideration in state ownership.

Where SOEs are financially sound in the presence of substantial non-commercial mandates that they are delivering on, but which are not explicitly funded, this is usually because financing is taking place implicitly through the prices charged by the SOE to its customers. That is often coupled with cross-subsidisation where the more fruitful sources of revenue are different from the customers or sectors identified by the non-commercial mandate. While in some cases this may be a satisfactory solution, it may also have undesirable effects on other sectors of society or the economy.

Funding of non-commercial mandates can take a number of forms and need not take place through direct transfers from the fiscus to the SOE. Among the options available, which are not mutually exclusive, are:

- Direct payment for costs incurred
- Providing favourable debt finance or guarantees
- Allowing higher tariffs and fees
- Reducing earnings expectations
- Allowing cross-subsidisation.

The merits of SOE funding mechanisms are given detailed consideration in section 4. Here we note some of the issues for financing that arise specifically from the separation, or conflation, of commercial and non-commercial mandates.

Literature

Most of the literature on financing non-commercial mandates has developed with reference to the challenges faced by particular sectors, such as telecommunications and postal services, in implementing universal access or service obligations. Much of this is outside the scope of the current report. There are fewer cross-cutting assessments, most of which concern non-commercial mandates under full privatisation. (Chisaro, et al., 2001), for example, discuss the experience of Latin American countries with financing increased access for the poor and affordability of services in the context of large-scale market 'liberalisation'. There is also a large academic literature on regulation of private and public entities.

The OECD's review of mandate separation in four of its member countries – Israel, Netherlands, New Zealand and Norway – reveals a range of approaches to the question of financing. The study suggests that in these developed countries, "the most common practice is to finance as much as possible through the SOEs' earnings in the market and cover the remainder through fiscal allocations" (Christiansen, 2013, p. 15).

In Israel, "universal service obligations are generally financed through implicit transfers within client groups" (Christiansen, 2013) – i.e. social mandates are financed through cross-subsidisation. In the Netherlands government purchases services from SOEs, often in competition with private sector companies. In Norway the state purchases services from utility companies and where provision is expected to take place below cost, the level of compensation is 'subject to negotiation'.

Funding in the absence of separation

As the above report suggests, an obvious question is how mandates are addressed and funded in the *absence* of a clear separation. There are four broad possibilities.

First, an enterprise may cross-subsidise a non-commercial mandate by diverting resources from commercial, or other funded, activities.

Second, the state may provide an entity with scope to raise revenue based on its total costs or past financial shortfalls.

Third, the state may provide recurrent favourable debt financing or cash (equity) transfers in response to financing shortfalls.

Finally, an entity may simply be unable to adequately finance all its obligations and engage in activities, such as underinvestment, that undermine its balance sheet and may eventually lead to it ceasing to be a going concern.

The second and third scenarios – allowing greater revenue raising powers, providing favourable loans or making cash transfers – are problematic in as much as they may encourage inefficiencies by effectively rewarding financial shortfalls. That in turn can place an increasing burden on the fiscus that is not compensated for by the SOE's contribution to society or the economy. The fourth scenario leads to crises in SOE performance and potentially dramatic demands on the fiscus when it becomes necessary to `bail-out' an SOE to prevent an intolerable decline in services or irreparable institutional damage.

The first scenario, ongoing cross-subsidisation, is the least dramatic but may lead to inefficiencies. Where it is not excessive and the state has inadequate information or expertise relating to an enterprise, cross-subsidisation may be a satisfactory `second-best' solution to the problem of getting enterprises to implement mandates (Laffont, 1998).

In cases where non-commercial mandates are a significant component of an SOE's operations none of the above implicit resolutions of the problem of funding and prioritising non-commercial mandates are likely to be desirable.

Deliberate funding of mandates

One notable benefit of *explicit* funding is that it emphasises the importance of considering issues relating to cost and financing when initially assigning non-commercial mandates to SOEs. As with other state expenditure, prioritisation of objectives requires some sense of the costs involved. Figure 2 attempts to summarise the basic components of the mandate determination process and the potential implications of neglecting financing issues, along with some of the different challenges involved.

It is important to note that making mandates explicit does not in itself resolve underlying problems but rather requires them to be resolved. As one author puts it: "the separation of commercial and non-commercial activities does not resolve the conflict between commercial and non-commercial goals...Separation only makes the [cost] more obvious by converting it from a hidden cross subsidy within the SOE to an explicit transfer from the treasury to the SOE" (Gómez-Ibáñez, 2007).

Having identified a possible non-commercial mandate in broad terms – 'access to telecommunications', for instance – there is the problem of costing, which depends itself on the prior operational specification of a clearly defined mandate. In some instances estimating the cost of a particular mandate may seem fairly straightforward – as when the prevailing price of a particular service is used. However, given that SOEs often operate in non-competitive environments, and it may be difficult to get access to direct measures of SOE operational costs, the costing process is typically more complex.[5]

There are also strategic considerations. The basic assumption in the economics and public finance literature is that SOEs will adjust their claims about costs in response to the mechanism developed by the state to estimate costs (or otherwise determine the amount of funds due to the SOE). Partly as a result, some authors have suggested that the extent of the challenge posed by costing provides one justification for allowing cross-subsidisation in developing country enterprises: government sets flexible parameters for the SOE to raise revenue and allows the SOE to determine how to finances will be reallocated internally to meets its non-commercial requirements (Laffont, 1998).

Nevertheless, while cross-subsidisation is a popular tool – even in developed countries – it is no panacea. Particularly in cases where an enterprise is underperforming, operationally or financially, the state still has to determine whether this is due to poor management or inadequate funding. Furthermore, there is the risk that the way in which revenue is raised to fund the non-commercial mandate may have undesirable consequences in other parts of the economy. Where such a situation exists, it requires constraints on market competition in which private operators might undercut the SOE on profitable activities while it is burdened with a social mandate (Panzar, 2001).

One response to these challenges, particularly in developed countries, has been to try and commercialise non-commercial mandates by putting them out to tender (OECD, 2012). SOEs then bid for these contracts alongside competitors. In some cases this serves as a preliminary step toward SOE privatisation. Where there is adequate competition, such an approach can assist in determining an appropriate market price for the service provided. It is less feasible where an SOE exists for

[5] The OECD notes four main methods of evaluating the cost of 'special obligations' (OECD, 2012, p. 73), but these only apply to non-commercial mandates that involve extension of services or provision of goods.

strategic reasons or is in a monopolistic position. While carrying the usual risks associated with any tender process, it may also create destructive uncertainty for an SOE's operations. Whether that is a problem depends on the role the SOE is expected to play in government's broader policies and objectives.

An overarching challenge is the coordination of different role-players responsible for different functions. Governance problems may arise where the decisions in that process are taken by different role-players with different priorities. The stakeholder mandate may be determined by a political party and operationalised by the policy department, while the Treasury makes an assessment of cost and a regulator makes particular determinations that affect financing. The fundamental principle is that non-commercial mandates follow from political decisions, but need to then be subjected to a technical process to determine operational and financial feasibility. Since it is assumed that government's objective is to ensure that SOEs are effective and stable institutions, any non-commercial mandate that is found to be infeasible must then be reconsidered.

3.3 Relevance to the South African experience with SOEs and the Budget

The above review suggests that although there is an increasing consensus in favour of separation, in some situations implicit financing of non-commercial mandates can work. In particular, where such implicit financing takes place in parallel to good governance, acceptable delivery on the relevant mandate, sound SOE finances and no major negative consequences for other parts of the economy or society, the approach may be sustainable.

Unfortunately, this is not currently the case with a number of important South African enterprises with commercial operations. The difficult financial and operational position of a number of major enterprises – notably Eskom and South African Airways – necessitates consideration of the reasons for the situation.

In both these cases, claims have been made that poor performance is partly due to unfunded non-commercial mandates. In this subsection we discuss the current situation with non-commercial mandates in South Africa, and consider some topical South African case studies, in light of the issues and principles discussed above. It is worth noting, however, that conflation of mandates and inconsistent application of funding principles across SOEs also means that good financial performance need not imply that an enterprise is being well-run. Such subtleties are discussed in the next section which considers the broader question of how to structure SOE financing in general.

Current South African situation regarding SOE mandates

As noted in the introduction, the PRC Report argues that the current legal framework governing SOEs in South Africa is undesirably complex and needs to be simplified. In particular, it argues in favour of the Government Shareholder Management Bill – drafted by the Department of Public Enterprises, but not yet tabled before Parliament. If passed, this Act would supersede other pieces of legislation and provide a uniform framework governing SOEs.

At present, the relationship between government and SOEs is governed primarily by the Public Finance Management Act (PFMA). The issue of mandate separation applies primarily to 'major public entities' under Schedule 2 and 'government business enterprises' under Schedule 3b of the PFMA. The PFMA requires Schedule 2 and 3b entities to report to the Treasury and "a department designated by the executive authority". Entities must report on their annual budget and corporate plan, in a manner prescribed by the Minister of Finance.

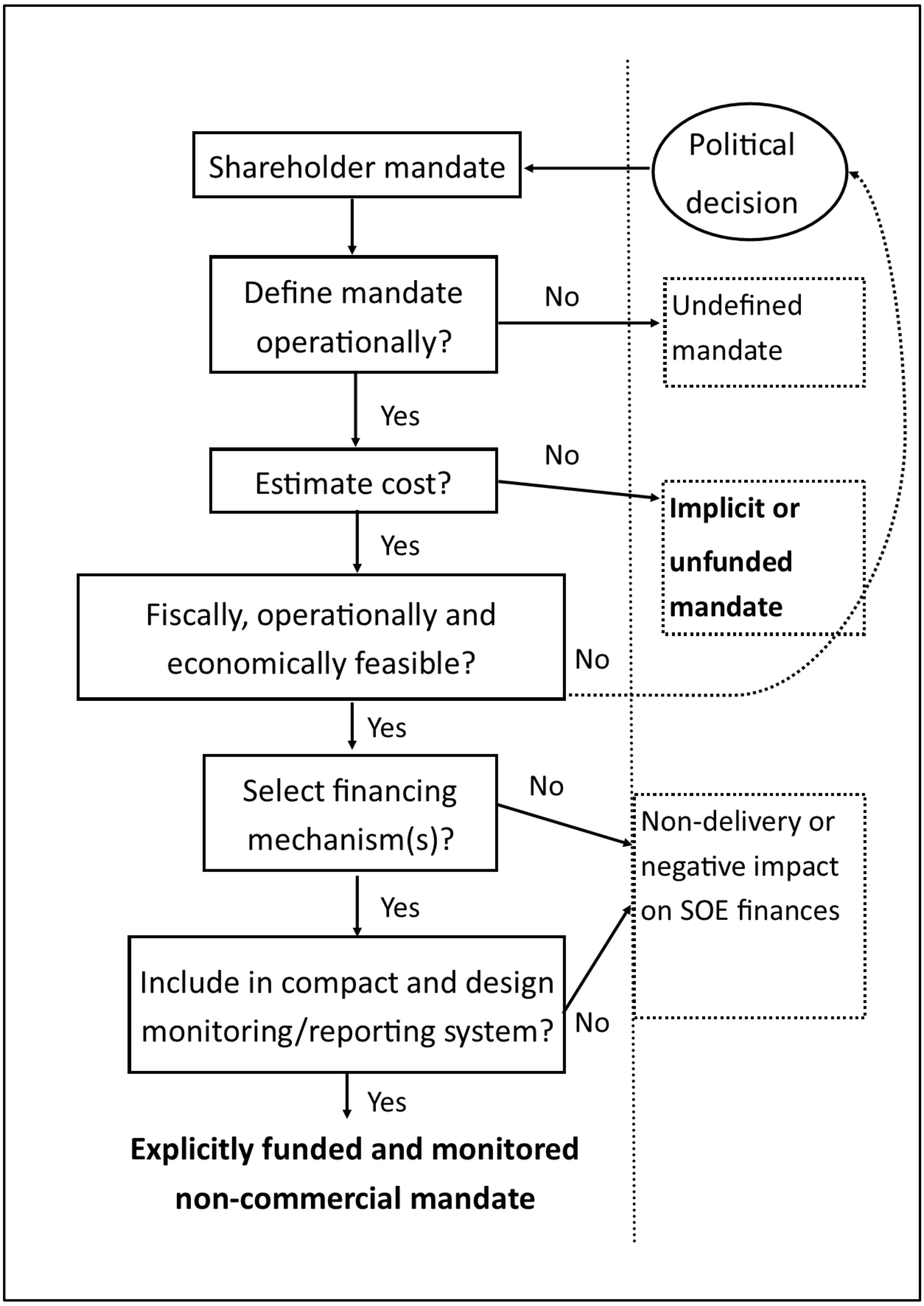

Figure 2 Defining and funding non-commercial mandates

According to the National Treasury guidelines, Schedule 2; 3b and 3d entities are required to submit shareholder compacts and corporate plans which are accompanied by other supporting documents such as a risk management plan; fraud prevention plan; corporate balanced scorecard; and financial plan (National Treasury 2002, Guideline Framework for Corporate Planning and Shareholder's Compact 2002). The original rationale for, and proposed structure of, shareholder compacts was discussed in detail during the previous phase of SOE restructuring (DPE, 2001, pp. 101-105).

Other important pieces of legislation are the 'founding Acts' governing individual SOEs. For example, the Airports Company Act is the founding legislation for the Airports Company of South Africa (ACSA), which is a Schedule 2 PFMA enterprise.

National Treasury has elsewhere noted that it is responsible for *financial oversight*, while the relevant policy ministry monitors *policy implementation* and Parliament is the final authority for conducting oversight (National Treasury, 2014). SOEs increasingly provide information in annual reports on their performance against key performance indicators. However, the legislature has reportedly not been provided with the detailed shareholder compacts and it is arguably within such compacts that commercial and developmental, or other strategic, mandates need to be clearly delineated. In 2011 Parliament's Portfolio Committee on Public Enterprises noted that, "The Department [of Public Enterprises] should provide the Committee with the shareholder compacts of state-owned companies to enhance the oversight work of the Committee" (Portfolio Committee on Public Enterprises, 2011). These have not yet been forthcoming.

The PRC report notes that the Government Shareholder Management Bill has similar provisions. Specifically, it: "included provisions for the formulation of a strategic intent statement for each SOE by the relevant executive authority, which would then guide the conclusion of binding shareholder compacts" (PRC, 2012, p. 74).

In the absence of a comprehensive framework for financing SOE mandates the situation varies across- and within-enterprises. There are a number of examples in the post-1994 era of attempts to formally implement a USOA requirement. That appears to have been fairly successful in the case of the government's Free Basic Electricity policy and Integrated National Electrification Programme. Eskom receives transfers for these subsidies and activities from the Department of Cooperative Governance and Traditional Affairs and the Department of Energy, respectively. By contrast, in the case of a commercialising entity in telecommunications, Telkom, the PRC report notes that the experience has largely been negative (PRC, 2012, p. 56).

Detailed consideration of the status of specific state-owned enterprises is outside the scope of the current report. Nevertheless, it is instructive to consider two, brief case studies where claims have been made about the importance of unfunded non-commercial mandates.

Case study 1: Eskom

It is now well-known that Eskom, South African's largest SOE on a number of dimensions including the extent of government guarantees, faces significant operational and financial challenges. Some authors (Fine, 2010) have argued that the problems with Eskom illustrate a failure, in practice, to link SOEs to a developmental state agenda.

