ASSESSING THE PERFORMANCE OF STATE-OWNED ENTERPRISES IN MONTENEGRO

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ABSTRACT

The average stock of state-owned enterprises (SOEs) assets in Montenegro accounts for almost 100 percent of the GDP. SOEs in Montenegro are concentrated in natural monopoly sectors such as energy, transportation, water supply, waste management, and tourism. A SOEs employment footprint in Montenegro accounts for almost 10 percent of total employment which is rather high and similar to some other South-East Europe developing economies.

The objective of this research is to analyze fiscal risks stemming from the 20 largest out of 45 central-government-owned SOEs and to show whether SOEs' corporate governance weaknesses are at the root of the arising fiscal risks.

The methodology used in the research, first includes the OECD corporate governance criteria implementation to measure the stance of corporate governance of 20 analyzed SOEs. The second step of the research methodology is about carrying out a financial ratio analysis to identify fiscal risks stemming from SOEs and confirm whether the fiscal risks are increasing if SOEs' corporate governance is weak. Assessing fiscal risks for the selected group of SOEs is based on the IMF methodology that defines a threshold to assess whether the financial performance of SOEs leads to fiscal risks.

Although having a prominent role in the Montenegrin economy, weaknesses in SOEs' corporate governance reflected in inefficiencies in their management impose substantial financial and fiscal costs. Looking a few years backward, the economic performance of SOEs varies across sectors from profitable SOEs in the energy sector to loss-making enterprises in transportation.

KEYWORDS: corporate governance, a state-owned enterprise, oversight, fiscal risks

JEL classification: JEL code E62; JEL code H6; JEL code H8

1. INTRODUCTION

State-owned enterprises (SOEs) play an important role in the economic development of Montenegro and account for a large part of the economy. Goals set for state-owned companies in Montenegro are different from those for commercial companies, which is like in many other countries. Whereas commercial companies are mainly focused on generating profit for their shareholders, state-owned entities fulfill, apart from economic goals, other specific social objectives, such as providing jobs, serving the public interest, or providing necessary goods (Razak et al., 2008). According to official data, there are around 150 SOEs in Montenegro out of which are 45 fully or majority-owned by the central government and the rest are municipal SOEs. The average government and municipal-owned SOE assets for the period 2018-2021 accounted for around 90-100 percent of GDP, with a significant employment footprint[1]. This is similar to some other countries in the region like Croatia, Bosnia and Herzegovina, and Serbia.

This paper is focused on the largest 20 out of 45 central-government-owned SOEs, whose assets accounted for 78 to 93 percent of GDP over the period 2018-2021. The paper does not include data on municipal SOEs, bearing in mind some research limitations.

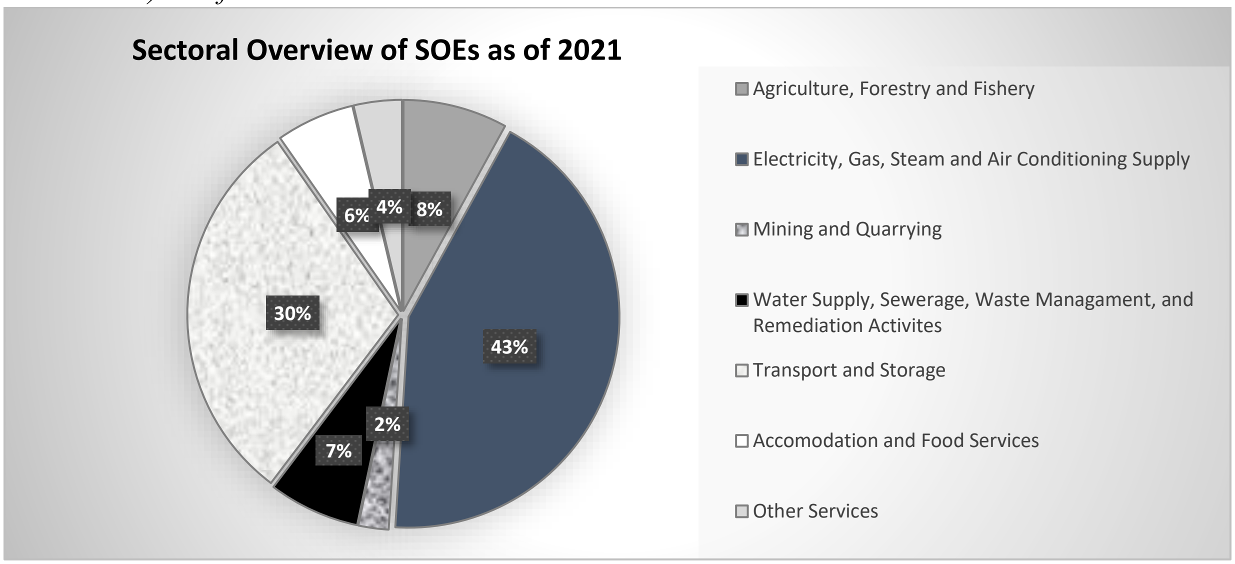
The objective of this research is to analyze fiscal risks stemming from the 20 largest SOEs and to show whether SOEs' corporate governance weaknesses are at the root of the arising fiscal risks.

