

Public Corporate Governance Codes: Necessary but Successful too?

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ABSTRACT

The formulation of Public Corporate Governance Codes has become popular in the last few years. But there are some shortcomings. First the variety of Codes makes comparisons difficult or even impossible. Secondly, many Codes state the necessity of steering by the government as the owner of Government Owned Enterprises (GOE) but do not mention the steering process explicitly. Another problem seems to be the qualification of the board members of the GOE together with the handling of conflicting interests. Quite often the considerations on the evaluation of the Code are somewhat imprecise.

Keywords: public enterprises; steering by objectives; public corporate governance

1. Introduction¹

Governments often choose to retain ownership in strategic enterprises, or enterprises that provide key infrastructure or social services. While the overall weight of Government-owned Enterprises (GOEs) in the global economy has declined in recent years, GOEs continue to play an important role in many countries, especially in transition economies where they account for a significant proportion of gross domestic product. (Baltic Institute of Corporate Governance 2010, 3)

These are not my words but were taken from the foreword of *Baltic Guidance on the Governance of Government-owned Enterprises*. They make clear the urgent need for instruments to bring into accordance the policy of the government as the owner of these enterprises and the activities of the GOE themselves.

¹ This is a revised version of a paper presented at the Halduskultuur-Administrative Culture conference in Tallinn on 27 April 2012. The character of a speech was kept. The author is thankful to J.P. Lehrke (Speyer) for helpful comments on the English translation. The view pointed out in this article is solely in the responsibility of the author.

Indeed, the problem is not only a Baltic one. The number of public establishments and enterprises in Germany, e.g., reaches nearly 15,000 and still shows a steady growth. Some of these entities are of considerable importance, such as the postal service or the railway company. Nearly 90% of the above-mentioned GOE can be found on the local level (Schmidt 2011, 157). About two-thirds of them are run in the form of private enterprises (Table 1); their share is rising slowly over time, too:

Table 1: Public Establishments and Enterprises in Germany 1996-2009

	1996	1998	1999	2002	2004	2005	2006	2007	2008	2008
Number	8793	10831	11505	12848	13498	13865	14054	14460	14704	14704
Share of private enterprises	58.0%	54.2%	57.0%	59.9%	61.4%	62.2%	62.3%	63.3%	63.7%	63.7%

Source: *Statistische Jahrbücher Deutschland*, various volumes, Tables 20.7.2 (1996, 1998), 20.6.2 (1999) and 23.6.2 (since 2002).

Referring to the different legal regulations the influence of the public owner is much more intensive in an establishment based on public law than in an enterprise which follows the rules of private law.² As a considerable part of enterprises has public and private shareholders (mixed enterprises) the influence can differ additionally. Therefore, especially for the enterprise sector thoughts about the steering by the national/regional/local government are necessary.

Indeed, the GOE might be of considerable fiscal importance, bringing good opportunities or bad threats to the public budget. As information from Germany on the micro-level is not available yet an example from Sweden is taken. In Table 2 it can be seen that in the first two cities the consolidated annual budget result is much lower than the result for the core budget. In the two other cities just the opposite happens:

Table 2: Annual results of core and consolidated budget in Swedish Cities 2007

City	Annual result, core budget SEK per capita	Annual result, consolidated budget SEK per capita
Helsingborg	21124	889
Norrköping	12454	2261
Göteborg	1988	3208
Stockholm	-64	7325

Source: Sveriges Kommuner och Landsting (2008, Table 1).

² Throughout this paper the term “establishment” is used for entities under public law and the term “enterprises” for entities under private law.

