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MANAGEMENT REFORM OF STATE COMPANIES: THE CASE OF ROMANIA

This paper studies the reform of state companies, the problem of arrears and their impact on Romanian state budget and fiscal deficit. Moreover, we discuss the relevance of applying private management solutions to state companies in Romania as well as the strengths, weaknesses, opportunities and risks of implementing such solutions. Finally, we give a number of conclusions on the effects of improving management at state companies in Romania.

Keywords: *state companies; reforms; arrears; public finance sustainability.*

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УПРАВЛІНСЬКІ РЕФОРМИ У ДЕРЖАВНИХ КОМПАНІЯХ: ЗА ДАНИМИ РУМУНІЇ

У статті досліджено реформи державних компаній, проблема заборгованостей, їх вплив на державний бюджет Румунії і фіскальний дефіцит. Продемонстровано, наскільки застосовані комерційні механізми управління до державних компаній Румунії, їхні сильні та слабкі сторони, можливості і ризики. Сформульовано висновки про можливі наслідки таких реформ у державних компаніях Румунії.

Ключові слова: *державні компанії; реформи; заборгованість; стійкість державних фінансів.*

Табл. 2. Літ. 10.

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УПРАВЛЕНЧЕСКИЕ РЕФОРМЫ В ГОСУДАРСТВЕННЫХ КОМПАНИЯХ: ПО ДАННЫМ РУМЫНИИ

В статье исследованы реформы государственных компаний, проблема задолженностей, их влияние на государственный бюджет Румынии и фискальный дефицит. Продемонстрировано, насколько применимы коммерческие механизмы управления в государственных компаниях Румынии, их сильные и слабые стороны, возможности и риски. Сделаны выводы о возможных последствиях таких реформ в государственных компаниях Румынии.

Ключевые слова: *государственные компании; реформы; задолженность; устойчивость государственных финансов.*

I. Introduction. Determination of the problem. Faced with a rather high contagion of the global financial crisis in 2008 – mainly expressed by stopping of foreign capital flows in the short term – Romania has entered the fiscal crisis of liquidity in 2009. High twin deficits problem – effective budget deficit of 5.4% of GDP and current account deficit of 12.8% of GDP, economy overheating in 2006-2008, rigid budgetary spending, high tax evasion and absence of a reasonable financial buffer (to cover the running costs for a period of at least 4 months) led to the aggravation of the crisis expressed by the impossibility of financing the budget deficit at moderate costs.

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Sustainability of public finances was a reduced one in 2009, as the structural budget deficit reached the worrying level of 8.9% of GDP (Dinu et al; 2011).

Under these conditions, Romania had to implement one of the most ambitious programs of fiscal consolidation in the European Union. Structural budget deficit (a real indicator that measures the sustainability of public finances) has gone from 8.9% of GDP in 2008 to 3.5% in 2011. The average speed of the adjustment of structural budget deficit in 2009-2011 was 1.8% of GDP, second only to Hungary, with 2.4% of GDP, but exceeding Greece (1.4% of GDP) and Latvia (1% of GDP).

The fiscal adjustment was made in a high proportion on expenditures, the austerity measures being ones of the toughest: cutting public sector wages by 25%, 15% reduction in social expenditures, reducing subsidies to companies, firing 15% of budgetary employees etc. Income adjustment was made by increasing both value added tax from 19% to 24% and excising property taxes.

However, further reducing the budget deficit for maintaining the sustainability level, involves reducing the losses in the field of state companies. Arrears caused by state-owned companies in Romania are threatening targets related to the budget deficit and have a significant impact on macroeconomic variables: aggregate demand, interest rates, inflation etc.

This paper is divided into 4 parts. The first part presents the literature review on the reform of state companies, the problem of arrears and their impact on the economy. In the second part our focus is on the diagnosis of the system of state companies in Romania, in terms of arrears and losses generated by these companies with a strong impact on the state budget. In the third part we discuss the relevance of applying private management solution to state companies in Romania as well as the strengths, weaknesses, opportunities and risks of implementing this solution. In the last part we give a number of conclusions on the effects of improving the management of state companies in Romania.