The methodology used in the research first includes the overview of the OECD SOE corporate governance criteria implementation in Montenegro to measure the stance of corporate governance of 20 selected SOEs. The second step of the research methodology is about carrying out a financial ratio analysis to identify fiscal risks stemming from SOEs on the level of each individual SOE as well as on the portfolio level of 20 SOEs. This is based on the IMF methodology that defines a threshold to assess whether the financial performance of SOEs leads to fiscal risks. The third step is to analyze whether the increase in fiscal risks arising from 20 SOEs is associated with SOE corporate governance weaknesses.

SOEs in Montenegro are concentrated in natural monopoly sectors such as Electricity, gas, steam, and air conditioning supply (43 percent of total central- government-owned SOEs assets), Transportation and storage (30 percent of total central-government-owned SOEs assets), Water supply; sewerage, waste management and remediation activities (7 percent of total central-government-owned SOEs); Agriculture, forestry, and fishery (8 percent); Accommodation and food services (around 6 percent of total central-government-owned SOEs).

[1] About 10% of total employment in Montenegro. This share is higher than in some EU member countries which are ex-socialist economies (like Latvia, Czech Republic, Lithuania, Croatia, Romania), but lower compared to Russia, Ukraine, and particularly Belarus where the SOE employment accounts for almost 1/3 of total employment.

Figure 1: Central Government SOEs Structure by SITC (% of total central-government-owned SOEs assets) as of 2020



Source: Tax Authority of Montenegro; author's calculations.

The main findings of this research are that fiscal risks stemming from SOEs are increasing and that SOE corporate governance weaknesses are one of the causes of that.

2. LITERATURE OVERVIEW

According to the IMF, fiscal risks are often compounded by institutional, governance, and financial weaknesses. The IMF finds that institutional and governance weaknesses causing fiscal risks are: (i) "SOEs used as a mechanism for circumventing traditional fiscal controls; (ii) Unclear or uncompensated public policy mandates can weaken performance; (iii) Poor internal governance can reduce returns and exacerbate risks; (iv) Financial reporting systems often fall short of best practice and undermine accountability."

Furthermore, IMF points out that "SOE-level risks are more likely to have a fiscal impact in SOEs that are:(i) *thinly capitalized*: equity serves as a cushion that enables companies to absorb shocks; (ii) *loss-making:* recurring losses erode the company's equity. Loss-making companies are not cash generative making them reliant on being able to raise debt; (iii) *low levels of liquidity*: companies may be unable to meet their obligations as they fall due"(IMF, 2021).

Some findings about SOE economic performance and oversight in Montenegro have been published in February 2022 by the IMF in Article 4 Staff Report. The IMF points out that public information on Montenegro's SOEs is limited and that their economic performance varies widely. Also points out that there is limited central oversight and review of the investment plans of SOEs and the financial performance of SOEs. The IMF finds the need to **manage fiscal risks from the sector, strengthen oversight, and improve governance arrangements for overseeing SOEs** in Montenegro.

Therefore, the purpose of this paper is to analyze whether SOE corporate governance arrangements, if weak, lead to an increasing trajectory of fiscal risks. Fiscal risks stemming from SOEs are defined as deviations of fiscal outcomes from those expected in the budget. According to the IMF methodology known as the “SOE Health Check Tool”, fiscal risks stemming from SOEs are assessed based on financial indicators of liquidity, profitability, solvency, and relations with the government.