In the last few years it has become quite popular in many countries to publish a Public Corporate Governance Code (PCGC).³ In doing so, the government shows its awareness that the sector of Government-Owned Enterprises needs more attention than in past years. This is not done voluntarily in every case. Mismanagement, malfunctions in services and a controversial debate about the remuneration of managers in GOE have led to public pressure; in some cases the reputation of the government itself suffered great damage. One possible (and very cheap) response to this pressure is a PCGC. But is this more than just window-dressing? Does the implementation of a PCGC improve the results of GOE and lead to more transparency? Well, the existence of a Code is a necessary but not a sufficient condition, as was seen during the recent crises in the private sector (Von Werder 2011, 60). While the structure of the Codes is discussed widely in the literature, there are not many scholars involved in the examination of their performance in reality. What I am trying to do in this paper is to show some shortcomings in existing codes. But I can give only preliminary considerations, ones which are not based on thorough empirical research.

The paper starts with an examination of the comparability of some Codes. This should be quite easy if they were derived from one Basic Code. Unfortunately this is not the case. The second question refers to the necessity of steering. While this is postulated in nearly every Code the question remains how steering will be ensured. This cannot be done without a look at the role of politicians as members of the parliament or council, or, resp., as members of the board of GOE. Then transparency in the appointment of board members and their qualification seem to be of great importance. The next step is a short consideration of the GOE's objectives followed by a treatment of the steering entity within the core administration. The third point is a critical look at board members' handling of conflicting interests within the board. Finally some thought is given to the evaluation of the handling of the Code in practice.

2. PCGC – Lost in Variety?

First of all no overall basic PCGC exists, even though the Guidelines published by the OECD in 2005 could be used as a blueprint. This is expressed in the foreword of the report, which states: "But, until now, there has not been any international benchmark to help governments assess and improve the way they exercise ownership of these enterprises, which often constitute a significant share of the economy. These OECD Guidelines on Corporate Governance of State-Owned Enterprises fill this important gap ..." (OECD 2005, 3).

But very often it is said that any code must be adapted to the specific conditions of a country or to the characteristics of the specific activities of the given enterprise. This is clearly pointed out in the *Baltic Guidance on the Governance of Government-owned Enterprises*:

³ I will refer mostly to the OECD Code, the Baltic Guidance and some codes existing in Germany.

It must be recognised that the Baltic countries have different economies, histories, languages, and legal traditions that make it difficult to make standardised recommendations ... The differences between the countries mean that the relative importance of each of the individual recommendations in the Guidance will vary depending on the context. Ultimately, any future reform initiative will need to be designed and implemented at the country level, and adapted to local circumstances (Baltic Institute of Corporate Governance 2010, 7).

The next problem is the differentiation between the levels of government. In most countries this requires a special look at Local Public Enterprises, which are of great importance (see Papenfuß 2011, 123).

The governance of municipal enterprises differs in some respects from that of state enterprises. Municipal enterprises tend to be smaller and the human and financial resources available for the professional governance of municipal enterprises are generally more limited. As a consequence, municipalities need to adapt these recommendations to the local context in order to achieve the desired outcomes. This being said, the basic governance issues faced by municipal enterprises are the same, and it is expected that municipality-owned enterprises comply fully with the spirit of these recommendations (Baltic Institute of Corporate Governance 2010, 7).

However, in federal states like Germany, the sub-national level (Länder) has to be considered as well. Because every sub-national public authority acts autonomously, there might be lots of different codes that vary in structure and content, as is the case in Germany (see Papenfuß 2011, 132). Thus, for example, the cities Berlin, Hamburg and Bremen, which are Länder in themselves, have their own codes with three differing recommendations on the declaration of D&O assurances located at different places within the code. The same is reported from another federal state, Switzerland, where the presentation of a draft paper for the cantonal assembly of St. Gallen from October 2011 lists 9 different guidelines or codes for the Federation, several Cantons and the Principality of Liechtenstein (Kantonsrat St. Gallen 2011). In addition many local governments have created PCGC of their own, at least in Germany (See the actual survey by Institut für den öffentlichen Sektor 2012).

