Introduction

The efficiency and effectiveness of a country’s public sector is vital to its development. Assisting developing countries in strengthening their institutions, improving public financial management and putting in place good governing systems are strategic priorities for the Asian Development Bank (ADB). In 2011, ADB approved public sector management and governance loans and grants totaling $2.7 billion. From 2000 to 2010 for the Pacific, ADB’s support in this sector amounted to $158 million for 10 loans and grants and $96 million for 96 advisory technical assistance projects. Technical assistance for state-owned enterprise (SOE) reform has been provided in all 14 Pacific developing member countries of the ADB, raising the level of awareness of the importance of SOE reforms for economic growth, and creating a unique body of knowledge about successful reform strategies. In Kiribati and Tuvalu where government is the largest employer and government revenue and spending are the main drivers of economic activity, ADB has been working with these governments to develop and manage its revenue sources and improve expenditure management. An essential component of this is tackling the impacts and issues of the heavy presence of SOEs in both countries, with support of ADB technical assistance.1

Poorly performing SOEs absorb large amounts of scarce capital, on which they provide very low returns. While some provide essential public services, many others operate as inefficient commercial ventures and crowd out the private sector. These can result in significant economic costs that countries cannot sustain. Reforming SOEs has numerous challenges, particularly in the smallest of the island countries. Yet in Kiribati and Tuvalu, much like in Tonga and the Marshall Islands—progress is being registered. Their experiences offer key lessons and recommendations that may be of use to other small countries facing similar challenges.4

Kiribati has a population of about 100,000 and Tuvalu 11,000. Both are made up of small, low-lying atolls and reef islands in the Pacific. Both have SOEs that were established to provide essential infrastructure services. These include public utilities providing services such as electricity, drinking water, telecommunications and, broadcasting. Other SOEs were established to undertake commercial activities such as banking, hotels, fishing and shipping. At the time these SOEs were established, the private sector was either unable or unwilling to provide these services, but this has changed over the years and private sector service provision is now a real possibility.

Impediments to SOE Reform in Kiribati and Tuvalu

Contextual Challenges

The structural and cultural characteristics of small Pacific island states such as Kiribati and Tuvalu can add particular challenges to SOE reform. Both countries are characterized by small domestic markets, remoteness, low incomes, high birth rates, a large subsistence sector and weak economic performance. With few natural resources other than fish, economic activity is dominated by the public sector and economic performance is driven by donor-funded projects, including capital expenditure on infrastructure, such as airports, ports, roads, and electricity. Given their small markets, there is often little room for having more than one enterprise operate the utilities or provide other essential social services. So in order to avoid the risks associated with private monopoly power, governments tend to own the utilities themselves and are reluctant to contract out enterprise management or service provisions.

Some development assistance directly or indirectly supports SOEs, since these are generally responsible for the provision and management of economic infrastructure. In some cases the provision of economic infrastructure has exceeded the government’s capacity to operate and maintain it at a satisfactory level. Requests from SOEs for grants, subsidies, and other financial support put considerable pressure on government revenues.

The small, close-knit communities of small island countries can create specific challenges for SOE reform. Extended family ties imply that ministers and senior SOE staff are well known to one another and Board members are typically selected from among those who are well-known to the minister. This means that some Board members may be appointed although they lack the necessary skills and experience and once appointed, can be difficult to remove. Civil servants are frequently appointed as directors although they often have demanding jobs in the public service and have little time to devote to director duties which may have to be performed in their spare time. For some, conflicts of interest arise when they perform their duties as SOE directors and as policy advisers to ministers. Close relationships also make it hard to discipline employees for poor performance. Non-attendance in the workplace is often tolerated, and making people they know redundant is practically impossible.

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On the financial side, cash is often in short supply, and government itself is often poor at paying what it owes to the SOEs. In return, the SOEs tend to regard any “loan” from government as a grant. Moreover, when an SOE faces a cash shortfall, its first response is to borrow from a state-owned bank or to approach the relevant minister for a bail out. SOEs, having received financing for capital expansion from donors as a grant, typically expect that the donors will also fund asset replacement. These hidden subsidies in the forms of government bailouts, ready access to state banks, and grants from donors make it not only difficult for the private sector to compete, but also reward poor SOE performance.