3. METHODOLOGY OF RESEARCH

The purpose of the research is to assess possible fiscal risks arising from the largest central government-owned SOEs and to show whether increasing fiscal risks arising from SOEs' are associated with the SOEs weak corporate governance arrangements.

The first step of the research methodology was to check whether the corporate governance mechanisms in the analyzed 20 SOEs are good and aligned with the OECD Guidelines on Corporate Governance of State-Owned Enterprises (OECD, 2015). Therefore, the OECD Guidelines were used as a benchmark to explain gaps in corporate governance of the 20 largest SOEs in Montenegro according to seven principles of effective corporate governance: (i) rationale for state ownership; (ii) the state’s role as an owner; (iii) state-owned enterprises in the marketplace; (iv) equitable treatment of shareholders and investors; (v) stakeholders’ relations and responsible business; (vi) disclosure and transparency (vii) the responsibilities of the board of state-owned enterprises. Each SOE out of 20 selected was analyzed according to seven OECD criteria to assess the stance of corporate governance.

The second step in this research was the assessment of fiscal risks stemming from the 20 largest SOEs based on computing financial indicators on profitability, liquidity, solvency, and government transfers for each SOE in order to assign fiscal risks of SOE. Fiscal risks stemming from SOEs are basically all deviations of fiscal outcomes from what was expected or forecasted by using selected buckets of SOEs’ financial ratios.

The theoretical background, to assess the financial risks of SOEs and assign fiscal risks stemming from SOEs is based on the financial ratios following Hida (IMF, 2021), from the IMF’s “SOE Health Check Tool” as given in the table below. The table shows the threshold for the classification of financial risk ratios in five categories: from very low to very high risk, based on computed financial ratios.

Table 1. Threshold for classification of risk ratios

	Very Low Risk	Low Risk	Moderate Risk	High Risk	Very High Risk
Profitability					
Return on Assets	greater than	0.04	0.01	0	-0.05
Return on Equity	greater than	0.05	0.02	0	-0.1
Cost Recovery	greater than	1.5	1.25	1	0.75
Liquidity					
Current Ratio	greater than	2	1.5	1.25	1
Quick Ratio	greater than	1.2	1	0.8	0.7
Debtor Turnover Days	less than	30	40	50	75
Creditor Turnover Days	less than	30	60	90	120
Solvency					
Debt to Assets	less than	0.25	0.5	0.75	1
Debt to Equity	less than	0.5	1	1.5	2
Debt to EBITDA	less than	1.5	2	3	5
Interest Coverage	greater than	2	1.5	1.2	1
Cash Interest Coverage	greater than	3	2	1.5	1
Debt Coverage	greater than	0.8	0.6	0.4	0.25
Government Relations					
Government Transfers to Total Revenue	less than	0.3	0.4	0.5	0.6
Taxes payable to current liabilities	less than	0.2	0.3	0.4	0.5
Z score		Z > 2.6	2.6 > Z > 1.1	Z < 1.1	

Source: IMF, FAD

The following financial ratios from table 1 were used in the assessment of the financial position of individual SOEs as well as of the whole SOE portfolio in Montenegro:

• **Profitability** – *Return on Equity*. Measures the ability of the company to generate profit that covers the opportunity cost of capital.

• **Leverage** – *Debt to Assets Ratio and Debt to Equity Ratio*. The debt-to-assets ratio measures the proportion of a company's financing that comes from liabilities. *Debt to Equity Ratio* measures a company's financial leverage or the proportion of a company's financing that comes from liabilities relative to equity.

• **Liquidity** – *Current Ratio, which* measures a firm's ability to meet its current or short-term liabilities from short-term assets.

Selected financial indicators are used to assign fiscal risks arising from SOEs based on the threshold given in the table 2.

