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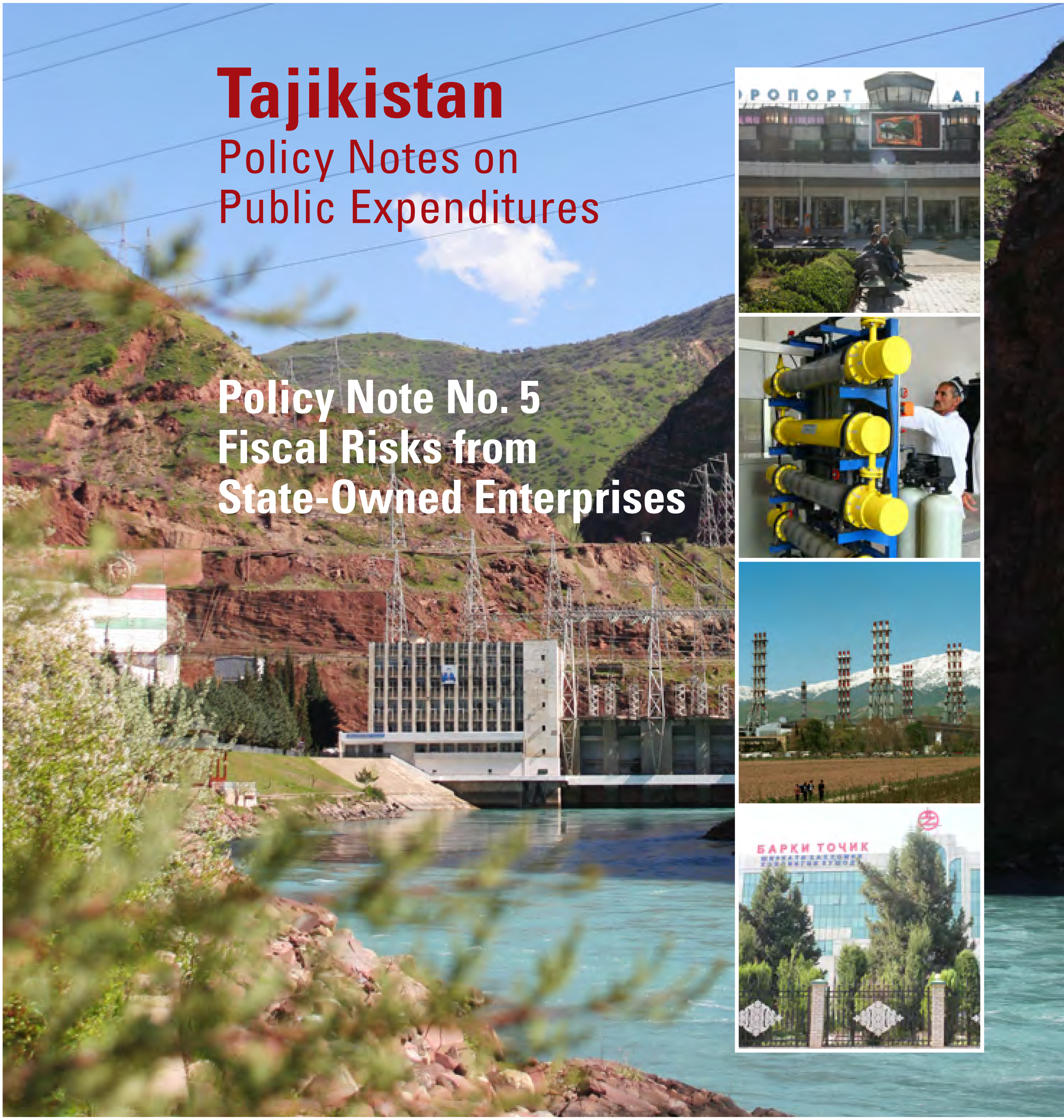
Tajikistan

Policy Notes on Public Expenditures

Policy Note No. 5 Fiscal Risks from State-Owned Enterprises



Report No. 89183-TJ

Tajikistan

Policy Notes on Public Expenditures

Policy Note No. 5

Fiscal Risks from State-Owned Enterprises

June 2014

Poverty Reduction and Economic Management Unit
Europe and Central Asia Region

THE WORLD BANK
Washington, D.C.

REPUBLIC OF TAJIKISTAN
Government Fiscal Year: January–December

Currency Equivalents
(Exchange rate as of June 16, 2014)
Currency Unit = Tajikistan Somoni
USD 1.00 = TJS 4.9237
TJS 1.00 = USD 0.2031

Weights and Measures
Metric System

Abbreviations and Acronyms

ADB	Asian Development Bank	*MTEF*	Medium-Term Expenditure Framework
BT	Barki Tojik	*OECD*	Organization for Economic Co-operation and Development
CAPS	Central Asia Power System	*PARS*	Public Administration Reform Strategy
CCT	Civil Code of Tajikistan	*PEFA*	Public Expenditure and Financial Accountability Assessment
CSIP	Centralized State Investment Program	*PER*	Public Expenditure Review
DCC	Development Coordination Council	*PFM*	Public Financial Management
DFID	Department for International Development (UK)	*PFMA*	Public Financial Management Act, South Africa
EBFs	Extra-budgetary Funds	*PFMMP*	Public Financial Management Modernization Project
EBRD	European Bank for Reconstruction and Development	*PFMRS*	Public Finance Management Reform Strategy
EC	European Commission	*PIP*	Public Investment Program
ECA	Europe and Central Asia	*PPP*	Public Private Partnership
FIs	Financial Institutions	*PRSP*	Poverty Reduction Strategy Paper
FMIS	Financial Management Information System	*QFAs*	Quasi-Fiscal Activities
GDP	Gross Domestic Product	*QFD*	Quasi-Fiscal Deficit
GOT	Government of Tajikistan	*SCIMSP*	State Committee on Investments and Management of State Property
IFI	International financial institution	*SCOPA*	Standing Committee on Public Accounts, South Africa
IFRS	International Financial Reporting Standards	*SFR*	Statement of Fiscal Risks
IMF	International Monetary Fund	*SME*	Small; and Medium-sized Enterprises
IPSAS	International Public Sector Accounting Standards	*SOE*	State-Owned Enterprise
JSCs	Joint-Stock Companies	*SOEMD*	SOEs Monitoring Department in the Ministry of Finance
LRAIC	Long-run average incremental costs	*SUE*	State Unitary Enterprise
LSIS	Living Standards Improvement Strategy	*TALCO*	Tajik Aluminum Company
MABA	Main Administrator of Budgetary Allocations	*TSA*	Treasury Single Account
MoEDT	Ministry of Economic Development and Trade	*UCOA*	Uniform Chart of Accounts
MoF	Ministry of Finance	*WBG*	World Bank Group

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Contents

List of Figures

List of Tables

List of Boxes

List of Annexes

Preface

At the request of the Government of Tajikistan the second stage of the Public Expenditure Review (PER-2) continues to support the government in analyzing public expenditures, fiscal management, and fiscal risks and making recommendations. PER-2 consists of three policy notes: *Key Issues in Public Finance Management, Fiscal Risks from State-Owned Enterprises*, and *Capital Expenditures and Public Investment Management*.

PER-2 continues the fiscal policy dialogue conducted in FY12–13. It builds on the findings of the three PER-1 Public Expenditure Review Notes completed in FY13: *Government Expenditures: Size, Composition and Trends; Review of Public Expenditures on Health*; and *Review of Public Expenditures on Education*.

PER-2 was prepared by a World Bank team comprised of Marina Bakanova (Task Team Leader, ECSP1), David M. Nummy (Senior Public Sector Specialist, ECSP4), Konstantin Shkurupiy (Consultant, ECSP1), and Ravshan Sobirzoda (Economist, ECSP1). Yuriy Miroshnichenko (Senior Energy Specialist, ECSEG) provided valuable contributions. Nasiba Saidova (ECCTJ) and Sarah Babirye (ECSP1) supported the team.

The peer reviewers were Chiara Bronchi (Lead Public Sector Specialist, AFTP5), Frederico Gil Sander (Senior Economist, EASPT), and John Zohrab (Regional PFM Advisor, IMF). The team benefited from the guidance and advice of Ivailo V. Izvorski (Sector Manager, ECSP1), Adrian Fozzard (Sector Manager, ECSP4) and Marsha M. Olive (Country Manager, ECCTJ). This note also reflects comments from colleagues from the World Bank and the International Monetary Fund made in internal presentations and informal discussions.

The team is grateful to the Tajikistan authorities for their collaboration and input during the preparation of the PER-2. The team is particularly grateful to the Ministry of Finance for facilitating the overall coordination of the work from the Government side.

Support of the ECA regional BOOST initiative, financed by trust funds from Bank-Netherlands Partnership Program and the ECA Public Financial Management Multi-Donor Trust Fund, is gratefully acknowledged.

1. Main Messages

1. **Despite privatizations and restructuring attempts, the public sector in Tajikistan is still large.** State-Owned Enterprises (SOEs) play an important role in the Tajikistan economy, having a major presence in many sectors ranging from infrastructure and communal services to energy, communications, transport, trade, banking, insurance, and metal processing. According to official statistics SOEs provide one-third of all the jobs and are responsible for more than 40 percent of total value added and 50 percent of total investment in fixed capital.[1]

2. **Despite their role in the economy of Tajikistan, financial information about SOEs is fragmented, incomplete and often inaccurate.** Financial data on SOE performance are sometimes inconsistent or not collected at all. There is no evidence that any single individual or unit of government in Tajikistan has a full understanding of the financial situation or even the size of the SOEs.

3. **Elaborate quasi-fiscal activities (QFAs) of SOEs and other public institutions create substantial fiscal risks and undermine the hard-earned benefits of fiscal consolidation.** The total costs of QFAs of 16 largest SOEs are estimated by the SOE monitoring department of the Ministry of Finance (SOEMD) at about 3 percent of GDP in 2012, or more than 25 percent of social and poverty-related expenditures in the same year.[2] The total scope of QFAs is arguably even larger, since practically all SOEs are involved in them one way or another. The resulting liquidity problems, operating losses, and growing indebtedness of SOEs are absorbed by accumulating arrears, lax financial discipline, subsidized loans, and debt write-offs.

4. **Major fiscal risks arise from the direct costs to the budget of SOE operating losses, explicit and implicit liabilities.** The present debts of close to US$2 billion incurred by the 24 largest SOEs will continue rising along with operating losses and emergency interventions to keep critical SOE operations afloat. Contingent liabilities from legal disputes, to the extent they are known, are as large as total budget spending on social security and welfare. In the long run this trend is unsustainable. What is needed is systemic intervention to both contain the losses and improve operational and management efficiency.

5. **Without more stringent reporting guidelines and more coordinated and robust monitoring of SOEs, the government is threatened with severe fiscal liabilities and improperly informed policy actions.** The opportunity costs of delayed SOE reform have been growing given the extent of the sector, its elaborate quasi-fiscal activities, and the large direct and contingent liabilities. A comprehensive SOE reform is made even more urgent given the significant risks to the Tajikistan economy, including from markedly weaker growth in Russia and its impact on trade, finance, and remittance flows to Tajikistan.

1 This is also consistent with the EBRD estimates of the share of private sector in Tajikistan's GDP at 55 percent in 2010. http://www.ebrd.com/pages/research/economics/data/macro.shtml#structural

2 Expenditures on health, education, and social protection.

6. **SOE reform should be considered as part of the overarching structural reform agenda.** SOE reform should address the core challenge: assuring proper SOE governance to minimize fiscal risks and deliver services to consumers cost-efficiently. In addition to the general reform task, many sectors where SOEs operate, such as energy, infrastructure, other service delivery sectors, and the financial sector, have specific challenges. The analysis and recommendations in this note complement the dialogue on structural reform in Tajikistan conducted by the World Bank Group (WBG), other development partners and the Government of Tajikistan (GOT). Establishment of a department to monitor SOEs in the Ministry of Finance (SOEMD), preparation of statements of fiscal risks (SFRs) posed by SOEs, and introduction of a dividend policy are major steps in the right direction. Now they need to be complemented by other institutional and organizational reforms, both economy-wide and sector-specific.

7. **To address the risks emanating from its SOEs the government is invited to consider four groups of recommendations:**

- **Enhance SOE transparency and accountability.**
    - Improve the presentation of SFRs and consider them during legislative review and adoption of the budget.
    - Expedite full implementation of International Financial Reporting Standards (IFRS) by all large SOEs. Set deadlines for the rate at which SOEs convert to IFRS with allowances for smaller ones but that do not pose significant fiscal risks or impact on the Tajik economy.
    - Require independent audits for all SOEs by licensed firms with industry expertise and adequate resources. The SOEMD should issue guidelines for appointment of auditors and the process to put these audits out to tender. As a best practice, audit contracts should be awarded for more than one year.
    - Identify what will be the consequences if audit opinions are qualified, such as impact on the evaluation of senior manages or requiring a corrective action plan. As a first step, the conclusions of the auditors should be reviewed and an action plan drafted to address the issues raised. The review and action plan should be managed by the SOE and monitored by the SOEMD.
- **Strengthen SOE monitoring and oversight.**
    - Clarify the role and build up the capacity of the SOEMD and the State Committee on Investments and Management of State Property (SCIMSP) to manage SOEs and issue reports that have all the information necessary to underpin decision making.
    - Ensure that the SOEMD has sufficient resources to collect comprehensive information on all SOEs, analyze it, and present it to those in government with oversight authority.
    - Set a clear schedule to expand coverage of all SOEs, especially TALCO Management Ltd. To balance resources with workload, consider limiting the amount and frequency of information on smaller SOEs but do not exempt them from coverage.

    - Establish policies that provide clearer, more consistent, and more transparent exercise of ownership rights in SOEs, such as policies on forgiveness of arrears, issuance of dividends, assumption of debt, and QFAs.
    - Move to introduce a modern system of SOE governance and financial oversight based on the assessment and recommendations detailed in Annex 1.