Various studies and reports have identified factors, which they claim have contributed to Eskom's financial situation, that are relevant to the question of separating and financing mandates. Specifically:

i. Significant universal access and service obligations;
ii. Massive infrastructure expansion programme;
iii. Delaying of maintenance to avoid social, economic or political costs that were deemed intolerable;
iv. Non-collection of municipal debt;
v. Use of costly diesel-powered turbines to avoid or minimise loadshedding.

Although some analysts are of the view that Eskom has been historically undercapitalised, there is an increasing consensus that the primary source of Eskom's current operational problems is its infrastructure expansion programme. The programme originates in the need to increase electricity output to meet rising demand due to economic growth and increased access combined with population growth. The planning and initiation of the necessary infrastructure projects was delayed due to an initial decision to meet demand through independent power producers that was subsequently reversed.

The infrastructure programme has also caused significant financial problems for Eskom for three main reasons. The first is that it was arguably not matched by appropriate tariff increases. The second is that costs were severely underestimated. The third is that the programme has been substantially delayed to internal and external problems, leading to rapidly rising project costs and a delay in the revenue that was expected once new power stations came on-line.

The assertion by some commentators is that non-commercial mandates are contained in, or have added to, these problems. The following claims have been made:

- Eskom has been refused tariff increases necessary to finance its operations and infrastructure investment due to a desire to avoid the negative impact on households and the economy.
- Eskom has large unrecovered debts from municipalities because of the negative social and/or political consequences of disconnecting defaulting municipalities (Hartley, 2014).
- Eskom has incurred significant costs because it has engaged in inadequate maintenance and use of emergency capacity, due to short-term concerns relating to the 2010 World Cup, 2009 national elections and the immediate impact on the economy (e.g. Mantshantsha & Mathews (2015) and Steyn & De Wet (2015)).
- Empowerment efforts in Eskom's coal supply chain have significantly increased costs (Prinsloo, 2015).

We discuss the question of tariff approval in the next section, but it is not within the ambit of the current analysis to determine how accurate these assertions are or the extent to which they have contributed to Eskom's financial situation. The relevance for the current report is that *if* such claims are true, then these factors arguably constitute a form of non-commercial mandate and should – based on the previously outlined principles – have been funded accordingly.

Case study 2: South African Airways

It has recently been acknowledged by South African Airways that it is 'technically insolvent' (SAA, 2015). One factor that has been cited as contributing to its recent financial losses are loss-making international routes that appear to have been selected as part of a non-commercial mandate. In the 2013/14 financial year the SAA group made a loss of R1.168 billion, reflecting losses in its international operations.

The PRC report has categorised SAA as an SOE where the rationale for government involvement is 'unknown' (PRC, 2012, p. 21). In contrast, SAA management have recently stated that the SOE has a non-commercial mandate to 'develop South African tourism' (PMG, 2014). However, the key performance indicators listed in SAA's 2013/14 annual report do not contain any information on measures to develop tourism and the full stakeholder compact is not publicly available.

Again, the issue in the context of the current analysis is not whether such a mandate is correct – that is ultimately a political decision, which may be based on weighing-up entity costs against tourism or other economic benefits. Instead, as others have noted (Business Day, 2014), the point is that in the absence of corresponding funding arrangements the SOEs long-term viability will be compromised. This in turn may lead to the scenario outlined previously, in which non-commercial mandates are eventually funded through equity injections ('bailouts').

There does not appear to be any reason to believe that the cost of an equity injection is any less than explicit funding of a non-commercial mandate. Since explicit funding enables more direct evaluation of performance, this would seem a strong argument in favour of funding such mandates when allocated rather than dealing with their financial effects at a later stage.

One reason for not explicitly funding non-commercial mandates is that doing so may be incompatible with industrial policy objectives. Specifically, some forms of SOE subsidisation are disallowed by certain international agreements. Some economists, such as Joseph Stiglitz, have therefore advocated for intelligent use of such methods to support local industrial development in developing countries.

While such an approach would be compatible with South Africa's economic and industrial development policies, such as IPAP and the NGP, there is little evidence of large South African SOEs currently being used to support industrial development or domestic competitiveness in this way. Indeed, as will be discussed below, the mechanisms used to finance some SOEs may in fact be impeding attainment of industrial policy objectives. The case in favour of separating mandates therefore remains a strong one.

The proposal in the MTBPS to develop a framework for mandate separation would therefore appear to be a step in the right direction. The one obvious problem is that the immediate financial problems of a number of SOEs will need to be resolved before this framework has been put in place. Two key questions in approving the relevant financing proposals, then, are: the extent to which these account for the previous conflation of mandates; and, how the new financing mechanisms will enable a clear separation of mandates, and monitoring of performance, in the future.

3.4 Conclusions

a need to recognise that the manner in which SOEs are funded needs cautious assessment, given the respective commercial and non-commercial mandates within the context of ensuring Developmental State outcomes (PRC, 2012, p. 181)

There is an increasingly broad consensus that where non-commercial mandates form a significant part of an SOE's operations it is desirable that these be made explicit and funded accordingly.

If such separation has not been the case historically, then it is typically not possible to accurately assess SOE financial or operational performance in the current period without taking these into account. Simplifying the financing problem by funding mandates implicitly means that performance monitoring and enforcement become more difficult. Neither financial nor operational performance can be reliably used to assess performance of the enterprise or its management.

That presents a challenge to interventions aimed at resolving financial concerns relating to existing SOEs. Evidence on major South African SOEs – such as SAA, Eskom, Transnet and others under Schedule 2 of the PFMA – suggests that it would be a mistake to directly interpret current performance as only, or primarily, reflecting organisational inefficiency and incentives. Historical undercapitalisation, underfunding and unclear mandates appear to be an important consideration.

Separation and funding of mandates is, however, a complex challenge, especially for developing countries. The best prospects for success may lie in a phased approach that keeps the funding framework as simple and credible as possible, while allowing sufficient flexibility to adapt in the face of unintended consequences or unexpected developments. The SOE reform process outlined by the Presidential Review Commission could enable the development of a coordinated, deliberate approach. The recommendations of the PRC can be taken further in parallel to more immediate interventions, but in that case should arguably also inform short-term decisions where possible. Furthermore, while uniformity across sectors would be ideal, where SOEs face very different operational environments it will be necessary to adapt any framework accordingly.

The critical components of the separation process are: identification of non-commercial mandates; costing of these mandates; prioritisation of mandates based on importance and cost; selection of appropriate financing mechanisms; and, agreeing performance indicators for monitoring of delivery.

The implications are summarised in the PRC's recommendations:

"*the Government should adhere to a clear set of principles:*

- *Recognition of the unique nature of SOEs for balancing service delivery, viability and delivery on socio-economic imperatives;*
- *Identification and articulation of socioeconomic and political objectives;*
- *SOEs must deliver on their core objectives in a viable/sustainable manner;*
- *Identified objectives should be included in the shareholder compacts;*
- *Objectives should align with the developmental goals of the State;*
- *Recognition of costs associated with delivery of essential but non-commercially viable mandates and the State must enter into funding arrangements with each SOE;*
- *There should be structured M&E of performance against identified objectives; and*
- *The application of these principles should take into account the proposed categorisation framework for SOEs."* (PRC, 2012, p. 57)

It would appear appropriate, as recommended in the PRC report, for the final outcome of the process to be contained in the performance agreements ('shareholder compacts') that the PFMA stipulates should be signed between the state and SOEs. The NDP recommends that shareholder compacts be transparent and released publicly (NPC, 2012, p. 45 and 61). This is consistent with the recommendations of other studies, but at present such agreements appear not to be available even to oversight institutions such as Parliament.

It is important to note one implication of the PRC's recommendations: an SOE should not act on any non-commercial mandate that is not contained in the shareholder agreement, and this will need to inform the structure and process of SOE governance. Furthermore, it remains to be determined whether the current guidelines for the drafting of shareholder compacts (National Treasury, 2002) deal adequately with the question of mandate separation.

In the absence of a governing framework of this kind, a key issue is how the financing proposals emerging from the MTBPS and the 2015 Budget address historical conflation of mandates, while laying a platform for a different approach in future.

Finally, there is the possibility that in some instances – albeit probably a minority of cases – there is an inherent tension between commercial and non-commercial mandates that cannot be remedied by separation of mandates. In such cases an alternative approach will need to be developed.

Key issues

- To what extent have non-commercial mandates, as opposed to inefficiencies or external factors, contributed to current SOE financing requirements?
- In the absence of a clear framework for funding non-commercial mandates, do new and existing SOE financing initiatives take into account the consequences of past and present approaches to funding non-commercial mandates?
- Are there instances in which the implicit financing of mandates is undermining the state's broader developmental objectives?
- Do the existing guidelines for shareholder compacts make adequate provision for mandate separation and funding?
- Given the critical role of shareholder compacts, and the recommendations of the NDP and PRC in this regard, what progress is being made in providing these to Parliament for oversight?
- What role, if any, can the draft Government Shareholder Management Bill play in addressing the separation and financing of non-commercial mandates?
- Are there instances in which commercial and non-commercial mandates are irreconcilable, and if so what might be the alternatives to separation in such cases?

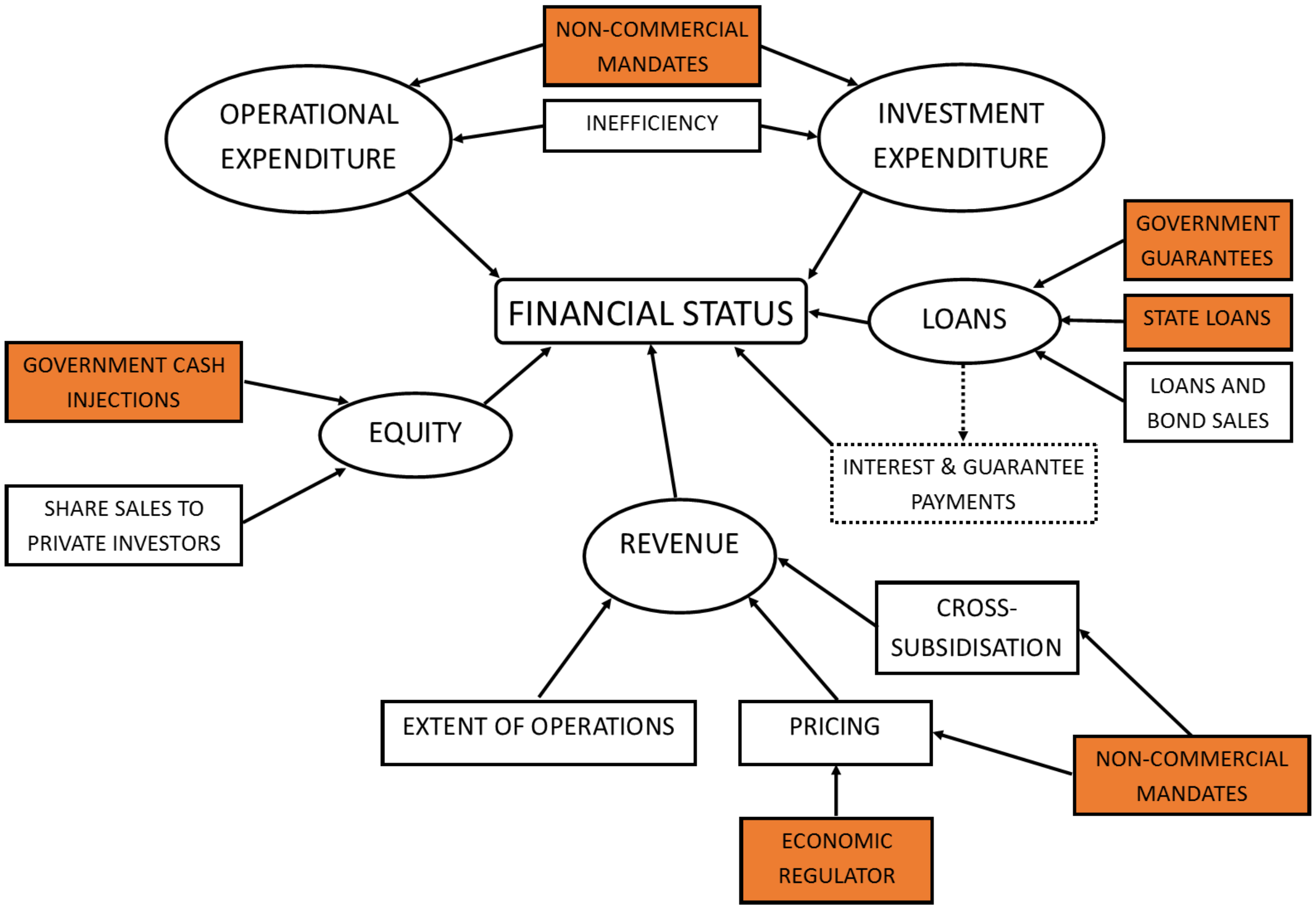

Figure 3 Non-commercial mandates and government financing of state-owned enterprises

4 CRITERIA FOR FUNDING OF STATE-OWNED ENTERPRISES

"*Given fiscal constraints over the next two years, capitalisation will only be funded by the sale of non-strategic state assets, and will not be drawn from tax revenue or added to the debt of national government. Government policy remains that state-owned companies should operate on the strength of their balance sheets*" (National Treasury, 2014, p. 26)

"The State, as owner should ensure [state-owned entities] access to adequate funding... The Government should adopt appropriate funding principles and models...*Government should address the issue of non-financially viable commercial SOEs"* (Presidential Review Committee on State-owned Entities, 2012, pp. 4, 11 and 22)

The first section of this report considered the role of state-owned enterprises, particularly in a developmental state. Many of the ways in which SOEs may advance the objectives of the state involve activities that are not strictly commercial in nature. In other words, SOEs typically have other objectives besides maximising profit or shareholder returns. The second section of the report examined the merits and challenges of separating commercial and non-commercial mandates. A specific concern is that non-commercial mandates need to be adequately financed to ensure an entity's medium- and long-term viability. Considering that problem raises the broader question of how to approach SOE financing and the mechanisms available for doing so.

The Medium Term Budget Policy Statement has indicated a reluctance to increase funding for SOEs through government expenditure or increased government debt. Leaving aside questions regarding SOE performance, there appear to be two primary reasons for this stance. First, reduced growth forecasts and lower levels of revenue collection mean that there is little revenue available for additional transfers to SOEs without reducing expenditure elsewhere. Second, the National Treasury appear to be concerned about the extent of the state's financial liabilities. The resultant desire for SOEs to fund themselves nevertheless raises important questions about the merits of different approaches to SOE financing given developmental and other objectives.

This section provides a short overview of different approaches to SOE financing and the merits of different mechanisms, with reference to international literature, current challenges in the South African context and the previous findings of the National Development Plan and Presidential Review Committee. Additional attention is given to: the importance of regulatory frameworks; infrastructure financing and public-private partnerships; and, government guarantees and contingent liabilities. Section 5 discusses the sale of state assets as an extraordinary measure to obtain funds for supporting SOEs.