One fundamental principle of governance codes for the private sector is the requirement of “comply or explain”. That means that any enterprise has to explain if and why it deviates from the rules laid down in a pre-formulated standard code. But, if no standard exists it is hardly impossible to claim “comply or explain”. In the case of the aforementioned three German cities, the benchmark for the adaptation of the code in a specific enterprise can be the PCGC for every single city only. In consequence the “comply-or-explain rule” is not respected. This is quite disappointing. Moreover, scholars have to build their own schemes for analyzing different PCGCs. But it is their subjective decision if they focus on remuneration, the qualification of board-members or the handling of trade-offs between objectives.

There are some approaches to developing a standard code which can serve as a

benchmark for individual codes. The greatest possible extent of this is the formulation of a national standard – an attempt made by the Kingdom of Morocco.⁴ An approach not reaching so far is a standardized regional code – which has been done by the Land Mecklenburg-Vorpommern in Germany (Innenministerium Mecklenburg-Vorpommern 2010). Yet another way is the publication of a “model code” by the associations of local governments – an example is the code formulated by the Association of Cities in the Land of North-Rhine-Westphalia (Städtetag Nordrhein-Westfalen 2010). But in reality the codes used in Germany still differ widely. Whether it is possible to bring them together into one basic code is a question that cannot be answered in every Land at the moment.

3. What happens to Politics and Politicians?

The recommendations given in the CGC for private companies cannot be applicable for Public Enterprises in their entirety, as they act in a “public surrounding”. The objectives of these enterprises are in a broad sense “public”, even if they do not fulfill the conditions of public goods as defined by economic theory. Thus the chain of democratic legitimacy of the actors from the parliament/local council to the board of a given enterprise can be very important, especially if usage of the goods or services provided by the enterprise is compulsory.

Moreover, the real shareholder of any Public Enterprise is the citizen. This leads to a very complicated principal-agent relation. “With regard to the multilevel principal agent relations the management of public enterprises is complicated in terms of transparency, because heterogeneous structures of interest – much more than in the private sector – multiply with the limited possibility to achieve symmetric distribution of information” (Lenk et al. 2009, 16).

Table 3: Local Public Enterprises and Multilevel Principal-Agents Relations

Citizens				
Parliament/Council as	Principal ↓			
State or Local Government as	Agent	Principal ↓		
Supervisory body of the enterprise as		Agent	Principal ↓	
Management of the enterprise as			Agent	Principal ↓
Management of subsidiary enterprise				Agent

Source: author

⁴ See *Code Marocain de Bonnes Pratiques de Gouvernance des Entreprises et Etablissements Publics*. This is also postulated, i.a., by Papenfuß (2011, 146ff).

Therefore, it is impossible to edge out political influence; but on the other hand it must not be too strong. Yet the role of politics must be exercised cautiously with respect to the objectives of the Public Enterprise as well as regarding the competences of the management and the board respectively. The concern over excessive political influence is stated very clearly in the Baltic Code:

Short-term political objectives, political instability, or changes in government administration should not be allowed to destabilise the GOE. The politicisation of strategy, investments, and operational decisions and frequent changes due to the election cycle damage the GOE's and society's interests by causing an uncertain planning and operating environment. The governance of the GOE should be systematized and policies formalised in order to insulate the GOE from changes in political currents, and to create continuity when individual ministers have different management styles. Professional, objective and independent oversight via the supervisory board and regulators is best suited to oversee the GOE. (Baltic Institute of Corporate Governance (2010, 12).⁵

To minimize direct political influence firstly the appointment of board-members should be transparent. Secondly, the choice of members should mainly be orientated towards the required skills to exercise their function not towards their political position (see German Ministry of Finance 2009, 23). They must have (or get) the necessary qualification; if not they cannot be appointed, or a given appointment has to be withdrawn. Moreover, a Code of Conduct or Code of Ethics should guide the behavior within the enterprise. I am aware that these recommendations in a certain sense contradict the idea of free access to a political mandate for everyone. One of the unsolved questions is related to the determination of the institution which can judge independently if the board members fulfill these requirements.