Table 2: Threshold for benchmarking financial performance to fiscal risks

	Low	Moderate	High	Very High
Selected Profitability Indicators				
Return on Equity	more than 10%	0% to 10%	0% to -10%	less than -10%
Selected Liquidity Indicators				
Current Ratio	more than 2	1.5 to 2	1 to 1.5	less than 1
Selected Solvency Indicators				
Debt to Assets	less than 1	1-1.25	1.25-2	more than 2

Source: IMF, FAD Fiscal Risk Program and SOE Health Check Tool

Each financial indicator was computed on the single SOE level, as well as on the level of the aggregated portfolio of 20 SOEs for each year over the period 2018-2021, and based on them, the the fiscal risk was assigned, based on the threshold, in four categories - from a very low to very high.

The next step was to analyze whether the fiscal risks arising from 20 SOEs are associated with SOE corporate governance.

4. RESULTS AND DISCUSSIONS

4.1 Corporate governance in the 20 largest SOEs in Montenegro

Results of this research were obtained by benchmarking the corporate governance practice in the 20 largest central government-owned SOEs, with OECD SOEs corporate governance guidelines.

The 20 largest central government-owned SOEs in Montenegro are presented in the table below:

Table 3: 20 largest SOEs in terms of their assets as of 2021

20 SOEs with the largest assets	Assets as of 2021 (EUR)
Elektroprivreda Crne Gore A.D. Nikšić	1,224,448,755
Željeznička infrastruktura Crne Gore A.D.	598,434,792
"13. Jul - Plantaže" A.D. Podgorica	465,404,373
Crnogorski elektrodistributivni sistem d.o.o.	414,154,476
Crnogorski elektroprenosni sistem A.D.	301,208,110
Aerodromi Crne Gore A.D.	159,498,566
Institut za fizikalnu medicinu, rehabilitaciju i reumatologiju "Dr Simo Milošević" A.D.	122,615,360
Hotelska grupa "Budvanska Rivijera" A.D. Budva	139,968,378
Rudnik uglja Pljevlja A.D.	105,242,561
Hotelsko turističko preduzeće "Ulcinjska Rivijera" A.D. Ulcinj	114,647,213
Regionalni Vodovod "Crnogorsko Primorje" d.o.o.	96,444,023
Luka Bar A.D.	68,324,143
Sveti Stefan Hoteli A.D.	61,864,573
Monte Put d.o.o.	51,055,668
Pošta Crne Gore A.D.	43,583,151
JP Radio-televizija Crne Gore	42,952,465
Crnogorska plovidba A.D. Kotor	38,528,836
Montenegro Bonus d.o.o.	38,367,924
Barska plovidba A.D. Bar	37,484,977
Željeznički prevoz A.D. Podgorica	33,394,172

Source: Financial Statements of SOEs'

According to the first two OECD criteria: "(i) *Rationale for State Ownership*" and (ii) "*State's role as an owner*" this research shows that there is no clear identification of the ownership function in Montenegro, centralized in a single entity, which is independent or under the authority of one minister. The ownership function for SOEs is very fragmented across more ministries, with no centralized single entity which makes the coordination and oversight function more challenging and costly. Therefore, the first two OECD criteria of corporate governance are not met in Montenegro.

Analysis of the implementation of the third criterion "*State-owned enterprises in the marketplace*" shows that there is no clear separation between the state's own function and other state functions that may influence the market conditions for 20 analyzed SOEs. While all 20 analyzed enterprises have mostly non-discriminatory and safeguarded public procurement procedures in accordance with the Public Procurement Law, the economic activities of at least 15 out of 20 analyzed SOEs have access to debt and equity finance under conditions that are not based on purely commercial grounds. At least 12 out of 20 analyzed SOEs benefit from the indirect financial support that confers an advantage over private competitors, such as preferential financing, tax arrears, etc. from the Government. Some SOEs like Elektroprivreda Crne Gore AD, Željeznička infrastruktura AD, Željeznički prevoz AD, Barska Plovidba AD, Crnogorska Plovidba AD, JP Radio-televizija Crne Gore, etc., benefit from state aid and other transfers from the government which creates an uneven business environment for all market players. Therefore, the third corporate governance criterion is not met. With regards to the fourth corporate governance criterion "*Equitable treatment of shareholders and investors*", 15 out of 20 analyzed SOEs are joint- stock companies. Most of them are listed companies and all shareholders must be treated equitably pursuant to the Company Law that is fully harmonized with the EU acquis. However, the degree of transparency is not high, including a challenge of equal and simultaneous disclosure of information to all shareholders. About 19 out of 20 analyzed companies have a website, but they do not regularly publish their financial statements and annual reports. Therefore, this criterion is partially met.