II. Literature review. Tanzi and Blejer (1983) showed the correlation between budget deficits and balance of payments by analyzing the impact of IMF adjustment programs on the two macroeconomic balances. Diamond and Schiller (1987) indicated the significance of arrears in distorting typical measures of fiscal stance and proposed a strategy of combining a program of arrear reduction with an appropriate monitoring system for broad aggregates of government expenditure with the objective to prevent further arrears. Ramos (1998) presented several options addressing arrear problem and recommend that the government should recognize its implicit financial liabilities, set a timetable for their clearance and issue market negotiable titles.

Shirley (1998) showed that some developing country governments seek to improve the performance of state enterprises by negotiating performance contracts with their managers when privatization is not feasible or palatable. Many of these contracts have been put in place with World Bank assistance. The research shows they rarely work. It concludes that since a well-designed and enforced performance contract can be as politically costly as a well-designed privatization, performance contracts are not likely to be successful in the countries that lack political will to privatize.

Shirley and Xu (1997a) concluded that the increasing use of performance contracts in China could not stem the fall in productivity of state enterprises. More importantly, the study found no robust, positive association between performance contracts and productivity. And a comparison of the sample of state enterprises that had signed performance contracts with a sample of firms that found no significant difference between these two groups.

Shirley and Xu (1997b) demonstrated how problems of information asymmetry, incentives, and commitment can lead to shirking. They had a sample of 12 contracts with monopoly state enterprises in 6 developing countries and found that all suffer from serious contracting problems and there is no pattern of improved performance that can be attributed to contracts.

G. Larbi (1999) provided an overview of the evolution of new public management approach, the combination of factors driving change, and the potentials and limitations of this procedure. The paper showed that the implementation of NPM raises capacity questions even for non-crisis states with mature public administration systems. While the new public management approach may not be a panacea for the problems in public sector management in crisis states, a careful and selective adaptation of some elements to certain sectors may be beneficial. Implementation needs to be sensitive to operational reality.

The problem of reform in state companies and arrears arising from their inefficiency was the one that accompanied much of the transition period in Romania. Thus, for the period 1990-2001, Croitoru and Schaffer (2002) believed that the measures of enterprises restructuring or of imposing financial discipline had distorting effects on the structure of incentives, thereby generating forces contrary to the objective of this restructuring. The ascendant trend of arrears was a good support for the industrial lobby convincing economic policy makers of the impending danger of financial destabilization in Romania. Consequently, in August 1991, the authorities announced their intention to compensate for the delayed payment of commercial credit by providing bank loans. Thus, Romanian National Bank had to credit the banking sector in order to intervene over the interruption of the cycle of default. Moral hazard arose as soon as state enterprises were convinced that the government promises would be fulfilled. In the 4 months preceding the effective time of compensation, arrears between enterprises had a double increase: from almost 21% of GDP in July 1991, arrears between enterprises reached 50% at the end of the year (Khan, 1992). Moreover, the total arrears reached about 81% of GDP at the end of 1991.

III. Definition of the target problem for the analysis. The diagnosis of the state company system in Romania. There is a number of potential risk factors regarding the "health" of public finance in Romania: high deficits of the pension public system and health system, lack of prioritization of public investments that generates low multiplier effects in the economy, tax evasion and extremely weak financial discipline both on the level of central and local public administration and of state companies.

Increased sustainability of public finances in Romania essentially depends on reducing losses and arrears in the companies where the state is the major shareholder. According to the European budget methodology, a number of state companies have been reclassified in the public sector during the notification to Eurostat in October 2010, their losses being the main cause for the upward revision of budget deficit based on ESA95 to 8.6% of GDP in 2009, compared to 8.3% of GDP in the initial report (Fiscal Council, 2011). In addition, the Ministry of Finance shows that state enterprises are the largest debtors to the social insurance state budget, the total outstanding debt to general government being more than 2% of GDP in June 2010. The data for the period 2006-2010 show a steady increase in the stock of arrears of the first 150 state companies up to the level of 4.2% of GDP in 2010. The arrears of all state-owned companies in June 2010 totalled about 4.8% of GDP (Fiscal Council, 2011).