- **Eliminate quasi-fiscal activities and fully reflect contingent liabilities in the SFRs.**
    - Halt the practice of directing SOEs to "voluntarily" undertake activities not related to their core businesses.
    - Properly plan in the budget for quasi-fiscal activities (QFAs). Prepare a time-bound plan for phasing out QFAs in every sector and start to put it into action.
    - Itemize any unresolved financial disputes of SOEs identified in the SFRs that are above the minimum threshold established by regulation as a contingent liability.

- **Optimize the size of the SOE sector and improve the management efficiency of those that remain.**
    - Hire professional managers for complex SOEs (IT, communications, air transport) that continue to have exclusive or majority state ownership.
    - Bring in the private sector through sale of shares, public-private partnerships (PPPs), and other forms of collaboration. This could have two potential benefits: raising private investment resources and obtaining access to better technology and corporate management.
    - Privatize some large SOEs in sectors dominated by the private sector in most countries, including transition economies (e.g., canning factories, cement plants).

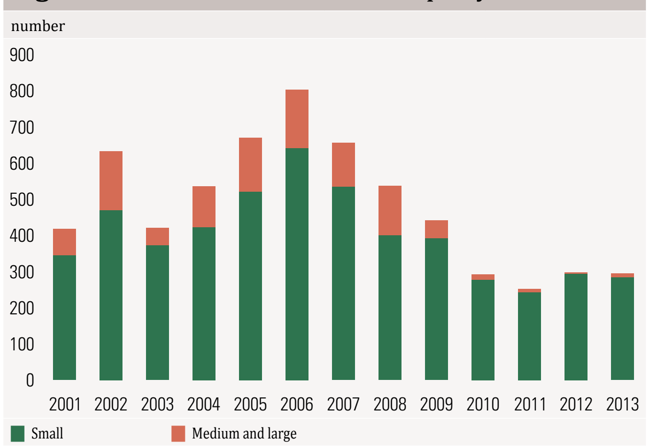
8. **The rest of the note is organized as follows.** Chapter 2 reviews the role of SOEs in Tajikistan's economy and identifies key issues. Chapter 3 assesses the fiscal risks posed by SOEs, especially those in the energy sector. Chapter 4 puts forward possible solution, and Chapter 5 draws conclusions. Annexes provide valuable information on SOEs performance and challenges, including in two key sectors—power and aluminum; benchmark SOEs governance framework and practices in Tajikistan against OECD principles and provide information on good practice in SOEs governance and oversight based on the experience of South Africa Republic. Reform of SOEs is part of Tajikistan's general market reform agenda. This note should be viewed as complementary to the continuing World Bank Group policy dialogue on structural reforms.

2. SOEs in Tajikistan: Key Facts and Issues

A. The Role of SOEs in the Economy

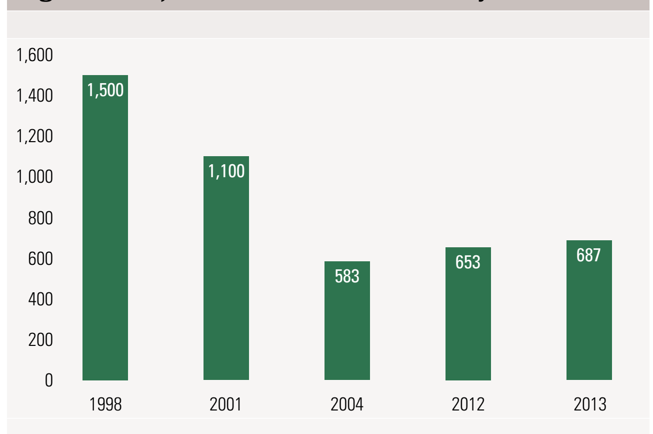
9. **Although many state companies have been privatized since the start of transition to a market economy, Tajikistan still has numerous SOEs.** Small SOEs were the first to be turned over to the private sector while privatization of medium- and large-size enterprises did not begin until 1998. Of the 6,029 state properties privatized in the first decade of transition (1991–2000), 95 percent were small enterprises. Privatization of the other SOEs picked up in the mid-2000s with the adoption in November 2004 of the Strategic Plan of Privatization of Medium and Large Enterprises for 2003–09, but it has practically stalled since then (Figure 1). And despite the privatization, the number of SOEs increased from 583 in 2004 to 687 in 2013 (Figure 2). This is due to the inclusion in the SOE lists of some government units—in contrast to standard practice around the world—but may also reflect problems with the registry and the information (see Section B).

Figure 1. Privatization of State Property



Source: SCIMSP.

Figure 2. Tajikistan: Number of SOEs by Year

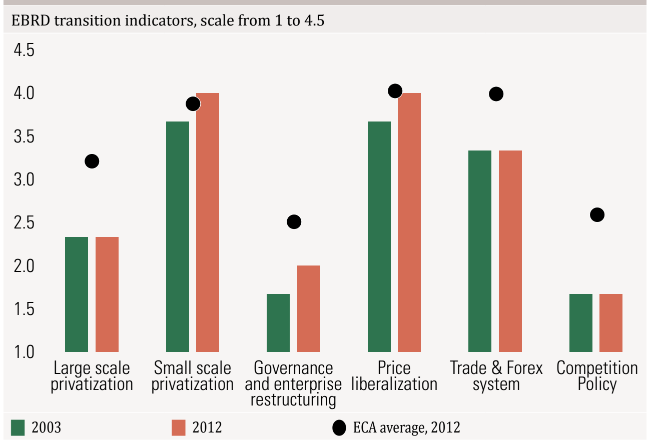


Source: World Bank, Tajik authorities.

10. **SOE reform needs to be seen within the context of market reforms.** Tajikistan's progress from plan to market has been slow and inconsistent. With an average score on the EBRD index of transition reforms at 2.9, Tajikistan is the fourth lowest performer in the Europe and Central Asia region (ECA) after Turkmenistan (1.8), Belarus (2.2), and Uzbekistan (2.3).[3] With regard to privatization of large SOEs, governance and enterprise reform, and competition policy there has been little or no change since 2003 (Figure 3).

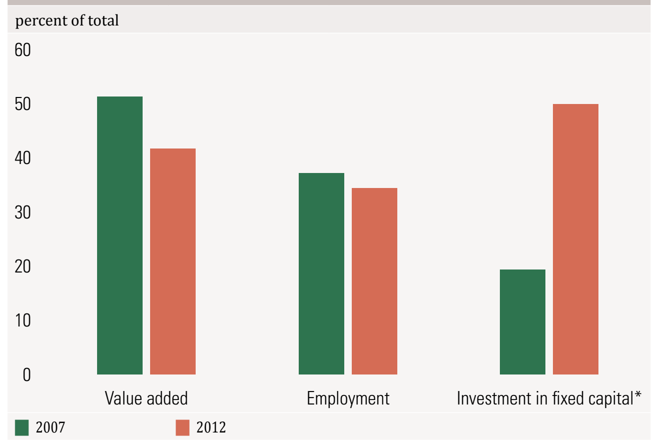
3 EBRD Transition Reports. www.ebrd.com

Figure 3. Tajikistan: Progress in Transition



Source: EBRD Transition Reports.

Figure 4. SOE Value-Added, Employment, and Investment in Fixed Capital



Source: TajStat. *2011 for investment in fixed capital.

11. **SOEs have a dominant role in the Tajikistan economy.** SOEs have a major presence in many sectors ranging from infrastructure and communal services (a mainstay for state ownership worldwide) to energy (power), communications, transport, trade, banking, insurance, and metal processing. Global trends for the past three to four decades clearly show that the latter groups have become dominated by the private sector or at least represents a mix of state and growing private ownership and the significant presence of PPPs. Not in Tajikistan. According to official statistics, SOEs provide one-third of all the jobs in economy. After more than 20 years of transition, Tajik SOEs are still responsible for 42 percent of total value added and 50 percent of total investment in fixed capital (Figure 4). Entry of the private sector is either forbidden by law or in practice not doable under current institutional and political arrangements. Partly, this is due to complex entry and operational requirements and partly to (both national and local) political preferences to protect the monopoly position of given SOEs and thus protect the overemployment and false sense of economic security that entails.

12. **Lack of a comprehensive database and a coordinated management system makes it difficult to understand the real economic impact of the remaining SOEs.** Other than a simple registry of individual SOEs with basic information (company name, address, and government share in capital), there is no central repository that systematically captures comprehensive information about SOE operations and management. Furthermore, since individual SOEs report to different line ministries and agencies, it is unlikely that any single government body has complete information on their plans and strategies, economic and financial performance, impact on the economy, or the fiscal, economic and social risks they pose to the budget, the economy, and the society at large.

13. **The government has made progress in recent years by establishing the State-Owned Enterprise Monitoring Department (SOEMD) within the Ministry of Finance.** Initially the SOEMD monitored the financial performance of 10 'large' SOEs but after several were restructured the scope of monitoring was expanded to 16 SOEs and about 130 of their subsidiaries.[4] In 2012, the gross income of the 16 SOEs accounted for over 15 percent of GDP. The five largest SOEs contributed 80 percent of the gross income. In 2013, eight more SOEs were added to

4 Large SOEs have more than 1,000 workers and annual gross revenue of more than TJS 30 million. The SOEMD was established by Government Resolution No. 454 on September 19, 2008. On March 2, 2013, Government Resolution No. 111 added eight more SOEs to the list to be monitored by SOEMD.

the list of enterprises managed by the SOEMD. The 24 SOEs on the expanded list had operating losses of more than US$77 million and presently owe almost US$1.9 billion—equivalent to 97.7 percent of Tajik public revenues of all kinds in 2013. More than 84 percent of the debt can be attributed to the three largest SOEs: the power company Barki Tajik (BT), the aluminum company TALCO, and Tajik railways (see Table 1). These three companies generate over 96 percent of SOE operating losses—a major problem for the Tajik public sector.

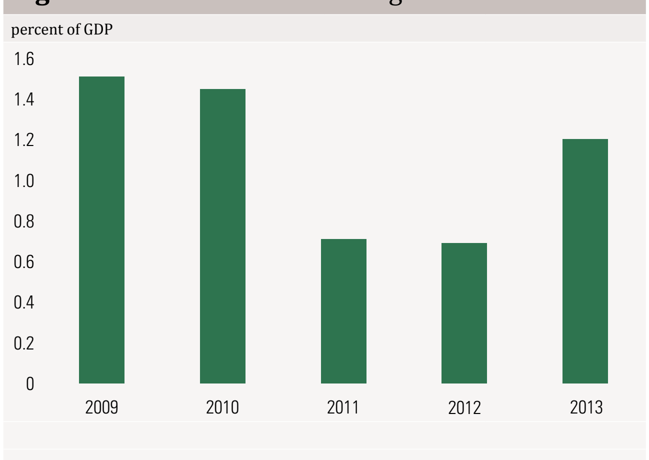
Table 1. Debt, Profits, and Losses of 24 SOEs, 2013

	Total Debt		Profit		Losses	
	US$ million	Percent	US$ million	Percent	US$ million	Percent
Tajik Air	71.5	3.8	1.7	5.0		
Airport Dushanbe	13.1	0.7	12.1	36.3		
Power Company	916.7	48.6			-40.8	53.0
TALCO -- Aluminium	362.3	19.2			-31.0	40.3
Tajik Cement	18.8	1.0			-1.5	1.9
Transgas	55.4	2.9			-1.5	1.9
SUE Oil, Gas & Coal	8.3	0.4	0.4	1.3		
Railways	316.5	16.8			-2.3	3.0
Telecoms	34.8	1.8	3.8	11.3		
Other SOEs	90.0	4.8	15.4	46.3		
Total	**1,887.3**	**100.0**	**33.3**	**100.0**	**-77.1**	**100.0**

Source: Ministry of Finance, preliminary data for 2013.

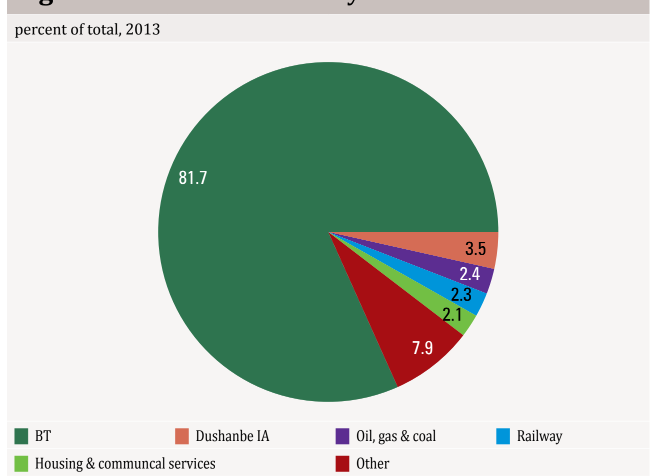
14. **The SOE contribution to the budget is lower than their economic size; moreover, they owe the budget the most.** According to 2012 data, the 16 largest SOEs paid less than 12 percent in taxes, well below their share in GDP. In 2012 they were also responsible for almost 40 percent of total tax arrears. After a moderate decline as a share of GDP in 2012, the tax arrears of the largest SOEs added up to 1.2 percent of GDP in 2013 (Figure 5). By the beginning of 2014, the tax arrears accumulated by the 24 largest SOEs comprised half of all tax arrears. BT is the major debtor, accounting for almost 82 percent of the tax arrears of the 24 largest SOEs and 45 percent of total tax arrears (Figure 6).

Figure 5. Tax Arrears of the Largest SOEs



Source: World Bank Staff calculations on data from MoF and TajStat.

Figure 6. SOE Tax Arrears by Debtor



Source: World Bank Staff calculations on data from MoF and TajStat.

15. **In short, despite privatizations and restructuring attempts, the public sector in Tajikistan is still large, inefficient, and heavily indebted.** As a result of inefficiencies, poor management and inadequate pricing, a small number of SOEs have a major negative fiscal impact. Poor public provision of services crowds out private provision, distorts product and factor markets, and significantly limits growth of the private sector. SOE reform should address the core challenge: assuring proper SOE governance to minimize fiscal risks and deliver services to consumers cost-efficiently.