As far as the fifth criterion "*Stakeholder relations and responsible business*" is concerned, it is partially met in the observed 20 SOEs. Almost all analyzed SOEs do not fully recognize responsibilities towards stakeholders and do not always report on their relations with stakeholders. There is limited implementation, monitoring, and communication of internal controls, ethics, and compliance programmes or measures, including those which contribute to preventing fraud and corruption. All 20 SOEs are under the strong pressure of political parties as their board and management are members of political parties appointed on that criterion. Political economy in this regard is particularly reflected in the increasing number of employees in the light of elections.

The OECD's sixth criterion "*Disclosure and Transparency"* is partially met. With regard to disclosure and transparency, as one of OECD principles, SOEs should report material financial and non-financial information on the enterprise in line with high-quality internationally recognized standards of corporate disclosure. In Montenegro, SOEs submit their annual financial statements with external audit reports, pursuant to the Law on Accounting and Audit to the Tax Authority. In addition, the joint-stock companies are obliged to submit both financial statements and audit reports to the Securities Commission of Montenegro (SEC). Specific state control procedures by the State Audit Institution are also performed. On the other hand, all 20 analyzed SOEs fall short in the following internationally recognized standards of corporate disclosure: (a) Board member qualifications, selection process, including board diversity policies, roles on other company boards, and whether they are considered as independent by the SOE board; (b) any material foreseeable risk factors and measures taken to manage such risks. Most of the analyzed SOEs receiving any financial assistance, like subsidies and guarantees from the state usually do not disclose that. As far as the seventh criterion "*The responsibilities of the boards of state-owned* *enterprises*" is concerned, it is not met in at least 18 out of 20 analyzed SOEs. Although the role of SOE boards is clearly defined in the Company Law, they are not always fully accountable to the owners due to the strong impact of the political economy, and lack of integrity and competencies. In at least 10, out of 20 analyzed SOEs, boards do not effectively carry out their functions of setting strategy and supervising management, although they should have the power to appoint and remove the CEO. In all 20 analyzed SOEs, all board members are not nominated based on qualifications. Political interference in the board's operations is very high and undermines the board's independence as a board member is proposed by political parties in all 20 companies to be appointed by the government without any criteria on their competencies. There are no fully implemented mechanisms to avoid conflicts of interest preventing board members from objectively carrying out their board duties and limiting political interference in board processes.

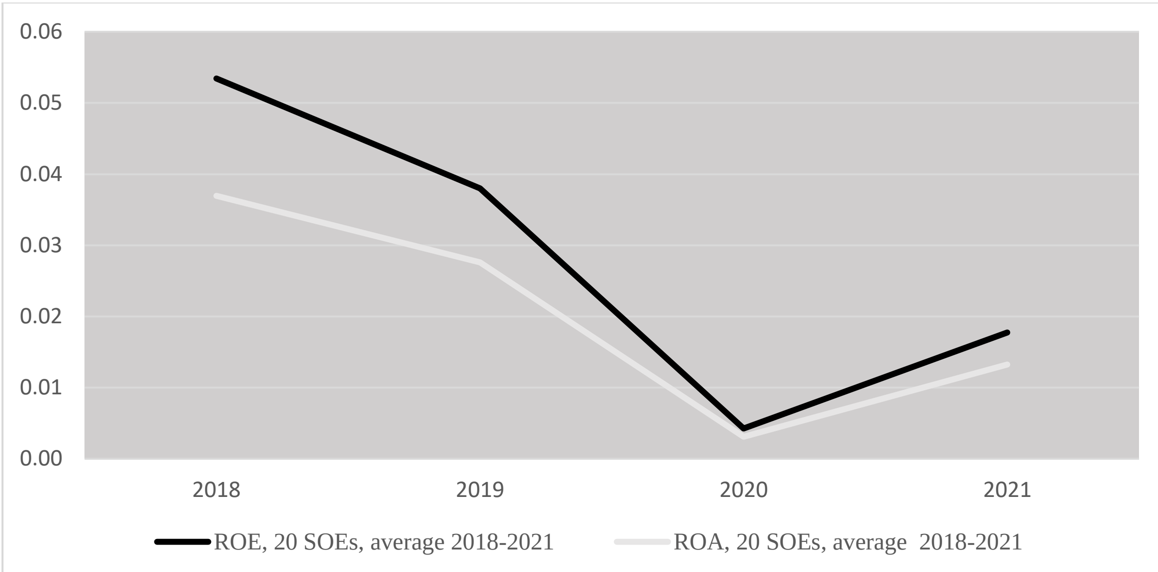
According to all seven above-mentioned OECD criteria on *corporate rules,* SOEs corporate governance criteria in Montenegro are partially met showing severe weaknesses in some aspects of corporate mechanisms. SOEs with the largest challenges in terms of implementation of the OECD corporate governance criteria Barska plovidba A.D. Bar, Crnogorska Plovidba AD, Željeznička infrastruktura AD, Rudnik Uglja AD, Institut "Dr Simo Milošević" A.D. Crnogorski elektrodistributivni sistem d.o.o.