In most cases, the domestic private enterprise sector in small Pacific countries is unable to take over SOEs or to provide competing services. The private sector in Kiribati and Tuvalu, for example, is small, concentrated in the retail sector and hampered by skill shortages, particularly of accountants and commercial managers. If a major infrastructure SOE is to be sold, there will be few local buyers able to fund the purchase and this is compounded by shallow domestic financial markets. At the same time, there is resentment of foreign ownership of strategic enterprises, despite the need for new capital and management expertise.

Operational Challenges
The majority of SOEs in Kiribati and Tuvalu have struggled to be financially viable and to provide reliable service to their customers. Some SOEs perform dual functions, being both commercial enterprises and, in effect, providing community services and helping to implement government policies. For example, public utility SOEs have been asked to extend services to remote, sparsely populated outlying islands where costs of providing the service are much higher than potential revenues. To compound these problems, government ministries are often major customers but have not always paid their bills in full or on time and SOE overhead costs have been affected by over-manning. These factors combined cause cash flow problems, which led in turn to the need for subsidies or government bailouts.

Financial management systems in the SOEs have not allowed managers to operate in a sound, commercial manner. Accounting systems were poor, and financial reporting was typically several years delayed—a reflection of the lack of capacity in these small island countries. Beyond the cash balance, there was little understanding of management or of the SOE’s profitability or rate-of-return on investment.

Tuvalu enacted a Public Enterprise Act in 2010, while Kiribati is in the process of drafting SOE legislation. These legal frameworks will help regulate and provide arms-length oversight of their SOE sectors. The overall aim of these legal frameworks is to ensure that all public enterprises conduct their operations in as close to a commercial manner as possible, thereby reducing the government’s ability to inappropriately influence business decisions and improving the efficiency and accountability of the SOEs.

Reforming the SOE sector in Kiribati and Tuvalu
Kiribati
Kiribati has 22 SOEs, which operate in most sectors of the economy, including transport, utilities, telecommunications, manufacturing, tourism, finance, media, wholesaling, and retailing. ADB is supporting overall sector reform and the establishment of an SOE Monitoring and Advisory Unit.

The Kiribati Supply Company Limited (KSCL), a hardware company, faced growing private sector competition for several years, causing it to lose market share and to register losses, which rendered it effectively insolvent. It did not cut its costs as its market share declined, and eventually ran out of cash and was unable to pay its creditors. With private firms active in providing hardware, there was little justification for the government to operate a loss-making business in that sector. At the same time, there was no government policy on ownership or retention of loss-making SOEs. A policy framework for SOE reform was developed that included a “decision tree” to help government decide if public ownership was warranted or not. The tree (Box) was ultimately adopted by the Cabinet as the basis for decision-making on divestiture, closure and other forms of SOE privatization.

Using the decision-tree approach, it was decided that KSCL should be liquidated. Government then played an active role in preparing the company for liquidation, including through the assumption of responsibility for the company’s debts. This cleared the way for the sale of the company’s assets, which included valuable long-term leases of prime land. Acknowledging the adverse social impact of staff redundancies, the government also agreed to a policy of providing minimum redundancy payments equivalent to six months’ salary.

Betio Shipyards Limited (BSL) provides a second example of successful reform of a distressed SOE, this time without divestiture. BSL constructs small-to-medium-sized vessels. Over the previous decade work volumes had declined but staffing levels had been maintained. Eventually BSL ran out of cash leaving insufficient funds to pay creditors and to buy the materials needed to complete two vessels under construction. A restructuring program was implemented, requiring around two-thirds of the staff being made redundant, and the government paying creditors and supplying working capital to enable materials to be purchased so that existing construction contracts could be completed. Those made redundant received a minimum of six months pay. With a lower core staff level, BSL now operates at lower output volumes but breaks even and is able to meet its payroll. BSL is currently being prepared for sale by the government.

