The Role of Divestments in Overcoming Present Economic Challenges

Key Takeaways

1. Divesting significant stakes in non-strategic assets and minority stakes in strategic assets can aid the government in overcoming the present economic challenges.
2. Partially divesting government ownership in SOEs does not correspond to a decrease in the government's ability to influence or control the enterprises concerned.
3. Sri Lanka is no stranger to divesting SOEs. Extensive SOE reforms were carried out between 1989 and 2002 with partial and full divestiture of 84 enterprises.
4. A due process that is transparent should be followed for the successful implementation of divestments including identifying strategic and non-strategic assets, ear-marking the proceeds and having an implementation plan, amongst others.
5. Selective divestments can bring in the much needed Foreign Direct Investments (FDIs), improve the current account, reduce the financial and administrative burden on the government, improve efficiency and effectiveness of SOE operations, and bring in investors with the potential to invest in expansions.
6. Countries such as Vietnam and India have utilised divestments to improve efficiency and profitability of public entities, and to raise revenue for annual budget cycles.

The Government of Sri Lanka (GoSL) has very ambitious plans for the country's economic transformation including an economic growth expectation of more than 6% during five-year period of 2022-2027. The national budget announced in 2022, forecasts public investment to be at 5.1% of GDP. A similar figure was announced during the last budget as well where it was targeted at 5.4% of GDP but currently the estimate for 2021 is at 3.5%.

The total tax revenue estimated in the national budget was an optimistic expectation as well with a growth projection of 50% (LKR 662 billion) in 2022. This is far more than what past budgets had also projected. This increase in revenue is expected to reduce the budget deficit as a percentage of GDP to 8.8% in 2022 from 11.1% in both 2020 (actual) and 2021 (forecast).

Therefore, the Government needs substantial funding in order to invest in relevant sectors of the country to accelerate economic growth. If this is to be raised through borrowings, it will crowd out the private sector while also put pressure on interest rates given government's policy of utilising domestic financing. This ultimately compounds the quagmire of financial indebtedness in the country.

Observing the 52 State-Owned Enterprises (SOEs)[1] monitored by the Ministry of Finance (MoF), an aggregate profit of LKR 103 billion was generated during the first seven months of 2021, but was eroded by loss-making entities with a total loss of LKR 96 billion. 94% of this loss was contributed

[1] In 2018, this number was 54 SOEs but in 2019 Ministry of Finance reduced it to 52 strategic SOEs

by 3 entities, namely; Ceylon Petroleum Corporation, Sri Lankan Airlines Ltd and Sri Lanka Transport Board, while, 85% of profits were contributed by 5 entities.

In this regard, letting go of significant stakes in nonstrategic assets and minority stakes in strategic assets could be the best course of action that can be followed given the political milieu of the country. This will enable strategic assets to be sustained for a long period of time while enabling growth in the economy. A clear distinction between strategic and non-strategic assets should be drawn for this purpose. This can avoid divesting controlling stakes of strategic assets, which could undermine the long-term growth potential of the country.

History of Divestments in Sri Lanka

Sri Lanka is no stranger to divesting SOEs. Divestment of public enterprises were incorporated into the state policy in 1987 with an aim of reducing the fiscal burden, and improving the efficiency and profitability of the entities. This led to extensive SOE reforms being carried out between 1989 and 2002 with partial and full divestiture of 84 enterprises.

SOE divestments has been a key channel of Foreign Direct Investment (FDI) into Sri Lanka. During 1990 and 2000, the 11 largest SOE divestment transactions that occurred in the country amounted to USD 609 million of the USD 1,791 million received as FDI during the same period. Furthermore, during the period between February 1990 to June 2001, just over two-thirds of SOE divestment proceeds were raised from foreign investors (Central Bank, 2002). Therefore, divesting SOEs can bring in the much needed FDI into the country and aid the government in their efforts of economic revival post the pandemic. A list of major foreign investments that occurred during the period of 1990-2001 is given in table 01 below.

Table 01: Profiles of a few Key Divestments with Foreign Investment

Enterprise	Date of Divestment	Amount realized (USD million)			Percentage Divested
		Local	Foreign	Total	
Puttalam Cement (Holcim Cement)	December 1993	18.9	23.1	42.0	100
National Development Bank	March 1993	10.4	91.8	102.2	55.3
Trans Asia Hotel (Ramada/Cinnamon Lakeside)	May 1993	11.6	11.6	23.3	86.9
Asian Hotels Corporation (subsidiary of John Keells Holdings PLC)	Jan 1992	8.1	13.6	21.8	91.4
Orient Lanka	May 1996	-	31.5	31.5	100
Lanka Lubricants	July 1994	11.1	14.1	25.2	100
Sri Lanka Telecom	August 1997	-	226.9	226.9	38.5
Air Lanka (Sri Lankan Airlines)	March 1998	-	77.1	77.1	40
Prima Ceylon Ltd.	June 2001	-	65.7	65.7	100

Source: Central Bank of Sri Lanka, 2003

Benefits of Divesting Non-Strategic Assets

Improving the current account

In line with the savings and investment model, current account of the Balance of Payment (BOP) is identical to private savings and government savings minus investments. In 2020, private savings accounted for LKR 4,007 billion while government savings stood at a negative LKR 1,180 billion. Therefore, by increasing government income or by cutting down government expenditure, the current account deficit can be reduced.