4.1 Competitive neutrality

The international literature is increasingly focusing on the notion of *competitive neutrality*: the idea that any state funding of SOEs should not unfairly advantage them relative to a private sector operator in the same industry. A detailed report by the Organisation for Economic Cooperation and Development (OECD) notes that this follows from its guidelines for SOE management, which endorses the creation of a "level playing field" between public and private corporations (OECD, 2012, p. 16). In practice, the principle of neutrality could guide specific policy decisions or regulatory and governance frameworks in particular areas. The OECD advocates that the "most effective way of obtaining competitive neutrality is arguably to establish an encompassing policy framework" (OECD, 2012, p. 13).

As other authors have noted (Balbuena, 2014, p. 8), however, an emphasis on competitive neutrality may be more appropriate in developed countries where there are long-standing SOE governance frameworks, stronger regulatory capacity and fewer developmental objectives. Besides capacity, the appeal of such a framework may depend on a state's policy orientation. The preceding section noted that competitive neutrality implies the need for adequate compensation of SOEs for non-commercial mandates. However, the competitive neutrality literature appears to emanate primarily from a concern that private firms not be disadvantaged by state policy towards SOEs and focuses on possible state distortion of market outcomes. Some analysis suggests that it may also reflect increasing concern among developed countries with the role of SOEs from large developing countries, such as China, in developed country markets (Mott & Nawawi, 2014).

By contrast, developing countries with policy inspired by the developmental state model described in section 1 may want an overarching governance framework to reflect different concerns. While fine-tuning SOE performance, removing any unnecessary funding and protecting local private firms from foreign SOEs may be the primary concern in developed countries, in developing countries the more basic priority is to ensure that local SOEs deliver on their core mandates and are funded adequately while not causing large, damaging distortions in the economy. To put it more directly: a failure to adequately fund major operational or investment obligations of SOEs will typically have larger and more immediate negative consequences for the public and the economy than the inefficiencies that accrue through a lack of a perfectly balanced playing field.

For these reasons the current report considers the question of SOE financing within the South African context of broad economic policy that is explicitly oriented toward a developmental state. Nevertheless, as the analysis below reveals – in relation to debt guarantee fees and competition policy - South Africa already implements components of a competitive neutrality framework. Furthermore, the literature on competitive neutrality does identify some important principles and lessons for SOE financing and we note those where relevant.

4.2 Different mechanisms for SOE funding

There are a variety of ways in which SOEs can be financed. State-owned companies themselves raise revenue through operations and borrow from local and international capital markets. Ability to borrow depends in part on the SOC's assets and expected future revenue flows. Subject to the relevant national governance frameworks, SOCs may also be able to raise funds by issuing shares (`equity') to private investors. Finally, subject to approval by the state shareholder they may also be able to sell assets or divest themselves of subsidiaries.

In addition to these, the state can provide further financial support. There are two broad ways in which this can happen: either the state *enhances the SOC's capacity for obtaining its own financing*, or it *provides direct financial support*. Table 2 shows the different possibilities.

The National Treasury provides a classification of forms of SOE financing similar to that in Table 3, which is shown in Table 2A in the Appendix. Treasury distinguishes between five main instruments for providing direct financial support to SOEs: current transfers; capital transfers; loans or subordinated loans; equity; and, guarantees. Transfers are not repayable and incur taxes. Equity is not repayable, except possibly through dividends, and does not incur tax. Loans and guarantees are subject to detailed agreements on terms.

Table 3 Channels for SOE financing

Possible sources of SOC financing	**Options for self-financing of state-owned companies**	
Self-financing	**Basic self-financing capacity**	**State 'enhancements'**
	Revenue from provision of goods or services	Allowing higher fees or tariffs
		Lower dividend requirements
		Tax exemptions
	Debt financing from loans or bonds	Debt guarantees
	Selling shares to private investors	Allow funds to accrue to SOC (equivalent to equity injection)
Direct state financing	Equity injection/cash transfer [equivalent if state owns 100%] Transfers/incentives for specific activities Provision of loan financing	

An important general point is that just because the state is not making transfers or loans to an enterprise, does not mean that the enterprise is not – at least partly – financially reliant on the state. Where an SOC is in a monopolistic position, the state can provide the SOC with significant financial support by allowing high tariffs to be charged to its captive customers. In that instance the cost is not directly to the fiscus but instead to customers and the economy at large.

State financial support to SOCs is often popularly referred to as a 'bailout'. The term does not have a specific technical meaning, but is most used to refer to government equity injections or loans to entities in financial distress. In the current South African context an intervention to support an SOC will typically involve a package of measures, not limited to these two mechanisms.

A critical point is that successful SOE financing requires a balance between commercial financing and various forms of direct and indirect state financing. If any one source of financing is inadequate it may place a greater burden on other sources. If financing from one source is excessive it may limit the efficacy of the conditions attached to other sources.

4.3 Rationale for providing financial support to SOEs

The channels and mechanisms used to finance an SOE's operations and infrastructure depend partly on the economic and fiscal environment, as well as the rationale for state ownership.

For instance, where an entity is owned for strategic reasons and has limited non-commercial mandates it may be feasible for it to operate using its own revenues and private debt financing. By contrast, where developmental mandates form a significant part of an entity's operations it is likely that significant, recurrent transfers will be required for its operations.

A separate issue, which applies to both situations, is whether an enterprise is adequately capitalised from the outset. If not, then additional measures will be required. In the South African context a number of studies have argued that, "Many…SOEs were arguably under-capitalised at the time of their corporatization." (IDG, 2012, p. 14)

Intuitively, the basic principles for providing financial transfers or support to SOEs concerns whether:

1. Such support is necessary in order for an enterprise to carry-out its mandate;
2. The cost to the fiscus is feasible and does not outweigh the expected benefits from the SOE.

In practice, each of these is complex. As shown in Figure 3, there are various factors that affect SOE finances and those may also vary over time. For example, in a period of high demand to fulfil its non-commercial mandates, reduced revenues due to a weak economy or large-scale infrastructure investment, it may be deemed appropriate to provide an SOE with additional financial support.

Where regular support is required it should be as a consequence of a non-commercial mandate (broadly defined), rather than poor performance. This does not, however, narrow down the challenge a great deal. For example, where an enterprise exists for strategic reasons a 'non-commercial mandate' could simply be that its *existence* is not sustainable in fully commercial form; in other words, the commercial returns available even for a well-run enterprise may not be enough to sustain it. Combined with the preceding analysis of non-commercial mandates, this suggests at least the following reasons for providing financial support to SOEs:

- Initial capitalisation – instead of obtaining funding via private ownership;
- Recapitalisation – where initial capitalisation was inadequate, or the nature of demands on the SOE's balance sheet have changed;
- Ongoing, direct funding of explicit non-commercial mandates;
- Debt financing or guarantees to reduce an SOE's borrowing costs;
- Debt financing, guarantees or equity injections to support large-scale infrastructure projects (could also be seen as a form of recapitalisation);
- Temporary support to offset the negative impact of changes in the external environment;
- Ongoing or irregular support to sustain a strategic commercial entity that cannot be entirely self-sufficient.

Determining whether such financial support is worthwhile depends on how important the SOE's mandate is to the state, alternative uses of the funds for other priorities and whether it is fiscally sustainable. The decision to retain loss-making enterprises is, then, ultimately a political one that needs to be coupled with governance frameworks to minimise the use of such support to compensate for inefficient operations or management.

As already mentioned, many international guidelines – including the OECD's SADC guidelines for SOEs (OECD, 2014) – increasingly emphasise the overarching principle of competitive neutrality in relation to all financing of SOEs. From a social perspective competitive neutrality is not an objective in itself: the basic principle is rather that SOEs should not be advantaged to the point of worsening social and economic outcomes. Where there is adequate private sector involvement in a sector this would take place by, for instance, providing costly financial support for an incumbent SOE when private operators could possibly achieve better outcomes without, or with much less, state support. An example provided in work done for the PRC is telecommunications (Steyn, 2011, pp. 21-23). However, the manner and extent to which principles of competitive neutrality should be combined with developmental priorities is currently unclear.

Another issue implicit in Figure 2, is that where an SOE is in a monopolistic position the state can shift more of the financing burden on to the SOE's customers by allowing (whether through a regulatory framework or otherwise) higher pricing of goods or services. However, this needs to be balanced with possible negative impacts on the economy, consumers and the state's other economic and social objectives. It makes little sense to resolve short-term financing pressures by compromising the state's longer-term economic objectives and thereby undermining future revenue collection.

The challenge then is to find the appropriate balance between the different financing mechanisms. This is far from straightforward and the discussion below of the PRC's findings on economic regulation suggests that South Africa does not appear to have found this balance with many of its SOEs.

Infrastructural expenditure typically presents different challenges to operational financing. In theory, if infrastructure will yield a commercial rate of return in future then an SOE should be able to borrow from local or international capital markets to fund its investment. In practice there may be a variety of reasons why an enterprise cannot adequately fund a large-scale infrastructure programme, or it might be in the public interest for the state to assist with funding in order to obtain lower debt costs. (This second point contrasts with the competitive neutrality literature which insists that SOEs must pay debt costs equivalent to comparable private firms). Another alternative is that SOEs use public-private partnerships (PPPs) as a means of getting private capital at the investment stage. The PRC gives detailed attention to the question of infrastructure financing and the merits and challenges of infrastructure and PPPs will be discussed further below.

At a broader level the PRC recommends that: "Government should address the issue of non-financially viable commercial SOEs…by considering some of the following options:

- Rationalisation of SOEs based on certain criteria; or
- Limit State involvement where technology disrupts natural monopolies; or
- Retaining and adequately funding them as non-commercial entities; or
- Injecting private sector practices and therefore gradually phasing them into commercial entities with a mix of public and private equity ownership; or
- Completely disposing of them as State entities; or
- Absorbing them into the line function department where there is a case for running them less costly as a Government line function.
- The final determination should be done in concurrence with the SOE Council of Ministers."

Options not on this list, but implied by other recommendations in the PRC report, include reforming the regulatory framework to allow higher tariffs and providing greater financial support for the non-commercial mandates expected of SOEs.

The fundamental challenge is to develop a clear notion of what 'financial viability' means in a context where an SOE's operating environment consists of multiple, sometimes conflicting, policy demands and governance frameworks that impact on year-end financial results.

The next subsection delves more deeply into the question of an appropriate choice of, and balance between, SOE financing mechanisms.

4.4 Merits and risks of different approaches

Assuming that the state does want to provide financial support to an SOE, for any of the above reasons, the next question is which mechanisms are most appropriate and how these should be employed. Table 4 provides a summary of possible advantages and disadvantages of the mechanisms listed in Table 3.

The following are all effectively equivalent in terms of the state's balance sheet in the sense that they either reduce government revenue or divert expenditure to SOEs: reduced dividend requirements; tax reductions or exemptions; state loans at less than the state's cost of borrowing; allowing SOEs to retain revenue from asset sales[6]; direct cash transfers or equity injections for balance sheet support; and, payments for specific activities.

The impact of direct state loans to SOEs depends on how they are financed. Typically one would expect that large loans are funded by additional government borrowing. As noted, if this cost is not fully passed on to the SOE then it is equivalent to a cash transfer (of the interest costs). Arguably more important is the effect on the sustainability of government's debt levels and borrowing costs.

The merits of these different options depend on: the state of the fiscus; the SOE's financial situation; the economic context; and, the problem or gap the financing is intended to address.

The *competitive neutrality* literature, discussed above, argues that all such mechanisms should be implemented in a way that does not provide any advantage to an SOE over a comparable private firm.

Another consideration is the *intergenerational equity* of a financing framework: does the financing burden correspond to the likely benefit? Among the factors to be considered are: expected economic growth; population growth; and, when the benefits of SOE performance are expected. This is a particularly important issue in the case of infrastructure investment. If an SOE is embarking on a large infrastructure programme that is expected to yield benefits for 50 years, it is arguably inequitable to fund that programme from tariff hikes over a 5 year period on a population that will not receive much of the benefit. It may also be economically inefficient to do so. The reverse also applies: generations benefitting from past infrastructure expenditure should pay those costs in proportion to the benefits they receive. This example illustrates that there is an important case to be made for a *mix* of different financing mechanisms to ensure efficiency and equity.

[6] In this regard the PRC notes that: "only a few of the SOEs [have been] able to inject long-term equity capital through the sale of non-core assets. Whether the Treasury permitted such asset sales proceeds to be retained by the SOEs, could not be conclusively ascertained. However, the assumption is that the SOEs were allowed to retain a portion of such revenues directly or indirectly." (Presidential Review Committee on State-owned Entities, 2012, p. 167)

Table 4 Merits and disadvantages of different financing mechanisms

	Financing mechanisms	Advantages	Disadvantages/concerns
Indirect state financing	Allowing higher fees or tariffs	▪ Reduces/removes financing burden from the fiscus ▪ Could encourage economic efficiency through cost-reflective tariffs	▪ Under monopoly: may create economic distortions ▪ Under competition: may compromise SOE's medium-term competitiveness/customer base ▪ May conflict with other economic policy objectives (such as industrial development) ▪ May shift the financing burden disproportionately to current generations (e.g. infrastructure)
	Lower dividend requirements	▪ Provides an incentive for SOE to maximise dividend	▪ May encourage profit-maximising behaviour at the cost of other mandates ▪ For fiscal aggregates is the same as a cash transfer ▪ (Not compatible with 'competitive neutrality')
	Tax exemptions	▪ Removes unnecessary 'financing loop'	▪ For fiscal aggregates is the same as a cash transfer ▪ (Not compatible with 'competitive neutrality')
	Debt guarantees	▪ May increase SOE's own borrowing capacity and reduce costs at a limited risk to the state ▪ Removes direct financing burden from the fiscus	▪ May encourage inefficiency if too open-ended ▪ Could allow the accumulation of fiscal risk ▪ (Not compatible with 'competitive neutrality' unless matched with charging guarantee fees) ▪ Could shift financing burden disproportionately to future generations
Direct state financing	Equity injection/ cash transfer	▪ Explicit and transparent form of financial support ▪ Can in principle be made contingent on specific conditions	▪ Immediate cost to fiscus that must be financed by increased revenue, debt or reallocation of spending ▪ Depending on context, could create precedent for 'bailing out' underperforming SOEs
	Transfers/incentives for specific activities	▪ Enables transparent separation of mandates ▪ Encourages efficiency if linked to specific performance measures ▪ Can be planned as recurrent expenditure	▪ Direct cost to the fiscus – funds could be spent elsewhere ▪ (Not compatible with competitive neutrality if SOE paid more than a 'market rate')
	State loans	▪ Takes advantage of lower state borrowing costs (where relevant) ▪ Explicit and transparent form of financial support	▪ May lead to unsustainable increases in government debt ▪ (May not be compatible with 'competitive neutrality') ▪ Could shift financing burden disproportionately to future generations

Debt financing

The PRC report argues that SOEs themselves could make greater use of debt financing and that in recent times government may have been excessive in encouraging SOEs to reduce their 'gearing' (the ratio of debt to equity) (Presidential Review Committee on State-owned Entities, 2012, pp. 176-177). This would seem to be consistent with the dictum that SOEs must finance themselves primarily 'on the strength of their balance sheets' (National Treasury, quoted in (Presidential Review Committee on State-owned Entities, 2012, p. 167)).