4. The enterprise is well-positioned – but what happens in the government?

The steering of any public enterprise and the execution of ownership rights by the government is part of nearly every code:

The state should act as an informed and active owner and establish a clear and consistent ownership policy, ensuring that the governance of state-owned enterprises is carried out in a transparent and accountable manner, with the necessary degree of professionalism and effectiveness (OECD 2005, 13).

First of all, the public owner should define the objectives of the public enterprise.⁶ This is the well-known case of steering or management by objectives, comparable to the New Public Management ideas. The government has to describe the kind and quality of goods or services that the public enterprise should deliver as well as the

⁵ The needed skills are described more precisely by Innenministerium Mecklenburg-Vorpommern (2010, Nr. 3.2.).

⁶ For a more detailed discussion see Lenk et al. (2009, 11ff).

expectations concerning the financial results and the treatment of stakeholders, especially the staff.⁷ Take, for example, a public railway company:

- Which proportion of train journeys has to be punctual, or how much of a deviation from punctuality is tolerable?
- How much surplus should be generated as revenue for the state budget?
- Is it possible to pay employees at wages below the level set by the collective labor agreement?
- What about diversity in the workforce, the management, or the board?⁸

Moreover, it has to be shown how trade-offs between those objectives are handled. Which is the leading objective, and does this apply in every situation? Is punctuality everything at any cost? Are high wages possible if – for example international – competitors can use a different collective labor agreement in which wages are agreed at a lower rate? The objectives and their handling need not necessarily be described in the statute of the enterprise (this would be quite inflexible). A perennial or yearly agreement between the government and the GOE (represented by its board and management) might serve them better. Yet unfortunately, many public enterprises still lack a clear definition of their objectives.

Of course, conflicts can happen when objectives are formulated. So some kind of strategic steering usually takes place. But cases can be found in which no steering exists at all. Here, either the management is quite independent in its actions or – a horrible prospect for managers – the government involves itself in day-to-day operations. This should be avoided in any case (See OECD 2005, 24).

Another theme has to be mentioned: To exercise ownership rights the head of government needs administrative assistance: “The exercise of ownership rights should be clearly identified within the state administration. This may be facilitated by setting up a co-ordinating entity or, more appropriately, by the centralization of the ownership function” (OECD 2005, 26).

Within the government the department that is responsible for exercising ownership rights should be identified. There are two possible approaches: First, the responsibility can be divided among different departments according to the branch to which the enterprise belongs. So a housing enterprise might be coordinated within the social department while waste collection is related to the department of environment.

The second way is to concentrate the responsibility in one department, sometimes within the department of finance itself, or in a special agency connected to the ministry. Sometimes we find a Holding-Structure, when the shares of different Public Enterprises are bundled together within a special Public Enterprise. Of course, this gives the minister of finance or CFO a strong position within the government, at least when a substantial part of state activities are done by GOE.

⁷ Sometimes it is explicitly said that this is a joint duty of administration and politics; see Stadt Stuttgart (2006).

⁸ See German Ministry of Finance (2009, 23). Many codes in Germany do not mention this topic at all; see Papenfuß (2011, 138).

In reality something in between takes place. One very common approach is the appointment of representatives of the ministries/departments affected to the board. If all respect the handling of the general objectives of the Public Enterprise as set by the government this might be an acceptable arrangement. But sometimes different ministries/departments treat the objectives, or at least trade-offs between them, in different ways. Take the example of the railway company: the Ministry of Transportation would give the quality of services priority while the Ministry of Finance would give more weight to the expected surplus.

I would prefer the centralization of the responsibility for enterprises of substantial importance and/or connected with some financial risks. This might be done within the finance or another central department.⁹ But of course, the allocation of those responsibilities will not be free of political considerations. In any case, the department responsible is obliged to inform the head of the government and the affected ministries/departments about the performance, financial results, or any other development of importance in the GOE, as well. Naturally, the same information also has to be given to the parliament or council.