4.2 SOE financial performance on the level of 20 largest central government-owned SOEs

Weakness in corporate governance of 20 analyzed SOEs (shown in table 3) can impose substantial economic and fiscal costs revealed in loss-making, low levels of liquidity, and consequently growing indebtedness. Therefore, financial indicators of the SOEs have been calculated for the period 2018-2021 to assess the financial performance of those central government-owned SOEs in Montenegro and to assess the fiscal risks arising from their portfolio.

The profitability risks of the 20 analyzed SOEs, measured by ROE and ROA have an increasing trajectory, looking at the level of the 20 largest SOEs. Even though it improved in 2021 compared to 2020, profitability is still below its pre-Covid 19 level (see figure 1). This is the consequence of loss-making in large companies, like "13. Jul - Plantaže" A.D. Podgorica, Barska plovidba AD, Crnogorska Plovidba AD, Institut "Dr Simo Milosevic" A.D., Crnogorski elektrodistributivni sistem d.o.o.

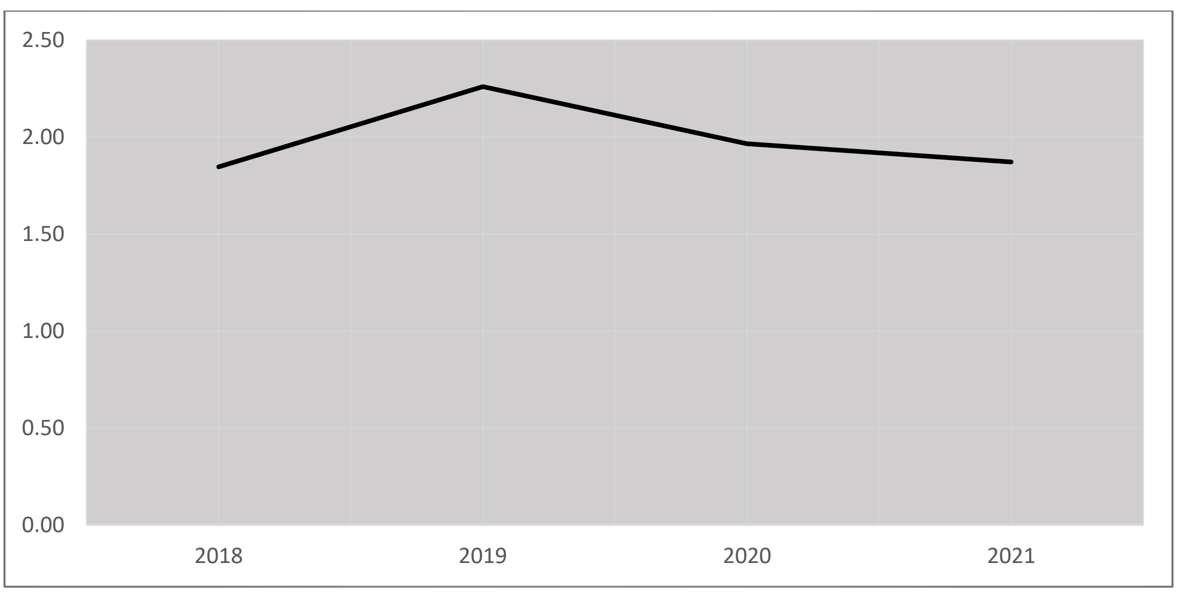
Figure 1: Profitability trends, 20 largest SOEs in Montenegro, 2018-2021



Source: Tax Authority of Montenegro; Author's calculations of ROE and ROA on the level of 20 SOEs portfolio

Liquidity risks are growing as liquidity has been decreasing (see figure 2). The current ratio has been decreasing since 2019 or in the post-pandemic period. The SOE sector continues to face liquidity challenges despite the significant number of transfers in the observed period, with increased risks of outstanding obligations that adversely affect the state budget.