At the same time, the PRC report argues that "the scale of [SOE] debt is not sustainable so SOEs will have to pursue other options for funding the projected colossal infrastructure requirements" including equity financing, possibly through partial listings on the JSE.

One way government can assist in placing most of the burden of funding on SOE balance sheets is by providing debt guarantees. This is not entirely costless, however, as it results in 'contingent liabilities' for government, which are discussed in more detail below.

In this context the National Treasury principle stated above – that SOEs should fund themselves off their own balance sheets – leaves open a broad range of possibilities. It allows for indirect state financial support via: a regulatory structure that allows higher tariffs; debt guarantees; retention of funds from asset sales; sale of equity to private investors; and other mechanisms listed above. Combined with the recognition that non-commercial mandates should be funded, and that it may be desirable to provide additional support for infrastructure programmes, the policy appears to be intended to rule-out only regular equity injections.

Private equity financing

A financing mechanism that is entirely different to those considered above, in the sense that it does not have any net effect on government's balance sheet, is to *sell equity in an SOE to private shareholders*.

Since selling equity has no direct negative effect on the fiscus, it is particularly appealing when it is undesirable, or infeasible, to provide funding from government itself. Furthermore, where an investor has sector-specific knowledge and becomes involved in the management and operations of the SOE there is the potential for institutional and operational improvements.

This does, however, raise difficult questions about compatibility between private ownership – that is necessarily focused on financial returns – and the primary mandate of the SOE. As noted by the PRC, where enterprises are natural monopolies there may be significant risks in selling large shareholdings to private entities. One can expect that any existing tensions between commercial and non-commercial mandates will be exacerbated by private ownership. In some instances these may be reconcilable, such as where government simply requires a controlling stake and is looking to obtain equity financing to smooth-over short-run fiscal difficulties. Although this, in turn, raises questions regarding the envisioned long-term ownership structure.

Finally, there is the generic concern as to whether such 'partial privatisations' will achieve their basic fiscal objectives. In the short-run there may be pressures for equity sales to achieve other objectives besides maximising revenue for the state. In the longer-run, if the returns required by private investors are not met through operational improvements they may require higher tariffs for users or lower revenue flows for the state.

Tariffs and the role of regulators

For commercial SOEs it is typically expected that a significant proportion of the required funding will be obtained through revenue from operations. However, many commercial enterprises operate in the presence of limited competition. The danger in that case is that inefficiencies will be funded through excessive prices to customers or consumers who have few alternatives. One way of addressing the importance of tariff determination for funding adequacy and equity is to create regulatory structures.

There is a large international literature on economic regulation in general, as well as the particular challenges of regulating state-owned enterprises. A survey of this literature is outside the scope of the current project and the analysis will instead focus on contributions specifically related to the South African context. Nevertheless, it is important to note a growing recognition even in the theoretical literature (Estache & Wren-Lewis, 2009) that the challenge of regulation is different, and more difficult, for developing countries.[7] There is therefore a need to be cautious in transplanting principles from countries at different stages of development, with more resources and greater institutional capacity.

In recent times responsibility for decisions regarding various critical aspects of SOE financing in South Africa – such as tariff determination – has increasingly been allocated to economic regulators (van Basten, 2007). Success has been mixed, at best (Steyn, 2011). A number of analyses have suggested that regulators often lack the information, methods, capacity and – in some cases – appropriate policy and legislative frameworks to make the correct determination.

To work effectively, approaches premised on economic regulation typically require extensive technical competence and capacity in a minimum of three institutions: within the SOE itself; in the policy department; and, in the relevant regulator. Furthermore, similar capacity is usually required for state financial oversight and on SOE boards, often in competition with private sector companies and consultancies. As discussed further below, at present it is not clear that there are adequate skills currently available to the public sector to meet the requirements of such a system.

Internationally, economic regulators of SOEs, or sectors in which SOEs are present, are sometimes also expected to regulate competition in that sector. This can have large indirect impacts on SOE revenue. For example, where a new entrant attracts customers of the SOE the latter's revenue may fall quite rapidly. The preceding section noted that this can be particularly problematic when SOEs have been expected to cross-subsidise non-commercial mandates. Nevertheless, competition can also be an important disciplining device in terms of the cost and quality of services provided. The issue then is finding an appropriate balance, which is often specific to the relevant SOE or sector.

In South Africa, economic regulators have largely concerned themselves with tariff regulation while the Competition Commission has dealt with regulation of competition. The latter has included a number of rulings relating to SOEs, most notably SAA and Telkom. Aproskie et al (2014) suggest that the Competition Act appears to cover SOEs. Those authors argue that enforcement by the Competition Commission and Competition Tribunal against SAA and Telkom supports the view that "a competitive neutrality framework has been adopted in South Africa" (Aproskie, et al., 2014, p. 11). That is consistent with the view expressed by government during an earlier restructuring of SOEs (DPE, 2001, pp. 52-53).

[7] "the facts and the casual observations are all consistent with Laffont's argument that weaknesses in institutions complicate regulation" (Estache & Wren-Lewis, 2009).

In line with the concerns expressed in the preceding section regarding the appropriateness of a full competitive neutrality approach, the authors note that in its current form there may be some important limitations. The absence of adequate provisions in the law for SOEs may exclude the possibility of SOEs invoking genuine public interest mandates in defending a claim of anti-competitive behaviour.

The PRC recommends the development of a uniform framework for economic regulation with a focus on capacity and independence, but also recommends "identifying policy inconsistencies and policy conflicts" (Presidential Review Committee on State-owned Entities, 2012, pp. 17-18).

As regards the specific issue of competitive neutrality, the PRC recommends that regulators ought to focus on competitive neutrality while taking into account developmental state objectives. However, this is likely to be challenging in practice. As the discussion of competitive neutrality in the previous section notes, there may be tensions between this concept and the policies and approaches that are necessary or feasible under a developmental state. With a few exceptions (Mondliwa & Roberts, 2013) there has been relatively little attention paid to the problem of reconciling dominant approaches to economic regulation of corporatized SOEs with developmental state objectives.

As regards tariffs, the National Treasury has previously initiated an assessment of 'administered prices', defined as: "all prices for services provided by state-owned enterprises or those regulated by organs of the state". The initial concern that led to the study was the contribution of these prices to inflation, but the scope also included possible effects of administered prices on the broader economy. The final summary report (Storer & Teljeur, 2013) comes to six main conclusions:

- That introducing "properly independent regulation" to the utilities and communications sectors would "increase transparency and consistency in price setting" and that existing regulatory capacity in all sectors needed to be improved;
- The role of sectors (or SOEs) in realising "wider economic and social objectives" needed to be explicitly taken into account in the price setting process;
- "the efficiency with which services are produced and the effectiveness with which they meet the government's objectives go largely unmonitored...[meaning] that there is a lack of transparency concerning the effectiveness of administered pricing in contributing to the realisation of national priorities";
- Intervening in the price setting process to achieve other (social or economic) objectives can create a number of other problems, such as over-consumption and underinvestment;
- Monopoly power, the nature of network industries and the need to achieve broader social and economic objectives mean that privatisation and liberalisation are not a 'cure-all';
- Although prices in sectors such as water and electricity may have been too low, there is a pattern of inefficiencies being passed through to consumers in higher prices that therefore contribute unnecessarily to inflation.
  (Storer & Teljeur, 2013, pp. 41-44)

This report on administered prices is therefore consistent with the view analysed in section 2, that non-commercial mandates need to be made explicit and funded accordingly. It also emphasises that tariffs play an important role in directing economic activity. Excessive or inappropriate reliance on tariffs as a source of funding can have undesirable consequences, including discouraging economic activity, reducing the welfare of poor households and allowing inefficiency in state-owned enterprises.

This issue has been, and remains, an important one in the South African context. The example of Eskom has already been discussed in section 3. The report for the PRC process (Steyn, 2011) suggests that despite being relatively high, approved tariff increases for Eskom have been inadequate in the context of its infrastructure programme.

Another important example, Transnet, is discussed as a brief case study below. An ongoing concern in that instance has been that – in contrast to the Eskom case – Transnet's port tariffs may be *higher* than desirable.

Case study: Transnet

After earlier consolidation, Transnet currently has two main operations: ports and freight rail. By comparison to some other SOEs, Transnet would appear to be financially sound in the sense that in recent times it has not required major equity injections from the state. It has also – as shown in a later subsection – reduced its reliance on state guarantees. An observer may therefore be tempted to conclude that it is operating effectively. Regardless of whether the conclusion is correct, this logic is problematic.

A well-known problem has been that South African ports tariffs appear excessive by international standards (Ports Regulator of South Africa, 2013). The role of port tariffs in cross-subsidisation within Transnet is well-established (DPE, 2001, p. 138; Steyn, 2011). The benchmarking report produced by the Ports Regulator also notes significant variation across types of cargo, with container traffic apparently cross-subsidising primary exports (such as minerals).

To the extent that this disparity encourages export of raw materials, increases the costs of manufacturing inputs and reduces the competitiveness of manufactured exports, it is inconsistent with government's industrial policy outlined in successive IPAPs, the NDP and the NGP. However, if tariffs were to be greatly reduced this would likely have a corresponding negative impact on revenue and Transnet's ability to raise its own debt financing.[8]

This example draws attention to the conflict between commercial and non-commercial mandates – as also noted elsewhere (ANC, 2012, p. 21). The implication is that in some important cases the state will need to reconsider the balance between the desire to have commercial enterprises self-funding (as recommended by the PRC and MTBPS) and pursuit of the objectives of a developmental state.

A number of other examples besides Eskom and Transnet have been discussed in the South African literature. For instance, in response to arguments that their charges were too high, the Airports Company of South Africa (ACSA) have suggested that this is partly because OR Tambo cross-subsidises unprofitable smaller airports (Maseko, 2013). If that is accurate, then that constitutes an example of SOE financing using a combination of tariffs and cross-subsidisation of a non-commercial mandate. And the PRC Report argues that in relation to the King Shaka International Airport:

"the commercial viability of ACSA was negatively affected by the pursuit of a national interest. ACSA carried the lion's share of the funding that was required, and the regulator forced ACSA to rely on borrowed funds" (Presidential Review Committee on State-owned Entities, 2012, p. 116)

That a framework for identifying and separating-out non-commercial mandates does not currently exist (National Treasury, 2014), is an indication that economic regulators are unlikely to have been able to take such mandates into account when estimating appropriate prices and tariffs.

Chapter 5 of the PRC report provides some detailed analysis of economic regulation, largely based on the report by (Steyn, 2011). The findings and conclusions can be summarised as follows:

[8] In theory this negative impact could be partly offset by an increase in freight flows.

i. Approved tariff increases have been inadequate to "ensure the financial viability of the SOEs during the peak of the investment cycle"
ii. "Regulatory methodologies are inconsistent and subject to frequent change"
iii. "Regulators are unable to review new market entry and new capital projects effectively"
iv. "problems of inefficient and inappropriate capital investment decision-making, and unfunded mandates, appear to be among the main causes of poor SOE performance and soaring infrastructure prices"
v. "Regulatory decisions are sometimes unpredictable, arbitrary or of poor quality…[and] this could lead to a downgrade in the SOE's credit rating"
vi. Part of the reason for such problems with regulatory decisions is "the lack of clarity on the principles governing the regulatory system"
vii. "Often, problems that appear to be regulatory failure are in fact the symptoms of an underlying policy failure".

From these observations and conclusions, the PRC made two high-level recommendations:

[6A] Develop a uniform framework for economic regulation

[6B] Process of identifying policy inconsistencies and policy conflicts; clarify the role of economic regulators; and develop a blueprint to guide regulatory designs

Given all the above, there appears to be a broad consensus that economic regulation of SOEs in South Africa is not currently achieving the desired outcomes and has in some important cases created serious problems. Some of the responsibility lies with regulators themselves, but arguably the core problem is with the framework and environment in which the regulators are operating.

The PRC report has made a number of important recommendations to improve economic regulation over the next two decades but a few questions remain:

I. Is the capacity available in South Africa to implement such a framework and if so is it efficient to allocate such scarce resources to these activities?
II. What is to be done to coordinate SOE financing mechanisms in the critical interim period?
III. Is economic regulation not working because it has not been implemented properly (or is too complex to implement), or might there be some *inherent* tensions between the arms-length 'corporatise and regulate' approach and the more activist developmental state? If the latter then arguably a broader rethink of the current financing framework is required.

Although there are plans to introduce new regulators and consolidate some existing bodies (e.g. a Single Transport Economic Regulator) there is currently no overarching plan to improve performance of existing regulators or to reconsider the role of regulators in light of the problems outlined above.

Most studies, including those for the PRC, assume that the only option is to make economic regulators work better. However, as some authors have noted, the generic assumption that an ineffective regulatory system is better than no regulation, and a different form of management, may not be accurate. As one author puts it: "In the extreme case, there are worse things than unregulated, profit-seeking monopolies – and regulators have historically been the ones who create those worse things" (Schmalensee, 1998).

This is an area that may require further consideration when implementing the PRC's recommendations.

Debt guarantees and contingent liabilities

Debt guarantees are arrangements in which the Treasury effectively stands surety for particular debt instruments issued by SOEs. This can serve to increase the extent of debt financing SOEs can obtain, as well as reduce the cost of such debt. However, guarantees constitute contingent liabilities for the state. For general accounting purposes the relevant definition by National Treasury of a contingent liability arising from a debt guarantee is as follows:

a possible obligation that arises from past events, and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the department (National Treasury, 2014, p. 6).[9]

In South Africa, the Ministry of Finance provides final approval for agreements that result in contingent liabilities, whether these are debt guarantees or public-private partnerships. Unlike in many other countries, Parliament does not have direct oversight over specific contingent liabilities (Cebotari, 2008, p. 19). Some research on the provision of information on such liabilities finds that while most countries surveyed provided information on explicit loan guarantees, information on PPPs is 'more limited' (ibid, p. 39).

As noted previously, the competitive neutrality literature argues that SOEs should not benefit from cheaper debt due to state support. If such benefit does accrue, such authors argue, it should be paid back to the national treasury. Although not widely known, such arrangements do exist in South Africa under the Treasury's debt guarantee policy (National Treasury, 2005), which does require SOEs to pay 'guarantee fees' in many instances.

Charging SOEs for debt guarantees may be desirable, even in a developmental state framework, as it potentially encourages more responsible SOE behaviour by necessitating internalisation of the Treasury's additional risk. Nevertheless, if the objective of debt guarantees is to reduce the overall debt cost to the SOE then charging fees equivalent to the reduced debt costs – as advocated in some of the competitive neutrality literature (OECD, 2012; Cebotari, 2008), – defeats the purpose. Therefore whether it is optimal to charge fees will depend on the entity, the nature of the agreement and the broader intentions behind SOE financing.

It is important to note that government typically expects debt guarantees not to be called upon. If it expected that it is 'probable' a debt guarantee will be called upon – i.e. an SOE creditor demands payment that the SOE cannot provide – then the debt guarantee should be classified as a 'provision' for accounting purposes. Nevertheless, even if contingent liabilities constitute only 'possible', not 'probable', future payments they can pose significant risk when large relative to the government's ability to repay its obligations.

An example where such subtleties matters can be seen in the recent Development Bank of Southern Africa Amendment Bill considered by the Standing Committee on Finance in 2014. In that case, although the callable capital of the DBSA was increased to R25billion, National Treasury took the view that this did not imply an increase in contingent liabilities since drawing on this capital would require agreement by the Treasury.