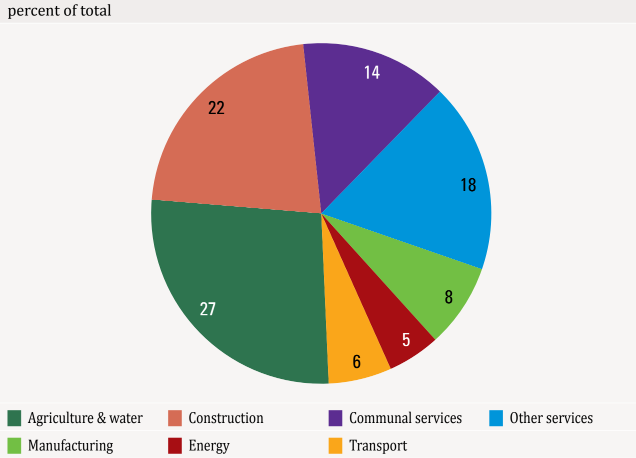
B. Lack of Reliable Information on SOEs

16. **While information on the largest SOEs has been collected regularly, the consistency of the data from different sources and the reliability of the information reported are questionable.** Although the data made available through SOEMD clearly indicate the size and importance of individual SOEs and the sector as whole, the precision and reliability of financial and other information does not meet statistical and financial reporting standards. A comparison of data from different sources reveals differences even in data pertaining to the same economic content or aspect of SOE operations. Data in financial statements publicly disseminated by SOEs do not always correspond to data reported to government entities monitoring SOE economic activity. The problems range from unresolved differences in the accounting standards used by SOEs and government agencies, statutory definitions (e.g., for tax reporting), and inconsistent application of accounting and statistical reporting rules due to insufficient capacity to accurately record SOE financial activities.

17. **The tax authorities are another source of statistics on SOE number and structure.** Their records cover about 800 SOEs, although a number of the state entities can hardly be considered enterprises. Some in fact are public institutions that have specialized functions and charge fees for their services (e.g., the management department within the office of the Parliament, the price-setting committee, the committee for youth, sport and tourism, the club of young businessmen, or the social investment fund). Figure 7 reflects the breakdown of 800 SOEs by sector.

Figure 7. SOEs Breakdown by Sectors, 2013

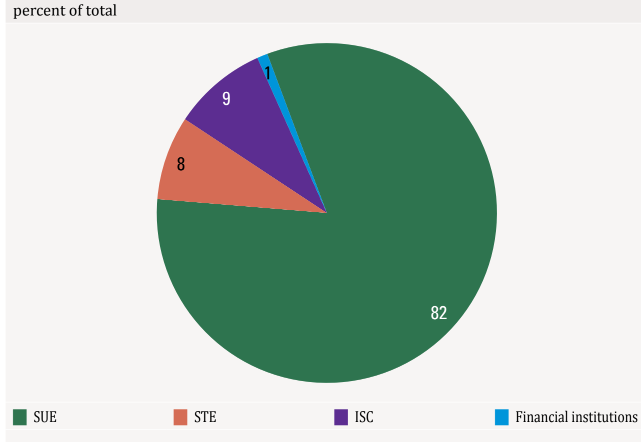
percent of total



Source: World Bank Staff calculations on data from MoF and TajStat.

Figure 8. Legal Types of SOEs

percent of total



Source: World Bank Staff calculations on data from MoF and TajStat.

18. **SOE financial data would be more consistent and reliable if SOEs were required to use internationally acceptable accounting and reporting standards and all of them systematically reported to a one single government unit.** Tajikistan has indeed adopted legislation requiring SOEs to adhere to IFRS,[5] but the gap between law and practice is wide. Not all SOEs have converted their accounting records to follow IFRS and, according to the opinions of external auditors, most of those that have are not in full compliance. Further, the most recent IFRS standards are not available in Tajik and previous translations are not systematically updated.

19. **Only one SOE that has undergone a full independent audit has earned an unqualified opinion; the others all received either adverse, qualified, or no opinion.** Thus, the auditor either concluded that the information in the financial statements did not fairly present the financial position and activities of the enterprise, could not conclude that the information in the financial statements fairly presented the financial position and activities of the enterprise, or could not obtain enough evidence to reach any conclusion. While it is not uncommon for SOEs in transition economies to receive an inconclusive or adverse audit opinion, it underscores potentially severe issues related to internal controls of the quality of the financial statements. It also represents a major risk for the state as ultimate owner.

20. **Since SOEs have reported inconsistent financial information from one year to the next and external auditors are reluctant to give unqualified opinions, questions naturally arise about the accuracy of a broad range of economic measures used to understand the Tajik economy.** Concepts as basic as GDP could be inaccurate and lead to many incorrect conclusions about numerous economic factors. A comparison of financial data from different sources for the largest SOEs found that the true size of the SOE sector as measured by revenue varies by more than 30 percent and could even be substantially more or less. It may well be that the entire Tajik economy is much smaller, or much larger, than anyone knows.

C. Lack of Budget Integrity

21. **As the SOEs fall outside of the normal budgetary process, a sizable amount of spending for public purposes remains outside the budget, undermining its integrity and credibility.** The lack of comprehensive information on the SOE sector and the imprecise information available about large SOEs could distort any conclusions about government activity as a whole—which is what a government budget is intended to convey. If SOEs are taking actions that are motivated by public policy objectives beyond what is in the best interest of the firms or if policies are being imposed on SOEs by government officials that are aimed at public policy objectives other than what best serves efficient SOE operations, the financial impact represents an allocation of resources for a public purpose that would not be reflected in the budget. Activities undertaken by entities outside normal budget operations are known as QFAs—activities that could be funded by direct taxation or spending by government. In these cases, the

5 Government Resolutions No.428, November 4, 2002 on International Financial Reporting Standards; and No.466, October 3, 2006 on Additional Measures on Introduction of IFRS). These Resolutions lost their effect with the adoption of the Law on Accounting and Financial Reporting, No.702, 2011 that requires all that all public interest entities prepare their financial statements in accordance with the international standards. The Government Resolution No. 154, April 3, 2012 On Additional Measures for Regulating Accounting and Financial Reporting provides an official definition of a public interest entity. The Law on Audit Activity No.993, 2013 requires financial statements of public interest entities to be audited according to international standards of audit on an annual basis.

integrity of the budget as a comprehensive source of information on how much public money is being spent and how resources are being allocated to achieve public policies is undermined.[6]

22. **Understanding the full nature, composition, and activities of the SOE sector is also important because SOEs can pose risks to the financial position of the state that can take several different forms.** For purposes of budget management, the possibility of deviations in fiscal outcomes from what was expected when a budget or other forecast was adopted is known as fiscal risk. Risk management consists in identifying potential risks, evaluating their likely impact and the probability of their occurrence, and determining what can be done to mitigate each risk.

23. **The Tajik Ministry of Finance has begun to identify possible fiscal risks and has issued a *Report on Fiscal Risks from State Owned Enterprises* (SFR).** The SOEMD has so far published two SFRs, for fiscal years 2011 and 2012.[7] SFR content is limited to the fiscal risks inherent in the contingent liabilities, QFAs, and debt of large SOEs that are in the category of "public interest entities" as defined in Law of the Republic of Tajikistan No.702 dated March 25, 2011, on accounting and financial reporting.[8] Although Tajikistan has not adopted a formal framework to assess the level of fiscal risks related to specific SOEs or the entire SOE sector, launch of the SOEMD and its issuance of the SFRs are important for a more complete picture of public finance and improved public finance management. The analysis in this note uses data provided by the SOEMD, the SCIMSP, the Tax Committee, and TajStat but it should be noted that the problems of data quality, comprehensiveness, and accuracy affect all the information used.

D. Inconsistent Governance and Oversight

24. **The Civil Code of Tajikistan (CCT) sets out the basic legal framework for SOE operations and management.** The CCT defines the main principles for commercial activity and regulates commercial relations. The CCT defines two types of SOEs: State Unitary (*commercial*) Enterprises (SUE) and State Treasury (*kazennye*) Enterprises (STE). The state can also be founder, single owner, or stakeholder in other types of commercial entities, such as joint-stock companies (JSCs), limited liability companies, and financial institutions (FIs) (the main types of SOEs are defined in Box 1). Presently, the majority of SOEs (542) are SUEs. The government is also majority owner of 86 JSCs, 5 FIs, and 54 STEs that have specific government tasks. This gives a total of 687 SOEs, fewer than the 800 or so reported by the tax administration. The discrepancy may be caused by flaws in the repository system and the lack of a common methodology for identifying SOEs in the registry.

25. **SUEs are a legal form unique to post-Soviet states.** They are state-owned corporations that may be national, regional, or municipal; they are managed independently but do not hold legal title to the government assets they use in their operations. In theory, if national they are overseen by a line ministry or other government body but do not have formal boards of directors. In Tajikistan a national SUE may be overseen by a line ministry but the legal

6 See also World Bank (2014). *Key Issues in Public Finance Management*, Policy Note No.4. Tajikistan Programmatic Public Expenditure Review. Report No.88050-TJ, June 2014.

7 Referred to as the 2011 SFR and the 2012 SFR.

8 The EU-funded project that started in December 2013 supports strengthening of the SOEMD and improvement in the presentation of the SFRs.

Box 1. SOE Forms in Tajikistan

State Unitary (*commercial*) Enterprise (SUE). SUEs are enterprises that have economic and commercial control of state assets and are responsible for all obligations related to the assets. The government or the governing body appointed by the government is not responsible for SUE liabilities

State Treasury (*kazennye*) Enterprise (STE). STEs are created in areas vitally important for the government (sectors closed to private businesses or where the government has a monopsony or produces socially significant products or services). Examples are development and maintenance of infrastructure, correction facilities, and topographic and cartographic institutions. STEs cannot divest or sell their assets and the government is fully responsible for their liabilities.

Joint Stock Company (JSC). JSCs are economic entities created in accordance with the law in which the state is owner or co-owner by holding shares. Regardless of the share in capital and weight in governance as a shareholder—whether a minority stake or 100 percent ownership—all JSCs in which the state has an interest are considered SOEs.

Financial Institution (FI). FIs are economic entities created as joint stock companies in accordance with the law on banks and banking activity and supervised by the National Bank of Tajikistan.

Source: Civil Code of Tajikistan.

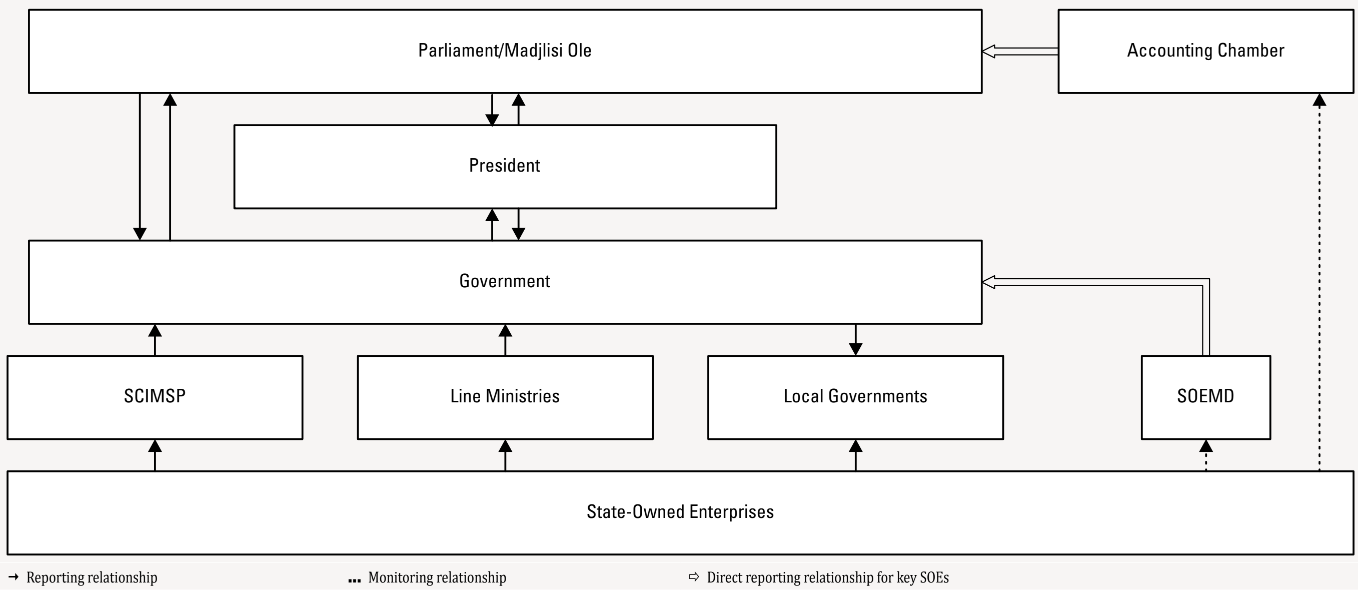
owner is the SCIMSP. In practice, ownership functions are exercised inconsistently, with at least one large SUE and its subsidiary being supervised by the government itself.[9]

26. **JSCs have a more defined governance structure but even their governance is not always consistent.** JSCs have formal boards of directors, clearer reporting relationships, and more established procedures but relatively few SOEs have this legal form, less than 15 percent of the total. A few JSCs report to the SOEMD and there is no consistent guidance for how the government is represented on their boards of directors.

27. **There are few regulations guiding the ownership and oversight functions and of these some are not consistently followed, as in the requirement for IFRS-compliant financial statements.** As the owner of SOEs, government has a responsibility to oversee management, be fully informed about the financial status and operations of the entities, and be transparent in the actions it takes as owner. Technically, the ownership function of most SOEs has been given to the SCIMSP, but it does not have the capacity to systematically monitor the financial status or activities of all the SOEs of which it is the designated owner. Its role is generally limited to SOEs that have been identified as candidates for privatization. There are no general guidelines on the oversight or supervision of SOEs by line ministries, nor is any information they capture aggregated in any way. Some strategic SOEs report to the administration itself. Responsibilities of the SOEMD, the SCIMSP, line ministries, and the administration itself overlap in the case of Tajikistan SOEs. As Figure 9 illustrates, reporting relationships for SOEs to their owner are inconsistent.