In 2020, about 30% of government recurrent expenditure was spent on salaries and wages, and about 23% were transfers to households, which includes subsidies and pensions. The 52 strategic SOEs represent about 10% of public sector employees and accounts for a noteworthy component of this expenditure. The pricing policy adopted by SOEs is also one of the causal factors that compromise the balance sheet of both the SOEs and state banks, and ultimately benefit the non-poor. Divesting even minority stakes of SOEs can bring in accountability and transparency, which can then improve the pricing policy of these SOEs and thereby improve the balance sheets.

Therefore, by carrying out selective divestment of assets, the government will be able to generate a one-off income as well as cut down on the fiscal burden and improve the persistent government dissaving. Barring 5 years, Sri Lanka has been recording primary balance deficits since the 1950s[2] and an improvement in that can translate into a favourable current account balance in the country.

Reduce the financial and administrative burden on the government

The total turnover of the 52 SOEs monitored by the MoF was significant in 2020, amounting to LKR 1,804 billion, which was close to 1.5 times the total Government revenue collected in 2020. However, the cumulative bank credit that was pumped into SOEs as at November 2021 was LKR 1,185 billion and treasury grants provided to the 52 SOEs in 2020 was at LKR 75 billion. Therefore, the financial burden of SOEs on the government is substantial and in return detrimental for the economy. The increase in bank credit also increases money supply, which then exerts pressure on inflation. Hence, selective divestments can help the government alleviate the financial and administrative burden of SOEs on the Government and thereby the economy.

Figure 01: Summary of Indicators of the 52 Strategic SOEs

Total Turnover	Bank Credit Provided	Treasury Grants
LKR 1,804 Bn 2020	LKR 1,185 Bn November 2021	LKR 75 Bn 2020

Source: Ministry of Finance and Central Bank of Sri Lanka

[2]Primary balance is the difference between government revenue and non interest government expenditure

Another dimension of the fiscal burden is the relationship between Sri Lanka's rating and the performance of SOEs. For example, Moody's changed the country's rating outlook from stable to negative in June 2016 owing to weak financial performance of SOEs. As highlighted by Moody's, SOEs were a substantial contingent liability risk for the government and a potential source of fiscal and BOP pressure.

Improve efficiency and effectiveness of operations

The private sector operating under a competitive environment is generally deemed to be profit oriented and is expected to strive towards minimising costs through improvements in its effectiveness of services offered. Therefore, divestiture can bring in the much needed efficiency and effectiveness to SOE operations. It can also provide the SOEs the freedom to operate outside of political and bureaucratic constraints, and separate the state's operational activities, from its policy making and regulatory functions.

The private sector can also bring in proven management skills and technology to the public enterprises and place SOEs on the path towards efficiency and effectiveness, while, ensuring their growth and success.

Investors with the capacity to invest in expansions

Divestiture can bring in investors with the capacity to invest in expansions. For example, Hilton has much potential for further development but owing to financial constraints, the government is unable to pursue such developments. The Hyatt project is also another example that requires significant investments to reach completion, which the Government is not in a position to undertake. The divestiture of public enterprises can also attract new business or trade for SOEs, which had not been explored previously.

Divestiture Process

1. **Identifying strategic and non-strategic assets**

It is important to first differentiate state assets as strategic and non-strategic. Strategic assets can be identified as assets that should remain under state ownerships for non-commercial reasons such as national security, managing price, provision of essential public goods or services, etc. A case for divestment of significant stakes can be made for SOEs if it is no longer deemed to be aligning with these state-ownership objectives.

Examples of a few non-strategic assets in Sri Lanka can be identified in sectors such as real estate, finance, insurance, investment funds, shipping, oil and gas, handicraft, fisheries, etc. Some of these, may be considered as strategic by the government for various reasons. However, the divestment process allows one to divest minority stakes without losing control of an enterprise. Even a single share in excess of a 50% stake will provide control of the enterprise. Absolute control can also be enjoyed with a 75% stake as that permits the government to pass extraordinary resolutions. Hence, reducing the ownership of an enterprise down to 75% will not result in any dilution of control.

2. **Selecting method of divestment**

Ideal method that can be followed is to offer significant stake through a competitive tender process or a bidding process conducted on a special board of the Colombo Stock Exchange (CSE) among shortlisted parties. Balance can be offered through an Initial Public Offering (IPO) allowing members of the general public to become part owners of a SOE.