In 2009, in accordance with the financial statements reported by 722 major companies with majority state capital to the Ministry of Finance, these companies had an aggregate turnover of almost 50 bln. RON (11.6 bln. euros). It is interesting that, while these companies' contribution to the total turnover was 6%, they accumulated delayed arrears representing 27.1% of the total debts registered in the whole economy, a fact which indicates low efficiency in this sector.

Table 1. **The diagnosis of state companies in Romania**

Indicator	State Companies	
	Value	% of total economy
Number of state companies	722	0.1
Value added (RON mld)	40	10.4
Turnover (RON mld)	49.9	6.00
Arrears (RON mld)	23	27.1
Number of employees	363 011	8.9

Source: Calculations based on Fiscal Council balance sheets submitted to the MFP.

The fact that Romanian economy has long faced the problem of arrears shows not only the urgency of reform of state companies but also the inertia in inefficient allocation of resources, resulting in lack of competitiveness and high opportunity costs.

The Fiscal Council (2011) considers that there are several explanatory factors for the growth of arrears of state companies. Firstly, the budgets of public enterprises are often approved without the authorities' ensurance that a company will be able to pay its budgetary obligations. Secondly, certain legislative provisions favor the lack of financial discipline particularly in relation to utility providers. Thirdly, compensation and frequent deletions of debt create weak motivation for state companies to pay their outstanding obligations.

Eventually, a substantial contribution to reducing the arrears can be achieved by self-protection of profitable state companies. They can call to stop their trade receivables to customers that produce losses, they may require advance payment or block supplies to them.

IV. Analysis of the solution of private management implementation in Romanian state companies. For the improvement of the financial situation, for the reduction of the arrears and, generally speaking, for a major reform of state-owned companies in Romania, there has been proposed the solution of private management implementation in state companies (one of the conditions provided in IMF-WB-EC multilateral financing agreement for the period 2009-2011).

We believe that the adoption of private management in state companies has a number of advantages but also disadvantages, as grouped in the table below:

Table 2. **Advantages and disadvantages of private management solution in state companies**

ADVANTAGES	DISADVANTAGES
Increased discipline in public finances Reduction of the influence of politics on public companies, of the waste of public money. Reduction of the arrears of public companies to the state budget. **Promarket orientation** Private management is preferable to public one because, by the agreement with the IMF, the government loses many instruments that could "help" consumers (subsidies, non-alignment to international prices); **Profitability, without privatization of profits and nationalization of losses.** Private management can be an alternative to privatization – it could increase the efficiency of state companies, but not privatize profits. **Gain of reputation, market positioning and easy access to finance.** Private management can lead to improvement of reputation of state companies that would be privatized. However, a more efficient solution for increasing confidence would be selling a minority part of these companies to financial/investment prestigious institutions (such as EBRD, IFC - World Bank Investment Division), as in Romanian Commercial Bank -BCR. These institutions will have representatives on the doards of directors of these companies who can act as inside pushers towards increasing efficiency. **Professionalism and integration of best practices.** Performance contracts signed with private managers require the adoption of modern management techniques, strategic planning, etc. **Self-corrective system.** Since the previous year's performance is the starting point for the next year, any erroneous information sent to assess these contracts are identified and corrected in a short time. **Possible increase in the quality of public services delivered to population.**	**Complexity**. The process of performance contracts includes assessment by mathematical formulas, which requires prior training for evaluators. **Suboptimal solution.** Management privatization can be considered a solution of the "second best" type - the state loses control and access to resources, but it does not receive a capital injection, as with privatization. **Transitory solution.** Privatization of management may be just a transitory solution to minimize the costs of the 2012 election. The government will avoid rapid privatization of state companies, which could involve massive staff layoffs. Being applied to a politicized environment, private management will generate important changes only in a longer period of time; **Private management cannot resolve short-term structural problems of a state company with losses.** There will be a rather rapid increase in selling prices and a reduction of labor costs due to layoffs. IMF stated that the objective of these managers would be only to maximize profit (although this objective could generate inflation and unemployment); **Failure of termination of precarious contracts already concluded by state companies.** Private management cannot reduce "money wasting" of state firms, provided they have signed contracts that put them at a disadvantage (with policy customers) over a long period of time. In addition, private management cannot solve the debt of these companies to the state as long as they cannot quickly recover debts from other companies; **Blockade of minority shareholders**. One of the problems that private management may face refers to the minority shareholders in such companies because if they dispute certain reform measures, the process can be blocked.