9 SUE TALCO and Talco Management Ltd.

Figure 9. Current SOE Reporting and Monitoring Arrangements



28. **Uncoordinated functions, responsibilities, and accountability lines limit government ability to form a comprehensive view of the SOE sector, define a consistent strategy with specific operational objectives, make effective decisions transparently, and improve SOE performance, reporting, and financial oversight.** At present, large SOEs have several channels of accountability within the executive branch but none to the supreme audit institution and the legislature, though the law envisages financial oversight by the Accounting Chamber. Within the executive branch, the role of the state in governing SOEs is divided between the Ministry of Finance; the SCIMSP; line ministries responsible for infrastructure, energy, transport, communications, utilities and metal production; and the Cabinet of Ministers. The SOEMD within the Ministry of Finance has demonstrated an intention to consolidate this function so that the government can make informed decisions about management of large SOEs. The quarterly and annual SOEMD reports on SOE performance and management, although limited in their coverage of the sector and their analysis of performance indicators, is a move in the right direction, though the reports pertain only to the 24 largest enterprises. The rest are monitored by line ministries and there is no consolidated reporting on their performance to either the Cabinet or the Parliament. The law assigns to the SCIMSP the task of keeping a registry of state assets, including SOEs, and managing them. However, the SCIMSP perceives this function to be secondary, does not maintain the register, and is mainly active in privatizing state assets as ordered by the Cabinet. Line ministries obtain reports from the SOEs within their own sectors but they do not consolidate them as a basis for further analysis and decision making.

29. **There is a vast disconnect between what the law requires and what happens in practice.** Tajikistan adopted modern legislation that applies the principles of corporate governance to SOEs, covering, e.g., the role of the state as an owner in SOE governing and oversight bodies; full adherence to transparency and disclosure policies, protection of the rights of minority shareholders, etc. But despite impressive legal advances in defining the role of the state in the SOE sector, progress on the ground has been limited by the fact that large SOEs in Tajikistan are 100 percent state-owned and the size and scope of the SOE sector is considerably bigger than in comparator countries.

3. SOEs in Tajikistan: The Main Risks

A. Quasi-fiscal Activities

30. **Elaborate quasi-fiscal activities of SOEs and other public institutions create substantial fiscal risks and undermine the hard-earned benefits of fiscal consolidation.** The primary quasi-fiscal vehicle is the extensive use of below market and even below variable cost prices of energy, utilities, and other services and the politically induced donations, which are extracted through "voluntary" participation of SOEs in non-commercial activities designated through a complex political process (Box 2). This creates a stream of subsidies that deprive the public sector of revenues, generate SOE losses, and give rise to huge contingent fiscal liabilities. Equally important, this undermines the rational economic behavior of SOEs, private companies and households alike resulting in inefficient use of energy and all public resources. It also erodes accountability of SOE managers and blurs the principles of responsible behavior of the state as an owner of SOEs and an efficient provider of critical public goods and services. The total costs of these QFAs are estimated by the SOEMD at about 3 percent of GDP in 2012, or more than 25 percent of social and poverty-related expenditures in the same year.[10]

Box 2. Main Quasi-fiscal Activities in Tajikistan

Based on the IMF classification of quasi-fiscal activities (QFAs) of SOEs, the following categories seem to be the most relevant source of fiscal risks in Tajikistan:

- **Mispricing:** The pricing of goods and services at below-market or below-cost recovery levels. This produces financial losses for SOEs and inefficiency in the use of scarce resources. This note attempts to assess the level and impact of price controls on resource misallocation and their potential to generate future fiscal risks.
- **Provision of noncommercial services:** SOE delivery of social services free of charge or below cost recovery, without any mention in the government budget.
- **Soft budget constraints:** The tolerance of SOE and other arrears leading to distortions in the allocation of resources. Arrears are an implicit subsidy, lost revenue for the enterprise, lost tax revenue to the budget, and creation or write-off of debts. They are often a consequence of poor financial discipline in budget entities, government departments, and SOEs.
- **Barter and offset arrangements:** Arrangements that reduce both revenue and spending, making it difficult to calculate the precise magnitude of QFAs or manage the related fiscal risks.
- **Operating inefficiency:** Technical losses and unmetered/unbilled consumption (including from theft) arising from poor operating performance, lack of monitoring and control, and revenue under-performance due to low collection rates.
- **Subsidized lending and rescue operations and bailouts:** Below-market and preferential lending rates, poorly secured and sub-par loans, and mispriced loan guarantees. Rescue operations (such as debt write-offs) of both financial and nonfinancial SOEs should be based on proper workout proposals and implemented through the budget.
- **Subsidies related to the exchange rate system:** Unjustified subsidies arising from biased application of multiple exchange rates and subsidized exchange risk insurance.

Source: Adapted from IMF 2001.

10 Expenditures on health, education, and social protection.

31. **Whether directing an enterprise to undertake activities that fall outside its primary line of business for a public purpose is formally or informally, in neither case is reflected in the budget.** The press reported that businesses in Dushanbe, both SOEs and purely private enterprises, were encouraged to contribute to repairs of city roads after an unusually harsh winter caused abnormal road damage. Voluntary or not, these contributions have the same effect as an increase in revenue and a corresponding increase in public spending for a public purpose that is completely invisible in the budget. Because QFAs do not show up in the budget as an allocation of resources to a particular function or program, the budget understates the true impact of government policy on the economy and distorts the amount of resources being committed to a particular government purpose or constituency. The 2012 SFR reflects activities undertaken by the largest SOEs as an equivalent to 0.2 percent of GDP in 2012 (see Table 2), but the total scope of QFAs is probably even larger, since practically all SOEs are involved in one way or another.

Table 2. Directed Activities of SOEs, 2012

TJS thousands

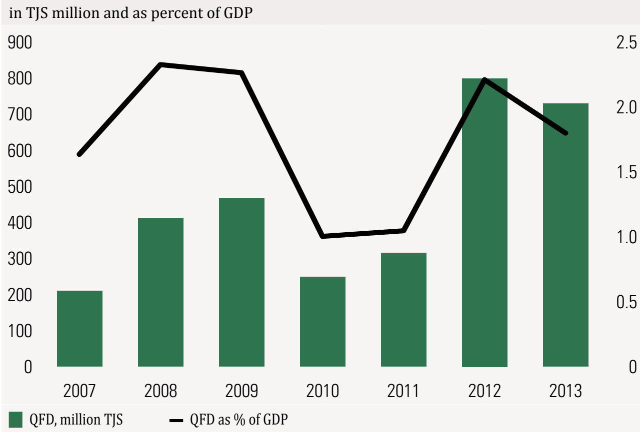
SOE Name	Non-Commercial Services: Public Purpose Charitable Activities [a]	Non-Commercial Services: Construction Activities Unrelated to Primary Business [b]
OJSC Dushanbe IA	487.6	643.0
OJSC Khujand IA	3,294.2	6,236.6
OJSC Tajik Air	1,393.4	1,393.4
SUE TajikAirNavigation	50.2	1,910.3
SUE Tajikistan Railways	295.2	71,370.7
SSB Amonatbonk	236.4	236.4
SUE Tajik Aluminum Company	219.0	805.8
OJSC Tojikcement	223.8	223.8
Other	495.4	585.6
Total	**6,695.2**	**83,405.6**

Source: 2012 Statement of Fiscal Risks, Ministry of Finance.
a Charitable payments include donations to orphanages and elder-care institutions, one-time payments to veterans of war, and aid to poor families.
b Construction of public housing for flood victims, construction and repair of buildings for the Defense Ministry, border guards, fire safety, prosecutor's office, libraries, road rehabilitation, landscaping of cities, and construction for cultural events.

32. **Even if only short-term recovery costs are taken into account, the quasi-fiscal deficit (QFD) in the power sector of about 2 percent of GDP is large enough to create serious fiscal risks.** Although the government does not provide any direct subsidies or cash transfers to support BT operations, the power sector has a large QFD.[11] The amount of subsidies varies from year to year depending on the difference between short-term cost recovery levels and actual tariffs and the percentage of non-payments. Tariff increases and high economic growth reduced the power sector QFD from about 2.5 percent of GDP in 2008/2009 to 1 percent in 2010/2011 (Figure 10). However, further progress in tariff adjustment has been stalled since then and other imbalances (see below) have begun to accumulate dramatically. BT has been subsidizing the Tajikistan economy for years through depressed electricity prices, uncollected payments, and commercial losses. The subsidies have caused BT to build up large accounts payable and seriously undermined the company's ability to maintain its assets, let alone invest in new assets to address winter energy shortages and meet growing power demand. In 2013 BT's implicit electricity

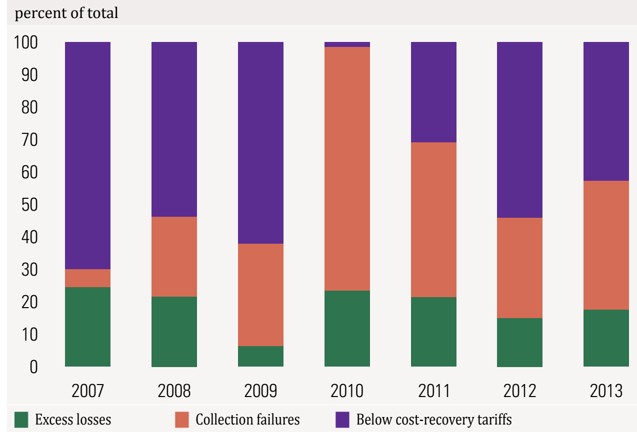
11 The quasi-fiscal deficit in power sector is defined as imbalances between revenues and expenditures of the sector due to below cost-recovery tariffs, high transmission and distribution losses and poor collections of billed energy.

Figure 10. Quasi-Fiscal Deficit In Power Sector



Source: World Bank Staff calculations on the data from Barki Tajik, Ministry of Finance, TajStat.

Figure 11. Sources of QFD In Power Sector



Source: World Bank Staff calculations on the data from Barki Tajik, Ministry of Finance, TajStat.

subsidies were comparable to cash revenues from electricity sales to domestic consumers: the subsidies reached almost TJS 729 million, and BT cash revenues were TJS 796 million. The loss-making tariffs accounted for about 43 percent and non-payments for another 40 percent of total subsidies; the remaining 17 percent stemmed from excess losses (Figure 11). The implicit BT subsidies are one of the main reasons BT has continued to accumulate arrears in tax payments, payments for electricity to independent power producers (IPP) Sangtuda HPP 1 and 2, and repayment of loan and credits to the Ministry of Finance. The subsidies forecast for 2014 are computed on optimistic assumptions of a 10 percent average tariff increase for the year and a significant improvement in cash collections—from 62 percent in 2013 to 75 percent in 2014. Still, they are close in absolute terms to the amount of subsidies in 2013 because of the expected increase in BT short-term recovery costs.

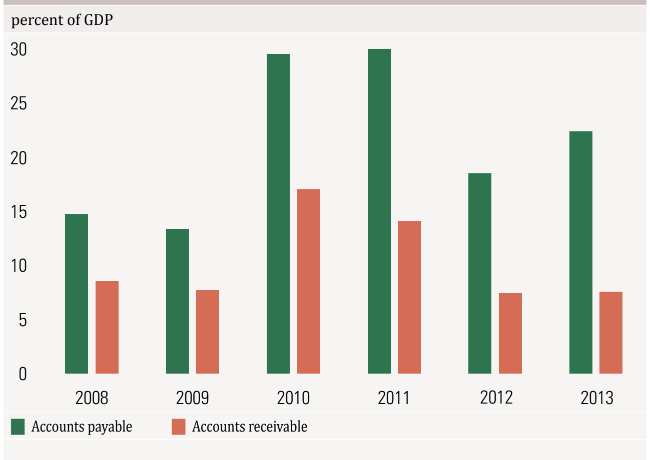
33. **While it is difficult to make a precise estimate, the true economic costs of subsidies related to provision of goods, services, and inputs are arguably much larger than the SFR reflects.** The power sector illustrates this graphically: Tajikistan has one of the lowest electricity tariffs in the world—less than 2 cents/KWh. At that price the national power company generates annual operating losses of close to US$41 million and continues to accumulate debt, which already exceeded US$900 million at the end of 2013. What is more important, at such a low price households, which presently consume about 33 percent of all power generated in Tajikistan, have no incentive to conserve energy, invest in energy-saving options, or seek cheaper energy sources.[12] Similarly, TALCO, the second largest consumer of energy, which presently uses 33 percent of all generated power, has little incentive to invest in energy-efficient technology, conserve energy, or relieve seasonal power demand peaks by conducting annual service of electrolytic pots during the winter. The estimated true economic subsidy cost in 2013 based on long run average incremental costs (LRAIC) for Tajikistan could be as large 15 percent of GDP.[13]

34. **The resulting liquidity problems, operating losses, and growing indebtedness of SOEs are absorbed by accumulating arrears, lax financial discipline, subsidized loans, and debt write-offs.** Though on a slightly declining trend through 2013, soft budget constraints persist in the form of tax arrears and poor payment discipline between SOEs (both payables and receivables). In 2013 combined SOE tax and payment arrears exceeded 30 percent

12 Households in Tajikistan pay 30 percent of the ECA regional average for electricity and consume 1.5 times more per month than the regional average. Laderchi, C.R., A. Olivier, and C.Trimble, World Bank (2013).

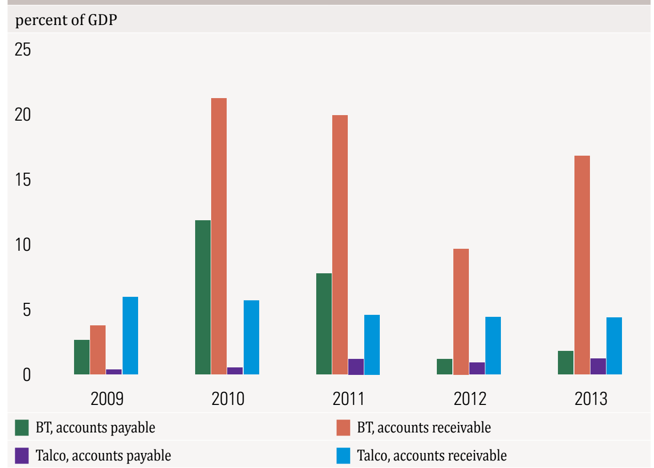
13 The LRAIC estimates are taken from Fields et al. (2013).