A related, important point is that some notable risks that could plausibly be classified as contingent liabilities, such as the likelihood of governments' intervention in banking crises (Cebotari, 2008, p. 7),

[9] This is in line with a standard definition in use in the literature: "obligations whose timing and magnitude depend on the occurrence of some uncertain future event outside the control of the government" (Cebotari, 2008, p. 5).

are nevertheless not included in national accounts. Such risks are sometimes referred to as ‘implicit contingent liabilities’.[10]

In considering South Africa’s fiscal framework, rather than the financial state of a particular SOE, the primary consideration in relation to debt guarantees and contingent liabilities is the financial risk they imply for public finances. In a recent presentation to the Portfolio Committee on Public Enterprises (National Treasury, 2014), National Treasury indicated that containing the combination of net national loan debt, provisions and contingent liabilities below 50% of GDP is prudent.[11] Guidelines agreed by members of the Southern African Development Community have reportedly indicated a 60% threshold (National Treasury, 2014), which is the same as that recommended by the IMF (IMF, 2014).

Figure 4 shows the change in net debt, provisions and contingent liabilities as a per cent of GDP, along with the composition of this, over the last decade and the forecast for the MTEF period (2015/16 to 2017/18). Net loan debt has grown rapidly since 2008 due to slower economic growth and government’s counter-cyclical fiscal policy. Provisions, guarantees and other contingent liabilities have also grown in absolute terms, but not as quickly as net loan debt and hence are a smaller portion of the total.

As part of its recent Article IV country consultation, the IMF modelled a number of simple scenarios as part of its standard debt sustainability analysis (IMF, 2014). The report noted that in the ‘extreme’ situation that 75% of South Africa’s contingent liabilities were called upon, loan debt would likely increase to the ‘high risk’ level above 70% of GDP. The report does not provide a probability for such an event occurring and as a result it would be inadvisable to place too much weigh on this finding. Nevertheless, it does usefully indicate the potential link between contingent liabilities and the sustainability of public finances.[12]

[10] “Implicit contingent liabilities...are political or moral obligations and sometime arise from expectations that government would intervene in the event of a crisis or a disaster, or when the opportunity cost of not intervening is considered to be unacceptable” (Cebotari, 2008, p. 6).

[11] The self-imposed threshold of 50% for South Africa is also noted by (Cebotari, 2008, p. 20).

[12] The IMF states that: “While extreme, this exercise serves to underscore the growing risks posed by contingent liabilities from SOEs, both to the fiscal outlook directly and indirectly through its potential impact on investor confidence” (IMF, 2014, p. 4).

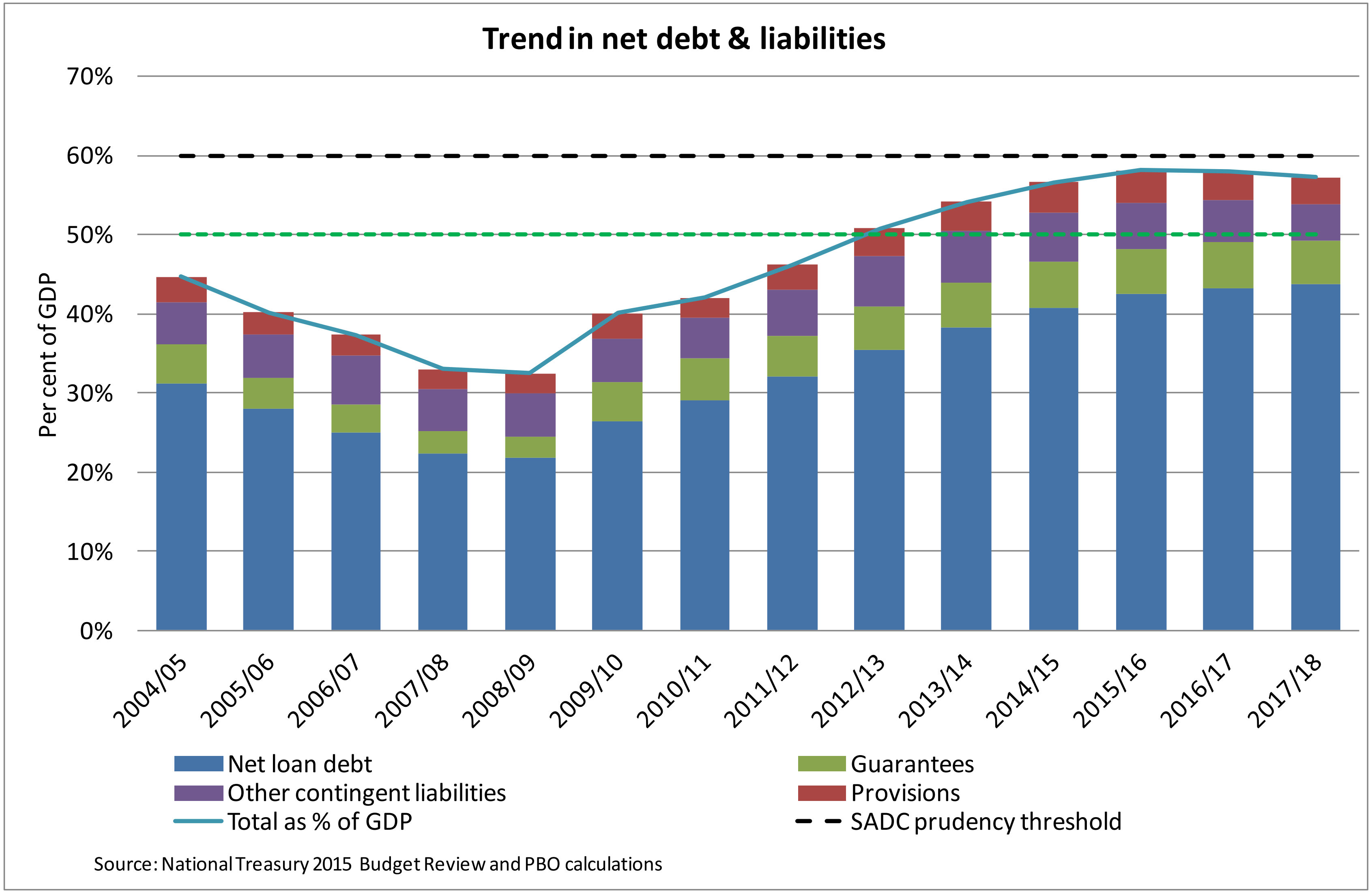

Figure 4 Government net debt, provisions and contingent liabilities

Figure 5 shows the composition of major debt guarantees – based on size in 2015/16 – to state-owned enterprises and state-owned entities over the last decade. While Transnet has decreased its debt guarantees, there have been substantial increases in guarantees to Eskom, SAA, SANRAL and the South African Post Office (SAPO). An important point in this regard is that the totals listed constitute debt guarantees *that have been borrowed against*, sometimes referred to as 'exposure', since the government would be required to pay these if the SOE was unable to do so. *Debt guarantees utilised by SOEs* total R224.9 billion in 2014/15, which is 5.8% of GDP from a lowest level 2.6% of GDP in 2008/9. However, *total guarantees issued* by the National Treasury are R461.1 billion, which is 11.9% of GDP (National Treasury, 2015, p. 97).

A critical question in the context of SOE financing, including PPPs, is: what is the purpose of government assuming contingent liabilities?

Much of the literature focuses on the 'market failure' rationale for financing through contingent liabilities (Cebotari, 2008). In the context of SOEs, the most important consideration is that financial markets often have less information about SOEs than the state shareholder. As a result, markets are either less inclined to provide debt financing, or do so at a higher cost than they would if they had full information. In such situations government can signal its confidence in the SOE's future performance through debt guarantees. Doing so enables the SOE to borrow more and/or at a lower rate from markets. This rationale can be particularly important when there is a short-term loss of confidence among private investors or lenders, whether relating to the SOE specifically or economic prospects in general, that may result in unwarranted financial difficulties for the SOE.

A second reason is that an SOE may require additional financial support in order to fulfil its non-commercial mandates. The basic principle, which is sometimes also placed under the market failure rationale, is that it makes sense for the state to take on risk to support SOE operations or investments that have correspondingly high social or economic returns. Such support could relate to operational or investment activities. It could also be necessary to compensate for initial undercapitalisation of the SOE.

Compared to the other forms of financing discussed above, debt guarantees have the advantage of not having any immediate effect on expenditure or borrowing. In the appropriate situation they may reduce total public borrowing costs without the addition of substantial risk.

That debt guarantees do not incur any short-term costs for the state can also be a drawback of this mechanism. It can be used to accumulate excess risk and shift financing burdens into future periods. The absence of immediate costs, along with more limited oversight as discussed above, can mean that projects or decisions that are not in the public interest are able to proceed.

Analogous issues arise with the use of guarantees in the context of PPP contracting – the subject of the next subsection. On the one hand, state guarantees – either for borrowing or revenue flows – can assist in attracting private capital. On the other hand, if the implication for future expenditure is not adequately appreciated or the risk is not appropriately structured, such arrangements could lead to the adoption of projects whose total cost outweigh their social benefit.

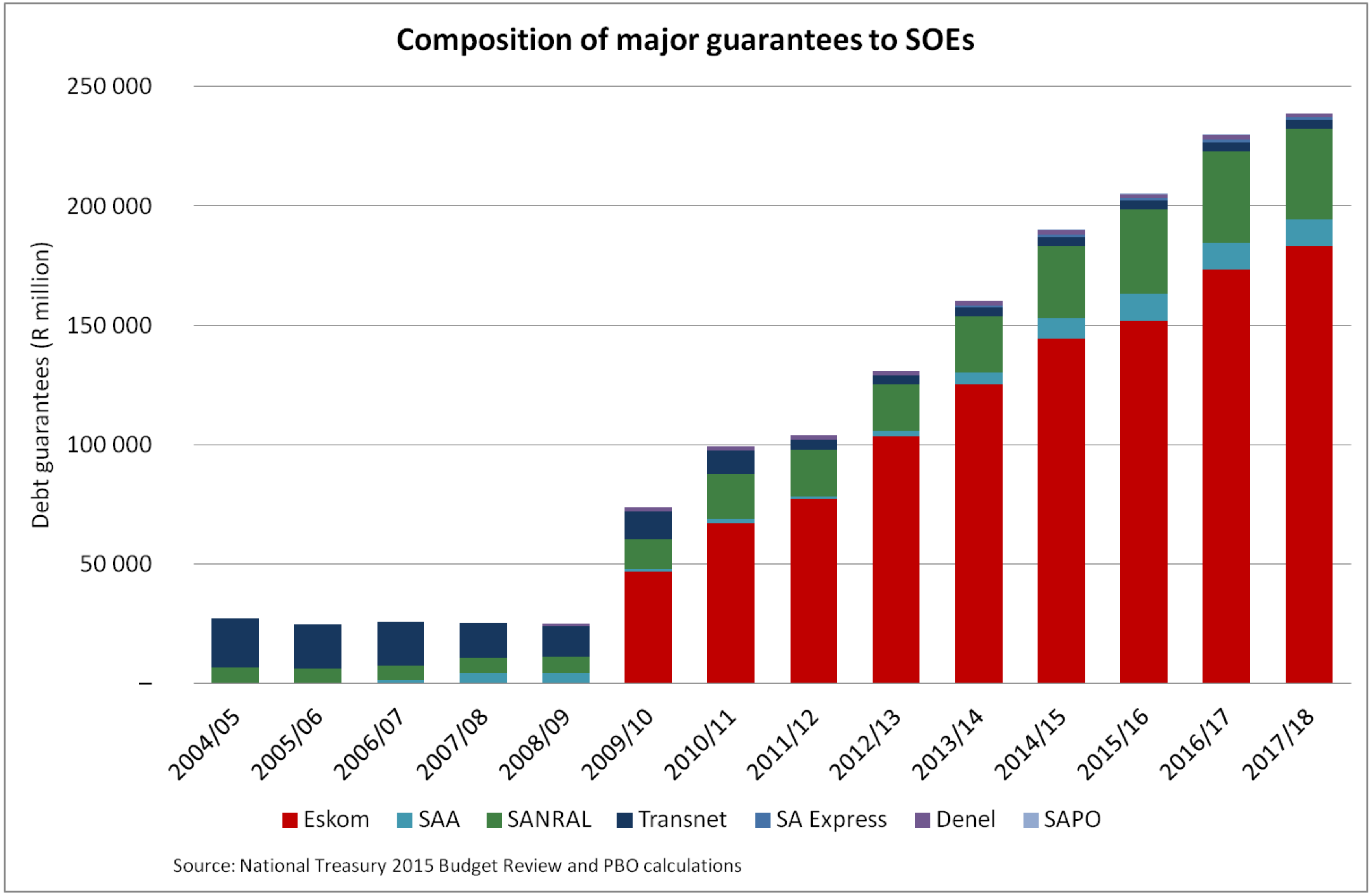

Figure 5 Guarantees to major state-owned entities: 2004/5–2017/18

Infrastructure financing and PPPs

In the context of slower-than-expected economic growth and pressing need for infrastructure investment, obtaining funding through partnerships with the private sector is particularly appealing. The World Bank notes that since the 2008 financial crisis "governments are increasingly turning to the private sector as an alternative additional source of funding to meet the funding gap" (World Bank, 2015).

The main appeal of PPPs from a financing perspective is that they utilise private capital to shift the burden, either for the state or consumers, to a future period when it is hoped that this will be easier to bear. Although the nature of the commitments taken on can constitute a form of 'indirect state support' to an SOE, we have not explicitly listed PPPs as a form of financing because they still rely on the same indirect mechanisms listed (guarantees, direct transfers, loans, tariff allowances, tax incentives, etc). The second attraction of PPPs is the prospect of leveraging private sector expertise for project management, infrastructure construction and provision of the relevant services. In theory such expertise could reduce the overall financing requirement, but there is little systematic evidence to show that PPPs are necessarily cheaper on average once profit requirements and risk are accounted for.

The *Public-Private Partnerships Reference Guide* (World Bank and Asian Development Bank and Inter-American Development Bank, 2014), produced in collaboration between three international financial institutions, provides extensive detail relating to PPPs in developing countries. That guide, as with other analyses, makes clear that from a financial perspective the benefit of PPPs is not typically in *reducing* the overall financing burden for infrastructure, but rather in *restructuring* it. Such restructuring, however, is accompanied by risks such as potential future financial liabilities for the state (Aslan & Duarte, 2014).

That in turn draws attention to the complexity of PPPs and the contracting they involve, since they require detailed agreements that adequately allocate financial and operational risks between the private and public partners. Poorly-implemented PPPs can expose the state to large future financial liabilities as well as political and other risks that arise from operational failures. As with economic regulators, ensuring that a PPP results in socially desirable outcomes requires significant state capacity and cost. One challenge for the South African legislature in this regard is that there is often little formal oversight by the legislature over the financial aspects of PPPs, even though these may commit the state to substantial future payments and risks.