Nevertheless, we believe that private management solution involves a number of risks.

Firstly, the principal agent problem can arise. Contradictions may arise between private management objectives and interests of the state, reflected by the Board of Directors. Therefore, private management should have members in the Board of Directors (as in the case of privatization, but maintaining the influence of the majority of the state). Currently, Norway, Denmark, the Netherlands and Australia do not allow a representative of the state to be a member in the Board of Directors of a state company.

Secondly, there is the possibility of continuing political influence. Manager recruitment by an "independent" human resource firm does not exclude political influence in any case, both in terms of their choice and in a company's management future decision. Private management will not solve the problem of depoliticization of public companies, if board members are still political appointees.

Thirdly, there are certain risks associated with the targets to be achieved. There is a high risk of failure in achieving targets. Privatization of management will be only a partial solution unless the independence of decisions is respected by shareholders and certain guarantees (material, financial, good practice) are introduced for managers – enforceable guarantees in the absence of performance (quantifiable and measurable by a management contract). There may be a possible conflict between the targets set by contract. In industrial/strategic areas, an inconvenient trade off may appear between the government objectives (lower prices during the economic recession) and the management targets (profit maximization). Last, but not least, there is the risk of focusing on short-term objectives. The shorter private management mandate is, the lower its usefulness will be, because this fact decreases the incentives to increase investment and increases those towards profits and bonuses immediately obtained, including the sale of assets.

V. Conclusions and recommendations. We consider that adoption of a management contract is a good solution before privatization of any state company. Private management requires at least 4 years to improve a company's activity (about one year is the time to develop a company's development strategy in the long run). Management contract must be extremely clear and transparent, to avoid long periods of negotiation or renegotiation. The performance indicators which determine the remuneration of the private management should be relatively few, but significant and easily measurable. Payments for private management performance should be the result of the activities they can influence (for example, for extra investments made and not for further sales of assets). A clear system of incentives and also of penalties to a contractor under a (temporary) failure in contract obligations must be developed.

It is necessary to implement a clear and independent mechanism for monitoring the activity of private management. Private management activity should be externally audited as to eliminate possible tensions between government and a private company. Financing of private management can be achieved by the World Bank or other development agencies, benefiting from their technical assistance. They can also provide financial support for investment projects of such companies. Private management must avoid to focuses exclusively on short-term targets. Private management contracts tend to be oriented on short-term solutions and not on significant investments (such as the extension of electricity or natural gas systems), because they could generate short-term losses and therefore fewer financial benefits.

We consider the following measures useful for Romania: inclusion of the activities on implementation of performance contracts signed by private managers in the technical assistance program signed with the World Bank (a financing program for the evaluation agency, the training company and the independent agency that monitors the results of the contract); simultaneous use of multiple solutions for making state companies profitable: the sale of minority stakes to the IFC-World Bank's investment division (as in Romanian Commercial Bank – BCR case) plus the implementation of performance contracts with Romanian and/or foreign managers; use of the World Bank expertise for selecting private managers on a difficult task to be done by Romania only, due mainly to the lack of experience and heterogeneity of selection criteria specific to each sector that is to be implemented in private management); initial implementation of a pilot program on 10 state companies with the purpose of minimizing the risk of failure in implementation of such a method; in case of a positive evaluation, it would be possible to extend performance contracts (with Romanian and foreign managers) to all state companies; in the last phase, acquisition of the best practices in the implemented system and their inclusion in performance contracts for all public institutions and local administrations; an integrated system for increasing public management efficiency – new public management.

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