Figure 12. Inter-Enterprise Arrears



Source: World Bank Staff calculations on data from Ministry of Finance and TajStat.

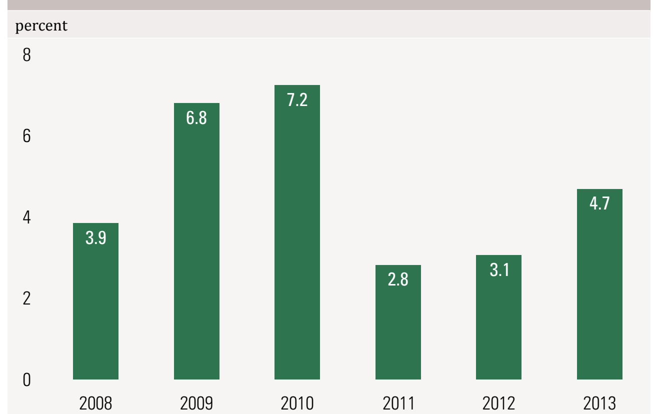
Figure 13. Indebtedness of BT and TALCO



Source: World Bank Staff calculations on data from Ministry of Finance and TajStat.

of GDP (Figure 12 and 13). BT's tax arrears soared in 2011–13 to the equivalent of almost 5 percent of total tax revenues (Figure 14). An increase in tax arrears not only severely constrains operation of the budget; it also undermines private sector confidence about longer-term production, investment, and employment decisions, with detrimental impact on economic growth and job creation.

Figure 14. Tax Arrears of BT as Percent of Budget Revenues



Source: World Bank Staff calculations on MoF data.

35. **The tolerance for SOE arrears cannot be sustained without limit.** The government must take action to relieve SOE balance sheets using a range of mechanisms, from capital injection to forgiveness of government arrears—all of which constitute a subsidy of some form. Often, the cost of the subsidy is not reflected in the budget, distorting the integrity of the budget as a document that presents a comprehensive picture of government activity, policy, and priorities. A particularly complex transaction in Tajikistan resulted from a government decision at the end of 2011 to convert the arrears owed by TALCO to BT to equity ownership shares in TALCO for BT, forgiveness of the tax arrears of HPP Sangtuda-1[14] in exchange for forgiveness of arrears of BT to Sangtuda-1, and forgiveness of BT tax arrears. The net cost of all this to the budget was TJS 143.7 million (0.5 percent of GDP), but the economic impact is not reflected in the Tajikistan budget. By the end of 2013, BT arrears to Sangtuda-1 HPP had plunged to just above TJS 437 million (US$89.5 million) and Sangtuda-1 had accumulated tax arrears of TJS 52 million (US$10.6 million). At the same time, TALCO arrears to BT for energy used reached TJS 67 million by end-2013. In early 2014 the GoT has recourse to the scheme similar to that used in 2011 by providing financial support to TALCO through converting its debt to BT to BT equity ownership shares in TALCO

14 Sangtuda-1 HPP is the JSC Russian-Tajik Company, of which Russia owns 75 percent minus one share. The HPP produces about 15 percent of all Tajikistan's electricity. BT is the monopoly buyer of the electricity generated.

and allowing for a complex off-sets between BT, Sangtuda-1 and the budget. After some decline at the beginning of 2014, BT arrears to Sangtuda-1 started to grow again and overall financial position of BT continue to deteriorate. The recent GoT resolution on the financial support to BT stipulates another off-set scheme (between enterprises of the Agency for melioration and irrigation, BT and the budget) in equivalent of about TJS 243 million and deferral of the BT tax payments in amount of TJS 170 million for three years.[15] The resolution, however, does not provide for any concrete measures and time line to improve financial viability of BT and prevent the use of non-transparent and costly schemes to temporary relieve the pressure in the future.

36. **To ameliorate the problem of growing arrears, the government has intervened with directed lending programs channeled through commercial banks.** These heavily subsidized loans often misallocate credits and distort the credit markets. Indirectly, they also undermine confidence in the credit culture, and increase the fragility of the entire financial sector. Directed lending programs to SOEs could create similar problems that occurred in 2012 (that were not caused by SOEs but caused costs to the government of about 2 percent of GDP—comparable to the health sector budget for the same year). Open and hidden contingent liabilities created by combined subsidized lending, debt write-offs, and related state bank bail-outs are likely to keep heading up until full financial discipline is restored and maintained.

37. **In addition, barter arrangements have been proliferating, often with the consent of the government.** There is not enough information available to estimate the full scale of the arrangements, but there is evidence that these activities are substantial. Thus, with the consent of the government BT has a barter arrangement with TALCO, receiving electricity materials and equipment in exchange for electricity supply. The size of the operation in 2011–12 is estimated as TJS 493 million or over US$100 million. In 2013 TALCO paid for 77.4 percent of the electricity billed but only about 8 percent was paid in cash, and the rest—almost TJS 200 million, about 0.6 percent of GDP—through barter.

38. **Major fiscal risks arise from the direct costs to the budget of SOE operating losses, explicit debts, and explicit or implicit state guarantees (Ministry of Finance).** The present debts of close to US$2 billion incurred by the 24 largest SOEs will continue rising along with operating losses and emergency interventions to keep critical SOE operations afloat. In the long run this trend is unsustainable. What is needed is systemic intervention to both contain the losses and improve operational and management efficiency.

B. Liabilities

39. **Explicit liabilities from SOE activities have arisen from agreements with international financial institutions (IFIs) to lend funds to Tajikistan for projects to benefit a specific SOE.** The state, as primary borrower, is obligated to repay the funds if the beneficiary is unable to repay its share of the loan. According to the 2011 SFR, total liabilities of TJS 738 million (US$156.4 million) were outstanding as of December 31, 2011, for loans that benefited five SOEs. BT accounted for 95 percent of the total (US$148.5 million). By the end of 2012

15 Resolution of the Government of Tajikistan No. 302 from May 3, 2014.

total loan assistance had increased by 19 percent, to US$186 million, or which US$181.6 million was in turn loaned to BT. The 2012 SFR makes it clear that BT has failed to take all necessary measures to comply with the sub-loan agreement requirements. The SFRs are silent on whether any of the liabilities have yet been realize, but given their size—equivalent to 2.4 percent of GDP in 2011–12—the fiscal risk is obviously significant.

40. **In addition to these direct liabilities, the state also provides direct guarantees for loans made by SOEs.** In 2011 the state guaranteed US$13.9 million in loans the European Bank for Reconstruction and Development (EBRD) made to SOEs for aviation, water supply, telecommunications, and solid waste management activities. According to the 2012 SFR, the total potential liabilities have risen by 7.2 percent, to US$14.9 million. So far there is no indication that recipient SOEs are not servicing the loans, but should that occur, the government would have to do so through its own budget (to an equivalent to 0.2 percent of 2012 GDP).

41. **Contingent liabilities from legal disputes, to the extent they are known, are as large as total budget spending on social security and welfare.** The SFRs give no data on legal disputes, though this contingent liability is well beyond the minimum threshold for disclosure.[16] In October 2013, TALCO as found to have breached 2003 agreements with RUSAL and ordered to pay damages of US$275 million (equivalent to 3.6 percent of GDP and about the same as the total 2012 budget for social security and welfare).[17] This dispute should have been disclosed as a contingent liability in the financial statements TALCO submitted to the SOEMD and identified in the SFR. It was not.

Table 3. Loan Guarantees Provided by Government on Behalf of SOEs

US$ thousands

SOE	Value
SUE Air Navigation	853.0
OJSC Khujand International Airport	292.0
OJSC Dushanbe International Airport	333.0
OJSC Tojiktelecom	4,249.0
SUE Khujand Water and Sewage	588.0
Waste collection in Dushanbe	3,264.0
SUE Housing and Communal Services	2,387.0
Improving the water supply in Khujand city	1,526.0
OJSC Kairokum Carpets	1,435.0
Total	**14,927.0**

Source: 2012 SFR.

16 The SFR discloses individual risks and their potential impact on the financial status of the Government of the Republic of Tajikistan for all amounts over TJS 100,000.

17 TALCO has been involved in costly litigation before. In 2008, legal bills for a multi-year dispute with a former director and supplier totaled over 3.6 percent of Tajikistan's 2007 GDP.

4. SOEs in Tajikistan: Possible Solutions

A. Phasing out QFAs

42. **Clearly, even the estimated lower level of implicit subsidies and the QFD in the power sector are not sustainable, especially as fiscal pressures heighten.** The adjustment that could close the demand-supply gap in winter months and in the power market hinges on a combination of policy, institutional, and behavioral changes[18]:

- Higher tariffs
- Fuel-switching incentives and programs for both urban and rural consumers
- Energy-saving incentives and programs for all consumers
- Reducing TALCO's winter energy demand based on optimal timing of annual maintenance programs for electrolytic pots
- Reducing technical (transmission) losses and theft.

43. **Open commitment to a swift policy change along with firm communication of expected benefits is essential for public buy-in.** It is critical that the process be started with an announced and clearly explained increase in energy prices to enable subsequent energy saving, fuel-switching, and technical improvements. Energy-saving programs, equipment, and implementation mechanisms should be prepared in time to make the essential adjustments in electricity demand. Detailed programs for reducing present technical and other losses in the power system should be prepared in time to make the adjustments in electricity supply. A portion of increased revenues should be made readily available to finance, e.g., social safety-net programs, quick interventions in the power sector, preparation of small energy-saving programs, and investments by individual households and small and medium enterprises. The remaining revenues should fund longer-run solutions for the power sector through 2020 and beyond as detailed by the World Bank (Fields et al., 2013).

44. **Tariff increases should be accompanied by well-designed safety-net programs.** The social and poverty consequences should be addressed through programs designed to reimburse lower-income and vulnerable groups. Despite the obvious political and social sensitivities associated with an increase in energy prices, the net welfare impact should not be that large because electricity expenditures are an exceptionally low share (about 3 percent) in household budgets and there should be a large expected improvement in welfare coming from full or virtually full elimination of winter blackouts. Associated improvements in productivity and incomes should also be taken into account.

18 Fields et al. 2013.

45. **Similar, though smaller, programs should be implemented in all SOEs that provide goods and services at below-market prices controlled by the state,** such as all municipal services, especially urban water, sanitation, and solid waste disposal services; public transportation; and telephone and other telecommunication services.

B. Optimizing the Size and the Scope of the SOE Sector

46. **Given their continued operating losses, growing indebtedness, and deteriorating competitiveness, the fiscal position of the state can no longer afford to sustain an inefficient SOE sector of this scope.** Some SOEs should be privatized sooner rather than later, and the rest need to be run efficiently and transparently. Rational decisions on the size and scope of the SOE sector would considerably reduce fiscal risks originating from the lack of clear ownership and from bad management. Based on their past performance and on evidence from comparator countries, the government needs to decide which SOEs should

- Continue operating as a monopoly provider of goods and services in a given sector, owned and managed by the state but with fully professional management;
- Be exposed to competition from private companies and subject to private co-ownership and mixed forms of SOE management; and
- Partially or fully privatized.

C. Improving SOE Management

47. **Effective corporate governance of SOEs can have a positive impact on the Tajik economy through improved financial performance, better service delivery, and increased investment.** The OECD *Guidelines on Corporate Governance of State-Owned Enterprises* are useful for analyzing SOE governance considerations and how they might affect management of fiscal risks. In Tajikistan, not one of the six OECD guiding principles is fully in effect (see Annex 1 for details). Despite the large size and even greater scope of state involvement in the economy through its ownership, management, and financing of SOEs, there is a surprising lack of

- Clearly articulated policy on the criteria for and objectives of state ownership;
- Implementation mechanisms for the ownership policy selected; and
- The role of the state in corporate governance of SOEs.

48. **The role of the state as owner has been considered mainly as a way of solving social problems while performing economic tasks in critically important sectors.** Yet the government does not have clear strategic

objectives for SOEs and rarely derives dividends from its ownership stake in a range of commercial activities in, e.g., trade, transport, energy, and mining. Often criteria for gauging SOE performance are either nonexistent or distorted; they represent a nontransparent combination of economic, financial, social, and political considerations to justify the state's presence in certain sectors and companies no matter what their importance, performance, or clear claim on state involvement.

49. **Until recently the government did not view state assets as a source of budget revenues and had no dividend policy.** In November 2013, Government Resolution No. 499 bound all SOEs owned 100 percent by the state to allocate 10 percent of their net operating profit to the state budget. That first step toward a comprehensive dividend policy for SOEs created a perception of state assets as the source of revenues. The policy should be applied to the SOEs, whatever the percentage of state ownership, and to subsidiaries like Talco Management to the extent they are not already covered.

50. **The dividend policy should be accompanied by better SOE accounting policy.** As discussed earlier, inconsistent application of accounting policies can dramatically impact SOE financial reporting, and the difference between a profit and a loss can be driven by either the application of or the failure to apply international accounting standards. Emphasizing the importance of better accounting at the largest SOEs should have high priority so that the new dividend policy is not undermined.

51. **Addressing just two issues related to governance—consistent and transparent exercise of state ownership and compliance with financial reporting requirements—would result in more effective SOE oversight.** Current best practice in corporate governance is for the board to establish an audit committee to oversee the external audit function, assure the independence of the auditor, and monitor management's response to audit recommendations. Tajik law does not require audit committees and, in fact, no SOE has one. Moreover, while some SOEs have been independently audited, only one earned an unqualified opinion.

5. Conclusions

52. **State-owned enterprises account for a large part of the economy in Tajikistan and for a substantial part of fiscal, governance and ultimately growth risks.** The analysis of SOEs in Tajikistan in this note leads to the following main conclusions:

- Despite privatizations and attempts at restructuring, Tajikistan still has a large, inefficient, and heavily indebted public sector.
- The lack of comprehensive information about the sector undermines budget credibility and budget integrity.
- Multiple but uncoordinated functions, responsibilities, and accountability lines limit government ability to form a comprehensive view of the SOE sector, define a consistent strategy with practical operational objectives, make decision making transparent and effective, and improve SOE performance, reporting, and financial oversight.
- Elaborate QFAs of SOEs and other public institutions create substantial fiscal risks and undermine the hard-earned benefits of fiscal consolidation.
- Liabilities, explicit and implicit, created by SOE operations are large and must be accounted for and properly delineated in the SFRs.
- Solutions proposed to address the major issues are (a) phasing out QFAs; (b) optimizing the size and scope of the SOE sector; and (c) improving SOE management.
- SOE reform should be an integral part of the general reform agenda.