South Africa passed PPP legislation in 2000 and a PPP Unit was established within National Treasury in the same year. Further regulations were passed in 2004 and a PPP Manual has been developed specifically for the South African context. There does not appear to have been a systematic assessment of the successes and failures of PPPs in South Africa since 2000. Aslan and Duarte (2014) note a number of benefits of centralised PPP responsibility, particularly in terms of resolving the roles of the finance ministry and the policy department. Though they also note that importance of structuring institutions so that "entities promoting PPP projects not be tempted to underestimate the disadvantages of the PPP mechanism and overestimate their benefits" (Aslan & Duarte, 2014, p. 10).

Since arguably the greatest challenge relating to SOE financing in the present South African context is in relation to the financing of large infrastructure programmes, PPPs are receiving increasing attention. For example, one paper prepared for the PRC argues that in the regulatory framework and environment in that sector, Eskom's capital programme was "in essence unaffordable" partly because the tariff increases awarded were inadequate (Steyn, 2011, p. 13). What is particularly interesting from the PPP perspective is the proposed role of Independent Power Producers (IPPs) that have been proposed as a solution to Eskom's affordability problems. The idea is that IPPs would be developed by private investors, meaning that additional electricity capacity could be brought online without any burden added to the fiscus. Under some forms of IPP contracts, Eskom or municipalities would sign contracts to purchase electricity at a particular price from these producers, effectively guaranteeing them a certain rate of return. Many authors have argued that the existing environment is unattractive to IPPs because tariffs are too low. If that is true then IPPs can only assist with the energy infrastructure problem if tariffs are increased.

However, in the context of the earlier section which discussed the important of balance in SOE financing sources, it is then necessary to ask whether low tariff levels may not be partly responsible for the very problems with the incumbent operator that have led to the consideration of IPPs. If that is the case, then arguably the question of tariff determination – and the regulatory framework in this regard – should be addressed first.

Case study: Gautrain

The Gautrain project, as one of the largest PPPs ever agreed in South Africa, serves to illustrate the role PPPs can play while also the challenges of infrastructure financing and that PPPs typically do not reduce financing costs. The original amount envisaged for the entire infrastructure project was R7billion, but this later escalated to approximately R23billion. In the final analysis the state contributed 87% of the capital required.

The agreement with the concessionaire that would run the project involved provision of a 'patronage guarantee' that assured the private operator a certain level of return. Although the project has reportedly exceed its original passenger projections, in 2013/14 the appropriation for the Gautrain patronage guarantee was adjusted upward from R802million to R1.4billion (Gauteng Provincial Treasury, 2014, p. 356). The MTEF estimates suggest this will increase to R1.8billion by 2016/17. The Gauteng Treasury appears to suggest that this has placed pressure on the province's fiscus, which has been compensated for by upward adjustments to its equitable share.

The Gautrain was part of a broader public transport plan in Gauteng, which included another PPP in the form of the E-toll system. The expectation was that through cost-reflective pricing e-tolls would also encourage road users to switch to Gautrain, thereby supporting Gautrain passenger numbers. This relationship has important implications for the financial and operational success of both PPPs, further illustrating the complexity of such projects. A recent report suggests that e-tolls contribute to a 6% increase in Gautrain's ridership figures (Gauteng Provincial Government, 2014).

In the South African context, a number of studies – including the PRC report – have emphasised the importance of different financing arrangements for 'social' and 'economic' infrastructure. Specifically, the argument is that the latter should be financed on a 'user pays' basis, whereas the former will typically require subsidies. These naturally imply different funding models for PPPs.

The E-tolls case mentioned above has highlighted the challenges in drawing a clear line between social and economic infrastructure. The E-tolls system is designed on a 'user pays' basis, but at least one part of the PRC Report classifies roads as social infrastructure (PRC, 2012, p. 167) and some opposition to the E-tolls system has been on the basis that it is socially inequitable (Gauteng Provincial Government, 2014). This in turn also draws attention to the connection between financing risks and political risks that are rarely adequately factored into the PPP contracting process.

As noted by various authors (Trebilcock & Rosenstock, 2015), the success of PPPs depends critically on the state's capacity to negotiate favourable agreements and put measures in place to ensure delivery, effective operations and limit the state's financial exposure. As noted previously, National Treasury has had a PPP Unit for some time and there are initiatives underway, such as the

Government Technical Advisory Centre (GTAC) under National Treasury, to improve the capacity of departments to design such arrangements.

Nevertheless, the above discussion presents something of a paradox relating to the two primary motivations for PPPs. First, PPPs are supposed to supplement limited government capacity, but in order to work successfully require significant capacity to structure and monitor the agreement between parties. Second, PPPs are supposed to alleviate the financing burden on the fiscus from infrastructure demand, but rarely reduce the net financing requirement and can also create significant medium- and long-term financing risks.

The first paradox can potentially be resolved by substituting capacity to implement infrastructure projects with capacity to structure PPPs. At the extreme, in countries with weaker state capacity and limited resources, this may manifest in outsourcing of many state functions by a strong finance ministry. For middle-income countries like South Africa that nevertheless struggle with state capacity in certain areas (NPC, 2012), and adopt a developmental state orientation, the issue is arguably whether PPPs constitute a short- or long-term solution to the capacity problem. Furthermore, it is also important to recognise that even where contracts formally place the responsibility for operations clearly on the private sector partner, failures may lead to political consequences that make state intervention unavoidable. This prospect undermines the credibility of state commitments that PPP contracts can ensure that the burden of poor performance is shouldered by private contractors.

These tensions are acknowledged by the PRC Report. In its Recommendation 20 the PRC states that:

> *"Private sector participation in partnering with SOEs to deliver on the provision of both economic and social infrastructure should be encouraged and expanded" (Presidential Review Committee on State-owned Entities, 2012, p. 175)*

At the same time it acknowledges that private partners may 'cherry pick assets', PPPs involving monopolies may require additional regulation, risks need to be appropriately allocated and "management of SOEs must be sophisticated in order to execute PPPs in the best interests of the economy and society". The overall conclusion being that: "SOE PPPs must "be handled with extreme care" (ibid).

From a financing perspective the critical point is that PPPs may have a role to play in SOE financing, but come with their own risks and "cannot be seen as a panacea" (World Bank and Asian Development Bank and Inter-American Development Bank, 2014, p. 32).

4.5 Conclusion

There are a variety of mechanisms within the control or influence of the state that affect SOE finances. Within these there are two broad categories: direct and indirect forms of financing. The former, such as transfers and loans, receive a great deal of attention, but where most of an SOE's funding is drawn from commercial activities the latter are usually more important. Slower economic growth, lower revenue collection and growing government debt levels have led to a renewed emphasis on SOEs funding themselves with minimal direct support.

The two most important forms of indirect financing are guarantees (either for debt or PPP contracts) and tariff regulation. In South Africa the National Treasury is the final arbiter of guarantees, while tariff regulation is typically left to independent economic regulators that have been established as public entities. In both cases oversight by the legislature is limited.

Both these mechanisms have important limitations. Guarantees lead to contingent liabilities for the state: essentially, the risk that large payments may be required in future if the SOE cannot meet its obligations. These liabilities are now routinely factored into the debt sustainability analyses conducted by the IMF and credit ratings agencies, so shifting financial obligations in this way may not have any appreciable benefit to external assessments of South Africa's public finances. Net liability levels are due to stabilise at approximately 58% of GDP over the MTEF period, more than National Treasury's preferred maximum of 50% but below SADC and IMF guidelines of 60%.

Furthermore, the PRC report notes that contrary to its intention, economic regulation in South Africa to date appears to have had a negative effect on SOE financial performance through its role in preventing necessary tariff increases – particularly to finance large infrastructure programmes. At the same time, caution is required in shifting a greater part of the financing burden to consumers and firms for two reasons. First, tariff increases may have negative distributional consequences, affecting the poorest the most. Second, to the extent that tariff increases discourage economic activity they may compound the underlying problems (declines in economic growth and revenue collection).

This is partly due to problems with regulators themselves, but to a significant extent because of the regulatory framework relies on policy clarity leading to inadequate tariffs for funding infrastructure programmes and the expectation that SOEs perform non-commercial mandates that are unfunded.

The guidance provided by the modern international literature on SOE financing is increasingly focused on the notion of 'competitive neutrality': the idea that state support to SOEs should not benefit those enterprises relative to actual or potential private sector competitors. Although there is no overarching policy, South Africa has incrementally adopted a number of policies that effectively implement competitive neutrality principles. Two particular examples are the charging of guarantee fees to SOEs for debt guarantees issued by the Treasury and the Competition Commission and Tribunal's rulings against SOEs for violation of competition law. The PRC has endorsed the role of economic regulators in applying principles of competitive neutrality, but one concern is whether such an approach is compatible with a developmental state orientation. While competitive neutrality policies have largely been developed in OECD countries at a further stage of economic development, it is questionable whether economic policy in a developmental state should make this the *predominant* concern of SOE financing and regulation.

As noted in section 3, the PRC made a number of recommendations on how "government should address the issue of non-financially viable commercial SOEs". An important prior question that must be addressed is how to assess 'financial viability' of SOEs in the absence of explicit, funded non-commercial mandates and economic regulators making decisions in the presence of unclear policy frameworks and limited capacity. In such contexts, SOE balance sheets are unlikely to be an accurate reflection of potential viability. The previously discussed example of Independent Power Producers illustrates the possible dilemmas: IPPs have been proposed by some experts as a solution to Eskom's supply limitations, but at the same time are reported to require higher tariffs than Eskom has been allowed. This implies that energy supply by private capital is also not financially viable under the current framework.

In the current context, with limited room for manoeuvrability in public finances and apparently large cash reserves being held by private sector firms, the involvement of private capital is particularly appealing. Restructuring of SOEs to facilitate this may be an important component of a new, comprehensive policy – as suggested by the PRC. However, if this is in response to financing problems then arguably the financing framework itself must first be determined to be adequate. It is also necessary for the state to assess whether current financial difficulties experienced by SOEs can be alleviated through improved governance and operational efficiencies. If such issues are not attended to, restructuring may not resolve the underlying causes of undesirable SOE outcomes.

While private equity financing – through selling a stakes in an SOE – may be appealing in the current economic climate, it would have to be reconciled with the broader mandate of the relevant enterprise. Similarly, the use of PPPs to alleviate the financing burden in infrastructure programmes requires careful consideration to ensure that it does not expose the state to excessive future financial and operational risks.

Key issues

- SOE financial performance is the result of different financing mechanisms. Where does the responsibility lie within government for ensuring that an appropriate balance is found?
- To what extent can existing financial challenges experienced by SOEs be alleviated through better management or a reorientation of operations and investment?
- The PRC makes a number of recommendations as to how the state can deal with 'non-financially viable' commercial SOEs, but assessing viability requires accounting for the relationship between *existing* financial performance and weaknesses in funding and policy frameworks.
- Economic regulation of SOE tariffs has been problematic, particularly in the context of large infrastructure programmes.
- The PRC envisages a uniform framework for economic regulation being implemented between 2020 and 2025; this may be a realistic timeframe, but what should happen with tariff-based financing until then?
- The relationship between developmental state economic policy and the principle of competitive neutrality must be adequately reconciled for consistency in SOE policy and regulation.
- What is National Treasury's plan to manage contingent liabilities over the MTEF, and how can Parliament improve its oversight of any associated risk to public finances?
- Can the use of private capital to reduce the burden on public finances be reconciled with the reason for state ownership of enterprises?
- PPPs may assist with spreading-out the burden of infrastructure financing, but can also expose the state to significant risk and could also be subject to greater Parliamentary oversight.
- For accountability and equity it is important to ensure that the financial burden and financial risk of SOE funding is distributed equitably over generations.

5 DISPOSAL OF 'NON-STRATEGIC' STATE ASSETS

Over the next two years, capital injections for Eskom and funding for other state-owned companies will be raised in a way that has no effect on the budget deficit. In some instances, government will dispose of non-strategic assets to raise resources for financial support. Such assets could include property, direct and indirect shareholdings in listed firms, non-strategic government shareholdings in state-owned companies and surplus cash balances in public entities. Private investment to strengthen the balance sheets of state-owned entities will also be explored. (National Treasury, 2014, p. 23)

The National Treasury has indicated in the 2014 Medium Term Budget Policy Statement (MTBPS) and 2015 Budget an intention to fund additional support for state-owned enterprises (SOEs) through the sale of state assets. As discussed in section 4, and in the PBO's presentations and reports on the MTBPS and Budget, the basis for this proposal is protection of the planned 'fiscal consolidation programme'. That programme aims to stabilise public finances by reducing the growth of government debt levels.

As a practical matter this proposal has the advantage of sending a signal to investors and credit ratings agencies regarding government's commitment to its debt and expenditure targets. However, the extent and timing of SOE financing requirements could mean that this approach places pressure on government to sell assets, which may lead to lower revenue or distort the selection of appropriate assets. At the same time, any delays could negatively affect perceptions of SOEs' financial positions, thereby negatively affecting credit ratings and increasing borrowing costs.

The broader advantages of selling state assets as a means of financing SOEs must be considered in light of the issues discussed in preceding sections. The appropriate extent of government support for an SOE depends on, among others: the reason for the SOE's existence; its current mandate; and the desired balance of the funding burden among the different sources of financing outlined in section 4. If financial shortfalls are due to inefficiencies, selling other assets to fill the financing gap may be ill-advised, unless there is reason to expect improvement in an SOE's performance. In contrast, if the financing requirement is the result of inadequate state provision in the past, asset sales may be more defensible if government is unable to provide funding through normal expenditure or borrowing.

One can infer from the discussion in section 4 what the proposal to sell assets implies for National Treasury's view on other financing mechanisms. Evidently Treasury believes that it is undesirable for the burden of additional funding to come from its expenditure or borrowing, cannot or should not be entirely shifted to the broader economy through tariff increases, and cannot be financed from the SOEs' own balance sheets at an acceptable cost.

An important point arising from this is that if one accepts the need for the additional SOE financing, but is *not* in favour of asset sales (broadly defined), then one of the following alternative mechanisms must be used:

1. Increase tariffs further than planned to cover any shortfalls;
2. Shift government expenditure from other commitments;
3. Increase consolidated government debt beyond the levels planned in the 2015 Budget;
4. Require that SOEs self-finance through additional borrowing.

Given the political and ideological contestation regarding the appropriate role of the state in the economy, stakeholders may hold widely differing positions on the desirability of these options. This was the case – see for instance (DPE, 2001; COSATU, 2001; Jerome & Rangata, 2003) – during the post-1994 ‘privatisation phase’. There is now reluctance to use the term ‘privatisation’ due to its association with the larger scale and ideologically motivated initiatives of the late 1980s and 1990s. However, according to most standard definitions selling state assets constitutes ‘privatisation’ since it results in the transfer of assets from public to private ownership.

It is important to note the context for the Treasury’s proposal. First, there has been a resurgence in sales of government assets since the Financial Crisis of 2008. This is due in part to high government debt levels that resulted from bailouts of the banking system, reductions in economic growth, or some combination of these factors. For example, Gorecki et al (2011) describe the Irish experience and The Economist (2014) has recently discussed the merits of selectively selling-off state assets in developed countries to alleviate the public debt burden. One advantage is that some assets may not currently be producing any revenue or serving a useful social purpose, but could realise significant revenue if sold. A different advantage, in the context of public financing pressure, arises where state ownership of revenue-producing assets is not needed for social or economic objectives. ‘Cashing-in’ the revenue obtained from these assets at a time when debt costs are high could reduce government’s total interest payments.