Offering a part of the shares to employees can help overcome resistance, and builds their commitment to remain and support the new management after the sale. A similar approach was followed in Sri Lanka in the first wave of divestments in 1988 with a divestment modality of 51:29:10:10 ratio. 51% of the stake was sold to corporate investors, 29% was offered at par to the public, GoSL retained 10% and 10% was given free of charge to workers. For example, when United Motors was incorporated as a public limited liability company[3], each employee received 500 shares as a gift. The divestments that took place in this period were also termed as "peoplisation" to limit resistance from the public.

However, if the Government wishes to retain majority control of an entity it considers as strategic, it can offer 25 to 49% of the shares, which can be distributed among the different modalities described above. For instance, in a 25% divestiture, 20% can be offered to a strategic investor with 5% to employees.

3. Specifying how the proceeds of the sale would be used

A weakness that was observed in divestments carried out by Sri Lanka in the past was that the proceeds were not allocated to an ear-marked account and instead went into miscellaneous expenditure. Therefore, carefully planning on how these will be used for Sri Lanka's economic development is imperative and following a transparent process in this regard is essential. Much of the recent criticism is due to the lack of a transparent process, both in terms of selecting investors and in the use of divestiture proceeds.

4. Detailed implementation plan

The complexity of these transactions will mean that it requires a carefully crafted implementation plan. Therefore, it is vital to have a detailed plan specifying the entities that will be divested, method of divestiture, modality of divestments for each SOE and earmarking the proceeds of these divestments on how it will be used. Much attention is also required to perform stakeholder consultations and obtain their support to ensure a smooth implementation process. The divestiture of significant stake in Sri Lanka Telecom can be cited as a successful case study that followed a due process including conducting stakeholder consultations.

Other Country Experiences

Vietnam

In Vietnam, divestments have been a major focus for the government since it increases the efficiency of loss-making SOEs. Divestments are also a significant source of revenue for the government, which helps the government in managing the fiscal deficit and fund economic development plans. In 2016, earnings from SOE divestments in Vietnam reached VND 30 trillion (USD 1.3 billion), while in 2017 it was about 5 times the figure in 2016 (VND 140 trillion - USD 6 billion).

Building on this, the Prime Minister of Vietnam recently issued a policy on state ownership thresholds for SOE divestment and restructuring from 2021 to 2025. This policy that came to effect on August 2021, allows the state to hold at least 65% of ownership in seven sectors (including

[3] Mitsubishi of Japan purchased 500,000 shares at par, prior to the sale of shares to the public

banking and finance and, terminals at special seaports) and in less crucial sectors, the state is to hold 50% to less than 65% ownership including in sectors such as air transportation and Telecommunications services. The state will also hold 100% ownership in SOEs engaged in 13 sectors that primarily focus on national defense and security.

India

In 1991, with the liberalisation of the Indian economy, the lack of market competitiveness and lack of efficiency in SOEs compared to private sector businesses were identified. This moved the government to opt for SOE reforms with divestments to improve SOE viability. This involved partial sale of government equity in SOEs while retaining majority control with the government. This era of partial divestment also enabled the government to use SOE divestment to raise revenue for the annual budget cycles.

Last year, too, the country set an ambitious disinvestment target of INR 1.75 trillion (about USD 24 billion) during its budget announcement. However, a lot needs to be done by the government to achieve this divestment target in 2022. If the proposed divestment of Life Insurance Corporation of India (LIC) valued at USD 203 billion goes through then it can narrow this shortfall.

Conclusion

Partially divesting government ownership in SOEs does not correspond to a decrease in the government's ability to influence or control the enterprises concerned. A 50% stake or more will provide control of the enterprise and absolute control can be retained with a 75% stake. Therefore, given the political milieu of the country and to avoid public resistance, options such as selling significant stakes with management for non-strategic entities and releasing smaller stakes or raising new equity through the issue of new shares for strategic entities can be considered rather than a full-scale privatisation programme. In a few non-strategic sectors such as hospitality, even the divestiture of majority stake can be considered. To list on the stock market even with minority stakes can provide the SOEs with the much needed transparency and efficiency in business operations through adherence to stringent regulations. It should also be noted that the 3 main loss-making entities aforementioned are high foreign currency intensive businesses as well and hence, require extensive financial discipline. Therefore, in the present scenario where Sri Lanka is facing significant funding constraints, SOE divestment should be seriously considered for inclusion in the economic recovery plan of the country.

This article was developed as a follow-up to the Strategic Insight piece on ''SOE Reform: The Impetus for Post Pandemic Economic Revival''. The Strategic Insight Series are a series of briefs that focuses on key contemporary topics that matter to the private sector.

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