Annexes

Annex 1. Benchmarking Tajikistan SOEs against OECD Guidelines

OECD Guidelines	Tajikistan Framework and Practices
1. Ensuring an Effective Legal and Regulatory Framework for SOEs	
To avoid market distortions, the legal and regulatory framework for SOEs should ensure a level playing field in markets where SOEs and private companies compete. The framework should build on, and be fully compatible with, the OECD Principles of Corporate Governance.	
A. There should be clear separation between the state's ownership function and other state functions that may influence conditions for SOEs, particularly with regard to market regulation.	*There is no clear separation of state ownership and other functions. The functions and objectives of the state are defined vaguely as an agent responsible for "solving socioeconomic tasks" and "fulfilling tasks in the area of defense, production of goods and services and for the realization of state functions."*
B. Government should strive to simplify and streamline the operational practices and the legal form under which SOEs operate. The legal form should allow creditors to press their claims and initiate insolvency procedures.	*The operational practices and the legal forms are simple. However, the government may change the legal form of SOEs and thus affect insolvency procedures: a switch from "unitary" to "kazennnye" form gives SOEs special status and direct financing from the state budget, and protects them from any pending insolvency procedures. The government also provides both direct and indirect support to SOEs thereby distorting the playing field.*
C. Any public service obligations and responsibilities an SOE is required to undertake beyond the accepted norms should be clearly mandated by law. They should also be disclosed to the general public and related costs should be transparent.	*Public service obligations and responsibilities delivery are not clearly mandated by present law and regulations.* *The general public has no access to information on public services or goods provided by SOEs and is not aware of the actual costs and how they are financed.*
D. SOEs should not be exempt from the general application of the law. Stakeholders, including competitors, should have access to efficient redress and even-handed decisions when they consider that their rights have been violated.	*SOEs are not exempt from the application of general law, including competition law. In practice, however, the playing field is often distorted by government grants of tax exemptions, write-off of debts, and other preferences to SOEs.*
E. The legal framework should be flexible enough that the capital structure of SOEs can be adjusted when necessary for achieving company objectives.	*The legal framework does allow sufficient flexibility for adjustments in SOE capital structure to achieve company objectives, except for SOEs with unitary status.*
F. SOEs should face competitive conditions in terms of access to finance. Their relations with state-owned banks, financial institutions and other companies should be based on purely commercial grounds.	*SOEs in Tajikistan may have better access to finance than other companies, especially in dealing with state-owned banks and other SOEs.*
2. The State Acting as an Owner	
The state should act as an informed and active owner and set a clear and consistent ownership policy to ensure that SOE governance is transparent and accountable and carried out with the necessary professionalism and effectiveness.	
A. The government should issue an ownership policy that defines the objectives of state ownership, the state's role in corporate governance of SOEs, and how it will implement its ownership policy.	*At present, there is no well-articulated state ownership policy.*
B. The government should not be involved in day-to-day management of SOEs and should allow them full operational autonomy to achieve their defined objectives.	*Current law gives SOEs full operational autonomy.*

OECD Guidelines	Tajikistan Framework and Practices
C. The state should let SOE boards exercise their responsibilities and should respect their independence.	*Boards of large SOEs act as independent governing bodies.*
D. Which agency will exercise ownership rights should be clearly identified within the state administration. This may be facilitated by setting up a coordinating entity or, more appropriately, by centralizing the ownership function.	*No centralized body coordinates state ownership rights. Different governance responsibilities of the state as SOE owner are scattered in different ministries and state bodies based on sector and financial considerations.*
E. The coordinating ownership entity should be held accountable to representative bodies (Parliament) and have relationships with public bodies, including the state supreme audit institutions, should be clearly defined.	*SOEs have multiple reporting requirements, but there is lack of clear accountability for their performance to the Supreme Audit Institution and the Parliament.*
F. The state as active owner should exercise its ownership rights according to the legal structure of each company. Its prime responsibilities include:	*Tajik law stipulates almost all that is required of the government in terms of exercising SOE ownership rights.. However, the laws are not fully implemented mainly for two reasons: (a) large joint-stock SOEs are 100% state-owned with no non-state shareholders, and (b) the government does not have a clear objective for SOE ownership.*
1. Being represented at the general shareholder meetings and voting the state shares.	*Yes, but meaningless when the government is the sole owner.*
2. Establishing well-structured and transparent board nomination processes in fully or majority-owned SOEs, and actively participating in nomination to all boards.	*Nomination process not clear and not public.*
3. Setting up reporting systems that allow regular monitoring and assessment of SOE performance.	*Partially defined, but not clear and not transparent.*
4. When permitted by the legal system and the state's degree of ownership, maintaining continuous dialogue with external auditors and specific state control organs.	*Dialogue with internal controls is not well-defined and often not transparent. External auditors are rare except for a few large SOEs.*
5. Ensure that remuneration schemes for SOE board members foster the long-term interest of the company and attract and motivate qualified professionals.	*The remuneration system is not clear but apparently does not offer incentives to attract qualified professionals.*
3. Equitable Treatment of Shareholders	
The state and SOEs should recognize the rights of all shareholders and, in accordance with the OECD Principles of Corporate Governance, ensure their equitable treatment and equal access to corporate information.	*Tajik joint-stock company law ensures equal rights and equal treatment of all shareholders. In practice, however, the law is not fully adhered to because (a) large joint-stock companies are 100% state-owned, and (b) stock market infrastructure is underdeveloped.*
A. The coordinating or ownership entity and SOEs should ensure that all shareholders are treated equitably.	*Not relevant when the state is the only owner.*
B. SOEs should observe a high degree of transparency toward all shareholders.	*Not relevant when the state is the single owner.*
C. SOEs should have an active policy of communication and consultation with all shareholders.	*Not relevant when the state is the single owner.*
D. Participation of minority shareholders in shareholder meetings should be facilitated to allow them to take part in fundamental corporate decisions such as electing board members.	*Not relevant when the state is the single owner.*
4. Relations with Stakeholders	
The state ownership policy should fully recognize the responsibilities of SOEs to stakeholders and request that they report on their relations with stakeholders.	
A. Governments, the coordinating or ownership entity, and SOEs themselves should recognize and respect stakeholders' rights established by law or through mutual agreement (as in the OECD Principles of Corporate Governance).	*Not in practice.*
B. Listed or large SOEs, as well as SOEs pursuing important public policy objectives, should report on stakeholder relations.	*Not in practice.*

OECD Guidelines	Tajikistan Framework and Practices
C. SOE boards should be required to draft, implement, and communicate compliance programs for internal codes of ethics. The codes should be based on country norms, conform to international commitments, and apply to the company and its subsidiaries.	*No internal codes of ethics.*
5. Transparency and Disclosure	
State-owned enterprises should observe high standards of transparency in accordance with the OECD Principles of Corporate Governance.	
A. The coordinating or ownership entity should report consistently on SOEs -owned enterprises and publish annually an aggregated report on all SOEs.	*No single state entity is in charge of the governance and financial control of all SOEs.*
B. SOEs should put in place efficient internal audit procedures and establish an internal audit function that is monitored by and reports directly to the board and to the audit committee or equivalent company entity.	*Annual consolidated reports on SOE performance are not prepared.*
C. SOEs, especially large ones, should be subject to an annual independent external audit based on international standards. The existence of specific state control procedures does not substitute for an independent external audit.	*Few large SOEs have an independent external audit based on international standards.*
D. SOEs should be subject to the same high-quality accounting and auditing standards as listed companies. Large or listed SOEs should disclose both financial and nonfinancial information according to internationally recognized standards.	*This is required by law in Tajikistan. However, the quality of accounting standards and the level of disclosure may vary for complex noneconomic considerations.*
E. SOEs should disclose material information on all matters described in the OECD Principles of Corporate Governance and also identify areas of significant concern for the state as an owner and the general public. Examples of such information are:	*Material information is disclosed in some but not all cases. Areas of significant concern are covered in some but not all cases.*
1. A clear statement to the public of the company objectives and their fulfillment.	*SOE objectives are not clearly stated.*
2. Transparent ownership and voting structure of the company.	*State ownership of SOEs is transparent.*
3. Disclosure of material risk factors and measures taken to manage them.	*There is no systematic reporting on risks.*
4. Disclosure of any financial assistance, including guarantees, received from the state and commitments made on behalf of the SOE.	*State guarantees and financial assistance are accounted for and reported to public.*
5. Disclosure of any material transactions with related entities.	*Disclosed in some but not all cases.*
6. Responsibilities of the Boards of SOEs	
SOE boards should have the necessary authority, competence, and objectivity to carry out their function of strategic guidance and monitoring of management. They should act with integrity and be held accountable for their action.	*The boards of large SOEs constituted as joint stock companies are appointed by the Government of Tajikistan as the single owner. The government also defines member functions and responsibilities. However, there a good monitoring system is missing and there are no criteria to measure how well boards perform.*
A. SOE boards should be assigned a clear mandate and ultimate responsibility for company performance. The board should be fully accountable to the owners, act in the best interest of the company and, treat all shareholders equitably.	*At present, SOE boards may be given political directives and a sense of national importance communicated to a given SOE, but they are not given a clear mandate and ultimate responsibility for company performance.*
B. SOE boards should carry out their functions of monitoring management and giving strategic guidance, subject to the objectives set by the government and the ownership entity. They should have the power to appoint and remove the CEO.	*Nominally, SOE boards do have a legal responsibility to monitor the management of SOEs and provide strategic guidance. But without a clear mandate and responsibility assigned, this has little impact on SOE performance.*
C. SOE boards should be composed so that they can exercise objective and independent judgment. Good practice calls for the chair to be separate from the CEO.	*The boards are often nominated to represent sector, financial, and political aspects of SOE operations, but rarely have sufficient independence.*

OECD Guidelines	**Tajikistan Framework and Practices**
D. If employee representation on the board is mandated, mechanisms should be developed to guarantee that this representation is exercised effectively and helps to enhance board skills, information, and independence.	*Employee representation on the board is not mandated by the law on joint-stock companies.*
E. When necessary, SOE boards should set up specialized committees to support the full board in performing its functions, particularly with respect to audit, risk management and remuneration.	*The law on joint-stock companies mandates that all companies establish an audit committee.*
F. SOE boards should evaluate their performance annually.	*Joint-stock company legislation requires annual evaluation and reports on company performance, but not board performance.*

Annex 2. What Is Needed in the Tajikistan Power Sector

In Soviet times the power sector was considered a major comparative advantage of Tajikistan. Ample hydropower was tapped by massive investments that created 20,000 GWh generating capacity to sustain the aluminum smelter TALCO and meet consumer demand for electricity. The pronounced seasonality of demand, with huge differences between peak winter and low summer demand, and large daily variations in electricity consumption, substantial maintenance and operating costs, and below-cost tariffs were addressed within the Central Asian Power System (CAPS) and the overall Soviet power systems.

With the collapse of the Soviet Union, the operation of CAPS gradually deteriorated, along with the technical and financial support. Increasing vulnerabilities and risks exposed the design and operational weaknesses of the system—and the inability of the Tajik power system to deal with new threats. The cumulative effect was a gradual deterioration on the power system and widening inability to meet growing production and consumer demand.

A recent World Bank study (Fields et al. 2013) established that 70 percent of the population in Tajikistan suffers from extensive electricity shortages during the winter, which imposes direct costs in terms of (a) foregone revenue from economic activity; (b) additional costs due to damage to equipment and interruption of business processes; and (c) costs from damage to household equipment. Beyond the economic burdens of an electricity system in crisis, there are difficult health and environmental consequences. Unreliable electricity supply also limits business opportunities. For example, the World Bank's Business Economic Environment Survey of 2008 reported that 80 percent of firms cited power supply reliability as a major obstacle to doing business in Tajikistan. The shortage, estimated at 2,700 GWh or ¼ of winter demand, creates economic losses of US$200 million or 3 percent of GDP (2012).

Also, the power sector owes more than US$900 million and generates almost US$41 million of operating losses annually—almost half of the public debt of the 24 largest SOEs and more than half of their losses. The power sector is also a source of multiple open and hidden contingent liabilities that significantly increase fiscal risks, threaten the Tajik economy (especially its export capacity), and the well-being of its people.

Known weaknesses of the Tajik power sector (such as lack of balance after the collapse of CAPS, too heavy reliance on hydro power, and unsustainable prices) have been exacerbated in recent decades by missed opportunities, such as investment in energy saving, diversification of energy sources, and regional integration, and new threats, such as energy disputes with Uzbekistan, critical lack of funding for maintenance and new investment, and a far from encouraging macroeconomic environment.

The World Bank (2013) has suggested a viable program to eliminate power supply deficits in winter months and meet consumer demand in the medium run. The first step is to raise tariffs to cost-recovery levels. This will eliminate part of the deficit through lessening demand and use of alternative energy sources and enable energy-saving programs. Equally important, higher tariffs would change behavior and help contain most of the contingent liabilities burdening the power sector, and ultimately the budget.

These measures need to be complemented by restructuring and governance reform in the sector to ensure that the BT contributes to growth of Tajikistan's economy and it is, among other factors, properly governed, does not create unmanageable fiscal risks and contingencies, delivers services to consumers cost-effectively, and does not distort the markets.

Annex 3. Aluminum Smelter TALCO Confronts the Global Market Challenge

When the TALCO smelter was constructed in the 1970s it was the largest aluminum plant in Central Asia and anchored Tajikistan industrial development, employing more than 10,000 people and contributing up to 7 percent of GDP and 40 percent of exports. The Nurek hydropower station constructed at the same time was intended supply the necessary power year-round. There were plans to gradually shift provision of up to 60 percent of non-energy inputs to local sources of supply and create a positive multiplier effect on the economy of Tajikistan and Central Asia. That never happened.