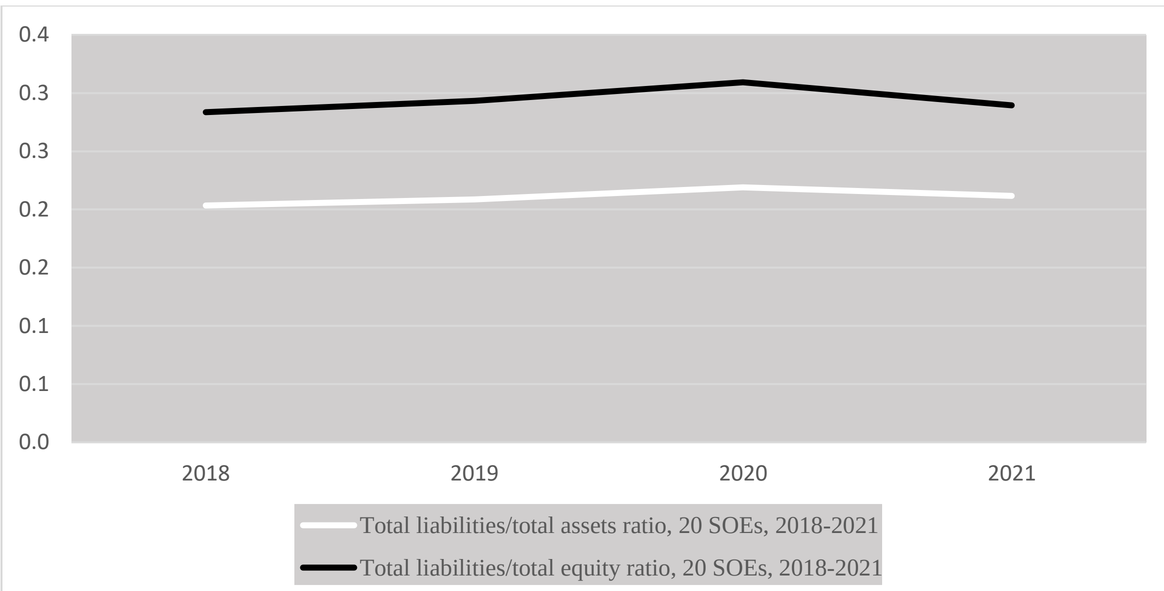
Figure 2: *Liquidity trends, current ratio, 20 largest SOEs in Montenegro, 2018-2021*



Source: Tax Authority of Montenegro; Author's calculations on the level of 20 SOEs portfolio

Total liabilities at the level of 20 SOEs increased in the observed period, especially in 2020, due to the Covid-19 pandemic. In 2021, they are higher by about 14 percent compared to 2019, which preceded the pandemic caused by Covid-19. Liabilities increased from 18 percent of GDP in 2019 to around 22% of GDP in 2020 (due to a drop in GDP in that year as the pandemic outbreak consequence). Looking at the whole portfolio of 20 SOEs, their solvency was improved in 2021 compared to 2020. However, **solvency risks increased** compared to the pre-pandemic period (see figure 2). Solvency has been measured by two ratios: total liabilities over total assets and total liabilities over total equity.

Figure 2: Solvency trends, 20 largest SOEs in Montenegro, 2018-2021



Source: Tax Authority; author's calculations on the level of 20 SOEs portfolio

The main finding of this analysis of financial indicators for the above-mentioned 20 largest SOEs, over the period 2018-2020, is that the **overall fiscal risks of the SOE sector moved from low before the Covid-19 pandemic to moderate in 2021.** This is partially associated with identified SOE corporate governance weaknesses.