Nevertheless, the strategy of selling assets has not been uncontroversial and there is ongoing contestation, among economists and political groupings in various countries, regarding asset sales. Among the concerns raised are that:

- Governments may not derive adequate revenue from such sales because of their timing during an economic downturn;
- Even if there are short-term gains in revenue raised and lowered debt levels, the net effect on state finances and social welfare over the medium- to long-term may be negative;
- The process of asset sales may be captured by vested interests, reducing the revenue obtained and possibly leading to selection of assets whose sale is not in the public interest.

A second context is the PRC Report, which noted a need for the ‘rationalisation’ of state-owned *entities*. In principle that process could lead to asset sales, as it appears unlikely that consolidating public entities – most of which are relatively small – will yield adequate funds to support the balance sheets of large SOEs. A more plausible alternative from a purely financial perspective is the ‘involvement of private capital’. Equity stakes in larger SOEs could be sold to private investors, as discussed briefly in section 4.

An important point in relation to the PRC recommendations is that the motivation for selling assets *in the context of that work* may have more to do with the efficiency, impact and sustainability of state-owned entities than raising revenue. Such motivations should be clearly separated to ensure that the process achieves its desired outcomes. In the UK in the 1980s, for example, one official document asserted that: “the effect of privatization on the government's finances is incidental to the programme's main purposes, which are to increase efficiency and to widen share ownership” (HM Treasury, 1986). If asset sales are supposed to raise revenue then the process must be oriented toward revenue maximisation – subject to assessing what assets (if any) are suitable for sale. If asset sales are intended to achieve other objectives, whether greater sectoral competition or transformation of ownership, then those must be clearly stated. Any conflation of objectives will hinder oversight and probably lead to final outcomes that are not socially optimal.

There are many examples in the international literature where the sale of state assets has not achieved the stated or desired objectives because other considerations were introduced during the process, in some instances to serve particular vested interests. A notorious, extreme case is the rapid sale of state enterprises in Eastern Europe in the early 1990s. That process was associated with large-scale asset stripping and capture of public assets by vested interests at below their market value. This led to a rapid increase in wealth inequality. The lesson from these experiences is that revenue maximisation requires that the process of selecting and selling assets does not enable rent-seeking behaviour – where private interests benefit from the asset being sold at below its market value.

Given the above, National Treasury's proposal is not without international or local precedent and is broadly compatible with some of the recommendations of the PRC report. Nevertheless, it is also not a strategy that is supported by all concerned parties.

This report will not consider the merits of *ex ante* positions that are in principle opposed to, or in favour of, state ownership since there is no *definitive* theoretical or empirical evidence that one or other position is 'correct'. It is nevertheless important to recognise that an emphasis on the 'strategic role' of assets necessarily implies an acceptance that state ownership is the exception rather than the norm – an assumption contested by some groups. Related to this is the question whether government will purchase assets again in a better fiscal climate, if it is *only* selling assets to raise revenue under difficult fiscal circumstances.

While noting issues raised by the PRC, the remainder of the analysis assumes that the sole purpose of asset sales is raising revenue. That is because the proposal from National Treasury, and the terms of reference for the current report, locate asset sales within the context of South Africa's current public finances rather than the broader question of how to utilise state assets.

The subsections below consider asset sales in the context of South Africa's mixed economy and the developmental state orientation of official government policy. The first subsection discusses different kinds of state assets and how they are classified. It also notes the challenges of valuing assets and choosing a sale mechanism. The second subsection discusses broader, policy-related criteria for determining which assets are most appropriate to sell. In the terminology proposed by National Treasury, this means determining which assets are least 'strategic'.

Little information was forthcoming from National Treasury regarding either the categorisation of state assets in South Africa, or specific asset holdings. This has significantly limited the analysis.

5.1 Categorisation, valuation and the process of selling state assets

In selecting state assets for sale there are at least three practical requirements:

1. categorisation and recording of assets held
2. valuation of assets
3. determination of appropriate processes for selling different types of assets.

Categorisation

There are a broad range of possible asset types:

- *State-owned enterprises*. Commercial enterprises such as ACSA, Armscor, Denel, Eskom, SAA, Transnet and others.
- *Components of state-owned enterprises.* One approach to privatisation of SOEs has been to sell some components while retaining others under state ownership. Examples are separation of generation from transmission in electricity, or separation of infrastructure from operations in rail or telecommunications. Another approach is to sell entire entities such as an airport or the infrastructure and train sets for a particular rail route.

- *State interest companies*. Where the state holds more than 10% shareholding in a "private business enterprise with commercial objectives" (PRC, 2012, p. 49) (National Treasury, n.d.). For example, the state's shareholding in Telkom.
- *Shareholdings in private companies*. Where the state holds a less than 10% shareholding in a private business enterprise with commercial objectives.
- *Other financial assets of state-owned enterprises or entities*. These could include cash surpluses.
- *State-owned land, buildings and other above-ground assets on land*.
- *Transport infrastructure*, such as roads (whether owned by SOEs or not).
- *'Subsoil' state-owned assets.* Such as mineral deposits or mineral licenses.
- *Radio spectrum and cellphone licenses*.

Individual assets are sometimes categorised into broader groups. The first distinction is typically between financial assets (including shares) and non-financial assets (including land). Bova et al (2013) suggest categorising non-financial assets into 'produced' (e.g buildings) and 'non-produced' (e.g. mineral resources and radio spectrum) assets.

Valuation

The second issue is valuing assets. All valuations can be considered *estimates* of a likely market price that may be received upon sale. Given the desire to sell assets to raise revenue, it is particularly important that some information on value is available for the selection of assets.[13]

With some simple forms of financial assets such as cash surpluses, valuation is straightforward. Unfortunately, valuation is more complex for other forms of assets.

As an earlier privatisation guide by the World Bank indicates: "Whether for the purpose of selling shares or assets, valuation and the resulting pricing are sensitive and difficult matters even where developed equity markets exist" (World Bank, 1988, p. 86). The recent IMF working paper by Bova et al (2013), which attempts to compare the treatment and extent of non-financial state assets across countries, notes similar concerns.

There are a variety of different methods for valuing assets, each of which typically produces a different outcome. Furthermore, methods used for the purposes of financial reporting may not be appropriate for assessing the likely market price.

Generally, assets are valued using either a discounted cash flow or relative approach. Discounted cash flow involves estimating *current value based on expected future cash flows*. If a company has a history of paying a stable dividend, then estimates of future dividend payments can be discounted back to determine its current value. A relative approach involves using financial information from other comparable companies to determine current value.

For whole SOEs with unpredictable cash flows and no comparable companies, an alternative valuation technique is the asset-based approach whereby the *net asset value* is calculated by off-setting the reported assets and liabilities of the enterprise. This does not, however, address the underlying problem regarding the valuation of individual assets. And the asset values derived from these approaches may not be a good guide to their likely market value if sold.

[13] Some economists have argued further that valuation of natural resources would ensure better recognition of environmental degradation in economic development. For example, depleting fish stocks may temporarily increase calculated economic production, but would be reflected in a decrease in a country's measured total assets.

It is often much harder to estimate the likely market value of infrastructure assets and what are sometimes referred to as 'intangible assets', such as mineral resources or radio spectrum. Infrastructure could be valued by utilising its *amortised historical cost*, where the cost of construction is adjusted for depreciation over time. An alternative to that might be finding comparable infrastructure that has a known market value. The *cost of replacement* is also a popular approach to valuing buildings and other infrastructure, and is sometimes seen as an 'upper-bound' to the price an investor would be willing to pay for the asset.

The basic point about valuing public assets is summarised by an earlier World Bank guide discussing SOE privatisation: "Only very rough guidelines can be set for SOE valuation... There are so many different circumstances, that any delineation of the required measures for valuation cannot be set." (World Bank, 1988, p. 88). In this vein, the extensive report into possible Irish privatisations elected not to place a value on the assets considered (Review Group on State Assets & Liabilities, 2011, p. 3). Nevertheless, ensuring that the proceeds from sale reflect a 'fair price' for public assets is critical for the net social benefit that accrues from the process. This is, therefore, a very important consideration in terms of oversight.

Sale process: mechanisms, cost and timing

As noted, any valuation prior to sale can only be considered an estimate of the likely price that would be obtained if sold in a market. Even then, there is an extensive literature showing that the way in which goods are sold can make a significant difference to the price obtained. There are three main issues: the market environment; the choice of mechanism; and, the design of the process using that mechanism.

For example, one option for selling assets is to auction them. But there are many different types of auctions and many details that need to be considered in designing one of those for a practical situation. The number of bidders participating in an auction is often important for ensuring that the final price is not below 'true market value', so additional measures may be required where there are few potential bidders.

The more limited the market for the asset to be sold, the greater the need for government to play an active role in determining an appropriate price for the asset (Jones, et al., 1987, pp. 7-9).

SOEs can be privatised in different ways, including: public offering of shares; private sale of shares; new private investment in SOEs; reorganization (or break-up) into component parts; management/employee buyout; lease and management contract (World Bank, 1988). For the sale of specific assets, the same World Bank guide notes that this can take place through auction, competitive tendering or through "direct negotiation with a pre-identified party" (ibid, 20).

Another issue is the cost of the process. Some mechanisms, such as public share listings or complex auctions, can be more costly than others. These need to be weighed against the likely revenue to be gained.

A final issue often discussed in the literature is timing. In a perfect market with an appropriate disposal mechanism, this strictly should not make a difference (Jones, et al., 1987, pp. 2-4) since the market price should reflect the potential value of the SOE. The potential value should include the costs of any restructuring and likely revenues once it has been restructured. However, most studies are of the view that timing is an important consideration and, in particular, that an SOE should not be sold when in crisis as the price obtained may be significantly below its potential value (DPE, 2001, p. 38; Review Group on State Assets & Liabilities, 2011, pp. 7-8). This may also be because there is typically policy and sectoral uncertainty associated with an SOE having financial difficulties and these contribute to perceptions of risk, which reduce the price investors are willing to pay. Where assets are sold at below potential market value due to the urgency of the process, this is often referred to as a 'fire sale'.

The South African situation

The excerpt from the MTBPS with which this subsection started, indicated the following asset types that might be 'disposed of' under the proposals for SOE financing: property; direct and indirect shareholdings in listed firms; non-strategic government shareholdings in state-owned companies; and, surplus cash balances in public entities. The inclusion of public entity cash surpluses is somewhat unusual and the public finance process to 'dispose' of these is unclear. However, it does have the advantage that the problems of valuation and selection of competitive mechanism for disposal fall away.[14]

The MTBPS also refers to the possibility of 'private investment' to support SOE balance sheets. It is not clear whether this refers to public-private partnerships, as discussed in section 4, or refers to the issuing of new shares in SOEs. The latter is arguably not materially different to selling existing shareholdings.

As per the terms of reference for the current report, the Parliamentary Budget Office submitted a data request to the National Treasury for, amongst other things, comprehensive information on state asset holdings. National Treasury indicated that a database of assets exists, but did not make this available to the PBO. Partly as a consequence of this, no empirical analysis has been possible in the limited time available.

There are reasons to believe, however, that the National Treasury database may have important limitations in identifying assets disposal to maximise revenue. These problems are not unique to South Africa (Bova, et al., 2013), but are nevertheless relevant to the current policy proposal.

One issue that has been identified is whether departments have adequately catalogued assets. A second concern, noted above, is that the values used for financial reporting purposes may not provide a useful indication of the likely market value.

National Treasury's reporting guidelines define an asset as: "a resource controlled by the department as a result of past events and from which future economic benefits or service potential is expected to flow to the department" (National Treasury, n.d., p. 13). This could be problematic where a department has control over a resource that it expects no benefit from, but which could yield substantial returns to the state if sold. In that instance the asset may not even be recorded in financial reports.

The Treasury guidelines describe seven major forms of capital assets: "investment properties; biological assets; specialised military equipment; heritage assets; infrastructure assets; intangible assets; and, other immovable and movable items of capital assets" (National Treasury, n.d., p. 83).

In terms of valuation, the guidelines suggest the following 'hierarchy' of valuation options for movable and immovable capital assets: original cost of the asset if purchased or exchanged; 'fair value' if not obtained through exchange; one Rand if fair value cannot be accurately estimated (National Treasury, n.d., pp. 90-91).

14 Interesting, the National Treasury's 2015 Budget proposal to provide a once-off UIF 'holiday' could in a broad sense be seen as disposing of a surplus in that Fund, but it appears to be used to offset income tax increases rather than fund SOEs.

‘Fair value’ is determined through either: an appraisal by a valuation professional; quoted prices for similar assets in active markets; use of available information that is “sufficiently reliable for the purposes of financial reporting”; depreciated replacement cost (National Treasury, n.d., p. 92).

In terms of the actual sale of assets, Treasury Regulations gazetted under the PFMA state the basic principle that assets should be disposed of at ‘market-related value’ unless there is reason to do otherwise:

- “Disposal of movable assets must be at market-related value or by way of price quotations, competitive bids or auction, whichever is most advantageous to the state, unless determined otherwise by the relevant treasury”
- “Any sale of immovable state property must be at market-related value, unless the relevant treasury approves otherwise” (National Treasury, 2005, p. 51).

However, ‘market-related’ value only means that the final price must have reference to the market value, but could be at a discount or premium to it.

It was outside the scope of the current report to attempt to compile information on state assets in the absence of receiving this from National Treasury.

There has been some speculation regarding what assets correspond to the description in the MTBPS, and could be disposed of in a relatively short period of time. One report concludes that government is most likely to sell direct and indirect shareholdings in listed companies. Based on the authors’ calculation using the share prices of the relevant companies, the report finds that government could raise up to R86 billion in this manner (Barclays Africa, 2015). Part of the rationale for their argument is that, as noted above, the sale of non-financial assets or stakes in SOEs is likely to take some time.

As noted above, delays in obtaining revenue could compromise SOE financing capacity further by increasing uncertainty and perceived risk. An option referred to in the MTBPS that could potentially be implemented in a short period of time is utilising ‘surplus cash balances in public entities’. It is not clear, however, what the process would be for using these to provide direct transfers to SOEs.

This brings us to the next major issue which is what types of assets government *should* sell.

5.2 Assessing the importance of state assets

The practicalities noted above are important for deciding whether to adopt a policy of asset sales and ensuring that the process achieves its objectives. Arguably the more fundamental question is which assets, if any, are appropriate to sell *given the state’s policy framework*.

Possible reasons for the existence of SOEs were discussed in sections 1 and 2 and these could guide identification of appropriate SOEs for some form of sale, whether of assets, a partial stake or the entire enterprise. The ‘strategic’ or ‘developmental’ value of an SOE depends on the broader policy stance toward the economy. South Africa has a mixed economy, and social and economic policies linked to the notion of a developmental state. Together these rule out large-scale state ownership and management of the economy, and an entirely laissez faire approach that minimises state ownership and involvement.

The National Treasury’s statement that it will only dispose of ‘non-strategic’ assets should simplify matters. However, the term ‘strategic’ as it is used in the international literature is quite narrow and does not appear to be the meaning intended. Treasury appear to have in mind a broader concept but one that is also more vague – no clear definition has been provided to date.