The huge electricity and labor inputs thus remained the only link to the local economy, with other inputs coming from world markets, with their volatile prices and input supply conditions. Transportation costs were aggravated by Tajikistan's remote landlocked location.

On average, TALCO pays one-third less for electricity and gas than global competitors, but this is not enough to compensate for the high cost of transportation and non-energy inputs, low labor productivity, and the production disruptions caused by power interruptions and other problems created by poor management. The situation became particularly tight after the global 2008 crisis began. With overproduction of aluminum caused by new smelter capacities in China and a huge decline in industrial demand, global aluminum prices fell by 50 percent.

Many aluminum plants around the world are being shut down or reconstructed with more energy-efficient processes to prepare for eventual revival of industrial production. TALCO has reduced production by 20 percent in recent years but has not done much to replace or upgrade its old energy-inefficient equipment and or adjust its production and maintenance cycle seasonally to minimize the cost of energy.

Since the 2007 reorganization TALCO has made a significant move forward by introducing the Board of Directors, transparent procedures, and division of responsibilities between eight new directorates. However, TALCO remained 100 per cent state-owned with an extremely important social responsibility. Although the government as sole owner is entitled to set and influence company policy, this should not undermine the role of the directors in pursuing TALCO's economic and commercial goals.

Without clear checks and balances in Tajik SOE governance, it is hard to reconcile the contradictions in government behavior as owner, regulator, and provider of social benefits. Instead of using its role as sole owner of TALCO to secure its efficiency—and maximize profits—the government used its ownership position to pursue social and political objectives (employment, housing, salaries), and introduce regulatory bias rather than leveling the playing field. As a result, improving TALCO's internal structure failed to deliver the expected improvements in performance because of the poor definition of the government's role as sole owner.

The combined result is unsustainable indebtedness (more than US$360 million at the end of 2013) and a sizable operating loss (US$31 million in 2013) despite reduced production. A thorough review of TALCO operations and all ownership and management options is needed to put the company on a viable export-driven production path.

Annex 4. Performance of SOEs Monitored by SOEMD, 2013

TJS thousands, unless otherwise is stated

	Full Name of SOE	Gross Income	Number of Employees (Persons)	Average Salary (TJS)	Expenditures	Net Profit (Loss)	Indebtedness	
							Receivables	Payables
Transport								
1.	OISC Tajik Air	410,345.0	620	5,200	402 112.0	6,174.7	57,704.0	342,837.0
2.	OISC Dushanbe IA	185,712.9	1,318	2,900	127,108.5	45,810.4	115,367.3	62,888.7
3.	OISC Kulob IA	21,649.0	220	1,500	11,565.0	7,563.0	8,897.0	1,856.0
4.	OISC Qurghonteppa	57,86.5	225	400	4,611.0	881.6	1,476.0	13,287.5
5.	OISC Khujand IA	59,695.5	819	1,700	41,016.1	14,009.6	31,118.9	12,398.2
6.	SUE TajikAir Navigation	38,389.6	400	3,800	23,338.3	11,288.6	29,374.4	10,140.4
7.	SUE Tajikistan Railway	657,909.6	5,080	1,000	666,500.4	-16,001.9	1,430,685.3	1,518,565.1
Energy								
8.	OISC Barki Tojik	911,736.1	13,225	1,300	1,108 100.4	-207,044.6	676,125.3	4,389,858.5
9.	OISC Tajiktransgas	1,356.1	123	600	8,131.8	-6,790.9	213,852.9	265,555.3
10.	SUE Oil, Gas and Coal	60,943.7	1,599	900	58,978.3	1,670.6	35,570.0	40,121.4
Industry								
11.	SUE Tajik Aluminum Co.	402,872.9	8,985	1,200	552,089.0	-153,622.4	287721.1	1738975.0
12.	SUE Aluminsokhhtmon	36,767.5	854	900	38,215.2	-1,914.6	16,971.6	13,029.5
13.	SUE Vostokredmet	6,973.0	922	400	7,276.0	-303.0	2,870.2	12,475.0
14.	OISC Tojikcement	9,040.4	853	500	16,288.5	-7,248.1	15,908.2	90,239.8
15.	OISC Isfara Canning Factory	1,753.8	82	200	1,947.7	-193.9	396.1	2,548.2
Municipal Services/Utilities								
16.	SUE Dushanbe Water & Sewage	26,685.2	946	700	26,520.0	-1.5	1,0514.3	145,362.6
17.	SUE Khujand Water Canal	8,727. 4	580	500	8,910.4	-332.9	4622.6	703,01.2
18.	SUE Housing Communal Services	69,749.8	6,295	600	67,846.8	1,529.7	2,8642.2	21,311.2
Banking								
19.	Amonatbonk	1,235,345.0	2,617	1,300	1,212,190.0	17,366.0	4,840.0	117,564.0
Telecommunications								
20.	SUE Tojiktelecom	85,742.7	2,406	800	67,664.8	13,558.4	77,777.0	166,780.0
21.	SUE Tajik Post	4,224.1	961	300	4,270.7	-46.6	367.6	3,800.7
22.	SUE Teleradiocom	30,833.9	1,137	1,100	30,138.6	521.5	4,350.3	13,307.0
Other Services								
23.	Tojiksarmoyaguzor	5,038.9	65	2,000	4,845.8	144.8	1,275.4	0.0
24.	SUE Tojiksughurta	50,179.2	1,038	1,100	47,140.1	2,279.3	2,852.3	5,303.1
Total		**4,327,457.8**	**51,370**	**1,287.5**	**4,536 805.4**	**-270,702.2**	**3,059,280.0**	**9,058,505.4**

Source: Ministry of Finance.

Annex 5. South Africa SOE Governance and Oversight System

The South African SOE governance and oversight system clearly defines government strategy for SOEs and provides a transparent and consistent division of responsibilities and reporting lines between SOEs, line and policy ministries, the executive branch of government (Cabinet), and the legislature (National Assembly or Parliament). It also defines the role of line ministries in setting policies and securing their implementation through participation in SOE management bodies and through effective M&E systems.

Bodies, Lines Of Control and Accounting, Financial Oversight, and Functions

Corporate governance consists of processes and systems to direct, control, and hold accountable SOEs. It is based on SOE-enabling legislation and the Companies Act, applied through the Public Finance Management Act (PFMA), and run in tandem with the Protocol on Corporate Governance, which encapsulates the principles in the King II Report on Corporate Governance.

Governance Oversight of SOEs

Parliament evaluates the performance of SOEs based on annual reports.

- The Standing Committee on Public Accounts (SCOPA) reviews annual financial statements and the audit reports of the Auditor-General.
- The Portfolio Committee oversees how SOEs deliver services based on nonfinancial information to ensure quality service delivery and enhance economic growth.

The Executive (Administration) acts as owner/shareholder and is concerned with return on investments and SOE financial viability; the Minister of Finance and the National Treasury are responsible for financial oversight.

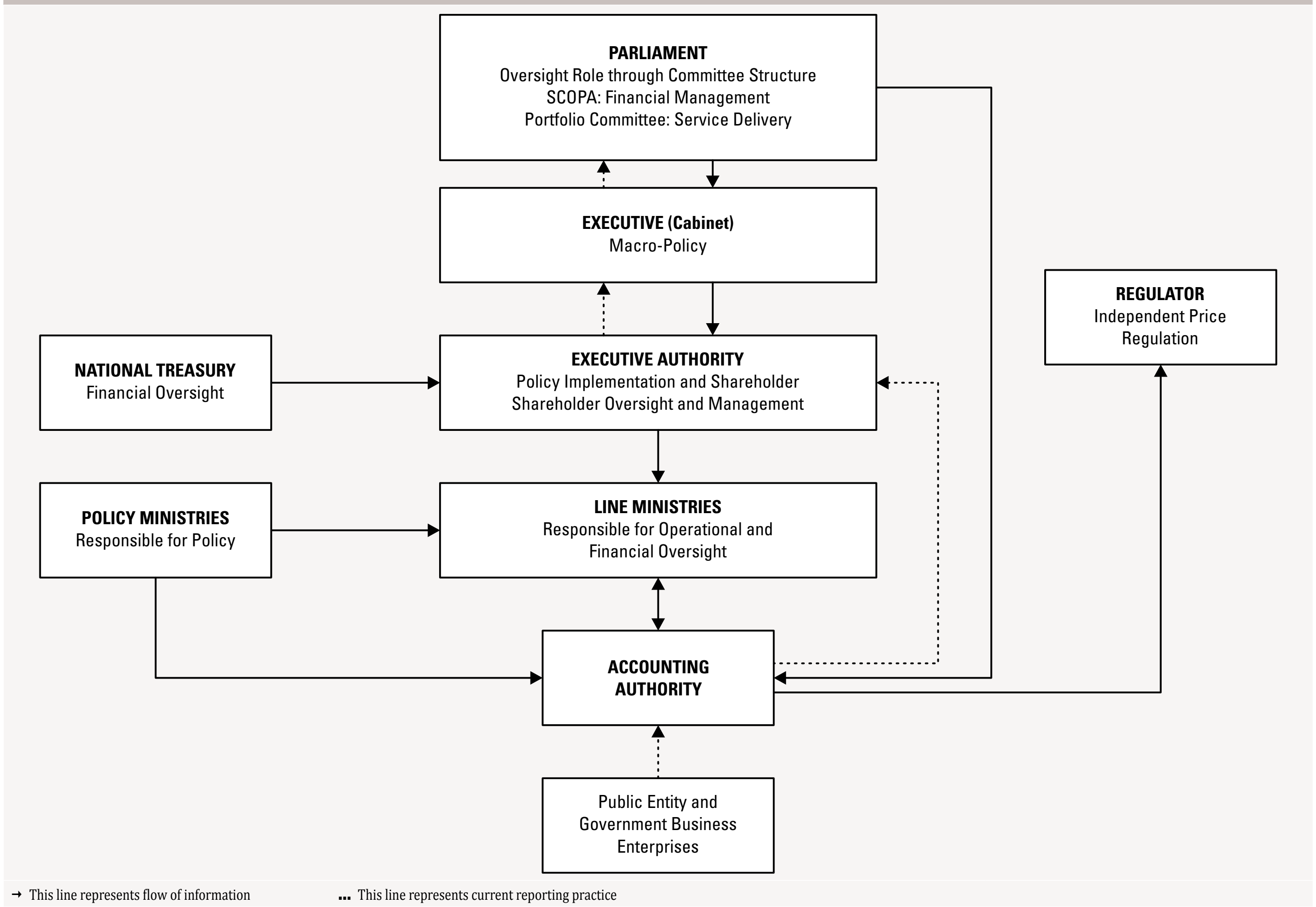
Government (the Cabinet and the ministry responsible) is also policymaker and regulator. Government oversight is based on the PFMA with particular reference to corporate plans, shareholder's compacts, and quarterly reports. The government appoints and dismisses SOE boards, ensures the appropriate mix of executive and nonexecutive directors, and ensures that directors have the skills necessary to guide the SOE.

Shareholder oversight may be spread across various departments; policy departments direct policy.

The Board of Directors is the SOE governing body. The board is responsible and fully accountable for the performance of an SOE based on the PFMA and the Protocol on Corporate Governance.

Figure 5.1 illustrates current South African oversight of SOEs.

Figure 5.1. How South Africa Oversees SOEs



PARLIAMENT

Introduction

The South African Constitution (Sections 55(2) and 42(3)) empowers the National Assembly to

- Ensure accountability of all executive organs; and
- Oversee and scrutinize actions of the national executive authority, including implementation of legislation.

Section 92(3)(b) also requires all members of the Cabinet to provide Parliament with full and regular reports concerning matters under their control.

The challenge is to improve the capacity of the policy/parliamentary committees to hold ministries and SOE's accountable for their performance, based on strategic plans, budget documents and annual reports. The PFMA gives managers more implementation responsibility and makes them more accountable for performance. The minister or the Cabinet resolves management problems, and Parliament oversees the SOEs and the Executive.

Annual Reports

Parliament evaluates the performance of a ministry based on annual reports. Until 2000, ministries filed only financial statements and audit reports. Annual reports and oversight of nonfinancial service delivery performance became mandatory after the PFMA and the Public Service Act were enacted. Each minister and the executive authority of an SOE must submit an annual report to the legislature within six months of after the end of each financial year.

Given the size and scope of public oversight (35 ministries and other government bodies; 250 SOEs and public entities), specialized parliamentary committees were established to facilitate oversight. The implied division of labor enables committee members to become experts in the appropriate field and spend more time doing actual oversight.

Roles of Parliamentary Committees

Public Accounts Committee

SCOPA reviews the reports of the Auditor General and has an important specialized role as protector of public monies. It focuses on

- Issues raised in the General Report of the Auditor-General on audit outcomes;
- Issues of financial probity as highlighted in the audit report or disclosed in the management report or notes to financial statements;
- Compliance with the PFMA, Treasury Regulations, the Audit Committee, and the management report of the accounting officer;
- Questioning and evaluating instances of overspending and of unauthorized spending;
- Questioning instances of irregular, fruitless, and wasteful spending;
- Inadequate functioning of risk management systems; and
- Corporate governance issues in ministries, public entities, and constitutional institutions.

Portfolio Committees

Because they are involved in the legislative, budget, and in-year monitoring processes, portfolio committees exercise oversight of how SOE's deliver services.

Portfolio committees review nonfinancial information contained in SOE annual reports to ensure that the entities have delivered services to which they have committed themselves in annual corporate plans. They also consider financial performance to secure a comprehensive understanding of SOE performance.

In considering SOE annual reports portfolio committees focus on

- The technical quality of the annual reports produced by ministries and SOEs;

- The economics, efficiency, and effectiveness of service delivery as measured by performance indicators presented in the annual reports;
- Management's explanation of any inadequate performance (e.g., why an SOE did not attain the targets set in corporate plans);
- Equity of service delivery; and
- Circumstances that may have led to financial underperformance, their impact on service delivery, and the adequacy of measures taken to rectify the situation.

