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SOCIAL COHESION, GLOBAL GOVERNANCE AND THE FUTURE OF POLITICS

Promoting Transparency and Anticorruption in State-Owned Enterprises

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Abstract

State-owned enterprises (SOEs) are important because they produce public goods that affect both the economy and the quality of life of citizens, such as energy, water supply, transport and communications. Weak governances and poor oversight state structures in SOEs can create favorable contexts for misused of state resources and corruption (Transparency International 2017). G20 leaders must endorse a policy framework for promoting transparency and disclosure in SOEs, this should be the main goal of international anticorruption policy (Transparency International 2017 and OECD 2016a).

Challenge

SOEs have usually a strong share in strategic sectors for the provision of public services such as water and sanitation, transport, energy and telecommunications (Bernal et al., 2012). In addition, SOEs can play a key role in the development of the country by generating positive externalities that favors the sectors with growth potential (Christiansen, 2013). In this way, improving the performance of SOEs is a primary objective without which it is difficult to think of them as a public policy instrument. However, SOEs are particularly vulnerable to corruption due to their closeness to governments, politicians and public officials, the scale of the assets they manage and the criticality of services they provide. For example, an OECD report analyzing completed bribery cases showed that 81 per cent of the total bribes were promised, offered or given to SOE officials (OECD 2014).

SOEs often have poor governance, weak management systems and inefficiency and these factors can raise the corruption risk. The highest corruption risks for SOEs lie in public contracting, conflicts of interest, marketing, privatization processes, theft of assets and money laundering. Weak public reporting practices by SOEs are indicators of poor anti-corruption systems. Transparency of ownership and operations and public reporting on anti-corruption programs are the best defense against corruption yet Transparency International's research shows that many states do not perform well on transparency of their beneficial ownership and that SOEs are weak in reporting on their anti-corruption programs. A 2015 report by Transparency International assessed the extent to which G20 members were fulfilling their legal and regulatory commitments implicit in the G20 Principles one year after their adoption. The report delivered a mixed report on the efforts of the G20 nations, with 15 out of 19 G20 countries showing either an average or weak legal framework for implementing the G20 Framework.

As custodians of public assets SOEs should be champions of integrity and transparency. This is also the best check against corruption. To counter corruption in SOEs, all actors (states, SOEs, investors, business partners, civil society and the public) need to set expectations for SOEs to operate to high standards of integrity, transparency and accountability. All actors should monitor and hold SOEs to account for the way they meet these standards. Best practice standards should include: OECD guidelines on corporate governance of SOEs (OECD 2015) and Transparency International's 10 Anti-Corruption Principles for SOEs which provide comprehensive best practice anti-corruption guidance.[1]

We call upon G20 governments to significantly strengthen their efforts to implement existing commitments made under previous presidencies, including the G20 High Level Principles on Beneficial Ownership Transparency and the High-Level Principles on Promoting Integrity on Public Procurement. The implementation of those Principles is imperative for increasing integrity and transparency and preventing corruption in State-Owned Enterprises (SOEs) – a key priority of the Argentinian Presidency.

Proposal

We recommend the implementation of best practice standards in SOEs founded on cultures of integrity, good governance, continuing risk assessments, rigorous oversight and monitoring, transparency, public reporting and stakeholder engagement. We ask G20 leaders to take urgent and decisive action in three important topics: (1) governance of the SOEs, (2) tender and procurement processes, and (3) asset transactions.

1. Governance of the SOEs

The importance of Board and its potential problems: Boards play a key role on the corporate governance since they are the link between the owners, investors and the employers. The members of the board are in charge of establishing the strategic long-term goals of the company, ensuring an effective business management and reporting the performance to the investors. The selection processes of the board members are key instances to improve the governance of the SOE insofar as they allow to establishing criteria and mechanisms to create professional, independent

1 10 Anti-corruption Principles for State-Owned Enterprises (Berlin: Transparency International, 2017). https://www.transparency.org/_view/publication/8077

and plural directories. The autonomy of the directors may be affected to the extent that there is a predominance of political officials in those positions or in cases where they are appointed in a discretionary manner while increasing the risk that the SOE is captured by the interests of politics and its resources are used for other destinations than those of the company itself.