In addition to supporting interventions aimed at addressing specific distressed enterprises, the SOE policy and regulatory framework was also improved. A first step in this process was the formation of an SOE Reform Steering Committee. This was chaired by the Secretary to Cabinet, who played a policy-coordination role. Other members included the Secretary of Finance, the Attorney General, the Secretary of Lands and the heads of the two ministries responsible for the majority of the SOEs. This committee has played a significant role in defining and driving SOE reforms elevating decision-making on SOE matters to a cabinet level and acting promptly to remove certain specific impediments to reform, for example, problems with land lease renewal. The Committee has met frequently—some 20 meetings being convened within the first 9 months of 2011—and in cooperation with ADB technical advisors, has developed key policies for reform. An SOE Act is also being developed which should improve governance. The Act empowers the SOE Monitoring Unit to monitor the performances of the SOEs.

One of the immediate issues that the Committee examined was the need to contain the fiscal impact of regular financial bailouts of SOEs. The government has frequently been called upon to honor its guarantee of SOE bank overdrafts and loans to pay creditors,
provide additional working capital, and fund redundancies. Over the period 2008–2011, it is estimated that the cost of government bailouts and budget-financed subsidies to SOEs totaled more than 9% of GDP.

The SOE Reform Steering Committee established a procedure requiring any SOE seeking a financial bailout to have an approved, realistic business improvement action plan with financial assistance being withheld until such a plan was approved by the Steering Committee. A number of the SOEs were assisted to reformulate realistic action plans, which will be monitored by the SOE Monitoring and Advisory Unit. Examples of provisions included in the business improvement plans include:

- Introduction of pre-payment for services. Where credit is given, it is on a short-term basis and is strictly monitored;
- Improved controls over operations so that losses through theft are reduced;
- Establishing staff levels that more appropriately match business volumes; and
- The hiring of local accountants to work with SOEs to improve their accounting and financial reporting systems. The aim is to have reliable up-to-date financial data and reports to enable managers to properly control their firms.

**Tuvalu**

There are seven SOEs in Tuvalu operating in key sectors of the economy including transport, banking, utilities, telecommunications, fisheries and tourism, although one of these is a non-commercial educational institution. Similar to the Kiribati case, ADB advisory assistance was provided to analyze and design reforms for specific SOEs and also to help the government improve the SOE policy and regulatory environment. Assistance was also provided to build public awareness for SOE reforms by sponsoring radio broadcasts covering the rationale and details of proposed reforms.

One of the SOEs assisted was Tuvalu’s power company. The Tuvalu Electricity Corporation (TEC) had been a chronic loss-maker. A fundamental issue was that tariffs were set too low to generate the revenue needed to cover costs. There was considerable reluctance to raise tariffs because of the potential impact on low-income families who used modest amounts of power, typically for lighting and to power a refrigerator. With ADB support, a three-tier tariff policy was devised and subsequently promulgated. The price for those who used relatively low volumes of power was set at a low or “lifeline” level to ensure that power would be affordable for low income consumers. Rates were then increased in steps as more power was consumed. Adoption of a three-tier power tariff allowed the power company to boost its total revenues while protecting the poor. Implementation of a stringent debt collection policy improved TEC’s financial position.

Improvements were made to SOE governance through policy, regulatory and institutional reforms. Towards this end, government developed an SOE Policy Statement that was subsequently approved by the Cabinet. This was similar to the Kiribati policy and “decision tree” on ownership and community service obligations (CSOs). It clearly states that those SOEs which the government wishes to retain will operate commercially, aim to make profits, and pay taxes and dividends.

A Public Enterprise Act was developed and passed by Parliament in 2010. The Act built upon the New Zealand experience and was modeled on SOE legislation which had been adopted in Samoa and which is also in place in the Solomon Islands. Some key features of the Act include:

- SOEs are required to operate as successful businesses by being as profitable as businesses not owned by the state;
- SOEs were converted to companies. A standard “Articles of Association” was developed to assist SOEs change from government bodies to commercial companies;
- A formal process for budgeting and gaining approval for CSOs was established;
- Each SOE is required to prepare a Corporate Plan and Statement of Corporate Objectives to be agreed-upon with government;
- Financial reporting is required on a quarterly and annual basis;
- A clear statement on director duties and responsibilities and the requirement to establish an independent committee to advice on the selection of SOE directors; and
- A Public Enterprise Review and Monitoring Unit was
established within the Ministry of Finance to oversee the operations of all of the SOEs.