Portfolio committees oversee ministries. SOEs directly report to an executive authority (the shareholder ministry), which then submits the annual reports to both the Public Accounts Committee and the relevant portfolio committee.

GOVERNMENT'S ROLE AS OWNER, POLICY MAKER, AND REGULATOR

Role of the Executive Authority

As owner and shareholder of SOEs, the government requires a suitable return on investments and ensures that an SOE is financially viable. As policymaker, it ensures that service delivery meets policy objectives. As regulator, it looks at industry practices of SOEs and their pricing structures and protects the interests of consumers.

The executive authority (i.e., the minister responsible) as the governing body of an SOE is responsible for effective and efficient service delivery and oversight on behalf of shareholders. The role of the executive authority in SOE governance and achievement of its service objectives is constructive and proactive. It reviews, monitors, and oversees the affairs, practices, activities, behavior, and conduct of an SOE to ensure that all is done in accordance with commercial, legislative, and other prescribed or agreed norms.

This ensures that the executive body effectively manages and oversees strategic and business planning, business operations reporting, and accounting, and that staff, assets, and goodwill are properly protected and preserved.

The executive authority must also ensure that the responsibility of the board of directors downward to consumers, and accountability of the board upward to the shareholder is done well, and that all necessary and appropriate corporate governance structures, procedures, practices, and controls and safeguards are in place and operating effectively.

For an SOE engaged in fully commercial viable and profitable activities, the executive authority must exercise the shareholder's concern for return on investment, which entails reviewing and monitoring strategic and business plans as well as analyzing actual operations, delivery, and performance to meet the expected and agreed levels of returns on investment or assets.

Monitoring financial performance from the shareholder's perspective monitors means ensuring that an SOE has

- Appropriate and effective planning and budgeting processes in place;

- Financial management and control structures and processes that enable accurate, timely, and reliable reporting of all financial transactions;
- Financial management systems and controls that ensure effective management of SOE financial affairs; and
- Financial affairs and performance reports that respond to corporate plans and shareholder compacts.

Corporate Plan and Shareholder's Compact

The executive authority and the ministry exercise oversight in accordance with Section 52 of the PFMA, which deals with annual budgets and corporate plans and stipulates that the board of an SOE must annually submit in the prescribed format

(a) A projection of revenue, expenditures, and borrowings for that financial year;

(b) A corporate plan covering the affairs of the business enterprise and any subsidiaries for the next three financial years.

Treasury Regulation 29.1 also requires submission of corporate plans (Schedule 2 and 3B) to the executive authority and the Treasury. The corporate plan must cover three years and include

- Strategic objectives and outcomes identified and agreed on by the executive authority in the shareholder's compact;
- Strategic and business initiatives as embodied in business function strategies;
- Performance measures and indicators for assessing the entity's performance in delivering the desired outcomes and objectives;
- A risk management plan;
- A fraud prevention plan;
- A materiality/significant framework, referred to in Treasury Regulation 28.3.1; and
- A financial plan addressing
    - Projections of revenue, expenditure and borrowings;
    - Asset and liability management;
    - Cash flow projections;
    - Capital expenditure programs; and
    - Dividend policies.

The executive authority of a SOE must also annually conclude a shareholders' compact in line with Treasury Regulation 29.2.2: "The shareholder's compact must document the mandated key procedures for quarterly reporting to the Executive Authority in order to facilitate effective performance monitoring, evaluation and corrective action."

The shareholder's compact is an agreement between the executive authority, as majority shareholder, and the SOE accounting authority with respect to performance expectations and parameters. It complements the strategic, corporate, and business plans by describing the relationship between the signatories and identifying the behavior required of both sides to support effective SOE management and performance.

The administration concerns of the owner/shareholder focuses on the appropriateness, adequacy, and effectiveness of the organizational structure, administrative structures, and administrative and management procedures and practices within the SOE to ensure that the infrastructure and practices are in place to manage and conduct a well-run and optimally performing business.

Government's Policy Role

Introduction

The Cabinet decides on the appropriate policy to meet the mission and mandate of the country. The responsible ministry issues a policy directive to an SOE charged with delivering on that policy.

The minister and the policy department ensure that the necessary structures, processes, practices, and business activities have been put in place to facilitate implementation of the policy and delivery of the required service or product. The policy department monitors, reviews, and oversees SOE service delivery. The accounting authority of the SOE submits quarterly reports to the executive authority (per Treasury Regulation 30.2) to facilitate performance monitoring, evaluation, and corrective action. Effective oversight is limited by the division of responsibilities: SOEs report to their line ministries while the policy ministry monitors service delivery. Furthermore, directives issued by the policy ministry can affect the financial viability of an SOE, which may not be properly reflected in the monitoring of financial performance done by the line ministry.

The shareholder's compact originates from the protocol of corporate governance in the public sector, which is time-*independent*. At the same time it is anchored in the strategic, corporate, and business plans of the public entity, which are time-*dependent*. The shareholder's compact describes the relationship between government and SOEs delivering public services through business entities. It reflects corporate governance and performance agreements between the majority/sole shareholders and boards, as well as subsequent discussions among stakeholders. The compact provides a framework for agreement with the executive authority on long-term objectives consistent with the vision of the organization. It also guides preparation of and convergence (by shareholder and accounting authority) on restructuring plans provided for in annual budgets. It should be noted that shareholder's compacts derive information from the corporate plan of a given public entity.

The Power of Executive Authorities to Dismiss and Appoint the Board

The executive authority has the power to constitute the board and to dismiss directors if an SOE is not performing satisfactorily.

The Role of the National Treasury

The National Treasury protects the National Revenue Fund and the sovereign credit rating of the country. In this role it exercises financial oversight by

- Setting guidelines on transparent reporting of SOE revenues, expenditures, assets, and liabilities;
- Monitoring SOE funding and borrowing programs;
- Controlling contingent liabilities; and
- Mandating the use of effective treasury management models.

These functions of the National Treasury are underpinned by PFMA provisions that:

- Enforce transparent and effective management of public revenues, expenditures, assets, and liabilities;
- Approve establishment of new public entities;
- Require corporate plans;
- Prescribe information, returns, documents, explanations, and rationales as required;
- Be informed of transactions undertaken;
- Receive annual financial statements within the deadlines set out in Section 55;
- Limit authority to borrow or issue a guarantee, indemnity, or security to the Minister of Finance acting on advice of the National Treasury's Government Guarantee Certification Committee; and
- Require a public entity authorized to borrow money to provide a borrowing program for the year and limit borrowing in foreign currency to a prescribed limit.

GOVERNMENT'S ROLE AS REGULATOR

Government's role as regulator is more focused on the industry in which an SOE operates, looking at issues like pricing and consumer interests. Unlike the more direct relationship between SOEs and the government as shareholder and policy-maker, the relationship between government as regulating agency and an SOE should be an independent, objective, and arms-length.

THE OVERSIGHT ROLE OF SOE DIRECTORS

Introduction

The Board of Directors is the governing body of an SOE. All SOEs should be supervised and controlled by an effective and efficient board with an appropriate mix of executive and non-executive directors representing the skills necessary to strategically guide the SOE. The board has absolute responsibility for SOE performance and is fully accountable to the SOE for such performance. The board should also give strategic direction to the SOE.

Mission of the Board

The mission of the board is to fulfil the mandate of an SOE in accordance with the strategic objectives of the government while achieving its commercial objectives. The board is ultimately accountable and responsible to the shareholder for SOE performance and affairs. It must retain full and effective control over the SOE and give strategic direction to management. The board must also ensure that the SOE complies with relevant laws, regulations, and codes of business practice.

The board also has a responsibility to a broader group of stakeholders that includes present and potential beneficiaries of its products and services, clients, lenders, and employees.

Fiduciary Responsibility

The individual directors and the board as a whole, both executive and nonexecutive, gave full fiduciary responsibility for the SOE in terms of the Companies' Act and the Public Finance Management Act.

Powers and Duties of the Board of Directors

Public Finance Management Act

The PFMA and the Treasury Regulations define the powers and duties of the Board of Directors of an SOE. The board must produce an annual budget and corporate plan and submit it to the accounting officer of the line ministry one month before the financial year begins; it should consist of

- A projection of revenue, expenditures, and borrowing for that financial year in the prescribed format; and
- A corporate plan in the prescribed format covering the affairs of the SOE for the following three financial years and, if it has subsidiaries, also their affairs.

Without derogating from any duty imposed by law, the Board must also

- Ensure periodically that management implements the SOE's strategy;
- Ensure that the SOE has effective, efficient, and transparent systems of operational, risk management, and financial controls ;
- Monitor the activities of executive management;
- Disseminate information on SOE activities to those entitled to it;
- Ensure the succession and approve the appointment of senior executives;
- Ensure that the SOE operates ethically;
- Address the adequacy of retirement and health care benefits and the funding thereof;
- Ensure that the SOE has a system of internal audit that complies with the PMFA;
- Ensure that the SOE has a fair, equitable, transparent, competitive and cost-effective procurement and provisioning system;
- Ensure that all applicable laws and requirements are complied with; and
- Ensure that the SOE has an appropriate evaluation system for major capital projects.

The board must take effective and appropriate steps to

- Collect all revenues due to the SOE;

- Prevent irregular, fruitless, and wasteful expenditures resulting from criminal conduct, and expenditure not complying with SOE operational policies; and
- Manage working capital efficiently and economically.

The board is responsible for management revenues, expenditures, assets, and liabilities of an SOE. It must comply with any tax, levy, duty, or pension and audit commitments as required by the statutes.

The board must take effective and appropriate disciplinary steps against any SOE employee who

- Contravenes or fails to comply with a provision of the PMFA;
- Commits an act that undermines SOE financial management and internal control; or
- Makes or permits an irregular expenditure or a fruitless and wasteful expenditure.

The board is responsible for the submission of all reports, returns, notices, and other information to Parliament, the Member Ministry and the Treasury, as required by the statutes.

The board must promptly inform the Treasury of any new entity an SOE intends to establish and seek approval from its executive authority.

Members of the board must do their best to achieve the SOE's objectives as set out in the memorandum of association of the SOE and as conveyed to them by the executive authority.

If the board cannot comply with any PMFA responsibilities, it must promptly inform the minister and the National Treasury and state the reasons.

The PFMA requires (section 55) that the board of an SOE:

- Keep full and proper records of the SOE's financial affairs;
- Prepare financial statements for each year in accordance with generally accepted accounting principles;
- Submit draft financial statements within two months after year-end to the Treasury and auditors; and
- Submit audited statements within five months after the financial year ends to the executive authority, the National Treasury, and the Auditor-General.

In consultation with its executive authority, the board must conclude an annual shareholder's compact documenting performance on the mandated key measures and indicators. The SOE board must also establish procedures for quarterly reporting to the executive authority to facilitate effective performance monitoring, calculation, and corrective action.

Protocol on Corporate Governance

The Protocol on Corporate Governance accepted by the Cabinet in 2003 mandates that all SOEs must comply with a code of conduct similar to the King Report on Corporate Governance. It encapsulates the King II Report and aligns corporate governance principles to the PFMA while striving to protect SOE independence.

As a shareholder in SOEs, the government is exposed to a wide range of risks associated with their operations, including financial, reputational, and political risks. Each executive authority must ensure that these risks are identified and managed. SOEs must report and account to the executive authority for their financial and nonfinancial performance, while maintaining independence in day-to-day conduct of their duties.

The purpose of the protocol is to guide this relationship and define the governance issues. The government's relationship with SOEs is similar to the relationship between a holding company and its subsidiaries, features of which include

- A strong interest in SOE financial performance;
- Reporting and accountability arrangements that facilitate oversight by the shareholder; and
- Remedial action by the shareholder when the SOE's strategic direction deviates from that preferred by the shareholder.

The executive authority and the Minister of Finance represent the government's ownership interest in an SOE. The executive authority acts as shareholder and the Minister of Finance and the National Treasury are responsible for financial oversight.

The guiding principles of the protocol are these:

- The executive authority should exercise policy control over SOEs consistent with their accountability to Parliament and the public.
- The executive authority should set clear objectives for SOEs.
- Any social service obligations an SOE is to undertake should be specified through a shareholder's compact.
- The directors of an SOE should ensure the development of business strategies, policies, and procedures and monitor how they are managed.

The directors of an SOE should ensure that

- Activities are conducted to minimize divergence of interests between the SOE and the shareholder;
- SOEs are managed in the best interests of the SOE, the shareholder, and other stakeholders;
- SOEs and their officers maintain the highest standards of integrity, accountability, and responsibility; and
- The board has a charter setting out its responsibilities and disclosed in its annual report as recommended by the King Code. At minimum, the charter must confirm the board's responsibility for adopting strategic plans, monitoring operational performance and management, determining policy processes to ensure the integrity of SOE risk management and internal controls, communication policy, and director selection, orientation, and evaluation.

The board constitutes a fundamental base for application of corporate governance principles in an SOE. Each SOE should have an effective and efficient board, with the majority being nonexecutive members to ensure independent and objective decision-making.

The role of the board is as follows:

- It holds absolute responsibility for the performance of the SOE.
- It retains full and effective control over the SOE.
- It has to ensure that the SOE complies with laws, regulations, and government policy.
- It has unrestricted access to information of the SOE.
- It formulates, monitors, and reviews corporate strategy, major plans of action, risk policy, annual budgets, and business plans.
- It ensures that shareholder performance objectives are achieved.
- It manages potential conflicts of interest.
- It clear defines levels of materiality.
- Members must attend annual meetings.
- It ensures financial statements are prepared.
- It must appraise the performance of the chairperson.
- It must ensure effective board induction.
- It must maintain integrity, responsibility, and accountability.

Since a board member cannot effectively attend to all matters, the protocol recommends the establishment of the following committees:

- Audit Committee
- Remuneration Committee
- Nomination Committee
- Risk Management Committee.

In line with the precepts of the PFMA the protocol states that the relationship between the executive authority and an SOE board should be governed by a shareholder's compact. The executive authority should closely monitor the extent to which the board as a whole achieve the objectives and specific performance targets set, and where necessary take remedial action.

Independent Auditors

Auditors of SOEs need to confirm in the auditor's report that the SOE has complied with the PFMA and the Protocol on Corporate Governance.

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