Evidence in Mexico, Brazil and Argentina: In the case of Mexico, the current institutional design of their energy SOEs' boards of directors (Petróleos Mexicanos –PEMEX- and Comisión Federal de Electricidad –CFE-) establishes by their respective laws a presence of the government with 5 of 10 public officials while the rest by independent directors. The figure of independent directors[2] was originally configured for granting technical professionalism to the Board and counterbalance the government's presence. In the case of Brazil, only 11% of board members at listed SOEs are classified as independent directors and performance evaluations of the board remain an incipient practice among listed SOEs, being formally adopted by only approximately 36% of them. In Argentina, in infrastructure SOEs there are no formal requirements to be a director, the sectorial ministries appoint them, and there are no quotas for independent directors (CIPPEC 2017).

Recommendation 1: Strengthening the selection mechanism of the members of the board. States are encouraged to apply good governance with balanced boards of directors, representation of independent directors and a rigorous and transparent process for appointments of board directors. The selection process for appointing members should be formal, structured and transparent and be based on criteria such as unblemished reputation, academic training, experience in responsibility functions and technical training in areas relevant to the company's activities. There should be a technical evaluation of the profile of the candidates. The board should have an active role in defining the profiles and the necessary skills of the candidate. (OECD 2016, Transparency International 2017)

Recommendation 2: Establishing high integrity and transparency standards: declare and register conflict of interest. Members of the board should maintain an update register of conflict of interest including the directors, officers, employees, subsidiaries, contracted third parties and key staff. Conflict of interest should be conceived in an extensive form: actual, potential or perceived. (Transparency International 2017). SOEs should incorporate good transparency practices documentation and/or statistics of the voting of board members that may allow the analysis of each board

2 According to the applicable legislation, to be an independent director, it is necessary to fulfill three requirements: i) to accomplish with high-profile technical credentials; ii) confirm independence from both the government and operation of the SOE by fulfilling specific requirements such as not being an active public official or contractor; and iii) be nominated by the President of Mexico and confirmed by the Senate. The law does not mandate candidates to speak at the Senate to defend their will to be independent directors.

voting orientation in order to evaluate boards' performance in order to test whether the current board design is effective for political equilibrium purposes.

Recommendation 3: Set clear division of responsibilities between the board of directors and the Chief Executive Officer. The overlap of responsibilities between the CEO and the board can reduce the independence of the accountability of the management to the directors. There should be a clear separation between the state's ownership function of the management of SOEs - by establishing a proprietary entity who could be in charge of creating technical, meritocratic and politically neutral mechanisms for the nomination of directors. The board of directors should receive a clear and unequivocal mandate from the State; have autonomy to make decisions in an independent manner and accountability for the SOE's performance. As the highest governance body, the independence of the board of a SOE will depend, among other factors, on the formalization and transparence of the communication channels between the State and the enterprise.

2. Tender and procurement processes

The importance of tender and procurement processes: Public institutions as well as state-owned enterprises need to procure goods, services and works to carry out their responsibilities and duties. Public procurement is one of the government activities most vulnerable to corruption. In addition to the volume of transactions and the financial interests at stake, corruption risks are exacerbated by the complexity of the process, the close interaction between public officials and businesses, and the multitude of stakeholders. (OCDE, 2016) Third parties (prospective or contracted business associates, agents, distributors, consultant, contractors, vendors and suppliers among others) constitute an important risk factor for SOEs and for private companies as well because they may not necessarily follow the same standards of transparency and integrity of the SOE. In fact, in an Anti-Bribery Program, third parties are always the most important risk factor and the largest settled corruption cases are those involving bribery between intermediaries and public officials (Transparency International 2017).