The PRC report noted that the existence of some SOEs remains more a function of history than relevance or usefulness in the present. Furthermore it recommended, based on its commissioned report on SOE viability (IDG, 2012), that the state should relinquish its role in sectors where its involvement is no longer necessary or desirable.

The PRC report does not provide a definition of a strategic SOE, but does discuss the importance of identifying 'strategic sectors' of the economy that require greater state involvement to achieve government's social and economic objectives. An input document states that the author(s) did not find, "strategic SOEs defined anywhere in a comprehensive manner" (Anon., n.d., p. 19).

The earlier phase of restructuring SOEs grappled with similar concerns and in many respects also adopted a sector-based approach to SOE privatisation and restructuring (DPE, 2001). Similarly, the detailed report on possible privatisations in Ireland was also structured around individual sectors and SOEs within those sectors (Review Group on State Assets & Liabilities, 2011).

An alternative approach is suggested by Table 5 reproduced from the PRC report; this provides an assessment of the rationale for existing SOEs. 'State and economic security' are often referred to in the international literature as 'strategic' reasons for state ownership. The more important row of the table is the one that suggests the reason for state ownership of some enterprises as is 'unknown'. *If* it is correct that there is no substantive reason for such SOEs, these could be categorised as 'non-strategic'.

Table 5 Reason for state ownership

Reason for State involvement	**SOE**
Natural monopolies	Eskom, Transnet, water boards, SANRAL, ACSA
Investment returns	IDC, DBSA, Land Bank
State and economic security	Denel, CEF, PetroSA, Armscor, TCTA, Water Boards
Social or developmental goals	Post Office, Post Bank, SABC, SETA's, SAFCOL
Market failures	IDC, DBSA, Land Bank, NEF
Unknown	Sentech, Broadband Infraco, Investment in Telkom, SAA

Source: Table 10 of PRC Report (PRC, 2012, p. 51)

As noted in the discussion of non-commercial mandates (section 2) this approach also provides SOEs an incentive to claim, or add, non-commercial or 'strategic' mandates. An assessment of the merits of state ownership therefore requires an objective assessment of existing (implicit and explicit) non-commercial mandates, whether these are socially desirable and whether they necessitate state ownership.

For state assets other than SOEs, there is still a wide range of possible approaches to determining what assets are important, even within mixed economies. These range across a wide spectrum: from a weak 'market socialist' approach where ownership stakes in the market economy may be held by the state on behalf of citizens (Bardhan & Roemer, 1992), to a 'free market' approach that minimises state involvement except in necessary areas such as national security. In other words, even if all groups accept that selling state assets could be in the public interest in some situations, there may still be irreconcilable differences on what kinds of assets the state *should* hold and what situations merit sale.

To illustrate the relevance of these different positions, consider arguably the simplest case: selling minor state shareholdings (less than 10%) in listed, private companies. One perspective is that there is no persuasive reason for the state to hold such shareholdings since they provide no meaningful control over the company or sector. In that case it makes sense for the state to 'cash in' the value of such an asset now, when additional revenue is needed, rather than continuing to collect revenue through any potential dividend payments. An opposing view is that some state ownership of major firms in important sectors increases the extent to which the benefits of economic growth are shared among all citizens, in a way that may not happen through taxation due to methods of avoidance and evasion. Another argument is that state shareholding allows some say in organisational transformation. Even if these concerns are well-founded, it might still be that the social benefit from selling the shares exceeds any such disadvantages. This net effect is what the Executive and Parliament will need to consider.

It is therefore arguably for the executive to determine what assets are unimportant, less important or 'non-strategic', and put these proposals with their rationale to the legislature for consideration.

Besides the 'strategic' relevance of a given asset, due consideration must be given to the implications of a change in ownership for social and economic outcomes. This argument is summarised by Gorecki et al (2011) as follows:

"[an absence of] strong or compelling reasons for public ownership...is only a necessary, not a sufficient condition for privatisation. Attention has to be paid to the way in which the state-owned firm is privatised, especially when it has market power, to ensure that complementary policies are introduced so that the firm is subject to appropriate checks and balances." (Gorecki, et al., 2011, p. 194)

Similarly, Jones et al (1987) note this as the second of the 'three fundamental questions of privatisation' they identify: "Should the enterprise be sold; to whom should the enterprise be sold; at what price should it be sold?" (Jones, et al., 1987, p. 5) Similar considerations apply to other state assets. The net benefit of asset sales depends not only on whether they currently serve an important function, or the revenue raised, but also how the new owner uses these assets.

A final point is that while it makes sense to conceptually separate the practical considerations (section 5.1) from the selection of assets for sale (this subsection), in practice these are not mutually exclusive. In most cases, a balance must be found between the ease of disposal, likely revenue obtained and the asset's importance for achieving social and economic objectives. Finding this balance will be particularly important in an environment where the additional revenue may be needed quite urgently. Particularly given Treasury's stated commitment not to obtain, even in the interim, the funds through any other source of financing. That commitment also puts the state in a difficult position where an asset, like an SOE, requires a lengthy process before it can be sold at its maximum value (DPE, 2001, p. 38). The Minister of Finance alluded to this in response to queries about the possible sale of SAA: "It would be premature for me to identify SAA as one of those (assets to be sold by government) while we are still trying to resuscitate it." (Maqutu, 2015) To account for these constraints the state may have to consider a schedule of asset sales in order to satisfy the immediate financing requirements of SOEs, reduce investor uncertainty and ensure that assets are sold at fair value.

5.3 Conclusions

The 2014 MTBPS has indicated an intention to sell non-strategic state assets in order to fund interventions to strengthen the finances of some state-owned enterprises. The term 'non-strategic' has not been defined, though some examples have been provided in the MTBPS – as quoted above. The work of the PRC and other literature suggest some possible definitions, but ultimately it is for the executive to determine what SOEs and assets are unnecessary for attaining its social and economic objectives.

There are at least three components to Parliament's role in this process. First, the legislature must determine whether additional financing for SOEs should be obtained through asset sales rather than alternative mechanisms. If so, it must then consider whether the assets selected by the Executive are appropriate; will the sale of these assets have a net social benefit? Finally, Parliament needs to satisfy itself at the relevant stages that the process of sale is designed to achieve, and does achieve, the stated objectives.

The merits of different financing mechanisms were discussed above. Whether it is appropriate to sell a particular state asset will first depend on the extent to which the asset is required to implement government policy. The Treasury's statement appears to imply a commitment that no asset required for implementing important policies will be sold.

Since the stated purpose of the disposal is to raise revenue, any proposal should be assessed by this standard. Two particular factors to consider regarding the design and implementation of the process are accurate valuation and choice of a revenue-maximising sale mechanism. Nevertheless, revenue maximisation should not mean that other government policies are compromised – as would happen if a stake in a natural monopoly was sold at a high price because buyers expect the enterprise to abuse its market position.

The process should also be maximally transparent, except where there are convincing reasons to make an exception. In keeping with the principle of maximising social benefit through revenue maximisation, the process must avoid rent-seeking.

As noted in the Irish context, whatever the short-term objective of asset disposal, the process: **"**should be assessed from the standpoint of its contribution to long-term economic recovery" (Review Group on State Assets & Liabilities, 2011).

Key issues

- The National Treasury's decision to sell state assets to provide additional funding to SOEs implies that other funding mechanisms (tariffs, debt guarantees and so on) are inadequate for this purpose.
- Whether asset sales are appropriate, in principle, depends on whether the additional financing is justified and whether the requirement is best met through assets sales rather than the use of one of the sources of SOE finance described in the previous section.
- Parliament has relatively little direct power over the disposal of state assets.
- As with other countries, there does not appear to be a comprehensive database of state assets with valuations that reflect likely market value – the database that does exist has not been provided to the Parliamentary Budget Office.
- Given the stated motivation for Treasury's proposal, the process of selecting and selling assets should prioritise the maximisation of revenue, without contradicting other government policy relating to economic growth and development.
- The commitment to only provide balance sheet support after receiving funds from asset sales could compromise revenue maximisation or SOE credit ratings, particularly with assets that cannot be sold quickly.
- The notion of a 'non-strategic' asset is not well-defined: it is either too narrow and fails to recognise the implications of a developmental state orientation, or is too broad to be useful.
- The sale of stakes in state-owned entities, or assets held by those entities, should ideally be consistent with broader policy decisions that emerge from the process proposed by the PRC report.

- Determining whether and how an asset should be sold must also involve considering the effects of a change in ownership – such as where the disposal of a state asset increases a private firm's market power.
- International and local best practice is to develop a clear and transparent process for disposal of state assets; in some instances exceptions may be necessary, but these are likely to further limit Parliamentary oversight.

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Appendix A Original Terms of Reference

TERMS OF REFERENCE

PARLIAMENTARY BUDGET OFFICE RESEARCH PROJECT ON STATE-OWNED ENTERPRISES

04 December 2014

Background

The Parliamentary Budget Office (PBO) was established in terms of section 15 of the Money Bills Amendment Procedure and Related Matters Act (2009). The primary function of the PBO is to offer independent and objective advice and analysis to the Finance and Appropriations committees of both the National Assembly and National Council of Provinces on money bills and other bills with financial implications.

Following from the 2014 Medium Term Budget Policy Statement (MTBPS), the Standing Committee on Finance has requested that the PBO conduct research relating to State-Owned Enterprises (SOEs). The present document constitutes the Terms of Reference for this work.

Given the Committee's role in conducting oversight relating to public finance, its primary interest is in the role of state-owned enterprises in driving growth and development and the financial implications of SOE performance for state finances. This research will also inform the PBO's support to the Committee's consideration of the 2015 Budget.

The SCOF engaged with the Public Enterprises Portfolio Committee who agreed with the research project.

Research focus

Taking into account the existing government policy framework and priorities, the research will focus on the following areas relating to SOEs:

- The role of the SOEs in forging a developmental state in South Africa;
- Separation of commercial and developmental mandates;
- Alternative approaches to deciding the extent of state financial support to SOEs;
- Factors relevant to determining whether state assets are 'non-core' and can be sold to raise revenue – as proposed in the 2014 MTBPS;
- Financial performance and current status of SOEs (where this relates to the above).

Sources of information

A large amount of research already exists on state-owned entities in South Africa, most notably the work done for the Presidential Review Commission on state-owned entities (PRC). The present research will not duplicate this, but rather use it to inform the analysis based on the focus areas listed above. The following sources of information will be consulted:

- Previous studies of the role and functioning of SOEs, in particular the Presidential Review Commission (PRC) on state-owned entities;
- Government database of SOEs as established by the PRC;
- Additional financial data on SOEs from National Treasury;
- Relevant government policy statements relating to state-owned entities (e.g. New Growth Path, Industrial Policy Action Plan, National Development Plan, Medium Term Strategic Framework);
- Relevant legislation (e.g. Public Finance Management Act) or proposed legislation (e.g. Government Shareholder Management Bill);

- Financial and performance reports published by various independent bodies (e.g. Auditor General, Public Service Commission) about SOEs;
- Political party policy and research documents on SOEs;
- Relevant contributions to the academic and policy literatures.

Due date

The report will be submitted to the Standing Committee on Finance by the 1st of March 2015 and presented to the Committee at a suitable date thereafter.

Appendix B Overview of Presidential Review Committee recommendations

Table 1A Overview and categorisation of Presidential Review Committee recommendations

Nature of recommendation	***#***	***Short description***
Financing or commercial orientation	6(a) 6(b)	Develop a uniform framework for economic regulation Process of identifying policy inconsistencies and policy conflicts; clarify the role of economic regulators; and develop a blueprint to guide regulatory designs
	18	Develop consolidated funding model for commercial SOEs and DFIs and NT to 'marshal and manage' all liabilities
	19	Policy shift to a greater equity finance, except where inappropriate (e.g. natural monopolies)
	20	Expand private sector participation in provision of social and economic infrastructure
	21	Develop a funding model for public infrastructure, distinguishing between social and economic
	22	Mining sector should contribute more to reflect its usage of economic infrastructure
	23	Turn selected SOEs into 'national world-class state commercial (industrial and economic) flagships'
	24	Address the issue of non-financially viable commercial SOEs through: rationalisation; limit state involvement; retain and adequately fund; phase into commercial entities with mixed ownership; dispose of them as state entities; absorb into the line function.
Mandates	10	All SOEs should be required to develop transformation plans
	11	Lead the economy in prioritising skills development
	12	Ensure that the procurement process is transformational
	13	SOEs should play a leading role in socio-economic development
Governance, legislation and capacity	1	Develop an overarching long-term strategy for SOEs
	2	Enact a single overarching law governing all SOEs
	3(a) 3(b)	Develop a framework for the appointment of SOE boards; recommends specific approach to CEO appointment
	4	Develop a mandatory framework for effective collaboration among SOEs and between SOEs and the three spheres of government
	5	Establish a Central Remuneration Authority (CRA)
	7	Develop a common performance management system
	8	Mandates of SOES should subject to review every five years and incorporate this into SOE Act

	9	Mandatory statements of strategic intent and corporate performance plans, within specified timelines
	14	Transformation should be an integral part of the contractual agreement between the Executive Authority and SOEs
	15	Sanctions for corrupt activities and register of implicated individuals and companies to be provided to SOEs
	16	Empowerment framework and legislation streamlined to facilitate substantial contributions
	29	Government should ensure that the Executive Authorities' SOE strategic management and relationships are professional
	30	Improve financial decision-making capacity in all departments dealing with SOEs
	31	Develop an integrated reporting, monitoring and evaluation capacity for SOEs across all spheres of Government
Provisions for post-PRC process	25	Actively promote a common national understanding and commitment to a Developmental State vision
	26	Government should build its capacity to develop and implement an overarching strategy for SOEs
	27	Establish a transitional SOEs Reforms Committee to drive the implementation of the PRC's recommendations
	28	Proposed SOE Council of Ministers and the Central SOEs Authorities should develop customised human capacity building programmes

Source: Report of Presidential Review Committee on State-Owned Entities: Volume 1. Categorisation of recommendations by the PBO.

Appendix C National Treasury categorisation of financing instruments

Table 2A Main instruments for providing financial support to SOEs (National Treasury)

Current transfer	"Grant provided to an entity to cover current expenditure. This money is not repayable. The entity records the transfer as revenue. The transfer attracts VAT and, where entities are taxed, income tax."
Capital transfer	"Grant provided to an entity to undertake capital expenditure. This money is not repayable. The entity records the transfer as revenue. The transfer attracts VAT and, where entities are taxed, income tax."
Loan/subordinated loan	"Funds are transferred to the entity as a loan. The loan must be paid back to the National Revenue Fund together with interest as per the terms and conditions of the loan. It is recorded in the relevant department's budget vote as a payment for financial assets. The entity records the transfer as a loan and concludes a loan agreement with government. No VAT or income tax is payable."
Equity	"Funds are transferred to an entity to increase its equity. It is recorded in the relevant department's budget vote as a payment for financial assets. Dividends may be payable. The entity records the transfer as equity and shares have to be issued to government. No VAT or income tax is payable."
Guarantee	"Guarantees provided to an entity, generally to enable an entity to raise financing. No funds are transferred to the entity therefore this is not recorded in the Estimates of National Expenditure, but the guarantees are reflected in the Budget Review. A guarantee framework agreement is concluded between government and the entity and a guarantee agreement is concluded with the lender."

Source: Information provided by National Treasury (January 2015)