In addition to the Act, a number of complementary reforms were mounted. Standardized accounting software was provided and accounting policies were improved and standardized across the companies. In this way, financial reporting has been improved and made more comparable between SOEs. Policy guidelines were prepared on topics such as staff remuneration, director skills and appointments as well as on handling staff reductions. Formal training was provided to a potential pool of 40 SOE managers and directors. Board directors and senior SOE managers have also formed an informal “business round table” at which experiences and issues are shared.

Formal CSO agreements have been negotiated for the first time in Tuvalu. This has involved considerable dialogue over the proportion of company overhead that should, or should not, be reimbursed when the government is paying an SOE to provide services to the poor. Budgetary subsidies have actually been reduced since these now need to be justified as CSOs and since electricity tariffs now cover costs.

SOE reforms in Tuvalu are paying off. Profitability and return on shareholder equity have improved. There has been a clear reversal of the trend towards ever-growing SOE losses that plagued the country from 2004 to 2010. In 2011, the TEC became profitable for the first time in that company’s history.

**Lessons from SOE reform in Kiribati and Tuvalu**

In Kiribati and Tuvalu SOE losses had mounted over several years. At a certain point the losses grew so large that they threatened to undermine the overall government budgets. The strong desire of the authorities to restore fiscal soundness contributed to the seriousness accorded to SOE reform. Despite initial conditions which made SOE reform exceedingly difficult, considerable progress has been registered. Lessons from the SOE reform experience of Kiribati and Tuvalu include:

- Giving SOEs a clear commercial mandate is a fundamental basis for improving their performance.
- Secure agreement with the government on an SOE policy framework. This should include clear criteria for identifying which enterprises need to be government owned and how CSOs will be handled.
- A strong and active SOE reform advocate, that could be a minister, cabinet or steering committee, is a key factor in achieving success. Such a group can lead policy change and act as the bridge between specialist reform advisors and the government.
- Reform needs to focus both on improving the immediate financial performance of key SOEs and on strengthening the rules and regulations under which all SOEs operate.
- Business improvement is essential for SOEs that are to be retained in government ownership.
- Formal plans for business improvement need to be realistic and have their implementation closely monitored by both the SOE board and external monitors.
- Improved accounting systems and financial reporting are needed if managers are to deliver better financial results.
- Hidden CSOs need to be made explicit, especially where they result from tariffs set below operating costs. Practical means are available of designing tariffs to protect low-income households while generating sufficient revenue to cover costs. They also need to be costed, contracted and funded so that SOEs can pursue their commercial mandates.
- An SOE Monitoring and Advisory Unit is essential if government is to provide arm’s length management and oversight of SOEs. Such a unit needs to have staff able to assess strategic plans, statements of intent, financial reports and capital development proposals. They also need to be adept at director selection to ensure that SOEs have balanced and competent Boards.
- Where a decision is taken to sell an SOE, the realized value from the sale can be improved by careful identification and valuation of the company’s assets and liabilities, especially land and land leases. Good accounting records and financial reports are keys to improving sale results as they reduce uncertainty for potential buyers.
- Where it is necessary to reduce SOE staffing levels, clear and fair redundancy policies which provide adequate compensation to staff, as well as support to ease the transition, are essential.

Reform takes dedicated leadership, and it also takes time. In Tuvalu and Kiribati, a good start has been made at SOE reform and there are signs that financial performance is improving. Much more still needs to be done to improve capacity to prepare financial accounts, ensure compliance with SOE legislation, and encourage SOEs to operate as commercial entities. Ongoing support will be required to help the governments rationalize their roles as owners and operators of enterprises, and to put those SOEs that are retained on a sound, commercial footing.