Evidence in Mexico and Argentina: In Mexico in 2015, it was identified anomalous purchasing contracts in PEMEX that summed 149 billion dollars.[3] That sum represents 36.6% of total Infrastructure budget for the period 2014-2018. The Mexican CFE's purchasing contracts from 2012 to 2017 summed $22.3 billion dollars, and $6.4 billion dollars of them had been identified of high risk.[4] That sum represents 28.7%

3 https://www.forbes.com.mx/corrupcion-sangra-pemex-con-11900-mdd/

4 A purchase was qualified by IMCO of high risk if: it lacked competition and transparency and presented anomalies.

of CFE's total purchases and 1.6% of national infrastructure budget. In Argentina, it is estimated that between 2012 and 2015 the overpricing on public infrastructure on the road sector due to lack of transparency and competitive practices reached 40%.[5]

Recommendation 1: Adopt Integrity Pacts for preventing corruption and establishing the highest degree of transparency for procurement activities. It is recommended the implementation of Integrity Pact, a contract between a contracting authority and economic operators bidding for public contracts that they will abstain from corrupt practices and will conduct a transparent procurement process (OECD Integrity Pacts). The Pact includes a separate contract with a civil society organization that will be monitoring that all parties comply with their commitments and will enhance trust in the process. Pacts will increase transparency, accountability and good governance in public contracting as well as will improve competition, and promote cost efficiency. Board should also establish flexible but clear guidelines in relation to safeguarding information integrity for protecting commercially sensitive information and to avoid undermining the highest degree of transparency of its procurement activity.

Recommendation 2: Require anti-corruption standards of third parties to ensure that their standards are equivalent to that of the SOE. It is recommended to create and maintain an up-to-date register and database of all its contracted third parties (past, current and potential relationship) capturing basic information. The information should be recorded by the SOE on the third parties in a register and should form the basis for risk assessment and due diligence on third parties. The register can be used to design the due diligence process to be applied to the third parties.

Recommendation 3: Develop e-procurement tools that support the whole cycle of procurement operations. Creating and implementing a single end-to-end platform for e-procurement ensures greater efficiency of the process by: i) aligning procurement and business strategies through the standardization of information systems, ii) producing more useful reports for decision makers in friendly formats; iii) making procurement plans, reports and information communicated internally and externally more accessible; and iv) advancing the professionalism of the procurement workforce.

3. Assets transactions

The importance of assets transactions: Assets transactions -merges, acquisitions, divestments, refinancing, sales and total loss passes- can be an area of high corruption risk since politicians or public officials can manipulate valuations and decision in

5 https://www.lanacion.com.ar/2038108-el-gobierno-ahorro-us-2000-millones-en-la-construccion-de-rutas-al-reducir-los-sobreprecios-pagados-en-el-kirchnerismo

transactions in their own benefits or money laundry (Transparency International 2017). These risks can be counteracted through rigorous and transparent processes in vulnerable areas, including requiring the commercial justification of transactions, limiting the persons involved in the transactions, carrying out due diligence processes of the counterparts, monitoring possible anomalies in transactions and obtain an independent review of transactions and valuations (Transparency International 2017). According to the OECD (2010) it is a good practice to disclose intercompany transactions as much as possible as it is highly linked to building up a reputation of a transparent, predicable and fair owner. Disclosing information regarding property, performance and general activities of subsidiaries and affiliate companies have a significant impact on the state future capacity to attract outside funding, on valuation and on the reputation of the SOEs.

Evidence in Argentina and Mexico: Energy SOEs in Mexico (Pemex and CFE) report their respective financial statements on a quarterly and annual basis but their affiliated companies are not comply with the transparency regulation. Moreover, in the case of Pemex, official information reported is inconsistent because Pemex reports 36 companies to the Securities Exchange Commission of US but 31 companies to the Mexican Congress. In the case of Argentina, there is also a very low rate of transparency regarding asset transactions; only 23% of SOEs discloses on their webpages their financial statements on a yearly bases (CIPPEC 2016).

Recommendation 1: Establish clear guidelines for public reporting of intercompany transactions with subsidiary and affiliate companies. Guidelines should include minimum transparency requirements for affiliates and criteria for information classification about high-risk transactions, in the form of focused manual or specific seminars and training for affiliates.

Overall, as custodians of public assets, SOEs should be champions of integrity and transparency. Although several Latin American countries have made progress in the development of specific transparency and corruption legislations, such as Access to Information Law, it is still necessary to advocate for a more comprehensive framework that takes into consideration both the political-institutional framework and the specific management processes in which SOEs perform. In this policy brief we highlight the most relevant changes that can significantly improve the governance of SOEs.

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