The assisting entity within or for the government must have very qualified staff; this is often overlooked or at least not mentioned. Moreover, this entity must have the possibility to report directly to the head of government if anything of importance has been detected. There is a broad debate (in Germany) about whether the staff from the assisting entity can attend the meetings of the boards of GOE with the status of guests.¹⁰ Of course, this has to be decided within the legal framework of every individual country.

5. Integrity of the actors – the handling of conflicting interests

Each member of the supervisory body is under obligation to pursue the object of the company. No member may pursue personal interests in taking decisions, nor may any such member exploit for himself business opportunities opening up for the company.

Each member of a supervisory shall disclose to same any conflicts of interest, in particular such conflicts that may arise due to consultancy provided to a customer, supplier, lender or other business partner, or due to the member having a representative supervisory function with that party.

In its report to the meeting of shareholders, the supervisory body shall disclose any conflicts of interest that may have arisen, also describing how they have been dealt with. Any major and not merely temporary conflicts of interest given in the person of a supervisory body member shall lead to their appointment ending (German Ministry of Finance 2009, 24f).

This is easily said, at least on the national level. But in a Local Public Enterprise, the occurrence of conflicting interests is likely. This becomes even more probable

⁹ For this discussion see, i.a. Geis and Nowak (2011, 101).

¹⁰ If the ministry/department of finance is responsible for the majority of the GOE this guest status might raise its power, at least in practice.

the smaller the local government in question. A lawyer or a tax advisor, possibly very qualified members of a board, might have business relations to business partners of the Local Public Enterprise. On the one hand the board needs their experience; on the other hand their appointment should be terminated if conflicting interests have been identified. The alternative, to avoid any conflicting mandate, might be dangerous for their private business. Moreover, who decides if conflicting interests are major and who has the right to terminate an appointment?

There is no clear-cut answer to these questions. The mayor cannot decide by himself if an appointment shall end; this might lead to political arbitrariness. Therefore the Code set for the German Federation knows the instrument of self-declaration (German Ministry of Finance 2009, Annex 1):

Textbox 1: Template for the Declaration by Members of Supervisory Bodies, who are Members of the Public Service

With effect as per ..., I was appointed as a member of the ... I hereby accept such appointment.

I assure that I will not exceed the maximum number of supervisory board appointments ... and that I will comply with the upper limit that may have been defined by my employer ...

I hereby declare that I am ready and willing to promptly inform the department responsible for holdings of the Federation in ... on the sessions of ..., to deliberate with the department responsible for holdings of the Federation in ... on how I am to cast my vote, to take account of the special interests of the Federation in addition to the interests of the corporation, and to transmit, immediately following the sessions, the reports to the department responsible for holdings of the Federation.

I am aware that in the context of my activity as a member of the above supervisory body, I must myself review the possibility of conflicts of interest being given with my function in ... for each individual case. To the extent that I believe a conflict of interest to be possible, I shall procure that the decisions required in this context ... will be taken by other persons authorised to take such decisions in accordance with the stipulations of the Appointment Guidelines ...

Option 1 (Employee is a member of the delegating department)

I am aware that I have been appointed on the initiative of my employer as a member of the ... and I accept that should the ... remove me from this office, I am to comply with this immediately.

Option 2 (Employee is not a member of the delegating division)

I am aware that I have been appointed on the initiative of my employer as a member of the ... and I accept that should the ... decide to remove me from this office, I am to comply with this immediately. I have received the principles of good corporate governance for indirect and direct holdings of the Federation ...

.....
(Place, date)

.....
(Signature)

Source: German Ministry of Finance (2009, Annex 1).