Looking by sector, the analysis of the 20 largest SOEs showed that the sector "Electricity, gas and steam" as the largest sector, records the lowest fiscal risks. The good financial performance of Elektroprivreda Crne Gore A.D. in 2021, contributed to low fiscal risks, both before the pandemic and after, because Elektroprivreda has the largest share in the assets of the SOE sector. On the other hand, the worse performance indicators of CEDIS d.o.o., especially in 2021, had an unfavorable contribution to the overall results of this sector. In general, the favorable indicators and low fiscal risks in the "Electricity, gas, and steam" sector have been significantly contributed by multi-year reforms due to the EU accession negotiations and membership in the Energy Community. This led to improvement of corporate governance, but it still faces weakness, especially in a few companies like Rudnik uglja Pljevlja AD (the Coal Mine Pljevlja JC), Crnogorski elektroistributivni sistem d.o.o. (Energy Distribution System of Montenegro d.o.o), whose financial indicators deteriorated at the same time.

Very high fiscal risks are stemming from the SOEs which operate in "Transport and storage" the second largest sector in Montenegro in which SOEs operate. At the same time, corporate governance in the sector faces many weaknesses, revealed by the strong interference of the state on their competitive position in the marketplace, disclosure and transparency procedures, board member qualifications, selection process, including board diversity policies, and political economy in their operations. Fiscal risks are reflected in very high risks of profitability, leverage, and liquidity, in addition to the fact that the largest part of the government's transfers is aimed at this sector. The situation in the transport sector, in terms of fiscal risks, due to the specificity of the industry, is similar to certain surrounding countries. One of the analyzed 8 SOEs, liquidity indicators in 2021 have improved in "AD Aerodromi Crne Gore" compared to the crisis year 2020, bearing in mind the re-establishment of traffic lines after the lockdown in 2020. On the other hand, SOE "Barska Plovidba AD", "Crnogorska plovidba AD Kotor", "Zeljeznička infrastruktura AD" and "Zeljeznički prevoz AD" faced high liquidity, profitability, and solvency risks in 2021, as in previous years. "Pošta Crne Gore AD" recorded slightly less favorable solvency indicators in 2021 due to an increase in total liabilities, while liquidity and profitability indicators remained at approximately the same level as before the pandemic. The indicators for "Luka Bar AD" were approximately at the pre-pandemic level. Slightly less favorable indicators of solvency and profitability in 2021 were recorded in Monteput d.o.o. compared to the previous two years.

The third largest sector in which SOEs operate in Montenegro is "Agriculture, Forestry, and Fishery". This sector faces increasing profitability risks.

In the sector "Accommodation and food services", liquidity has improved in the post-pandemic period, but profitability is still a challenge. Even before the pandemic, the sector had very low profitability, but since the beginning of the pandemic, it has been operating with a negative result.

5. CONCLUSION

Corporate governance practices in the 20 largest central government-owned SOEs in Montenegro are not aligned with international best practices and OECD Guidelines on Corporate Governance of State-Owned Enterprises (OECD, 2015). Lack of accountability and implementation of best international practices, especially regarding the ownership policy, completion and state aid rules, transparency, and disclosure procedure, and the selection and responsibilities of the boards of directors are the biggest challenges for SOEs in Montenegro at the root of arising fiscal risks. Weak corporate governance mechanisms, especially in a few large sectors like "Transportation and Storage", and partially "Electricity, gas, and steam" is accompanied by increasing fiscal risks.

Results of this research show that fiscal risks stemming from central government-owned SOEs increased from low in 2018 to moderate in 2021, so the overall fiscal risk trajectory is increasing. It is very likely that increasing fiscal risks arising from 20 SOEs, is associated with identified SOE corporate governance weaknesses.

In order to enhance SOEs corporate governance and reduce fiscal risks, Montenegro should modify its legal framework to implement the OECD governance practices and strengthen the coordination and SOE oversight function. SOEs in Montenegro, should align their corporate governance with international best practices which will include transparency in the disclosure process; developing criteria for the appointment of a board of directors in line with OECD guidelines. The SOEs oversight function should be strengthened, through the stronger role of the Ministry of Finance in overseeing the SOEs' performance. The fiscal risk function to reduce fiscal risks stemming from SOEs should be strengthened.

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