The judgment of the behavior of actors in the management or on the board of GOE must be embedded in an overall rule of compliance for the entire public sector. The requirement of compliance must be the same if anyone is working within the administration itself and/or in any position related to a GOE. This close connection is not always mentioned when PCGCs are examined. Two very fundamental principles can be included in such compliance rules:

- the responsibility for and the monitoring of compliance
- the treatment of cases of non-compliance¹¹

The responsibility should follow the normal hierarchy which means that Deputy heads bear the core responsibility. But of course: “Managers and employees are responsible for taking the necessary steps to keep themselves informed of legal and Treasury Board policy requirements that relate to their areas of decision-making and availing themselves of training and educational opportunities” (Treasury Board of Canada 2009, 8.3.). But the best referee possibly is the public. If non-compliance is transparent to everyone, external pressure from the public might be the best way to ensure that good governance takes place. But for this to occur, a complete reporting procedure that is noticed by the population is essential.

One of the crucial points is the possibility and the use of sanctions. While the violation of a recommendation of a Corporate Governance Code in the private sector might lead to very strong reactions, for example of creditors or even an attorney, this is not the case for GOE (at least not yet in Germany). This is stated clearly in a recent paper: “However, chances for success should not be overestimated due to the relatively mild mechanisms of sanctions” (Lenk et al. 2009, 16). One interesting example is found in the compliance framework of the Treasury Board of Canada (2009, Appendix D):

Table 4: **Sanctions in cases of non-compliance**

Severity of consequences	Consequences (examples)
Minimal	Training and education Coaching/mentoring
Moderate	Reassignment Observation in performance appraisal
More severe	Disciplinary reprimand Suspension Financial penalties/no performance pay Demotion Changes in delegated authorities
Most severe	Termination of employment Prohibition from contracting

Source: Treasury Board of Canada (2009, Appendix D).

¹¹ See for this in more detail: Treasury Board of Canada 2009.

But of course, these sanctions can be used only if the board members are employees of the government. In the case of political board members these instruments are not applicable. However, if an important deviation from a PCGC damages the reputation of the government in the eyes of public opinion, then the compliance with such a Code might be improved. The awareness of the traditional media to such deviations from the code is quite high; even more important might be platforms in social media, such as Facebook or Twitter. To ensure compliance in GOE the role of public opinion should not be underestimated.

6. Codes under monitoring – who and how?

“SOE boards should carry out an annual evaluation to appraise their performance” (OECD 2005, 52).¹² This corresponds to the statement of the board in private companies. But as GOE act in a different framework self-evaluation might not be the best way. The most important difference to private enterprises is the fact that no legal sanctions exist if the Corporate Governance Code is violated. Thus, external evaluation might come to mind. Like the annual report the external auditor could judge the performance of the board, as well. “In carrying out the evaluation, the SOE boards could seek advice from external and independent experts as well as by the ownership entity” (OECD 2005, 52).

Another deficiency is the lack of clearly formulated questions to pose in the evaluation. In any case the “comply-or-explain rule” should be respected if any standard code exists. Another field of evaluation should be the attention of compliance. Moreover the quality of steering by the owner should be analyzed as well as the balance between active steering and excessive influence.

The short remarks about PCGC could not go very deep into the matter. I have tried to show only some very real contradictions that hinder a simple conversion of any code into practical daily application. The actors and their roles cannot be neglected; politics are all around. Indeed, there exists no neutral referee to decide what is wrong and what is right. Even public opinion could not act as a “neutral” force in every case; sometimes the media tend to sensationalize. And, of course, they decide what they will report about.

A PCGC is a good thing – no doubt about that. This is common sense among scholars as well as politicians. But how does the Code work in daily use? Unfortunately, too many scholars are looking at the recommendations concerning the remuneration of the management of the board and a few related issues. Of course, this is not without importance. But the focus on this topic, which is very intensively discussed in the public, obstructs the view of many other themes of interest, such as the quality of the members of a board or the steering of GOE by clearly formulated objectives. The search for a way to good governance in GOE has not come to an end yet.

¹² SOE is synonymous to GOE. For a detailed study of board reports see Cervellini (2012).

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